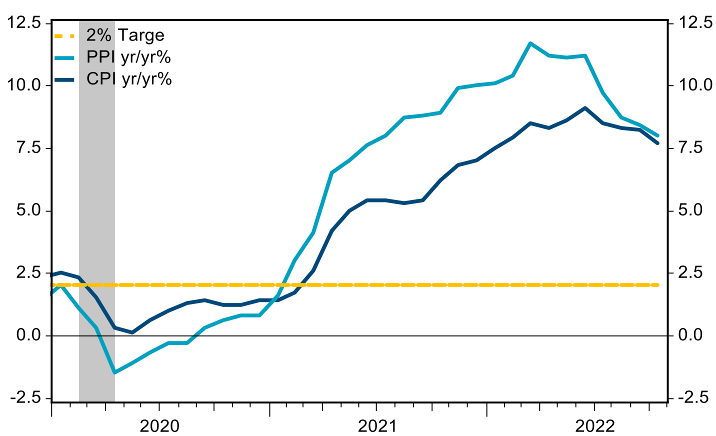
November 21, 2022

A Slower Pace of Still Rising Prices, Underscores Need for Additional Federal Reserve Action

Economic INSIGHT

The latest read on prices suggests the worst of the cost pressures may be behind us. Of course, with inflation still near a four-decade high, the Federal Reserve (Fed) continues to face a fierce challenge to reinstate price stability. For some Fed officials, the recent improvement in inflation is enough to signal the need for a more benign policy pathway. For other members, the battle has just begun with arguably minimal – albeit welcomed – movement in the right direction. As the December Federal Open Market Committee (FOMC) meeting approaches, there is an increasingly robust debate about the Fed's next move and the longer-term pathway for rates.

PRICE PRESSURES COOL (SLIGHTLY)



Source: Bureau of Labor Statistics/Haver Analytic

The latest read on consumer prices showed a welcome cooling in cost pressures. While prices are still rising, their ascent has slowed, gaining "*just*" 0.4% last month. Year-over-year, consumer prices continue to push higher at a 7.7% pace, which is notably slower than the 8.2% of September and an even further retreat from a peak rate of 9.1% in June.

As expected, the majority of the price pressures remain concentrated in energy and shelter costs. Energy prices alone rose nearly 2% in October, with transportation, food prices, and housing costs all increasing 0.5% to 0.7%. Excluding the volatility of the food and energy components, the core Consumer Price Index (CPI) rose 0.3% in

Lindsey M. Piegza, Ph.D.
Chief Economist
piegzal@stifel.com

Lauren G. Henderson
Economic Analyst
hendersonla@stifel.com

October, also significantly less than expected and pulling the year-over-year increase down from 6.6% to 6.3%.

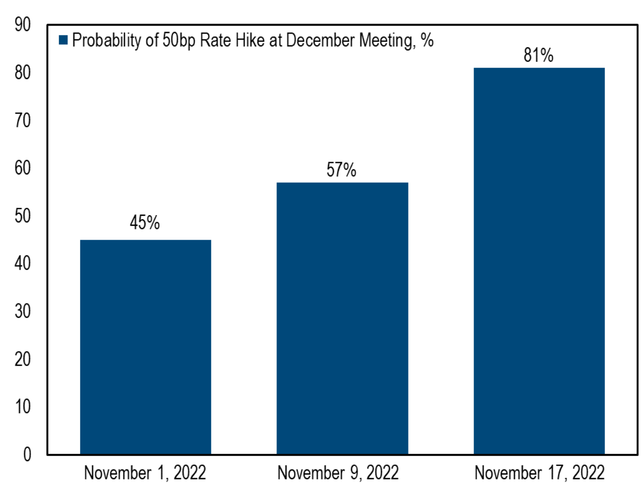
More recently, the latest read on producer prices offered a welcome confirmation to the cooler-than-expected trend in the CPI report. According to the October Producer Price Index (PPI) report, producer costs continue to rise, but the pace of increase is slowing. The PPI rose 0.2% in October, half of what was expected and matching the monthly increase in September. From this time last year, producer costs are still up 8.0%, but they are down from 8.4% the month prior and a peak pace of 11.7% in March of this year.

