

Watching the wedge

Parsing Powell

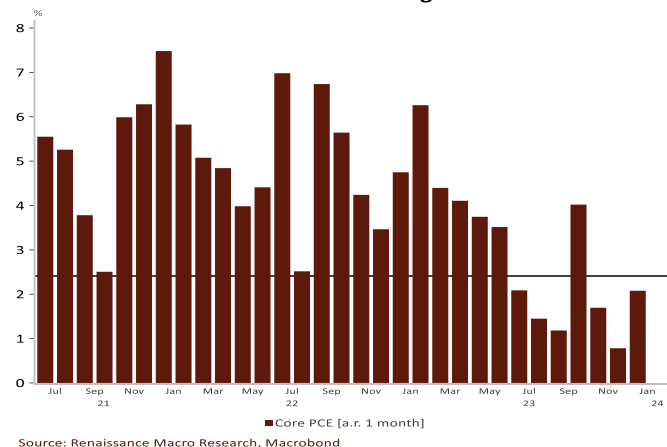
Taking stock of last week’s Fed meeting and Chair Powell’s weekend 60 Minutes interview, a few things stood out.

- First, inflation data need not get any better for the Fed to cut. The first cut is unlikely to be in March, but there is a relatively high bar for the Fed to not cut in May. As such, the Fed is less data, and more time dependent.
- Second, March may not be the base-case, but I can’t completely rule it out either. After all, as Powell noted in his interview, “The kinds of things that would make us want to move sooner would be if we saw weakness in the labor market or if we saw inflation really persuasively coming down.” We’re not seeing a meaningful crack in the labor market, but there is room for continued easing in inflation. We’ll effectively get two more PCE prints (CPI/PPI) between now and March. **There might be enough there to see some soft, core inflation prints.**
- Third, at the same time, the CBS reporter told viewers that cuts could be a “quarter, maybe half percentage point at a time” and that the first cut could come in the “middle of the year.” Powell himself did not say this in the interview, and it was not in the transcript, but this raises the risk of a later start to cuts and a deeper initial cut than I think. **My sense is that because inflation is slowing more quickly, the Fed will get started sooner.**
- Fourth, **cuts are likely to come this year and inflation does not need to be at 2.0% on a 12-month basis for the Fed to deliver them.** Indeed, as Powell noted, “we’re actively considering now going forward cutting rates, and on a 12-month basis inflation, you know, is not at 2%. It’s between 2-3%.”

Core inflation softening alongside unit labor costs



Recent annualized core inflation running below benchmark

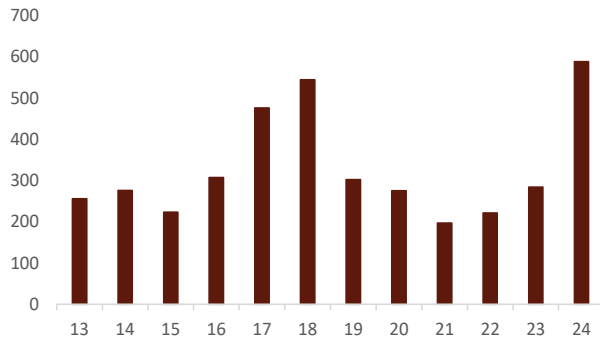


In short, if the Fed is not cutting rates in March, we won't have to wait that long before they do and because inflation is coming under more control, it would not take much in terms of growth slowing or financial conditions tightening to get the Fed to shift to cuts sooner.

Reviewing January Jobs

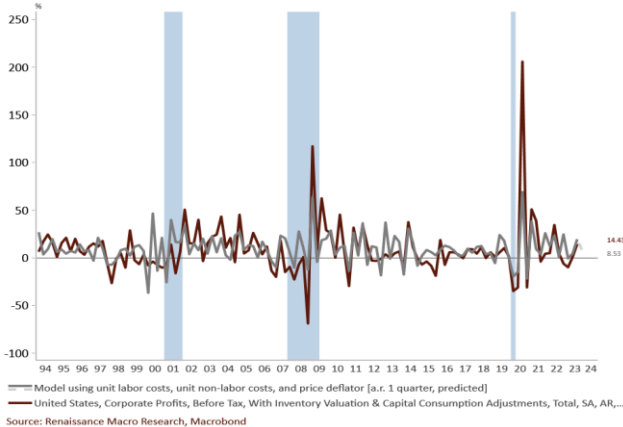
January's employment report was a weird one, but here is what is notable.

