

US Macroeconomics | SMBC Capital Markets

November 2, 2022

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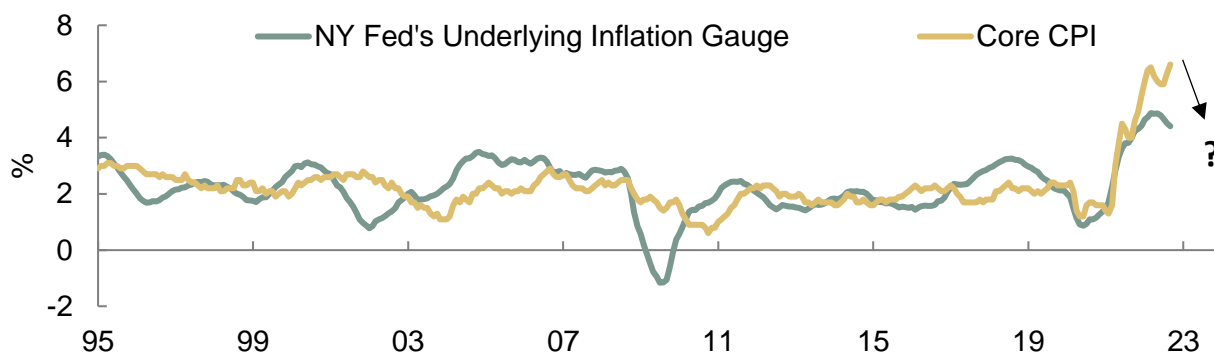
Inflation Inflection Point?

The inflation rate can be extremely volatile even when its growth is relatively low. For this reason, policymakers often focus on measures of core inflation to gauge the underlying trend in prices. Traditionally, this has meant looking at the inflation rate after food and energy prices are excluded. The problem with this is threefold: One, while these series are volatile, other series can be more volatile, thus obfuscating the “true” inflation rate. For example, airfare and apparel prices can severely distort monthly core inflation readings. Two, changes in energy prices can have significant secondary effects its importance in the production and distribution of various goods. Three, inflation expectations which impact labor negotiations are based off headline rather than core inflation. Thus, **a reliable gauge of underlying inflation is critical to the proper calibration of monetary policy.** Fortunately, the Federal Reserve Bank of New York has created one such series.

The Underlying Inflation Gauge (UIG) is shown in the chart below alongside the core consumer price index (CPI). The series is created using a dynamic factor model that uses the underlying CPI components as well as other macroeconomic variables such as manufacturing ISM prices paid, the unemployment rate, the money supply, commodity prices and the treasury yield curve to create a “core” measure of inflation. Leaving aside its statistical complexities, we can see that the UIG does a good job tracking turning points in underlying inflation.

Historically, the UIG peaks before core inflation. In September, the UIG rose 4.4% from 12 months earlier, flat relative to August. Moreover, the growth rate of the series has slowed from a 4.9% rate experienced from March 2022 to May 2022. Meanwhile, the core CPI rose 6.6% in September from a year-earlier, matching its cyclical high set in the previous month. **The current 2.2% spread between the two series is the largest since September 2009.** The last time this happened, core CPI collapsed within nine months. The upshot is that investors and monetary policymakers alike should proceed more cautiously going forward.

Underlying Inflation Turning Down



Sources: Federal Reserve, Haver, SMBC; Note: For more information on UIG, see “The FRBNY Staff Underlying Inflation Gauge: UIG”, Staff Report 672, April 2014

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