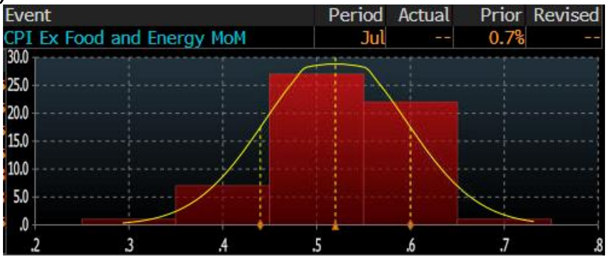
U.S. CPI Preview: August 2022

MNI View: Buckle Up

By Chris Harrison

The July CPI report is expected to see monthly core inflation moderate after surging in June with the market again sensitive to upside surprises after three successive (and large) beats of consensus.



- **Consensus has core CPI inflation moderating to 0.5% M/M in July after the 0.7% in June** was the strongest sequential print since Jun'21 at the height of auto sector disruption.
- 23 of 59 analysts see 0.6% M/M, with the average forecast of 0.52%.
- The median would push the year-ago rate up two tenths to 6.1% Y/Y, back closer to the March peak of 6.5% Y/Y and with some analysts looking for a further increase into August on base effects.
- **Headline CPI inflation should slow notably from +0.2% M/M after a storming +1.3% M/M on reversal in gasoline prices**, slowing the year-ago rate from 9.1% to 8.6% Y/Y.

Analyst Expectations Of Key Sequential Drivers

Core items:

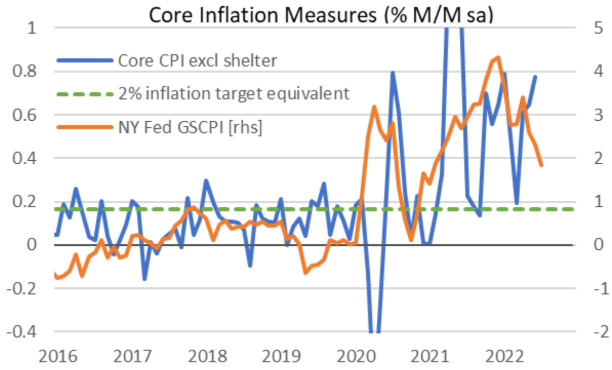
- Travel-related (-ve): Airfares are due a notable slowdown after only dipping -1.8% in June having surged 48% in the prior three months. GS expect a 7% decline in airfares whilst UBS see airfares dragging almost 0.1pp from core with the website Hopper showing a -20% decline in airfares since late-May. For perspective, the 13% increase in CPI airfares in May contributed roughly 0.1pp to core inflation.
- Autos (-ve): A range of views on auto prices but Scotia, at the high end of consensus, see used vehicle prices potentially knocking 0.1pps off headline M/M CPI whilst new vehicle prices are flat.
- Apparel (-ve): Some analysts again look for a decline in apparel prices as retailers mark down excess inventory, after it failed to materialise in June with a surprising acceleration from 0.67 to 0.79% M/M.
- Shelter (small -ve): Once again, tenants' rents and OER are seen struggling to match June when they surprisingly surged to post 1986 and 1990 highs, having been on a tear ever since OER broke out of a very tight 0.41-0.45% range. GS, JPM and MS see rents between 0.66-0.72% (from 0.78%) and OER between 0.64-0.67% (from 0.70%), with UBS - at the low end of consensus for core CPI - also at 0.64% for OER.

Non-core items:

- Energy (large -ve): Energy prices are seen falling from a sharp fall in gasoline pump prices, with JPM estimating a -3.7% M/M decline in energy after the +7.5% in June.
- Food (unch to small -ve): Mixed analyst expectations with food seen either repeating the +1.0% M/M from June (and average of the prior five months) or slightly softer.

Some Trends To Watch

- Whether shelter can once again beat expectations and accelerate further or even keep to the June rate, being a typically persistent component.
- Signs that easing supply side pressures – per the NY Fed's GSCPI (chart on right) – are feeding through to softer non-shelter core prices or inflation diffusion metrics after moving in different directions in recent months.
- What happens to medical care services, an unsung contributor to core CPI last month with a 7% weight only a little less than primary rents, having last month been the median category at +0.73% M/M and with an upward trend.

