August 14, 2023

Headline Inflation Reverses Course as Core Signals Further – Albeit Minimal – Improvement, Muddying the Outlook for the Federal Reserve

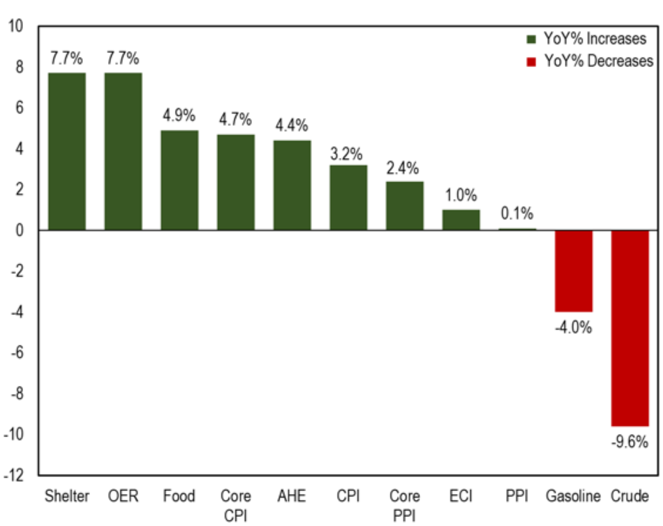
Economic INSIGHT

The latest inflation numbers were increasingly favorable as core consumer costs dropped to a 21-month low. With a continued retreat in price pressures in mind, investors have increased expectations for a second-round pause in Federal Reserve (Fed) rate hikes in September and a soft-landing for the economy. But while even July's minimal retreat in core inflation is welcome, a simple extrapolation of last month's deceleration as an indication of what's to come appears superficial at best. After all, headline price pressures *rose* at the start of July, and with commodity prices on the rise, the August inflation report is likely to show an even greater threat to recent disinflationary improvement.

Policy officials have made great progress lessening the pace of inflation from peak levels in June of last year. However, the goal is not to get inflation from 7% to under 5%. It is to ensure a continued downward trajectory back to the Committee's 2% target level.

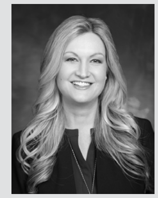
RISING HEADLINE PRICES, COOLING CORE

Consistent with economic forecasts, the core Consumer Price Index (CPI) rose just 0.2% in July and 4.7% over the past 12 months, now marking the slowest pace of ascent since September 2021. But while a further reduction of any size in price pressures is welcome, the pace of descent remains disappointingly slow with core inflation still more than double the Fed's preferred 2% level. Additionally, taking a broader assessment of costs, the headline CPI rose 0.2% in July and 3.2% year-over-year – inching *higher* from a 3.0% pace reported the month prior.

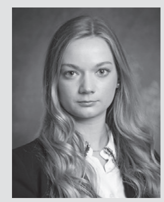


Source: Haver Analytics

In the details, there were several pockets of outright deflation in July with transportation prices dropping 0.1%, medical care prices down 0.2%, and airline fares dipping more than 8% after a similarly sized decline in June. On the other hand, shelter prices increased 0.4% at the start of the third quarter, reflecting



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



Lauren G. Henderson
Economist
hendersonla@stifel.com

STIFEL

a 0.5% rise in the Owners' Equivalent Rent (OER) component while other goods and services costs as well as recreation prices gained 0.1%. Perhaps more concerning, food prices rose 0.2%, and energy prices gained 0.1% in July, the second consecutive month of increase.

