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James Bianco

Inflation, The Fed and Markets in 2002
SFBTA
February 4, 2022



Fed has no reliable theory of inflation, says Tarullo

Former Fed governor calls for more attention to actual data



© Bloomberg

The Financial Times – (October 4, 2017) [Fed has no reliable theory of inflation, says Tarullo](#)

Former Fed governor calls for more attention to actual data

Central bankers are steering the economy without the benefit of a reliable theory of what drives inflation, a former top Federal Reserve policymaker said, as he called for policymakers to pay less attention to theoretical models and more to actual data. ... “The substantive point is that we do not, at present, have a theory of inflation dynamics that works sufficiently well to be of use for the business of real-time monetary policymaking,” said Mr. Tarullo in a speech at the Brookings think-tank in Washington.

February 4, 2022

Bianco Research L.L.C

Finance and Economics Discussion Series (FEDS)

September 2021

Why Do We Think That Inflation Expectations Matter for Inflation? (And Should We?)

Jeremy B. Rudd

Abstract:

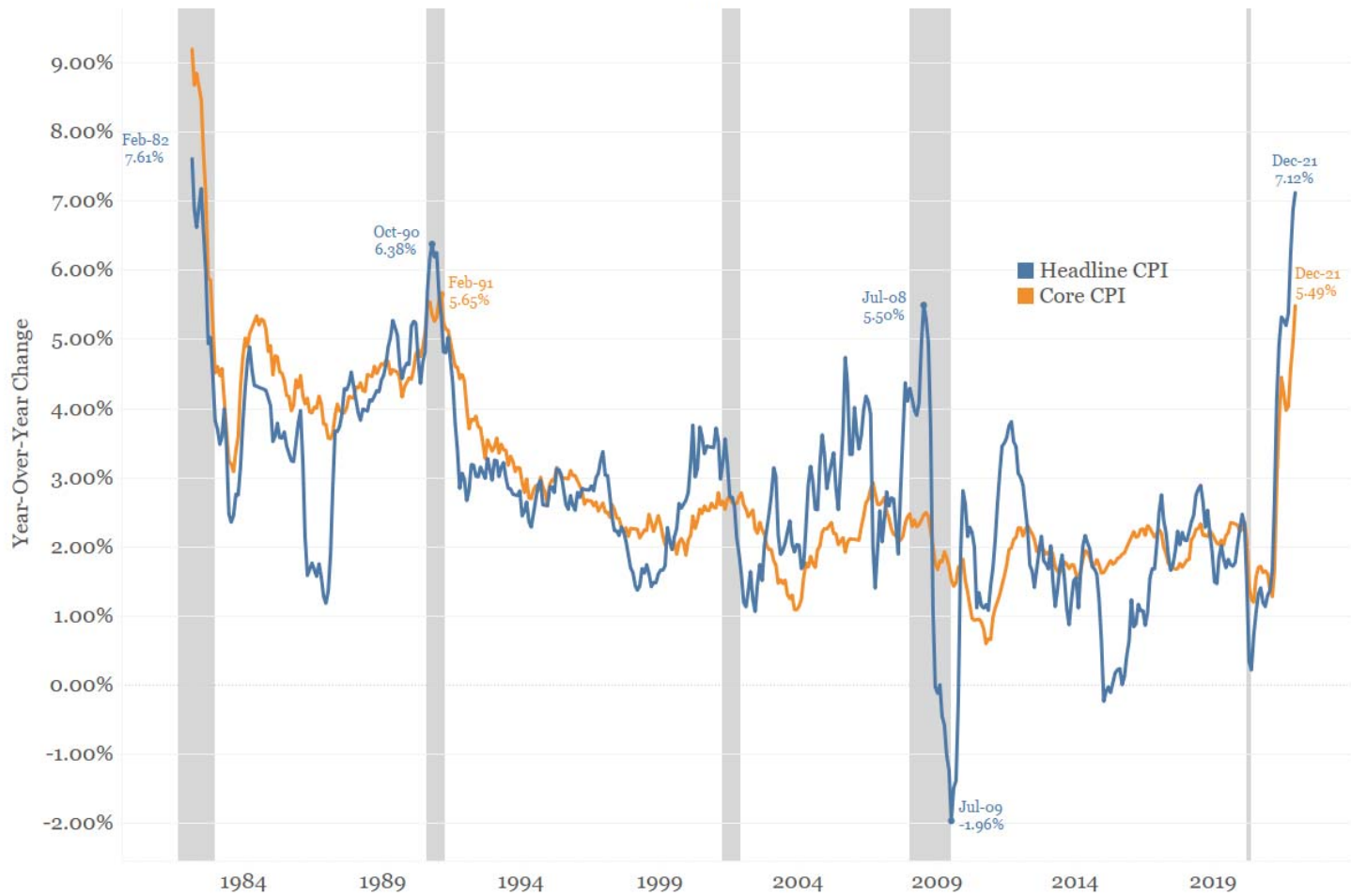
Economists and economic policymakers believe that households' and firms' expectations of future inflation are a key determinant of actual inflation. A review of the relevant theoretical and empirical literature suggests that this belief rests on extremely shaky foundations, and a case is made that adhering to it uncritically could easily lead to serious policy errors.

DOI: <https://doi.org/10.17016/FEDS.2021.062>

PDF: [Full Paper](#)

Year-Over-Year Change in CPI

Seasonally Adjusted



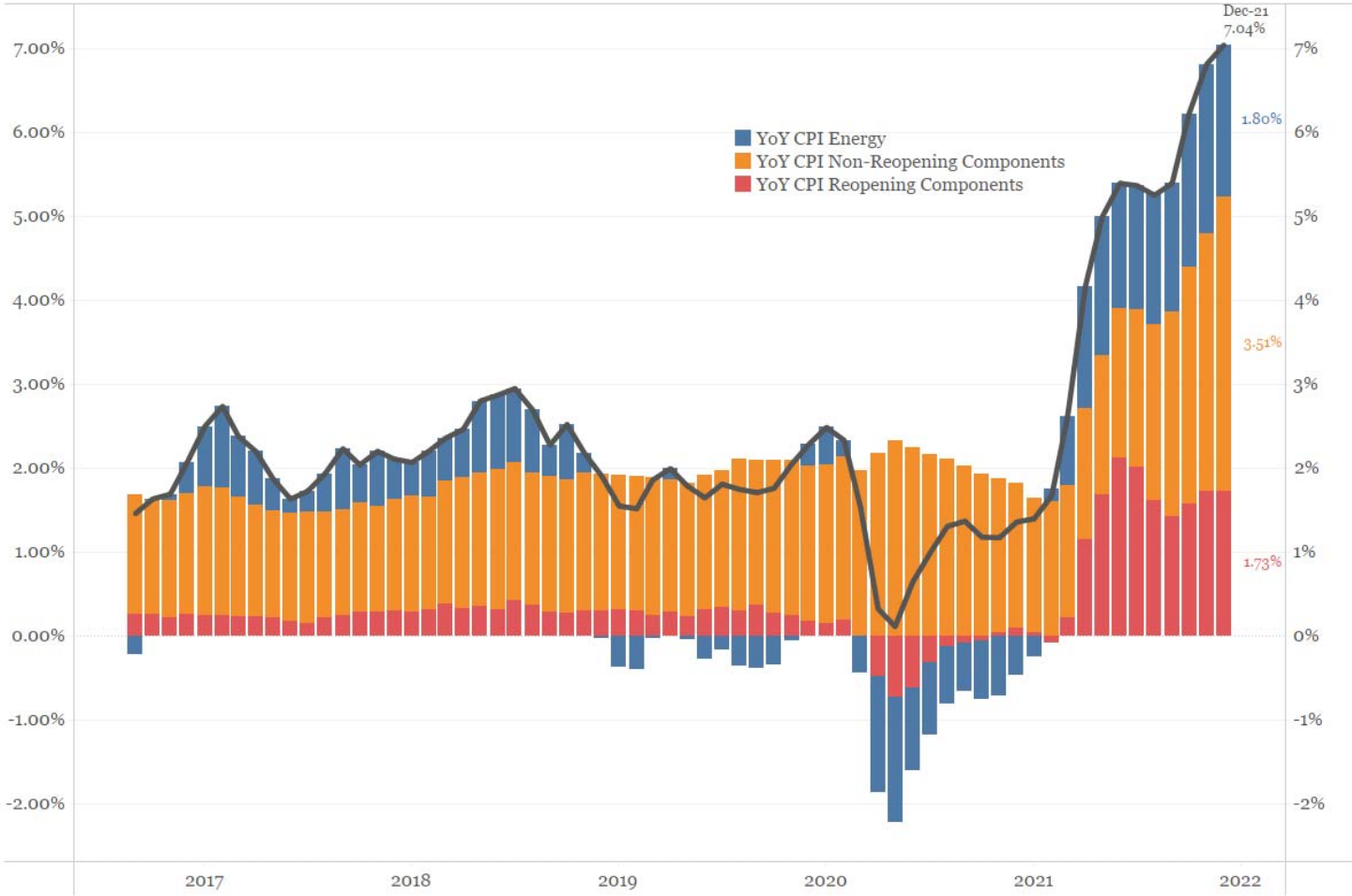
Source: The Bureau of Labor Statistics

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Reopening vs Non-Reopening Components of CPI

Year-over-Year Contributions

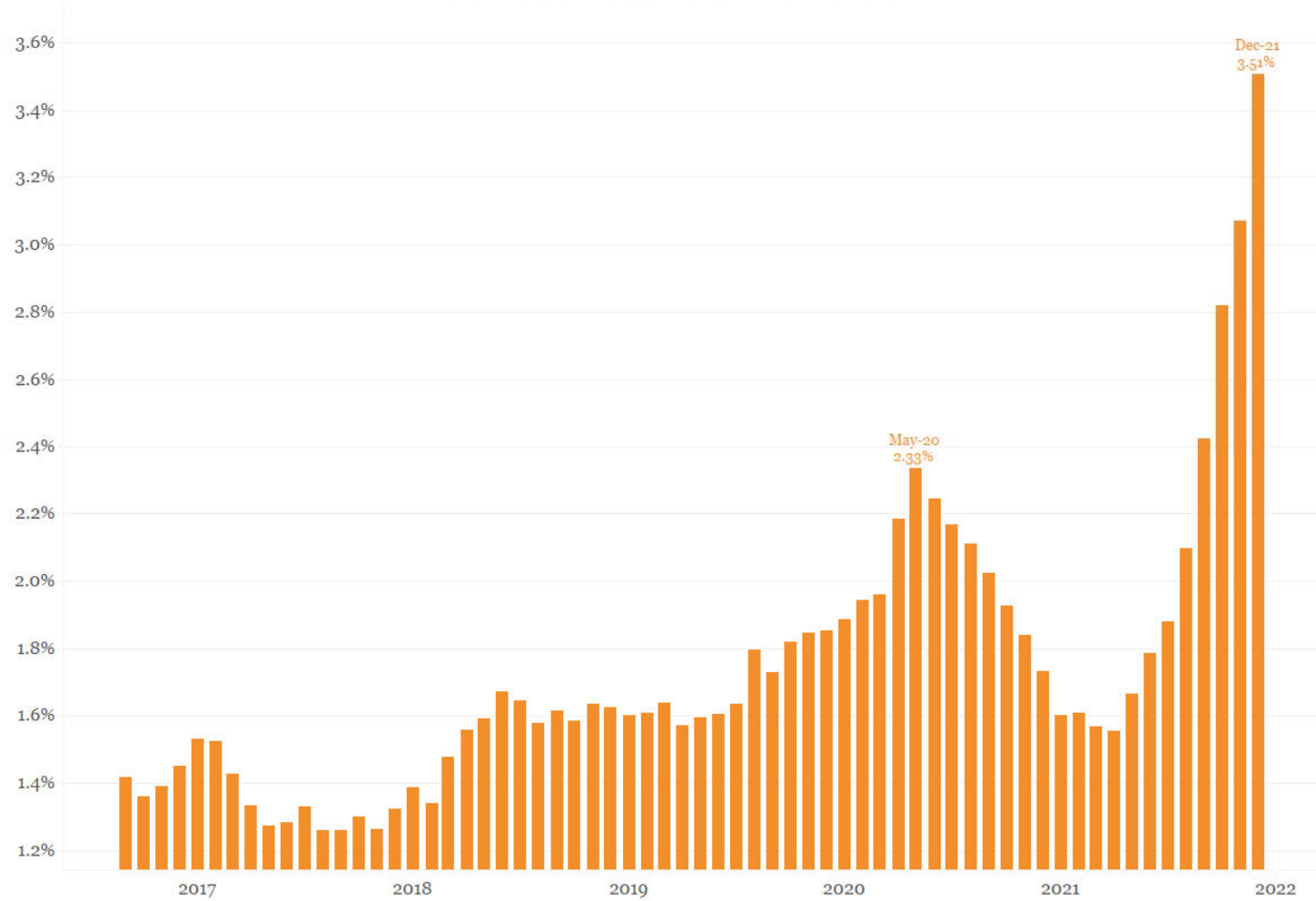
CPI Components	Weight
All items	100.00%
Energy	7.26%
Non-Reopening Components	78.41%
Reopening Components	14.33%
Food Away From Home	6.23%
Used Cars and Trucks	3.49%
Lodging Away From Home	1.11%
Other Lodging Away from Home Including Hotels and Motels	0.99%
Car and Truck Rentals	0.21%
Motor Vehicle Insurance	1.59%
Airline Fares	0.71%



Source: Bloomberg, Bureau of Labor Statistics

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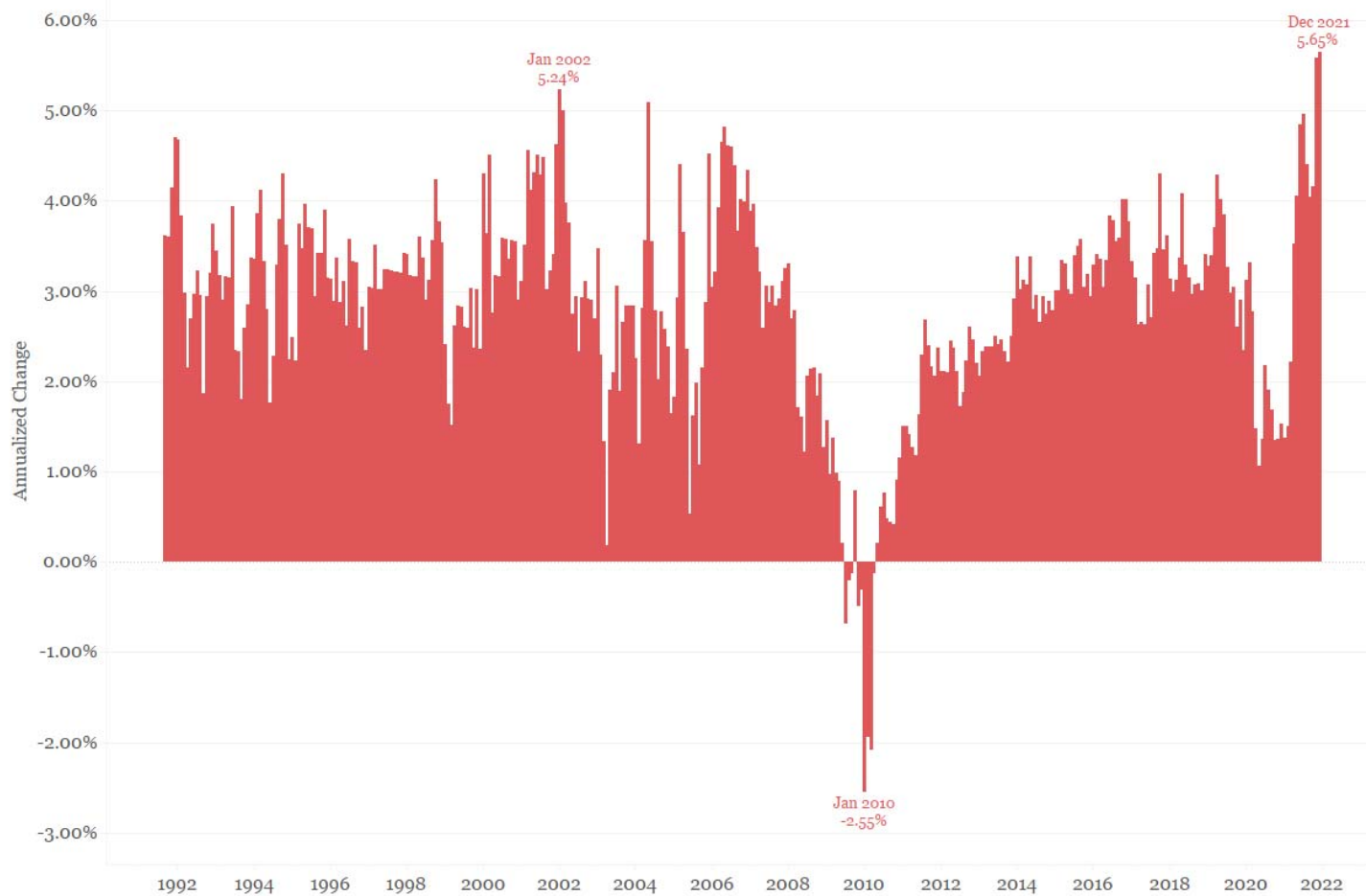
YoY CPI Non-Reopening Components



