Expectations Convergence

Convergence of Policy Path Expectations, Bills Only Policy, Narrower Disinflation, The Phillips Curve Comeback

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The January Effect

The last three January employment and CPI reports have been hotter than expected, and like the recurring pattern of soft 3Q and stronger 4Q employment growth following the Lehman bankruptcy, we suspect the pandemic-distorted seasonal adjustment factors are overstating the strength in the labor market and inflation data. That said, the sustainable broadening disinflation FOMC participant narrative and our quadrilemma (4% unemployment plus 4% wage growth facilitating a year-end '24 4% policy rate and 4% 10-year Treasury) were dealt a significant setback by the January employment and CPI reports, distortions or not. We will dig into the details of this week's inflation reports later in the report, but in short, the 2H23 disinflation is highly concentrated in core goods prices that appear to be bottoming, and non-housing services inflation in the CPI and PPI reports reaccelerated in 2H23 amidst a setback in the recovery in the supply of labor. We expect cooler data in the coming months, but with the manufacturing and residential real estate sectors looking increasingly likely to expand in '24, and no signs of consumption weakening despite the January retail sales undershooting consensus, the hurdle for the FOMC beginning to reverse the policy tightening increased over the last couple of weeks.

A year ago, the Fed had slowed the pace of hikes from 75bp to 25bp, until the January data led the Chair to suggest in his early March Monetary Report to Congress, the FOMC might need to reaccelerate the pace to 50bp hikes. That suggestion caused a spike in real rates (TIPS yields) that exacerbated the Silicon Valley Bank run on uninsured deposits. The equity and fixed income market's quick stabilization following the setback in the sustainable broadening of disinflation this week is a function of the convergence of the Fed and market expectations for the ‘24 policy rate path. In other words, investors took comfort that the FOMC wasn’t surprised, but what market and FOMC participants are missing is the implication of sticky services inflation for the terminal policy rate. If the FOMC only gets to 4% by the end of 2025, an increasingly likely outcome we discussed in last week’s note, The Wrong Price, pressure on banks, small businesses, real estate and federal finances will intensify. In short, 4.25% 10-year nominal Treasuries and 10-Year TIPS at 1.90%, with a -6bp term premium, are — in the words of Lee Cooperman — ‘returnless risk’ if the ‘24 year-end is likely to be 4.75% or higher. Additionally, the bounce in small caps and regional banks post-CPI is also misguided; as we discussed last week, the 200bp hit to bank return on common equity to the 10% threshold where banks build or burn capital, requires yield curve disinversion and a scrapping of the regulatory capital increase proposal to make a ‘healthy broadening’ sustainable.

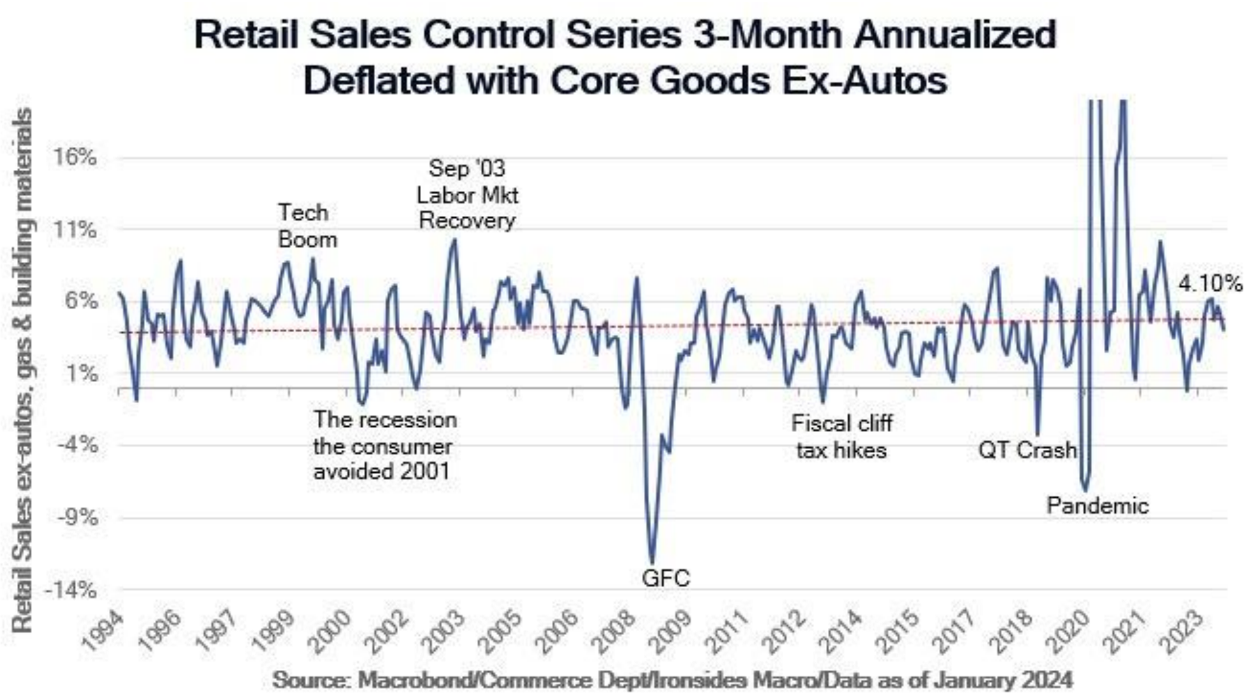

Figure 1: Core retail sales (control series) missed expectations reducing the Atlanta Fed PCE and GDP tracking models by 50bp to 2.7% and 2.9%. The headline number is nominal, we deflate the series using core goods ex-autos, because of goods deflation the real was greater than nominal. In ‘21 and ‘22, November and December were surprisingly weak, and January beat. The opposite was true over the last three months. It is not clear based on the composition that weather suppressed sales, however given the impact on the employment report, it likely did.

