mni

All Signal, No Noise

MARKET ANALYSIS

U.S. Inflation Insight: March 2023

MNI View: CPI Warrants Hike, Financial Stress Could Prevent It

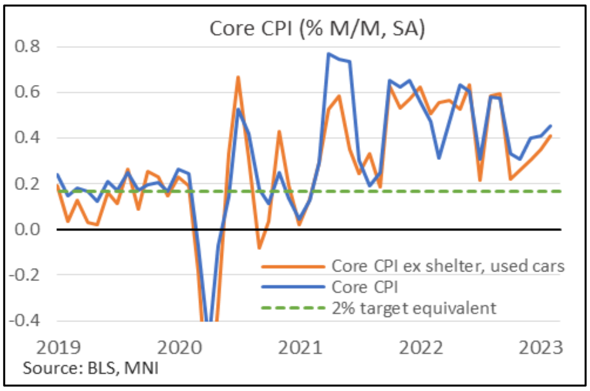
By Chris Harrison and Tim Cooper

- Core CPI inflation was slightly stronger than expected in February at 0.45% M/M (cons 0.4), the highest since September with no sign of slowing down.
- Core non-housing services accelerated more notably to also the fastest pace since September, but was boosted by a strong bounce in airfares (which wasn't replicated in subsequent PPI data, the PCE input).
- Markets after the release priced circa 80% probability of a 25bp hike from the Fed at next week's FOMC meeting, and indeed a majority of analysts see it as a baseline barring a further intensification of financial market stresses.
- However, with the situation still highly fluid, that has since dropped to circa 50% chance of a 25bp hike (with 50% of a pause) as European bank shares tumble.

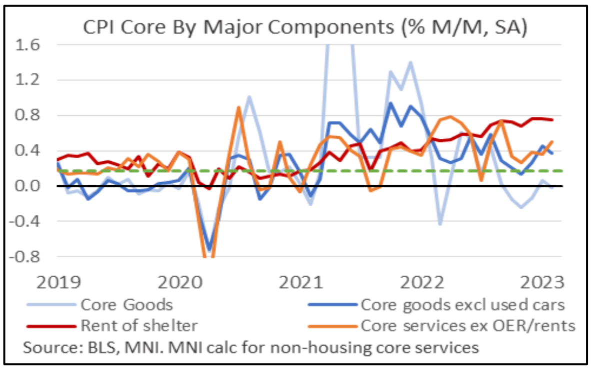
Core CPI Inflation Sees Modest Beat With Offsetting Drivers

- Core CPI was slightly stronger than expected in February, rising 0.45% M/M (cons 0.4%) after 0.40% and 0.41% prints.
- In doing so it hit its fastest monthly pace since Sep'22 and is clearly trending in the wrong direction for the Fed.
- Rounding helped exaggerate progress in Y/Y terms, easing from 5.58% to 5.54% Y/Y.

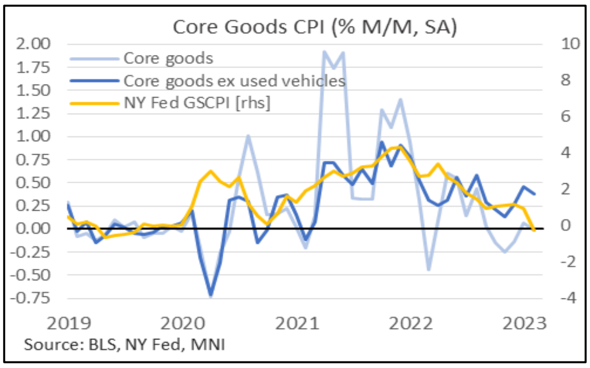
	Jan *actual*	February *actual*
Core	0.41%	0.45% (cons 0.4)
Headline	0.52%	0.37% (cons 0.4)
Core Y/Y	5.58%	5.54% (cons 5.5)
Headline Y/Y	6.41%	6.04% (cons 6.0)



Looking by major sector, core goods fell back into the lightest of deflation (from 0.07% to -0.01%) whilst core services accelerated to the highest since September (from 0.55 to 0.62% M/M). Relative to expectations, core goods was biased down by further weakness in used cars whilst non-housing core services was biased higher by a notable bounce in airfares, although with the used cars weighting declining of late, airfares provided the greater relative boost.