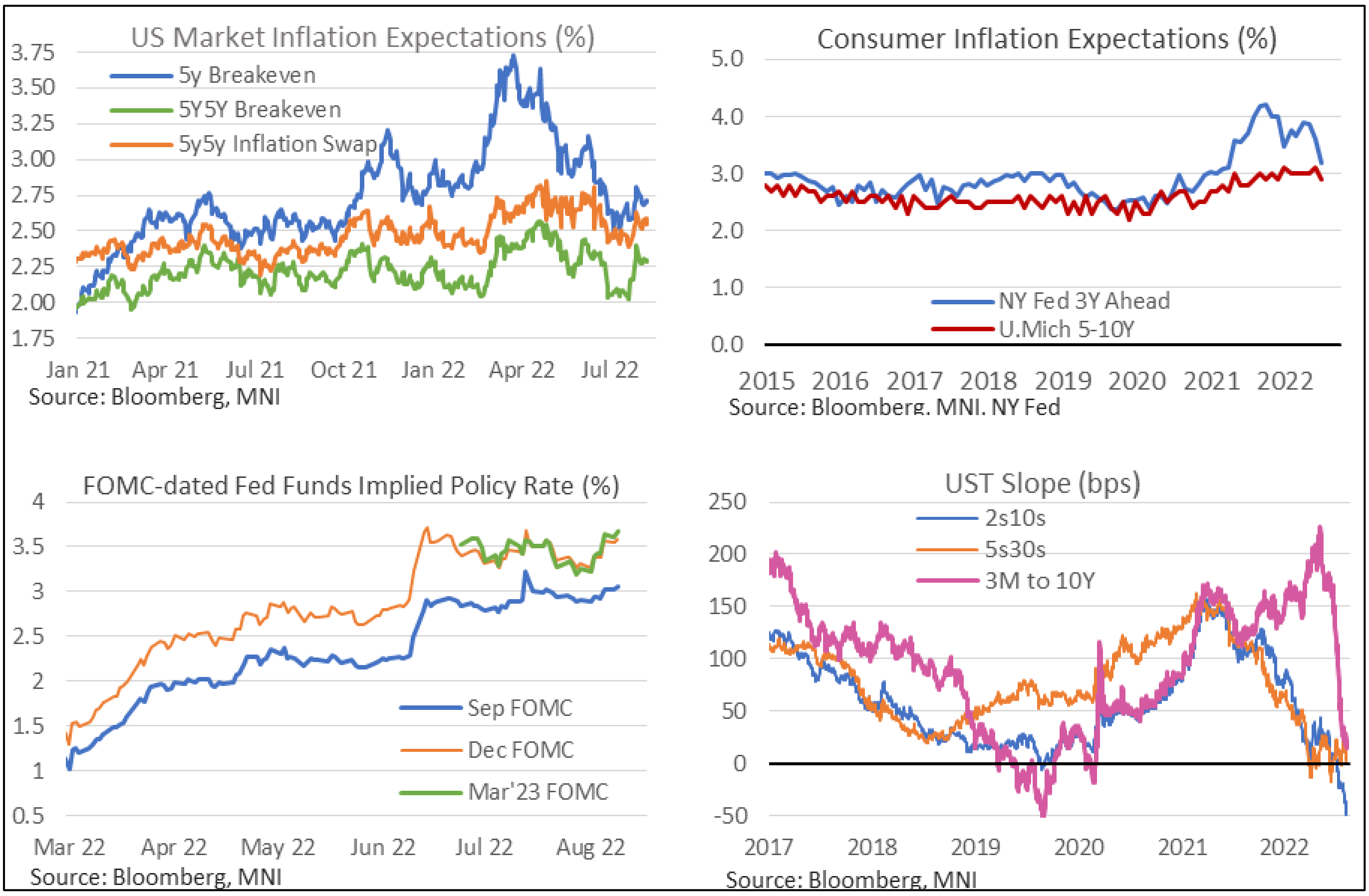


Source: BLS, NY Fed and MNI.