Data Source: Bloomberg, Bureau of Labor Statistics

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CPI Shelter 3-Month Annualized Change



Source: The Bureau of Labor Statistics

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The other one is we will eventually get relief on the supply side and, you know, the ports will be cleared up and there will be semiconductors and things like that. Now what we're learning is **it's just taking much longer, so I think longer than expected. And that I think does raise the risk that if - that high inflation will be more persistent.**

Monthly CPI Inflation

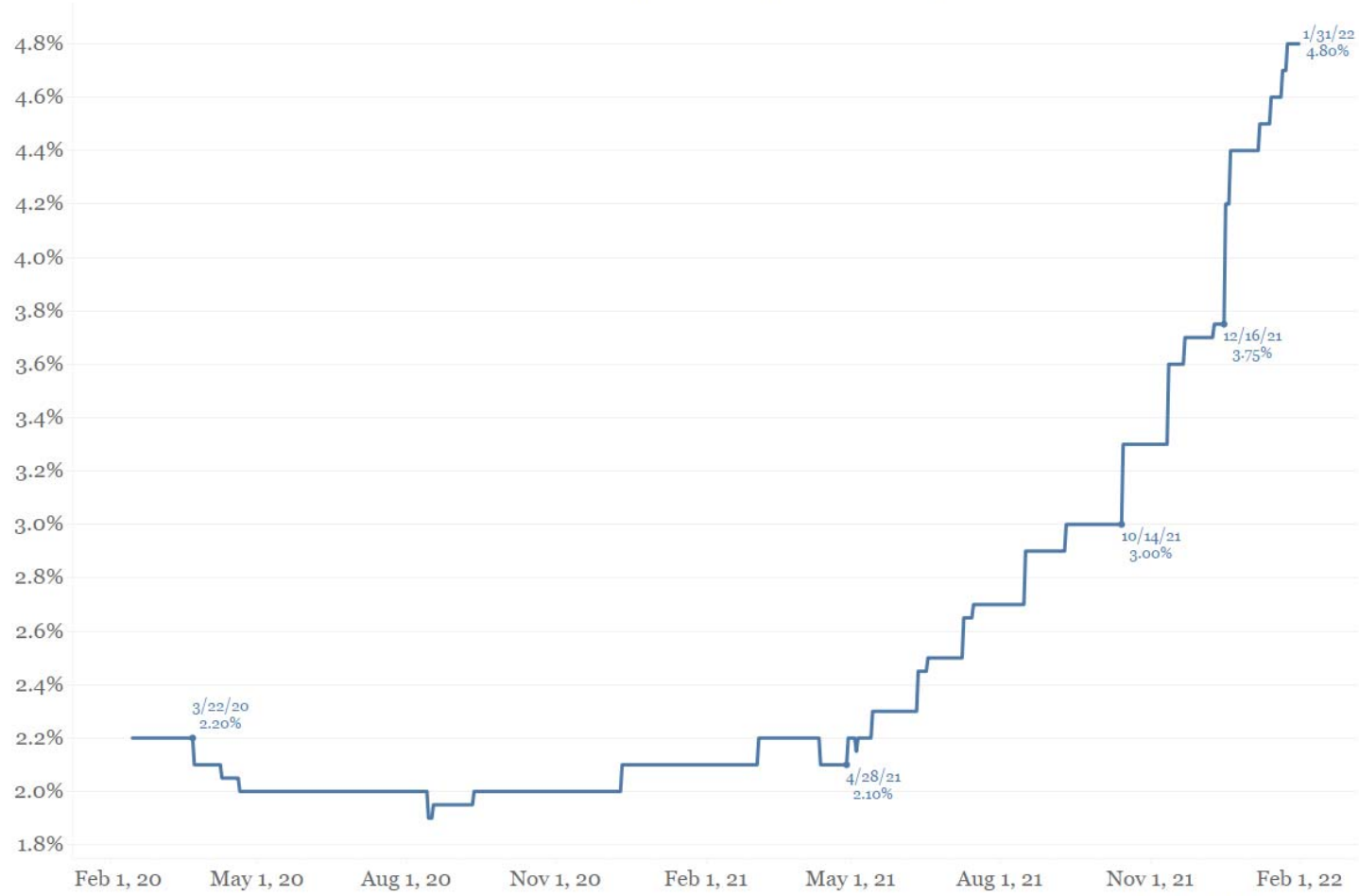


Source: Bloomberg

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Median Economists 2022 CPI Forecast

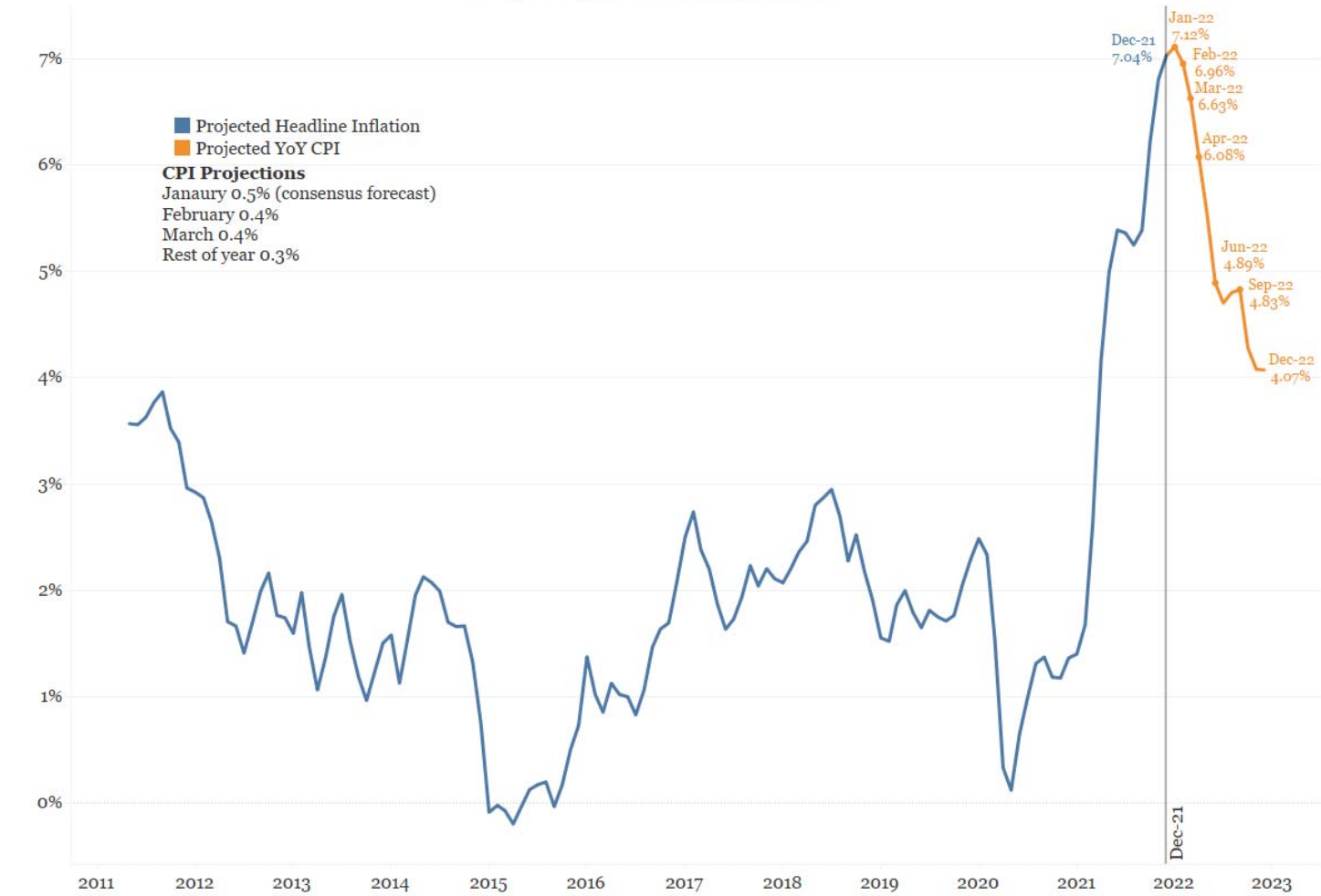
Estimate of 50-ish Economist Surveyed By Bloomberg



Data Source: Bloomberg

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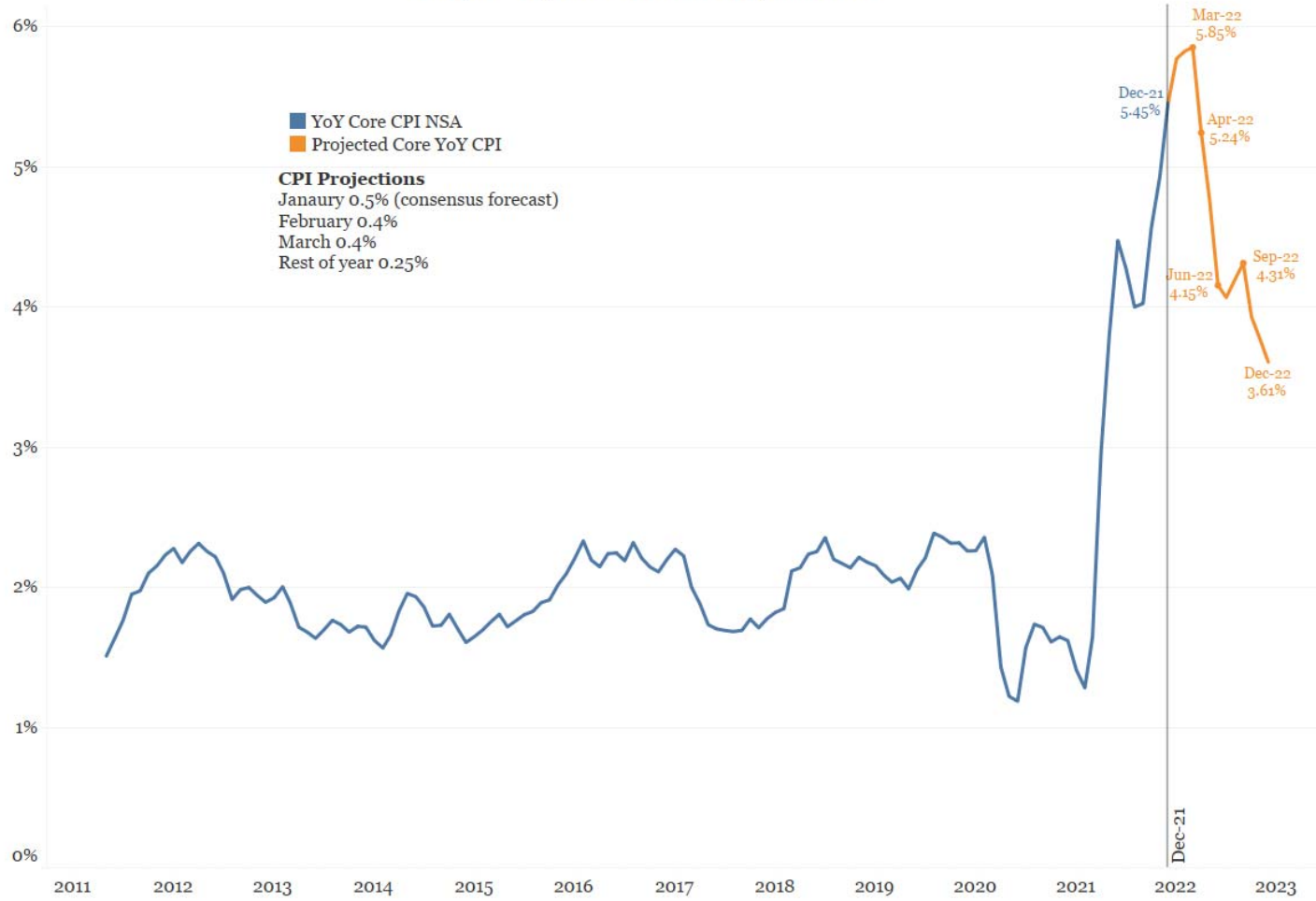
Projecting CPI Throughout 2022



Data Source: Bloomberg, Bureau of Labor Statistics

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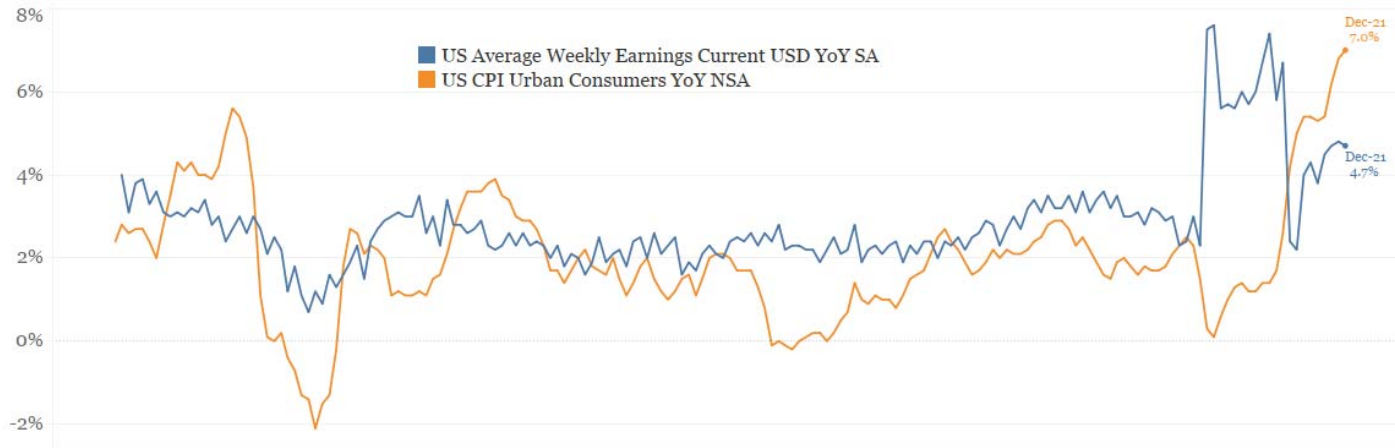
Projecting Core CPI Throughout 2022