Let the Market Decide: The Future of QT

(BN) FED REVERSE REPO USE DIPS BELOW $500B FOR FIRST TIME SINCE 2021

The recovery in USTs following CPI and negative term premium reflect market expectations the FOMC's longer-run estimate of the natural rate (r*) is a reasonable guesstimate, however, the Fed's balance sheet continues to exert pressure on longer maturity rates. When the FOMC debates QT in the March meeting, we hope someone puts our suggestion of a 'bills only' policy on the table. They should maintain their abundant reserve regime with Treasury bill holdings, not mortgages or Treasury notes or bonds. As the RRP balance dwindles and reserves prove stubborn thanks to banks hoarding cash, due in part to the inverted curve environment, the Fed should reinvestment any maturing Treasuries or mortgage paydowns above their balance sheet reduction cap (currently $95 billion per month), into Treasury bills. This would shorten the duration of the System Open Market Account (SOMA) and reduce their suppression of the most important price in global markets. The Fed had a 'bills only' policy from the Fed/Treasury Accord of March 1951 that began the process of removing the WWII rate cap until the Global Financial Crisis. Large-scale asset purchases were implemented due to the zero-lower bound on the policy rate, just as RRP was implemented to prevent negative repo rates. The policy rate corridor is 5.25% to 5.5%, and it is time to restore markets to their rightful place in setting longer term rates. In addition to causing capital misallocation, the FOMC is enabling reckless fiscal policy.

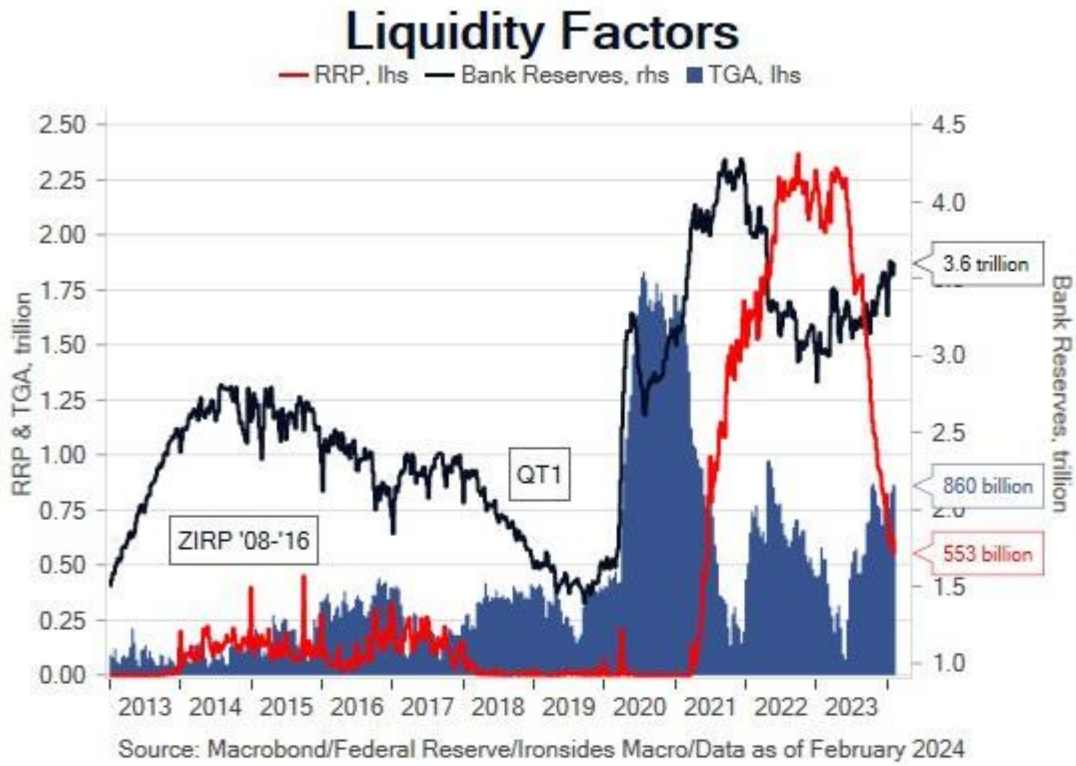

Figure 2: The sharp increase in bank reserves in 2013 was QE2, the RRP program was introduced to prevent repo rates from going negative due to all the excess cash in the system. Reserves bottomed in the fall of 2019 following 2 years of balance sheet contraction (QT1) when repo rates spiked to 9% and the Fed launched 'NotQE', $60 billion per month of bill purchases to increase liquidity. The RRP chart shows the middle of the period (weekly) balance, it dropped below $500 billion on Thursday.