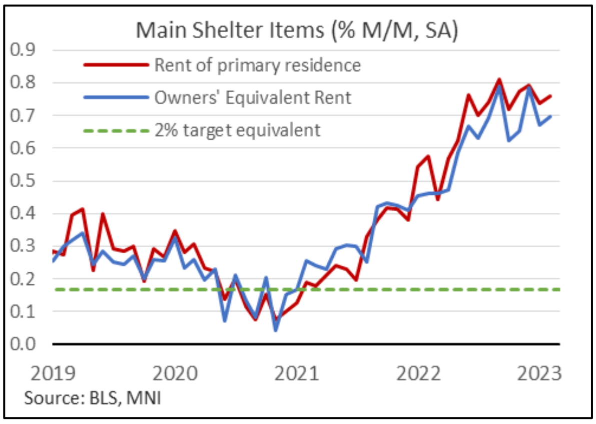
Core goods inflation was weighed down by used cars providing one of the main downside surprises of the report relative to broad analyst expectations of at least a pause after three months near -2%, instead falling -2.8% despite a solid pick-up in auction prices. However, with a declining weight, this only dragged -0.03pps from overall core CPI relative to last month's contribution. Core goods ex-used cars also eased but only from 0.46% to 0.38% M/M, still bucking a prior downtrend and importantly showing little sign of the immediate feedthrough from the sharp improvement in global supply chains in February (as indicated by the NY Fed's Global Supply Chain Pressures Index). This was however subsequently followed by weaker than expected core PPI inflation data, suggesting potentially renewed goods disinflation in the pipeline.



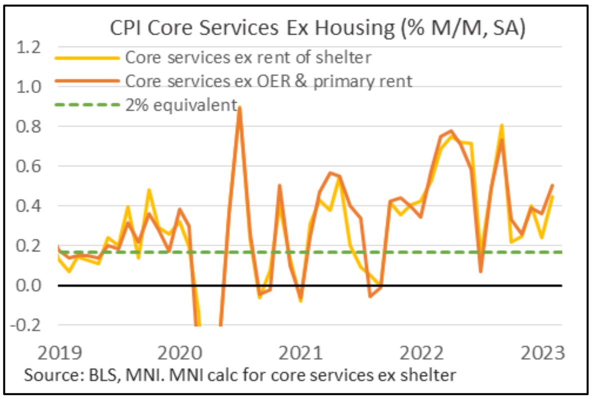
The key shelter items of OER and primary rents were surprisingly resilient as they accelerated slightly in the face of expectations for a further modest moderation.

- OER at 0.70%, up from January's 0.67% M/M vs analyst average 0.63% (range 0.59-0.67).
- Tenants' rents at 0.76% M/M, up from 0.74% M/M vs analyst average 0.67% (range 0.62-0.70).

Both remain a little off cycle highs but for now show little sign of recent softness in new rent leases having an impact, which could still be a few months away.