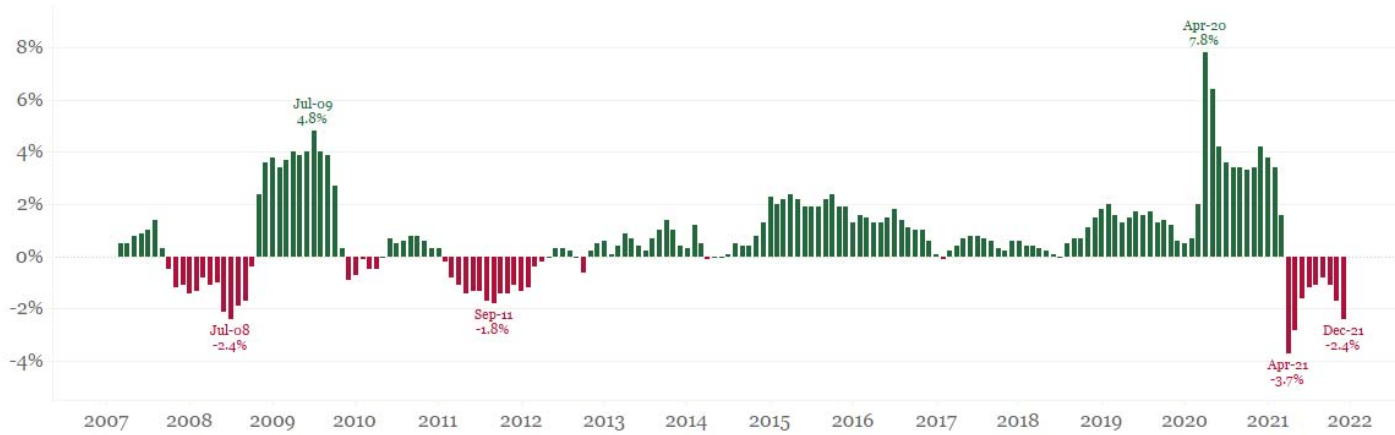
Data Source: Bloomberg, Bureau of Labor Statistics

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Inflation and Wages



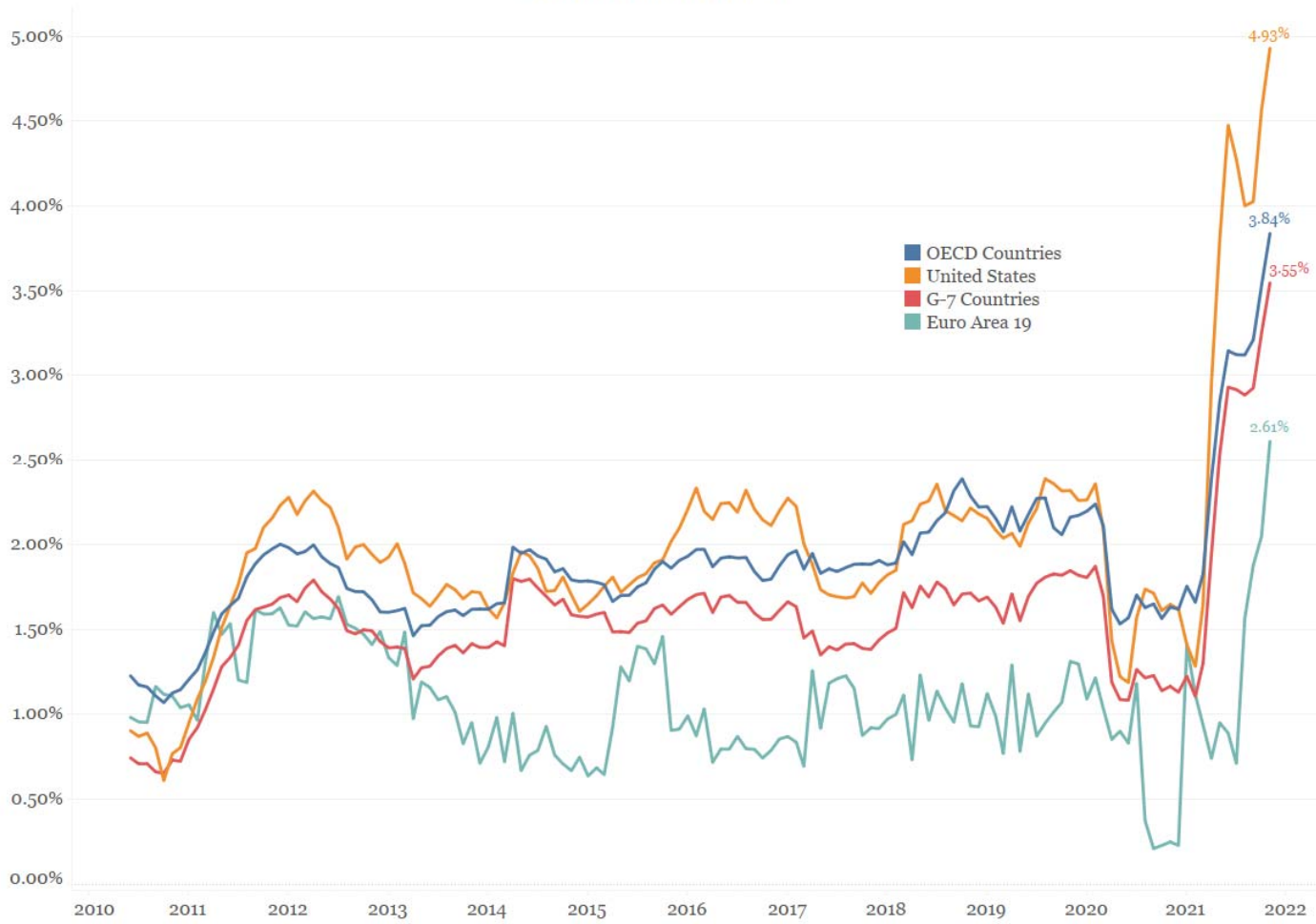
US Real Average Hourly Earnings YoY SA Wages minus Inflation



Source: The Bureau of Labor Statistics, Bloomberg

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Core Inflation Rates



Source: Organization for Economic Cooperation and Development

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Core Inflation Around the World



Source: OECD

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• ***Barron's – (January 8, 2022) Supply-Chain Constraints Are Easing. 5 Stocks That Should Benefit.***

Global supply-chain constraints are beginning to ease, which will benefit a host of stocks

• ***The Financial Times – (January 27, 2022) Apple's revenue hits another record as it navigates supply chain crunch***

iPhone maker's earnings top expectations after chip shortages do less damage than feared
[Finance chief Luca] Maestri said supply chain concerns were being resolved, adding: "We expect to set a March quarter revenue record and we expect to grow revenue solidly on a year-over-year basis."

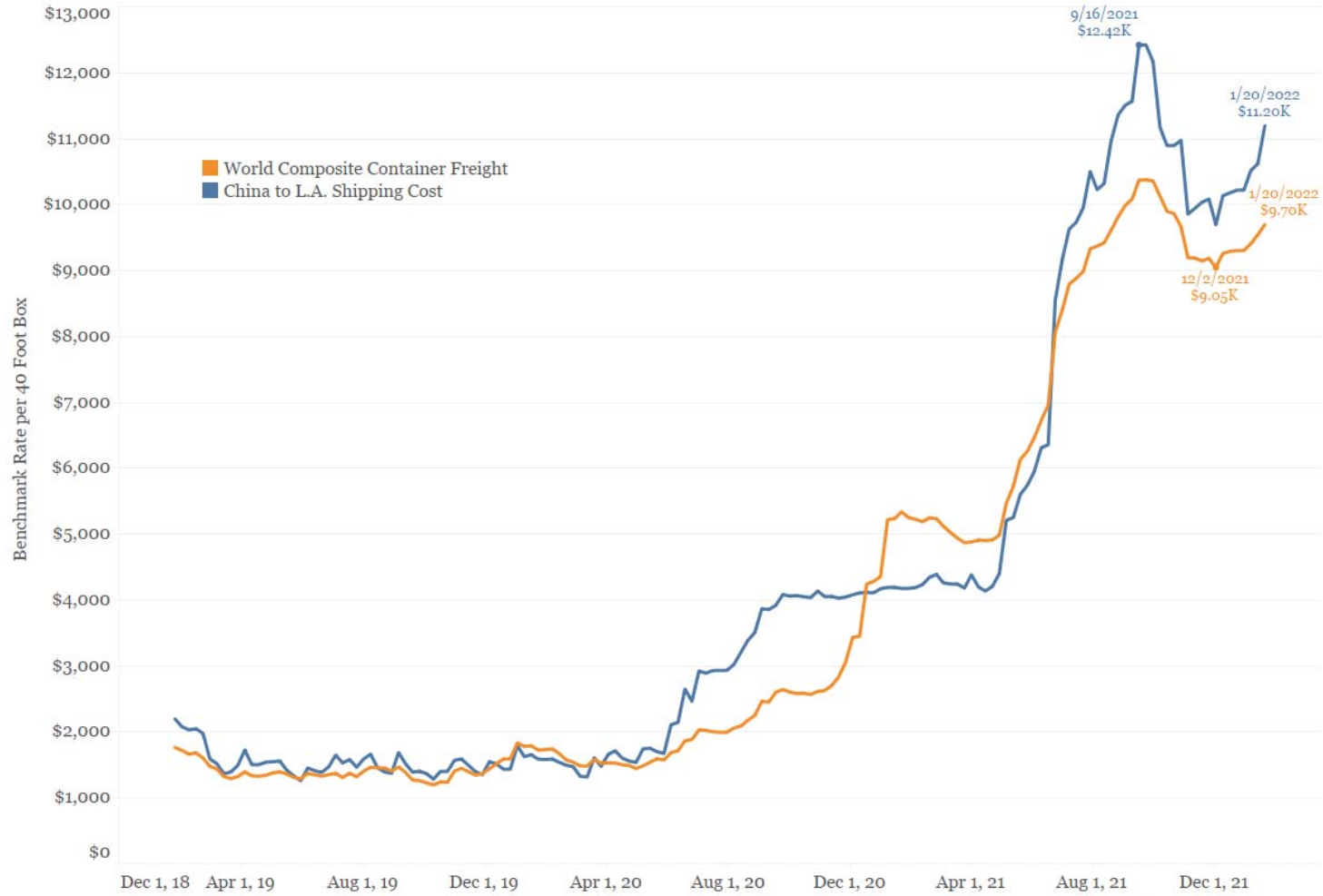
• ***The Financial Times – (January 26, 2022) Tesla warns of supply chain constraints as it reports record profit***

Electric vehicle pioneer says factories 'have been running below capacity for several quarters'

Powell: I would not say that I would expect the supply chain issues to be completely worked out by the end of this year. I do not expect them and I have not expected them. What I would say and I have been saying is that I expect progress to be made in the second half of this year, mainly, progress. **Because we're not making much progress. If you look at a ton of metrics you can find some that suggest that delivery times are shorter and inventories in some industries moving up. But overall, we're not — we're not making progress.** And things like the semiconductor issue, we're going to — they're going to be quite a long time. I would think they'll go more than through to 2023.

The other one is we will eventually get relief on the supply side and, you know, the ports will be cleared up and there will be semiconductors and things like that. Now what we're learning is it's just taking much longer, so I think longer than expected. **And that I think does raise the risk that if – that high inflation will be more persistent.**

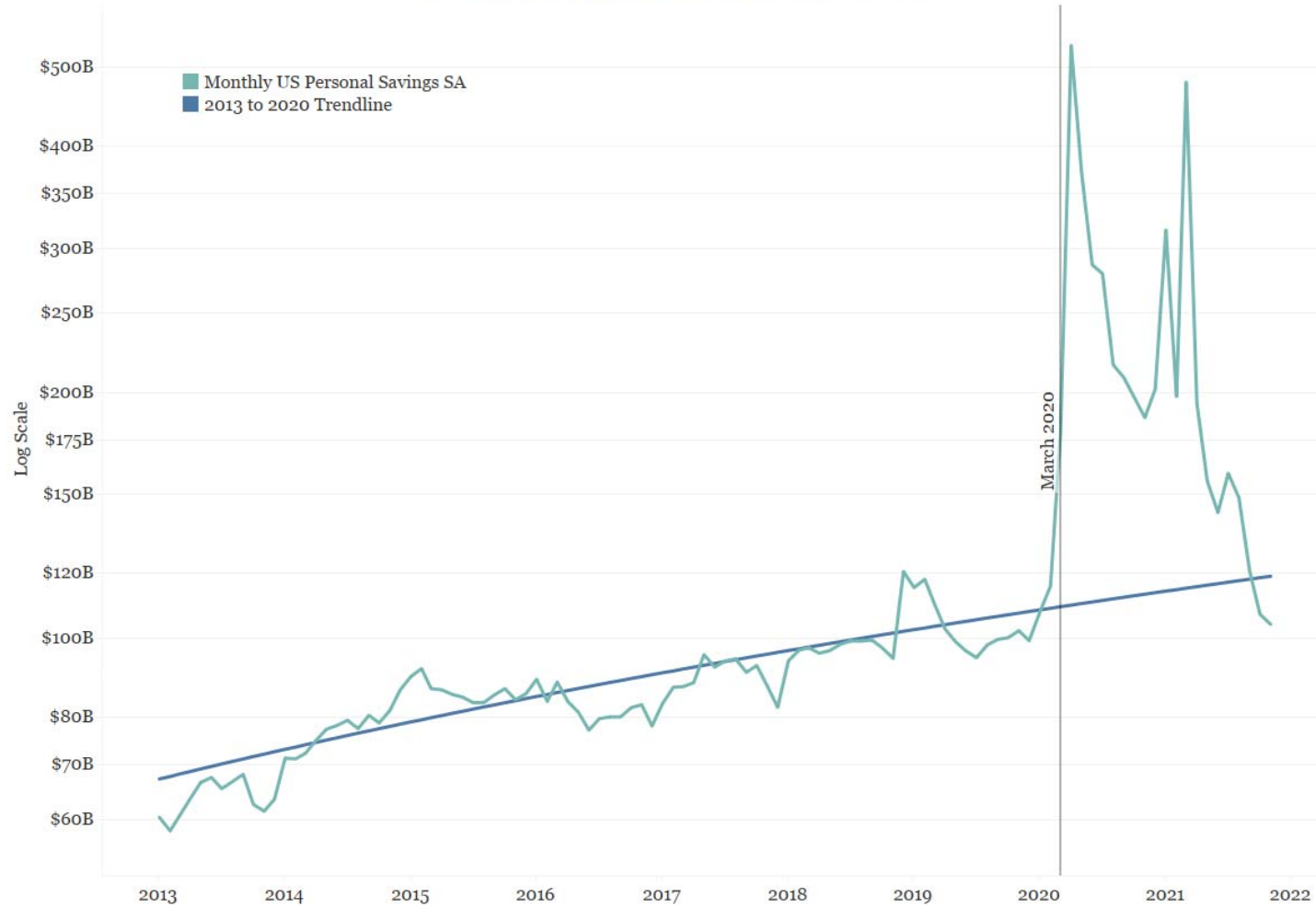
China to US Container Rates



Source: Drewry World Container Index, TAC Freight

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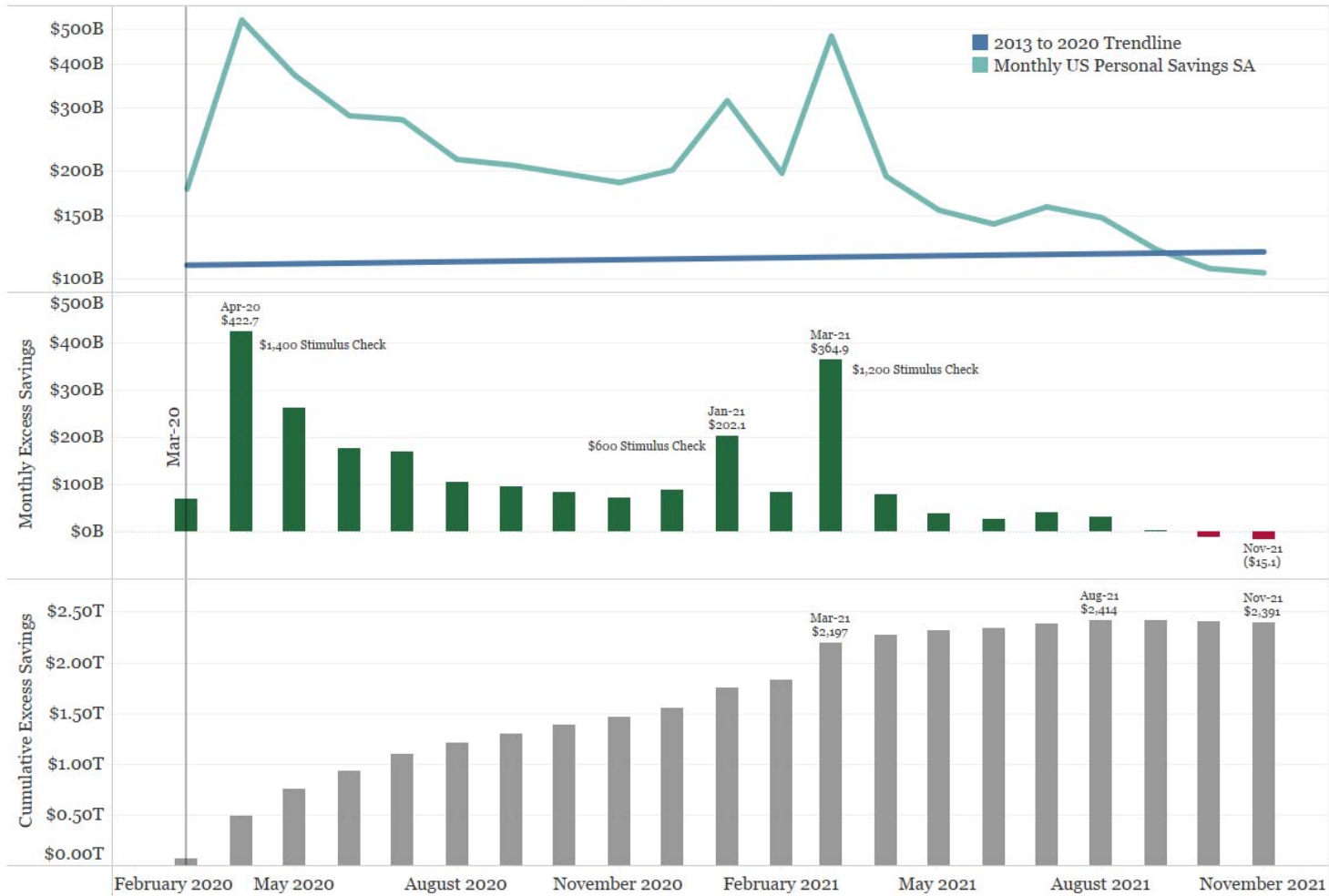
The Savings Rate and its 2013 to 2020 Trend