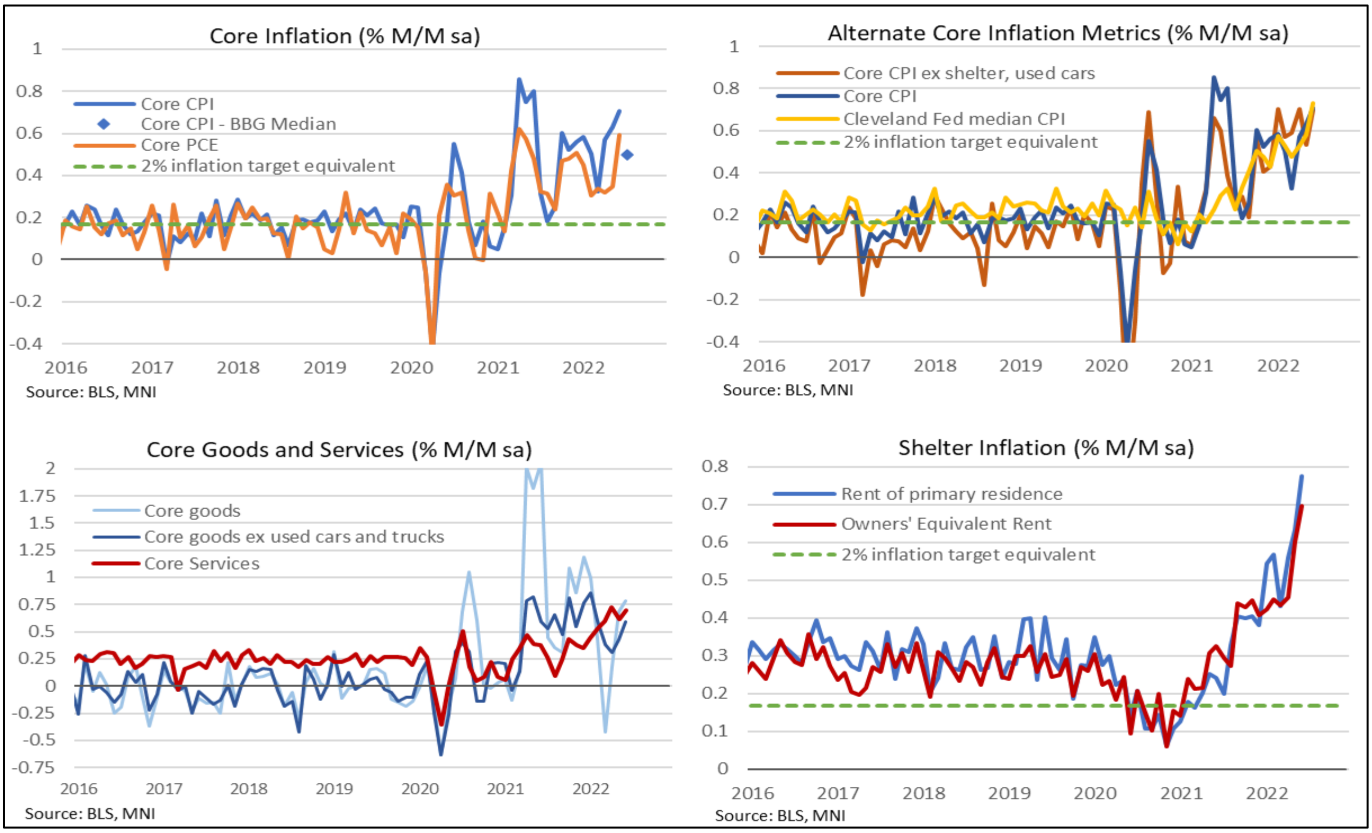
Potential Implications: Significant Two-Sided Risk

