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On July CPI: So What will Powell Find to Hate About It?

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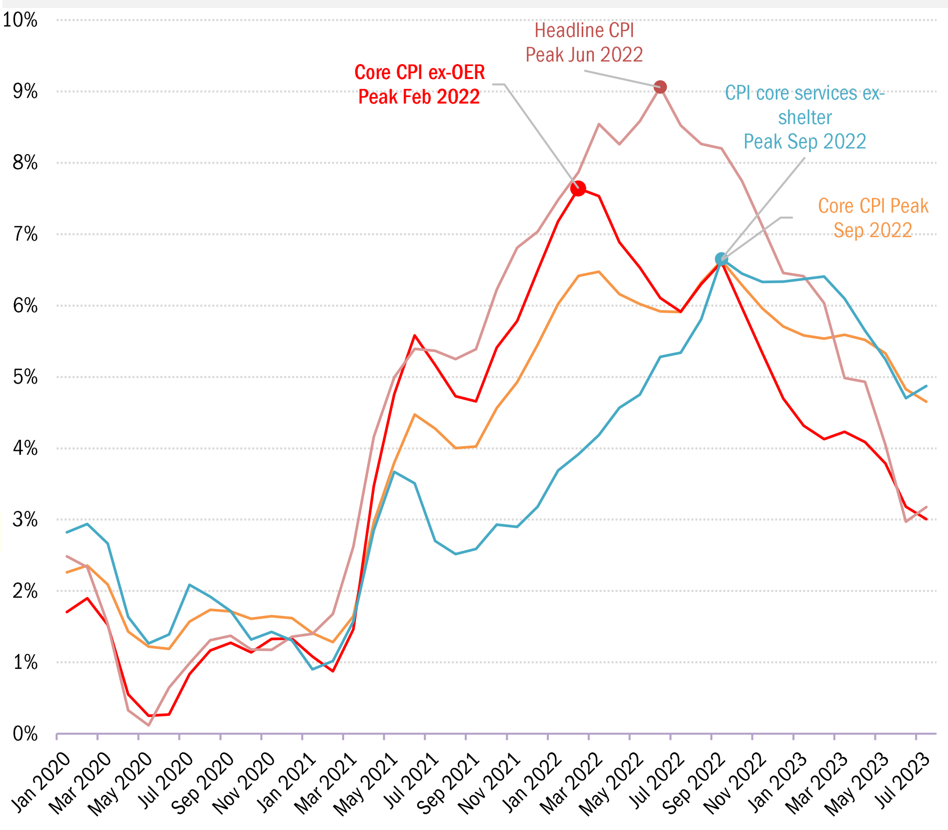
Donald Luskin

Jackson Hole would be a good time for Powell to declare victory. He probably won't.

As of this writing, risk markets seem appropriately delighted by this morning's July CPI report. But no sooner had it been released than a client emailed us with this question: "So what will Powell find wrong to downplay a good result?"

- That's the critical question, with Jackson Hole coming up – and an opportunity for Powell to unwind his brief stern remarks last year promising to burn down the village to save it from inflation (see "On Powell at Jackson Hole" August 26, 2022).

Consumer Price Index, year-on-year



Source: BLS, TrendMacro calculations

Update to strategic view

US MACRO, FEDERAL RESERVE: The data, and our opinions, do not matter: Powell matters. Base effects caused year-on-year headline CPI to rise slightly, even with a below-target rate for the month. Core CPI lags, so comparables were easier – and the month's rate was even further below target. Our favorite measure, core ex-OER, is in outright deflation for the month, and at a mere 3% year-on-year. Powell's favorite measure, core services ex-shelter, a small subset of index weight, is above target for the month, but at its lowest year-on-year reading in 14 months. Inflation is done. Deflation is starting to manifest. Powell won't likely declare victory at Jackson Hole, but could start to shift the narrative from how high the funds rate will go to how long it will have to stay where it is. The curve expects no more hikes, and we agree. The curve expects the first cut next March. We think it will be sooner as deflation becomes obvious.