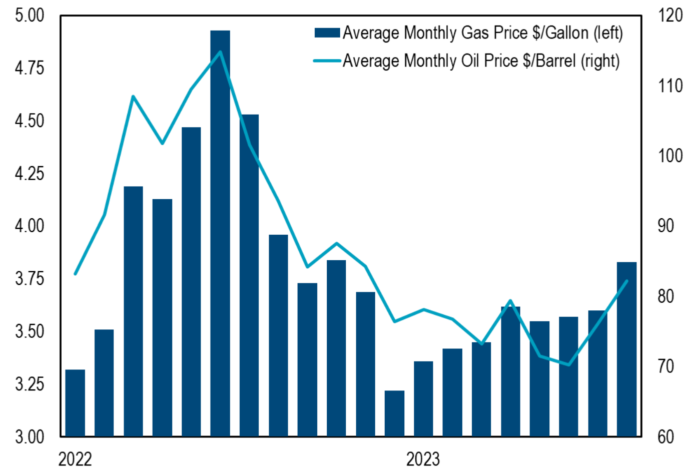
Turning to producer prices, the July Producer Price Index (PPI) report was somewhat hotter than expected with the headline rising 0.3% in July and 0.8% over the past 12 months, up from the 0.2% annual gain reported in June. Excluding food and energy costs, the core PPI also came in above expectations, rising 0.3% for the month and 2.4% year-over-year, matching the annual gain in June.

Traders were quick to focus on the good news in the latest inflation report: they surmise that a further retreat in prices, albeit minimal, supports the notion the Fed is increasingly approaching the elusive soft landing whereby a sustained level of disinflation can be achieved without a significant rise in unemployment. Following Thursday's CPI report, the probability of a September rate hike dropped to a low of 9.5% before ending the week at 11.5%.

The assumption, however, that a string of *"comforting"* summertime data will continue uninterrupted until the Fed reaches its goal of price stability may be overlooking the sticky nature of wage pressures and more recently, the upward movement in commodities costs. A further backup in the price of energy, food and/or other raw materials could at the very least undermine the downward trajectory in cost pressures or worse, result in a – further – uptick in headline prices, complicating the Fed's next move, let alone the longer-run pathway for rates.

RISING ENERGY PRICES

Energy price reprieve has been well established with gasoline costs in particular broadly declining for roughly a year. Dropping by more than $1.15 a gallon, or more than 23% from a peak in June 2022, the lower costs at the pump have helped consumers offset a loss of purchasing power elsewhere in the marketplace. More recently, however, higher energy costs are once again taking a larger chunk of consumers' discretionary spending and potentially creating a mounting challenge for policy aimed at taming price pressures.



Source: AAA/Bloomberg

*Aug. 2023 data through 8/10/2023

According to AAA, the national average of a gallon of gasoline remained at $3.83 a gallon over the past week, a 10-month high. In states such as California and Washington, prices have pushed up even higher to over $5 a gallon. While still down 24% from an earlier national peak of $5.02 more than a year ago, year-over-year costs are now off just 4%. Furthermore, amid hotter temperatures and reduced global supply, some projections suggest additional energy price pressures are coming.

GLOSSARY

AHE – Average Hourly Earnings

CPI – Consumer Price Index

ECI – Employment Cost Index

OER – Owners' Equivalent Rent

OPEC – Organization of Petroleum Exporting Countries

PPI – Producer Price Index

QoQ – Quarter over Quarter

YoY – Year over Year

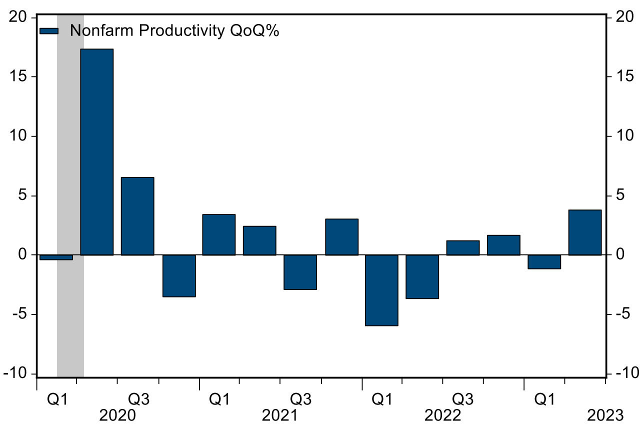
STIFEL

Excessively warm weather this summer has worked to restrain refinery capacity. According to GasBuddy, national refinery utilization has decreased by nearly 1%, reducing daily average gasoline production to 9.5 million barrels and distillate fuel production to 4.8 milllion barrels.