- There is still a long way to go until the Sept 21 FOMC decision but the size of reaction to Friday's payrolls beat showed just how much markets, especially FI, can move in the interim.
- 2Y Tsy yields saw an almost 50bp range last week and currently sit towards the top of that at 3.27%.
- That has come about with 70.5bp priced for the Sept FOMC, the closest to fully pricing in a third consecutive 75bp hike since fairly open guidance at the July FOMC. The curve remains heavily front-loaded, with a 124bp of hikes over the three meetings to year-end and 132bp to an implied peak of 3.67% at the Mar'23 meeting, before more than 50bps of cuts to end'23.
- This terminal rate has lurched higher from circa 3.45% prior to payrolls, leaving room to both the downside but also upside with hawkish FOMC member commentary of late including some views of rates needing to go back to the high 3s/low 4s whilst pushing back on rate cuts.
- Yields may be towards the top of recent ranges but with latest, rare guidance from Governor Bowman that she sees 75bp hikes as on the table until inflation slows, an upside surprise could see the sell-off run further and drive a further flattening in the yield curve despite 2s10s already close to breaching 2000 lows whilst currently at -47.5bps.
- Indeed, TD noted in their payrolls review that 2s10s could invert towards -80bps for levels not seen since the early 1980s.
- Alternatively, the trend declines in both market inflation expectations and recent declines in surveyed measures (see below) would give further legs to a dovish reaction in the event of a sizeable miss.

Inflation Expectations and Market Moves



Recent Inflation Developments



Full review of July report here: https://marketnews.com/markets/pdfs/mni-us-inflation-insight-eyeing-a-100bp-july-hike

July 2022 CPI Report: Analyst Previews

(In order of strongest to weakest for core inflation):

Scotia: Modestly Above Consensus But A Lot Can Happen Before Sept FOMC
Scotia are above consensus for CPI inflation but note the FOMC's nimble decisions tend to go down to the frail and rather brittle wire and there may well be plenty of other developments between now and the Sept FOMC.

- Core CPI seen a tenth stronger than consensus at 0.6% M/M but in line at 6.1% Y/Y, keeping to the three-month moving average of sequential inflation and indicate that inflationary pressure remain hot.
- Headline CPI meanwhile is seen rising 0.4% M/M, slowing from 9.1% to 8.9% Y/Y (cons 8.7% Y/Y).
- The Cleveland Fed's inflation 'nowcast' shows inflation running a tenth or two beneath 9% Y/Y and it has been slightly underestimating actual CPI inflation for several months. Further, while some PMIs have been indicating lessening price pressures, small businesses are not.
- Other drivers are somewhat mixed. Year-ago base effects will shift toward dragging the Y/Y headline and core rates down by about a 0.5pp or slightly less in both cases. July is typically a modest month for seasonality.
- Within core, house prices will probably keep OER on the hot side and there is also likely to be an ongoing reopening effect upon prices as pent-up services demand continues to get unleashed. Used vehicle prices could have knocked 0.1pps off headline M/M inflation while new vehicle prices seemed to be fairly flat.
- In volatile items, all-grades retail gasoline prices fell by over 7% m/m NSA and about half that in seasonally adjusted terms whilst the small weight of piped gas should mean minimal drag from Henry hub natural gas prices falling circa 5% M/M NSA. Food-at-home and food-away-from-home are assumed to combine for another gain of around 1% M/M but pressures may be abating.

Barclays: Core CPI To Ease At The Margin

- Core CPI seen easing at the margin to +0.6% M/M, pushing the year-ago rate up three tenths to 6.2% Y/Y.
- Headline CPI meanwhile is seen rising +0.3% M/M with a moderation led by a drop in energy prices, which sees the year-ago rate slow from 9.1% to 8.8% Y/Y, with the NSA index at 296.92.

CIBC: Further Increases In Core Y/Y Into August

CIBC expect annual headline inflation to have slowed in July on lower pump prices but core inflation to have accelerated further, magnified by base effects.

- Consumers saw some relief from lower prices at the pump in the US in July, which will help total annual inflation decelerate to 8.8% y/y, along with base effects.
- Although global food price indices have softened lately as wheat harvests in the northern hemisphere have begun, that will take some months to feed through to consumer prices.
- Another strong increase in core categories likely resulted in an acceleration in core inflation to 6.2% Y/Y, magnified by base effects. Indeed, higher rents are still feeding through to the CPI's shelter index.
- Total inflation is set to decelerate further ahead. However, with core still propped up by rents, Y/Y core could accelerate further in August before slowing with consumer resistance to higher prices.

