Economic INSIGHT

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A Tale of Two Inflation Pictures

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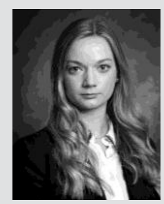

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Economists typically need two hands when weighing the significance of contrasting data, and this week's inflation reports are no exception. On the one hand, the latest read on prices showed headline inflation cooling for the second consecutive month with some categories showing vast improvement from peak levels. On the other hand, certain categories continue to climb, leaving broad-based inflation still uncomfortably elevated.

From a consumer standpoint, while any inflationary relief is welcome, a further step back in costs is desperately needed. And from a policy standpoint, while a reduced pace of ascension is encouraging and may serve to justify smaller rate hikes going forward, it falls well short of a meaningful decline in prices. And that will likely keep pressure on the Federal Reserve (Fed) to continue along a pathway to higher rates, despite mounting evidence of weakness in the domestic economy.

THE LATEST READ ON INFLATION

Consumer Prices

The Consumer Price Index (CPI) unexpectedly rose 0.1% in August contrary to expectations for a 0.1% *decline*. Year-over-year, however, consumer prices continue to slow their rate of growth, up 8.3%, down from the 8.5% pace reported the month prior, albeit still near a four-decade high.

Food prices rose 0.8% in August and 11.4% over the past 12 months, while energy prices dropped 5.0% on the month, following a similarly sized decline in July. Despite the monthly retreat, energy prices have risen nearly 24% from this time last year, down from a near-term peak of 42% in June.

Stripping out the volatile food and energy components, the core CPI rose 0.6% in August, double the 0.3% rise expected. Year-over-year, the core CPI increased 6.3% last month, *rising* from a 5.9% pace in July, albeit still below the near-term peak of 6.5% in March.

In other details, housing prices, medical care costs, and apparel prices, as well as education and communication costs continue to climb higher rising between 0.5% and

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8% over the past 12 months. Even transportation and commodities costs, which were down 2.3% and 0.8% in August, rose 13% and 11% on an annual basis.

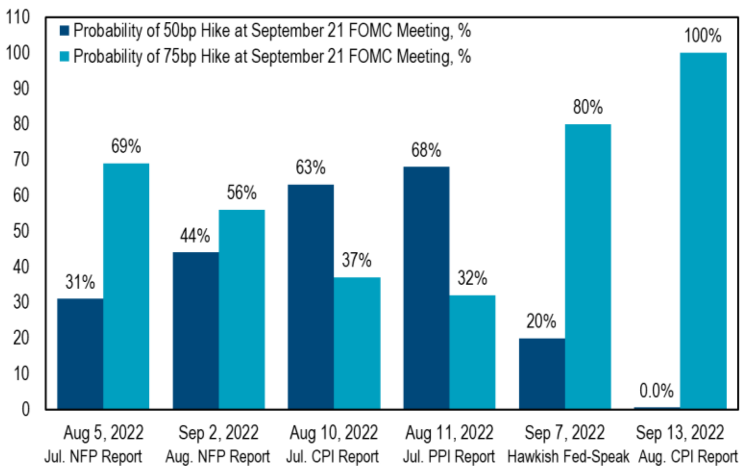
Producer Prices

Producer prices, meanwhile, fell 0.1% in August, *in line with expectations* and following a 0.4% decline in July. Year-over-year, producer prices rose 8.7% in August, less than the 8.8% gain expected and down from a 9.8% increase in July.

In the details, energy prices dropped 6.0% in August, the second consecutive month of decline, while food prices were unchanged (0.0%) from the prior month. Excluding food and energy costs, the core PPI *rose* 0.4%, a tenth of a percent more than expected. Year-over-year, the core PPI increased 7.3% in August, a ten-month low, albeit more than the 7.0% annual increase expected.

Similar to the CPI report, declining energy prices were the primary driver of the headline PPI report reflecting welcome reprieve at the pump despite rising pressures in other categories. Peaking at $5.02 on June 13, according to AAA, the national average of gas has dropped to $3.69 a gallon as of September 16, a 16% reduction.

WILL IT BE 50BPS OR 75BPS?



Source: Bloomberg/CME FedWatch

After countless attempts to convince the market the Fed was firm in its resolve to tame inflation regardless of the costs, over the past several weeks investors have now seemingly bought into the Fed's more aggressive tone. Two stronger-than-expected employment reports, positive, albeit moderate, consumer activity, and Federal Reserve Chairman Jerome Powell's clearly articulated need for a prolonged period of pain for households and businesses tipped the scale back in the direction of a more sizable hike in September. The latest read on August inflation, however, was the final straw needed to put investors over the edge.

