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Potential Grave Policy Error

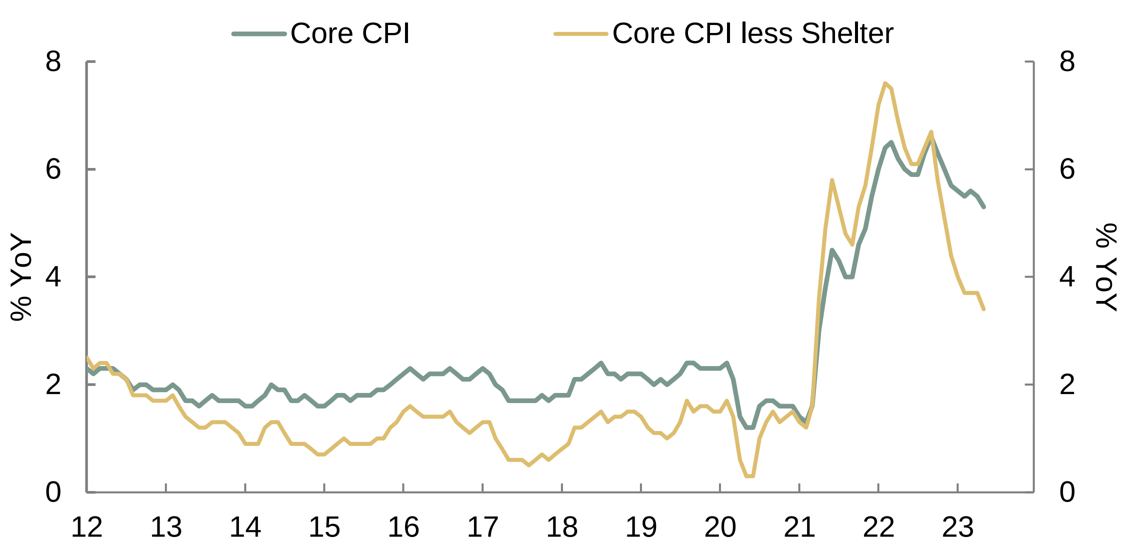
Headline inflation is falling fast but this does not matter to the Fed because it is focused on core inflation. The problem with core inflation is that it is sticky. Its growth rate is not coming down as fast because of elevated shelter costs, which mask fundamental improvement in the inflation backdrop. Consequently, the Fed runs the risk of keeping policy too tight for too long, in turn risking a deeper and longer downturn than what is necessary to lead inflation back to 2%.

Over the last 12 months, headline inflation is up 4.0%, which compares to last June's cyclical peak of 9.1%. Because of an easy year-over-year comparison, **the June 2023 CPI could be up only 3.0% from its year ago level**. This is real improvement which is consistent with the historical record. See "The Inflation Rate is Following Historical Script," US Macroeconomics, June 14, 2023. It is possible headline CPI finishes 2023 only modestly above 2%. We care about headline CPI because it influences inflation expectations and the wage-bargaining process.

However, **the core CPI is running at an uncomfortably high 5.3% versus its 6.6% September 2022 peak**. And its year-over-year rate may not fall much below 5% when this month's data are released on July 12th. So, it still appears as if there is an inflation problem. But is the underlying trend in the core CPI really that bad? We do not believe so.

Recent data from Zillow and REIS show significant disinflation in apartment and housing rents. While this has yet to show up in the BLS data, it could by the second half of this year. Therefore, it makes sense to look at core CPI excluding shelter. As illustrated in the chart below, this series is up just 3.4% over the last 12 months, which is down sharply from its 7.6% February 2022 peak. And further year-over-year slowing is expected next month because the data are going up against a large 0.6% monthly increase in June 2022.

Unfortunately, the Fed is ignoring this underlying improvement, which means monetary policy is mis-calibrated. The persistence of this situation risks a more severe recession down the road. Investors take note.



Sources: BLS, Haver, SMBC Nikko

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