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TRENDMACRO LIVE!

On June CPI: Sticky Inflation Just Came Unstuck

Wednesday, July 12, 2023

Donald Luskin

The FOMC said it needed more information. Well, here it is.

As we predicted – no, *better* than we predicted (see “Video: What you’re not hearing about the coming deflation” June 23, 2023) – this morning’s June CPI report showed the headline index dropping to 2.97% year-over-year. Yes, a two-handle. From its peak the prior June at 9.06%, a mere year ago, it has come 93% of the way back to the Fed’s target for it at 2.50%.

- *Wait, it gets better*. So much to love…
- Core CPI – the simplest symbol of dreaded “sticky inflation” (please see last week’s hilariously wrong cover of *The Economist*, below) – fell to 4.83%, well below the consensus expectation for 5.10%. Owners’ Equivalent Rent, the stickiest component (and the largest) has now fallen on a year-on-year basis for two months. Core ex-OER (our own favorite way of seeing the true underlying inflation signal), is down to 3.18% year-on-year – virtually equivalent to headline (for all that and much more, see “Data Insights: CPI/PPI” July 12, 2023).
- Whenever we’ve talked about our expectation that this would happen, we always get the rejoinder that it’s a form of cheating to look at year-on-year numbers, which will look good right now just because the worst months a year ago are rolling off. But that punch doesn’t land – *headline, core, and core ex-OER*

Update to strategic view

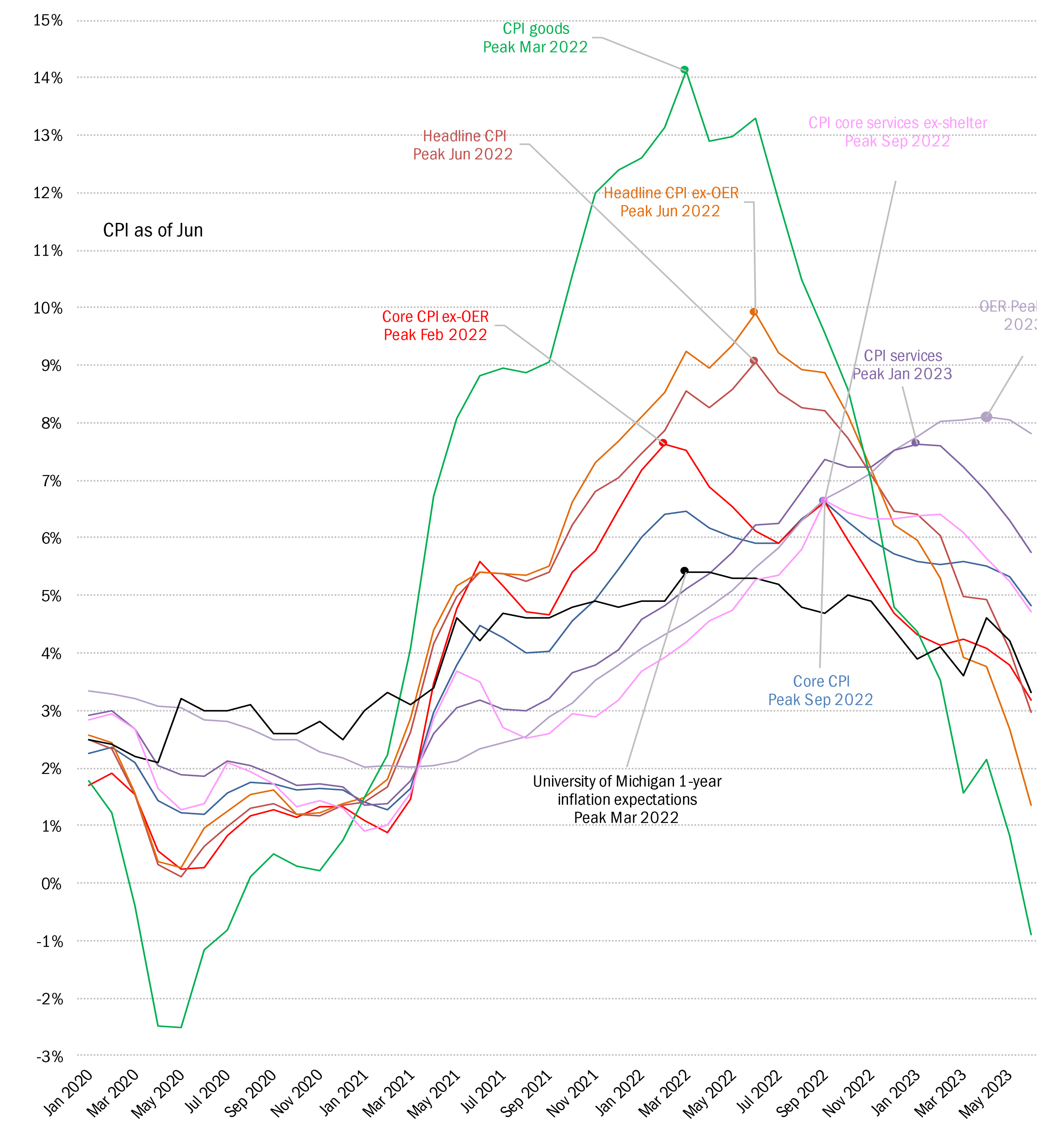
US MACRO, FEDERAL RESERVE, US STOCKS, US BONDS: Headline CPI at 2.97% brings inflation 93% of the way back to the Fed’s target from its peak one year ago. Core at 4.83% sharply beat expectations. Without OER, core is at 3.18%. 3-month and 1-month inflation are at even lower rates, so this is more than just bad data from a year ago rolling off. We reiterate our call that the July FOMC will pause again, an upside impeller for the economy, stocks and bonds (especially the short end). The rationale for the June pause was to await information – but information could have been gathered anyway, so that decision represented the Fed’s concern that they may have already done enough or too much. Now, with this information, why would they hike in July if they had reason to pause in June? PCE data won’t come out until after the FOMC, but they may have early access to it. The best CPI proxy for Powell’s favorite PCE measure is at the best level in 14 months, and sharply decelerating.