While one month's data point, particularly a tenth of a percentage point in either direction would not be enough to sway the market in more normal times, today, with a hyper-focus on prices, it appears to be more than sufficient. In fact, the larger-than-expected increase in monthly consumer costs appears to have solidified a third-round 75-basis-point (bps) increase next week. Meanwhile, the minimal retreat in producer prices should remove any mounting pressure for a larger 100 bps hike (or more).

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

PPI – Producer Price Index

GDP – Gross Domestic Product

SEP – Summary of Economic Projections

YoY – Year over Year

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As of September 13, the market is fully pricing in a 75-bps hike with a larger increase of 100 bps gaining some momentum, at roughly a 22% probability.

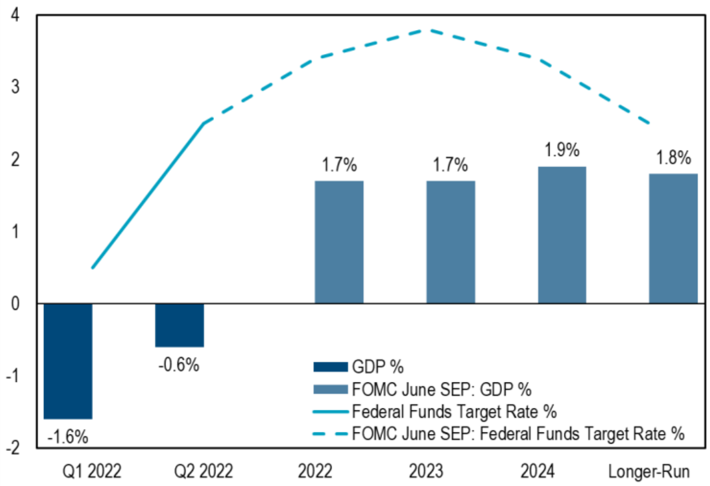
LONGER-TERM OUTLOOK

Of course, while day traders and Fed watchers are engrossed in the debate of the potential size of the September rate hike, the outcome next week is somewhat inconsequential. The real question is how the Fed will proceed in the coming months with additional data points painting a clearer picture of both growth and inflation, as well as the labor market. How high will the federal funds rate climb and by when? Will the Fed pause by year end, or early next year? When can the market expect the first rate *cut*?

According to Bloomberg's September Forecast Survey, the Fed is expected to reach a terminal rate of 3.88% by the first quarter of 2023 and begin to cut rates as early as the second quarter of 2023. While investors are convinced the Fed will hike another 75 bps on September 21 and potentially 100 bps more by the end of the year, taking the upper bound of the Committee's target range to 4.25%, the majority of market players anticipate policy makers will quickly reverse course and lower the target rate to 3.50% by the end of 2023.

Such an "*optimistic*" forecast, however, is based on the underlying presumption that inflation behaves and continues to retreat nearer the Fed's preferred 2% target range over the coming months. As this week's inflation reports indicated, a clear and accelerated retreat in prices, however, may remain a utopic and unobtainable outcome. At the very least, reining in inflation is likely to prove more complicated than expected as price pressures remain more persistent in nature. Thus, arguably, more important than even the presumed trajectory of policy is the Fed's expected pathway for prices, second only to the *realized* pathway of prices.

Along with the policy announcement next week on Wednesday, the Fed will also release an updated version of its Summary of Economic Projections (SEP). Given the Fed's heightened rhetoric regarding restoring price stability and the painful consequences that such an effort would incur, the Committee is likely to materially increase its outlook for rates and near-term inflation as well as sizably reduce its anticipated growth rate at least in 2022 and early 2023.



Source: Federal Reserve

As of June, the Federal Open Market Committee indicated it would likely raise rates to roughly 3.5% by the end of the year with a terminal rate of 3.75% in 2023. In terms of inflation, mid-year projections showed policy makers anticipating a sizable reduction in costs to 5.2% by year end and further to 2.6% by the end of 2023, with a steady outlook for 1.7% GDP over the next 18-24 months. More recently, however, at least some Fed officials have indicated the federal funds rate may reach 4% or higher with inflation stubbornly elevated through the fourth quarter and posing a larger downside risk to growth.

WHAT TO EXPECT

With the market clearly in the camp of a 75-bps hike, the Fed is likely to take advantage of the green light to "go big" for the third consecutive meeting. Going forward, however, as policy has now presumably moved beyond neutral, with emerging evidence of weakness from slowing activity in housing and production to waning momentum in spending and negative topline growth, without an equally sized reduction in costs, the Fed will struggle to maintain a balance between moderating prices and providing support to a potentially failing economy. At this point, the Fed has been clear that pain is not only likely, but *necessary* to achieve its inflation goals. As recessionary conditions become increasingly apparent, the big question is will the Fed be able to hold the line?

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