Like in the CPI, energy costs were again the primary driver of the rise in the headline PPI. Energy prices increased 2.7% in October, the largest monthly gain since June. Excluding energy costs, the PPI was flat and rose 7.0% over the past 12 months. And with food prices up 0.5% for the month, excluding food *and* energy costs, the core PPI was flat in October. Over the past 12 months, the core PPI is up 6.7%, down four-tenths of a percentage point from last month's increase and off 3% from a peak in March of this year.

PEAK INFLATION OR PEAK PRICES?

The latest read on consumer and producer inflation seemingly provides an affirmative answer to the question of whether or not peak price pressures are behind us. The more important question, however, is whether inflation will continue to retreat from here back toward the Committee's 2% target range, or will cost pressures remain elevated continuing to drive list prices – significantly – higher? **After all, a peak in inflationary pressures is not synonymous with a peak in prices. Even a slower pace of ascent continues to drive higher the cost of everyday goods and services in the marketplace.**

Nevertheless, at this point, the market appears convinced there has been enough progression toward the Fed's goal of price stability to move policy makers away from a more sizable rate hike in December. Rather than a fifth round "*supersized*" increase of 75 basis points (bps), market players are pricing in a smaller 50-bps hike at an 81% probability, up from 57% prior to the release of the October CPI report.



Source: CME FedWatch Tool

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

PPI – Producer Price Index

YoY – Year over Year

STIFEL

From the Fed's perspective, some officials, including Federal Reserve Vice Chair Lael Brainard and Kansas City Fed President Esther George, are supportive of the market's call for a slowing of rate hikes sooner than later given the improvement in inflation. Speaking to Bloomberg News on November 14, Brainard said she supports slowing the pace of tightening "*soon*," which some have interpreted to mean as early as the December 14 FOMC meeting. Acknowledging additional rate hikes are still needed, Brainard emphasized that she is in favor of a more tempered pace of policy adjustments.

Brainard has voted in favor of the Fed's earlier policy decisions, although with a bid for the position of Treasury Secretary potentially on the horizon, some suggest there could be additional incentive to take extra care in depicting a more tempered and controlled approach to policy. "*We have additional work to do*," she said. "*By moving forward at a pace that's more deliberate, we'll be able to assess more data and be better able to adjust the path of rates to bring inflation down*."

Also speaking on November 10 at an energy conference hosted by the Kansas City Fed and Dallas Fed, George reiterated a call for a "*more measured*" approach to monetary policy. Specifically noting concerns about the state of the consumer, the broader economy and financial market stability, she suggested the Committee may benefit from slowing the pace of future rate increases to fully assess the impact of earlier policy initiatives.

George was the sole dissent at the June 15 meeting when the Fed launched the first of what has now been four supersized rate hikes of 75 bps each. She has not dissented since; however, she has several times voiced support for a slower pace of increases. *"Without question, monetary policy must respond decisively to high inflation to avoid embedding expectations of future inflation*," she said. "*A more measured approach to rate increases may be particularly useful as policymakers judge the economy's response to higher rates*."

ON THE OTHER, MORE HAWKISH SIDE OF THE COIN

With the consumer accelerating the pace of expenditures into the final quarter of the year, a five-decade low in the unemployment rate, and still near a four-decade high in prices, other Fed officials are less convinced now is the time for the Fed to downshift policy or celebrate minimal improvement. Several Fed officials, including Federal Reserve Chairman Jerome Powell, Cleveland Fed President Loretta Mester, and most recently, St. Louis Fed President James Bullard have reiterated the importance of raising rates sufficiently to quell inflation as well as maintain a pace sufficient to convince market players the Fed will continue to raise rates until their goal of price stability has been achieved.

