Wednesday, November 03, 2021

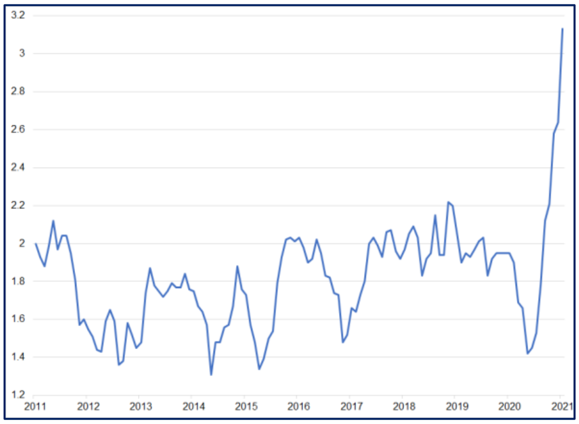
Hypothesis Rejected

Jackson Hole

Remember Powell's dovish Jackson Hole speech on August 27, 2021? He laid out a dovish hypothesis planting five flags to argue why the Fed expects inflation to remain subdued. Here is where they stand[1]:

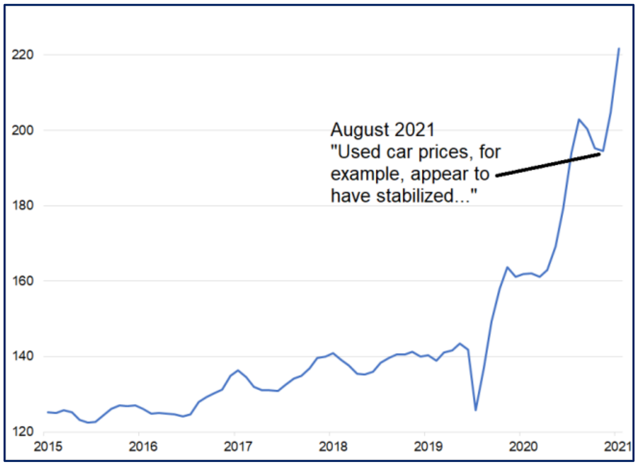
1. "The absence of broad-based inflation pressures" (he cites Dallas Trimmed Mean PCE and another index that I can't find on Bloomberg). Here is the most timely read on Dallas Trimmed:

Dallas Fed Trimmed Mean Six Month PCE Inflation Annual Rate



2. "Moderating inflation in higher-inflation items" He cites used cars which now look like this:

Manheim Used Car Price Index



3. "Today we see little evidence of wage increases that might threaten excessive inflation" He cites the Atlanta Fed Wage Growth Tracker.

am FX

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"There's a smiley face on the hill, Daddy!"

"Sure there is son. Finish your sandwich please."

Current Views

Long 15NOV 1.3550 GBP put

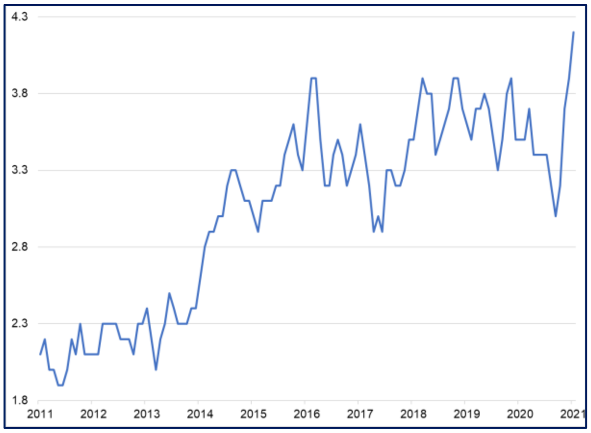
Was a calendar spread
Price 21bps off 1.3730 spot

Short leg expired worthless

Now worth around…
25bps off 1.3657 spot
33bps off 1.3625 spot

[1] The WSJ did a piece about this yesterday and I know some FX strategists have mentioned it. I think it's the most useful framework, so I'm doing my own piece on it.

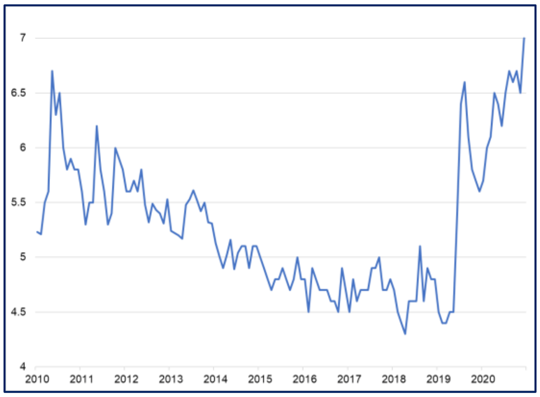
Atlanta Fed Wage Growth Tracker



NOTE: Employment Cost Index looks even worse

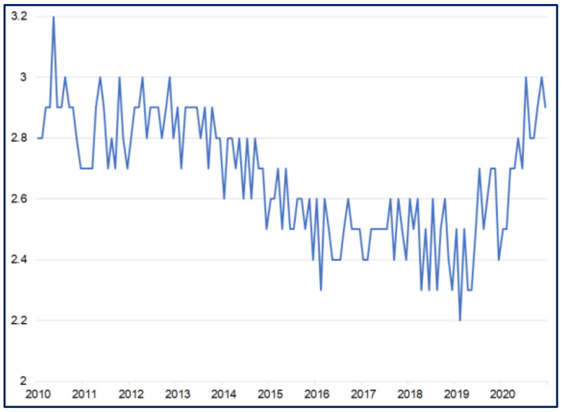
4. “Longer-term inflation expectations… are at levels broadly consistent with our 2 percent objective”. He cites the index of common inflation expectations (which is not up to date, so I can’t show it). That index of common inflation expectations includes a bunch of 1-year stuff and measures out to 10 years. All the near-term stuff looks like this Conference Board reading (which is part of the common inflation expectations index cited by Powell).

