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MARKET SIGHT LINES

# Hovering Around the Line: Inflation Approaches 2%

By Michael O'Keeffe, *Chief Investment Officer*

With everything going on in the world, like the Ukraine war, U.S.-China tensions, the debate over Environmental, Social, and Governance (ESG), D.C. gridlock, and the developing cast lining up for the 2024 elections, when it comes to the U.S. economy and markets, the results of the past couple of years can be traced back to elevated inflation, Federal Reserve (Fed) rate hikes, and the resulting higher market interest rates.  As a result, we've been keenly focused on various inflation measures, looking for evidence that inflation is getting back to the Fed's 2% target.  This week we received an update on two important measures, the producer price index, or PPI, and the consumer price index, or CPI.

In this Sight|Lines, we summarize these June inflation reports and what to expect at the July 2023 Fed meeting.

## THE TAKEAWAY:  INFLATION IS CLOSER TO 2%, BUT THE FED MAY NOT BE SATISFIED.

While we have a way to go, inflation cooled in June, 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:

- PPI was up only 0.1% in June and 0.1% over the last year, well below the Fed's 2% target.  Core PPI, which excludes food and energy, rose 0.1% in June and 2.4% over the last year.
- CPI was up 0.18% in June and 3.0% over the last 12 months.  Core CPI, which excludes food and energy, rose 0.2% in June and is up 4.8% over the last year, both readings a little better than expected.
- The three-month average of monthly increases ended June for PPI and CPI were -0.1% and 0.2%, respectively, both close to 0.17%, the monthly equivalent of the Fed's 2% target.
- Sticky shelter prices, which rose 0.4% in June and were a large contributor to the CPI's monthly increase, are expected to decline given softness in real-time data.
- Fed futures signal that market participants anticipate the Fed to hike rates 0.25% at its July meeting, then keep rates steady for the balance of the year.
- CPI has fallen by more than two-thirds from its 9.1% year-over-year (YoY) peak in June.

The tighter financial conditions resulting from the Fed's hawkish policy shift continued to help inflation fall back toward the Fed's 2% target, but we have a bit more to go before CPI hits that 2% level.

## IN-DEPTH:  JUNE INFLATION READINGS WERE NEAR THE FED'S 2% TARGET, BUT THE FED WANTS TO SEE MORE OF A TREND AND IS EXPECTED TO HIKE 0.25% IN JULY.

Inflation cooled again in June, with three-month rolling monthly rates now near a level equivalent to the Fed's 2% target.  And the shelter component of CPI remains elevated, while real-time data is signaling that shelter prices will stabilize. Now the Fed, of course, will want to see an inflation trend, and inflation expectations, more firmly close to its 2% target. So we expect a 0.25% rate hike in July. Going deeper:

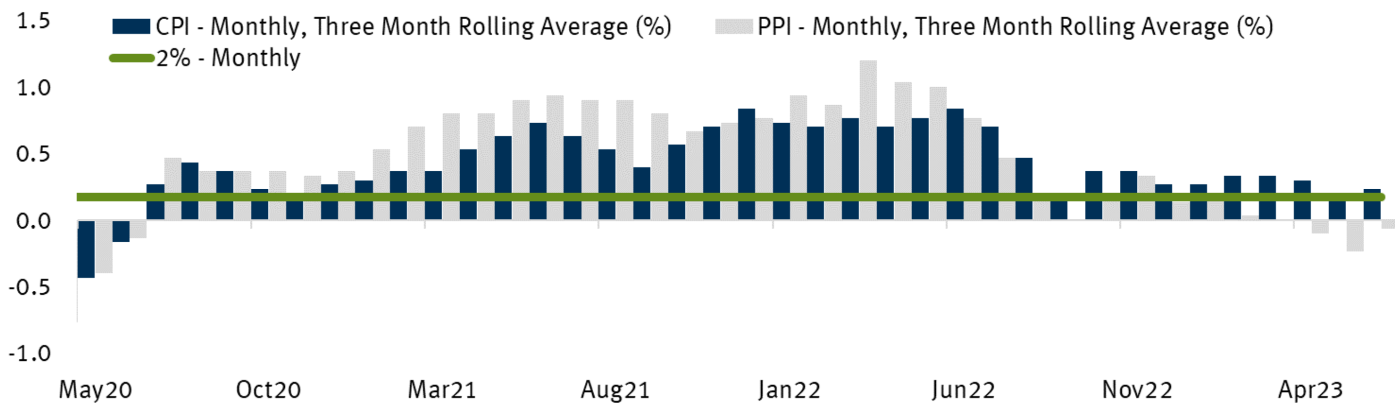
- PPI and core PPI, often viewed as a leading indicator for CPI, have trended below the Fed's 2% target:
    - The headline producer price index (PPI) rose 0.1% in June, with prices for final demand services rising 0.2% and prices for deposit services 5.4%. The index increased only 0.1% over the last year, below the Fed's 2% target.
    - Core PPI rose 0.1% in June and 2.4% over the last year, close to the Fed's 2% target.
- CPI and core CPI are improving, with solid June readings, but there's a bit more to go:
    - This headline index was up just 0.2% in June and averaged 0.23% over the last three months, much closer to 0.17%, the monthly figure aligned with the Fed's 2% annual target. CPI was up 3.0% over the last 12 months.
    - Shelter prices were again a large monthly contributor, up 0.4%, but real-time indexes suggest a continued cooling, with the Zillow Rent Index now back to its pre-pandemic average.
    - As we've anticipated, used car and truck prices, which had been elevated, fell 0.5% in June.
    - Core CPI, which excludes food and energy, rose 0.2% in June and is up 4.8% over the last year, both readings a little better than expected.
- The Fed is expected to hike rates at its meeting later this month:
    - Fed futures are signaling a 0.25% hike, steady rates for the balance of the year, then six 0.25% cuts totaling -1.5% in 2024.
    - The Fed's Summary of Economic Projections (SEP) reported Fed officials see the fed funds rate peaking at 5.6%, implying two more 0.25% hikes from here.
- Inflation has fallen considerably from its peak in June 2022, which stood at 9.1% YoY.
    - Base effects suggest that the YoY decline in inflation going forward may not be as steep for the remainder of the year.

## CONCLUSION

When it comes to the U.S. economy and markets, the results of the past couple of years can be traced back to elevated inflation, Fed rate hikes, and the resulting higher market interest rates. So we've been acutely focused on various inflation measures, looking for evidence that inflation is getting back to the Fed's 2% target. This week we received an update on two important measures, the producer price index and the consumer price index, showing that these headline measures have been hovering near the Fed's 2% target for the last three months, on average. But Fed officials will want to see more of a trend, so market participants expect another 0.25% Fed rate hike at its July meeting.

**Michael P. O'Keeffe, CFA**
*Chief Investment Officer*
michael.okeeffe@stifel.com
www.stifelinsights.com

Figure 1: CPI and PPI Index




Source: Stifel CIO Office via Bloomberg, as of July 13, 2023
PPI = Producer Price Index

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