Less Sustainable and Narrower Disinflation

"The evidence from data, our surveys, and our outreach says that victory is not clearly in hand, and leaves me not yet comfortable that inflation is inexorably declining to our 2% objective," "That may be true for some time, even if the January CPI report turns out to be an aberration." Atlanta Fed President Bostic (source: Bloomberg)

While the annual consumer price index revisions showed modest broadening of 2H23 disinflation, the January report widened the gap between globally driven goods deflation and domestic policy determined housing and non-housing services inflation. While the January employment and consumer price index reports led to a compression of the spread between the market implied monetary policy path and the FOMC's December Summary of Economic Projections (SEP) '24 median forecast, if the meeting were this week, we suspect the March SEP policy forecast would be little changed. A year ago, hot January data prompted Chair Powell to suggest at the semi-annual Monetary Policy Report to Congress on March 8 that the FOMC might have to reaccelerate the pace of hikes from 25bp back to 50bp. Within a week, the regional banking crisis began. A year later the deep inversion of the yield curve, largely attributable to the excessive monetary policy pandemic accommodation and suboptimal tightening (passive QT, aggressive rate hikes), continues to pressure regional bank profitability. The next meeting is March 20, between now and then we get another employment report, January PCED, February CPI and presumably the semiannual monetary policy report to Congress. The most likely outcome is a set of cooler reports that leave a May liftoff on the table, without a soft commitment from the SEP, press conference or post-meeting speeches. If there is no evident weakening of the demand for labor without an increase in supply, and another month of core goods deflation without services disinflation, the SEP forecasts could prove hawkish.

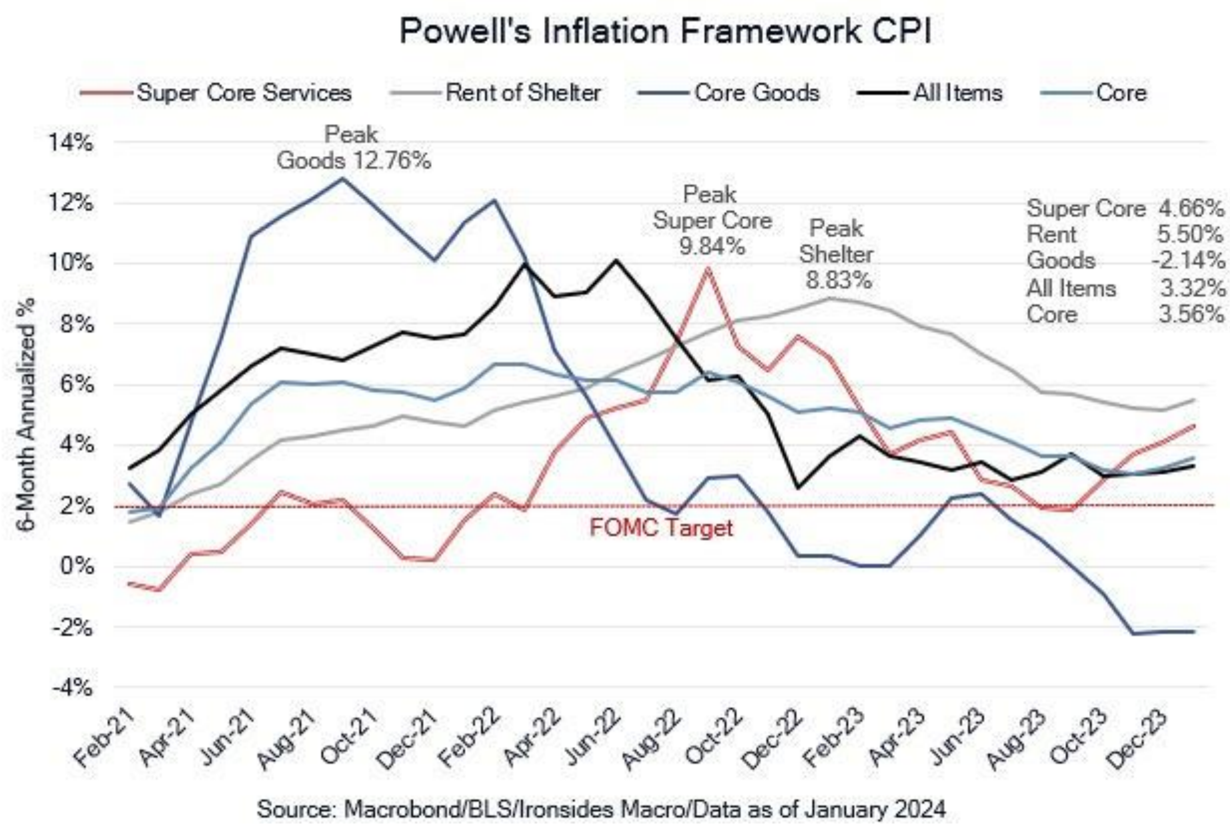

Figure 3: As this chart of the 6-month annualized rates of non-housing and housing services inflation shows, the uptick in services inflation was not a one-month aberration.

Here are the details of the surprising January CPI report. Rent of shelter increased 0.60% from December, faster than 0.43% in December and last six-month median increase of 0.42%. It was suggested to us that BLS treatment of utilities, natural gas specifically, may have boosted the monthly change. We doubt the trend in rents is accelerating, however, in February the annualized rate will lap the last of seven 0.72% increases. Consequently, to get the current 6.06% annualized rate to cool to the pre-pandemic trend just below 3%, the monthly rate needs to fall to 0.25%, some distance from the current 0.44% median since rent of shelter peaked in March '22. Our core view is that excessive monetary policy accommodation in '21, and the passive QT/aggressive rate hikes in '22 and '23, reduced housing supply of single and multifamily real estate at least as much as demand, leaving the pandemic price shock in place and exacerbating the structural shortage. It is certainly possible, if not probable, that the monthly trend will ease to 0.25% later in '24, however, the structural damage combined with strong household formations implies a longer-run trend well above the '00s and '10s 3% trend.

