July 13, 2022

Another red-hot inflation print: when will prices cool?

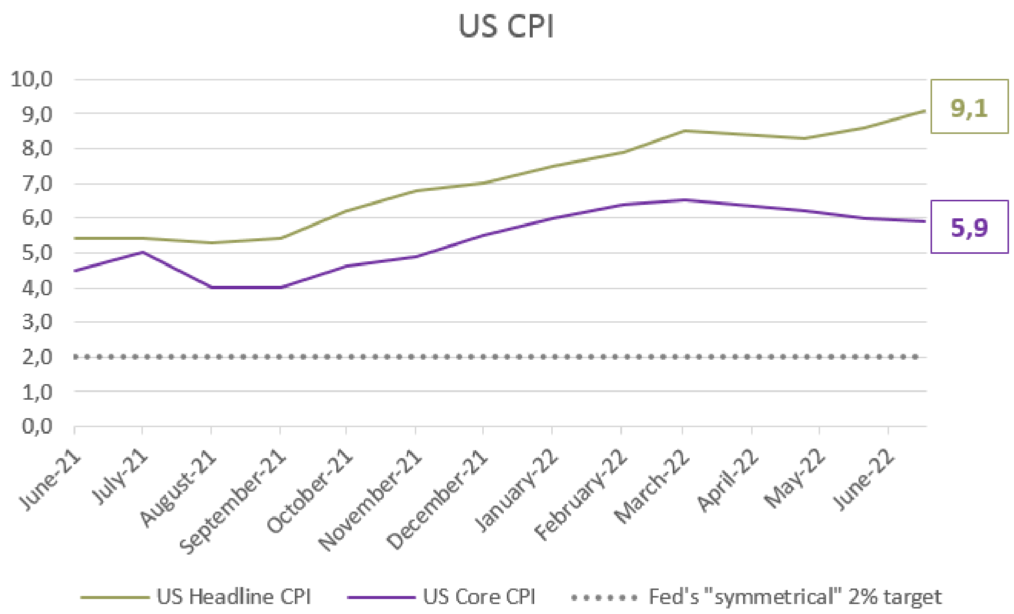
- US Headline CPI rose 9.1% in June, above estimates of 8.8%
- The increase was broad-based, with the indexes for gasoline, shelter, and food rising the most
- The Core figure edged lower to 5.9% from 6% but still surpassed estimates of 5.8%
- The next FOMC is scheduled for 26-27 July at which another 75bp hike is expected

So highly anticipated was today's inflation reading that yesterday, a fraudulent version of the report later discredited by the US Bureau of Labor Statistics, which wrongly reported inflation at 10.2% appeared to influence stock prices.

The authentic report revealed that inflation still shows no signs of abating, coming in above expectations at 9.1% on an annual basis, the fastest pace since 1981 and above Bloomberg consensus estimates of 8.8%. The monthly rise was 1.3% following a 1% rise in May and the increase was broad-based, with the indexes for gasoline, shelter, and food being the largest contributors. The energy index rose 7.5% over the month and contributed nearly half of the "all items" increase.

PUTTING THINGS IN PERSPECTIVE: THE MONTHLY RISE IN CPI WAS 1.3% IN JUNE 2022. THIS IS ALMOST EQUAL TO THE YEARLY RISE OF 1.4% RECORDED BACK IN JANUARY 2021.

The core index which excludes food and energy rose 5.9% on an annual basis, or 0.7% month-on-month in June, after increasing 0.6% in the preceding two months. While almost all major component indexes increased over the month, the largest contributors were the indexes for shelter, used cars and trucks, medical care, motor vehicle insurance, and new vehicles.



Source: Trading Economics, BIL

IMPLICATIONS FOR MONETARY POLICY

The Fed is fully engaged in a battle to bring inflation down from four-decade highs, having already hiked by 150 basis points so far in 2022. Today's print, paired with Friday's strong employment report (non-farm payrolls rose 372k in June vs. 265k expected and just shy of May's revised 384k), gives the Fed leeway to continue with its tightening campaign while conditions still permit. After June's 75 basis point (bp) hike, the largest leg up since 1994, another 75bp Fed hike in July looks likely.

