MORNING BRIEFING
June 15, 2022

It's Fed Day!

Check out the accompanying chart collection.

Executive Summary: Now that May's CPI report has dashed hopes that inflation has peaked, it's clear to investors that tethering inflation will take more aggressive tightening by the Fed. Today we will find out if the FOMC has decided to put more muscle into the fight. Will Powell show the same conviction to stay the course as his predecessor Volcker did decades ago? This may be Jerome Powell's Volcker Moment. … Also: We look at what various Fed officials have said recently about the battle against inflation. … And: Tuesday's inflation numbers mostly showed that inflation isn't getting worse, but it isn't getting better either.

Yellowstone: Timing Is Everything. "*Après moi, le deluge!*" means "After me, the deluge!"—with "deluge" referring to a flood of troubles. The declaration is often attributed to French King Louis XV. Of course, he was remarkably prescient: He was succeeded by Louis XVI, who was beheaded during the French Revolution.

Today, we can attribute the declaration to Fed Chair Jerome Powell, who flooded the financial system with liquidity in response to the pandemic. Both presidents Donald Trump and Joe Biden also flooded the economy with helicopter money in response to the pandemic. Now we are all paying the price for their royal excesses with a deluge of rapidly rising prices.

You can also attribute the declaration to me. One week after my wife and I visited Yellowstone National Park, all entrances to the park were temporarily closed due to what the National Park Service deemed "extremely hazardous conditions," including heavy flooding and rockslides. There has been no inbound visitor traffic at any of the park's five entrances through at least today. *Après moi, le deluge!*

The Fed I: Heads Up! It's Fed Day! Following the release of May's CPI shocker on Friday, Melissa and I concluded that the FOMC is more likely to raise the federal funds rate by 75bps than by 50bps today. Our expectation was confirmed on Monday by a *WSJ* article by Nick Timiraos titled "Fed Likely to Consider 0.75-Percentage-Point Rate Rise This Week." Nick is the *Journal's* ace Fed watcher. In the past, Fed chairs have often provided the markets with a heads-up by leaking their latest views to the *WSJ*. The article starts as follows:

"A string of troubling inflation reports in recent days is likely to lead Federal Reserve officials to consider surprising markets with a larger-than-expected 0.75-percentage-point interest-rate increase at their meeting this week. Before officials began their premeeting quiet period on June 4, they had signaled they were prepared to raise interest rates by a half percentage point this week and again at their meeting in July. But they also had said their outlook depended on the economy evolving as they expected. Last week's inflation report from the Labor Department showed a bigger jump in prices in May than officials had anticipated."

In other words, don't be surprised if the Fed hikes by 75bps today instead of 50bps. We have been forewarned. The FOMC last raised the federal funds rate by 75bps at a meeting in 1994, when the Fed was rapidly raising rates to pre-empt a potential rise in inflation. It was one of the few times when monetary policy tightening did not lead to a recession (*Fig. 1* and *Fig. 2*).

The two-year US Treasury note yield rocketed to 3.40% on Monday (*Fig. 3*). The 12-month forward federal funds rate futures jumped to 3.96% on Monday as well (*Fig. 4*).

The Fed II: No Longer Woke for Now. In Monday's *Morning Briefing*, Melissa and I wrote: "Perhaps the most important similarity between the 1970s and recent events is the lame response of the Fed to the wage-price-rent spiral. The Fed was well behind the inflation curve during most of the 1970s and is now once again. In many ways, the Fed exacerbated the current spiral. Most importantly, under Fed Chair Jerome Powell's leadership, the Fed turned woke and prioritized 'inclusive' maximum employment over its stated 2.0% inflation target in its August 2020 statement on its long-run goals and strategy. Also in that statement, the Fed embraced flexible average inflation targeting, indicating that it now would tolerate inflation overshoots to compensate for prior inflation shortfalls.

"By maintaining ultra-easy monetary policies through the start of this year, the Fed succeeded in lowering the unemployment rate to a recent low of 3.6% over the past three months through May. In addition, the ratio of job openings to unemployed workers rose to a record 2.0 during March. The result has been a significant increase in wage inflation, which has spiraled into price inflation, thus eroding the purchasing power of all workers. That has been the unintended consequence of the Fed's wokeness!"

The rebound in inflation has forced Fed officials to turn less woke and to refocus on bringing inflation down. At his post-meeting press conference today, Powell is likely to be more hawkish than usual and indicate that similarly sized hikes following the FOMC's next two meetings, in July and September, could take the range up to 2.25%-2.50% next month and then to 3.00%-3.25% in September, in line with the predictions of both the two-year Treasury bond yield and the 12-month futures rate.

