MORNING BRIEFING
June 12, 2023

Inflation & The Fed

Check out the accompanying chart collection.

Executive Summary: Investors are on the edge of their seats: Will the FOMC raise the federal funds rate (FFR) when it meets this week or pass this time? Key will be how fast inflation is falling, and the Consumer Price Index for May will be released as they deliberate. We say monetary policy is restrictive enough already, as the higher *effective* FFR implies a tighter environment than the straight FFR suggests. … Also: We recap what consumer inflation measures have been doing for goods and for services since peaking last year. The latter has proven more stubbornly persistent than the former. … And: Dr. Ed reviews "BlackBerry" (+ + +).

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Inflation I: The CPI Is Coming! Have you heard? On Tuesday, May's CPI will be released by the Bureau of Labor Statistics, and it could move the financial markets one way or another.

The same day, the FOMC starts a two-day meeting. The Fed's research staff will scramble to analyze the latest inflation data, and the monetary policy committee's participants will have to decide whether they should skip another rate hike or move ahead with yet another one. They have increased the federal funds rate (FFR) at each of the 10 FOMC meetings since March 2022 by a total of 500bps to 5.00%-5.25% in May 2023 (*Fig. 1*). The FFR futures suggest that the FOMC will hike by 25bps at either the June or the July meeting of the committee (*Fig. 2*).

May's CPI obviously will affect their decision. For perspective, April's CPI was up 4.9% y/y; we've long been projecting moderation to 3.0%-4.0% this year. Our bet is that May's CPI release will sway the committee to skip a hike at the upcoming meeting. In fact, we think they should be done through the end of this year. In our opinion, the FFR is sufficiently restrictive to keep a lid on economic growth and to slow inflation.

The June FOMC meeting will provide the latest quarterly Summary of Economic Projections

(SEP). In the December and March SEPs, FOMC participants projected that the FFR would get to 5.1% this year, suggesting that 5.1% might be the terminal rate. In recent months, many of them said that they expect to maintain the restrictive terminal rate for a while. In the March SEP, they also projected that the FFR would fall to 4.1% in 2024 and 3.1% in 2025. (See our *FOMC Summary of Economic Projections*.)

If they skip a rate hike at this week's meeting, they might signal their willingness to continue hiking again at the July meeting by raising their FFR projections in June's SEP. That of course will depend on whether May's CPI and subsequent inflation readings moderate in line with their projections. In the March SEP, the median headline PCED was projected to fall to 3.3% this year, 2.5% next year, and 2.1% in 2025. It was 4.4% in April.

In March, the FOMC participants deemed this pace of moderation possible without causing a recession, as evidenced by their projected real GDP growth rates at 0.4% this year, 1.2% next year, and 1.9% in 2025. The *minutes* of the May meeting, which did not include a SEP, suggested that the FOMC participants as a group were in the soft-landing camp even though the Fed's staff projected a mild recession:

"The economic forecast prepared by the staff for the May FOMC meeting continued to assume that the effects of the expected further tightening in bank credit conditions, amid already tight financial conditions, would lead to a mild recession starting later this year, followed by a moderately paced recovery. Real GDP was projected to decelerate over the next two quarters before declining modestly in both the fourth quarter of this year and the first quarter of next year."

In other words, the staff acknowledged that the effective FFR is higher than 5.00%-5.25% because of the "further tightening in bank credit conditions." The staff should have mentioned that quantitative tightening also is raising the effective FFR.