Lots of folks were off the job in January relative to normal
Not at Work Due to Bad Weather (January only)



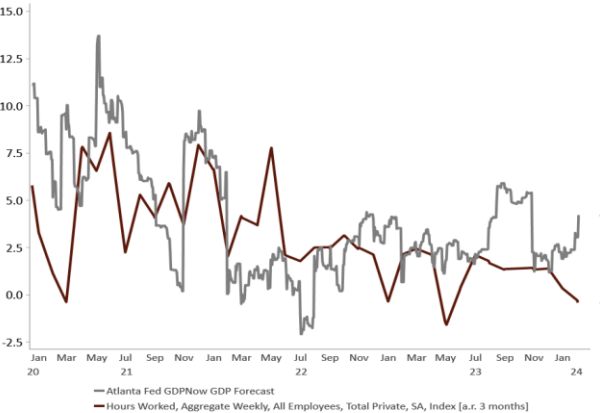
Source: Renaissance Macro Research, Haver Analytics

Corporate profits climbing



Source: Renaissance Macro Research, Macrobond

This cannot last forever



Source: Renaissance Macro Research, Macrobond

- Many people were off the job due to bad weather. In January, 588,000 folks were “employed but not at work” due to bad weather. This was the highest tally for January since 2011. The closest in recent memory was in 2018 when we saw this number hit 544,000.
- Average hourly earnings were strong, but this was likely a function of the workweek being soft. **I believe the underlying pace of compensation growth is easing.** Indeed, we just got the ECI data, a far more robust measure of wage growth, and it was a touch softer than expected. If quits are any guide, looks for ECI to continue easing in Q1.
- **Labor productivity is climbing.** We can debate the reasons why, but the important story here is that up is up. Growth is solid and aggregate hours worked have been sluggish. While its likely that hours worked pick-up somewhat, the revealed increase in labor productivity is a good story for corporate profits.

The jobs number is not changing the Fed’s calculus, but it did reduce the sense of urgency to cut. If the economy is growing and labor markets are solid, the Fed can take its time to recalibrate policy.

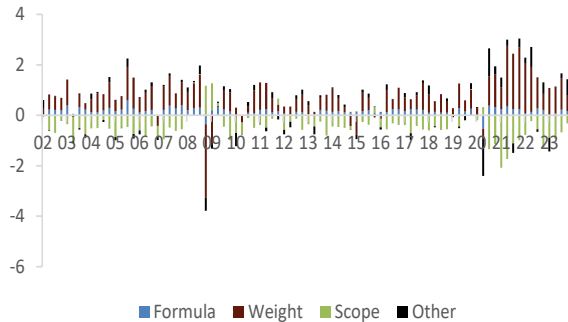
Fed watches PCE, not CPI

In economics, we often use different indicators to measure the same concept. For example, the monthly employment data includes two separate surveys, the Establishment Survey and the Household Survey. Price inflation is no different, and the two measures used are the Consumer Price Index (CPI) and the Personal Consumption Expenditures Chain Price Index (PCEPI). While the two series generally move up and down together, they have diverged at times as well.

There are differences of construction between the two series. We'll explore that here.

Recent CPI-PCE gap is mostly due to weight effect

(Contribution to difference in %chg saar (ppt))



Source: Haver Analytics, Renaissance Macro Research

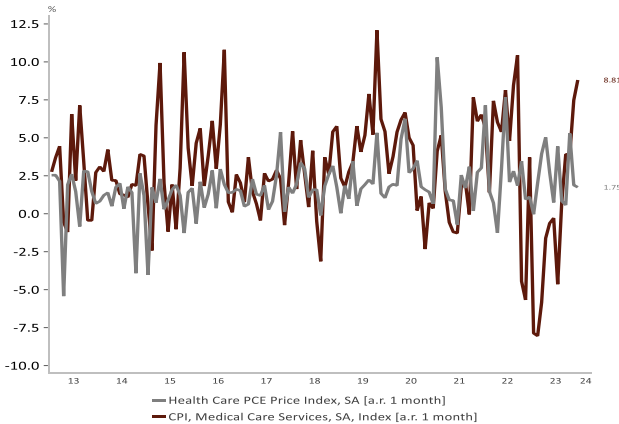
There are differences of **scope**; the items in the price baskets differ reflecting conceptual differences between the two series. CPI measures inflation in out-of-pocket spending by households while the PCEPI measures the growth in the cost of the entirety of personal consumption in the economy. As a result, PCEPI casts a wider net, having a broader scope.