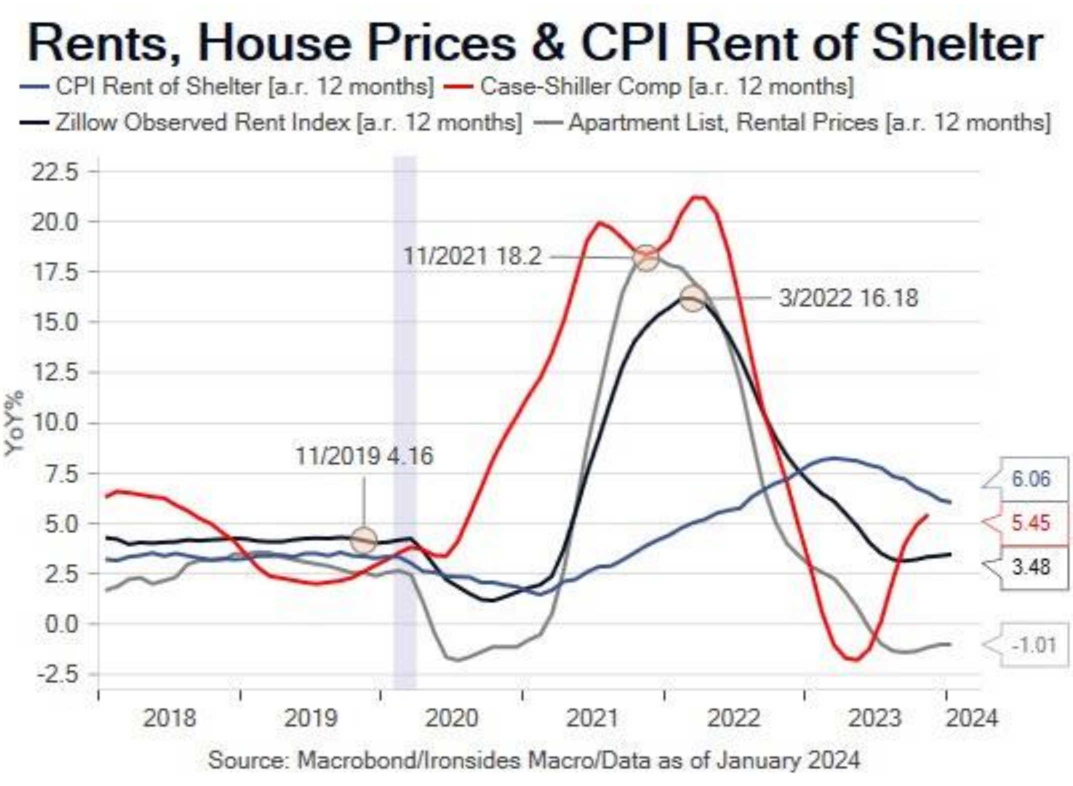

Figure 4: The recovery in house prices reflects the damage the Fed policy did to the supply of housing and the likely path for rent of shelter in the longer run.

Goods Deflation: Cyclical Recovery, Structural Persistence

Core goods fell 0.32%, 3-month annualized deflation intensified to -2.42% from -1.25%, 6-month was little changed at -2.14% from -2.15%, and the year-on-year rate contracted 0.31% from +0.12% in December. We took a hike and listened to a lengthy interview on the Forward Guidance podcast with China-focused analyst Brian McCarthy. In short, Brian characterized China as trapped in a real estate debt deflation trap that they are trying to offset with doubling down on the excessive manufacturing capacity that has been the source of goods disinflation, with periods of deflation, since their admittance to the World Trade Organization in 2002.

In 2015, during what we've characterized as China's heavy industry investment bust, they took tentative steps to devalue their currency, however the outflow pressures were far more intense than they expected. Subsequently, they doubled down on state-directed malinvestment. Like Brian, we expect significant currency devaluation, however, with global trade recovering, the deflationary impulse could persist. A Trump reelection, were he to follow through with his threat of a 60% tariff on Chinese imports, could exacerbate China's massive structural imbalance and currency overvaluation. When China devalued their exchange rate 25% in 1995, they were not a significant factor in global trade or capital flows, today a large devaluation would destabilize capital markets and produce an inflationary goods price shock.

Brian didn't break any ground in our structurally negative view of China, but he provided some additional granularity. Thursday's import prices report showed firming prices, likely primarily attributable to the weakness of the dollar following the Fed pause/pivot in 4Q23. The first two regional Fed manufacturing surveys (Empire and Philly Fed) showed better activity and higher prices paid. On balance, the cyclical trend is likely for core goods price deflation to dissipate, but the structural goods disinflation resulting from globalization and the rise of China during the '00s and '10s, may last a bit longer in the '20s despite the restructuring of global supply chains.

Figure 5: Import prices are turning up, Chinese prices are lagging.

