

March 18, 2023

## Inflation Concerns Keep Federal Reserve on Sidelines for Much – Much – Longer

Ahead of the Federal Reserve (Fed)'s March rate decision, Fed Chairman Jerome Powell headed to Washington, D.C. to testify before Congress on the current state of policy and expectations for rates going forward. Without convincing proof of inflation retreating, the Committee, he said, is in no rush to initiate rate cuts, setting the stage for a prolonged position on the sidelines.



Following January's hotter-than-expected consumer price report, officials – and investors alike – were hopeful February would offer some needed relief, and evidence to reopen the door for a near-term change in policy, but to no avail. Instead, the continued acceleration in monthly price pressures resulting in a flattening – rather than improving – trend simply affirms the notion of higher rates for potentially much – much – longer than previously expected.

### TESTIMONY LEADS STATEMENT

With just five days until the March Federal Open Market Committee (FOMC) policy announcement, there is little expectation for an adjustment in rates away from the current terminal level of 5.50%. However, with an updated Summary of Projections (SEP) poised for release, market players remain optimistic the Committee will continue to indicate expectations for a reduced level of policy firming beginning sometime soon, with additional rate cuts by year-end. While investors have seemingly capitulated to at least a while longer on pause, an expectation for a first-round rate reduction in June (as opposed to March) and up to three in the subsequent six months, still appears to be somewhat aggressive given the Fed's ongoing message of "patience."

In prepared testimony shared before Congress earlier this month, Fed Chairman Powell reiterated a message of uncertainty and temperance, suggesting rate cuts would likely be appropriate at some point in 2024, but the Committee is not ready yet. Powell was clear the Fed needs further evidence of disinflation, or at least further confidence in the inflation data that the underlying trend will continue to retreat back to the price target of 2%. Such cautious testimony, furthermore, was delivered before the latest rise in February consumer prices. The additional backup in cost pressures reinforces, rather than mitigates, the Committee's hesitancy to initiate rate reductions. Thus, contrary to market hopefulness, the March SEP could show a reduced outlook for policy easing relative to the December report both in terms of launch date and pace.

"The Committee does not expect that it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2% ... If the economy evolves broadly as expected, it will likely be appropriate to begin dialing

Economic  
**INSIGHT**



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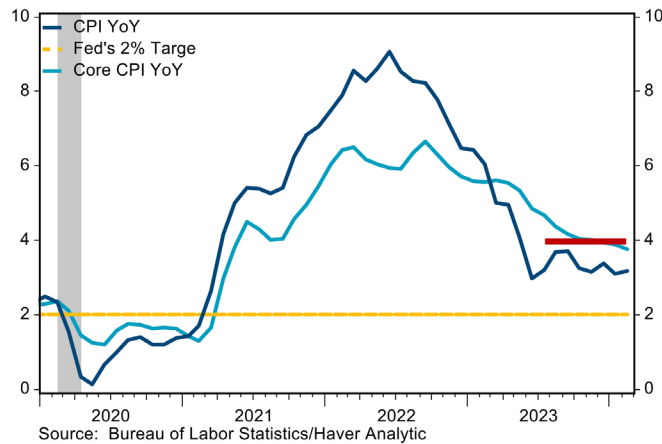


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back policy restraint at some point this year. But the economic outlook is uncertain, and ongoing progress toward our 2% inflation objective is not assured.”

-Federal Reserve Chairman Jerome Powell, Semi-Annual Testimony, March 6, 2024



### THE BREAKDOWN OF INFLATION

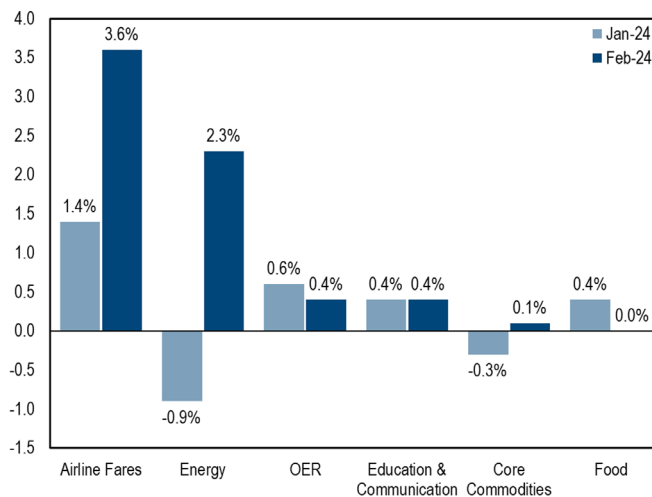
The latest commentary from Fed officials has indicated an ongoing – and heightened – sensitivity and focus on prices, as the latest inflation figures showed somewhat of an acceleration in costs at the start of the year. Such trepidation was further exacerbated this week with

a second round, hotter-than-expected read on consumer and producer costs.

Consumer prices rose 0.4% in February, as expected, however this follows a 0.3% rise at the start of the year. While a minimal increase relative to the previous month, the additional pressure on a monthly basis was enough to hike the annual pace up from 3.1% to 3.2%.

Excluding food and energy costs, the core Consumer Price Index (CPI) also rose 0.4% for the month and 3.8% year-over-year. While down from a previous pace of 3.9% in January, both the monthly and annual increases were higher than anticipated. Furthermore, with monthly gains accelerating since September, the core CPI has seemingly leveled off near 4%, still roughly double the Fed’s intended target.