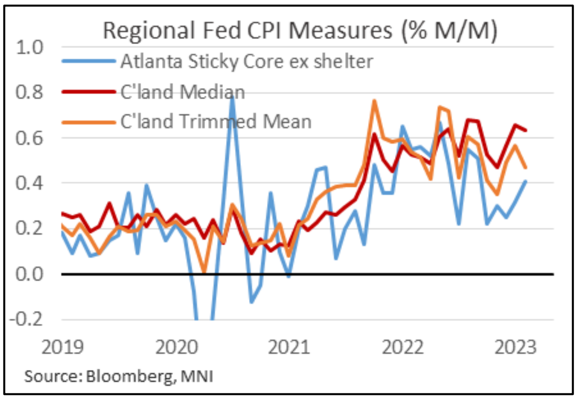


With its increased focus in recent months, the non-housing core service inflation increase from 0.36% to 0.50% M/M (ex OER & primary rents) was also eye-catching, clearly moving the wrong way for the Fed with its highest also since Sept. However, a bounce in airfares played a large role here, adding 0.06pps to core CPI relative to last month's contribution by coming in right at the top end of expectations as it increased 6.4% after -2.2% (something that notably wasn't subsequently replicated in the PPI data). It was however perhaps less idiosyncratic than it first appeared, with lodging away from home also accelerating from 1.2% to 2.3% M/M in a sign of travel-related strength. Further detracting from the strength of non-housing core services and likely more of note for the Fed was softer medical care service details, considering healthcare is more heavily weighted in core PCE than core CPI. The overall category held at -0.70% after -0.68% M/M, but within that, more relevant professional & hospital services both slowed on the month. Professional service prices in particular fell further with -0.32% M/M after -0.09% M/M for the fastest monthly drop since Apr'17.

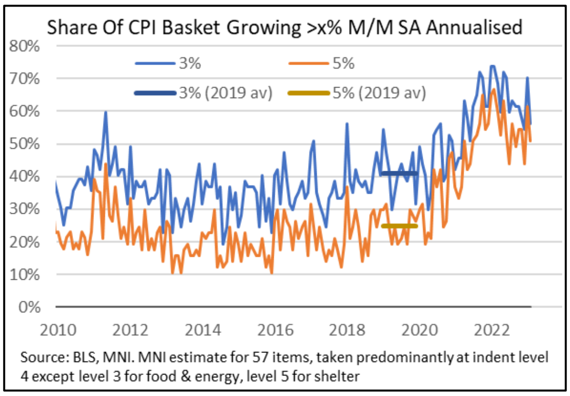


Minimal Recent Progress In Disinflationary Progress

The Cleveland Fed median CPI was almost unchanged at 0.63% M/M in Feb, still close to August's high of 0.68% M/M which in turn pushed a new cycle high of 7.20% Y/Y. The 16% trimmed mean measure did however unwind January's pop higher, falling from 0.57% to 0.47% M/M for very close to the 0.45% of actual core CPI. Separately, the Atlanta Fed sticky core CPI ex shelter series accelerated from 0.32 to 0.41% M/M for its fastest since Sept. There is a caveat that intuitively we would expect airfares (which bounced) to be excluded here although historical methodology included total public transportation. In Y/Y terms, sticky core CPI ex shelter continued to moderate despite the M/M acceleration, easing from 5.26 to 5.11% Y/Y although that's only the lowest since May.

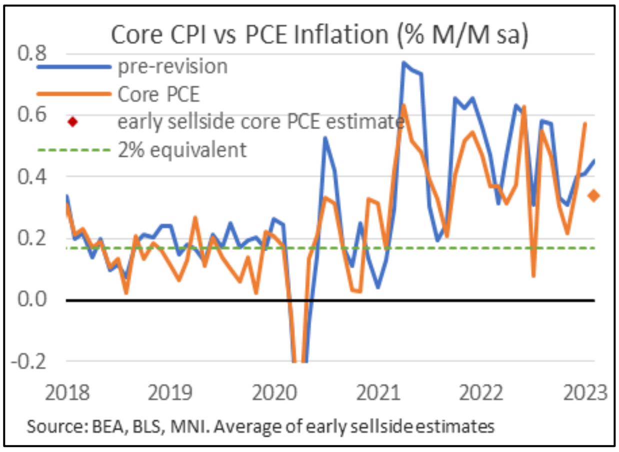


MNI's dispersion measures broadly corroborated the underlying strength implied by those measures. We estimate that the January spike in the breadth of inflationary pressure within the overall CPI basket was unwound yet nevertheless there remains little recent disinflationary progress. By our calculations, 56% of the basket increased by more than 3% annualized, down from 70% in Jan but close to the 58% in Q4. Importantly, those shares are little different for those in excess of 5% annualized, with 51% in Feb vs 61% in Jan and 53% averaged in Q4. The share seeing outright deflation has also narrowed, at 23% in Feb from 25% in Jan and 29% in Q4.