Fiscal Theory of the Price Level

The larger issue in January CPI, as quirky as it may have been, was non-housing services at 0.46% by our calculation (there is no official measure, we back out energy services from services less rent of shelter), up from 0.39% in December and the median '23 0.28% rate. The '23 median rate is misleading: in the first half, as demand for labor was cooling and supply was increasing, the median was 0.24%, in 2H23 the median accelerated to 0.39% amidst a drop in participation of prime age and 55+ workers. We remain skeptical of the Phillips and Beveridge Curve inflation models contribution to the inflation shock; we may be at the 'nonlinear' portion of the curve transitioning from fluidity driving wages to diminished slack. It is also evident that for sectors awash in government industrial policy stimulus, namely manufacturing and construction, wages are running hot. Additionally, medical care services are heating up, perhaps due to the Obamacare subsides and Medicaid eligibility expansions. The PCED uses Medicare and Medicaid utilizes reimbursement rates, a methodology that misses the surge in insurance costs and rising physician services inflation. Finally, direct transfer payments, which could get boosted further if the House childcare credit bill gets through the Senate, and residual savings from pandemic transfer payments, continue to boost prices in the 'food away from home' CPI and robust dining out retail sales. On balance, until and unless the federal government runs a primary budget surplus (deficit less interest payments), we expect core non-housing services to run hotter than the '00s and '10s 2.5% trend.

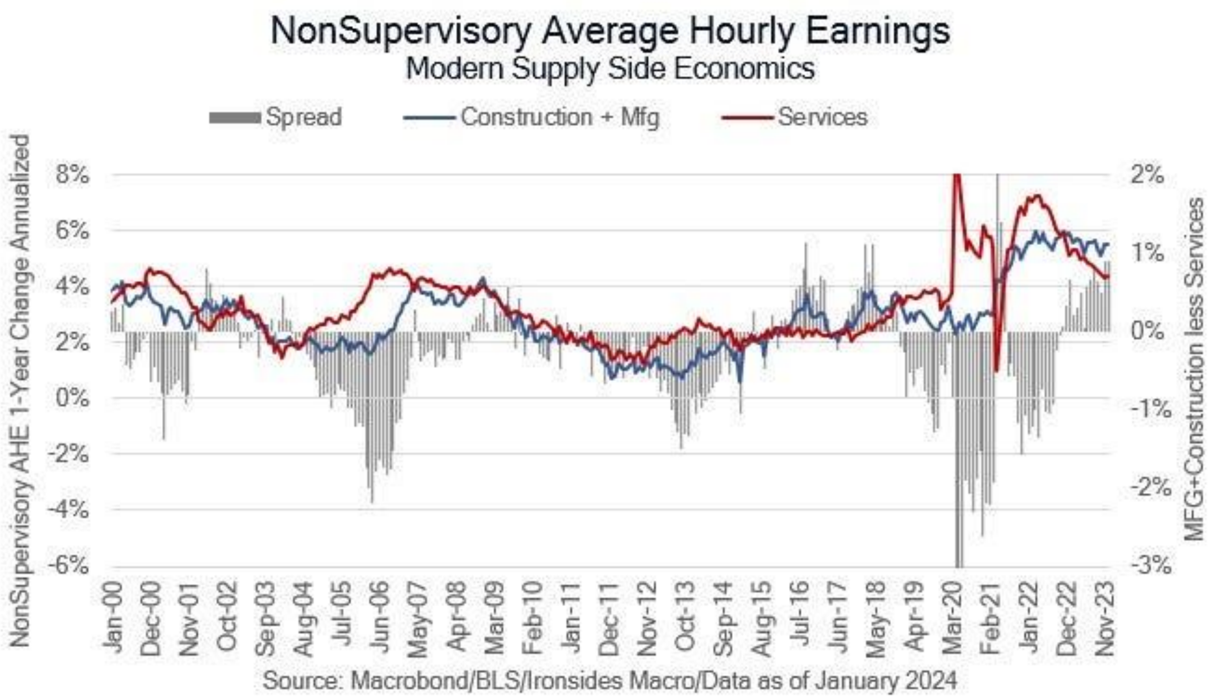

Figure 6: For two decades construction and manufacturing wage growth lagged services, that is no longer the case.

The bottom line is that we expect the disinflationary trend in all items CPI and the personal consumption deflator from June '22 through June '23, and disinflation in the core measures driven by core goods prices in 2H23, to broaden somewhat in coming months. Additionally, we have been discussing the rolling peaks in the major components of inflation for well over a year; goods peaked in February '22, energy in June '22, food in August '22, non-housing services in September '22 and housing had the final of its seven months of 0.72% monthly increases in February '23. Consequently, the gravity of lapping supply chain and policy shocks ends next month, the underlying trend is likely to become increasingly evident. If we do return to the Fed's target, it'll likely prove transitory. Goods prices may remain under pressure, though not to the same degree. Housing and non-housing services are likely to run above pre-pandemic trends in the '20s due to excessive pandemic monetary and fiscal policy, as well as persist deficit spending. Additionally, disinflation occurs without a resolution of our quadrilemma, a 4% unemployment rate and 4% wage growth that allows the Fed to cut to 4% and the 10-year nominal yield in the vicinity of 4%, the banking system, real estate sector and small businesses generally will remain under pressure due to the curve remaining inverted. In other words, those claiming January was a fluke because it was only 0.1% above expectations and a robust labor market is good for earnings, are underestimating the importance of the timing of the Fed disinverting the yield curve and the Fed's ability to return inflation to their target.