Source: Bloomberg

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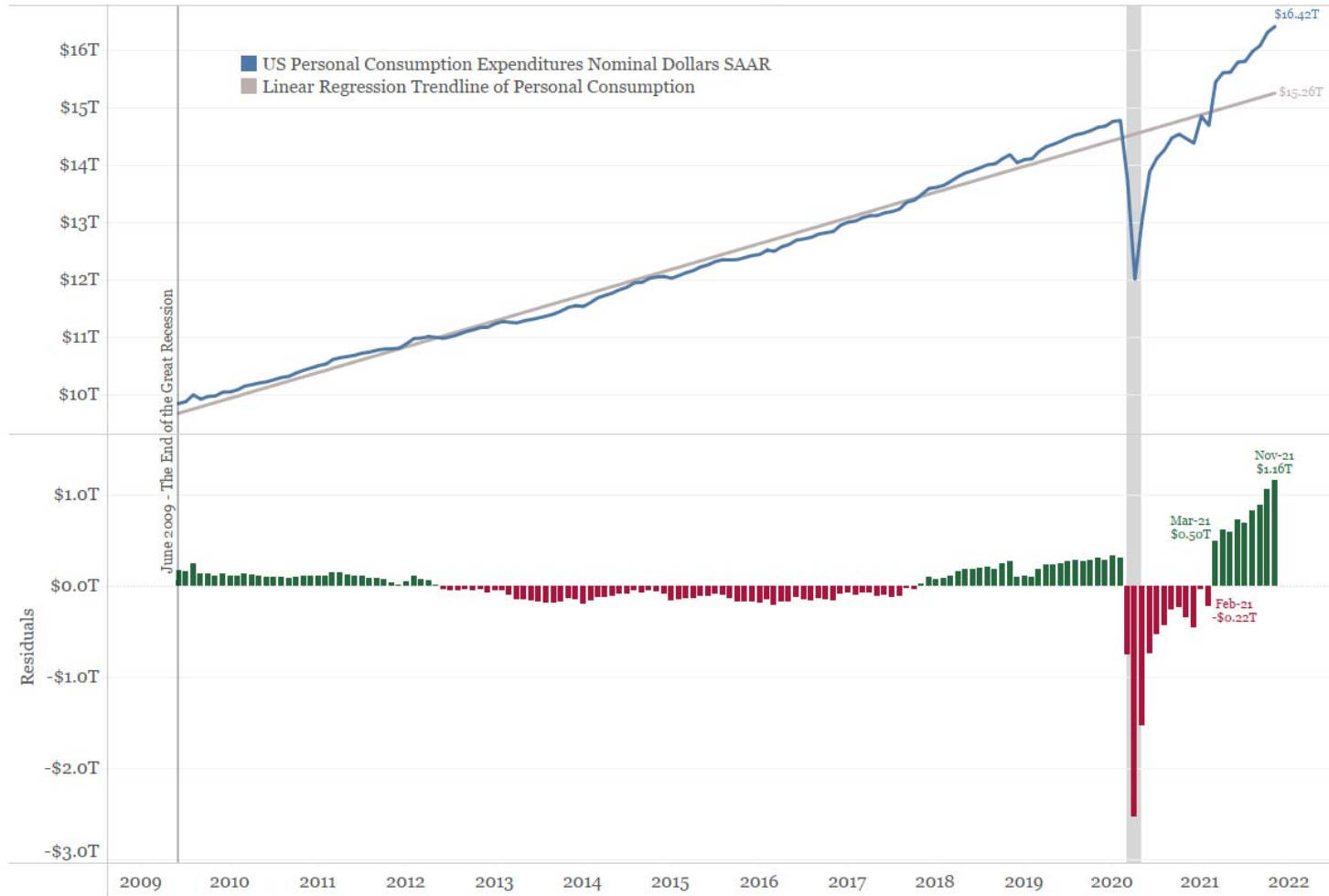
Excess Savings



Source: Bloomberg

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Personal Consumption



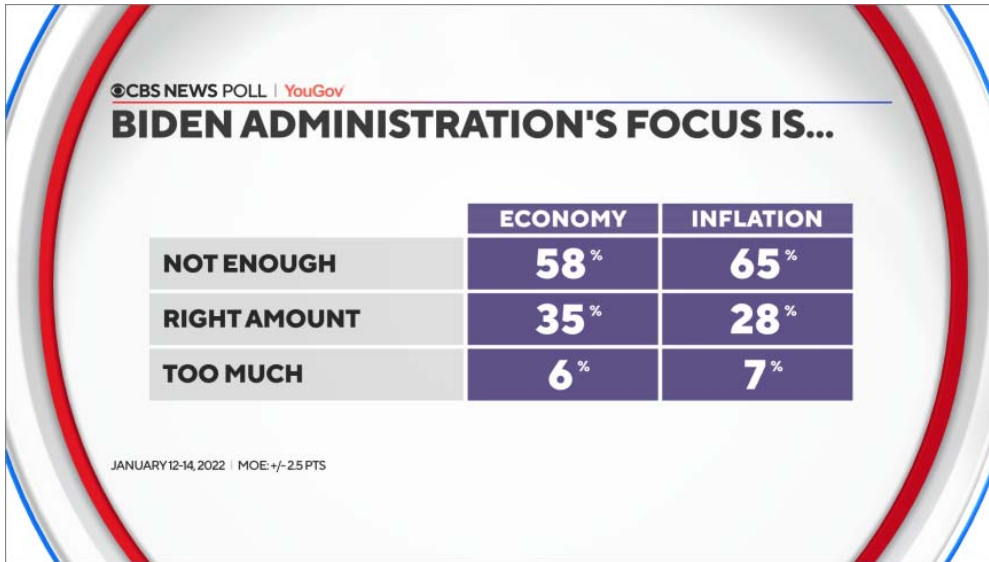
Source: Bureau of Economic Analysis, Bloomberg

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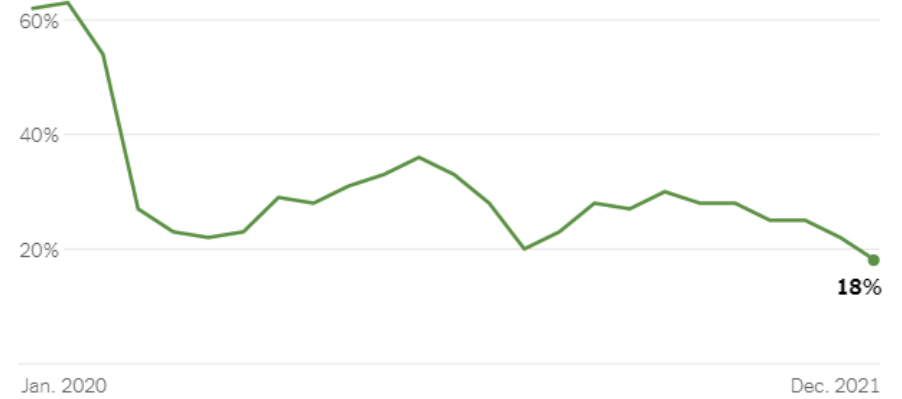
From the transcript of Biden's presser last week.

Now the second challenge we're facing are prices. COVID-19 has created a lot of economic complications, including rapid price increases across the world economy. People see it at the gas pumps, the grocery stores and elsewhere.

*So, here's what we're going to do. A critical job in making sure that the elevated prices don't become entrenched rests with the Federal Reserve, which has a dual mandate, full employment and stable prices. The Federal Reserve provided extraordinary support during the crisis for the previous year-and-a-half. Given the strength of our economy and the pace of recent price increases. It's appropriate, as the Federal chairman, **Chairman Powell, the Fed chairman, Powell, has indicated, to recalibrate the support that is now necessary.***

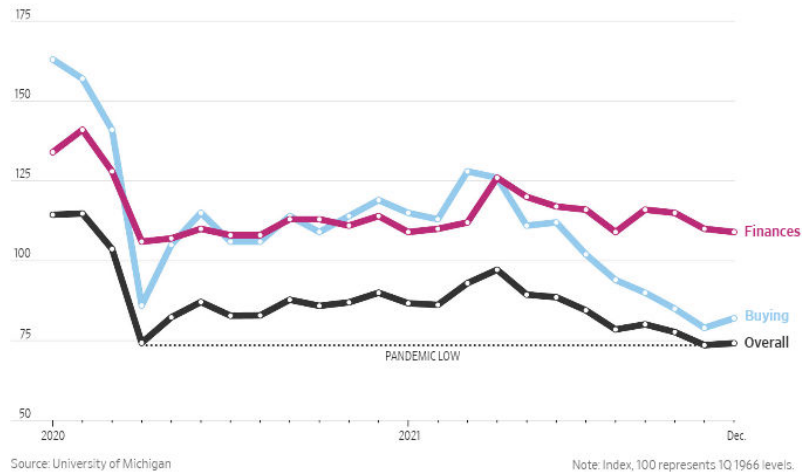


Share of Americans who rate U.S. economic conditions as excellent or good



Source: Gallup • By The New York Times

Consumer sentiment, current conditions



• *The New York Times* – [Prices and Ire, Rising](#)

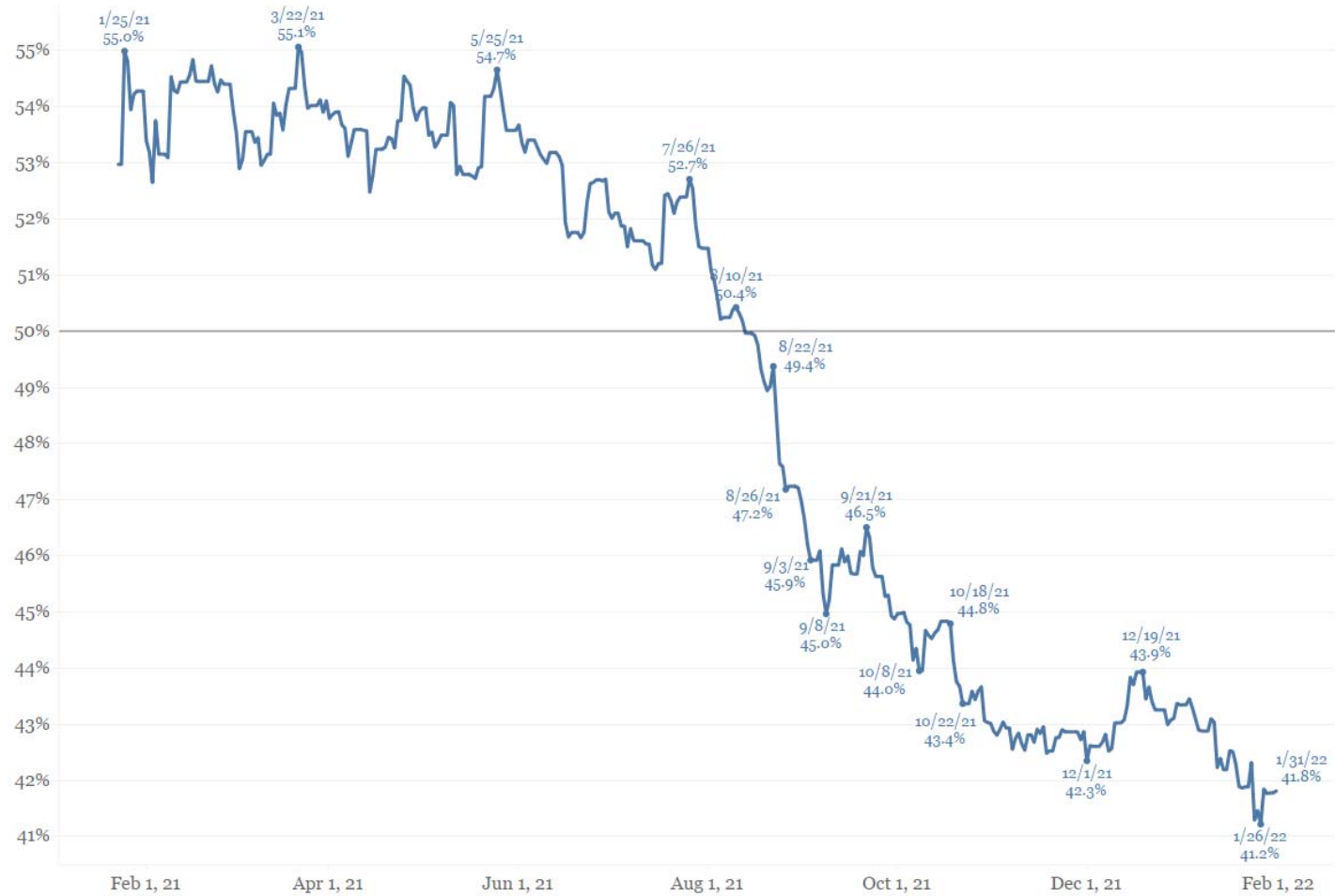
Inflation is up, and Americans are mad. But it's not a simple story.

But inflation is [especially high in the U.S.](#) The main reason is probably that this country spent more money on pandemic stimulus than many other countries. A second reason is that daily life here remains more disrupted than in [much of Europe](#) or Asia.

• *Wall Street Journal* – [Consumer Pessimism Grows as Inflation Accelerates](#)

Demand for labor is still high, despite growing employment costs. Industries hit hard by the pandemic, such as leisure and hospitality businesses, have since seen large wage gains and a steep climb in payrolls. Leisure and hospitality jobs have recovered 2.6 million positions in 2021. Likewise, retail jobs have outpaced the overall labor market, while those jobs have been more expensive to fill. Continued recovery in hiring for in-person services and shopping—at a time when the Great Resignation has driven up the costs of workers—shows that businesses think there will be room to grow.