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- Don't think he can't do it. Just three months after that speech the November FOMC announced slowing the pace of hikes (see "On the November FOMC" November 2, 2022), and they've been as good as their word (even including an outright "skip" in June -- see "On the June FOMC" June 14, 2023). That launched a bull market in stocks and bonds that has taken the S&P 500 29.6% higher as of this writing (even the unweighted S&P 500 is up 21.3%).

We suppose Powell could gripe that headline CPI for July was reported this morning up 3.18% year-on-year (see "Data Insights: CPI/PPI" August 10, 2023). That's a vast improvement from the 9.06% reported for June 2022, but still above the Fed's CPI target of 2.50%. But as we warned last week (see "On the US Downgrade and July Jobs Report" August 4, 2023), this would be an uptick from June 2023's 2.97%.

- But that uptick is because the June year-ago comparable was easy to beat at 17.1% for the month at an annual rate. The July year-ago comparable is way harder at negative 0.02%. There's nothing wrong with July 2023's monthly CPI number – it's 2.02% at an annual rate, well below the Fed's CPI target. But when a negative number rolls out of the year-on-year calculation and a positive number rolls in, even a low one, the year-on-year number rises.

Core CPI doesn't have that same "base effect" problem, because core lags headline (see "Video: What you're not hearing about the big lie of 'sticky inflation'" July 31, 2023). Year-ago June's core inflation at 8.8% at an annual rate was easily beaten by July 2023's 1.93%. So on a year-on-year basis, core fell to 4.65% from 4.83%.

- Of course Powell can say 4.65% is still too high.

Powell's most likely objection is that his favorite measure of inflation, core services ex-shelter, reported for July at 3.86% at an annual rate. Natch – the secret sub-index he thinks best represents "underlying inflation" or "sticky inflation" – though a small subset of weight in the consumption basket – would be the worst.

- Our view is that "sticky inflation" isn't "sticky" at all. It just lags (see "Video: What you're not hearing about the big lie of 'sticky inflation'" July 31, 2023). *But our view doesn't matter. Powell's does*.
- That said, even this lagging indicator of inflation is now at its lowest year-on-year reading since May 2022, at 4.87%.

Our favorite inflation measure is core CPI ex-OER. We want to see the true inflation signal, with no noise. So we take out food and energy that artificially excite the signal, and we take out OER that artificially suppresses it. That measure of inflation – we think the true measure – was in outright deflation in July, down 0.51% at an annual rate. *But our favorite measure doesn't matter. Powell's does*.

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- It's a cinch that this morning's CPI data is enough to ensure a "skip" at the September FOMC. That's what the yield curve already had built in, and still does. With additional inflation data that will arrive over the coming months, after that September "skip" there will be no more hikes. The curve has that built in, too.
- But it's probably a bridge too far for Powell to declare victory on inflation at Jackson Hole, even though it has plainly been won.
- In the meantime, the course of least resistance for Powell is to begin to shift the narrative from how high the funds rate has to go (no higher) to how long it has to remain at peak. That's just a different way of being too hawkish.
- As our favored inflation measure suggests, the next step is outright deflation (see, among many, "Video: What you're not hearing about the coming deflation" June 23, 2023). When that becomes more obvious than it is in this morning's data, you can be sure that Powell will panic, and markets will too.
- The curve gives a 100% probability to the first rate cut coming in March 2024. We think it will be earlier. But you won't hear that at Jackson Hole.

Bottom line

The data, and our opinions, do not matter: Powell matters. Base effects caused year-on-year headline CPI to rise slightly, even with a below-target rate for the month. Core CPI lags, so comparables were easier – and the month's rate was even further below target. Our favorite measure, core ex-OER, is in outright deflation for the month, and at a mere 3% year-on-year. Powell's favorite measure, core services ex-shelter, a small subset of index weight, is above target for the month, but at its lowest year-on-year reading in 14 months. Inflation is done. Deflation is starting to manifest. Powell won't likely declare victory at Jackson Hole, but could start to shift the narrative from how high the funds rate will go to how long it will have to stay where it is. The curve expects no more hikes, and we agree. The curve expects the first cut next March. We think it will be sooner as deflation becomes obvious.