John Dessauer Investments, Inc.

John Dessauer's market review and update as of Wednesday February 15, 2023

A couple of weeks ago I wrote about an editorial by Alan Blinder, former vice chair of the Fed and professor of economics at Princeton. He detailed the almost hidden good news on inflation. He has now written a follow-up that was published in the Wall Street Journal on February 9. Here are excerpts from that follow-up editorial:

"The Fed Now Has a Good Chance at a Soft Economic Landing.

They came, they saw, they conquered—maybe a bit too much. I refer to the most recent meeting of the Federal Open Market Committee, which concluded on Feb. 1. FMOC members came to Washington, studied and discussed recent and prospective economic developments, and decided unanimously to raise the federal funds rate by another 25 basis points. No problem there, virtually everyone on the planet expected that.

My gripe about excessive agreement refers to their unanimous decision to continue saying that, "The committee anticipates that ongoing increases in interest rates will be appropriate." Calling "ongoing" rate hikes "appropriate" displays no recognition whatsoever that inflation has crumbled, or in the committee's far-to-modest words, "has eased somewhat."

Somewhat? In truth, the first and second halves of 2022 were like two different worlds in terms of inflation. The most stunning example is the behavior of the overall consumer price index. While this measure of inflation isn't the Fed's favorite it gets vastly more public attention than any other measure. The CPI rose at an 11.1% annual rate in the first half of 2022 and a 1.9% annual rate in the second half. No that is not a typo---a tad under 2%.

Yet the FOMC statement virtually ignored this important fact. Why?

One possible reason may be that the Fed's 2% inflation target applies not to the CPI but to the deflator for personal consumption expenditures---a wonkish point, but it's true. However, PCE inflation also crumbled—from 8% in the first half of 2022, to 2.1% in the second. That's "only" a 6-point drop, less than the 9-point drop in CPI inflation, but still remarkable. The FOMC calls that "easing somewhat?"

A second reason may be that six months of quiescent inflation data doesn't prove that the inflation dragon has been slain. True again. But six months is also too long a period to be dismissed as a mere blip in the data. The dragon is, at a minimum, seriously wounded.

Finally, a sizeable part of the sharp decline in inflation came from falling energy prices. Between the first and second halves of 2022, the "core" version of CPI inflation—which excludes food and energy prices—dropped only 2.3 points (from 6.8% to 4.5%) and the core version of PCE fell only 1.5 points (from 5.2% to 3.7%). But focus your attention as the Fed does, on that last number. A rate of 3.7% is only about another 1.5-point decline in core PCE inflation away from the Fed's 2% target.

My point isn't that inflation has been vanquished, and the FOMC should declare victory. Rather, it's that pausing rate hikes now is at least worth debating. It's been wonderful to see the FOMC lined up solidly behind its outstanding leader, Jerome Powell. But unanimity should be fraying at this point. Hawks and doves should be arguing. If they aren't, the hawks may fly the economy straight into a recession.

Remember the Fed's job is to reduce inflation, not to drive the economy into the ground. Some observers insist that conquering inflation requires a recession. But that's based on Phillip's curve reasoning: High unemployment is supposedly needed to slow the growth of wages, which in turn will slow the growth of prices. Maybe. But what if it proves wrong here—as it has for most of the 21st century?

Consider these amazing facts. When the Fed started tightening in March 2022, the unemployment rate was 3.6%. Since then, about four million net new jobs have been created, and the unemployment rate today stands at 3.4%. Yet inflation has come way down, not up: wage increases are moderating, not accelerating, and less inflation from rents is in our future. We also know that the effect of tight money on inflation is long delayed. Maybe, just maybe, the Fed can finish off the dragon without killing the economy.

Six months ago, before all the good inflation news started pouring in, I thought the odds were strongly against achieving a soft landing. Now they look to be at least 50-50, maybe better. And if a soft landing is possible, shouldn't the Fed try for it?

That's why I hope there's a lot more arguing inside the FOMC than the central bank is letting on."

Thank you, Alan Blinder for exposing the truth about the inflation story. In my view the Fed does not want to see financial markets surging based on premature optimism. Rather the Fed prefers to stay cautious until it is clear that inflation is down and going to stay down. That way a financial market rebound will have staying power.

I will have the next market review and update for you one week from today on Wednesday, February 22, 2022.

All the best,

John Dessauer