In fact, the Federal Reserve Bank of San Francisco provides a monthly estimate of the *effective FFR* on their website. Four staff economists at the San Francisco Fed published an *article* titled "Monetary Policy Stance Is Tighter than Federal Funds Rate" in the November 7, 2022 issue of the *FRBSF Economic Letter*. Their model calculates an effective federal funds rate (EFFR) using a set of 12 financial variables, including Treasury rates, mortgage rates, and borrowing spreads, to assess the broader stance of monetary policy. Here is their conclusion:

"The FOMC's use of forward guidance provides more information about future policy than what is reflected in the federal funds rate alone. Similarly, the use of the balance sheet has a monetary policy impact that is not captured in the federal funds rate. A proxy funds rate based on financial conditions measures the broader stance of policy and suggests that these combined policy tools have a more complex effect on the economy than the federal funds rate indicates. The stance of monetary policy in September 2022 was conducted as if the policy rate was above 5¼%, as opposed to the actual rate of 3-3¼%. As the FOMC increasingly used forward guidance and the balance sheet, the proxy rate has tended to lead the actual funds rate, reflecting the fact that financial markets are forward looking."

The monthly EFFR was almost identical to the actual FRR prior to December 2008, when the rate first fell to zero (*Fig. 3*). From 2009 to 2015—a period that included QE1, QE2, and QE3—the EFFR was negative most of the time (*Fig. 4* and *Fig. 5*). The EFFR has consistently exceeded the FFR since October 2021.

What about now? As of May, the EFFR was 6.01%, well above the FFR's reading of 5.06%.

Inflation II: Transitory & Persistent. Inflation has turned out to be both transitory, for consumer goods, and persistent, for consumer services. Nevertheless, it has been moderating and should continue to do so. Over a year ago, in the April 19, 2022 *Morning Briefing*, Debbie and I wrote:

"History shows that the inflation genie is hard to stuff back in the bottle without a recession first slimming the scoundrel down. Fed officials hope to achieve a Goldilocks soft landing by raising interest rates to cool off the demand side of the economy just enough so that the supply side of the economy isn't forced to cut back production and employment. They must also be counting on some improvements in the supply-chain problem. We think they might succeed. In our scenario, the PCED headline inflation rate peaks during H1-2022 between 6.0%-7.0%. Led by consumer durable goods prices, it moderates to 4.0%-5.0% during H2-2022. Next year, it falls to 3.0%-4.0% as persistently rising rent inflation offsets moderation in other consumer prices."

Let's review the latest developments on the inflation front:

(1) *Headline and core inflation rates.* The headline PCED inflation rate peaked at 7.0% y/y in June 2022 (*Fig. 6*). It was down to 4.4% during April. The core PCED inflation rate peaked last year at 5.4% in February. It was down to 4.7% in April. The headline and core CPI inflation rates peaked last year at 9.1% and 6.6% in June and September, respectively, falling to 4.9% and 5.5% by April.

(2) *Transitory inflation.* CPI goods inflation has turned out to be quite transitory after all, having peaked at 14.2% last March before dropping to 2.1% in April (*Fig. 7*). The CPI for consumer durables plunged from last year's high of 18.7% to -0.2% in April (*Fig. 8*). The CPI for nondurable goods (including food and energy) is down from 16.2% last June to 3.2% in April (*Fig. 9*).

(3) *Disinflation correlations.* Services account for 61.5% of the CPI. So it isn't surprising that the CPI inflation rate on a y/y basis is highly correlated with the ISM Services prices paid index, pushed ahead by three months (*Fig. 10*). The actual latter series fell from a peak of 84.5 in December 2021 to 56.2 in May 2023.

That implies that the CPI inflation rate is on track to fall to 3.0% by August! But it's a little hard to believe that will happen since rent isn't reflected in the ISM measure but is a major component of the CPI. Rent inflation seems to be peaking only now and might take a while to fall back down to its pre-pandemic pace.

Christmas comes in December, not September, but maybe it will arrive three months early this year for investors. Christmas might come in September if we can rely on the correlation between the CPI inflation rate and the percent of small business owners planning to raise their average selling prices, pushed ahead by five months (*Fig. 11*). The actual latter series peaked at a record 54% in November 2021 and fell to 21% in April 2023. That suggests that the CPI inflation rate could fall to 3.0% by September.