For example, medical care spending includes out of pocket costs, but also spending on behalf of consumers through third-party providers. Public schools provide education that is not paid for out of pocket.

Roughly one-fourth of PCE spending is not captured by the CPI.

Because there are differences of scope between the two series, there are differences of **weight** in the specific components. Since the PCEPI has a broader scope, it tends to lead to smaller weights for the components the two series have in common. Housing rent is the best example, accounting for roughly one-third of CPI but about 15% of PCEPI. Similarly, used cars and trucks have roughly twice the weight in CPI than in PCEPI.

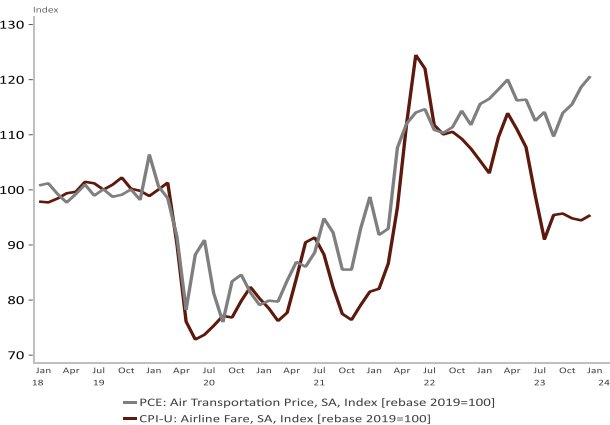
Medical care inflation to keep core CPI higher



Source: Renaissance Macro Research, Macrobond

There are smaller factors behind the gaps between the two series, such as **seasonal adjustment** and the **source data** used for specific goods and services are different. As an example, the CPI index for airfares is based on specific routes. By contrast, PCEPI is based on passenger revenue miles. There are also differences in **formula**. The weights in the PCEPI update more frequently than the weights in CPI and as a result, better account for consumer substitution. The way these price indexes are calculated reflect that with one allowing for more substitutability between categories than the other.

PCE airfares are running firmer than CPI and expected to change



Source: Renaissance Macro Research, Macrobond

In Q4, the annualized rate of CPI ran 1.1ppt above the rate of PCE, 2.8% SAAR versus 1.7% SAAR. A sizable portion of this gap can be explained by, as it has in recent quarters, differences of weight – pushing up CPI relative to PCE. Shelter has been a major driving of consumer prices inflation, and it simply does not count as much in PCE as it does in CPI. Differences of scope tend to push up PCE relative to CPI though this, at least in Q4, is not as important as weight. Finally,

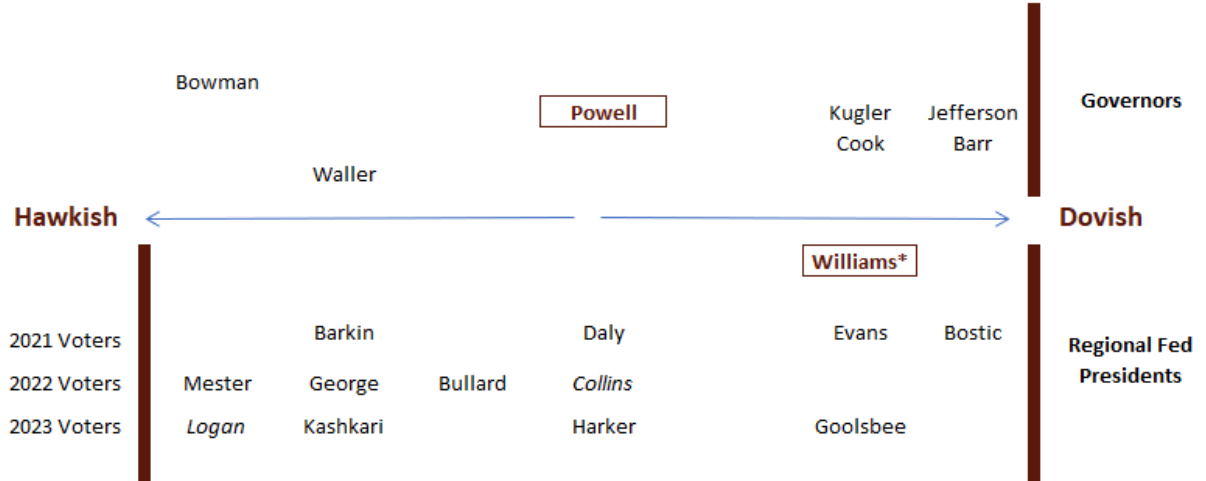
price or source data effects are pushing up PCE relative to CPI. Interestingly, airfares have been running much firmer in PCE than CPI in recent months. I'd expect this to change in the months ahead.

