Economic INSIGHT

November 20, 2023

Inflation Three Ways: Still Elevated Price Pressures Reinforce Powell's Willingness to Raise Rates Further despite Market Skepticism

The latest commentary from Federal Reserve (Fed) officials has been mixed at best. Despite the growing noise, however, from both voting and non-voting policy makers, Fed Chairman Jerome Powell seemingly set the tone last week regarding the future of monetary policy and its dependency on the performance of inflation as the driver. "We are making decisions meeting by meeting, based on the totality of the incoming data … determining the extent of additional policy firming that may be appropriate to return inflation to 2 percent over time," he said at an International Monetary Fund event in Washington, D.C. last Thursday. "We will keep at it until the job is done."

The good news is the Committee's 525 basis points (bps) in rate hikes over the past 21 months has significantly slowed inflation's ascent. That being said, there is still considerable ground left to cover to get inflation to the Fed's 2% target, suggesting it may be too early to declare "success" just yet. And as that quest continues, consumers and businesses continue to face a massive erosion of purchasing power, paying more dollars (those pretty, green pieces of paper) and receiving less in exchange.

Some Fed officials are suggesting the Fed should err on the side of caution not to raise rates more than needed and potentially damage the economy, while others have indicated the painfully slow pace of inflationary improvement means they have not raised rates enough to ensure price stability. As Minneapolis Fed President Neel Kashkari reminded investors last week, the risk is not that the Fed raises rates too much, but that it doesn't raise them enough and inflation remains elevated. Acknowledging the resilience of the economy, he underscored the upside risks to inflation. "Undertightening will not get us back to 2% in a reasonable time," he said.

Further complicating the inflation picture is the varying measures of prices, which directionally all show downward momentum from earlier peak levels, but at different speeds and with diverging degrees of improvement.

MEASURE WHAT YOU WILL

There is a debate among economists on how to accurately measure inflation. For decades, they have struggled to fully capture the level of price growth across an increasingly complicated and ever-changing economy. This challenge continues today as the Fed attempts to tweak monetary policy to a terminal level that will – eventually – reinstate price stability without unnecessarily undermining growth.

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

Lauren G. Henderson
Economist
hendersonla@stifel.com

STIFEL

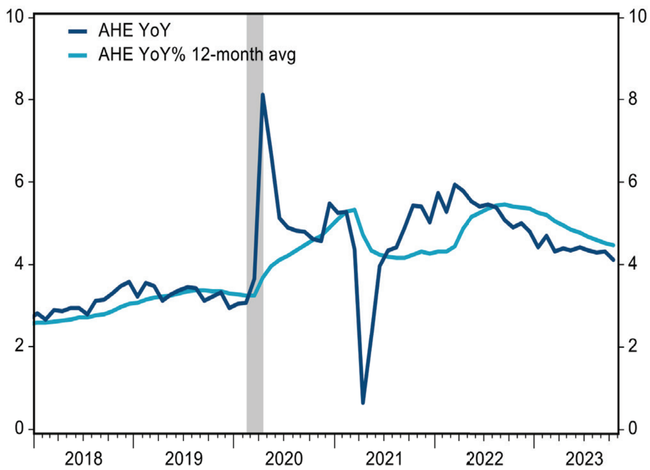
There are three primary metrics used to gauge inflation. The Producer Price Index, or the PPI, measures the average change in prices charged by businesses (domestic producers). On the consumer side, the Consumer Price Index, the CPI, and the Personal Consumption Expenditures Index, the PCE, measure the cost of a basket of goods and services being purchased by the end user. Both the CPI and the PCE aim to capture the costs incurred by the consumer, although the CPI is based on what households are buying (including foreign-made goods). The PCE is the Fed's preferred measure of inflation and is based on what businesses are selling (including capital goods).

Each metric – PPI, CPI, and PCE – varies in weighting, methodology, how to account for changes in purchasing behaviors, the scope of coverage, and seasonal effects. Each of them also come in two "flavors" – a headline and a core measure. The headline captures overall inflation across goods and services in the economy. The core excludes food and energy costs.

