CIO Memo

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U.S. CPI: moderating but still elevated

Key takeaways

- U.S. inflation continued to moderately decline with the headline April Consumer Price Index (CPI) coming in at +4.9% year-on-year (YoY), down from the previous reading of +5.0%. Core CPI, which excludes Food and Energy, declined as well by 0.1 percentage point to +5.5% YoY.
- The slowdown of the downward trend in the headline CPI figure was mainly caused by a strong increase in used car and truck prices as well as an increase in gasoline prices. With inventories returning to normal levels, goods manufacturers and retailers appear less inclined to offer discounts.
- Markets appeared to respond positively to the data that shows the inflation picture is still improving slowly.

1. What happened?

Today the latest consumer price inflation (CPI) release from the Bureau of Labor Statistics showed a YoY decline in the rate from +5.0% to +4.9% for April. The latest headline figure is now the lowest since May 2021, with the -0.1 ppt decline slightly better than the expectations of an unchanged annual reading. Core CPI, which excludes Food and Energy, showed a month-on-month (MoM) rise of +0.4%, the same pace as last month and in line with market expectations.

Assessing the monthly figures, shelter costs remained an important contributor, rising by +0.4%. Over the last 12 months, shelter costs have increased by +6.8%. After shelter costs, the next important drivers were the index for used cars and trucks (+4.4%) and the index for gasoline (+3.0%). The significant increase in used car and truck prices marks a trend reversal after nine straight months of declines. April gasoline prices reflect the surge after OPEC+ had announced production cuts.

Prices for Food overall were flat again month-on-month in April. Four of the six major grocery store food groups declined month on month: fruits and vegetables -0.5%; meats, poultry, fish and eggs -0.3%; dairy and related products -0.7%; milk index -2.0%, the largest decline since February 2015; non-alcoholic beverages declined 0.1%. Only the “other food at home” component rose 0.2% and cereals and bakery products increased 0.2% as well. The “food away from home” index rose 0.4%, full service meals increased 0.1% and the index for limited meals increased 0.6% month-on month.

Energy rose 0.6% in April after falling by -3.5% in March. As already mentioned, gasoline prices increased 3%, but the other energy components declined. Natural gas prices decreased 4.9% month-on-month, electricity moved 0.7% lower and fuel oil also declined 4.5% in April.

Overall, the inflation report confirms a slow decline in prices with some stickiness especially in the services sectors.

2. How did markets react?

The slightly better-than-expected CPI release was taken positively on financial markets. At the time of writing, all major indices, the Dow Jones (+0.08%), the S&P 500 (+0.34%) and the NASDAQ (+0.99%) were trading moderately higher. Within Fixed Income, Treasury yields moved 5 to 7 bps lower across the yield curve.

Finally, market expectations of a 25 basis point increase in the Fed Funds Rate in June were further priced out and the implied probability of such a step declined to only 8%.

3. What does it mean for investors?

Today’s CPI report confirmed that both components of inflation – headline and core – declined more slowly than expected. In combination with the surprisingly strong April nonfarm payroll data published last Friday, current data seem to be at odds with the Fed’s signalling at the May FOMC meeting that they are likely take a pause in the rate hike cycle. This data does not seem to support the view the interest rates have reached a sufficiently restrictive level.

On the other hand, problems at individual regional banks as well as tighter lending standards and weaker credit demand for commercial and industrial loans reflected in the recent bank lending survey confirm the view that recent rate hikes are feeding through to the real economy. Monetary policy measures and interest rate changes are usually transmitted with significant time lags and thus the disinflationary forces of the rate levels reached are likely to continue to feed through into the economy.

Another level of complexity has arisen from increased U.S. debt default uncertainties. Since Treasury Janet Yellen warned that a failure by Congress to act on the debt ceiling would provoke a constitutional crisis, market uncertainties have increased, which can be seen in increases in U.S. sovereign credit default swap spreads. The combination of these uncertainties provide good reason for the Fed to pause and observe closely how things evolve. With the announcement of a data-dependent approach the Fed had kept its window open for adequate action.

The combination of stubborn inflation, a strong labor market, but a slowdown in credit market activity and uncertainty about a timely raising of the debt ceiling provide reason for the Fed to take a cautious, data-dependent approach.

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.

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

The Organization of the Petroleum Exporting Countries (OPEC) is an international organization with the mandate to "coordinate and unify the petroleum policies" of its 12 members. The so-called "OPEC+" brings in Russia and other producers.

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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