At any rate, **this wedge between CPI and PCE is worth focusing on. I suspect that core CPI will be somewhat firmer than PCE in the months ahead**, owing in part to differences of weight but also differences of scope, particularly in medical care services, where we should expect CPI healthcare inflation to remain strong.

Monetary metrics



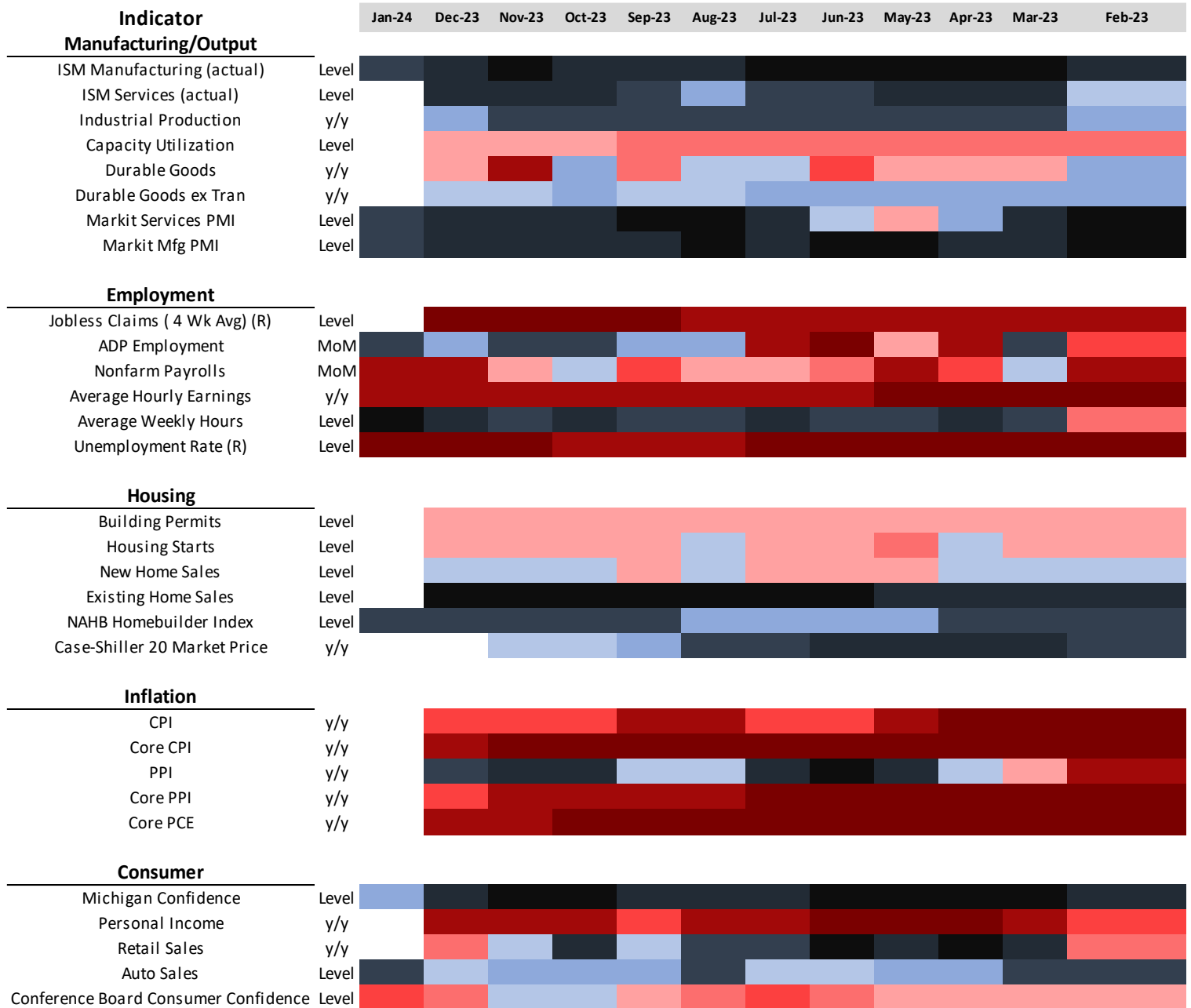
Hawks and Doves



*Federal Reserve Bank of NY President always votes
Boxed individuals represent FOMC core

FOMC Forecasts	2023					2024				
	2023	2024	2025	2026	Longer run	2023	2024	2025	2026	Longer run
Change in real GDP	2.6	1.4	1.8	1.9	1.8	2.5-2.7	1.2-1.7	1.5-2.0	1.8-2.0	1.7-2.0
September projection	2.1	1.5	1.8	1.8	1.8	1.9-2.2	1.2-1.8	1.6-2.0	1.7-2.0	1.7-2.0
Unemployment rate	3.8	4.1	4.1	4.1	4.1	3.8	4.0-4.2	4.0-4.2	3.9-4.3	3.8-4.3
September projection	3.8	4.1	4.1	4.0	4.0	3.7-3.9	3.9-4.4	3.9-4.3	3.8-4.3	3.8-4.3
PCE inflation	2.8	2.4	2.1	2.0	2.0	2.7-2.9	2.2-2.5	2.0-2.2	2.0	2.0
September projection	3.3	2.5	2.2	2.0	2.0	3.2-3.4	2.3-2.7	2.0-2.3	2.0-2.2	2.0
Core PCE inflation	3.2	2.4	2.2	2.0		3.2-3.3	2.4-2.7	2.0-2.2	2.0-2.1	
September projection	3.7	2.6	2.3	2.0		3.6-3.9	2.5-2.8	2.0-2.4	2.0-2.3	
Projected policy path										
Fed funds rate	5.4	4.6	3.6	2.9	2.5	5.4	4.4-4.9	3.1-3.9	2.5-3.1	2.5-3.0
September projection	5.6	5.1	3.9	2.9	2.5	5.4-5.6	4.6-5.4	3.4-4.9	2.5-4.1	2.5-3.3