Meanwhile, global crude supply has taken a sizable hit with intensified production cuts from OPEC+ driving higher oil costs (which account for roughly 50% of the cost of a gallon of gasoline). In June, Saudi Arabia announced a supply cut of 1 million barrels a day beginning in July, lowering its output from 10 million to 9 million barrels per day, a two-year low. It recently extended the cut for at least another month. At the same time, Russia announced plans to cut oil exports by 300,000 barrels per day starting in September. As a result, crude prices have risen more than $15 since a low in June, now hovering near $83 a barrel, a four-month high.

EARNINGS PRESSURE

Along with broader metrics of inflation reversing course and moving *higher* last month, wage pressures have also slowed their rate of descent, undermining expectations for a sooner than later end to further policy firming. Average hourly earnings rose 0.4% in July, a tenth of a percentage point more than expected, and maintaining a 4.4% annual pace. While not accelerating, the Fed had hoped to see more improvement – meaning downward momentum in wage pressures. Further upward pressure in labor costs is unlikely as the Fed continues to firm policy; significant downward pressure, however, is equally unlikely until labor supply increases markedly or the demand for labor is sizably diminished as businesses find technological alternatives or falter under – eventually – slowing economic conditions.



Source: Bureau of Labor Statistics/Haver Analytic

Nevertheless, some remain optimistic the latest surge in productivity will help offset the more recent rise in labor costs, mitigating pressure on the Fed to take further action. But while the unexpected rise in second quarter productivity was a welcome gain of 3.7%, the highest level since third quarter 2020, *broadly productivity* remains lackluster at a longer-term average of "*just*" 1.5%. Furthermore, according to Stanford's Institute for Economic Policy and Research, the work-from-home model has been found to lead to a 10-20% *reduction* in productivity. Thus, while the more utopic scenario would be a more efficient workforce justifying or offsetting elevated wage pressures with gains in output and resulting in a rise in real earnings for consumers as market prices recede, the reality – and more importantly, the data – do not support such a conclusion. Nor does this let the Fed off the hook from further rate hikes to tame inflation. Businesses continue to face elevated input costs and as a result, consumers continue to foot higher prices.

COMPLICATIONS

Rising energy costs, elevated wage pressures, and more broadly, an uptick in headline consumer costs complicate the outlook for Fed policy as even those Committee members still in favor of "*some*" further policy firming believe the terminal level is near. Of course,

STIFEL

such an assumption has long been predicated on the notion that the trend of disinflation was well established and would continue until the Committee's 2% objective for inflation was met. The latest data suggest the pathway to reinstating that target level, however, may be less liner than hoped. After all, even a minimal backup in prices doesn't just raise questions about the Fed's goal of stable prices, but also the consequences of ongoing tighter monetary policy, particularly on the U.S. consumer.

As the backbone of the economy, the ongoing resilience in terms of consumer spending has buoyed optimism the Fed can achieve the elusive soft landing whereby policymakers are able to achieve price stability without a significant cooling in the level of joblessness. However, cracks are already becoming evident in the labor market as businesses, still hiring, have needed – or opted for – fewer workers and household spending has slowed. In the near term, such weakness is likely to be exacerbated as many consumers face rising energy, housing and borrowing costs, as well as higher monthly payments including the reintroduction of student loan payments perpetuating an erosion of purchasing power.

Looking forward, the realization of the potential for further deterioration of the consumer, coupled with stagnant or rising inflation, suggests the Fed may need an even stronger response – not weaker – at a time when the household balance sheet can least withstand further pressure, increasing the odds of an eventual downturn.

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

DISCLAIMER

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

0823.5876993.1