Biden's Approval Rating FiveThirtyEight's Average of Approval Using All polls

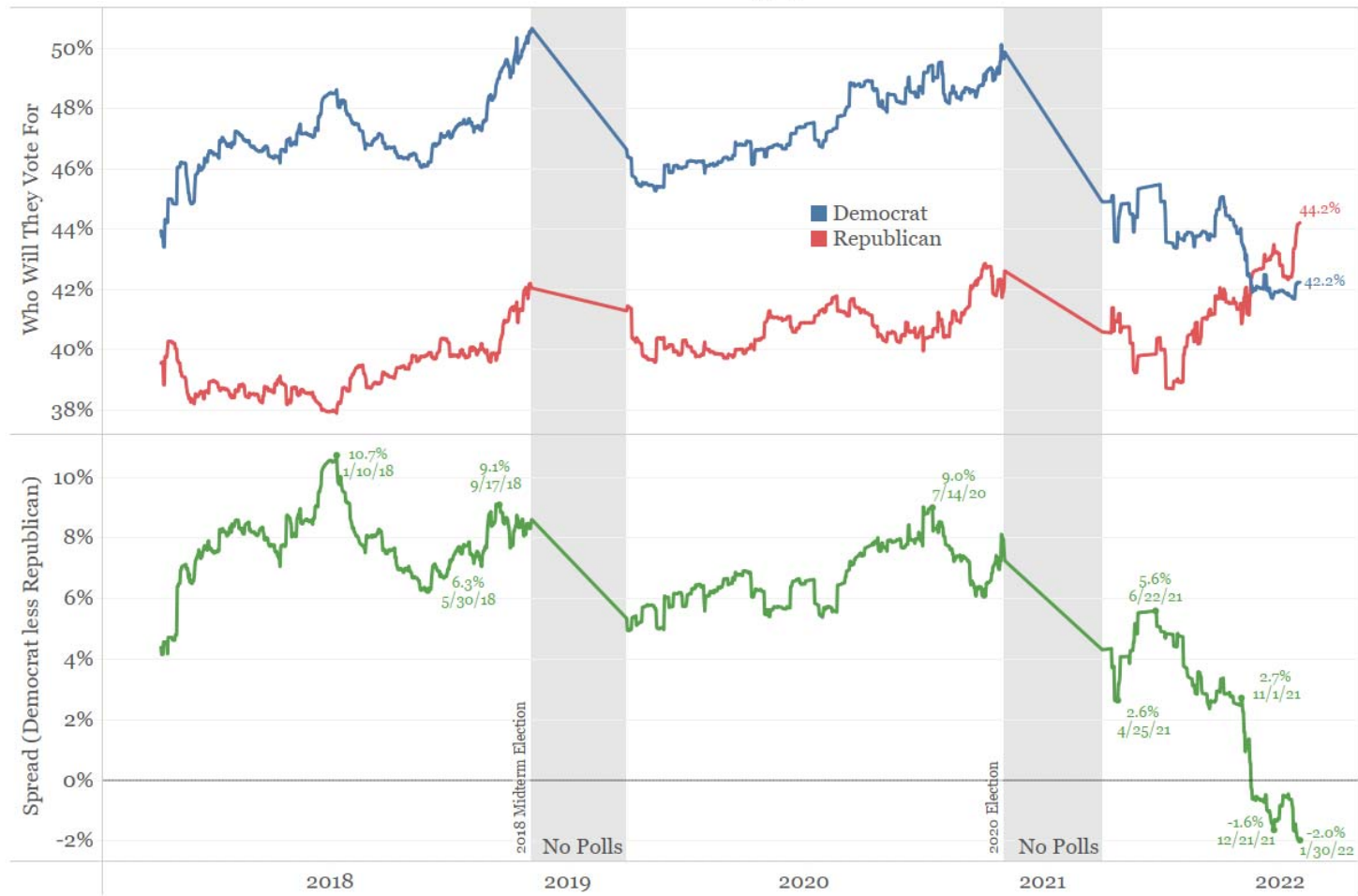


Source: FiveThirtyEight Blog
<https://projects.fivethirtyeight.com/biden-approval-rating/>

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Which Party Will You Vote For?

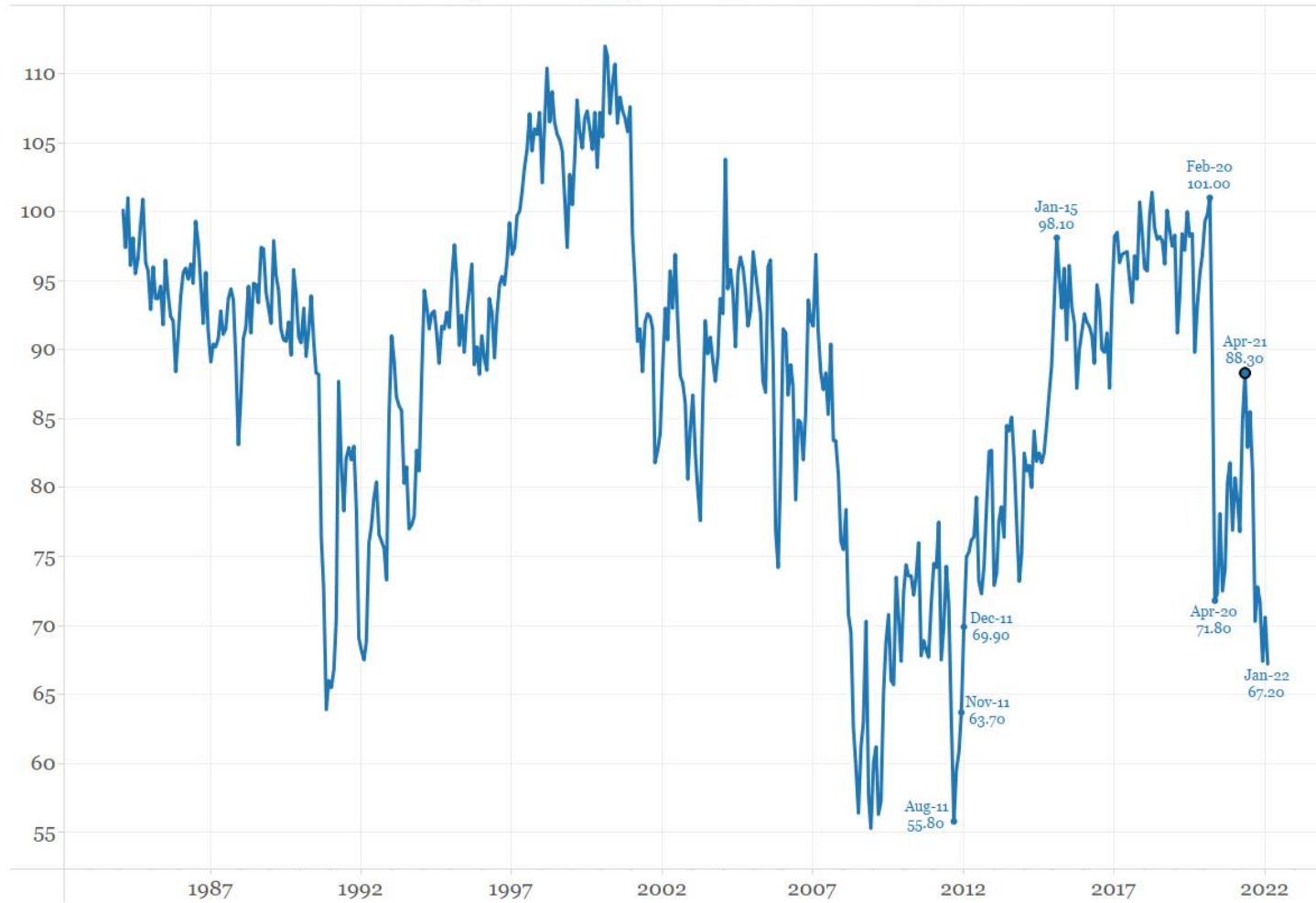
Generic Ballot - All Polls Aggregated



Source: FiveThirtyEight Blog

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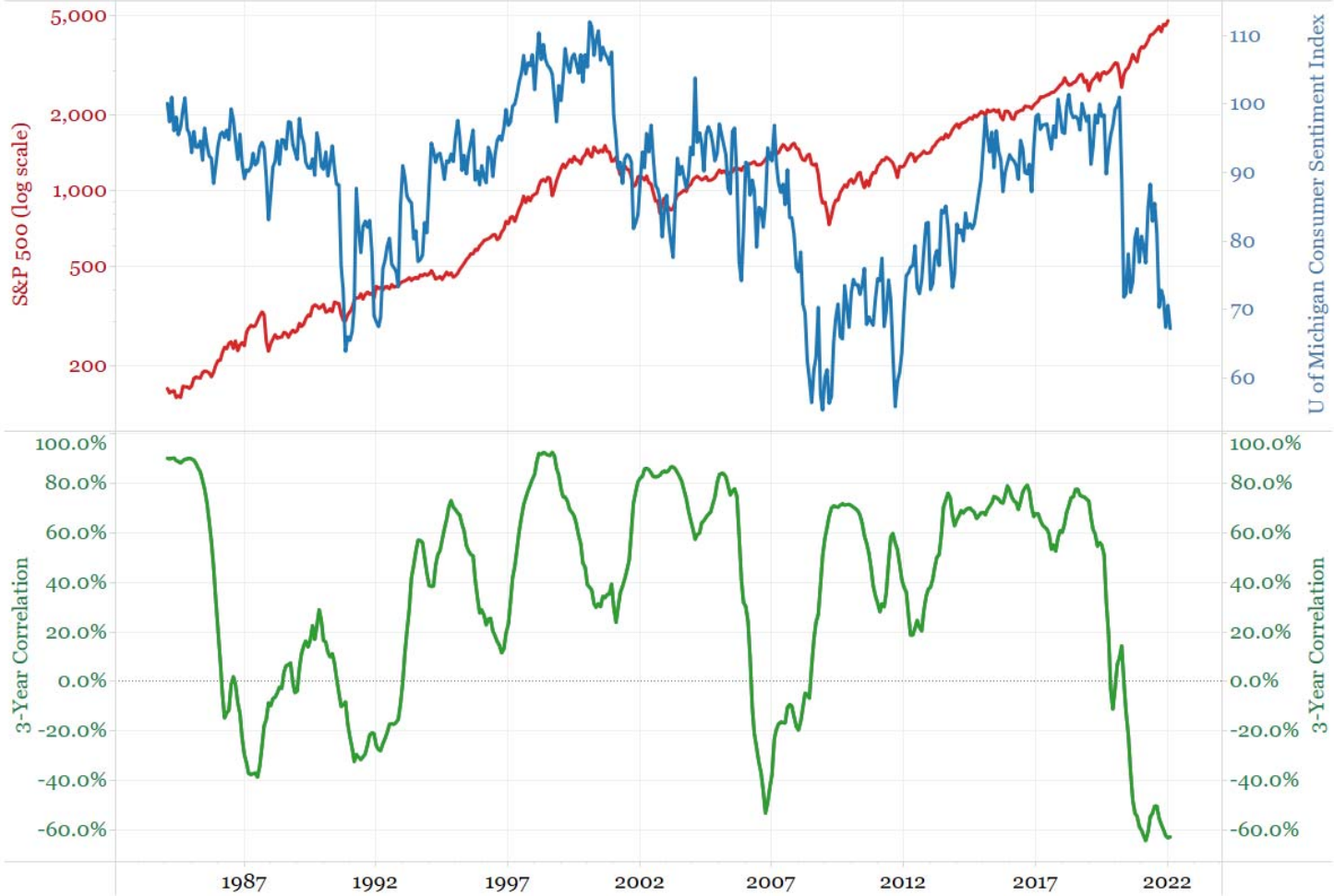
University of Michigan Consumer Sentiment



Source: University of Michigan

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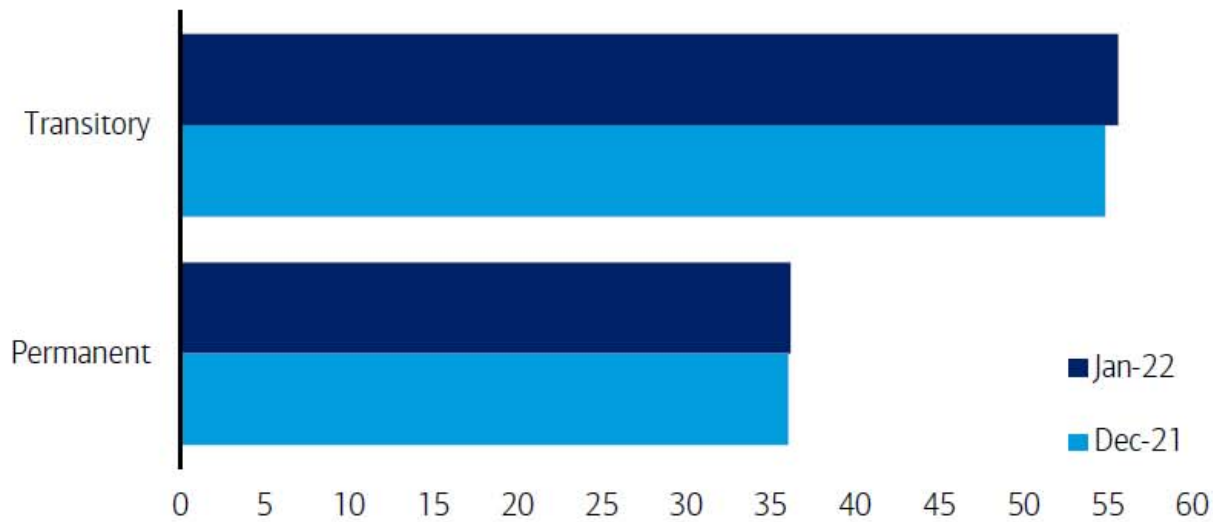
Consumer Confidence vs. The S&P 500



Data Source: University of Michigan, Standard & Poors, Bloomberg

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Chart 7: 36% of investors think inflation is permanent
Do you think inflation is transitory or permanent?



...and only 36% think inflation is permanent while 56% think it is transitory...

Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

From the transcript of the Powell Presser

So, you ask whether we can - whether we can raise rates and - and move to less accommodative and even tight financial conditions without hurting the labor market. I think there is quite a bit of room to raise interest rates without threatening the labor market.

When Does the Market Expect the Fed to Hike?