(4) *PPI and CPI for personal consumption.* While the CPI was still up 4.9% y/y through April, the PPI for personal consumption was up only 2.7% y/y through April, little changed from March's 26-month low of 2.5% and down dramatically from last year's peak of 10.4% in March 2022 (*Fig. 12*). The PPI does not include rent either.

(5) *Rent.* The CPI measures of rent inflation remained elevated in April, with primary residence at 8.8% and owners' equivalent rent at 8.1% (*Fig. 13*). However, the three-month annualized rates for both fell to 7.3% and 6.9%, suggesting that both have peaked.

(6) *Food & energy.* Clearly peaking is the CPI foods index (*Fig. 14*). The y/y rate was 7.7% through April, but the three-month annualized rate was down to 1.7%. The CPI energy index peaked at 41.6% y/y in June 2022. It was down to -5.1% in April.

(7) *Core services inflation excluding housing.* Fed officials are particularly concerned about the stickiness of the core services PCED ex-housing costs inflation rate (*Fig. 15*). It has

been stuck around 4%-5% for the past 11 months through April. The comparable series for the CPI is for services excluding energy and shelter. It peaked at 6.7% in September 2022 and fell to 5.0% through April.

Movie. “BlackBerry” (+ + +) (*link*) is a fascinating and fast-paced docudrama about the very rapid rise and fall of Research In Motion, the Canadian tech company that invented the BlackBerry cell phone. This film is part of a new genre of movies about the development and marketing of new products. “Air” is about Nike’s launch of its Air Jordan sneakers. “Tetris” is about a new game introduced by Nintendo. A few I reviewed last year are “WeCrashed” (about WeWork), “The Dropout” (Theranos), and “SuperPumped” (Uber). They all are interesting depictions of how free market capitalism works. The entrepreneurs behind these inventions are all driven by the profit motive to produce the next New New Thing that will be a big hit with consumers. While some of the entrepreneurs have remained successful, others have crashed, often when competitors came up with a better product; in a few instances, they broke the law. BlackBerry was buried by Apple’s iPhone. Capitalism’s most consistent winners are consumers.

Calendars

US: Mon: Consumer Inflation Expectations; Federal Budget Balance; 10-Year Note Auction. **Tues:** Headline & Core CPI 0.3%/0.4%; Real Earnings 0.1%; NFIB Small Business Optimism; API Weekly Crude Oil Inventories; OPEC Monthly Report. (Bloomberg estimates)

Global: Mon: NIESR GDP Estimate; Japan Machine Tool Orders; China New Loans & Chinese Total Social financing 1,600b & 2.000b; Mann; Australian Westpac Consumer Sentiment 0.0%. **Tues:** Eurozone Core CPI; Germany CPI -0.2%/6.3%; Germany ZEW Economic Sentiment -13.0; Spain CPI 0.2%m/m/2.9%y/y; Italy Unemployment Rate; UK Average Earnings Including & Excluding Bonus; UK Claimant Change Count; UK Employment & Unemployment; Bailey; Dhingra. (Bloomberg estimates)

