August 15, 2022

A Slower Pace of Still-Elevated Price Pressures Complicates Outlook for Policy

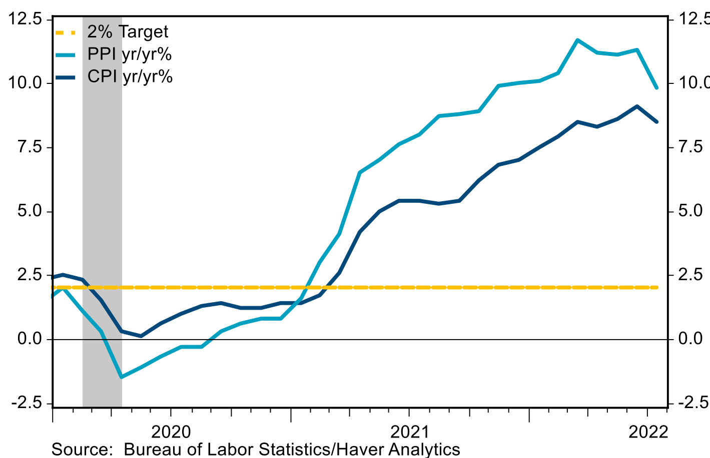
The latest read on inflation showed a welcome decline in price pressures, at least on the surface. However, while energy costs cooled somewhat in July, dragging down the headline read, other price categories continued a relentless climb higher, complicating the outlook for costs and policy.

Market participants appear to be focused on the slower pace of rising inflation, and subsequently anticipating a more benign pathway for policy. However, with headline costs still more than four times higher than the target rate, officials have significantly more work to do to rein in cost pressures. After all, with increased uncertainty on the horizon, one month's modest reduction does not make a trend, nor should it be enough to convince the Federal Reserve (Fed) prices are on a sustainable downward trajectory.

INFLATION

The latest read on the Consumer Price Index (CPI) was unchanged (0.0%) in July, following a 1.3% increase in June, and falling short of an expected 0.2% gain. Year over year, consumer prices rose 8.5%, down from the 9.1% pace last month, albeit still near a four-decade high.

Food prices rose 1.1% in July, while energy prices fell 4.6% after a 7.5% increase at the end of the second quarter. Excluding food and energy costs, the *core* CPI rose 0.3% in July and remained steady at an annual pace of 5.9%, down from the near-term peak of 6.5% in March.



Source: Bureau of Labor Statistics/Haver Analytics

Similarly, on Thursday, the Producer Price Index unexpectedly fell 0.5% in July, the first monthly decline in

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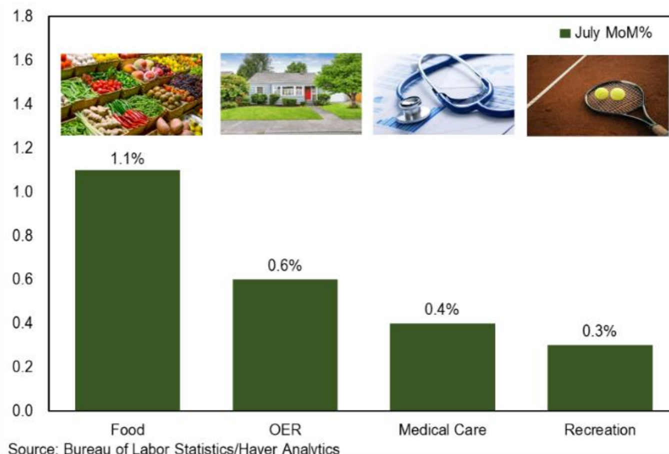
more than two years – since the 2020 recession – and following a 1.0% gain in June. Year over year, producer prices rose roughly 10% in July, less than the 10.4% gain expected and down from an 11.3% increase the month prior.

On the wholesale side, food prices rose 1.0%, while energy prices declined 9.0% in July. Excluding food and energy costs, the *core* PPI rose 0.2%, half the anticipated rise, and increased 7.6% year over year, a nine-month low.

In the details, along with lower pump prices, transportation prices fell 2.1% thanks in part to a 0.4% decline in used cars and truck costs. Commodities prices dipped 0.5% in July, and apparel prices fell 0.1%.

For the average American, while any reprieve is welcome, relatively lower monthly gas prices do not offset the painfully high costs of other key components of monthly expenditures, particularly food and housing. Housing costs, for example, increased 0.4% in July, thanks to a 0.6% rise in the Owners' Equivalent Rent (OER), a proxy for the cost of shelter, which accounts for roughly a quarter of the CPI. Year-over-year, the OER alone is up nearly 6%.

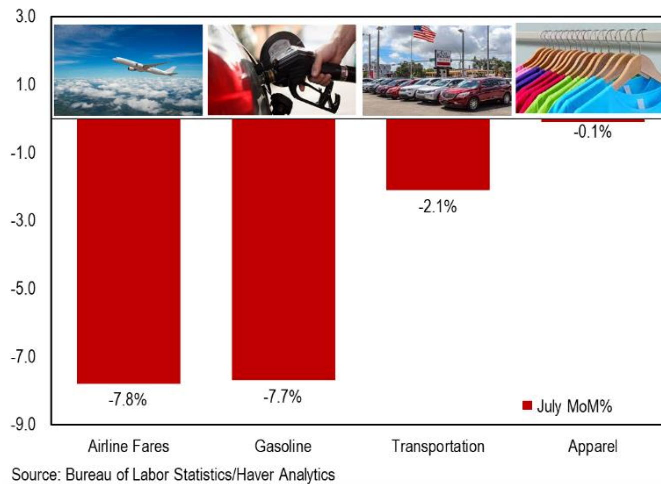
Additionally, medical care prices gained 0.4% in July and 3.7% over the past 12 months, while other goods and services costs pushed higher by nearly half a percentage point, and roughly 6% year over year.