High frequency data heat-map



Notes

R - Reverse Formatting

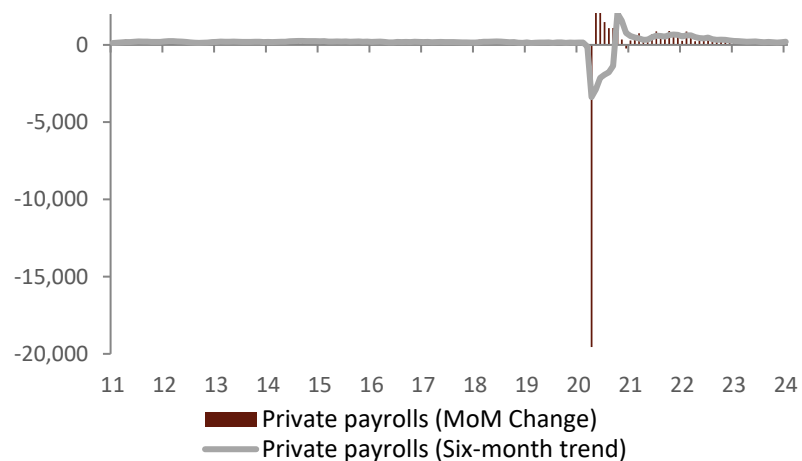
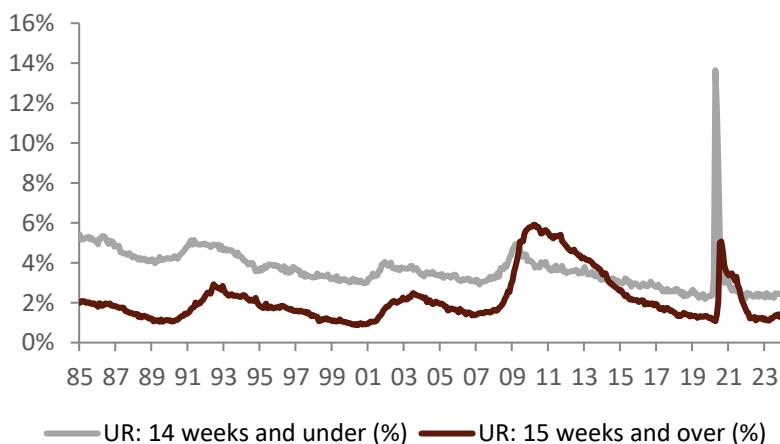
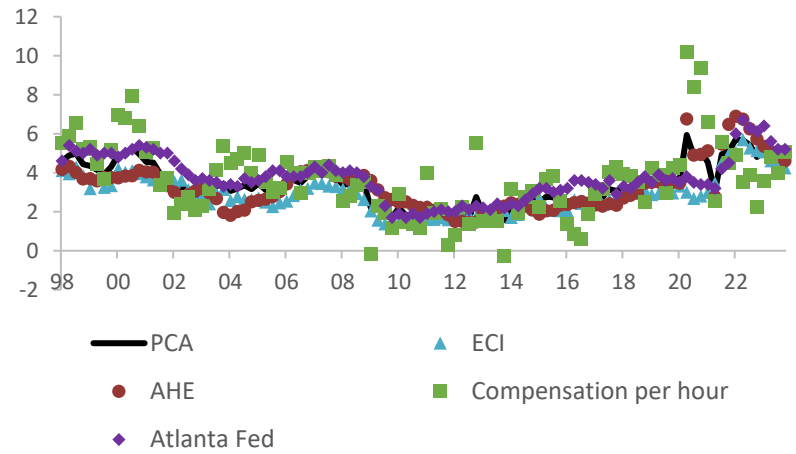
