July 23, 2024

Not All Inflation Indicators Are Pointing in the Same Direction, Complicating the Fed's Policy Plans

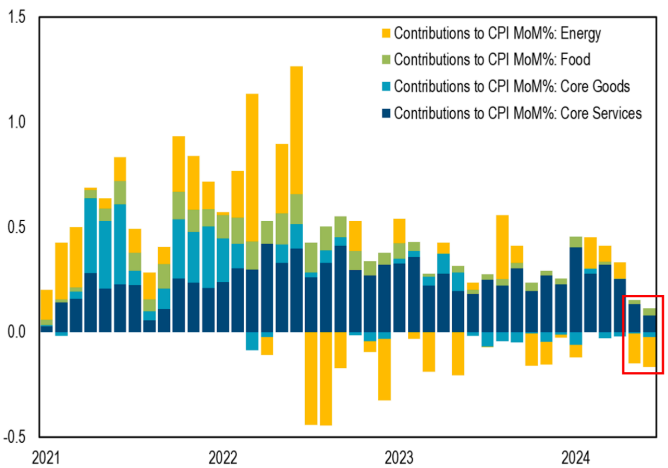
Economic INSIGHT

The latest read on June consumer inflation was notably cooler than expected, buoying expectations for a potential near-term adjustment in Federal Reserve (Fed) policy. The latest read on other measures of prices, however, including the PPI and alternative calculations provided by regional Federal Reserve banks, came in hotter than expected, muddying the outlook for the future trajectory of rates.

The latest commentary from monetary policy leadership points to a growing willingness to adjust the Fed's current monetary stance sooner than later in light of further "progress" on inflation. But while the Federal Open Market Committee (FOMC) is ready and willing to respond if it witnesses unexpected weakening, particularly on the labor market front, Fed Chair Jerome Powell was clear that more good data is still needed to instill the required confidence to justify a rate cut.

A COOLER CPI

The latest read on consumer prices showed a welcome loss of momentum, with the headline unexpectedly falling 0.1% in June, the first monthly decline since May 2020 and following a flat reading the month prior. Year-over-year, consumer prices rose 3.0% at the end of the first quarter, down from the 3.3% annual increase in May, and now marking the slowest pace in a year.



Source: Bloomberg

The majority of the relief in the CPI, both last month and in May, was centered on softer energy prices. Down 2% in the latest June report, cooler energy costs shaved nearly two tenths of a percentage point off the headline CPI.

Excluding food and energy costs, the core CPI rose 0.1% in June, albeit still a tenth of a percentage point less than expected and following a larger 0.2% increase the month prior. In fact, June's relatively reduced monthly increase now marks the third consecutive month of cooling momentum. Year-over-year, the core

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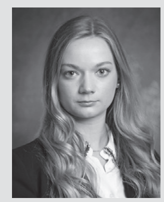

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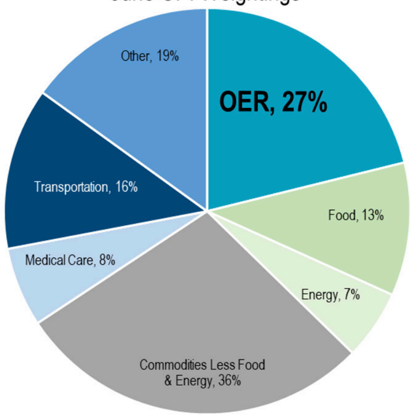
CPI increased 3.3%, a welcome reduction from the 3.4% annual increase in May and the slowest pace in more than three years.

While cooler energy costs helped mute the headline rise, other key components, particularly housing – which accounts for 45% of the index – offered little reprieve. The broad-based shelter component rose 0.2% in the June CPI report, down from a larger 0.4% gain the month prior, and increased 5.2% on an annual basis. While elevated nominally and providing sizable support to the headline read, this is the weakest annual gain in shelter inflation since April 2022.

June CPI Weightings



Source: Bureau of Labor Statistics/Haver Analytics

Owners' Equivalent Rent, (OER) meanwhile, a subcomponent within shelter used to measure how much a property owner would have to pay in rent to be equivalent to their cost of ownership, rose 0.3% in June. Relative to an average monthly gain of 0.4% since July 2023, this is a cooler pace of acceleration, marking the smallest monthly gain since August 2021. Year-over-year, however, the OER remains elevated, up 5.4% in June, albeit down from the 5.7% annual gain in May.

Stripping out even more of the volatility, the supercore, which excludes goods, food, energy and housing costs – like the headline – also declined 0.1% in June following no change the month prior. Over the past 12 months, however, the supercore increased 4.6%, still more than double the Fed's intended 2% target.