By the way, on April 21, in pre-recorded remarks at a special briefing of the Volcker Alliance and Penn Institute for Urban Research, Powell called former Fed boss Paul Volcker, who battled high inflation in the 1970s and 1980s, "the greatest economic public servant" of the era. Volcker raised interest rates to a record 20% in the 1980s in response to the nation's double-digit inflation. Volcker had known that to save the economy, he needed to stay that controversial course and couldn't be swayed by political opinion. No one ever accused Volker of being woke or anything like that. Powell's Volcker Moment may have arrived.

The Fed III: Talking Heads. About a month ago, Fed Chair Powell *said* at a May 17 *WSJ* web event: "What we need to see is clear and convincing evidence that inflation pressures are abating and inflation is coming down—and if we don't see that, then we'll have to consider moving more aggressively. If we do see that, then we can consider moving to a slower pace." Powell and his colleagues had hoped that supply-chain problems would abate to help lower inflation over time.

But investors' hopes for an imminent sign of the clear inflation peak Powell is awaiting were dashed on Friday with the release of May's CPI report. Now, the prevailing view is that global commodity supply shock associated with Russia's war on Ukraine is expected to worsen supply-chain bottlenecks and further raise price inflation for food and energy. China's Covid lockdowns are also exacerbating supply-chain problems.

So far this year, the FOMC has raised the target range for the federal funds rate by 75pbs. Forward guidance in the May FOMC statement said the Committee "anticipates that ongoing increases in the target range will be appropriate." The Fed clearly needs to be more aggressive to bring US aggregate demand more in balance with available supplies.

After the May meeting, Powell suggested that at least two 50bps hikes are coming and repeated that message to the *WSJ* on May 17. But more aggressive hikes over the near term now are likely given the persistence of inflation with May's CPI report. Additionally, by September the Fed anticipates about $95 billion of securities rolling off the balance sheet every month. That would reduce the Fed's assets by about $1 trillion over the next year, which various Fed officials have suggested would have a tightening effect equivalent to two or three more rate hikes of 25bps each.

Let's review some of the key views expressed by various Fed officials prior to the blackout period that preceded the June 14-15 FOMC meeting:

(1) *Measured hikes.* Before the March FOMC meeting, St. Louis FRB President James Bullard was the first to come out and say that the FOMC could raise the policy rate 50bps. Others, including San Francisco FRB President Mary Daly and Cleveland FRB President Loretta Mester, had said they would prefer not to be quite that aggressive, recounted former Fed advisor Ellen Meade during an *interview* with Bloomberg.

During a May 30 *speech* in Germany, Fed Governor Christopher Waller said he supports tightening policy by another 50bps for the next several meetings. By the end of this year, Waller wants to raise rates above "neutral" to lower demand for products and labor and bring it in line with supply. At the time, he noted that financial markets expect 50bps hikes at each of the FOMC's next two meetings and a 2.65% federal funds rate at year-end, implying 2.5 percentage points of tightening this year. But that was prior to the release of May's CPI numbers. Waller said that his plan is in line with markets' expectations but is "prepared to do more" if "the data suggest that inflation is stubbornly high."

During a June 2 CNBC *appearance*, Fed Governor Lael Brainard said: "We've still got a lot of work to do to get inflation down to our 2% target." She said it was reasonable to expect two 50bps rate hikes at the next two meetings. Brainard emphasized that she did not see the case for pausing the rate hiking after that, but said it was too early to make that call.

The possibility of pausing hikes after two more of 50bps each this summer has been floated by a couple of Fed officials, including Atlanta Fed President Raphael Bostic and San Francisco FRB President Mary Daly. Daly *said* on CNBC on June 1 that she backs raising interest rates by 50bps for the next couple of meetings, followed by taking "a look around" to see "what else is going on."

(2) *Soft landing.* Waller attempted to explain how the Fed might achieve a "soft landing" for the economy and subdue inflation without harming the labor market in his May 30 speech. In his view, layoffs wouldn't increase as labor demand cools during an economic slowdown because job vacancies currently are high. He would expect to see fewer job openings, but not higher unemployment. Brainard similarly told CNBC that tightening shouldn't harm an economy in which household and corporate balance sheets are as strong as they are now.

(3) *Employment priority.* At least, Fed officials are no longer delusional in their thinking that employment should be prioritized over inflation, as they had outlined in their August 2020

revised *Statement on Longer-Run Goals and Monetary Policy Strategy*. Fed officials supposed at that time that if they allowed inflation to rise as the labor market ran hotter, then labor market participation would continue to pick up as opportunities improved for marginalized Americans but inflation would not get out of hand.

Brainard, a chief proponent of prioritizing the employment mandate, clearly has changed her thinking in recent months. She said in an April *speech*: “All Americans are confronting higher prices, particularly for food and gasoline, but the burden is particularly great for households with more limited resources.” Now, she says: “getting inflation down is our most important task.” Waller agreed in his May 30 speech that “the Fed’s top priority” is “inflation” even though the labor market participation has not fully recovered from the pandemic.

