

US Macroeconomics

July 12, 2023

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Going in the Right Direction

Results from the June inflation report were better than expected as both the headline and core consumer price index (CPI) rose 0.2%. Moreover, the latter was close to rounding down to 0.1% (0.157%). The net effect was a further slowing in the year-over-year growth rates.

Over the last 12 months, the headline CPI is up 3.0% versus 4.0% in May while the core CPI is 4.8% versus 5.3% in May. The year-over-year peak in headline CPI was last June (9.1%), and the year-over-year peak in the core CPI was last September (6.6%). This represents tangible progress in reducing the inflation rate.

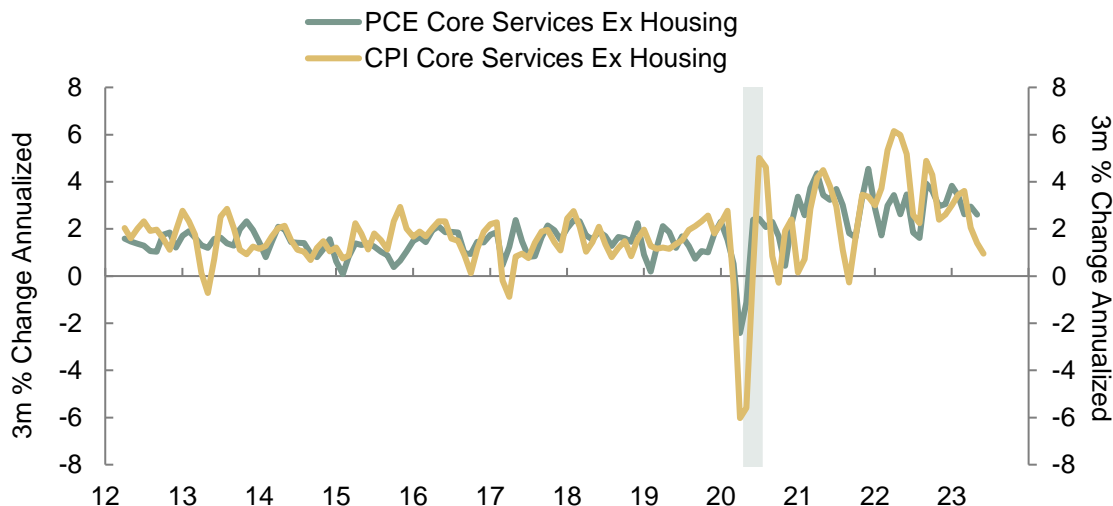
As we highlighted in yesterday's commentary, the Fed is focused on a narrower measure of inflation—what is known as the “super” core which is core services excluding housing. The thought from policymakers is that this version of the core is most correlated with worker wages since labor is the dominant cost in the production of services.

The CPI super core was flat in June after having risen just 0.2% in May and only 0.1% in April. There is significant downward momentum in this series which should carry over in the PCE super core to be released on July 28th. Both super cores are shown in the chart below.

Over the last three months, core CPI services excluding housing is up a meager 1.0% at an annualized pace which compares to modest 1.4% growth in May. Its correlation with core PCE services excluding housing is nearly 70% so there is high probability the latter will slow further as well. Its three-month annualized change was 2.6% in May. All of this should be welcome news to the Fed.

Some investors, however, are worried that inflation could still stabilize around current levels, that the “easiest” part of the inflation improvement is past us. This is mistaken. **The improvement in inflation has occurred with the economy still growing and the labor market still tight.** If a downturn is ahead, and we continue to believe there is, then pricing power will weaken sharply. In fact, a recession could give way to renewed concerns over deflation.

For the bond market, **Fed rhetoric is likely to remain hawkish**, as policymakers will follow-thru on another rate hike (25 basis points) at the July 26th FOMC meeting. Of course, the longer monetary policy is restrictive, and the yield curve is inverted the higher the probability we eventually get the well-advertised recession.



Sources: BLS, Haver, SMBC Nikko

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