Strategy Indicators

Global Stock Markets Performance (*link*): The US MSCI index rose 0.4% last week for its fourth straight weekly gain and moved further away from a bear market to an 11.6% correction from its record high on December 27, 2021. The US MSCI ranked 31st of the 48 global stock markets that we follow in a week when 34 of the 48 countries rose in US dollar terms. The AC World ex-US index outperformed with a 0.9% gain, but remains in a deep 16.2% correction from its June 15, 2021 record high. Nearly all non-US regions rose w/w, but EM Latin America was the best performer with a 4.7% gain, ahead of EM Eastern Europe (2.8%), EMEA (2.3), BIC (1.6), and EM Asia (1.2). EMU was the worst performing region last week, with a decline of 0.3%, followed by EAFE (0.6). Colombia was the best-performing country last week, with a gain of 8.0%, followed by Argentina (7.7), South Africa (7.1), Israel (6.2), and Brazil (5.8). Among the 24 countries that underperformed the AC World ex-US MSCI last week, the 2.4% decline for New Zealand was the biggest, followed by Sri Lanka (-2.0), Ireland (-1.9), Malaysia (-1.2), and Switzerland (-1.2). Looking at 2023's performance so far, the US MSCI is up 12.2; its ytd ranking rose one place w/w to 15/48. The AC World ex-US's ytd gain of 7.2% is trailing the US MSCI, with 32/48 countries now in positive territory. EM Eastern Europe is the best regional performer ytd, with a gain of 21.8%, followed by EM Latin America (14.3), EMU (12.0), and EAFE (8.6). The regional laggards so far in 2023: BIC (-1.1), EMEA (2.1), and EM Asia (4.6). This year's best ytd country performers: Greece (37.0), Mexico (26.2), the Czech Republic (25.3), Argentina (24.8), and Hungary (22.1). Here are the worst-performing countries of the year so far: Pakistan (-28.3), Turkey (-13.9), Malaysia (-12.3), Norway (-10.2), and Hong Kong (-7.2).

S&P 500/400/600 Performance (*link*): All three of these indexes moved higher w/w. LargeCap rose 0.4% w/w, behind SmallCap's 1.7% gain and MidCap's 1.5% rise. At Friday's close, LargeCap finished the week at 10.4% below its record high on January 3, 2022, MidCap at 12.7% below its record high on November 16, 2021, and SmallCap moved further away from a bear market to end at 18.0% below its November 8, 2021 record high. Twenty-five of the 33 LargeCap and SMidCap sectors moved higher for the week compared to all 33 rising a week earlier. SmallCap Financials and SmallCap Real Estate were the best performers with gains of 2.7%, ahead of SmallCap Industrials (2.6%) and the 2.4% gains for LargeCap Consumer Discretionary, SmallCap Energy, and MidCap Energy. Among the biggest decliner for the week were MidCap Consumer Staples (-1.4), SmallCap Consumer Staples (-1.1), LargeCap Tech (-0.7), and LargeCap Consumer Staples (-0.6). Looking at performances so far in 2023, LargeCap, with a gain of 12.0%, remains well ahead of MidCap (4.6) and SmallCap (3.8); 18 of the 33 sectors are higher ytd. The top sector performers in 2023: LargeCap Tech (34.9), LargeCap Communication Services (33.3), LargeCap Consumer Discretionary (25.2), SmallCap Tech (17.9), and MidCap Tech (16.9). Here are 2023's biggest laggards: SmallCap Financials (-12.6), SmallCap Energy (-9.4), LargeCap Energy (-7.7), MidCap Financials (-7.4), and MidCap Utilities (-7.0).

S&P 500 Sectors and Industries Performance (*link*): Seven of the 11 S&P 500 sectors rose last week, and seven outperformed the composite index's 0.4% gain. That compares to a 1.8% gain for the S&P 500 a week earlier, when all 11 sectors rose and six outperformed the index. Consumer Discretionary was the best performer, with a gain of 2.4%, followed by Utilities (1.9%), Energy (1.7), Industrials (1.4), Financials (1.1), Real Estate (0.7), and Materials (0.5). Tech was the worst performer, with a 0.7% decline, followed by Consumer Staples (-0.5), Communication Services (0.4), and Health Care (-0.1). Looking at 2023's performance so far, the S&P 500 is up 12.0% ytd, with just three sectors still outperforming the index but five now higher for the year. The best ytd performers: Tech (34.9), Communication Services (33.2), and Consumer Discretionary (25.2). These are 2023's worst performers: Energy (-7.7), Utilities (-6.6), Health Care (-4.4), Financials (-3.5), Consumer Staples (-2.1), Real Estate (-0.1), Materials (1.2), and Industrials (3.9).

