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MARKET SIGHT LINES

Exploring the Data:
Inflation May Be Cooling

By Michael O'Keeffe, *Chief Investment Officer*

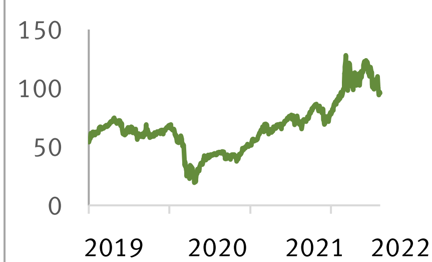
Everyone is waiting for a break in the elevated inflation problem. In last week's Sight|Lines (Exploring the Data: Supply Chain Pressures May Be Easing), we shared information signaling supply chain pressures may be softening. Such relief, coupled with easing demand from the Federal Reserve (Fed)'s hawkish shift in monetary policy, means inflation may begin to cool.

And in this week's Sight|Lines, we dive into the data to better understand inflation today and where it might be headed from here.

OIL

With the Russia-Ukraine war and other supply chain issues, higher energy prices have contributed to elevated inflation. Figure 1 tells the story. In early 2020, the cost of Brent crude oil fell as the pandemic took hold and shutdowns occurred. But as the economy reopened, prices started climbing. Then in the first half of 2022, oil climbed further as a result of supply pressures from the war. Finally, and importantly, prices began falling in July. Since energy is a key input to the costs of most goods and services, these movements should influence inflation.

Figure 1.
Brent Crude Oil ($/bbl)

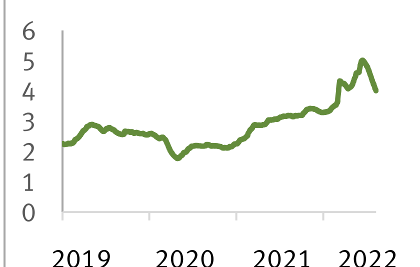


Source: Stifel Investment Strategy via Bloomberg as of August 10, 2022

GAS PRICES AT THE PUMP

While oil prices influence the cost of doing business in many ways, the consumer is appropriately sensitive to how rising oil prices hit home directly, most notably with the cost of gasoline. The cost of gas carries a 5% weight in the calculation of Consumer Price Index (CPI). Figure 2 shows a similar pattern of price movement for a gallon of gas, based on the national average price in the U.S. We see costs falling in early 2020, rising into 2021 with the reopening, and then climbing to record levels in 2022, given the oil supply shock from the war. And, like oil more generally, gas prices have fallen recently.

Figure 2.
Average Gas Price ($/gallon)

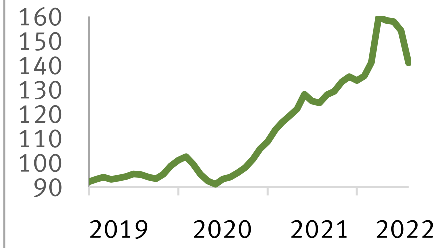


Source: Stifel Investment Strategy via Bloomberg as of August 3, 2022

FOOD PRICES

Food prices are another important consideration when assessing inflation and its impact on the consumer. The FAO Food Price Index (FFPI) measures international prices of a basket of food commodities comprised of five components – cereal, vegetable oil, dairy, meat, and sugar. We see a similar pattern with this index in Figure 3, with some upward movement in the latter part of 2020 and into 2021, but then a big move higher in 2022. Importantly, we see prices start to fall in July, dropping by about 12% from their high in March.

Figure 3.
FAO Food Price Index



Source: Stifel Investment Strategy via Bloomberg as of August 3, 2022

JULY 2022 CPI/CORE CPI

In our view, the July CPI report from the U.S. Bureau of Labor Statistics was positive. Headline CPI was unchanged in July, better than the consensus forecast for month-over-month growth of 0.2%. The fuel and airline components fell, while electricity prices rose 1.6%. Core CPI, which excludes food and energy, rose 0.3%,better than the consensus forecast of 0.5%.

Table 1. July Consumer Price Index

	CPI		Core CPI	
	Monthly	Annualized	Monthly	Annualized
2020	0.11%	1.29%	0.13%	1.60%
2021	0.57%	7.10%	0.45%	5.48%
1H22	0.89%	11.16%	0.55%	6.85%
July '22	0.00%	0.00%	0.30%	3.66%

Source: Stifel Investment Strategy via Bloomberg as of August 3, 2022

Table 1 shows the average monthly inflation (CPI and core CPI) for 2020, 2021, the first half of 2022, and July 2022, with the first three progressively higher. To provide some context for annual inflation, we've annualized that monthly average. We see inflation levels well below the Fed's 2% target in 2020, then inflation growing dramatically in 2021 and the first half of 2022. Inflation cools some in July, but we would like to see a longer-term trend of improved inflation.

BREAK-EVEN RATES

The forward-looking break-even inflation rates moved only modestly lower in response to the inflation report, with the 10-year break-even rate now at 2.43%, well below its high of 3.04% on April 21, but still above the Fed's 2% target. Also notable, futures markets are now pricing in a 0.5% Fed rate hike in September, down from 0.75%.

CONCLUSION

As mentioned last week, investors and other people remain worried about high inflation and a slowing economy. We reviewed some supply chain data and saw signs of relief. As we dug into prices further this week, we learned that inflation may be cooling, with headline CPI unchanged in July, a big improvement compared to the last few months. But we're watching for a trend back to the Fed's 2% long-term inflation target, which means we're not out of the woods just yet.

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