Probability of a Hike as of February 3, 2022

Green Cells Mark Hike Probabilities over 50%, Bold 40% to 49%

FOMC Meeting	One Hike to 0.25% - 0.50%	Two Hikes to 0.50% - 0.75%	Three Hikes to 0.75% - 1.00%	Four Hikes to 1.00% - 1.25%	Five Hikes to 1.25% - 1.50%	Six Hikes to 1.50% - 1.75%	Seven Hikes to 1.75% - 2.00%	Eight Hikes to 2.00% - 2.25%
16-Mar-22	87%	13%	0%	0%	0%	0%	0%	0%
4-May-22	100%	82%	11%	0%	0%	0%	0%	0%
15-Jun-22	100%	99%	78%	10%	0%	0%	0%	0%
27-Jul-22	100%	100%	91%	51%	6%	0%	0%	0%
21-Sep-22	100%	100%	96%	74%	32%	3%	0%	0%
2-Nov-22	100%	100%	97%	82%	48%	14%	1%	0%
14-Dec-22	100%	100%	99%	92%	69%	35%	9%	1%
1-Feb-23	100%	100%	99%	94%	76%	46%	18%	4%
15-Mar-23	100%	100%	100%	97%	87%	64%	34%	12%
3-May-23	100%	100%	100%	98%	89%	69%	41%	17%
14-Jun-23	100%	100%	100%	99%	93%	77%	53%	27%
26-Jul-23	100%	100%	100%	99%	94%	80%	58%	32%

Source: The Chicago Mercantile Exchange

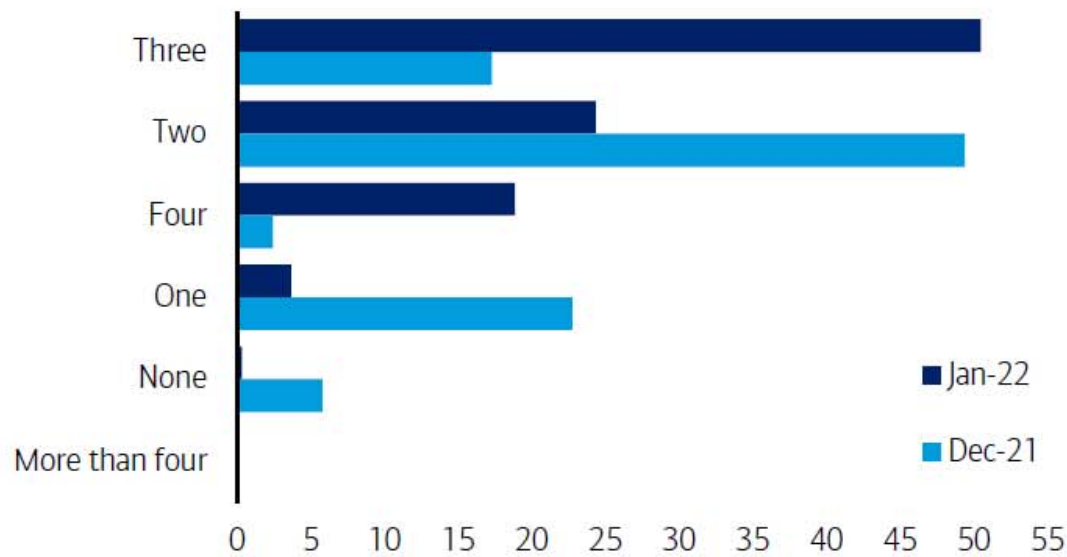
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<https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html>

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Chart 9: Investors expect 3 rate hikes in 2022

How many times do you think the Fed will raise rates in 2022



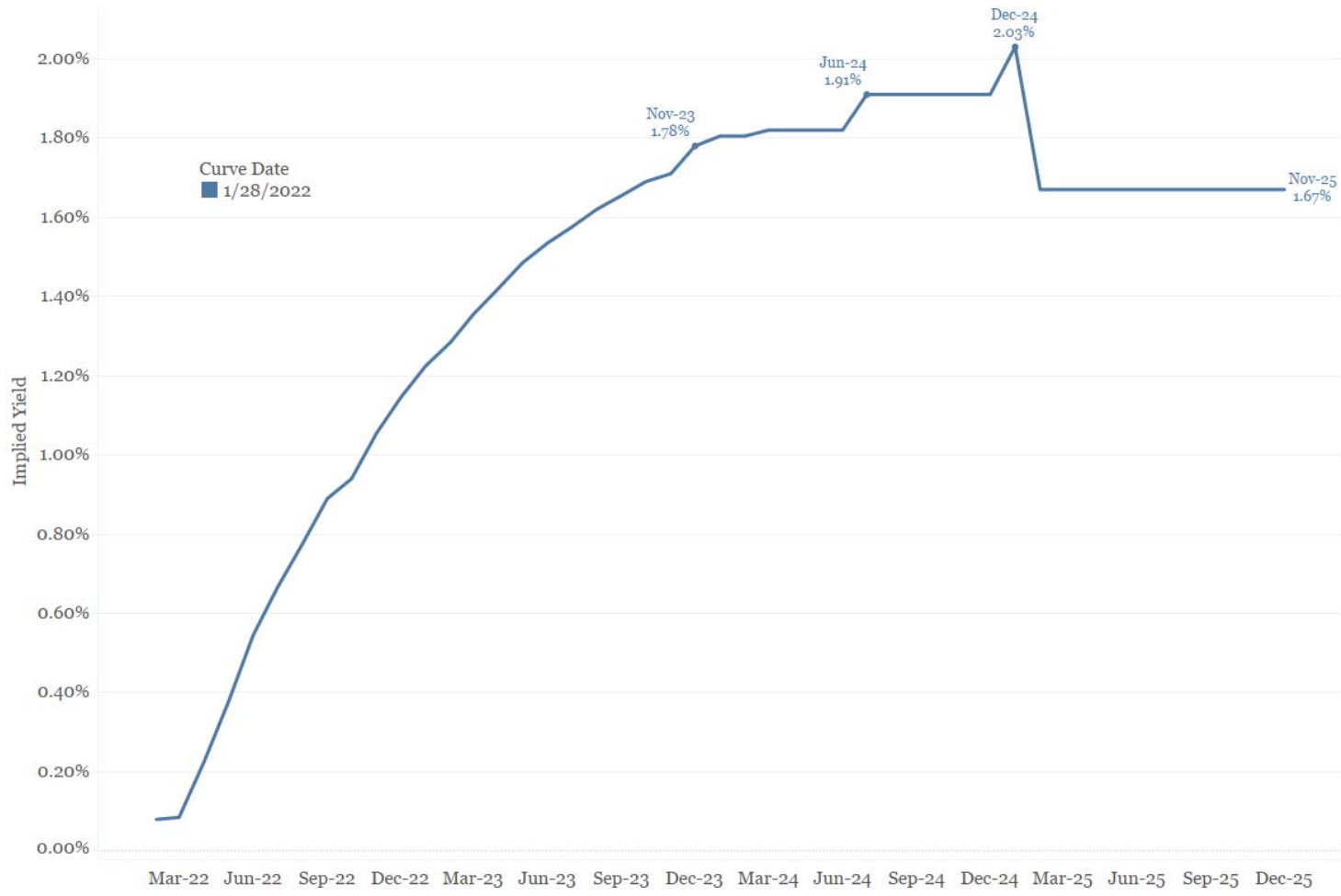
Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

In line with still elevated expectations of inflation, FMS investors now on average expect 3 Fed hikes in 2022 (+1 MoM).

Investors now expect the first hike announcement to take place mid Apr'22 (up from Jul'22)...

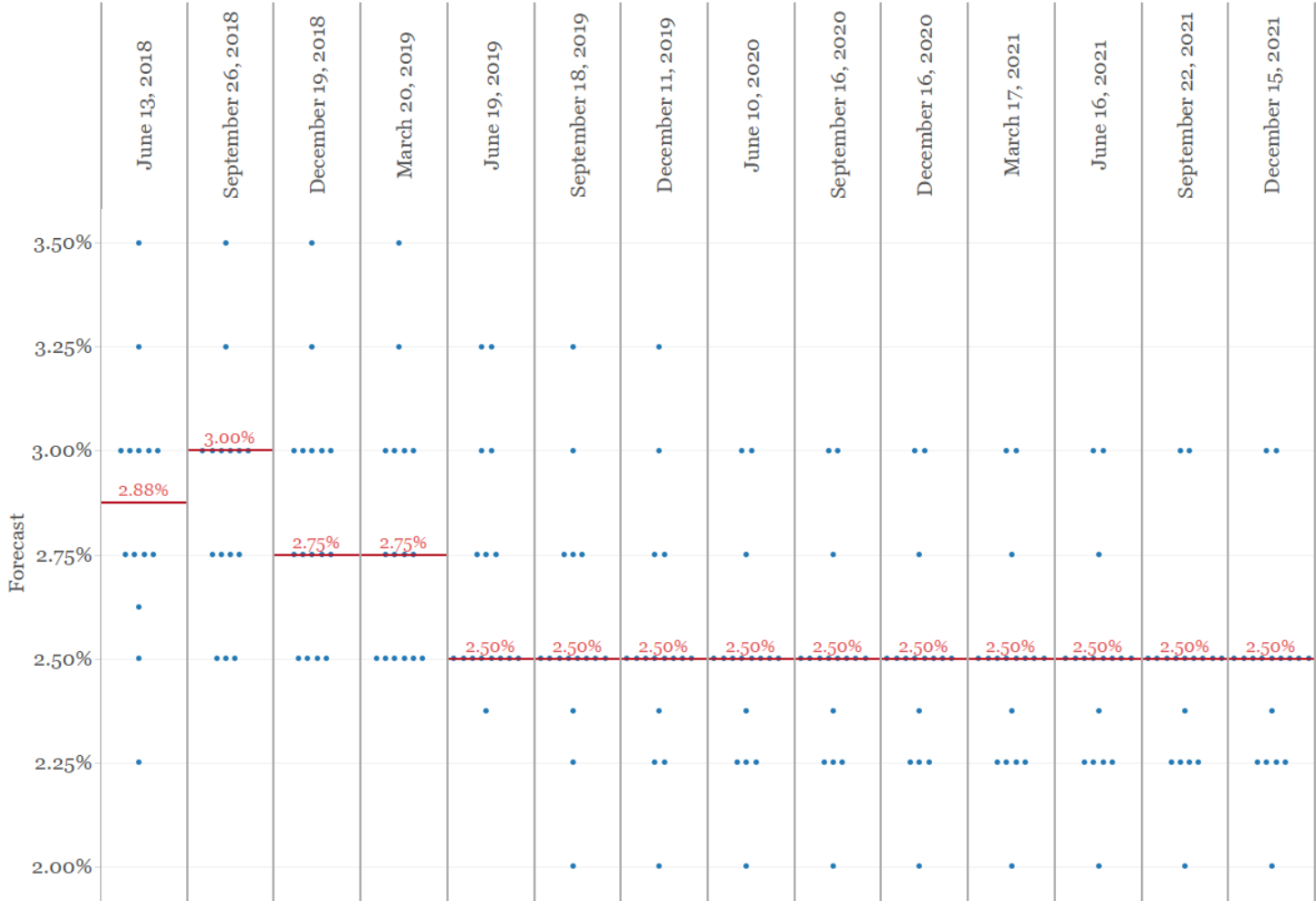
What is The Terminal Fed Funds Rate? Using the Fed Fund Futures Forward Curve



Source: Chicago Mercantile Exchange, Bloomberg

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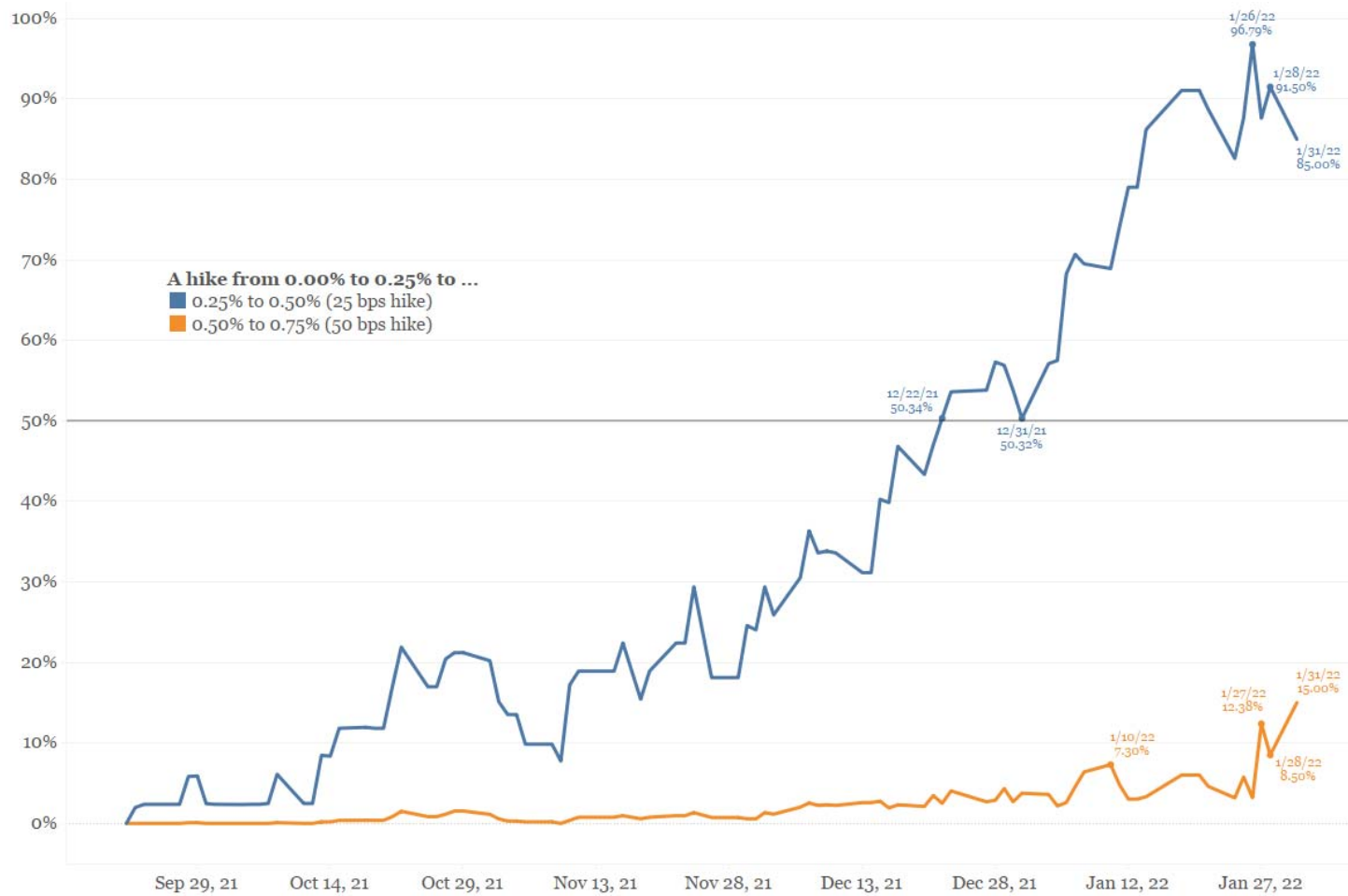
Fed Projection For Long-Term



Source: The Federal Reserve

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How Much Will The Fed Hike on March 16, 2022? As Calculated by the Chicago Mercantile Exchange "Fed Watch" Tool



Source: Chicago Mercantile Exchange
<https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html>

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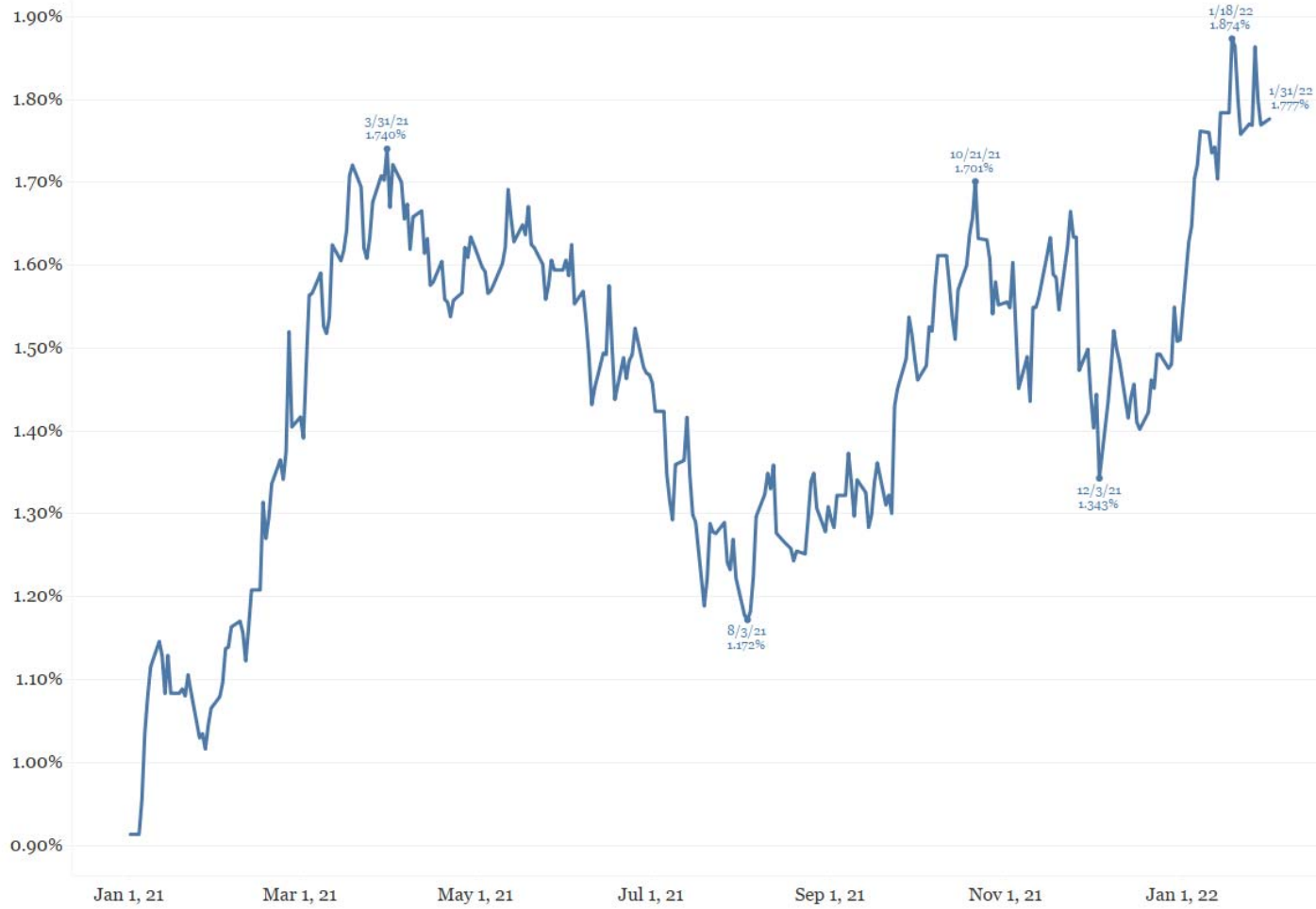
US 2-Year Yield