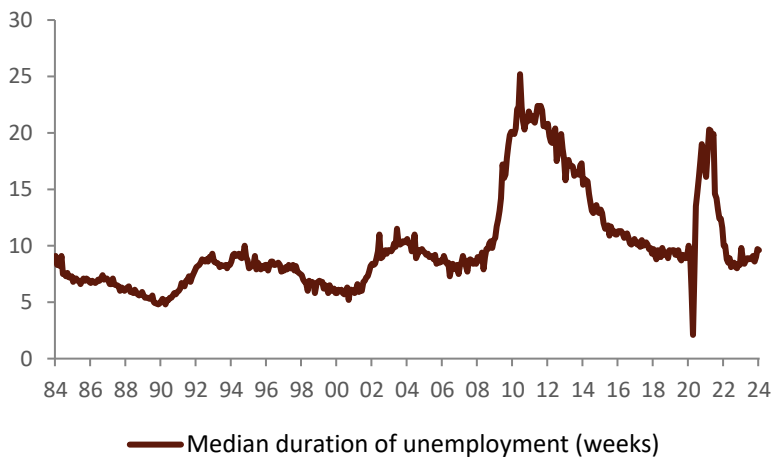
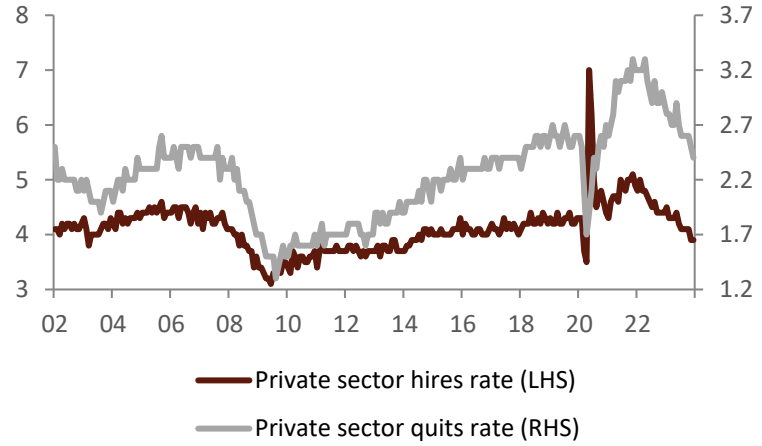
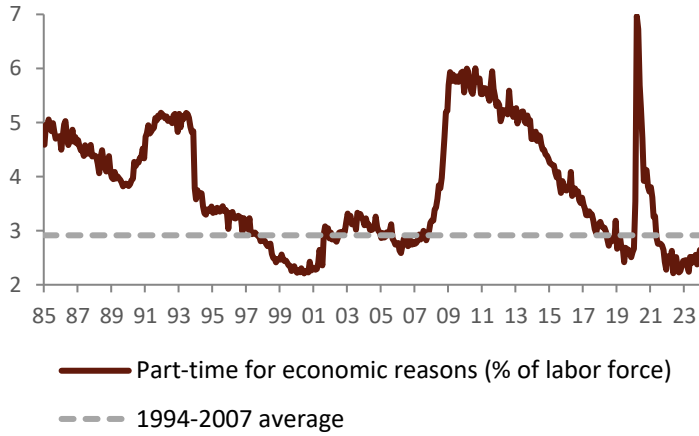
Deciles are based on expanding window since 2001