Conference Board Inflation Rate Expectation 1-year



The one place where Powell’s August 2021 hypothesis is not off the rails is in measures of long-term inflation expectations. Michigan 5-10-year inflation expectations look like this:

Michigan survey, price changes next 5-10 years



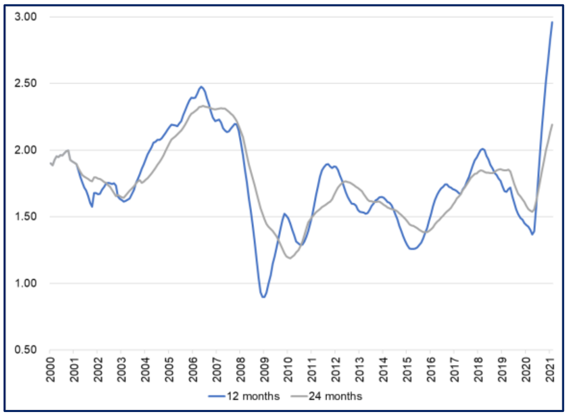
5. "The prevalence of global disinflationary forces over the past quarter century." These disinflationary forces might come back. But they're nowhere in sight still as we enter November 2021. Global forces are highly **INflationary** as supply chains remain badly impeded and there is no end in sight to this global issue. Professionals in the industry (such as the DSV CEO I quoted yesterday via Steen) maintain nothing will be fixed until deep into 2022.

I don't fault Powell for being wrong. I was wrong too. I thought inflation would be transitory. The point here is just to lay out how specifically wrong Jay and I both were and how the new evidence completely contradicts the transitory view. Or at the very least: the new evidence extends the definition of the word "transitory" beyond one year and necessitates policy action, not calm popcorn munching on the sidelines.

One year memory

Meanwhile, let's check in on Clarida and Bernanke's concept of the 1-year memory. Here is 12-month and 24-month average of YoY inflation in the United States, using the Fed's preferred measure. I like the 24-month average because it smooths out the entire collapse and rebound from COVID. To get a better idea of where this measure is going into year-end, I assume Core PCE drops back to 3.0% by December. This is conservative and the number is more likely to end up higher, not lower than the graph shows.

Core PCE YoY, 12 and 24-month average January 2000 to December 2021



The point of that last chart is to say that even under average inflation targeting, the target is met. If Powell is a true scientist, he will look at the empirical results of the experiment that has run since August 2021 and reject his "keep calm and carry on" hypothesis. This should lead to more and more hawkish policy as the Fed needs to maintain optionality as inflation is close to a non-linear tipping point. It's the number one topic of conversation these days, inside and outside finance. If inflation is transitory (which it still might be), that transitory period is too long to look through.

FOMC meeting view

As a general rule of thumb, I like to bet on dovish FOMC in easing cycles, and hawkish FOMC in tightening cycles. This rule of thumb worked well at the June and September meetings. This time, there is one difficult-to-handicap wildcard. Powell has not been renominated. There are two ways you can read this:

1. Guy who is fighting for his job doesn't want to sound hawkish and hurt his chances. Dovish.
2. Guy who knows he is not being renominated might as well do the heavy lifting for the man or woman set to replace him. Hawkish.

I guess number one is more likely, but I'm not sold on this issue having a big influence on policy. Considering the FOMC is a committee and there are plenty of dissenting opinions these days, I don't think this renomination variable should receive much weight. **I lean to the hawkish side again today.**

What could sound hawkish? Something like this at the press conference: "…need to keep all options open as inflation has remained more persistent than expected." Something like that could be taken as a veiled attempt to open the door for faster hikes or even a couple of 50bp starters in 2022. Remember Williams: "Go big and go early?" Could that apply to tightening too?

No matter what is priced in, the market can always price in more.

People I talk to are mixed. Positioning is light. Market reaction should be orthodox and almost symmetrical. It will be modestly easier for the USD to rally on a hawkish outcome than for it to sell off on dovish. I like selling GBPUSD and buying USDJPY on hawkish. Buy NZDUSD on dovish (you see those jobs numbers? Mamma Mia). Strong job creation with tame earnings. Goldilocks for NZ corporates.

Recall that the hawkish outcomes in June and September boosted the dollar and it never looked back. With US equities going kinda parabolic vs. rest of world, the USD has strong tailwinds on a hawkish Fed. On a dovish Fed, I think the USD will sell off, but less.

US Exceptionalism Index vs. DXY

US exceptionalism index is (NASDAQ futures/EM equity futures) ratio

Let the madness begin!

https://ftx.com/trade/TRUMP2024

Confirmation

A reader sent me this research paper which comes to a similar conclusion as my piece yesterday: A rise in SNB Sight Deposits is bullish EURCHF. Not rocket science, but still probably useful to know.

https://ideas.repec.org/p/bsl/wpaper/2020-04.html#download

Have a smiley day.

good luck ⇅ be nimble

Giant smiley face of trees greets drivers in Polk County every fall

https://www.oregonlive.com/pacific-northwest-news/2020/12/who-planted-a-giant-smiley-face-of-trees.html

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