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MACROCOSM

Today's CPI Miss

Wednesday, February 13, 2024

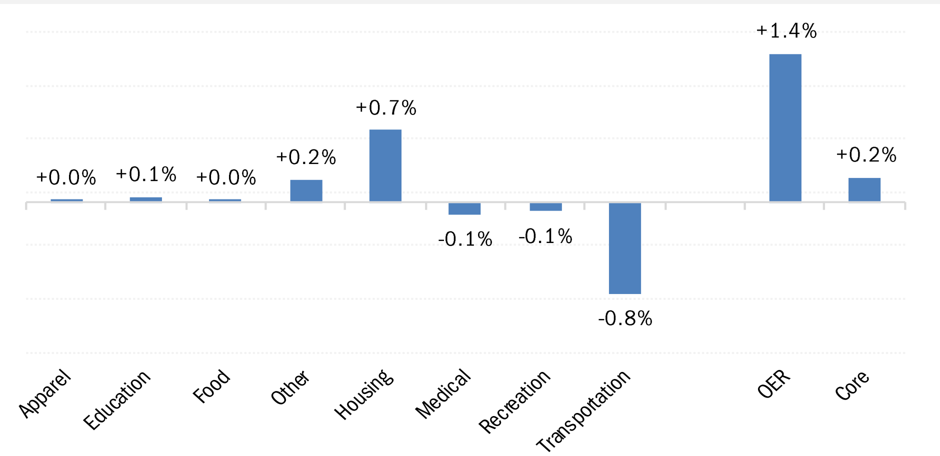
Donald Luskin

They upweighted the stuff that inflated most and downweighted the stuff that deflated most.

There's no sugar-coating it. This morning's January Consumer Price Index report was a miss versus both the market's expectations and ours. That said, it seems worse than it is because so much is at stake for the Fed. But the reality is that *the misses were the smallest increment possible: headline 0.3% month-over-month versus 0.2% consensus; core 0.4% versus 0.3% consensus.* But they were misses, and across both headline and core.

- Moreover, we estimate that *the miss is entirely due to the annual reweighting of consumption basket weights* (please see the chart below). At the old weights, *CPI would have been exactly at consensus*.
- *Generally, the weights were increased for components that experienced the most inflation, and decreased for elements that experienced less, or downright deflation* (please see the chart on the following page). It's most egregious at the extremes. The transportation sector, which is dominated by energy, deflated by 7.3% month-over-month at an annual rate – it was downweighted by 0.8%, from 16.7% to 15.9%. The housing sector, dominated by owners' equivalent rent, inflated by 7.7% month-over-month at an

CPI basket weights (change from last year)