Source: Bloomberg

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US 10-Year Yield



Source: Bloomberg

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The 10-Year less 2-Year Yield Curve

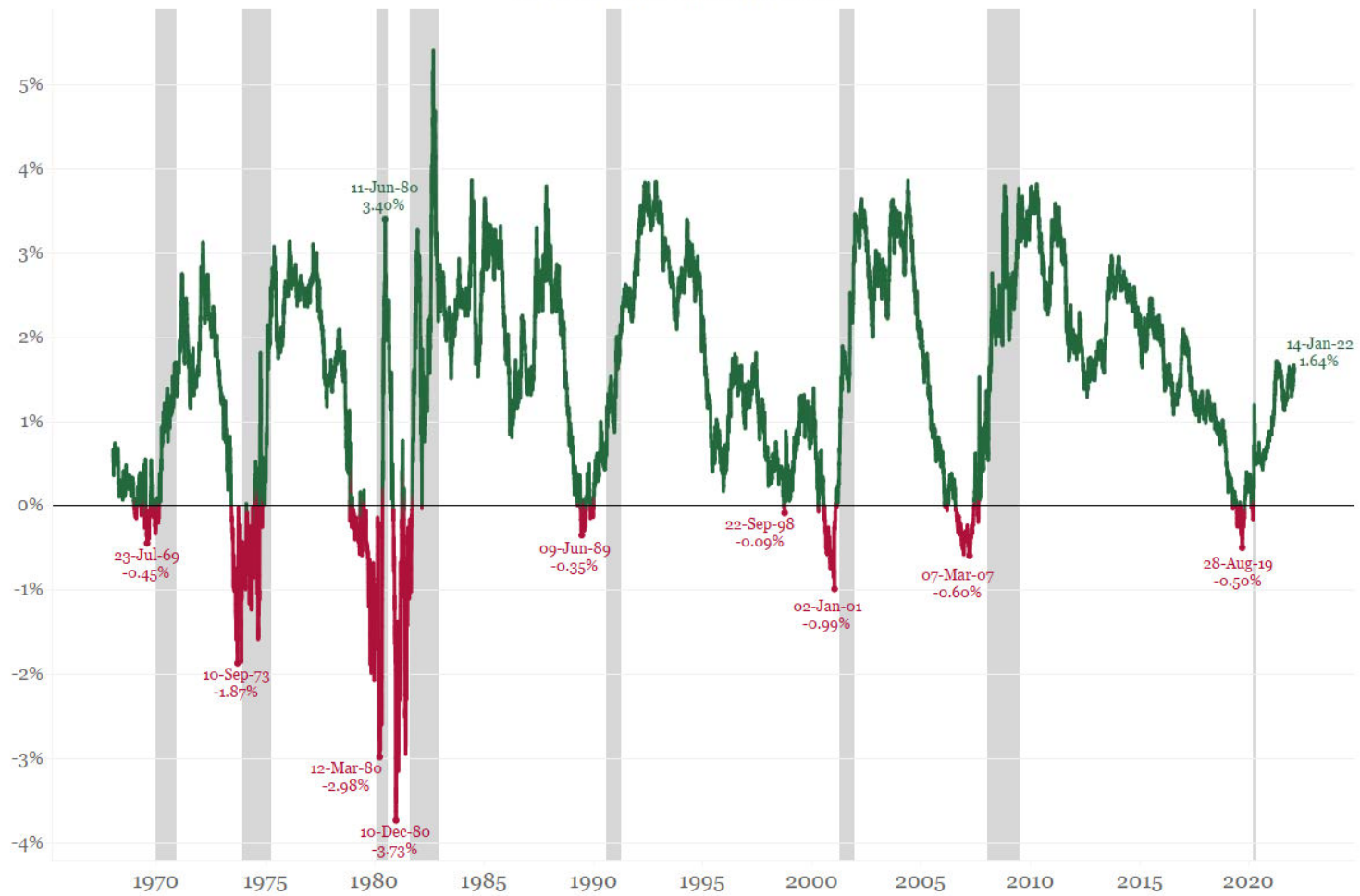


Source: Bloomberg

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Yield Curve Inversions Lead Recessions

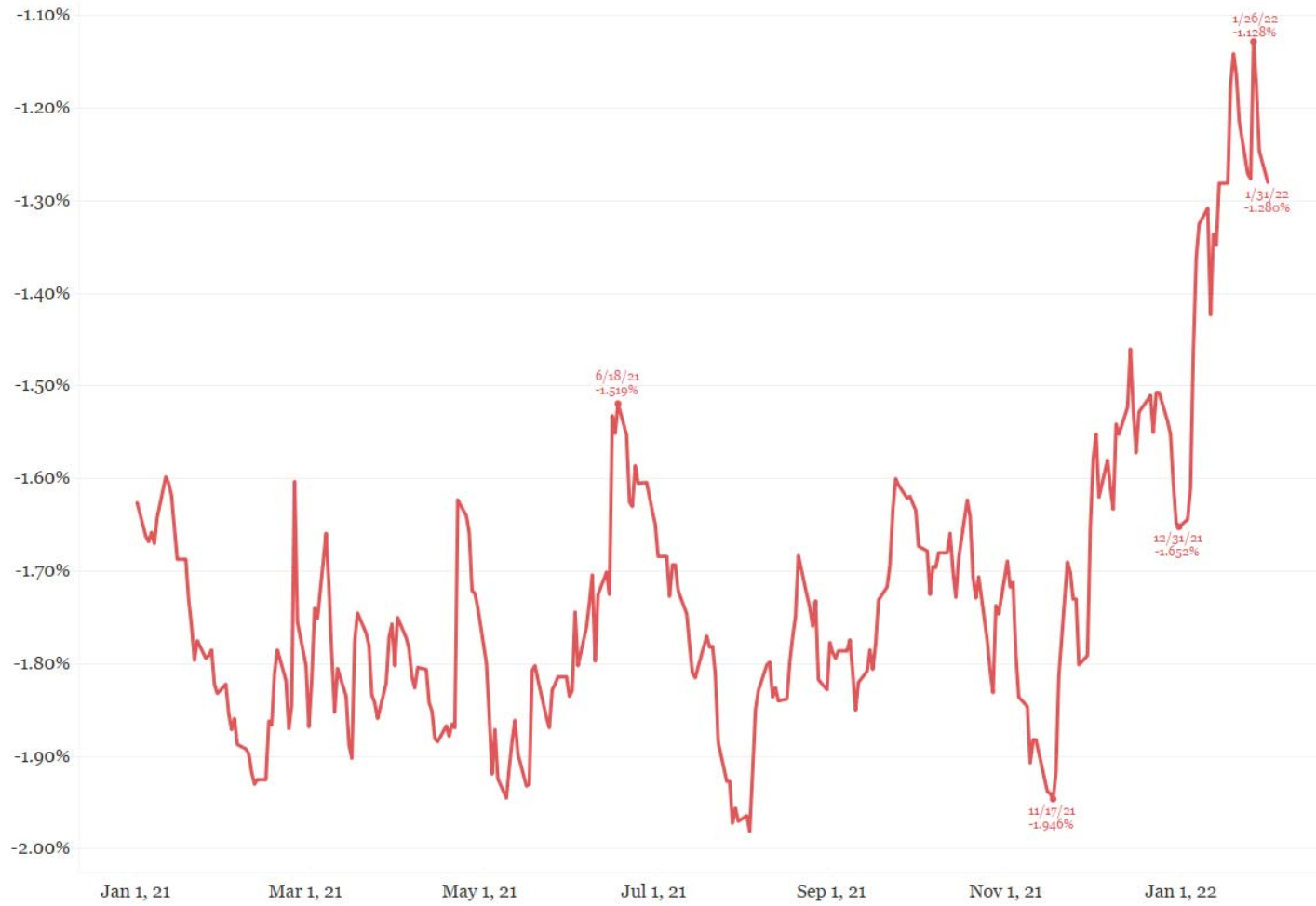
10-Year less 3-Month Yield Curve



Data Source: Federal Reserve and Bloomberg

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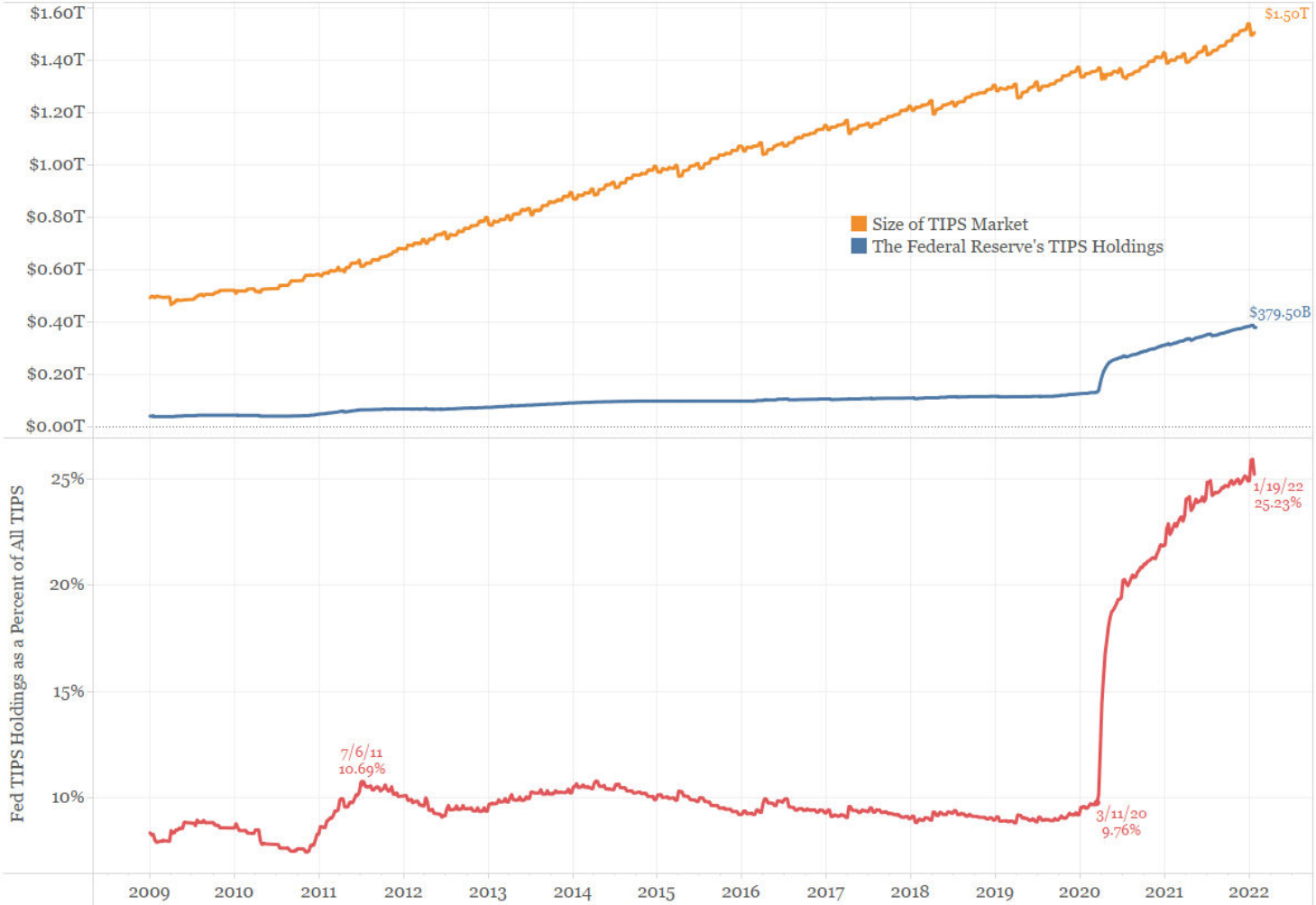
US 5-Year TIPS Yield



Source: Bloomberg

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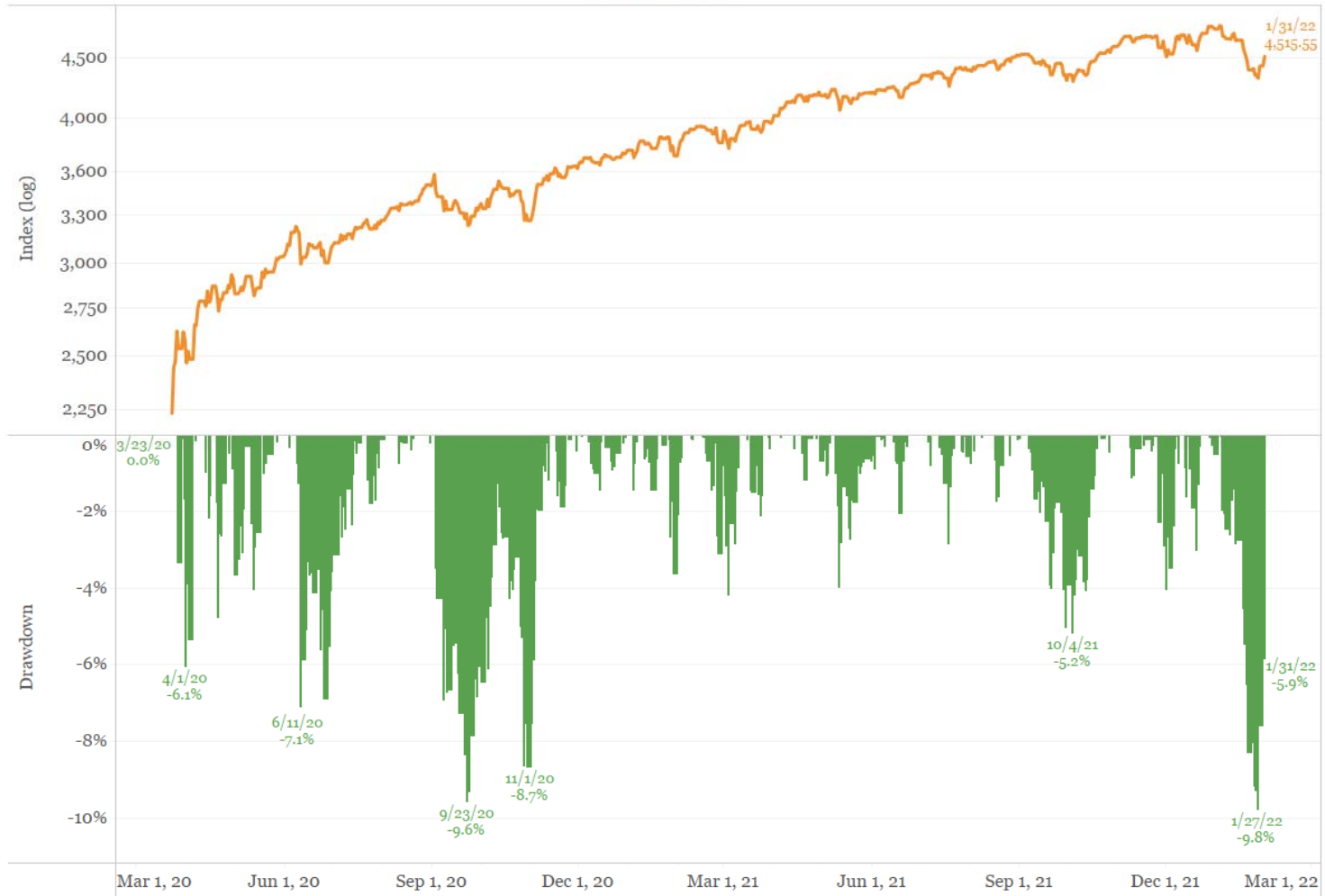
The Fed's Holdings of Treasury Inflation Protected Securities (TIPS)