CPI Composition Leaves Core PCE On Track For Pullback

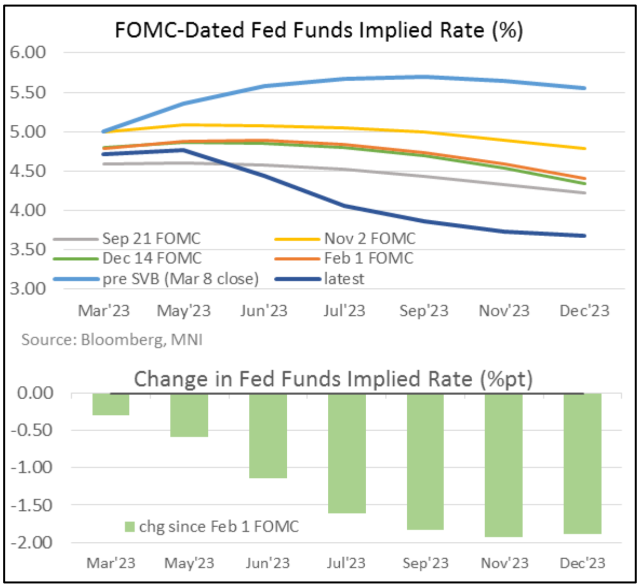
Despite the push higher in core CPI, analyst pre-PPI estimates put core PCE inflation easing (JPM 0.31%, MS 0.36% and UBS 0.39%, plus NWM rounded 0.4% M/M from 0.3% before CPI) after a surprisingly strong 0.57% M/M in January. Some pertinent factors at play:



i) PCE's reading for Airfares, a source of strength in CPI, are taken from PPI, where instead of jumping +6.4% in Feb fell -2.6%.
ii) Even excluding health insurance, medical care services were a source of weakness in CPI. PCE healthcare includes expenditure made on behalf of consumers instead of just out-of-pocket expenses in CPI and accordingly has a heavier weight in PCE, potentially a larger drag if the CPI weakness is broadly representative.
iii) In contrast, food services, not in core CPI but included in core PCE, held at a strong 0.63% M/M after 0.62%, bucking the trend of food at home hitting its softest pace since Apr'21.

Market Reaction

Pretending for a moment that we weren't in the midst of a US banking crisis, the February inflation report would have cemented at least another 25bp March Fed hike with probably at least a 50/50 chance of a half-point raise as hinted by Powell last week.



Going into next week's FOMC meeting, there is certainly no evidence of monetary tightening producing a decisive reversal in inflation pressures yet. There was some category-by-category volatility contributing to the slightly-above-expected core print (both overall and the narrower non-housing core services metric eyed by the Fed), which blunts a decisively hawkish takeaway.

But now that we're through the key pre FOMC data, and given that there is an ongoing banking crisis, a 25bp hike seemed like the central outcome for next week after yesterday's CPI print, something that a majority of analysts agreed with in the section further below. Since then, spillover into European banks, and Credit Suisse in particular, has pushed markets to pricing only a 50% chance of a 25bp hike next week, tapping out for the tightening cycle at a similar level before circa 110bps of cuts to year-end (at typing in volatile markets).

It's possible the FOMC decides to pause with a pledge to resume hiking if appropriate, though judging from the last press conference, that doesn't seem to be Powell's favored approach. And with inflation still way above-target, combined with the strong Feb jobs report, there will still be many FOMC participants eyeing the risks of under-tightening being greater than those of overtightening at this juncture - even with the banking shock tightening financial conditions.

If pricing returns to the 80% probability of a 25bp hike seen post-CPI over the next few days, the FOMC will likely take what the market is now "giving them" in a cautionary 25bp raise with a pledge of a true meeting-by-meeting approach going forward as they assess the lagged impact of existing tightening. Banking sector developments between now and then will likely dictate the outcome.

