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TRENDMACRO LIVE!

Our Hot Take on Surprisingly Cool CPI

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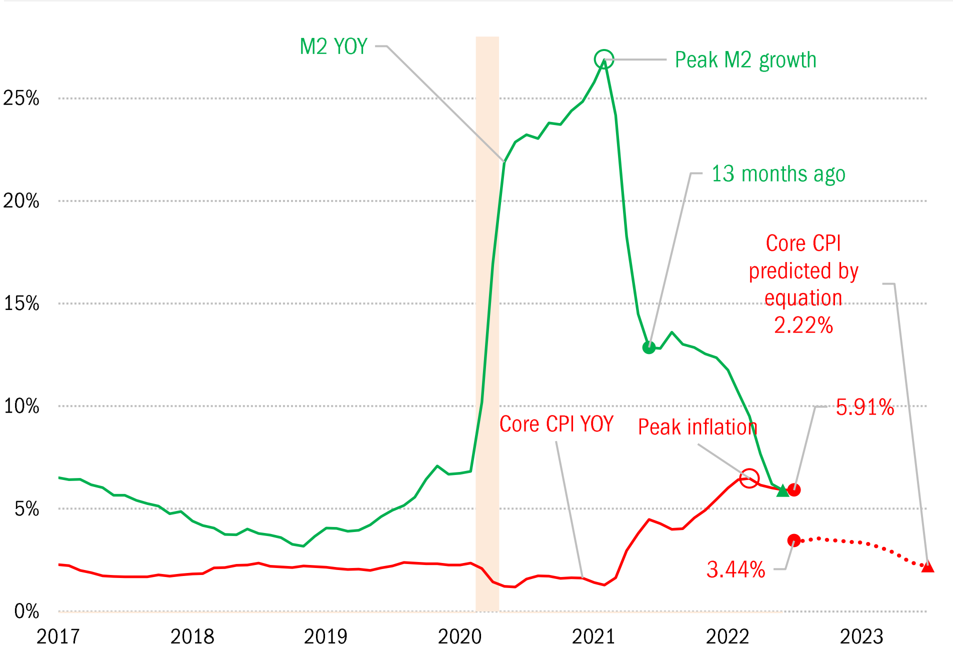
Donald Luskin

Even if the Fed makes a contractionary error in September, good that inflation is improving.

We're going to take the win on our out-of-consensus calls for the July Consumer Price Index. *We said that month-on-month headline could come in negative – and it did*, a contraction of 1 bp, versus consensus expectations for a 20 bp rise. *Our monetarist model predicted that year-on-year core would experience its fourth-in-a-row sequential decline – and it did*, at 5.91%, a contraction of 1 bp from June's reading, versus consensus expectations for 6.1% given very tough year-ago comparables (please see the chart below).

- On the surface, the big factor was gasoline. That alone contributed 51 bp to June's 1.30% inflation, and it subtracted 39 bp from July's, a month-on-month swing of 90 bp (almost four times the Fed's inflation target, just to give a sense of the enormity of it).
- *But we think the more important story is that pretty much nothing else arose to take gasoline's place to maintain the torrid pace of the last several month's CPI readings*.