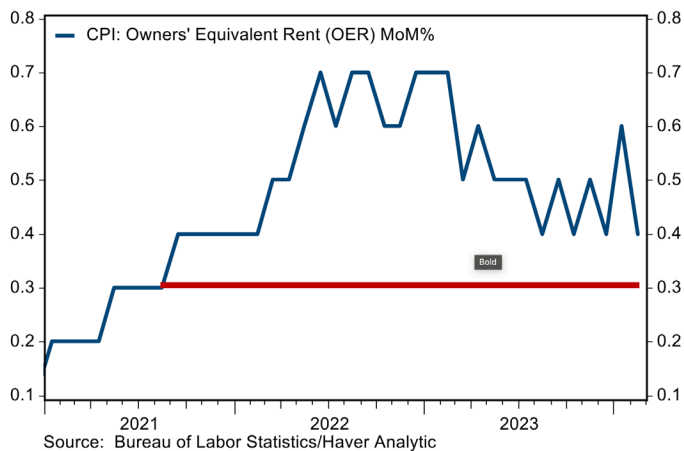
In the details, energy prices jumped 2.3% in February, the first monthly gain in five, although the annual pace remains in the red, down 1.9%, and now marking a full year of contraction. Food prices, meanwhile, were unchanged in February following a 0.4% gain at the start of the year, and rose 2.2% over the past 12 months, the smallest annual increase since May 2021.



Transportation prices in total rose 1.4% in February, despite a 0.1% drop in new vehicle costs, with a 0.5% gain in used cars and trucks prices, and to a larger extent, a sizable gain in airline fares. Airline fares jumped 3.6% in February, the largest monthly gain since May 2022. Other notable components included core commodities prices, which exclude food and energy costs, up 0.1% in February, the largest gain in nine months, and education and communication prices increased 0.4%, matching the increase the month prior.

### GLOSSARY

- CPI** – Consumer Price Index
- OER** – Owner’s Equivalent Rent
- PPI** – Producer Price Index
- SEP** – Summary of Economic Projections
- YoY** – Year over Year



One of the largest and longstanding culprits, however, in terms of the lack of improvement in the desired disinflationary trend remains shelter costs. Owners' Equivalent Rent (OER), especially, jumped 0.4% in February, following a 0.6% increase in January, and gained 6.0% year-over-year.

While down on an annual

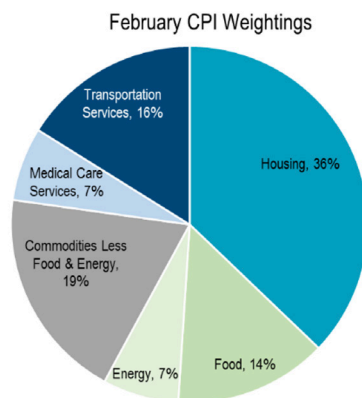
basis from a peak of 8.1% in April, since September 2021, the OER has risen more than 0.3% month-to-month, the longest stretch of outsized monthly gains on record and suggesting ongoing pressure. Despite expectations for a rollover in shelter costs for the better part of the past two years, housing prices continue to surprise to the upside.

Keep in mind, the shelter component of the CPI itself consists of four factors: the OER, lodging away from home, rent of primary residence, and tenants' and household insurance. The OER is the largest component of shelter and has a sizable weighting in the overall CPI index at 27%. The OER is used to estimate what the rental value of a home would be if an owner was renting it, as opposed to "rent" which is used to approximate the value of a rental property. By using the OER as a proxy instead of housing prices directly, the measure is able to remove the investment component for the purchase and resale of homes from the consumption aspect.

Nuances of the housing component aside, the CPI, excluding goods, food, energy, and shelter, the so-called supercore also showed an acceleration in recent months. The supercore rose 0.5% in February, surpassing expectations for a more muted monthly increase. While noticeably less than the 0.9% increase in January, on an annual basis, the supercore rose 4.4%, unchanged or posting no further improvement relative to the prior month.

Similarly to consumer costs, producer prices gained further momentum in February, underscoring broad-based inflation concerns. The Producer Price Index (PPI) rose 0.6% in February, double the rise expected and following a 0.3% gain the month prior. Year-over-year, producer prices rose 1.6% in February, up from the 1.0% gain in January and the largest annual increase in five months.

Food prices rose 1.0% in February following a 0.3% decline the month prior, while energy prices jumped 4.4%, the largest monthly gain in six months. Excluding food and energy costs, the core PPI rose 0.3% following a 0.5% gain in January. According to the median forecast, core producer prices were expected to rise 0.2%. Year-over-year, the core PPI increased 2.0% in February, matching the 2.0% annual gain in January and surpassing the 1.9% increase expected.



Source: Bureau of Labor Statistics/Haver Analytics

## CONCLUSION

The Fed has been clear in its message of patience, desperate to see additional evidence of an improving inflationary environment before taking the first step toward easing monetary policy. The latest read on consumer and producers prices, however, offered no further or convincing evidence price pressures are on a firm retreat back towards 2%, suggesting a rate reduction may still be some ways away into the future.

While the Fed tends to prioritize the PCE when it comes to gauging price pressures in the economy, and a rise in alternative measures does not necessarily guarantee a backup in lockstep, the lack of downward momentum in consumer prices, and specifically the supercore, raises the likelihood of a more disappointing assessment of inflation regardless of the preferred measure of prices.

Market participants appear content with somewhat of a further delay in rate cuts amid the context of an eventual reduction at some point this year. An ongoing lack of improvement, or worse, a reversal in last year's disinflationary trend, however, could force the Fed to more permanently shelf the notion of rate cuts, or even reconsider additional rate hikes.

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