Contents

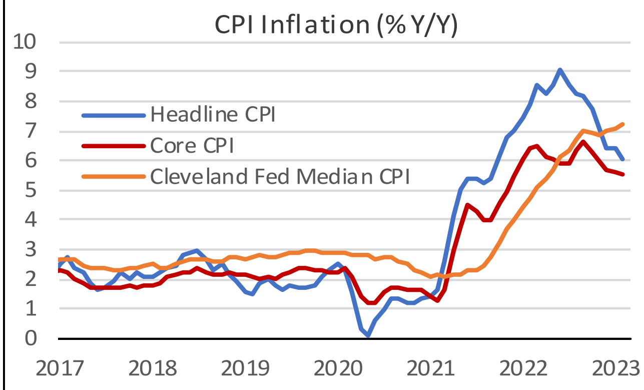
Feb 2023 CPI Report: Analyst Reviews

Written post-CPI yesterday, most of the 18 analysts below expect a 25bp hike next week from the FOMC barring a further intensification of financial market stresses. After slipping further this morning, Fed pricing currently hovers around 15bp for next week with just shy of a 25bp hike fully priced for a peak in May.

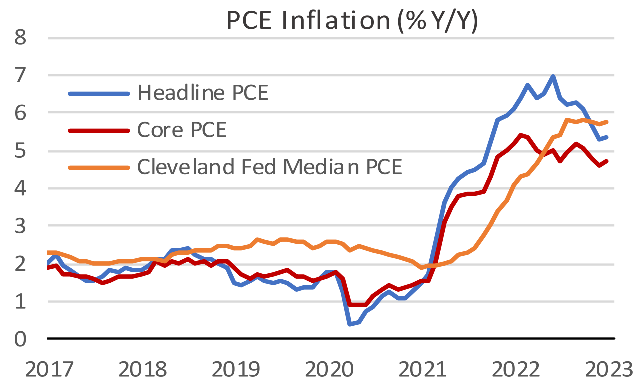
Select excerpts from each analyst included further below.

Analyst	Summary
ABN Amro	Base Case That Fed Hikes 25bp Next Assuming Market Conditions Continue To Ease
BMO	Fed Likely Needs To Hike By 25bps Next Week
BofA	Financial Markets Have Increased Uncertainty About Near-Term Outlook But Expecting 25bp Hike
CIBC	Core Service Inflation Keeps 25bp Hike In Play Next Week, With Another 25bp In May
Commerz	Large Fed Hike Probably Off The Table And Even Small One Has Become Uncertain
Deutsche	Maintaining Expectation Of 25bp Hike In March As Volatility Offsets Data Strength
GS	Non-Housing Core Services Strong By Partly On Airfares Jump
ING	Fed Probably Inclined To Hike 25bp But Contingent Of Calm Being Restored To Financial System
JPM	Continue To Look For 25bp Hike At Upcoming FOMC
MS	Data Firmly Support 25bp Hike Next Week, Risk Of More Tightening Than Last Hike In May
NatWest	Keep To Latest View Of Fed Pause Next Week Due To Mounting Financial Stability Concerns
Pantheon	Not Good Enough To Stop The Fed Hiking Next Week, Provided Markets Are Calm
RBC	25bp Hike Coming Short Of More Stress Coming From Banking System
Scotia	Remains A Strong Case To Hike 25bps, Not Buying Pause Let Alone Cut
TD	25bp Rate Hike Next Week Most Likely Option
UBS	Progress On Slowing Monthly Core CPI Has Stalled
Unicredit	Banking System Stress Sees Stick To Call Of 25bp Hike Next Week
Wells Fargo	25bp Hike Still A Distinct Possibility If Financial Stresses Ease

Inflation Overview



Source: Bloomberg, MNI



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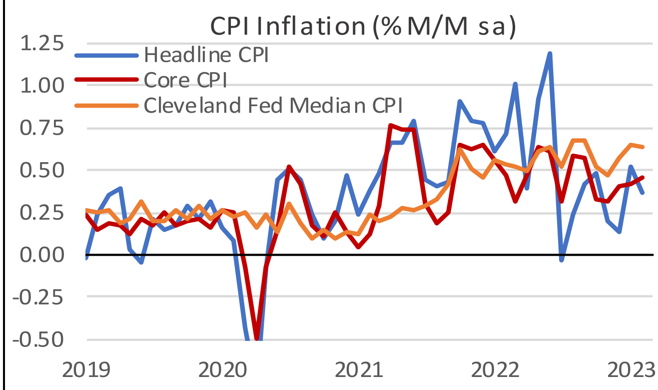