A HOTTER PPI

Despite declining overall price pressures on the consumer front, producer price pressures reversed course in June, suggesting an accelerating inflationary environment at the end of Q2. The headline PPI rose 0.2% in June, a tenth of a percentage point more than expected. Furthermore, May's lower-than-expected print of -0.2% was revised away for a zero monthly change (0.0%), exacerbating the significance of June's outsized increase.

	MoM %	Yoy %
Headline CPI	-0.1%	3.0%
Core CPI	0.1%	3.3%
Supercore CPI	-0.1%	4.6%
Headline PPI	0.2%	2.6%
Core PPI	0.4%	3.0%
Headline PCE*	0.0%	2.6%
Core PCE*	0.1%	2.6%
Supercore PCE*	0.1%	3.4%
Atlanta Fed Sticky Price CPI	0.2%	4.2%
Cleveland Fed Median Price CPI	0.2%	4.2%
Dallas Fed's Trimmed Mean PCE**	1.4%	2.8%

Source: Bloomberg
*Data as of May
**Data as of May (MoM % is reported at an annualized rate)

Year-over-year, producer prices gained 2.6% in June, climbing from the 2.4% annual gain in May and marking the largest annual increase since March 2023.

Excluding food and energy costs, the core PPI rose 0.4%, double the 0.2% increase expected and following a 0.3% rise in May. Year-over-year, the core PPI increased 3.0% in June, up from the 2.6% annual gain in May and marking the largest annual increase since April 2023.

The majority of the upside pressure in the PPI was segmented to fluctuations in trade margins, with final demand services costs up 0.6%. According to the Bureau of Labor

GLOSSARY

CPI – Consumer Price Index

FOMC – Federal Open Market Committee

MoM – Month over Month

OER – Owner's Equivalent Rent

PCE – Personal Consumption Expenditures

PPI – Producer Price Index

YoY – Year over Year

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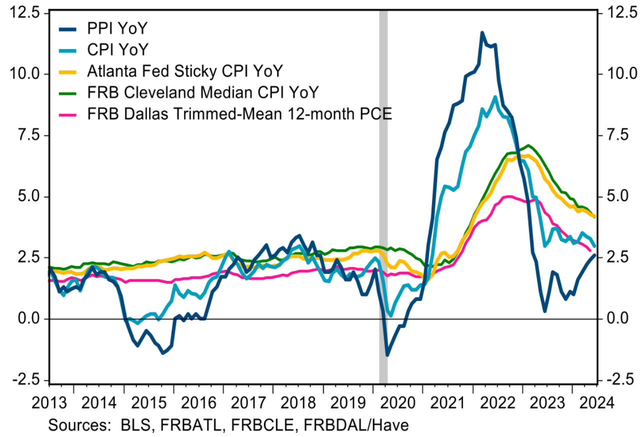
Statistics (BLS) report accompanying the latest release, nearly all of the June increase is attributable to a 1.9% jump in the margins for final demand trade services, the largest monthly gain since March 2022. Final demand transportation and warehousing services, on the other hand, fell 0.4%, a welcome reflection of ongoing improvement in global supply chains. Excluding food, energy and trade services, the PPI was more muted, coming in flat (0.0%) in June following an upwardly revised 0.2% gain in May, and still rising a robust 3.1% year-over-year.

RECONCILING VARIOUS PATHS OF MOMENTUM

In addition to the "good news" from the CPI in June and "bad news" from the PPI, the Fed has a third avenue of alternative metrics of inflationary pressures by which to gauge the "true" underlying momentum of costs. Unfortunately for the Committee, desperate to provide near-term relief from a 23-year high in rates, the alternative data appears to be supporting a more negative assessment that inflation is still stubbornly elevated.

The Dallas Fed's Trimmed Mean PCE, for example, indicated a 2.8% pace of inflation on an annual basis in May. While down minimally from a 2.9% pace reported in April, this alternative measure of core inflation in the price index for the PCE suggests inflation may be 20bps above the traditional core reading of 2.6% as of May. Like the core PCE which excludes food and energy costs, the Trimmed Mean PCE Inflation Rate also excludes the most extreme monthly observations (on both ends), and is calculated as a weighted average of the remaining components.



Alternatively, the Cleveland Fed's Median CPI Index rose 0.2% in June, following a similarly sized increase in May. Year-over-year, the Median CPI Index rose 4.2%, down from the 4.3% annual gain in May but significantly above the 3% annual gain indicated by the composite CPI.

Additionally, the Atlanta Fed's Sticky Price CPI Index also rose 0.2% for the month of June. And, like the Cleveland calculation, on a year-over-year basis, the Sticky CPI rose 4.2%, down from a 4.3% annual gain in May. While marking the third month of cooling momentum for the Sticky CPI and the fourth for the Median CPI, both indicate a notably higher trend pace of inflation, up 90bps relative to the CPI Index.