Source: Bureau of Labor Statistics/Haver Analytics

BETTING ON LOWER INFLATION

With inflation coming in cooler than expected, the market is reading the latest report as evidence prices have peaked. Furthermore, assuming the worst of the cost pressures are behind us, investors are increasingly optimistic the Fed will revert to a more benign rate pathway. With headline GDP slowing for the past six months and recessionary boxes checked in nearly every sector of the economy except the labor market, market



Source: Bureau of Labor Statistics/Haver Analytics

GLOSSARY

CME – Chicago Mercantile Exchange

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

OER – Owners' Equivalent Rent

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

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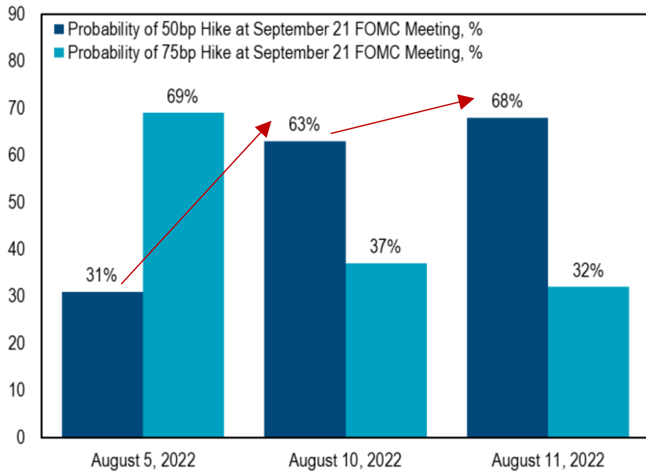
players are betting on the Fed backing off from a more aggressive approach to policy with smaller rate increases, a subdued terminal rate and a sooner-than-later reversal of policy tightening.



Source: Bloomberg/CME FedWatch

Ahead of Wednesday's CPI report, according to *Bloomberg* data, market participants were expecting a 75-basis-point (bps) increase at the Fed's upcoming September meeting at roughly a 70% probability. Following the downside surprise in the July consumer inflation report, however, expectations for a relatively smaller 50-bps increase rose from 31% to 63%, and further to 68% after the release of last month's PPI report. Additionally, according to *Bloomberg* data, the market is pricing in a peak rate of 3.75% in federal funds and the first rate cut as early as May 2023.

Federal Reserve officials, meanwhile, continue to posture a relatively more hawkish stance with the latest commentary reiterating a need for substantially higher rates to tackle inflation. According to San Francisco Fed President Mary Daly, for example, the Fed is nowhere near done in its fight against rising costs. After all, while headline inflation decelerated at a faster than expected pace thanks in good part to cooling prices at the pump, down 7.7% from last month, broader cost pressures remain at still alarmingly elevated levels.

That being said, the latest Summary of Economic Projections, or the SEP, shows the Committee remains at least slightly hopeful regarding the near-term pathway for price pressures. According to the report, the majority of Fed officials anticipate inflation – as measured by the PCE – to slow from 6.8% to 5.2% by year end and further to 2.6% by the end of 2023.

From an investor's standpoint, such an optimistic forecast appears to be sending somewhat of a mixed signal relative to the recent remarks of ongoing and strong action needed by the central bank. After all, a slower pace of inflation would presumably take the pressure off, or at least reduce the pressure on the Committee to keep its foot on the brake. More likely, however, the Fed's more promising view of inflation reflects the fact that the Committee intends to continue to raise rates until prices are forced to retreat. In other words, policy makers are seemingly convinced price pressures will ease because of ongoing policy action, not the other way around.

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WHAT IF INFLATION HASN'T PEAKED?

Independent of the directional causation, the question remains: What if the broader forecast of declining inflation proves incorrect? Cost pressures retreated modestly in July, but remain largely elevated. What if there is no further price reprieve in August, or worse, inflation pushes higher between now and the September 21 Federal Open Market Committee rate decision?

Under a mounting threat of sustained elevated inflation, the Fed could – and arguably should – materially increase its expectations for rates in the coming months and, furthermore, reaffirm its resolve to do "*whatever it takes*" to root out inflation. Given the Fed has indicated a marked reduction in inflation, or several months of a marked reduction is a prerequisite for a more benign policy pathway, without a convincing retreat in the July *and* August inflation reports, it's going to be difficult for the Fed to pivot away from a more aggressive size of rate hikes without potentially losing credibility, lessening a grip on inflation, inciting a rise in inflation expectations, or some combination of the three.

For the market, with a lack of forward guidance from the Fed, coupled with uneven data and the appearance of conflicting policy messaging, volatility has understandably intensified as investors violently (over) react to a single data point. Ping ponging between expectations for a 50-bps or 75-bps hike next month, should next month's inflation report show another headline decline, investors are likely to go all in for a smaller 50-bps hike – or even a 25-bps hike. On the other hand, should the August inflation report show prices stalling or worse gaining upward momentum, the decision for market players is likely to shift from 50 bps versus 75 bps to 75 bps or 100 bps.

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