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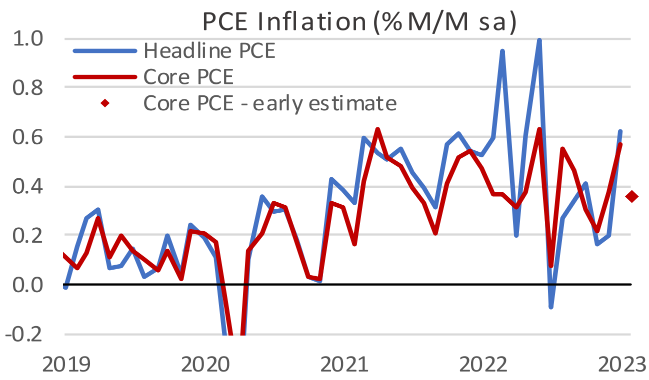
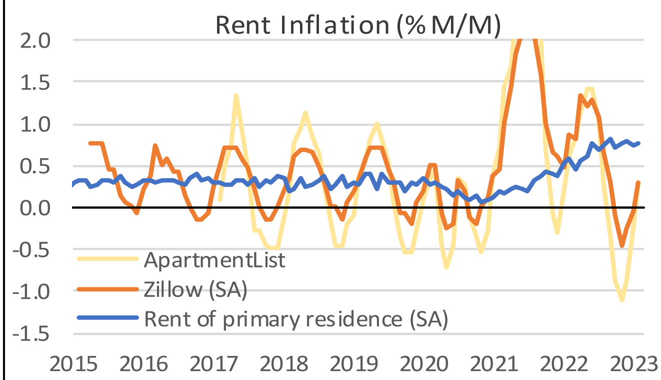
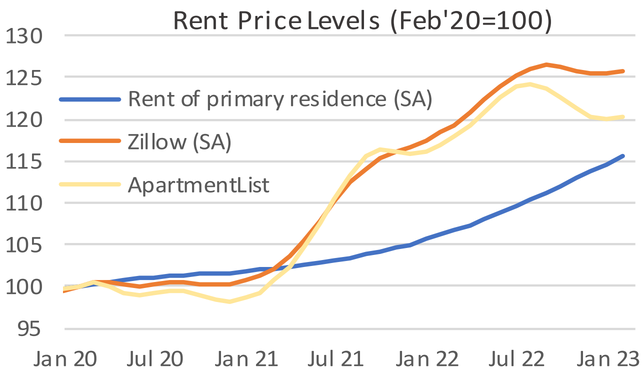