ANZ: Core CPI To See Goods-Led Moderation

ANZ are in line with consensus for core CPI (+0.5% M/M) but slightly below for headline (+0.1% M/M).

- Energy prices declined sharply, with the average retail price of gas 13% lower in July relative to June, whilst global food prices also fell steeply.
- Core goods inflation should decelerate amid falling commodity prices, lower shipping rates, a stronger USD and easing supply bottlenecks.
- By contrast, core services inflation is expected to remain elevated amid robust rental and wage growth.
- Supply side bottlenecks are correcting sharply, contributing to an easing in cost pressures facing manufacturers. Some of this is related to reduced demand for goods as households reallocate more spending to services.

MS: Sequentially Softer Core But Shouldn't Stop The Hiking Cycle Before Year-End

Morgan Stanley see core CPI in line with consensus at 0.5% M/M but headline a tenth below at 0.1% M/M as a sharp decline in gasoline prices creates a strong drag but underlying pressures remain meaningfully elevated.

- Headline inflation should slow from 9.1% to 8.6% Y/Y and kick off a continuous decline through our forecast horizon but base effects will keep core CPI higher, from 5.9% to 6.1% Y/Y, and only peak in Sept.
- Persistent strength in core inflation, in particular in cyclically sensitive core services, will provide little room for the Fed to deviate from its steep tightening path through the end of the year.
- Both core goods and core services inflation should slow sequentially but the pace will remain elevated.
- OER seen at 0.64% M/M and rents 0.72% (vs. 0.70 and 0.78), with readings staying high on strong underlying drivers and sampling methodology persistence. Total shelter inflation, including hotel prices, should accelerate marginally as hotel rates ticked up. Y/Y shelter inflation won't peak before Jan'23.
- Other core services are likely to have slowed on the margin reflecting a somewhat softer consumer demand environment, with airfares the main detractor as high-frequency data point to a large decline after three months of double-digit gains from March through May and only a mild fall in June.
- We see core PCE at 4.8% in 4Q22 and 3.2% in 4Q23, making it difficult for policymakers to stop the tightening cycle before year-end, and to move to cuts before the end of next year, with a peak in Dec'22 at 3.625% and a first rate cut only in Dec'23.

TD: Core CPI Stays Strong With Shelter Maintaining Momentum

- Core prices likely stayed strong in July at 0.5% M/M, pushing the annual rate up 0.2pps to 6.1% Y/Y.
- Shelter inflation likely maintained strong momentum, though we look for airfares to retreat for a second straight month.
- Headline CPI to see notable relief from gasoline prices declining a sharp 8% MM. In line with consensus, TD see headline CPI inflation cooling from 9.1% to 8.7% Y/Y.

GS: Consensus Call As Airfares Pull Back But Rents Still Soar

Goldman are broadly in line with consensus for core CPI with +0.48% M/M in July (cons. 0.5%) after +0.7% to boost the year-on-year rate by two tenths to 6.09% Y/Y.

- This reflects a 7% pullback in airfares on the back of lower oil prices as well as a 0.8% drop in apparel prices from markdowns on excess inventory.
- On the flip side, they expect continued increases in auto prices (new +1.0%, used +0.5%, parts +0.8%) due to the Ukraine-Russia war whilst also seeing continued upward pressure on personal care, recreation and household operations from labor shortages and elevated short-term inflation expectations.
- Importantly, they expect another set of very strong shelter readings (rent +0.70% and OER 0.67%), reflecting additional catch-up in the official measures relative to our shelter tracker but an OER drag from imputed utilities, along with another gain in car insurance.
- Headline CPI is eyed at +0.24% M/M (cons 0.2%) from lower gasoline prices despite higher grocery and restaurant prices, corresponding to a 0.3pp decline to 8.83% Y/Y.
- Going forward, GS see monthly core CPI inflation in the 0.4-0.5% range for the next couple months before edging down to 0.3-0.4% by Dec’22. They see Y/Y core CPI inflation of 6.1% in Dec’22, 2.7% in Dec’23, and 2.8% in Dec’24. This reflects a negative swing in health insurance prices and a larger slowdown in goods than in services inflation next year.

JPM: Core CPI To Moderate From A Variety Of Drivers
JPMorgan see core CPI at 0.47% M/M in what’s viewed as a solid gain but at least some moderation.