Highest decile

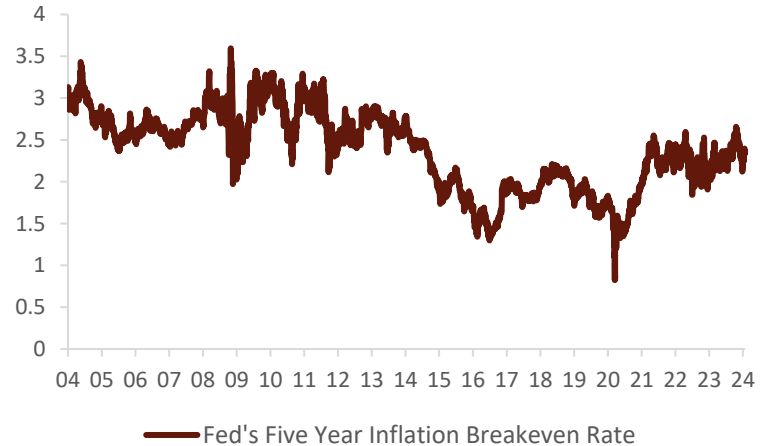
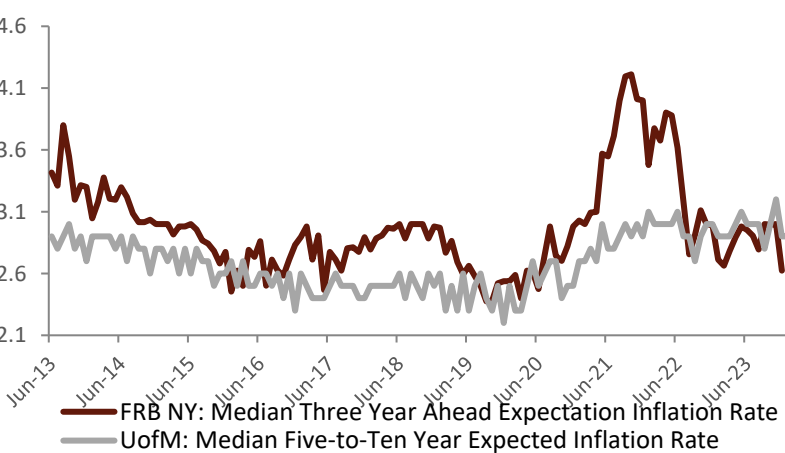
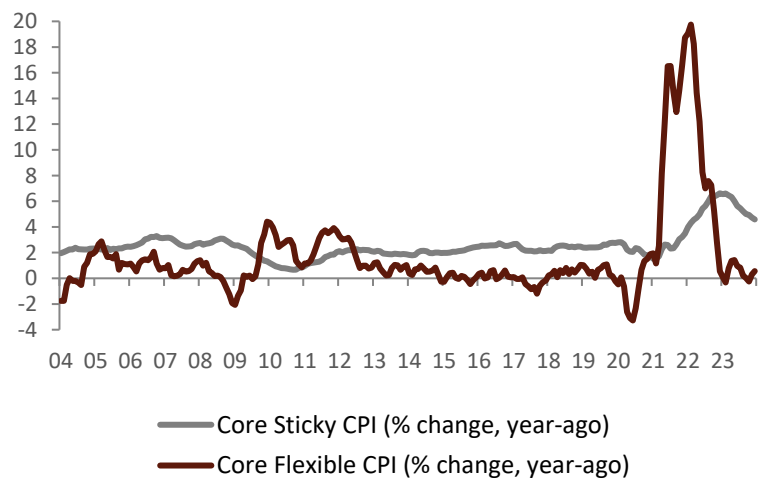
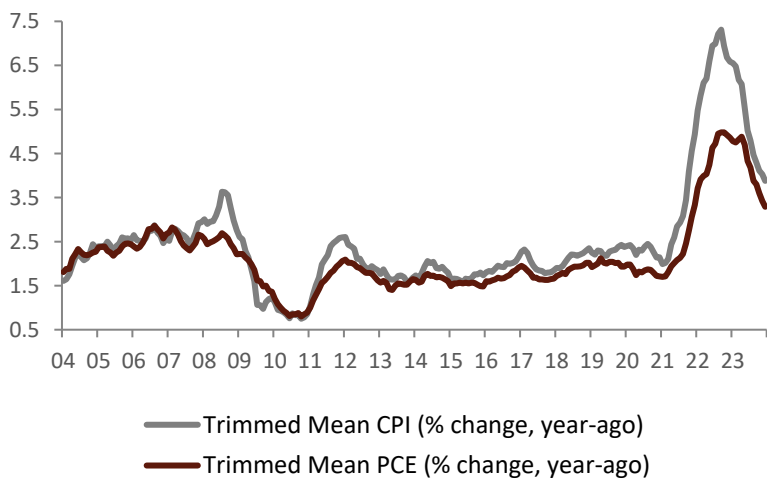
