US Macroeconomics

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Joseph Lavorgna, Chief US Economist | 212.893.1528 | joseph.lavorgna@smbcnikko-si.com

Will a Disinflationary Breeze Turn Into a Gust?

The Fed has been harping about the need to lower the inflation rate. Fortunately, its underlying trend has been collapsing. And the newfangled Powell-created inflation series has been slowing as well. There are good reasons for these bond-friendly trends to continue.

The headline consumer price index (CPI), which is the best and longest running price metric we have, grew 4.0% in May 2023 from its year-earlier level. While still too high, this is less than half its peak growth rate recorded last June (9.1%). As we have chronicled numerous times, when headline price gains slow, they continue to do so for some time.

Given the fact that inflation is the “laggingist” of all the economic indicators and that it peaked in the month the Fed started hiking by 75 basis points, we can be confident that its growth rate will slow further. Monetary policy works with lags so if inflation peaked last June when the funds rate was 1.75%, we can be confident that the massive further increase in borrowing costs will work its demand depressive magic.

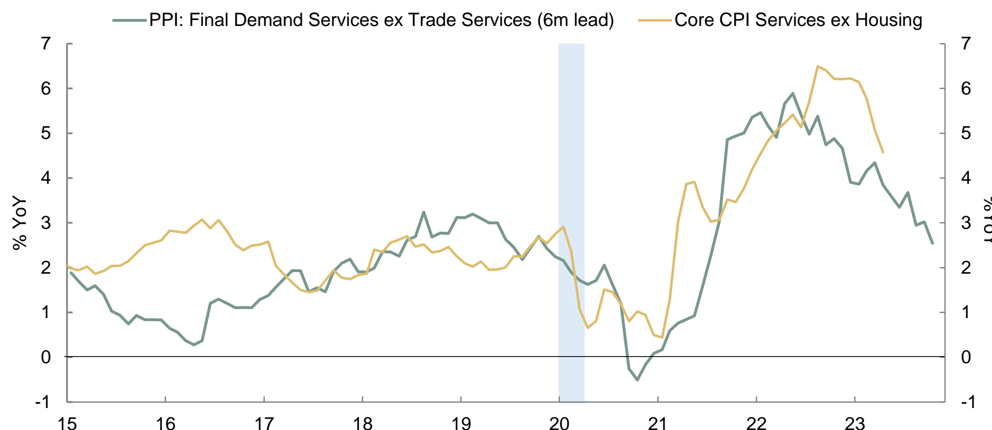
It is possible that CPI ends 2023 up only around 2% thanks to expected weakness in food and energy costs. North American fertilizer prices are down about 50% over the past 12 months, and refined energy prices such as No. 2 fuel oil and gasoline, are not showing their typical seasonal strength.

The inflation worry warts will downplay the significance of much weaker headline inflation and highlight today’s tight labor market and the fact that core inflation is sticky. But is it?

Powell highlighted the Fed’s focus on core consumer services prices excluding housing (i.e., the super core!) because this series is allegedly dominated by labor costs. Beside the fact that our work has determined that this is not the case, policymakers can nonetheless take comfort in its likely further deceleration.

In the chart below, we show the latest data from the producer price index (PPI). **Final demand services less trade services, a leading proxy for the super core, has been moving lower since last June**. In May, the series was up only 2.5% from its year-ago level, which is down from 3.0% in the previous month and nearly 6% from its June 2022 peak.

The PPI points to a slowdown in the super core from 4.6% currently to well under 3% by November. If so, other broader measures of inflation should move lower, too. Despite hawkish Fed rhetoric, a disinflationary breeze is in the air. And if there is a hard landing later this year, the backdrop may shift to deflation.



Sources: BLS, NBER, Haver, SMBC Nikko

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