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Immaculate Disinflation: The Only Hope to Avoid Recession

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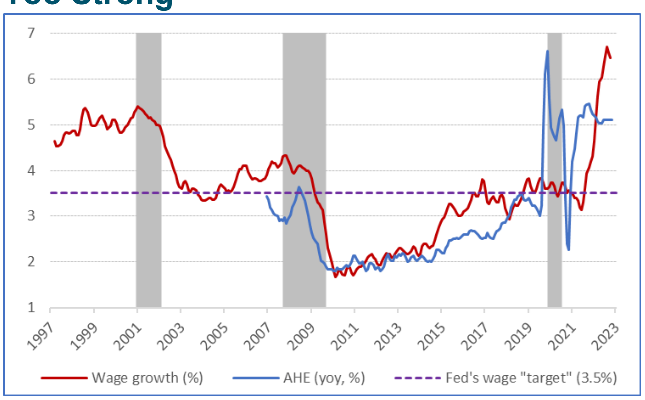
"You probably want to revise your views on inflation and its overall dynamic more based on today's jobs report than any other data report this entire year. And not in a favorable direction."
-- Jason Furman, Harvard, Dec 2, 2022

Today's payrolls report revealed that labor demand remains robust, despite the Fed's best efforts to crush hiring. It also demonstrated that labor supply isn't recovering (the participation rate is actually down slightly from the beginning of the year). The inconvenient result is wage growth that is still leagues above the Fed's 3.5% target (**Figure 1**).

FIGURE 1 – Wage Growth Remains Far Too Strong



Source: Bloomberg Note: Wage growth is the Atlanta Fed's series; AHE (average hourly earnings) is from the payrolls report; and Fed's wage "target" as stated by Fed chair Powell on Wed Nov 30.

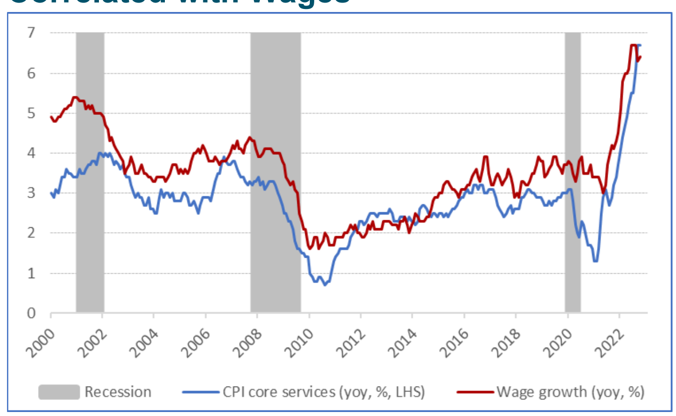
Two Days is a Long Time in Markets: Powell Already Regrets Wednesday's Dovish Speech

The Fed believes inflation consists of three components:

1) Goods prices (which are plummeting)
2) House prices (strong, but set to rollover hard)
3) Services prices ex-housing (still rising)

Unfortunately, services inflation is highly correlated with wages (**Figure 2**). This suggests overall inflation will decline only glacially, preventing the Fed from pivoting until Q2 of next year.

FIGURE 2 – Services Inflation is 83% Correlated with Wages



Source: Bloomberg

A More Hawkish Fed Means There is Only One Way to Avoid Recession

Strong consumer demand (as seen in yesterday's retails sales release) and stubbornly high wage growth indicates the Fed has at least another 100 bps of hiking in the pipeline, with interest rates to remain elevated for a considerable period. This means the only way to avoid a recession is that wage growth and services inflation just decide to roll over and play dead all on their own, despite strong economic growth. "Immaculate disinflation" if you will.

Implications for U.S. Equity Markets

A recession is highly probable, which implies S&P 500 EPS earnings are likely to decline by 10% in 2023. Bottom line: Equity markets are likely to remain choppy for another quarter or two.