Of course, consumers and businesses pay for both food and energy, and the proportion of the household balance sheet designated to these categories is not insignificant. In fact, arguably the fastest way to derail the American consumer is with sustained heightened energy costs. So why are they excluded from the core measure? Quite simply because, while they are key components of the household budget, they are also the two most volatile elements of inflation and often do not reflect the underlying trend of price pressures in the broader economy. In other words, one would not expect the Fed to adjust the federal funds rate based on a weather-related spike in coffee prices that temporarily elevates the headline CPI.

WHAT ELSE IS THERE? WE NEED MORE ...

In the quest to finely tune measurements of inflation, and accurately deploy monetary policy, some economists have proposed alternative methods to the primary three indices (CPI, PPI and PCE) to try to account for anomalies in the data or special circumstances in the economy. After all, food and energy are not the only components that can face extreme volatility in a short period of time and temporarily skew price pressures. The Dallas Fed, for example, proposed an alternative measure of core inflation back in 2005 called the Trimmed Mean PCE. Rather than focusing on excluding particular categories as does the core, the metric attempts to eliminate the "noise" in the data itself by excluding the most extreme upside and downside price changes each month. While the measure does not eliminate all variability, it attempts to offset one-off events or factors that may not be indicative of the "real" level of inflation.



Source: Bureau of Labor Statistics/Haver Analytic

More recently, officials have taken further steps to isolate the "true" measure of price pressures. One such measure stealing the show with its massive popularity and widespread appeal is the "super core." Dubbed the proverbial "Taylor Swift" of inflationary metrics, it removes not only food and energy, but also strips out housing costs and the price of goods. While again like the core, consumers and businesses pay for these excluded components

GLOSSARY

AHE – Average Hourly Earnings

CEA – Council of Economic Advisors

CPI – Consumer Price Index

IMF – International Monetary Fund

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

YoY – Year over Year

STIFEL

as they account for a substantial portion of monthly spending, these factors are also the ones most distorted in this new post-pandemic world and thus, may be skewing the broader measure of prices.

Keep in mind, the key concern for the Fed when looking at inflation is the wage-price spiral, whereby businesses are forced to pay higher wages, which leads to higher prices in an ongoing cycle that ultimately results in longer lasting – and higher – inflation. Labor costs account for the largest proportion of expenses for business services, as opposed to parts and materials for goods production. Therefore, wages are the primary driver of services-sector inflation, and by extension, they act as a proxy for the wage-price spiral that officials so greatly fear.

In order to detach the costs of services specifically, wages or wage growth must be isolated. Such specifications, however, are not provided by the Labor Department, which reports the monthly figures on employment and earnings. Alternatively, the Council of Economic Advisors (CEA) has recently constructed a wage series that tracks only the labor costs of the industries that go into the "super core" inflation measure.

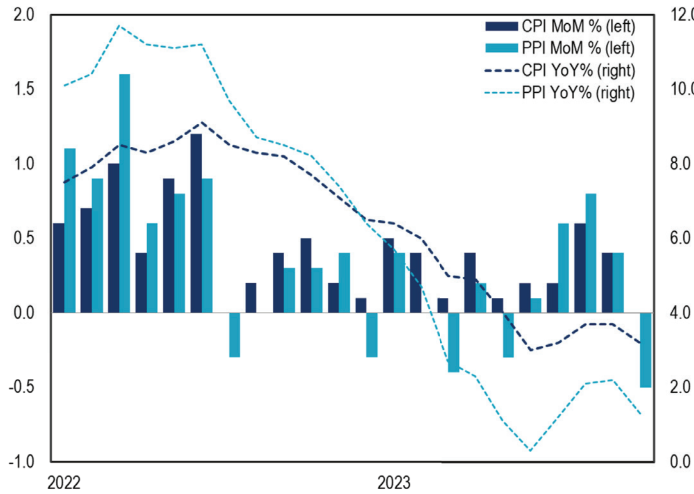
AN UPDATE

While no longer at peak rates, the level of improvement in inflation has fallen well short of expectations, leaving at least some price measures still more than double the intended 2% target, and complicating the outlook for monetary policy.

The latest read on the CPI, for example, was flat (0.0%) in October following a 0.4% gain in September. Year-over-year, consumer prices rose 3.2% following a 3.7% gain in September and marking the smallest gain since July. The improvement on an annual basis, however, follows three months of upward momentum in costs. Thus, the latest report simply returns the headline read to where it was in July.

