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MARKET SIGHT LINES

The Fed Holds Steady Even as Inflation Moves Higher

By Michael O'Keeffe, *Chief Investment Officer*

As we've discussed recently, the Federal Reserve (Fed) sets monetary policy in consideration of its dual mandate for maximum employment and stable prices. Since the economy has been out of balance, with a very strong labor market and higher inflation, the Fed has hiked its funds rate 5.25% to loosen the tight job market and cool inflation. This week the Fed elected not to hike rates further, even as two key inflation rates, the consumer price index (CPI) and producer price index (PPI), reversed a downward trend and moved higher.

In this Sight|Lines, we review key inflation reports as well as the results of the September Fed meeting.

THE TAKEAWAY: INFLATION BREAKS HIGHER, BUT THE FED SKIPS A HIKE.

Even as headline inflation moved higher, the Fed kept the restrictive funds rate steady. In summary:

- Headline inflation moved higher in August, with CPI increasing 0.6%, and PPI rising 0.7%.
- Monthly core inflation, which excludes food and energy, remained at about 0.2% for each index.
- The Fed kept its benchmark rate unchanged at the September meeting, a level still highly restrictive and designed to slow the economy and cool inflation.
- Minor changes in the Fed's statement highlighted a strong economy and some loosening of the tight labor market.
- The Fed's September Summary of Economic Projections (SEP) shows the Fed may hike the funds rate again in 2023 and keep the rate elevated for longer, projecting inflation at 2% in 2026.
- The Fed, and market participants more generally, will keep a focus if energy prices move and remain elevated, as such higher prices will translate into higher costs and inflation in other areas.

Headline inflation reports for August disappointed, but core inflation remained under control, allowing the Fed to keep its benchmark rate unchanged in September.

IN-DEPTH: AUGUST INFLATION MOVES HIGHER DRIVEN BY HIGHER ENERGY PRICES, BUT THE FED HOLDS ITS FUNDS RATE STEADY.

Headline inflation moved higher, driven mostly by a jump in energy prices. As a result, core inflation, which excludes both food and energy, remained under control. Perhaps informed by these more muted core inflation levels, the Fed kept the restrictive funds rate steady in September. Going deeper:

- Headline CPI moved 0.6% higher in August:
  - Energy prices, which have a 7% weight in the index, rose 5.6%, resulting in a contribution of 0.4% to the index's overall increase.

    - Shelter prices, an inflation component that has been sticky, carries a weight of 35%, so the 0.3% rise contributed 0.1% to the increase to the headline index.
    - The core CPI, which excludes this energy component as well as food, was up 0.2%.
- Headline PPI moved 0.7% higher in August:
    - Goods prices, which include energy and have a 31% weight in the index, rose 2%, resulting in a contribution of 0.6% to the index's overall increase.
    - The core PPI, which excludes food and energy, was also up 0.2%.
- The Fed kept its benchmark rate unchanged at the September meeting. In its statement, the Fed:
    - Described the economy as expanding at "a solid pace."
    - Explained that "job gains have slowed in recent months but remains strong."
    - Said it "decided to maintain the target rate" in support of the goals to "achieve maximum employment and inflation at the rate of 2% over the longer run."
- The Fed's September SEP provided some key insight into Fed officials' future views:
    - The median forecast for 2023 GDP jumped to 2.1% from 1.0% in June, and with it the expectation of a tighter job market, with 2024 unemployment falling to 4.1% from 4.5%.
    - The median forecast for the fed funds rate signals that officials expect the benchmark rate to remain above 5% through 2024, returning to the longer-run level of 2.5% sometime after 2026. This reinforces the view that interest rates will remain higher for longer.

Headline inflation reports for August disappointed, showing that the path back to the Fed's 2% target may be difficult. The Fed chose not to hike rates further, but its monetary policy, which remains highly restrictive, seems to be loosening a very tight job market, which should help with inflation in the future.

CONCLUSION

The Fed's tight monetary policy has been loosening the job market and cooling inflation some. But headline inflation rates moved higher in August, much the result of markedly higher energy prices. The Fed kept its benchmark rate steady, but Fed officials, our team, and market participants more generally, will keep a close eye on elevated energy prices, as such higher prices may well translate into higher costs and inflation in other areas of the economy.

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

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