CIO Memo

August 10, 2023

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U.S. CPI: Moderating but still elevated

Key takeaways

- U.S. inflation showed a modest increase with the Headline July Consumer Price Index (CPI) coming in at +3.2% year-on-year (YoY), marking a slight increase from the previous reading of +3.0%. Core CPI, which excludes Food and Energy fell to +4.7% YoY.
- The YoY prints for Headline CPI were lower than market expectations of +3.3% and were in line for Core CPI at +4.7%.
- Markets appeared to respond positively to the data, reinforcing expectations that the Federal Reserve may not increase benchmark interest rates in September while also lowering expectations for further hikes later in the year.

1. What happened?

Assessing the monthly figures, shelter costs remained an important contributor, rising by +0.4%. Over the course of the last 12 months, shelter prices have contributed to over two-thirds of the total increase in Core CPI. Elsewhere motor vehicle insurance also increased over July. In terms of declining prices, airline fares fell by -8.1%, while used cars and trucks (-1.3%), new vehicles and household furnishings came down. Overall, medical care services registered their largest drop since March at -0.4%.

Prices for Food showed a marginal increase over the month, rising by 0.2% with 'Food-at-Home' prices increasing by +0.3% . Specific items such as meat, poultry, fish and eggs declined by -0.2% over the year with dairy increasing by +1.3% and nonalcoholic beverages and other food at home increasing by 5.4%. 'Food-away-from-Home', essentially dining out at restaurants, continued to increase in cost as the index rose 0.2% in July, with prices now reaching an annualized +7.1%.

Broader energy prices increased by +0.1% after increasing by +0.6% the previous month. Over the course of the last 12 months, such energy prices have fallen by double-digit figures, highlighting the broader weakness seen in commodity markets. On an annualized basis, the CPI Energy Index has fallen -12.5% with both Natural Gas and Fuel Oil also falling by -13.7% and -26.5% respectively.

Powell's favored inflation gauge from this report is on core services, i.e., shelter ticked up from 0.01% in June to 0.19% in July. However, the 3-month trend of 1.7% is well below both 6 month and 12-month patterns of 2.9% and 4% respectively.

2. How did markets react?

The slightly better-than-expected CPI release was well received by markets. The overall decrease in Core CPI, slightly below market expectations, has fueled optimism amongst investors that the Federal Reserve will soon be able to pause their interest rate hikes in the short-term.

At the time of writing, both the S&P 500 (+0.91%) and NASDAQ (+1.07%) were trading in positive territory. Within Fixed Income, Treasury yields declined across the curve with the more interest rate sensitive 2-Year Treasury falling 3-basis points to reach 4.77%.

3. What does it mean for investors?

Today's CPI release saw a slight uptick in Headline Inflation and Core inflation. On a monthly basis, several categories are starting to show signs of slowing down as the Federal Reserves aggressive monetary policy continues to cool demand. Even if inflation levels are currently above the 2% target set by the Fed, inflation numbers have dropped significantly compared to their 40-year highs in mid-2022.

These decelerating inflation numbers could be a positive for the members of the FOMC as they could hit the brakes on further increasing interest rates in the short-term. As per the Fed's dual mandate of delivering 'price stability' and 'maximum sustainable employment', the Fed would likely maintain the higher rates for a longer time. For inflation levels to keep coming down, the U.S. labor market must start to show further signs of weakness.

Last week's Nonfarm Payroll data saw labor markets slightly cool for the month of July following a trend of downward revisions in the two months prior. However, the overall wage growth picture remains robust for the disinflationary traction to get more entrenched into the wider economy. The market participants would like to see softening wage inflation and employee cost index, both of which are currently not exhibiting a sharper correction.

The latest CPI print will be seen as further affirmation that the broad-based index price pressures are moderating. Markets now await the Jackson Hole Summit which we do not think will be market moving this year.

Before the September 26 Fed meeting, we await a further batch of data (Nonfarm Payrolls and CPI) which could impact decisions made but we expect the Fed to stay put in the September meeting.

Glossary

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

Core CPI is the consumer price index excluding the volatile components of food and energy prices.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

Jackson Hole is the location (and common name) of an annual economic symposium of the Kansas City Fed.

The NASDAQ index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

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