Source: Bloomberg, Federal Reserve

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The S&P 500



Source: Bloomberg

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Russell 2000



Source: Bloomberg

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Russell 2000

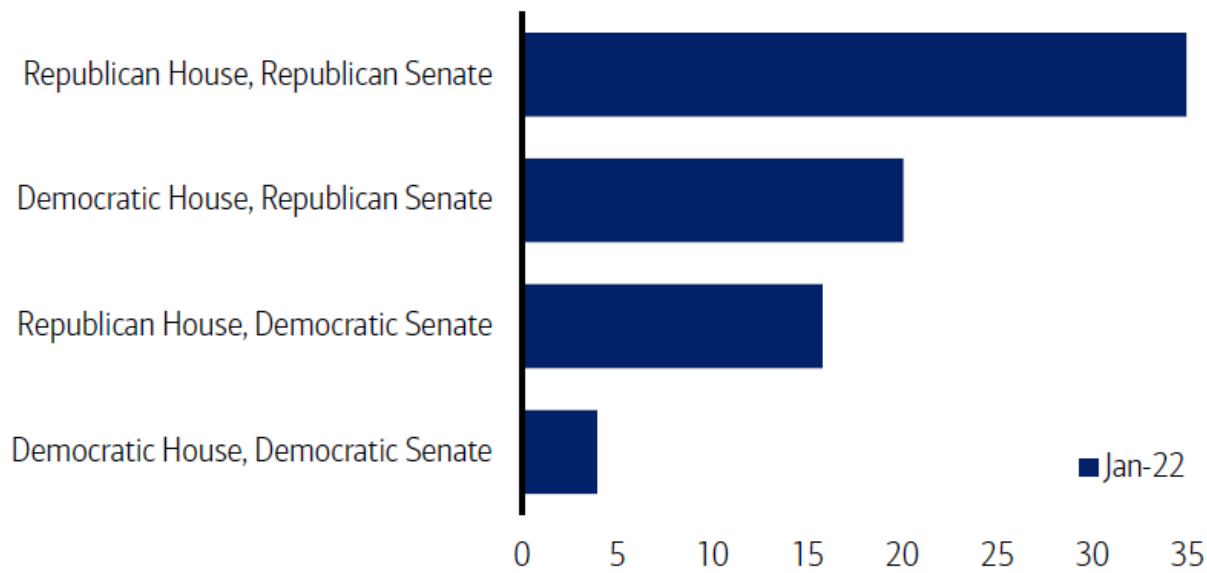


Source: Bloomberg

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Chart 25: 35% of investors think Congress will be Republican

What do you think the outcome of the 2022 midterm elections will be?



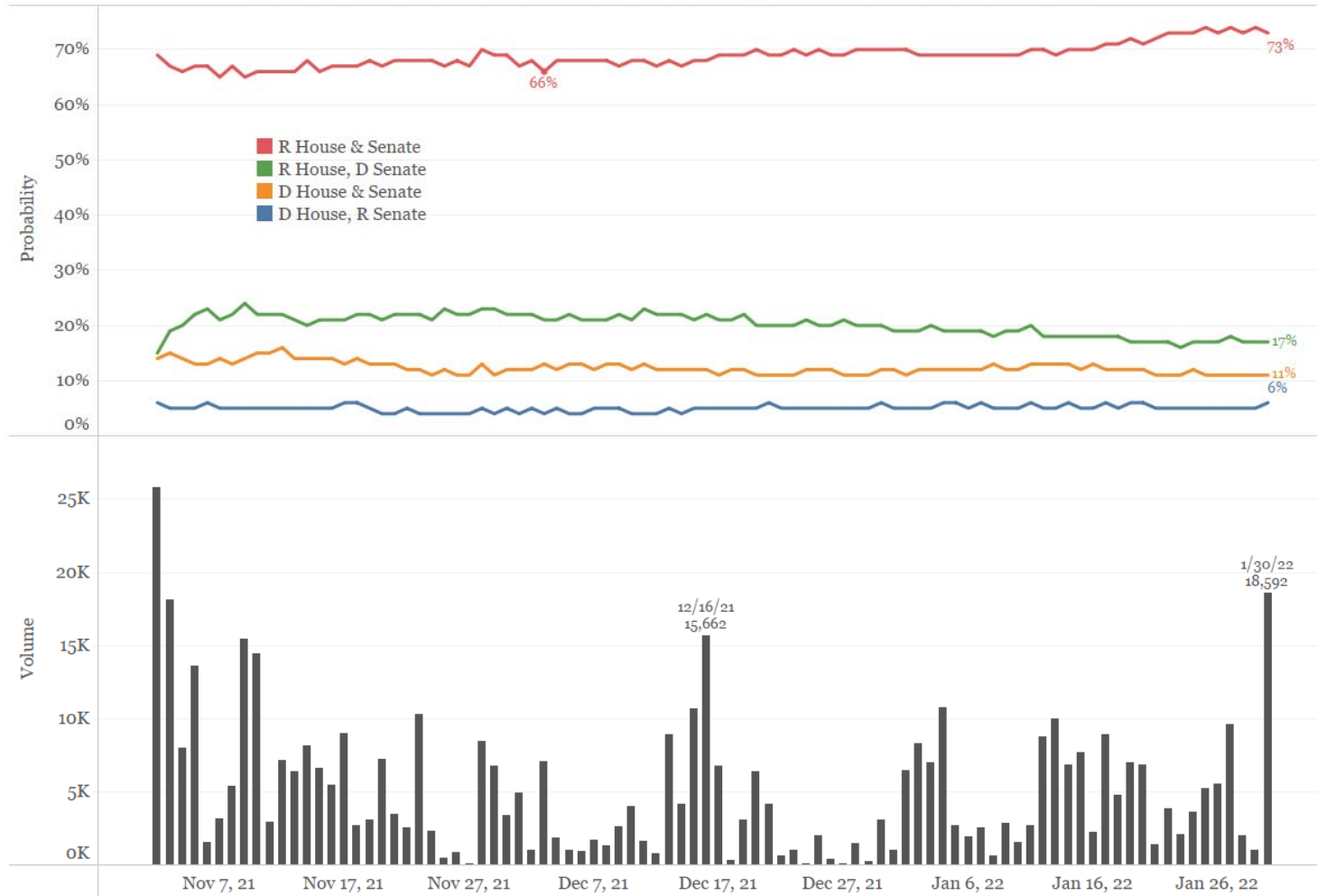
A plurality of investors (35%) believe Congress will be Republican after the 2022 midterms while only 4% of investors think it will remain Democratic.

This compares to OddsChecker odds of 70% expecting a Republican Congress while only 7% expect a Democratic Congress.

Source: BofA Global Fund Manager Survey

BofA GLOBAL RESEARCH

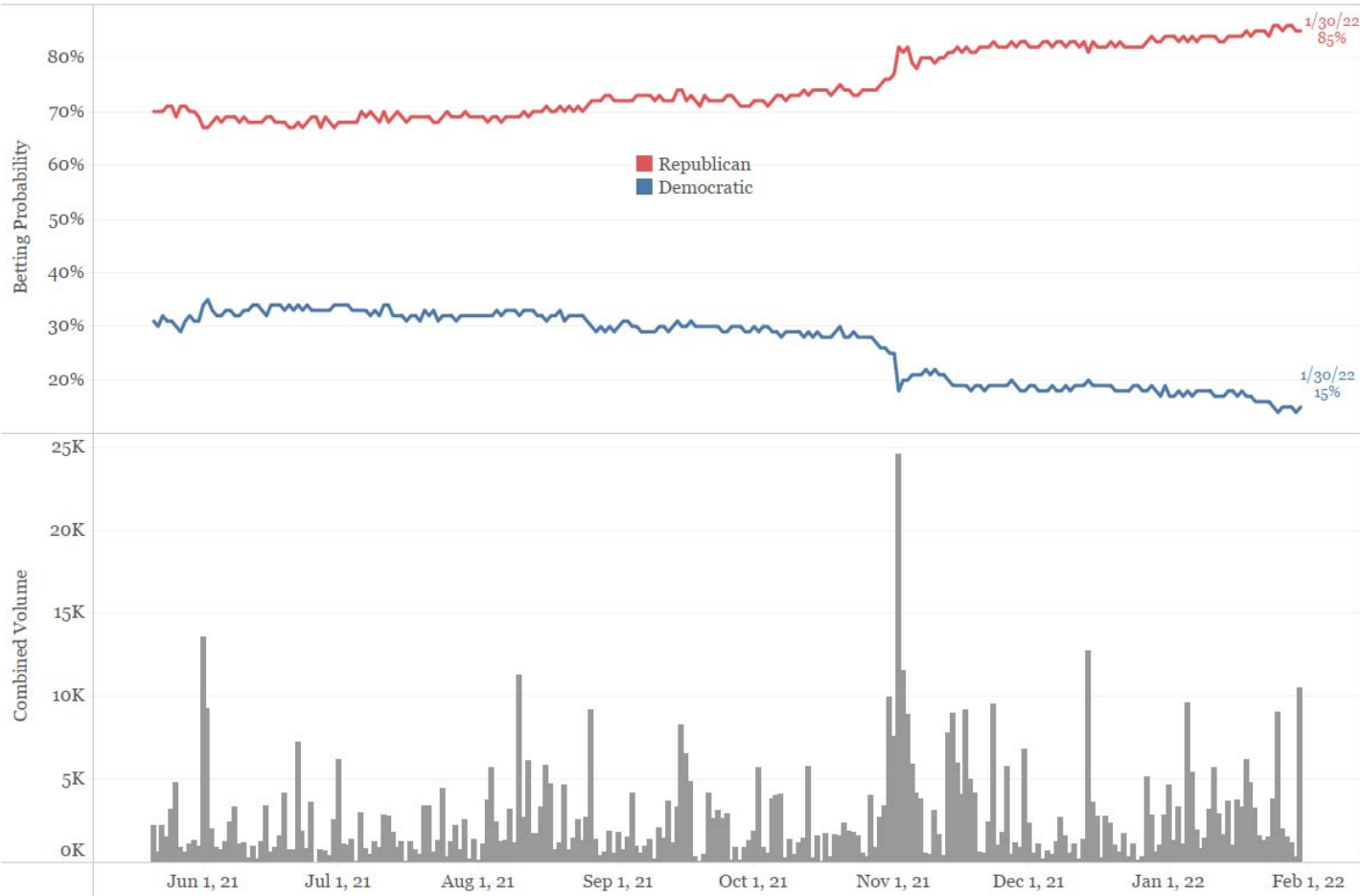
What Will be the Balance of Power in Congress after the 2022 Election



Source: Real Clear Politics
<https://www.predictit.org/markets/detail/7172/What-will-be-the-balance-of-power-in-Congress-after-the-2022-election>

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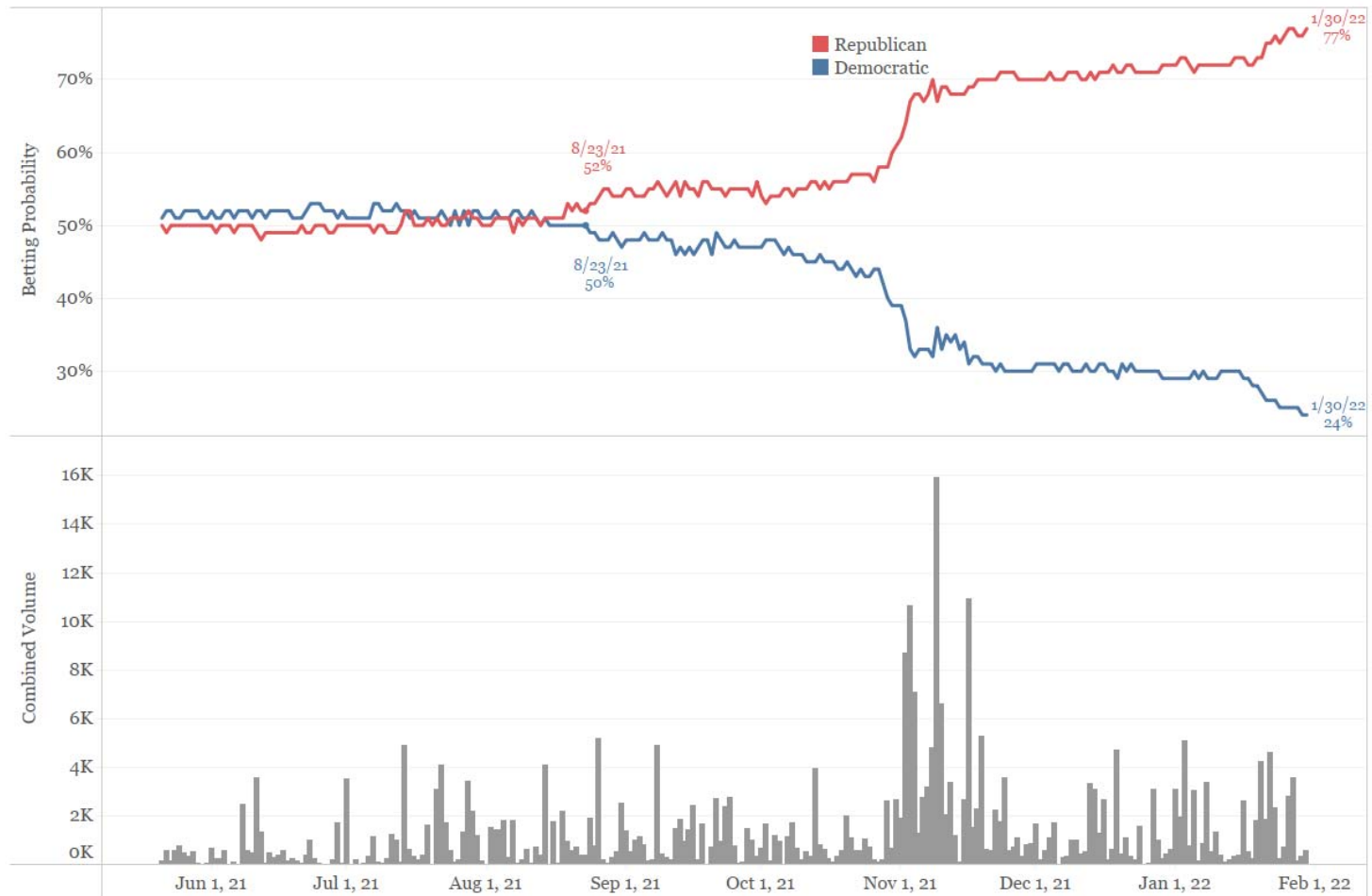
Which Party will Win the House in the 2022 Election? Predictit.org Betting



Source: Predictit
<https://www.predictit.org/markets/detail/6892/Which-party-will-win-the-House-in-the-2022-election>

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Which Party will Control the Senate After 2022 Election? Predictit.org Betting



Source: Predictit
<https://www.predictit.org/markets/detail/6874/Which-party-will-control-the-Senate-after-2022-election>

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