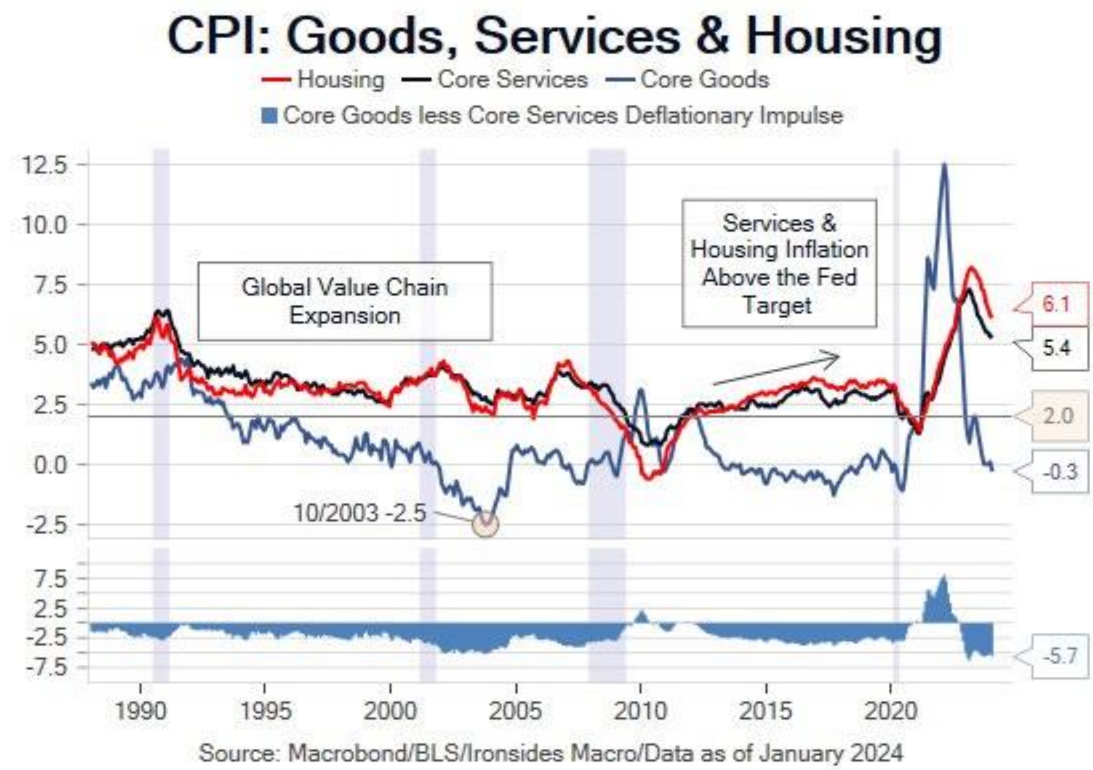

Figure 7: During the '00s and '10s goods prices averaged zero with periodic periods of deflation.

Final Thoughts

Small caps and financials outperformed technology during the CPI is a 'one-off' 2-day bounce. Meanwhile Treasuries bear flattened, mortgages widened to Treasuries, crude rallied 3% to $79, and the yen weakened to 150. Next week is short week with limited data and two tricky long duration auctions (20-year nominals and 30-year TIPS). We expect USTs, banks and small caps to struggle. The pressure is building on the next round of labor market data, if it doesn't soften the probability of a broad risk-off episode is growing.

US Equity Market Valuation Index/Sector	PE	Fwd PE	P/S	P/B	EV / Sales	EV / EBITDA	Valuation Z-score	ERP	ERP Z-Score	Index Weight	Ironsides Weights
SPX	24.52	21.01	2.73	4.73	3.01	15.54	1.57	2.16%	1.86		
SPW (equal weight)	16.09	15.77	0.02	2.90	1.98	11.17	0.30	3.16%	2.24		
Discretionary	29.21	24.43	2.34	9.64	2.60	16.77	1.77	1.58%	1.46	10.48	10%
Financials	17.08	15.47	2.38	2.05	2.54	#N/A N/A	0.36	4.45%	1.17	12.75	5%
Technology	37.83	29.78	8.29	12.04	8.38	26.60	2.28	0.78%	1.57	30.10	30%
Comm Services	21.69	18.25	3.50	4.18	4.00	12.96	1.47	3.47%	1.40	9.10	10%
Industrials	24.25	20.86	2.28	5.61	2.61	16.55	1.66	2.82%	1.25	8.59	20%
Materials	21.26	20.10	2.12	2.84	2.47	12.82	1.12	2.96%	1.01	2.22	5%
Energy	11.32	11.89	1.25	2.16	1.44	6.57	0.13	6.51%	-0.18	3.72	10%
Healthcare	26.02	19.43	1.79	4.99	1.97	17.46	0.45	3.17%	1.11	12.67	10%
Staples	20.76	20.02	1.40	5.92	1.63	16.26	0.73	2.85%	1.36	5.98	0%
Utilities	16.54	15.37	2.09	1.83	3.98	12.33	0.85	4.05%	1.25	2.11	0%
Real Estate	41.17	35.91	6.44	6.44	8.93	20.34	-0.70	0.47%	1.70	2.30	0%
Russell 2000	35.98	23.93	1.22	2.05	36.84	1.70	0.23	1.00%	1.45	5.68	3%