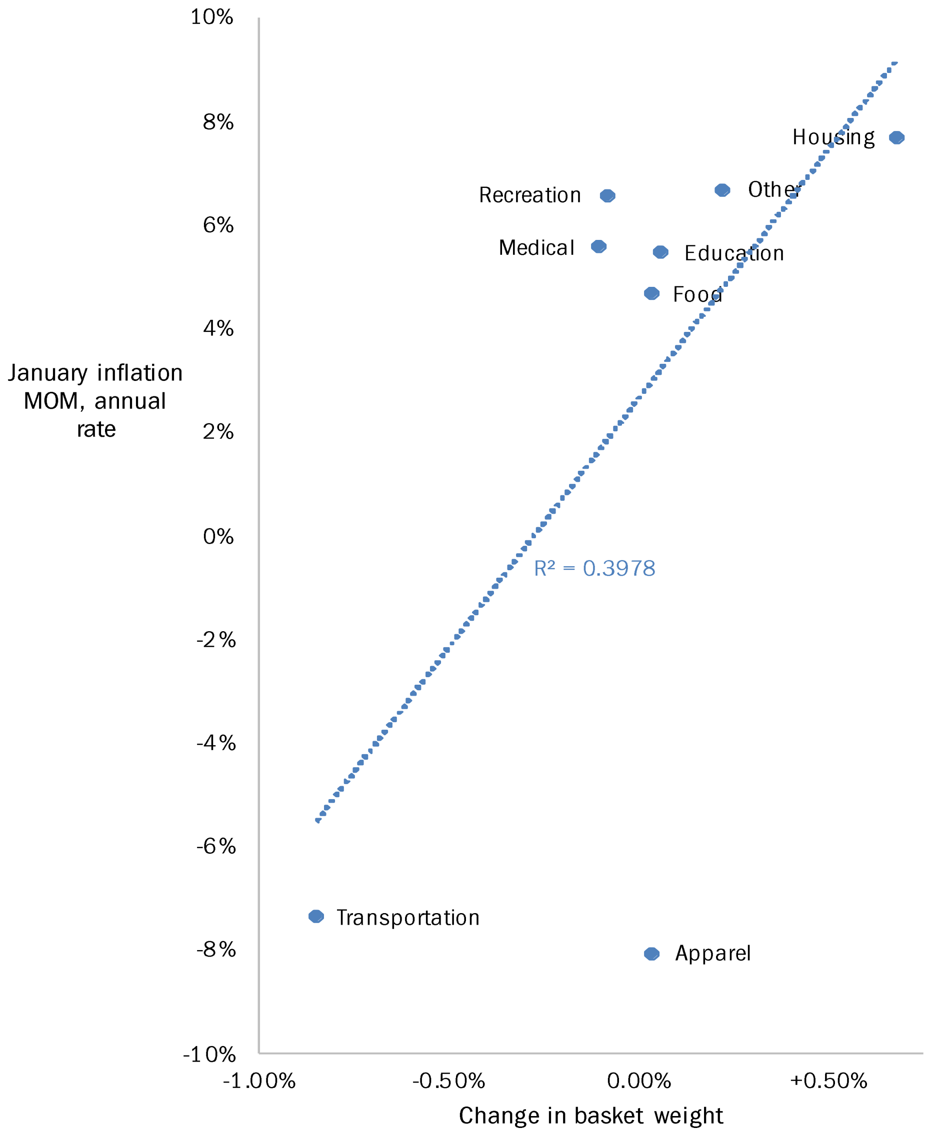
Source: BLS. TrendMacro calculations

Update to strategic view

US MACRO, FEDERAL RESERVE: A double miss in headline and core, but by the smallest possible increment. If the annual reweighting of basket components hadn't been implemented, CPI would have reported right at consensus estimates. Components that inflated the most were upweighted – notably housing, including OER – and those that deflated were downweighted – notably transportation, including energy. Nothing here changes our view that disinflation is underway and deflation is coming. By upweighting the most lagging components, deflation has more fuel now It probably dooms our call for a March rate cut, but May and June are live prospects. Given booming economic growth and stocks at new highs, the Fed may well be wrong that policy is "highly restrictive." It would be useful for stressed banks to have a lower funds rate sooner, but other than that it probably doesn't matter for growth.

[Strategy dashboard]

Change in basket weight versus January inflation (month-on-month, annual rate)



Source: BLS. TrendMacro calculations

annual rate – it was upweighted 0.7% from 44.4% to 45.1%. OER itself was upweighted a rather astonishing 1.4% from 24.0% to 25.4%.

- Beyond the impact on January, the reweightings will impact the future as well. Energy, the *most high-beta and leading* component was downweighted while OER, the *most low-beta and lagging* component was upweighted. This reinforces our deflation expectations because the *components that have arguably already shot their deflationary wad count less, while those that can continue to contribute future deflation count more*.
- This view is useful in separating out our two key concerns here – first, what this data will do to the Fed's policy outlook, and second, what this data means about inflation itself.

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- As to inflation itself, this data – even without backing out the new weightings – is just another step down the road of disinflation on the way to deflation.
- As to the Fed, according to Chair Jerome Powell on 60 Minutes right after the January FOMC, "We just want to see more good data… It doesn't need to be better than what we've seen, or even as good. It just needs to be good" (see "Video: What you're not hearing about Jerome Powell's "evidence" that inflation is really dead" February 12, 2024). We'd say this qualifies.
- We're coming more and more to the idea that *it's inflation itself that matters, not the Fed*. Inflation is a potential cancer on economic performance, and it's great that it has, in our view, already returned to normal and acceptable levels. *The Fed would be an issue, too, if Powell and other Fed officials were correct that policy now is "extremely restrictive." But it self-evidently isn't*, because after one of the most violent hiking cycles ever, and with the funds rate at 5-3/8% now for over six months, economic performance has been excellent – better than excellent.
- It would be constructive for the cost-of-funds for hard-pressed mid-sized banks, in the wake of the Silicon Valley Bank failure, to have the funds rate come down. But judging from economic growth over the last year, and from stocks at all-time highs, *at this point it hardly matters whether a couple of good CPI reports inspire the Fed to cut rates soon (at this point, our long-suffering call for a March cut looks doomed). But if it's May, or even June, it's not clear at all it would matter.*

Bottom line

A double miss in headline and core, but by the smallest possible increment. If the annual reweighting of basket components hadn't been implemented, CPI would have reported right at consensus estimates. Components that inflated the most were upweighted – notably housing, including OER – and those that deflated were downweighted – notably transportation, including energy. Nothing here changes our view that disinflation is underway and deflation is coming. By upweighting the most lagging components, deflation has more fuel now. It probably dooms our call for a March rate cut, but May and June are live prospects. Given booming economic growth and stocks at new highs, the Fed may well be wrong that policy is "highly restrictive." It would be useful for stressed banks to have a lower funds rate sooner, but other than that it probably doesn't matter for growth.