Relation of M2 growth to Core CPI Recession



Source: Federal Reserve Board, BLS, TrendMacro calculations

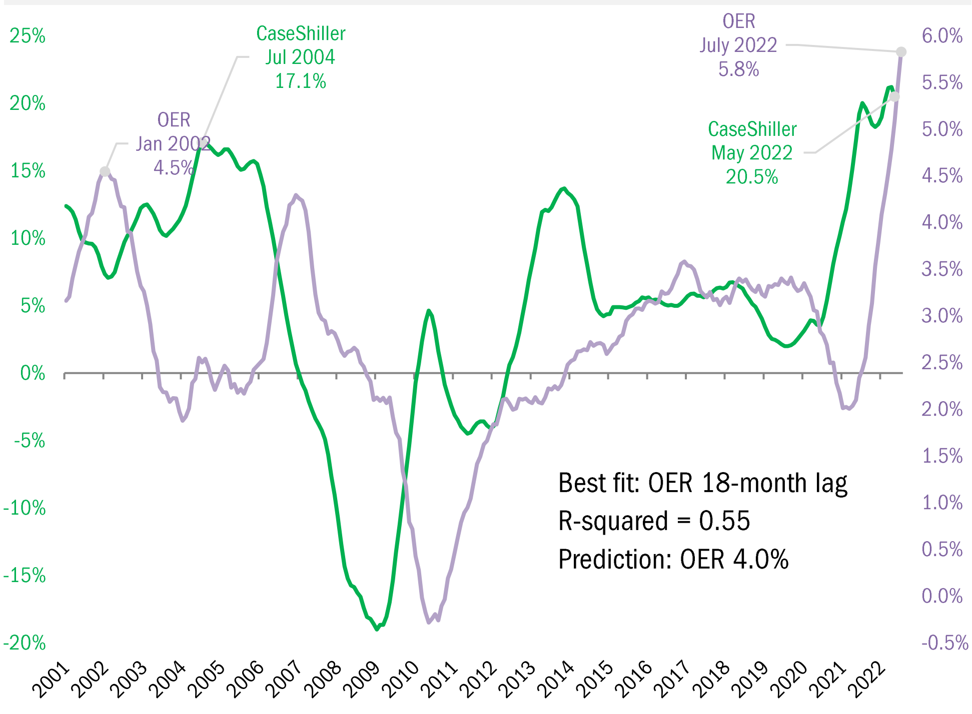
Update to strategic view

US MACRO, FEDERAL RESERVE: As we predicted, headline July CPI came in negative on a month-on-month basis, driven by falling gasoline prices, sharply beating the consensus. Core CPI beat, too, logging its fourth-in-a-row sequential drop since March's peak. OER was the only single component to make a substantial upside contribution, but it was less than last month's, and based on the historical relationship to changes in home prices can be expected to lessen over the coming 18 months. Market-implied expectations for the September FOMC still point to the possibility of a 75 bp rate hike. We reiterate our out-of-consensus call for just 25 bp. Anything more than that would be a contractionary error – but if the Fed is going to make an error, it is nevertheless good news that the underlying reality of inflation is improving.

[Strategy dashboard]

- To be sure, food as a super-category contributed 15 bp. This is remarkable considering the collapse in virtually all agricultural commodities – but that only implies that the pass-through into consumer food prices will show up with a lag, probably next month.
- The only truly notable *single* component to contribute positively was owner's equivalent rent, adding 14 bp to July's headline reading on a month-on-month basis (see "Data Insights: CPI/PPI" August 10, 2022).
- In June, OER alone grew by 70 bp month-on-month, an extraordinary gain for a single month. In July, it grew by 63 bp – still high by historical standards, but lower than June.
- OER is the largest component of CPI, and an even larger component of Core. Without it, headline would have contracted 14 bp (instead of 1, actual) and Core would have grown only 14 bp (instead of 33, actual).
- OER is the stickiest component, because rental contracts track changes in home prices only with a long lag (we estimate 18 months, based on more than two decades of historical experience – please see the chart below).

Relation of changes in home prices to OER inflation



Source: Bloomberg,, BLS, TrendMacro calculations

- On a year-on-year basis, OER has grown by 5.8%. If the historical relationship to changes in home prices holds, we expect that will cool to 4.0% in 18 months.

This CPI report gives us confidence that our model for thinking about inflation is correct – we've seen the peak, following with a lag in the wake

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of peak growth in the money supply (see "Why Inflation Is on the Way Down" July 25, 2022).

- If only we had confidence that the FOMC would see what we see.
- As of this writing, from before the CPI report was released, market-implied expectations for the September meeting have reduced the probability of a 75 bp hike from 76% to 45%. That's progress – but is leaves our call for only a 25 bp hike still very far out-of-consensus (see "On Inflation, If You Don't Study History…" June 13, 2022).
- That said, we nevertheless take comfort from this morning's cool inflation report. *Remember, if the Fed is going to make a contractionary policy error no matter what, better for the underlying reality of inflation to be a good one rather than a bad one.*

Bottom line

As we predicted, headline July CPI came in negative on a month-on-month basis, driven by falling gasoline prices, sharply beating the consensus. Core CPI beat, too, logging its fourth-in-a-row sequential drop since March's peak. OER was the only single component to make a substantial upside contribution, but it was less than last month's, and based on the historical relationship to changes in home prices can be expected to lessen over the coming 18 months. Market-implied expectations for the September FOMC still point to the possibility of a 75 bp rate hike. We reiterate our out-of-consensus call for just 25 bp. Anything more than that would be a contractionary error – but if the Fed is going to make an error, it is nevertheless good news that the underlying reality of inflation is improving.