[Strategy dashboard]

are all lower on a one-month and three-month basis than they are on a year-on-year basis. Inflation is decelerating.

- *Indeed, our worries about outright deflation are already starting to materialize – goods inflation is now at negative 0.90% year-on-year* (please see the chart below).

Consumer Price Index inflation, year-on-year



Source: BLS, University of Michigan, TrendMacro calculations

[Generative AI token](): "Inflation is almost back to target. Will that keep the Fed from causing a recession?"

Source: DreamStudio running Stable Diffusion 1.5

- Another critique we always hear has more bite. We connect our optimistic forecasts for inflation to our optimistic forecasts that the Fed's June "skip" will prove to be the end of this hiking cycle (because the cessation of inflation removes the reason to hike). *But there is a world of difference between what the Fed should do in light of our correct inflation predictions, and what the Fed will do*. Especially this Fed. Indeed, we've been too dovish in our predictions of this Fed's reaction-function all year (see, most recently, "On the June FOMC" June 14, 2023).
- But we're going to stick to our guns. To be sure, an array of Fed spokespeople continue to speechify about additional rate hikes (plural). But now some are openly agnostic about their decision at the upcoming July FOMC, or downright dovish. That's a change.
- *And whatever they may say – and whatever that "dot" at a funds rate of 5-5/8% for year-end may say – the last thing they all did when the decision was upon them – unanimously – was to not raise rates* (again, see "On the June FOMC").
- Why? According to the June FOMC statement, it was because it "allows the Committee to assess additional information."
- They must think we are fools – *because the committee can always assess additional information, whether it hikes, skips or cuts. You pause when you think it is possible you have already done enough (or too much). From that expectational starting point, the "additional information" afforded by today's CPI data confirms to us that the July FOMC will "skip" again – and that the May FOMC hike will prove, in the fullness of time, to have been the last one.*
- Could *additional* additional information come in before the FOMC meets on July 26 and deflect this outcome? The Fed's preferred inflation metrics, the Personal Consumption Expenditures Price Indices, won't come out until two days *after* the meeting (although presumably they could get an advance peek). But there's no

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particular reason to think it will look any different than CPI. Chair Jay Powell's personal private version of PCE, core services ex-housing, is well proxied for by core CPI ex-shelter – and this morning it printed at 4.71% year-on-year, the lowest reading in 14 months (again, please see the chart on the previous page). It is sharply decelerating, at a rate of just 2.38% for the month of June, which puts it below the Fed's CPI target (again, please see "Data Insights: CPI/PPI").

- If we're right about the Fed, it's part of an ongoing case that we can avoid a hard landing (or any landing at all – see, among others, "On the June Jobs Report" July 7, 2023). And in the intermediate term it is a strong bull case for both stocks and bonds (especially the front end of the curve). If we're wrong about the Fed, that is going to cost some of the potential upside – but the better part of two hikes is already in markets. *And Fed or no Fed, it is part of a bull case that markets are not expecting to have inflation so rapidly returning to target*.
- *And then – by year-end, the deflation comes. That will be a whole 'nuther story* (see "Mid-Year Outlook: Our Unloved Bull Market in Equities" July 5, 2023).

Bottom line

Headline CPI at 2.97% brings inflation 93% of the way back to the Fed's target from its peak one year ago. Core at 4.83% sharply beat expectations. Without OER, core is at 3.18%. 3-month and 1-month inflation are at even lower rates, so this is more than just bad data from a year ago rolling off. We reiterate our call that the July FOMC will pause again, an upside impeller for the economy, stocks and bonds (especially the short end). The rationale for the June pause was to await information – but information could have been gathered anyway, so that decision represented the Fed's concern that they may have already done enough or too much. Now, with this information, why would they hike in July if they had reason to pause in June? PCE data won't come out until after the FOMC, but they may have early access to it. The best CPI proxy for Powell's favorite PCE measure is at the best level in 14 months, and sharply decelerating.