- Part of this comes from shelter components, with rents seen +0.66% (from 0.70) and OER +0.67% (0.78).
- They see lodging away from home nudging -0.1% after -2.8% in June whilst public transportation prices declining -2% after -0.4%.
- Vehicle price gains are expected to be softer after strong increases across May and June, with new vehicle prices edging up 0.1% and used vehicle prices -0.2%, whilst also looking for a modest pullback in apparel prices (-0.1%) after jumping in May and June.
- Elsewhere, medical care inflation has been solid lately and we forecast 0.4% for July but communication prices have been trending lower recently and we forecast -0.2%.
- Headline CPI seen rising 0.2%, with year-ago rate easing from 9.1% to 8.7%, coming as gasoline prices pull total energy down 3.6% M/M. Food inflation is expected to ease but only to 0.8% M/M.

UBS: Core CPI To Slow On Airfares, Other Transportation Services and Used Cars
UBS are below consensus with a core CPI forecast of 0.43% M/M in July, below the 0.71% in June and 0.56% averaged since October but still 5.25% annualized.

- Roughly one third of the slowing on the month coming from sharply falling airfares (Hopper suggests -20% since late-May), another third a return to the recent strong trend for other transportation service prices following a down and up swing in May and June, whilst used cars account for most of the remainder.
- Risks tilted slightly to the downside from a possible greater-than-expected slowing in non-vehicle core goods prices amid falling import prices and elevated inventories at some retailers.
- OER seen with a minor slowing to 0.64% M/M and core goods slowing from June’s pace.: Rising wages could force greater increases in this relatively persistent segment of core services ex shelter, medical, and transportation, but the trend has not been clear in recent months.
- Headline CPI is to only see a very moderate monthly increase of 0.14% M/M and with the annual rate slowing from 9.1% to around 8.75% Y/Y, with the sharp slowing driven by fuel prices with regular gasoline pump prices down 83 cents per gallon since their Jun 13 peak. Food prices are however expected to show another above 1% increase.
- The monthly pace is expected to slow notably over the remainder of the year as fundamentals weaken and futures prices suggesting a notable decline in retail gasoline prices. Nonetheless, Y/Y core CPI inflation should rise further in August, and perhaps in Sep, due to base effects (though remain slightly below the 6½% peak from March of this year).

MNI Policy Team Insights on next page

MNI INTERVIEW: Fed Funds May Need To Reach 7% Or More-Levin

By Pedro Nicolaci da Costa (Published Aug 8)

(MNI) Washington - High and persistent inflation will force Federal Reserve policymakers to raise interest rates much more than they are currently projecting, perhaps nearly twice as much, ex-Fed board economist Andrew Levin told MNI.

Fed Chair Jerome Powell said in his July press conference that the June Summary of Economic Projections, which shows the federal funds rate peaking at 3.8%, was still the best guide available for where official interest rates are headed.

But that view is too sanguine because it is unclear that inflation has peaked and, even if it has, any decline will likely be choppy and slow, said Levin, a former Fed board economist for two decades until 2012, including two years as a special adviser on monetary policy strategy and communications.

"The more likely scenario is that core inflation continues running in the neighborhood of 5, 6, 7%, and really to bring inflation down the Fed is going to have to raise the federal funds rate up to 5, 6, 7% or more," he said in an interview. "The longer this goes on the harder it's going to get because the more entrenched the expectations are in the wage- and price-setting behavior." (See MNI: CPI Shortens Odds Of 75-BP Hike In Sept-Ex Fed Staffers: https://marketnews.com/mni-fed-has-room-to-tilt-hawkish-after-75bp-ex-staff)

One of the problems, Levin said, is that the Fed sees itself as already having raised rates to an effectively neutral level, even though rates are deeply negative when adjusted for inflation.

"If inflation is running at 7 to 8% then they want cost of living increases of 7 to 8%, and then it's very hard for firms to raise their prices by much less than 7 to 8% and you just get the same cycle that we had in the 60s and 70s," he said. "What that means is the markets are probably totally wrong and that probably by this fall it will be clear the Fed still has a long way to go (https://marketnews.com/mni-interview-firms-price-expectations-may-be-unanchoring)".

