TrendMacrolytics

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INTELLECTUAL AMMUNITION

Inflation Mission Accomplished? Not So Fast

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Seeming downticks in reported inflation are just counter-trend blips in a continuing uptrend.

Update to strategic view

FED FUNDS: Illusorily benign inflation readings and ambiguous news from the housing sector will keep the Fed on pause for the December FOMC meeting. With continued volatility in the price of oil, upcoming data is likely to be noisy – but economic and inflation surprises will mostly be on the upside, and the next Fed rate move will be higher, potentially as early as the January FOMC meeting.

[see Investment Strategy Dashboard]

The ink on a better than expected print for last month's core inflation had barely dried Thursday when credit markets snapped back on the realization that policy makers were hardly prepared to offer an "all clear" signal on the release. Three Fed officials who happened to be speaking at separate events coincident with publication of the release had virtually indistinguishable reactions to the news, all noting that one month's data doesn't constitute a trend, and that it would be premature to assume that their inflation worries are now behind them. Dallas Fed President Richard Fisher probably gave the clearest bottom line response, asserting that "we have no tolerance for inflation above 2%. We must remain constantly vigilant." The 10-year Treasury, which had rallied 12 ticks in initial trading on the report of just a 0.1% rise in core CPI, promptly sold off and finished with a yield some five basis points higher on the day.

To be sure, recent readings from the statistical price indexes constitute a challenge to our view that the trend toward higher inflation remains in place, and that a still accommodative Fed continues to feed marginal inflationary impulses into the system. Since May, the 3-month annualized increase in core CPI has dropped off from 3.8% to 2.3%. The year-on-year core rate has seen its first decline since last February, dropping from 2.9% to 2.8% on the latest release. But it should be noted that such short-run counter-trend moves are not unusual in the context of a longer-run trend. During the last inflationary run-up in the late 1980s, there were four separate occasions when the 3-month annualized core inflation rate fell by 1.5% or more within the space of a few months. Overall, the trend higher remained in place, with the year-on-year core rate rising from 3.6% in early 1987 to 5.7% by early 1991. Actually, the current episode has already witnessed a sharp counter-trend move, with the 3-month annualized core rate dropping from 3.1% to 1.2% in the second quarter last year. But that did not amount to a meaningful shift in the upward trend that has seen the year-on-year core inflation rate move inexorably higher since bottoming at 1.1% nearly three years ago.

There also is good reason to question whether the conventional core CPI is providing the most accurate reading of the current inflation environment. As a fixed-weight measure, the CPI does not account for shifts in spending patterns caused by changes in relative prices. The chain-weighted CPI, a relatively recent innovation in the Bureau of Labor Statistics' arsenal, is regularly updated to track such shifts, and is now emitting a signal significantly at variance with core CPI. Earlier in this cycle, the chained CPI was providing more benign readings and was

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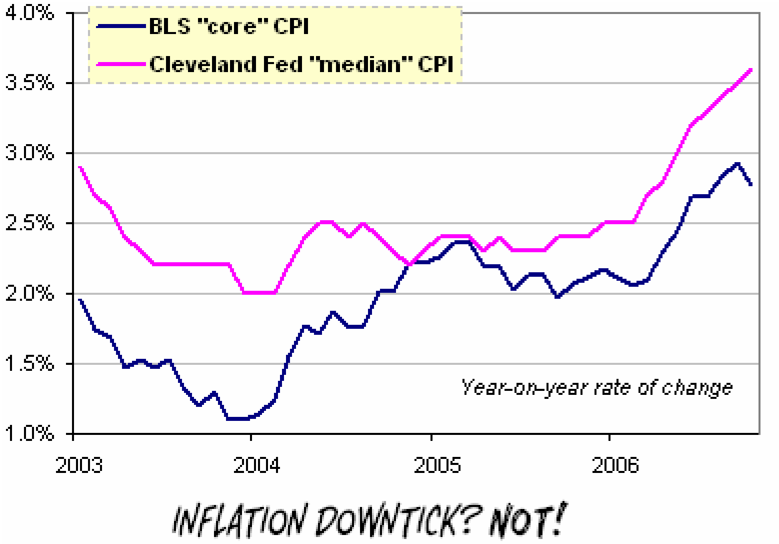
often cited by those skeptical of the notion that a significant inflation uptick was at hand. But that has changed. On a 3-month basis, the core chained CPI is now rising at a 3.2% annual rate, having shown three consecutive 1-month readings of 0.3%.



The concept of a "core" measure of inflation is that removing the most volatile elements from the calculation yields a more focused view of underlying inflation fundamentals. The statistical bureaucracy has attempted to get at this by publishing core CPI and PCE indexes excluding food and energy. While these are frequently among the most volatile components, they are not alone. The latest core CPI, for example, was pulled lower by declines in such volatile product areas as autos, apparel, airfare and hotel rates. One way of dealing with this is to calculate the median price change, rather than the mean price change, from among the component categories, thus effectively ignoring categories with anomalously low or anomalously high price changes. This is precisely what the Cleveland Fed's Median CPI does, and it is garnering significant interest among economists now because it is certainly not conforming to the feel-good message coming from core CPI. The Median CPI last month rose 0.3%, and is up by 3.6% over the past year. The Cleveland Fed maintains that its index has predictive value for reported inflation, which if true in this case would suggest that the recent air of contentment regarding the inflation picture could well be short lived.

BOTTOM LINE: The report of just a 0.1% increase in core inflation last month bolstered the sense that the worst of the inflation threat has passed and that the Fed can rest easy, its task complete. While Fed officials have attempted to counter such notions, the market remains priced for more than 50 basis points in rate cuts next year, which from our perspective remains a key vulnerability for fixed income. The feed-through lag from actual inflation influences into core CPI appears to be more pronounced than usual in this cycle, but other gauges of the price environment are not nearly so benign. While the reported statistical data is likely to provide the Fed with enough cover to remain on hold in the short run, we maintain our call that the next move in rates will be higher, and that the longer the Fed waits to resume hiking rates, the more it will eventually have to do to catch up. TM