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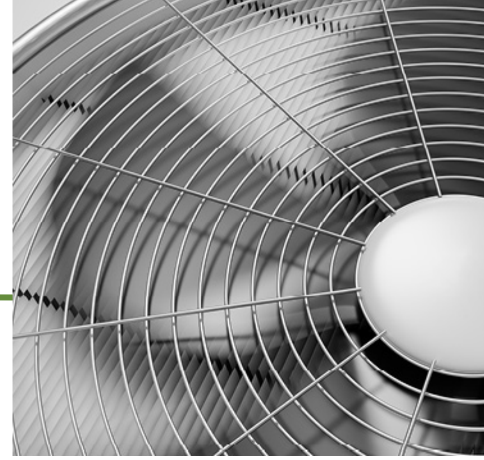
MARKET SIGHT LINES



Inflation Cools Further: The Federal Reserve Pauses … or Is It a "Skip?"

By Michael O'Keeffe, *Chief Investment Officer*

Over the last year or so, we've actively written about elevated inflation and the historically dramatic Federal Reserve (Fed) policy shift since early 2022. In total, the Fed hiked rates by 5% and has been signaling the need for more. But at its May meeting, the Fed opened the door to a pause based on improving inflation and a desire to wait to monitor the data for signs of inflation easing further. And the Fed held its June meeting this week, issuing a statement that confirmed the fed funds rate will remain unchanged, but also signaling this may be more of a "skip" than a "pause," leaving the door open for more hikes later this year.

In this Sight|Lines, we summarize recent inflation reports and the results of the June 2023 Fed meeting.

THE TAKEAWAY: INFLATION COOLED FURTHER, AND THE FED KEPT RATES STEADY.

While we have a way to go, inflation cooled in May, moving further toward the Fed's 2% target. Based on this and other data, the Fed held rates steady despite a firmer-than-expected economic environment. In summary:

- The headline consumer price index (CPI) was up just 0.1% in May and 4.0% over the last 12 months.
- Core CPI, which excludes food and energy, rose 0.4% in May and is up 5.3% over the last year.
- The headline producer price index (PPI) fell 0.3% in May and rose only 1.1% over the last year, below the Fed's 2% target.
- Core PPI, which also excludes food and energy, rose 0.2% in May and 2.8% over the last year.
- The Fed left rates unchanged, with its benchmark rate range set at 5%-5.25%, but signaled a continued reduction in its balance sheet.
- The Fed's Summary of Economic Projections, or SEP, showed the Fed raised its 2023 GDP forecast and lowered its unemployment forecast, acknowledging the economy has been more resilient than expected.

While there is more work to do, the tighter financial conditions resulting from the Fed's hawkish policy shift have contributed to a softening of inflation back toward the Fed's 2% target.

IN-DEPTH: INFLATION IS COOLING, BUT SOME SEGMENTS REMAIN STICKY. THE FED KEPT RATES STEADY BUT WILL CONTINUE TO SHRINK ITS BALANCE SHEET AND PROJECTS TWO MORE HIKES IN 2023.

The May CPI and PPI reports were very positive steps for inflation returning to the Fed's 2% target. Based on this and other data, the Fed kept its benchmark fund rate unchanged at 5%-5.25%. The Fed also issued its latest

Summary of Economic Projections (SEP), signaling the strong potential for two more 0.25% hikes this year while upping its forecast for 2023 GDP growth and lowering its unemployment projection. Going deeper:

- CPI and core CPI are improving, but there's a way to go:
  - This headline index was up just 0.1% in May but averaged 0.36% over the last six months, still elevated compared to 0.17%, the monthly figure aligned with the Fed's 2% annual target. CPI was up 4.0% over the last 12 months.
  - Shelter prices were again the largest monthly contributor, up 0.6%, followed by used cars and trucks prices, up 4.4%. We expect both of these components to cool going forward, given more real-time data that suggests prices are declining.
  - Energy prices fell 3.6% in May, and food prices rose 0.2%.
  - Core CPI, which excludes food and energy, rose 0.4% in May and 5.3% over the last year.
- PPI and core PPI, often viewed as a leading indicator for CPI, have returned close to the Fed's 2% target:
  - The headline producer price index (PPI) actually fell 0.3% in May, with prices for final demand goods falling 1.6% in May and prices for energy dropping 6.8%. The index increased 1.1% over the last year, below the Fed's 2% target.
  - Core PPI rose 0.2% in May and 2.8% over the last year, close to the Fed's 2% target.
- The Fed's statement was carefully updated to reflect its policy:
  - "…the Committee decided to maintain the target range for the federal funds rate at 5 to 5-1/4 percent."
  - "…the Committee will continue reducing its holdings …"
  - "…the Committee will continue to monitor the implications of incoming information…"
- The Fed published its latest SEP, which reflected improved economic and labor conditions but the prospect of higher rates:
  - 2023 GDP growth of 1%, up from its 0.4% forecast in March.
  - Year-end unemployment at 4.1%, down from the March estimate of 4.4%.
  - A fed funds rate peaking at 5.6%, implying two more rate hikes from here.

CONCLUSION

The Fed has been committed to tightening monetary policy in order to rein in elevated inflation, hiking rates 5% over the last year or so, a dramatically hawkish policy shift. Inflation has cooled, but not yet fully back to the Fed's 2% target. As it processes incoming data, the Fed chose to keep its benchmark rate steady in June but commented that it will continue to monitor the data, and more hikes may be necessary. In fact, the SEP forecasts just that, signaling the potential for two more 0.25% hikes this year. The bottom line? This Fed decision may have been more of a "skip" than a "pause."

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