Beware Rising Real Rates

Today’s July CPI report is another dataset affirming the broader disinflationary trend that has taken place over the last year, and this has been right in line with our view. What is of particular interest going forward, however, is how inflation’s comedown has effectively led to a rapid tightening of financial conditions even though the Fed is stepping away from hikes.

What started as a drop in food and energy inflation, has given way to the stickier components of inflation softening too. Shelter, which accounts for 34% of the overall CPI index, has softened quickly. This alone moves the index lower. Over the last three months, shelter costs have risen 5.6%, annualized. Compare this with June’s 5.5% rate, May’s 6.3% rate, April’s 7.2%, March’s 8.5% and February’s peak of 9.5%. Meanwhile, Fed Chair Powell’s preferred ‘super-core’ measure is falling even faster. Annualized over the last three months, super-core is up just 1.7%! Again, compare this with 1.4% in June, 3.1% in May, 4.2% in April, 5.2% in March. Inflationary forces, across the board and especially in critical areas, are in retreat. Not only is this likely to dominate the recent rise in energy prices that has occurred since July 21, but this has profound, far-reaching consequences.

There are two big picture takeaways. First, the decline in inflation has led to a sharp tightening in financial conditions as illustrated in the left chart below which shows the highest real rates (2.18%) since July 2009 (2.23%). This means that price increases are insufficient in covering interest costs (in other words: debt is no longer being inflated away). Second, softening inflation also means that nominal growth — by definition — is slowing. For the first time since Q2 2009, interest rates are greater than nominal growth (see right chart), meaning that the economy is also not outgrowing its interest obligation either. In sum, neither increased productivity nor inflation is sufficient in covering interest expenses. No wonder loans are running increasingly delinquent (see our August 8th piece)! This dynamic (interest rates relative to growth) is one of the most profound in economics and now implies that economy-wide debt is going to become a lot harder to payback as the flow of funds on net are pulled out of the private sector and into the financial sector. This requires households to cut spending, thus exacerbating the disinflation.

Sources: Federal Reserve, BLS, BEA, NBER, Haver, SMBC Nikko
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