S&P 500 Technical Indicators (*link*): The S&P 500 rose 0.4% last week and edged down relative to its 50-day moving average (50-dma). However, it improved relative to its 200-day moving average (200-dma). The index was above its 50-dma for an 11th week and its 200-dma for a 12th week. It had been above its 200-dma for eight weeks through early March in its longest positive 200-dma streak since it was above for 81 straight weeks through January 2021. The S&P 500 ticked down to 3.5% above its rising 50-dma from a 15-week high of 3.7% above its rising 50-dma; that compares to 2.4% above a week earlier—and it also compares to a 20-week low of 3.6% below at the beginning of March, a four-month low of 10.6% below at the end of September, a 23-month high of 8.7% above the index's rising 50-dma in early August, and a 27-month low of 11.1% below its falling 50-dma in mid-June. The index had been mostly trading above its 50-dma from late April 2020 to early April 2022; in June 2020, it was 11.7% above, which was the highest since its record high of 14.0% in May 2009. That compares to 27.7% below on March 23, 2020—its lowest reading since it was 29.7% below on Black Monday, October 19, 1987. The price index closed Friday at a 17-month high of 8.1% above its rising 200-dma, up from 7.9% above its newly rising 200-dma a week earlier. The S&P 500 is well above its 26-month low of 17.1% below its falling 200-dma in June 2022 and compares to 10.8% above its rising 200-dma in November 2021. That also compares to 17.0% above in December 2020, which was the highest since November 2009 and up from the 26.6% below registered during the Great Virus Crisis on March 23, 2020—the lowest reading since March 2009. At its worst levels of the Great Financial Crisis, the S&P 500 index was 25.5% below its 50-dma on October 10, 2008 and 39.6% below its 200-dma on November 11, 2008. The 50-dma moved higher for a 12th week and the 200-dma rose for a second week, but has risen in just 14 of the past 56 weeks.

S&P 500 Sectors Technical Indicators (*link*): Six of the 11 S&P 500 sectors are trading above their 50-dmas, unchanged from a week earlier and down from all 11 sectors above during the April 28 week. These six sectors trade above their 50-dma: Communication Services, Consumer Discretionary, Financials, Industrials, Information Technology and Real Estate. Six sectors have a rising 50-dma, down from 10 a week earlier, as these four joined Utilities in the falling 50-dma club this week: Consumer Staples, Energy, Materials, and Real Estate. Looking at the more stable longer-term 200-dmas, the positive club dropped to five members w/w from six as Consumer Staples moved below and joined these five sectors still trading below their 200-dma: Energy, Financials, Health Care, Real Estate, and Utilities. The rising 200-dma club improved to nine members w/w from five as these four sectors turned up w/w: Consumer Discretionary, Consumer Staples, Energy, and Financials. That leaves Real Estate and Utilities as the only two sectors with falling 200-dmas.

Global Economic Indicators

Eurozone GPD (*link*): The Eurozone has entered a technical recession, as real GPD fell 0.1% during Q1 while revisions turned Q4's 0.1% gain to a 0.1% loss. However, declines in real GDP in both Ireland and Germany neutralized expansions in other Eurozone economies. Real GDP in Ireland tumbled 4.6% during Q1 following a 0.1% decline during Q4, while Germany's real GDP contracted 0.3% after a 0.5% shortfall during Q4. Meanwhile, the broader European economy averted a recession, with real GDP for the EU ticking up 0.1% during Q1 after falling 0.2% during Q4. Real household spending in the Eurozone contracted 0.3% during Q1, as rising food and energy costs depressed consumer spending, while real government spending contracted 1.6% during Q1. Meanwhile, real gross fixed capital formation, which tracks investment, increased 0.6% during Q1. Real exports were virtually unchanged during Q1, while real imports fell 1.3%. There has been some improvement on the price front. Since peaking at 10.6% in October 2022, the CPI has slowed to 6.1%, though it remains significantly higher than the ECB's target rate of 3.2%.

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