Both Roads Lead to Lower Prices

Core inflation is trending lower for two reasons: First, supply-chain disruptions associated with the global pandemic have massively eased. And second, the economy is slowing, which will lead to fewer wage demands, thus putting downward pressure on input costs. Consequently, concern that inflation will be sticky is misplaced. Instead, policymakers should be more worried they have tightened rates too much.

The Fed’s preferred inflation metric is the core PCE deflator although Chair Powell has highlighted a variant, which is core PCE services less housing. Our analysis, which focuses on the former, does not change if we look at this narrower measure of inflation.

As we have highlighted on several occasions, the San Francisco Fed breaks the core PCE deflator into two parts: One component measures acyclical prices, which are those components whose price is independent of the economy’s performance. These prices are not correlated with the unemployment rate. For example, this would include education and healthcare. The other component measures cyclical prices, which are those components whose price is dependent on the economy’s performance. These prices are highly correlated with the unemployment rate. This would include recreational services, residential rents, and restaurant sales.

According to our calculations, most of the runup in core PCE deflator was the result of soaring acyclical prices—they accounted for 80% of the increase in the inflation rate and were the direct result of covid-related shutdowns which disrupted global supply chains. This is evident from the left-hand side chart below, which shows the New York Fed global supply chain pressure index. To note, the series soared during the pandemic and peaked in December 2021. But as the global economy has normalized, supply pressures have collapsed, and currently the series shows downward pressure as it is back to levels seen during the 2008-09 recession. Acyclical prices will continue to slow.

At the same time, cyclical prices are moderating too, the result of a cooling labor market. The quits rate, which leads both the unemployment rate and wage demands, continues to slow. Consequently, quits are back to their pre-covid levels. This suggests that cyclical prices (with a lag) will fall significantly further as illustrated in the right-hand side chart below.

Based on the trends in acyclical and cyclical prices, the core PCE deflator could be back to a 2% rate sometime next year. But if the economy goes into recession, inflation is likely to be even lower. This is a factor monetary policymakers should consider as they debate the need for another interest rate hike.
Disclaimers

This document is provided by SMBC Nikko Securities America, Inc. (“SMBC Nikko”), the US-registered broker-dealer affiliate of Sumitomo Mitsui Banking Corporation, for informational purposes only. This document was prepared by SMBC Nikko’s economist(s). The views, statements, assumptions and forecasts expressed herein are those of the author(s) and do not reflect the judgment of any other person or of SMBC Nikko. It does not constitute an offer, or solicitation of the sale or purchase, of securities or other investments. The information contained herein is obtained or derived from sources believed to be reliable, but SMBC Nikko and the author(s) make no representations as to its accuracy or completeness. In some cases, such information may be incomplete or summarized. This document has been prepared based on assumptions and parameters determined by the economist(s) in good faith. The assumptions and parameters used are not the only ones that could have been selected, and therefore no guarantee is given as to the accuracy, completeness, or reasonableness of any such quotations, disclosures, or analyses. Past performance is not a reliable indicator of any future results.

This document has been prepared for and is directed at institutional investors and other market professionals, and is not intended for use by retail customers. It does not take into account any specific investment objective, financial situation, or particular need of any recipient. The information contained herein should, for whatever purpose, be used solely at the discretion and responsibility of the recipient. SMBC Nikko and its affiliates do not accept any liability or responsibility for any results in connection with the use of such information. Recipients are responsible for making final investment decisions and should do so at their own discretion after conducting a careful examination of all documentation delivered prior to execution, explanatory documents pertaining to listed securities, prospectuses, and other relevant documents, and their own independent analysis and assessment of the merits of any transaction. The financial instruments discussed may be speculative and may involve risks to principal and interest.

Conflicts of Interest Disclosures

The views, statements, assumptions and forecasts expressed herein may differ from those expressed in globally branded research produced by SMBC Nikko or its affiliates. The trading desks of SMBC Nikko and its affiliates trade or may trade as principal in the financial instruments that are the subject of this material, and the author(s) of this document may have consulted with the trading desks while preparing this document. The proprietary interests of SMBC Nikko and its affiliates may conflict with those of the recipient. SMBC Nikko and its affiliates may seek to do business with the companies mentioned in this material and the trading desks may have accumulated, be in the process of accumulating, or accumulate long or short positions in the financial instruments mentioned and may have acquired them at prices no longer available. The trading desks may also have or take positions inconsistent with the views expressed in this document or may have already traded on those views.

This material is not a research report, and neither this material nor its author(s) is subject to SMBC Nikko policies and procedures that apply to the globally branded research reports and research analysts of SMBC Nikko and its affiliates or to legal requirements designed to promote the independence of investment research. It is not subject to any prohibition on dealing ahead of the dissemination of investment research. This means that on the date of this document, SMBC Nikko, its affiliates, and their respective directors, representatives, or employees, may have a long or short position in any of the instruments mentioned in this document and may make a market or trade in instruments economically related to the securities, derivatives or other underlying assets mentioned herein, in each case either as principal or as agent.

No part of the author(s) compensation was, is, or will be, directly or indirectly related to the specific recommendations or views expressed herein. The personal views of authors may differ from one another.

Distribution, possession or delivery of this document in, to or from certain jurisdictions may be restricted or prohibited by law. Recipients of this document are required to inform themselves of and comply with all such restrictions or prohibitions.

© 2023 SMBC Group. All rights reserved.