January 23, 2023

Headline Inflation Improvement Masks Underlying Risks

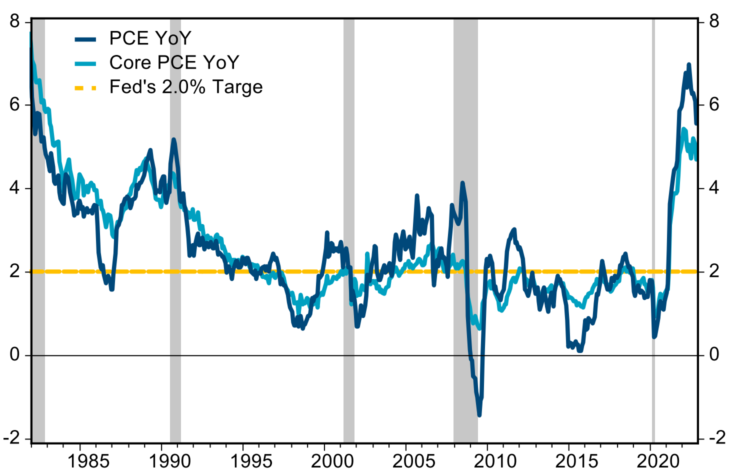
Economic INSIGHT

The latest inflation data shows headline prices continuing to cool, perpetuating the notion that the Federal Reserve (Fed) can continue to take its foot off the brake. Some Fed officials have been vocal in support of further reducing the size of future rate hikes, amid a presumed lag in policy impact and a growing fear of recession. Others are less convinced inflation is on a meaningful – and *sustainable* – downward trajectory. Looking beyond the headline, some components of inflation remain worrisome as they continue a relentless move higher.

The Fed has been clear in its intentions to use all monetary policy measures necessary to douse the flames of inflation, but some officials appear emboldened by simply putting out the fire in the annex while the house remains aflame behind them.

HEADLINES SELL, BUT THE DEVIL IS IN THE DETAILS

The Bureau of Labor Statistics' Consumer Price Index (CPI) released earlier this month showed a welcome retreat in headline prices. Declining 0.1% for the month of December, the annual CPI dropped from 7.1% to 6.5% at year end. Excluding food and energy costs, the core CPI also showed improvement. Rising 0.3% in the final month of 2022, core inflation slowed from 6.0% to 5.7% over the past 12 months.



Source: Bureau of Economic Analysis/Haver Analytic

Similarly, the Producer Price Index (PPI), which was released last week, indicated cooling inflation as well. The headline PPI fell 0.5% in December, more than the 0.1% decline expected and the largest monthly drop since April 2020. Year-over-year, producer prices rose

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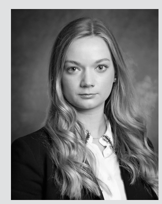

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6.2% in December, down from a 7.3% increase in November. Excluding food and energy costs, the core PPI rose 0.1% in December and 5.5% from this time last year, down from a 6.2% gain in November.

Of course, the Personal Consumption Expenditures (PCE) price index, specifically the core PCE, is what the Fed predominantly uses to gauge inflation and determine appropriate policy. That being said, the latest reads of the CPI and PPI do support the PCE's indication that price pressures are modestly improving – at least in terms of the headline measures.

The latest PCE data reported a rise of "*just*" 0.1% in in November, resulting in a retreat of the annual pace from 6.1% to 5.5%. Excluding food and energy costs, the core PCE rose 0.2% and 4.7% year-over-year, down from a 5.0% pace reported the month prior. Of course, while headline inflation has consistently cooled since a peak of 7.0% in June, the improvement in the core has been less clear-cut.

Following two months of retreat from a first-round peak of 5.4% in March, core inflation surprised to the upside in June before reaching a new peak level of 5.2% in September. Since then, two consecutive months of improvement totaling a reduction of 50 basis points (bps) is a welcome step in the right direction, but as Federal Reserve Chairman Jerome Powell himself has indicated, there remains ample uncertainty as core prices remain well above earlier forecasts and "*down months in the data have often been followed by renewed increases*."[1]

Furthermore, the unevenness or zigzag pattern of core inflation aside, the nominal improvement – both in the core and the headline – has been far from impressive. Since fourth quarter 2021, this has been the highest period of inflation since the early 1980s. In other words, historical context dictates that small concessions of improvement are not synonymous with meaningful improvement in prices. At the very least, the volatile pattern of the core PCE month to month and lack of significant nominal reduction in inflation underscore the Fed's need to remain cautious in its policy pathway to root out inflation.