(4) *Not behind.* In an earlier, May 6 *speech* in California, Waller had defended the Fed’s perceived inaction during 2021—saying that even though the Fed did not change the federal funds rate last year, it did in its September statement provide forward guidance on tapering Fed assets as a precursor to this year’s rate hikes. But during his May 30 speech in Germany, Waller acknowledged that inflation has remained “alarmingly high.” Core inflation is “not coming down enough to meet the Fed’s target anytime soon,” he said, adding “we are not meeting the FOMC’s price stability mandate.”

Inflation: More of It. Tuesday’s inflation numbers mostly showed that inflation isn’t getting worse, but it isn’t getting better either. Fed officials have rightly observed that their forward guidance has tightened credit conditions. However, they haven’t done enough yet to actually bring inflation down. Consider the following:

(1) *PPI.* The PPI for final demand actually edged down during May to 10.8% y/y from 10.9% during April and 11.5% during March, its most recent high (*Fig. 5*). The inflation rates of the PPI for final demand of goods rose to a new high of 16.6%, while services edged down to 7.6% from its recent high of 9.2% during March.

Much of the improvement in services occurred in the PPI for trade services, which measures markups of wholesalers and retailers (*Fig. 6*). It fell from 18.2% in March to 13.6% in May. Most disconcerting is that the inflation rate of PPI for transportation & warehouse services moved still higher to 23.9%.

The inflation rate of the PPI for personal consumption excluding food and energy is down from 8.0% in March to 6.5% in May (*Fig. 7*). That seems to confirm that the core PCED inflation rate may be peaking, as we’ve been expecting. However, the PPI for final demand energy and food remain very high at 45.3% y/y and 13.0% y/y (*Fig. 8*).

(2) *Inflation expectations.* On Friday, the consumer sentiment survey, conducted by the University of Michigan, found that respondents said they expect inflation to rise 5.4% over the next year, up from 5.3% a month earlier. They expect prices to advance 3.3% over the next five to 10 years, the most since 2008 and up from 3.0% in May.

May's survey of consumers' inflation expectations, conducted by the Federal Reserve Bank of New York, shows one-year ahead and three-year ahead readings of 6.6% and 3.9% (*Fig. 9*). The former is much higher than its 4.0% rate a year ago, while the latter is up from last May's 3.6%.

(3) *Small business survey.* There's no relief in sight for inflation in May's survey of small business owners, conducted by the National Federation of Independent Business. It found that 72% of them are raising their selling prices currently, while 47% are planning to do so over the next three months (*Fig. 10*). The former is back up at its record high, while the latter isn't far from November's record 54%.

On the other hand, the percentage of small business owners planning to raise worker compensation in the next three months was down to 25% from a record high of 32% during each of the final three months of 2021 (*Fig. 11*). This series is well correlated with the Employment Cost Index on a y/y basis. Nevertheless, during May, a record high 51% of small business owners said that they have job openings (*Fig. 12*).

Calendars

US: Wed: Retail Sales Headline, Core, and Control 0.2%/0.8%/0.5%; Empire State Manufacturing Index 3.0; Import & Export Prices 1.1%/1.3%; Business Inventories 1.2%; NAHB Housing Market Index 68; MBA Mortgage Applications; Crude Oil Inventories -1.92m; Gasoline Production; IEA Monthly Report; Fed Interest Rate Decision 1.50%; FOMC Projections; FOMC Press Conference. **Thurs:** Housing Starts & Building Permits 1.701mu/1.785mu; Initial & Continuous Jobless Claims 215k/1.302m; Philadelphia Fed Manufacturing Index 5.5; Natural Gas Storage (Bloomberg estimates)

Global: Wed: Eurozone Industrial Production 0.5%m/m/-1.1%y/y; Eurozone Trade Balance; Germany WPI; Canada Housing Starts 252.6k; Japan Exports & Imports 16.4%/43.6% y/y;

Australia Unemployment & Participation Rates 3.8%/66.4%; Australia Employment Change 25k; RBA Bulletin; Lagarde; Panetta; Nagel. **Thurs:** European Car Sales; Italy CPI 0.9%m/m/6.9%y/y; BOE Interest Rate Decision 1.25%; BOJ Interest Rate Decision -0.10%; Eurogroup Meetings; Panetta; DeGuindos; Wuermeling. (Bloomberg estimates)