Levin said the Fed is not being straight with markets, which raises its own set of dangers.

"There's a chance here that the markets are going to totally lose confidence in the Fed and that will make things go even more haywire," he said.

--LABOR MARKET PAIN

Making matters worse, despite real rates still at negative levels, Levin said that it's not accurate to say the labor market is too tight despite stronger-than-expected monthly job growth such as that registered in July. He said the Fed seems to have forgotten about its new framework language focused on "broad and inclusive" employment, adding that workers are set to pay much of the price of the hikes to come.

"We're not really at maximum employment, it's not accurate to say the labor market is overheated," Levin said, noting that wage increases are not keeping up with inflation.

"It's true that the unemployment rate is low on average, but just like in the past it hasn't fully reached some groups within the economy and there are still people out of the workforce where if things continue to improve hopefully labor force participation would continue to recover," he said. "If the labor market were overheated we'd see wages growing faster than inflation, that's definitely not what we're seeing."

By claiming the job market is too hot, the Fed is effectively asking workers to make sacrifices, Levin added.

"They should hold down on their wage increases and that's how we're going to manage to reduce inflation, by having workers hold back on their cost-of-living increase," he said.

"We're probably in for a tough period ahead. We might have to have shortfalls from maximum employment for a while in order to get inflation down. I'm not arguing against that," he said. "But like a good doctor, they have to be honest with the patient's family."

MNI INTERVIEW: Tantrum Risk Rises As Fed Resets- Ex-Researcher

By Greg Quinn (Published Aug 4)

(MNI) - The Federal Reserve will face a greater risk of sparking market volatility as it continues to tighten policy to fight inflation even as the economy slows, former Fed visiting scholar and MIT professor Ricardo Caballero told MNI.

That danger runs against recent clarity from policymakers playing catch-up against big price gains according to Caballero, who has done research at the Fed's main board and the Boston branch of the central bank.

"Tantrum risk will rise substantially once the tradeoff between activity and inflation becomes more balanced," Caballero said. "Stay tuned."

The MIT economics professor is studying mismatches between Fed and market outlooks, arguing (https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3612949) that ideally the FOMC incorporates some investor views and gradualism into its actions to blunt any miscalculations.

"They were doing a great job early on, both during the worst of the Covid shock and the early stages of the recovery," he said by email. "The Fed was constantly communicating its plans to the market. The problem was of a different nature: they just fell behind the curve, so they could no longer afford that gradualism."

--STOCK MARKET DISAPPOINTMENT

Debate has shifted to a potential recession as the FOMC upped rate hikes to 75 basis points at the last two meetings. Officials say (https://marketnews.com/mni-evans-2657793466) they could tighten another 75 at the next meeting, one of the steepest tightening campaigns in decades.

But slowing inflation from around 9% now may lift record low unemployment and bring questions about meeting the Fed's maximum employment goal. The job market could also be weaker than officials expect based on what could be misleading vacancies data, ex-Bank of England MPC member David Blanchflower has told MNI (see MNI INTERVIEW:US Jobless Rate Masks Slack – Blanchflower https://marketnews.com/mni-interview-us-jobless-rate-masks-slack-blanchflower-paper-2657783097).

"We are going through a very complex scenario, where there is much more scope for disagreements than we are used to," Caballero said. "One lesson from our papers is that by becoming very data-dependent, the Fed implicitly tells the market that if they make a mistake, it won't last for very long. This stabilizes the impact of potential mistakes."

Bond investors are still pricing in tame longer-term views of inflation, with 10-year Treasuries yielding 2.79% Wednesday morning. Economists at ING argued Tuesday the Fed will find it hard to keep hiking its fed funds target rate, now at 2.25%-2.5%, and "there is no modern example" of continually taking it higher than the 10-year bond yield.

Stock investors may also be in for an unpleasant surprise, Caballero suggested. "The equity market seems to be taking the news from the bond market as good news, without pausing to think about what the Fed may have to do to the economy," he said. "Unless we get lucky with commodity prices and supply chain bottlenecks, which may well happen, inflation may be a lot harder to tame than the equity market is assuming."