The Median CPI is the one-month inflation rate of the components whose exposure weights are in the 50th percentile of price changes. Essentially, the calculation omits both small and large outliers in order to focus on the interior (the median) of the distribution of price changes. The Atlanta Fed Sticky CPI Index, meanwhile, measures a flexible weighted basket of items that change price relatively slowly (sticky), excluding more flexible components or those identified with a higher frequency of price adjustment.

In either case, rather than simply excluding food and energy costs, these alternative assessments seek to remove the most volatile series every month, removing short-lived price fluctuations, and thereby better capturing the "*true*" trend in prices. Fed officials, including Chairman Powell, have applauded the regional bank's inflation analyses, indicating such measures are monitored and included in making policy decisions.

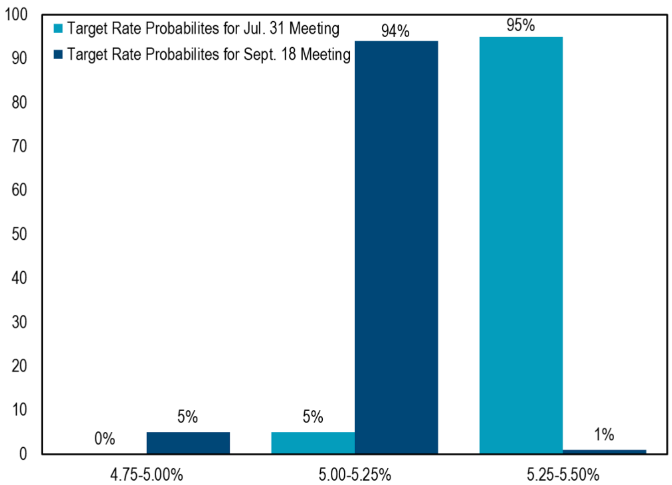
"*We consult a range of measures meant to capture whether price increases for particular items are spilling over into broad-based inflation. These include trimmed mean measures and measures excluding durables and computed from just before the pandemic.*"

- Federal Reserve Chairman Jerome Powell, Jackson Hole Webcast, August 27, 2021

OPTIMISM, DESPERATION, AND A REALITY CHECK

Taken together, the latest – multidirectional – inflation reports, at the very least, support the Fed's message of caution even as the CPI specifically slowly resumes its previous disinflationary trend. While continuing to take steps in the right direction, the lack of clear downward directional momentum ***should*** leave the Committee hesitant to repeat its earlier, overzealous assessment of improving inflationary conditions, which was met by a number of head fakes at the start of the year.

In fact, a hotter-than-expected June PPI report coupled with still-elevated readings of inflation from alternative regional Fed bank metrics is a welcome reminder of why the Committee has been steadfast in its need to see "*many*" months of improving data to instill confidence of a sustained disinflationary trend. It's, furthermore, a reminder why policy makers have been cautious to move too quickly to adjust policy based on a limited set of data.



Source: CME FedWatch Tool
Data as of 7/19/2024

Inflation is improving and the latest data points "*do add somewhat to confidence*," Chair Powell noted last week. But price pressures remain uneven and bumpy at best. And, with three months of accelerating price pressures at the start of the year, at this point, despite investors' optimism and Fed officials' desperation to bring rates down, two months of more favorable data in May and June are not enough to justify a change in policy, at least not yet.

Nevertheless, with each indication of further cooling in terms of labor market conditions and each improving price report, monetary policy officials and market participants are becoming increasingly expectant that a change in policy is (right) around the corner. In fact, despite the lack of clarity in the data and an ongoing message of unease from Committee members, investors are convinced the Fed is poised to adjust policy, potentially as soon as September. According to the CME FedWatch tool, the probability of a July rate cut remains at less than 10%. The probability of a rate cut in September, meanwhile, is now priced in at near certainty!

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July is certainly too soon, and even with September back on the table, a very compelling case would have to be made in the July and August data. That's not to say the Fed can't or won't cut rates before the end of the year, but first there needs to be considerably more and unquestionable improvement in the incoming data. Remember, inflation has been increasingly bumpy and uneven, with a number of key price components reversing course as of the start of the year. Thus, while the Fed will "*eventually*" cut rates, with the bar set relatively high at "*many*" months of improving inflation data, ongoing consumer resilience and still solid labor market conditions, "*eventually*" still appears to be somewhat off in the distance, or at least until inflation is on a clear downward trajectory – that's the key.

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Fed's Median CPI Index is the one-month inflation rate of the component whose expenditure weight is in the 50th percentile of price changes.

The Atlanta Fed's sticky-price CPI is a measure of price change for the components of the consumer price index that are relatively slow to change.

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