Strategy Indicators

S&P 500 Growth vs Value (*link*): The S&P 500 Growth price index has tumbled 29.6% ytd through Monday's close, well behind the 12.1% decline for the S&P 500 Value index. Growth is now in a deep bear market, with a 30.5% decline from its December 27 record high. Value is down just 13.4% from its January 12 record. Growth's price index relative to Value's peaked at a record high on November 30. Since then, Value's price index has dropped 6.1% while Growth's has tumbled 27.9%. Since the Pure Growth price index peaked relative to Pure Value on November 18, Pure Growth has plummeted 33.6% into a deep bear market while Pure Value has easily avoided a correction with its drop of 4.8%. Looking at the fundamentals, Growth is expected to deliver higher revenue growth (STRG) than Value over the next 12 months, but Value is expected to have higher earnings growth (STEG). Growth has forecasted STRG of 9.5%, but its STEG is lower at 8.3%. Value has forecasted STRG and STEG of 6.8% and 10.9%, respectively. Growth's forward P/E peaked at a 20-year high of 30.4 on January 26, 2021, and has since tumbled 38% to a 25-month low of 18.7. Value's forward P/E is down 21% since then to 13.9 from 17.6. Regarding NERI, Growth's dropped to a 22-month low of 3.7% in May from 6.6% in April, but was positive for a 22nd straight month. Value's NERI was also positive for a 22nd month, but rose to 1.5% from a 21-month low of 0.3% in May. Growth's forward profit margin of 18.9% is down 0.2ppts from its record high of 19.1% in mid-February and compares to its prior pre-Covid record high of 16.7% during September 2018. Value's 11.2% has dropped 0.2ppt from its record high of 11.4% in December.

US Economic Indicators

NFIB Small Business Optimism Index (*link*): "Inflation continues to outpace compensation which has reduced real incomes across the nation," noted Bill Dunkelberg, NFIB's chief economist. "Small-business owners remain very pessimistic about the second half of the year as supply-chain disruptions, inflation and the labor shortage are not easing." May's

Small Business Optimism Index (SBOI) ticked down to 93.1 in May—the fifth consecutive month below the 48-year average of 98.0—after holding steady at 93.2 in April. It had dropped 5.7 points the first three months of this year, from December's 98.9. In May, five components contributed positively to the SBOI, four negatively, while plans to increase inventories was unchanged at 1%. Plans to increase employment (+6ppts to 26%) posted the biggest positive contribution to the SBOI, followed by current job openings (+4 to 51), now a good time to expand (+2 to 6), current inventory (+2 to 8), and expected credit conditions (+1 to -4). Meanwhile, earnings trends (-7 to -24) was the biggest drag on the SBOI, followed by expect the economy to improve (-4 to -54), sales expectations (-3 to -15), and plans to make capital outlays (-2 to 25). In May, 28% of owners still reported inflation as their single most important problem, down 4ppts from April's 32%, while concerns about the cost of labor jumped 4ppts from 8% to 12%. Meanwhile, the net percent of owners raising their average selling prices (+2ppts to 72%) was back up at March's record high—up 32ppts from a year ago.

Producer Price Index (*link*): The final demand PPI rose 0.8% in May, in line with expectations; the result was double April's 0.4% but half March's 1.6%, with the yearly rate easing for the second month, from March's 11.5% record high to 10.8% in May. Core prices—which excludes food, energy, and trade services—rose 0.5%, half March's 1.0%, with the yearly rate looking toppy at 6.8%. It shot up from -0.2% y/y in April 2020 to 7.0% in November 2021, and has been bouncing around that rate ever since. The yearly rate for final demand goods continues to accelerate, reaching 16.6% y/y in May, yet another record high—with 70% of May's 1.4% m/m rise energy related—while the yearly rate for final demand services slowed from March's record-high 9.2% to 7.6% in May. The PPI for personal consumption jumped 0.6% in May after no change in April; it averaged monthly gains of 1.1% the first three months of the year. The yearly rate ticked up from 9.4% to 9.5% in May, holding below March's record-high 10.4%. Looking at pipeline prices, pressures remain elevated, though have eased from recent highs. The yearly rate for intermediate goods prices slowed for the fourth time in five months to a 13-month low of 21.4%, down from November's 26.5% y/y, which was its highest rate since the mid-1970s. Meanwhile, the yearly rate for crude goods prices eased a bit to 48.9% y/y in May after accelerating from 34.0% in February to 51.1% in April. The rate was at 59.0% last April, within a tick of its 59.1% record high in April 1973.

Contact us by *email* or call 480-664-1333.

Ed Yardeni, President & Chief Investment Strategist, 516-972-7683
Debbie Johnson, Chief Economist, 480-664-1333
Joe Abbott, Chief Quantitative Strategist, 732-497-5306

Melissa Tagg, Director of Research Projects & Operations, 516-782-9967
Mali Quintana, Senior Economist, 480-664-1333
Jackie Doherty, Contributing Editor, 917-328-6848
Valerie de la Rue, Director of Institutional Sales, 516-277-2432
Mary Fanslau, Manager of Client Services, 480-664-1333
Sandy Cohan, Senior Editor, 570-228-9102