Source: Bloomberg/Ironsides Macro/Data as of February 2024

Bonus Charts

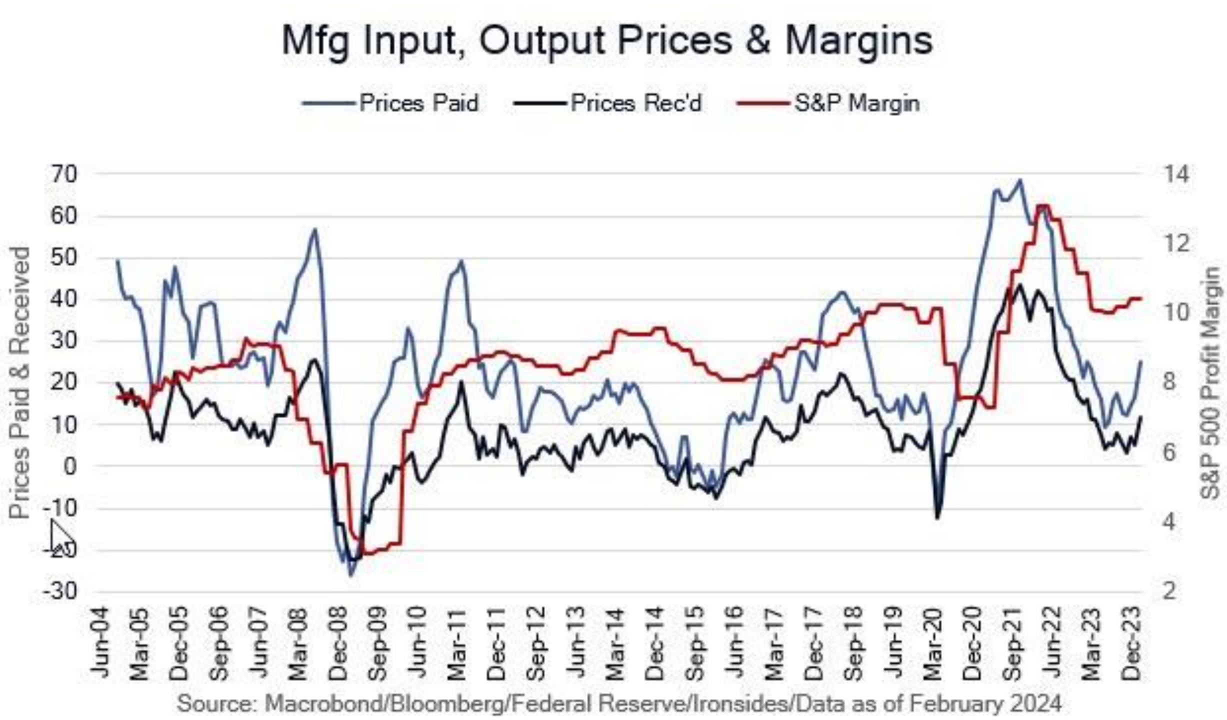

Figure 8: Prices paid and received are rebounding providing more evidence that the good deflation impulse from the strong dollar in 3Q and Chinese deflation is dissipating.

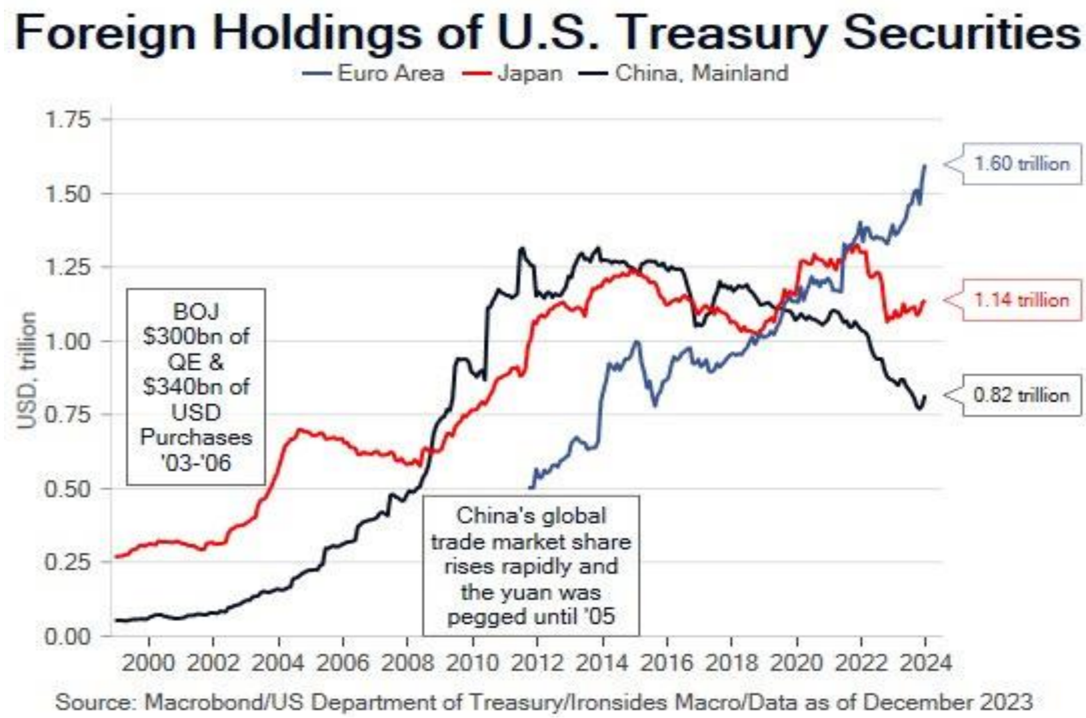

Figure 9: The Fed pause, and premature pivot party, sucked foreign buyers back into Treasuries in December, those trades are under water.

