US Macroeconomics

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Reinflation Risk Remains Low

When the Fed began raising interest rates in March 2022, in what turned out to be the fastest and most aggressive tightening cycle in decades, policymakers harped on the need to anchor inflation expectations. Consequently, we find it peculiar that the Fed prefers to look at "core" inflation or in the case of the Fed Chair, the "super core" which is an even narrower measure of inflation.

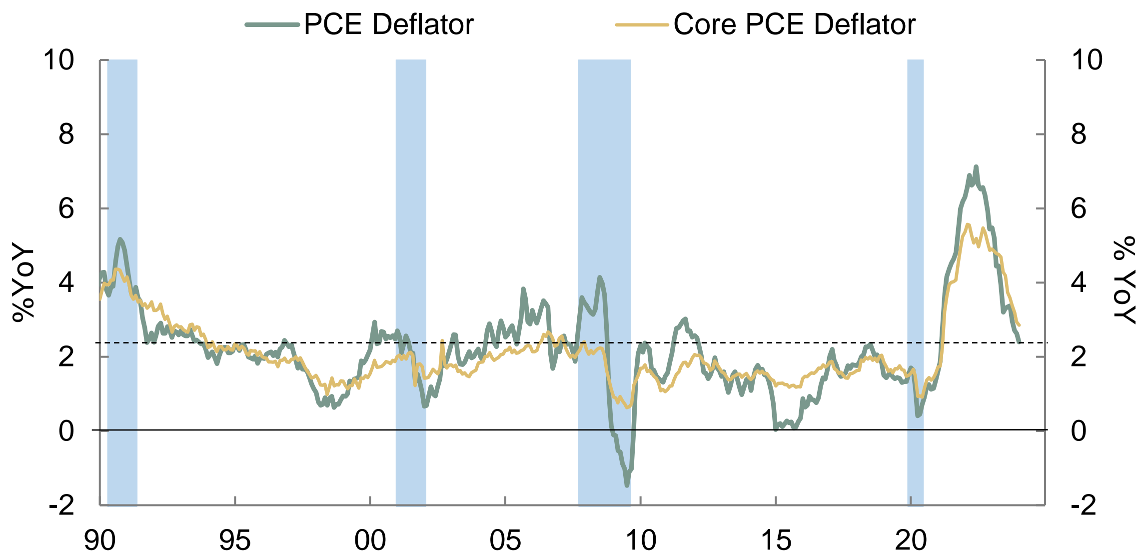
Leaving aside the issue of whether the PCE deflator is better than the CPI — it is not but the Fed prefers the latter regardless — headline inflation continues to move lower. Last month, the 12-month change in the PCE deflator fell a couple of tenths to 2.4%, its lowest reading since February 2021. So, inflation is close to the Fed's 2% target.

Core inflation is much higher, running at 2.9% in January compared to 12 months earlier, the same pace as in December. But if headline inflation continues to slow, thereby keeping inflation expectations stable, then core inflation should trend lower, too. After all, the correlation coefficient between the two series is nearly one. Seldom do the trends in the series deviate much and when they do, it is not for an extended time.

Right now, investors also should focus more on year-over-year trends as opposed to monthly percent changes or three-month annualized changes because of the likely residual seasonality in the data. As we have highlighted, the monthly January inflation figures have been printing progressively higher — this phenomenon may continue into February — only to weaken sharply thereafter. To the extent "residual seasonality" exists, the 12-month change gives a cleaner reading on inflation.

Consequently, the likelihood that inflation suddenly stops slowing and revisits a 1970s style resurgence is low. Something has to happen to change the downward trajectory of inflation. The Fed would have to ease aggressively, the government would have to run even larger budget deficits, food and energy costs would have to reaccelerate. Surging inflation expectations would then push headline inflation higher and spillover into the core.

There are several reasons why this 1970s repeat is unlikely at this point. One, long-term inflation expectations have been low and stable. They collapsed after the Fed began raising rates. Two, the real fed funds rate is positive. In fact, it is the highest since June 2007. Three, the yield curve has been deeply and persistently inverted. This is putting a brake on bank lending and credit creation. The opposite was the case during the 1970s. Inflation expectations were soaring, the real funds rate was negative, and the yield curve was steep. Instead, the current pattern in inflation more closely resembles the period during and immediately after the Second World War.



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