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What is Powell Watching and Why He Should Change

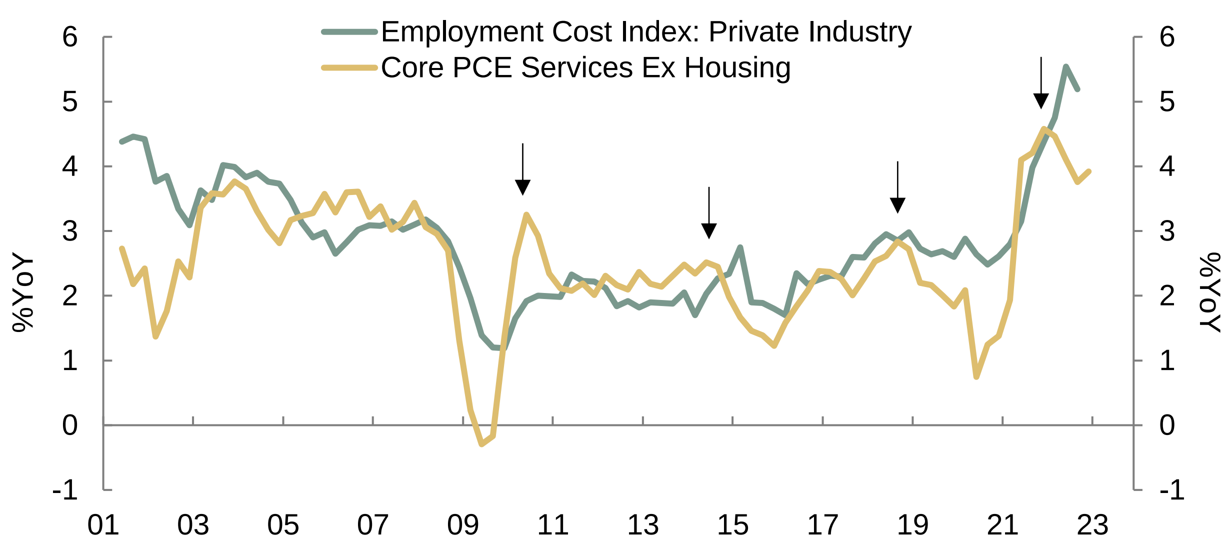
The Fed meets on January 31 - February 1. The FOMC will raise interest rates by 25 basis points (bps) and restate its desire to hike rates further. Recall the December 2022 median FOMC dot showed a yearend 2023 funds target of 5% to 5.25%. **Given the rally in credit, equities and interest rates, Chair Powell is likely to push back against what has been a significant easing of financial conditions**. He will do this by repeating the "higher for longer" mantra regarding the level of fed funds.

Furthermore, **Powell is likely to reiterate that inflation remains uncomfortably high and that wage gains need to slow**. Notably the employment cost index (ECI), the Fed's preferred wage metric, is released on January 31 and is projected to increase 4.5% annualized (1.1% unannualized). While still elevated, this would be the third quarter in a row in which its growth rate has moderated, having increased 5.1% annualized in Q3 2022 and 5.4% in Q2 2022. Peak annualized growth in the ECI was 5.8% in Q1 2022. We expect the ECI to continue to moderate in lagged response to slowing inflation.

Last month, Powell said that the price of core services excluding housing is "the most important category for understanding the future evolution of core inflation," because it accounts for more than half of the weight within the core PCE deflator. Moreover, "because wages make up the largest cost in delivering these services, the labor market holds the key to understanding inflation in this category." We disagree with the conclusion.

In the chart below, we show the year-over-year change in core PCE services excluding housing versus the ECI. On first pass, it is clear the two series are highly correlated but look a little closer. **Remarkably, the year-over-year growth rate in Powell's inflation metric leads the change in the ECI, not the other way around as Phillips Curve orthodoxy postulates**. But this has always been the case. Various markup models of inflation have never been good predictors of inflation. Indeed, they recently missed the largest inflation surge in more than forty years!

As the graph below clearly demonstrates, core PCE services ex housing peaks BEFORE wages. This happened in 2010, 2014, 2018 and again in 2021. And the lead time is anywhere from one to four quarters. These episodes are labeled with arrows in the chart. Perhaps Chair Powell should abandon his current inflation framework because it increases the risk of another policy error but in the other direction. We are likely to be disappointed.



Source: BEA, BLS, Haver, SMBC Nikko

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