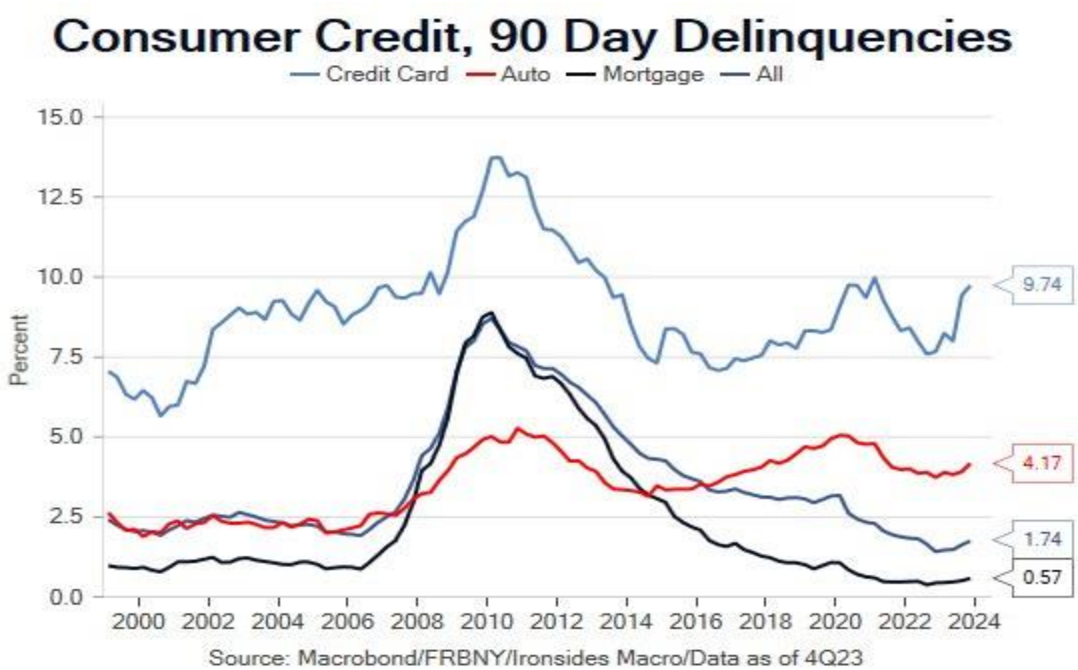

Figure 10: Credit card delinquencies triggered some legitimate questions and plenty of 'bear porn' on Twitter, mortgages make up the majority of household interest obligations. Consequently, until and unless, delinquencies broaden households remain in a strong position, in aggregate.

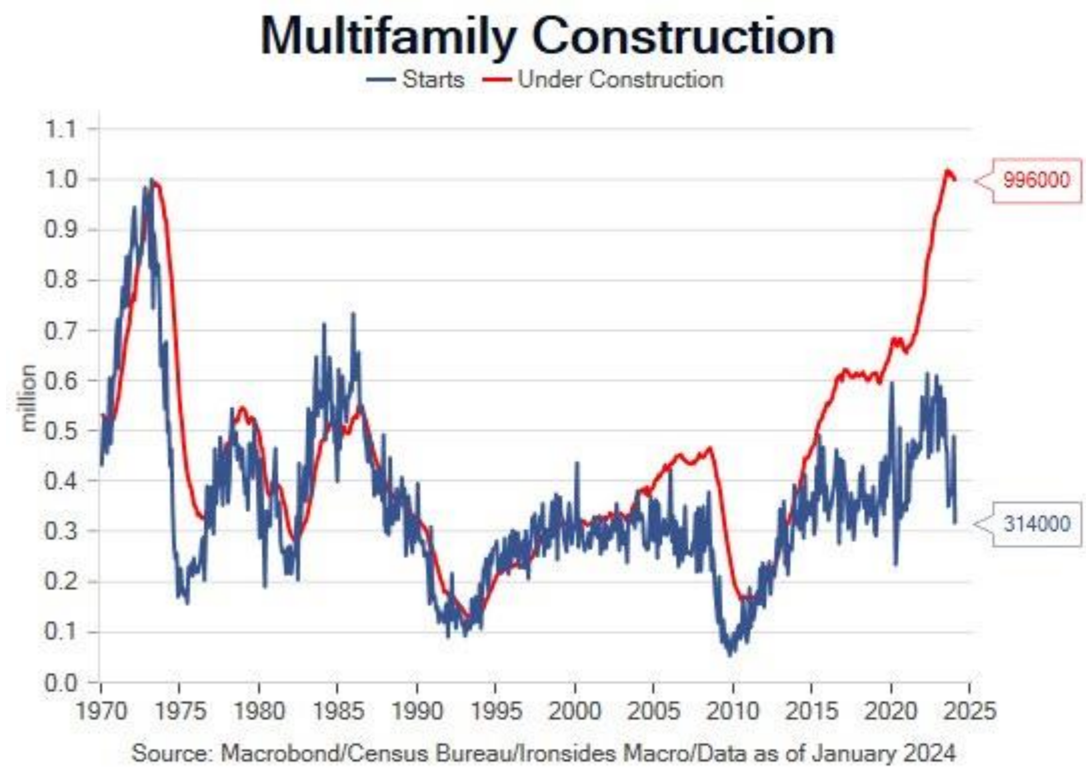

Figure 11: This is an excellent illustration of the damage monetary policy did to the housing stock. There are a million multifamily projects under construction from the '21 monetary jubilee, but new starts have collapsed. Rents could soften in some markets in '24-'25 as these projects get completed, but they are likely to rebound sharply in the years that follow.

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