INFLATION BY CATEGORY

Given that inflation continues to underperform in terms of the presumed marked retreat, the question remains, what is holding it back? Or better said, what categories are continuing to support elevated costs pressures?

Goods prices appear to be the bright spot in the inflation equation. Core goods inflation, which peaked at 6.7% in September, has since retreated from the high, dropping 100 bps to 5.7% as of late. At first, goods prices were driven higher by a surge in demand

[1] "*Inflation and the Labor Market*" Speech on November 30, 2022 at the Hutchins Center on Fiscal and Monetary Policy, Brookings Institution, Washington, D.C.

GLOSSARY

YoY – Year over Year

CPI– Consumer Price Index

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

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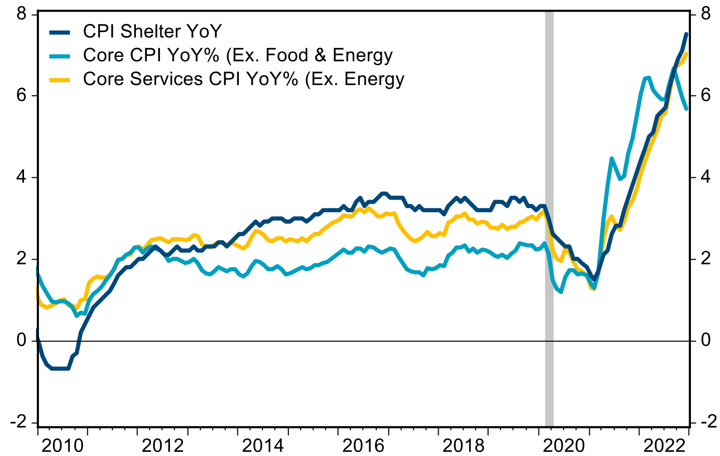
perpetuated by fiscal generosity and limited supply cut off by a global pandemic. Now, however, as supply chain constraints are lessening and fiscal support wanes, goods price pressures are abating.



Source: Bureau of Labor Statistics/Haver Analytic

Service inflation, on the other hand, appears to be intensifying. Amid a lack of labor, particularly skilled labor, with millions yet to return to a more traditional position in the labor force, wages remain elevated, perpetuating a rise in service-sector inflation. Housing services prices in particular, a proxy for shelter costs, continue to rise, pushing higher for 16 consecutive months and gaining from a low of 1.5% in February 2021 to 7.5% as of December 2022. As some Fed officials have noted, rents have "*surged*," a trend that is expected to continue well into 2023.

And core services excluding housing, which tracks insurance, healthcare, education, and personal services among other categories, and accounts for the majority of the core PCE, has failed to indicate a clear pathway of improvement. Still not at a definitive tipping point, core services less housing price inflation remains on an upswing, rising for 17 consecutive months to 7.0% in the latest December report.

IT'S NOT CLEAR-CUT

Inflation has improved from the "*red-hot*" price pressures in 2021-2022. That being said, not all Fed officials – or market participants for that matter – are convinced inflation is on a meaningful and *sustainable* downward trajectory. Some categories of price pressures, particularly goods inflation, have shown more discernable progress and will expectedly continue to do so as the global economy and international trade lines regain pre-COVID fluidity. On the other hand, services costs, including shelter costs, have shown little, if any, indication of cooling despite already 425 bps in Fed rate hikes.

Since March 16, 2022, the Committee has been clear that taming inflation remains – above all else – the main policy objective. A partial reduction in inflation is *not* sufficient to satisfy the goal of reinstating price stability, but is it enough to pacify a majority of Fed members that earlier policy initiatives are already having the intended impact of slowing inflation, opening the door for a further reduction in the size of rate hikes? The market is convinced with a 97% probability the Fed will opt for a smaller 25 bps hike in just under two weeks' time. If the Fed intends otherwise, policy makers would be well advised to begin to communicate a more aggressive plan of action.

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