Excluding food and energy costs, the core CPI rose 0.2% at the start of the fourth quarter following a 0.3% increase the month prior. Year-over-year, the core CPI increased 4.0%, down minimally from the 4.1% gain in September. While marking the slowest pace of accent since September 2021, the core CPI has improved less than 1% since June and remains double the Committee's intended target.

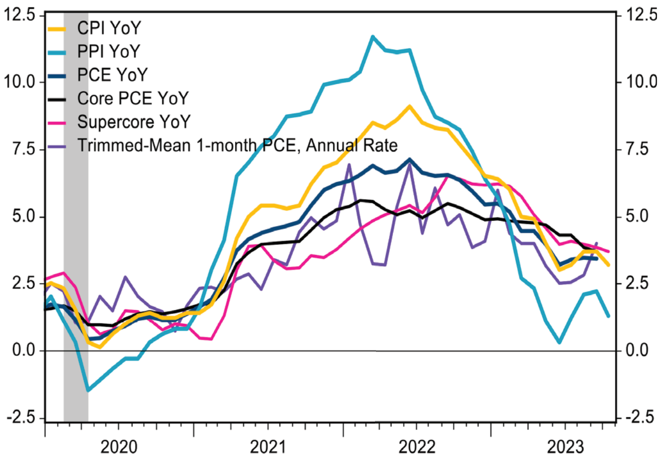
Turning to producer prices, the PPI unexpectedly fell 0.5% in October relative to an expected 0.1% rise and following a 0.4% increase the month prior. Year-over-year, producer prices rose 1.3% in October, down from the 2.2% gain in September and marking the slowest pace since July. Of course, like the CPI, October's cooler PPI print marks the first annual decline from the prior month following three consecutive months of upward momentum.



Source: Census Bureau/Haver Analytics

Excluding food and energy costs, the core PPI was unchanged (0.0%), also a weaker than expected monthly reading and following a 0.2% increase in September. Year-over-year, the core PPI rose 2.4% in October, down from the 2.7% gain in September and the slowest annual gain since January 2021.

On the other hand, the Fed's preferred measure of inflation, the PCE, rose 0.4% in September, a hotter-than-expected rise after a similar sized increase in August. With an outsized monthly gain at the end of the third quarter, year-over-year, headline inflation remained steady at 3.4% as it has since July. Excluding food and energy, the core PCE rose 0.3% in September, and 3.7% year-over-year, a minimal retreat from a 3.8% annual increase last month.



Sources: BLS, BEA, BLS/H, FRBDAL/Haver

Looking beyond the big three, the trimmed mean PCE rose 4% in September on an annualized basis, a sizable jump from a 2.8% gain in August. At 4%, this marks the fastest annual rise in the trimmed mean PCE in five months.

And, finally, the dashing, flashy super core rose 0.2% in October following a hefty 0.6% gain in September, the largest monthly increase in a year. Over the past 12 months, the super core increased 3.7%, dropping, again minimally, from a 3.8% gain in September. Like most inflationary metrics, while continuing to show disinflationary progress, the pace of improvement remains lackluster at best, down less than three percentage points from a 6.5% peak in September 2022 despite over 500 bps in Fed rate hikes.

THIS IS WHERE I LEAVE YOU

While undoubtedly there is no perfect measure of inflation, the additional breakdowns and analysis of price data offer further insight into the underlying forces and directional momentum of price pressures that could serve to aid monetary officials to best direct policy. At this point, however, pushing unfounded hopefulness and optimism to the sidelines, the data, any way you slice it, is not yet convincing that inflation is on a clear and sustainable downward trajectory back to the Fed's 2% target.

While some policy makers are convinced (hope) the disinflationary trend will continue, and investors continue to overreact to the smallest of improvements, others are more skeptical (realistic) in their assessment of price conditions. As Chair Powell noted, with some measures of inflation trending lower, higher and sideways, inflation has given us more than a few "head fakes" and there remains a risk of being "misled by a few good months of data."

There has been progress from peak levels no doubt, but the painfully slow pace of improvement should not – does not – offer confidence the Fed has yet done enough to ensure a return to price stability, and soon. After all, the longer the Fed delays, the more entrenched price pressures become.

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

STIFEL

DISCLAIMER

1123.6104985.1

STIFEL