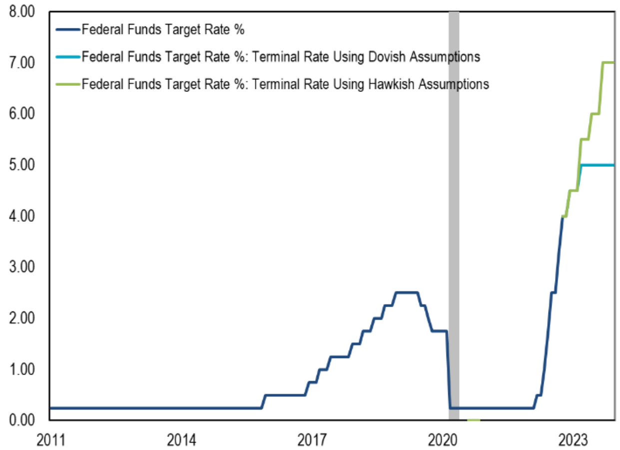
STIFEL

Speaking in the aftermath of the November FOMC rate decision, Powell emphasized the still solid nature of the U.S. economy and labor market. And while he acknowledged the need to understand the "*lags*" of monetary policy on the real economy, he suggested this cycle's delay may be materially reduced given the anticipatory reaction from financial market conditions. Furthermore, Powell emphasized that with inflation consistently surprising to the upside relative to earlier year-end forecasts, rates are also likely to push higher than expected to ensure positive real rates across the curve. The Fed has already revised higher its outlook for the terminal federal funds rate by 200 bps since the initial March Summary of Economic Projections. Come December, Powell's comments set the stage for the Committee to again materially revise higher its forecast for peak policy rates.

Similarly, Mester emphasized a growing concern that the Fed could fail to raise rates enough to tame inflation by prematurely slowing or pausing policy initiatives too soon. Speaking last week at Princeton University following the release of the October CPI report, Mester said while she was "*encouraged*" by the better-than-expected inflation report, a lot more needs to be done.

Mester has been an increasingly vocal member of the Committee underscoring the risk of the Fed stopping short of taming the inflation dragon. In fact, as Powell also emphasized during the November FOMC press conference, Mester said that the risk is not that the Fed does too much or overtightens. The real risk to the economy is that the Fed does too little, allowing inflation to become entrenched in the economy.

"*Given that inflation has consistently proven to be more persistent than expected and there are significant costs of continued high inflation, I currently view the larger risks as coming from tightening too little,*" Mester said.



Source: Federal Reserve Board/Bloomberg

Quantifying the need for potentially "*higher*" rates, Bullard suggested the Fed will likely raise the federal funds rate to a range of 5-7%, materially above the median forecast of a 4.6% peak rate presented in the September Summary of Economic Projections. With earlier rate hikes clearly having "*only limited effects on observed inflation,*" Bullard said, rates are likely needed to move significantly higher. Speaking at an event in Louisville, Kentucky, Bullard explained that using even "*dovish*" assumptions, a basic monetary policy rule would require rates to rise to at least around 5%, while stricter assumptions potentially show rates rising above 7%.

STIFEL

CONCLUSION

The October inflation reports were a welcome step in the right direction toward the goal of reinstating price stability with headline inflation down from recent highs. Of course, said another way, with already 375 bps in tightening, inflation remains near a four-decade high, potentially *reinforcing* the need for additional policy action. Still positive, albeit reduced, spending activity coupled with a near five-decade low in unemployment is not the type of meaningful "*pain*" the Fed insinuated was "*needed*" to quell inflation. As Fed Chairman Powell said, *"there is more work to be done."*

Of course, there remains ample debate as to the amount of work to be done. Some Fed officials contend the Fed must stay the course with a more robust and aggressive approach to inflation, while other Fed members, along with market participants, are suggesting a smaller rate hike may be on the horizon sooner rather than later.

Lindsey Piegza
Ph.D., Chief Economist
piegzal@stifel.com

STIFEL

DISCLAIMER

The information contained herein has been prepared from sources believed to be reliable but is not guaranteed by us and is not a complete summary or statement of all available data, nor is it considered an offer to buy or sell any securities referred to herein. Opinions expressed are subject to change without notice and do not take into account the particular investment objectives, financial situation, or needs of individual investors. There is no guarantee that the figures or opinions forecasted in this report will be realized or achieved. Employees of Stifel, Nicolaus & Company, Incorporated or its affiliates may, at times, release written or oral commentary, technical analysis, or trading strategies that differ from the opinions expressed within. Past performance is no guarantee of future results. Indices are unmanaged, do not reflect fees or expenses, and you cannot invest directly in an index.

Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. The Standard & Poor's 500 index is a capitalization-weighted index that is generally considered representative of the U.S. large capitalization market. The Dow Jones Industrial Average (DJIA) is a price-weighted average of 30 significant stocks traded on the New York Stock Exchange (NYSE) and the NASDAQ. The DJIA was invented by Charles Dow back in 1896. The MSCI EAFE index (Europe, Australasia, and the Far East) is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets, excluding the U.S. and Canada. The NASDAQ Composite Index is a capitalization-weighted index that is comprised of all stocks listed on the National Association of Securities Dealers Automated Quotation System stock market, which includes both domestic and foreign companies.

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | www.stifel.com

1122.5236369.1

STIFEL