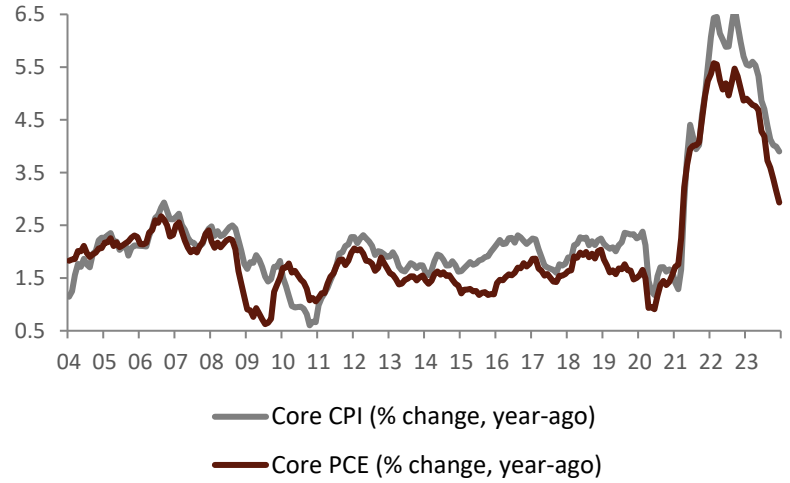
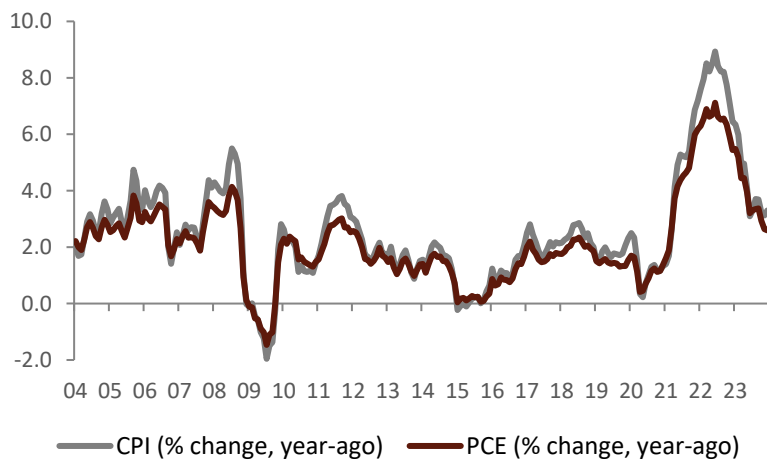
Lowest decile



Labor market indicators



Inflation indicators



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