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FED SHADOW

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**David Gitlitz**

**The Fed needs more proof that inflation has been tamed – and arbitrary core readings aren't it.**

The bond market is taking some solace today as the 12-month rate on the core personal consumption deflator in May came in a tick below the 2% top end of the Fed's so-called "comfort zone." But yesterday's post-meeting statement from the FOMC left the clear impression that the central bank is less focused on current price readings than on the inflation outlook, about which it continues to have considerable concern. Indeed, the Fed's message had to register as a notable disappointment for those hoping for a more dovish tilt from policymakers. Today's data, which included further evidence that "the consumer" remains buoyant, is unlikely to alter the Fed's perceptions of current reality.

**Update to strategic view**

**FED FUNDS:** Today's benign core PCE inflation reading will do little to influence the Fed's fears. The Fed needs to see these levels sustained – which we believe they will not be. At the same time, the Fed is losing confidence in arbitrary core measures as truly representative of inflation reality. Today's report does nothing to move the Fed toward rate cuts, and we continue to believe their next move will be a hike.

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The committee deleted the reference in last month's statement to core inflation remaining "somewhat elevated," acknowledging that readings "have improved modestly in recent months." Importantly, though, it also removed from last month's statement the assertion that "inflation pressures seem likely to moderate over time." Instead, a new sentence was inserted, observing that "a sustained moderation in inflation pressures has yet to be convincingly demonstrated." On balance, we view this modification in the language as marginally more hawkish.

That's also reinforced by the upgrade in the Fed's assessment of the economy, which shifted from noting last month that "economic growth slowed in the first part of this year," to stating yesterday that "economic growth appears to have been moderate during the first half of this year." That still seems to be downplaying the degree of reacceleration in the economy that's now underway. For now, though, it's probably as far as the Fed wants to go in pointing to a potential policy-relevant shift in outlook.

But the statement continues to point to the "high level of resource utilization" -- meaning the unemployment rate remaining at a low 4.5% -- as having the "potential to sustain" inflation pressures. And it again repeated the caution that the "Committee's predominant policy concern

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remains the risk that inflation will fail to moderate as expected." In the Fed's demand-based model, that concern will only heighten with the economy returning to 3%-plus growth rates, as now appears to be the case.

In the run up to this latest meeting, there was some speculation that the FOMC might be preparing to somehow modify its reliance on the "core" PCE rate as its principal inflation indicator. There appears to be growing recognition that in current conditions, simply excluding food and energy in the core rate calculation is not providing an accurate reading of underlying inflation conditions. In a recent interview, Richard Fisher, president of the Dallas Fed, stated that "both food and energy have had a steep upward tilt for the last three years in a row. Under those circumstances, I'm personally reluctant to put complete faith in the core measures because they may be removing more signal than noise."

In a publication last week, the St. Louis Fed drew attention to alternative measures of core inflation -- such as the median CPI and trimmed-mean indexes -- which seek to filter out volatile influences whatever they may be, rather than arbitrarily always excluding food and energy. The paper notes that the difference between headline and core inflation has been widening over the past few years due primarily to the rising price of oil. "A disconnect between measures of headline and core inflation could be a concern for policymakers," said the St. Louis Fed article. "It may not be reasonable to conclude that monetary policy has been effective in maintaining price stability by looking solely at a core measure of inflation that excludes sustained oil price increases." The Cleveland Fed calculates the median CPI, which is now running at a 12-month rate above 3%. Although the Fed did not touch on this issue in its statement yesterday, it appears to be arousing some ferment within the central bank. If the Fed were to make a move to alter its reference inflation indicator, it would have a significant impact on expectations for future policy moves.

**BOTTOM LINE:** Another benign inflation reading from the core PCE index is giving bonds a lift today, but it's probably a stretch to think the Fed is putting much weight on it. In its post-meeting statement yesterday, the Fed acknowledged the recent moderation in core inflation, but emphasized that it's not yet convinced the moderation will be sustained. Indeed, our market-based indicators strongly suggest otherwise, and the Fed's demand-based indicators over the coming months will likely leave it hard-pressed to remain on hold. We maintain our view that the Fed's next move will be a hike, not a cut.