Currently, the federal funds rate is set at a range of 1.50 to 1.75 and policymakers have signaled their intent to raise rates to a level that begins to restrict economic activity by year-end (assumed to be around 3.5%). It is worth noting that changes to Fed policy take months to seep into the real economy.

MARKET REACTION

Following the release, the dollar which was already sitting around a two-decade high (benefitting from increased fear of a global recession and the prospect of more Fed tightening) naturally strengthened.

US Treasury yields shot up, especially for short-term maturities, on bets that the Fed will have to continue with its aggressive tightening campaign in coming months. With the increase in yields, TINA (there is no alternative) has left the building and risk assets are under selling pressure. This is despite the fact that markets had been readied for a “highly elevated” CPI reading by the White House Press Secretary Karine Jean-Pierre on Monday, who said it would be largely attributable to high gas prices resulting from the conflict in Ukraine. She also added that the reading for June is “already out of date” as energy prices have declined this month and “are expected to fall further”. So far, the White House has said it will release over 1 million barrels of oil per day for 6 months from the Strategic Petroleum Reserve and US President Joe Biden will travel to Saudi Arabia July 14-16 for a meeting with Persian Gulf leaders; the oil market is probably a key agenda point.

SIGNS OF RESPITE?

If inflation starts to soften, the Fed may not have to press as hard on the brakes, giving it more chance of orchestrating a so-called “soft landing” for the economy.

In line with comments from the White House, Brent crude dipped below $100/barrel this week. Other key commodities such as copper also declined as investors start to contemplate a slower growth environment.

In terms of macroeconomic data, though the June US inflation print was still exceptionally high, other recent data releases brought very early indications that inflation might be starting to cool.

The US ISM Manufacturing Prices Paid Index for June, for example, was reported at 78.50, down from 82.20 in May and down from 92.10 one year ago.

While the NY Fed’s 1-year-ahead consumer inflation expectations rose to 6.8% in June (from 6.6%), expectations for inflation in ensuing years eased; the three-year outlook fell to 3.6% (from 3.9%), and the five-year outlook edged down to 2.8% from 2.9%, revealing some confidence that the Fed’s actions will be effective. Median year-ahead household spending growth expectations also retreated from May levels, declining by 0.6 percentage point to 8.4%. While still well above the 2021 average of 5.0%, this could be an early indicator of softer demand. The reported mean probability that the US unemployment rate will be higher one year from now increased by 1.8 percentage points to 40.4%, its highest level since April 2020. This is important for consumer sentiment and demand.

The NFIB small business optimism index revealed that the net percentage of firms reporting an increase in average selling prices was 69 versus 72 in May. The hiring plans component came in at 19, down from 26 in May.

Lastly, Adobe's Digital Price Index also showed inflation for online goods cooling for the third consecutive month in June. The cost of goods sold online rose 0.3% year-on-year in June and fell 1% compared with the previous month, driven by a decline in the cost of electronics (down 7%) and clothing (down 4%).

The market is noticing these signs and market-based expectations of inflation have come down too (two-year inflation break-evens have fallen from nearly 5% in March to 3.2% today). Perceptions about inflation are an important driver of actual inflation.

CONCLUSION

Inflation has become the single most important issue facing households, policymakers and investors (and also voters in the upcoming US Midterm elections). The Fed is under intense pressure to rein in price pressures.

The market is oscillating between two competing narratives: one built around fears of economic overheating and another driven by fear of an impending recession. As the tug-of-war between the two continues, it will be difficult for expectations about monetary policy, and thus markets, to stabilize. As such, it is hard to overstate the importance of today's inflation release.

9.1% inflation in the US undoubtedly means that the Fed must maintain its hawkish stance for now – for how long largely depends on the trajectory of inflation and on how the labour market responds to tightening monetary policy. This week will give more clues as to both with US PPI and Weekly Jobless Claims due tomorrow. We will also have more insight as to the health of the overall economy on Friday with Retail Sales data, the Michigan Consumer Sentiment survey and Industrial Production stats – all of which will further set the stage for the July FOMC.

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