

Weekly Economic Update—Aug 14th, 2023

The latest consumer price report is adding fuel to the debate over whether higher unemployment is needed to tame inflation. For sure, the Federal Reserve has a major stake in the debate as it must decide how forcefully it needs to restrain growth – and hence jobs – to bring inflation down to its 2 percent target. No doubt, policymakers are pleasantly surprised that progress on the inflation front has been so pronounced without sending workers to the unemployment lines. It enabled them to take a pause in their rate-hiking campaign in June, and it most likely will keep them on the sidelines at the upcoming September FOMC meeting. The financial markets are fully on board with that assessment, and then some, as the futures market is pricing in less than a 20 percent probability the Fed will raise rates in September and less than a 40 percent chance at the November policy meeting.

Despite an unemployment rate that hovers near historic lows, including a tick down to 3.5 percent in July, inflation continues to steadily retreat. In July, the consumer price index rose by another slim 0.2 percent, the third consecutive month the index has advanced by 0.2 percent or less. That's the longest stretch of benign readings since the fall of 2020. Compared to a year ago, the CPI did tick up to 3.2 percent from 3.0 percent, but that's mainly due to base effects as inflation downshifted sharply last July. Those effects should push the year-over-year rate higher in August as well. But over the past three months, the headline CPI has increased at an annual rate of 1.9 percent, the slowest pace in more than three years.

The headline number, of course, includes volatile food and energy prices, which have behaved quite tamely in recent months, but could be a disruptive influence going forward. Oil prices have been on the rise since early July and will have a bigger impact on the August CPI if they remain at current levels throughout the month. Aside from the direct impact on the headline CPI, there could also be knock-on effects, as higher diesel fuel prices could put upward pressure on air fares. Food prices might also come under pressure owing to Russia's blockade of grain shipments from Ukraine. Notably, wholesale food prices increased 0.5 percent in July, according to Friday's producer price report. Indeed, most of the outsized swings in the consumer price index – both up and down—during the current inflation cycle have been driven by food and energy prices.

For that reason, the Fed looks at price measures that strip out the volatile food and energy items to better monitor underlying inflation trends. Happily, this exercise also reveals significant progress on the inflation front. True, the improvement has been less dramatic than the retreat in the headline CPI. But the underlying, or core, inflation gauges never rose as high as the 9.1 percent year-over-year peak that the overall CPI hit in June 2022. The core CPI peaked at 6.6 percent and has since receded to 4.7 percent. The good news is that the core rate continued to slip in August – from 4.8 percent in July – unlike the uptick in the headline CPI. The bad news is that the core rate is still well above the Fed's 2 percent target – at least when compared to year ago levels.

But the gap is narrowing rapidly when measured against recent trends. Over the past three months, the core CPI has increased at an annual rate of 3.1 percent, within striking distance of the 2 percent target. A key component that is keeping the rate from reaching the target is housing, where rents are still climbing at an outsized year-over-year rate of 8.3 percent driven by forces mostly outside of the Fed's control. The Fed has recently placed more emphasis on a so-called supercore index, which focuses on core service prices excluding shelter and is heavily influenced by labor costs. This subindex stands 3.8 percent higher than a year ago – uncomfortably elevated – but has recently downshifted markedly, increasing at a 2 percent annual rate over the past three months.

The question is whether the Fed believes the shorter-term disinflationary trend is sustainable, given the still-tight labor market and above-trend growth in GDP. Clearly, the recent trend gives it more flexibility than otherwise and the option to skip another rate increase in September if there are no radical upside surprises in the August inflation or jobs reports. We don't expect that to be the case and believe the Fed has completed the rate-hiking cycle with the 25-basis point increase taken at the July meeting. That said, policy makers are plainly not ready to claim "mission accomplished" in its inflation fight for several reasons. For one, it does not want to encourage looser financial market conditions, which would undermine efforts to slow growth. For another, such a proclamation would invoke fears that the Fed is once again stepping back before inflation has been extinguished, recalling past episodes of premature easing that reignited the inflation embers.

Indeed, policymakers have been highly vocal in delivering a hawkish message, which Chair Powell will probably reaffirm at the September 20 post-meeting press conference. Simply put, several Fed officials have put the markets on notice that while rates may be on hold for a while, they will clearly not be cut anytime soon. At the September meeting, a fresh set of economic and interest rate projections will be released, and it will be interesting to see if another rate increase that was predicted in the last set of projections in June will be taken off the table. If so, we suspect that Powell will also state that the policy rate will stay at its elevated level for a longer time than the markets currently expect.

It will also be interesting to see how much of an increase in unemployment the Fed thinks will be needed to bring inflation down to its 2 percent target. In June, it projected the unemployment rate would increase to 4.1 percent by the end of this year and 4.5 percent in 2024. But the jobless rate has since declined from the May/June level even as inflation has receded. That may give the Fed comfort that the disinflationary trend can continue without a significant rise in the unemployment rate. But the Fed is clearly not comfortable with a resilient job market that is generating faster wage increases than inflation. That, in turn, sustains the pressure on companies to cover rising labor costs by increasing prices.

However, there is no sign that workers are demanding higher wages to stay ahead of expected price increases, a mind-set that stoked the wage-price spiral during the 1970s. While it is true that worker pay has outpaced inflation for three consecutive months, that follows two years in which wages have lagged price increases and workers are in the process of restoring some of that lost purchasing power. But that catch-up phase is poised to weaken as job growth is slowing. From our lens, the Fed's rate hikes are steadily winding through the economy and will be causing outright job losses towards the end of the year. That will short-circuit worker bargaining power and restore a balance between the demand and supply of labor. It would be fortunate if the inflation target could be reached without a rise in unemployment; but history suggests otherwise, and it is unlikely that this time will be different.

FINANCIAL INDICATORS

INTEREST RATES	Aug 11	Week Ago	Month Ago	Year Ago
3-month Treasury bill	5.43	5.41	5.41	2.56
6-month Treasury bill	5.49	5.46	5.48	2.95
2-year Treasury note	4.89	4.78	4.75	3.26
5-year Treasury note	4.30	4.14	4.05	2.99
10-year Treasury note	4.15	4.05	3.83	2.84
30-year Treasury bond	4.26	4.02	3.93	3.17
30-year fixed mortgage rate	6.96	6.90	6.96	5.22
15-year fixed mortgage rate	6.34	6.25	6.30	4.59

STOCK MARKET					
Dow Jones Industrial Index	35,281.40	35,065.62	34,509.03	33,761.05	
S&P 500	4,464.05	4,478.03	4,505.42	4,280.15	
NASDAQ	13,644.85	13,909.24	14,113.70	13,047.19	

COMMODITIES				
Gold (\$ per troy ounce)	1,945.70	1,978.20	1,959.30	1,818.90
Oil (\$ per barrel) - Crude Futures (WTI)	83.04	82.62	75.26	91.88

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/Quarter	Two-Months/Quarters Ago	Average-Past Six Months or Quarters
Consumer Price Index (July) - % change	0.2	0.2	0.1	0.2
Core CPI (July) - % change	0.2	0.2	0.4	0.3
Producer Price Index (July) - % change	0.3	0.0	-0.3	0.0

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