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Powell 'Laughs-Off' Stagflation And Flip-Flops Again

May 02, 2024 10:30 AM ET | TLT, SP500

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Summary

- Fed Chair Powell flip-flops again - hawkish turn on April 16, but dovish two weeks later.
- Powell also dismissed the idea of stagflation despite stagflationary economic data, and stagflationary macro environment (deglobalization).
- Powell's Fed is starting to resemble Burn's Fed of the 1970s.
- Both the stock market and bond market are vulnerable in this situation.

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The flip-flop

Fed Chairman Powell signaled a hawkish turn at the Wilson Center's Washington Forum on the Canadian Economy on April 16. Among other things, Powell said:

> Right now, given the strength of the labor market and progress on inflation so far, **it's appropriate to allow restrictive policy further time to work** and let the data and the evolving outlook guide us

The implication of this statement was that the Fed was possibly abandoning an easing bias, and returning to a "higher-for-longer" policy stance. Thus, many analysts expected that the Fed would officially confirm a hawkish turn at the May FOMC meeting.

I expected that the Fed would change the official post-meeting statement to reflect a hawkish turn. Specifically, I expected that the Fed would replace the statement:

> The Committee **does not expect it will be appropriate** to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2 percent.

With something along lines of the April 16 statement: "**it's appropriate** to allow restrictive policy further time to work". This change would signal that the Fed is actually abandoning an easing bias.

However, the Fed has not made this change to the official May post-meeting statement. Instead, the Fed added this sentence:

> In recent months, there has been a lack of further progress toward the Committee's 2 percent inflation objective.

This new sentence confirms that the Fed still has an easing bias, and that still views the recent spike in inflation as a temporary bump.

So, Powell really flip-flopped again. On April 16, he was hawkish, but not only with what he said, but also how he said it - his voice was resolute and commanding, similar to the hawkish Powell voice from 2022. And then two weeks later, at the Fed's May post-meeting press conference, he was dovish again, with lots of studdering and non-verbal insecurities.

Powell flatly rejected the possibility of another interest rate hike, and suggested an asymmetric policy response to inflation and growth. Specifically, Powell suggested that the Fed would cut immediately in case of unexpected weakening in the labor market, but not necessarily hike in case of hotter inflation. This is dovish.

But this is not surprising, Powell has flip-flopped many times before. Just recently, only two weeks before the Fed's December 2023 meeting, Powell stated: "It would be premature to conclude with confidence that we have achieved a sufficiently restrictive stance, or to speculate on when policy might ease." And then at the December 2023 meeting, the Fed made a major dovish turn, canceling the last interest rate hike, and signaling three interest rate cuts in 2024.

The result of the December 2023 premature dovish turn is the current situation of accelerating inflation - due to loosening of the financial conditions after the dovish turn. Thus, the hawkish expectations were based on the realization that the Fed cannot ease monetary policy until the labor market weakens - or until a recession. That's the normal cycle.

And yet, the Fed, with Powell at the helm, continues to hope for a "soft-landing" type of interest rate normalization.

The stagflation dismissal

Recent economic data has been suggesting that the US economy could be slipping into stagflation. Specifically, the Advance Q1 2024 GDP showed a below expectations 1.6% growth, and above expectations 3.7% inflation. Even the ISM manufacturing for April showed that growth is contracting, but the prices paid are soaring.

Thus, Powell was asked a question about stagflation at the FOMC post meeting conference, and he actually laughed at the idea of stagflation. Specifically, Powell said:

> I was around for stagflation, and it was 10% unemployment, it was high-single-digit inflation. And very slow growth. Right now, we have 3% growth which is pretty solid growth, I would say, by any measure. And we have inflation running under 3% … I don't see the 'stag' or the 'flation,' actually.

Powell was referring to the stagflationary environment of the 1970s and early 1980s, and made a contrast with today's environment. Obviously, the economic data today does not resemble the data at the peak of stagflation in 1974 and 1980.

But, there were three inflationary spikes during the 1970s and 1980s, with disinflationary periods in between. How can Powell be sure that we are currently not in-between two inflationary spikes? Given the Fed's dovishness, it is actually likely that we could be facing a second wave of inflation. In fact, today's Fed resembles the Fed under Chairman Arthur Burns, who allowed inflation to spike.

Furthermore, Powell is missing the point. We are currently in a process of deglobalization, which will be unfolding in the foreseeable future. Deglobalization is inflationary on many levels - onshoring, reshoring, supply chain disruptions, commodity price spikes, geopolitical instability, trade barriers, labor shortages, etc. All of this is happening now, as we speak. That's the "flation" part of stagflation Mr. Powell.

The "stag" part is also unfolding. Despite the headline strong labor market, the economy has been losing full-time jobs, excess savings are exhausted, and based on recent household income reports it looks like the lower-income population is struggling. The "stag" part is also due to less trade (deglobalization).

Implications

Under Chairman Powell, the Fed resembles the Fed under Chair Burns of the 1970s. They seem to be too dovish, and possibly easily influenced by politics. President Biden expected the cut before the election, and maybe he gets it.

They (FOMC) seem to be too data dependent and hoping for a miracle, ignoring the macro framework - and that's the unfolding process of deglobalization, which is stagflationary.

Under these conditions, the bond market seems vulnerable (TLT), as long-term interest rates could rise sharply.

The S&P 500 (SP500) is vulnerable to a 1974-like 25% correction, as 10Y yields rise above 5%, and the inflationary recession unfolds. However, over the near term, stocks could bounce if investors "celebrate" a dovish Fed. However, this would be an opportunity to sell the rally.

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