Source: Bloomberg, MNI and average of sellside post-CPI estimates

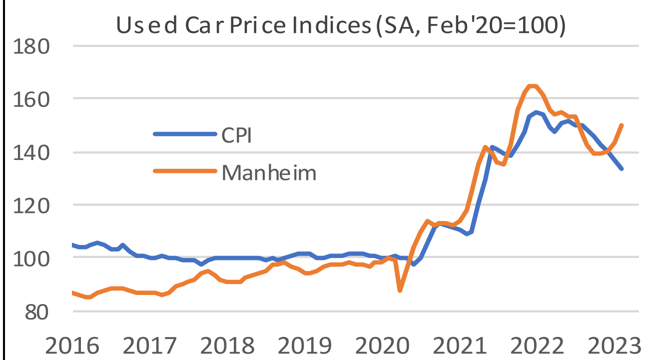
Moves In Select Categories



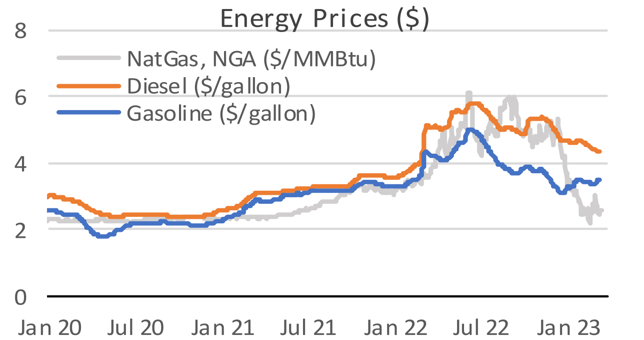
Source: ApartmentList, BLS, MNI, Zillow



Source: ApartmentList, BLS, MNI, Zillow

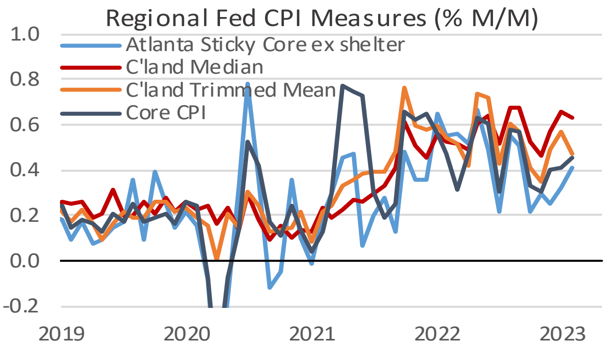


Source: Bloomberg, MNI

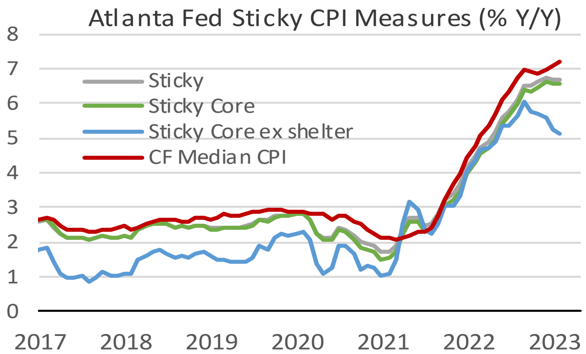


Source: Bloomberg, MNI

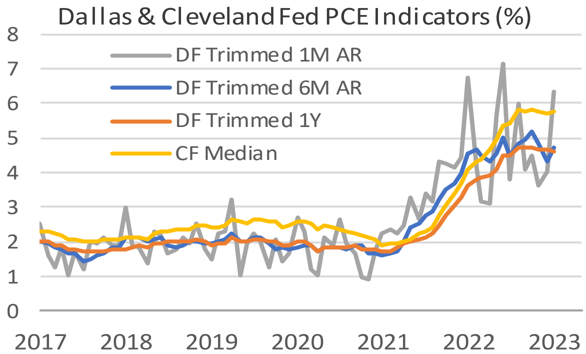
Regional Fed Inflation Indices



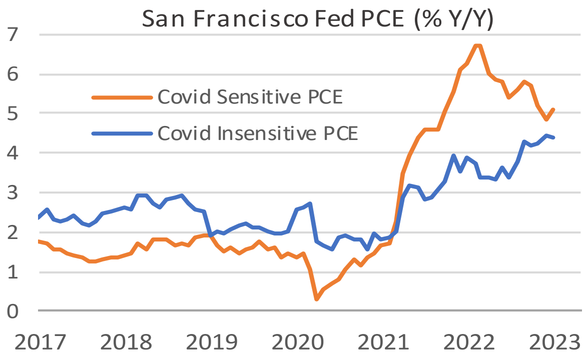
Source: Bloomberg, MNI



Source: Bloomberg, MNI



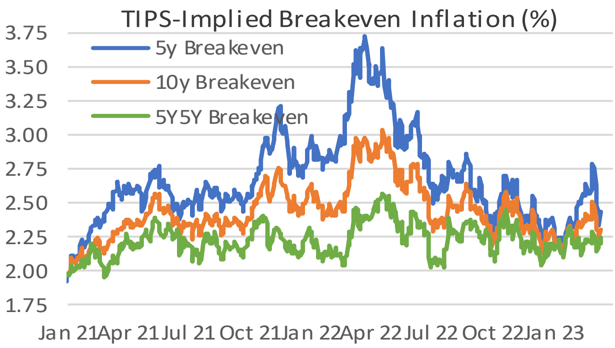
Source: Bloomberg, MNI



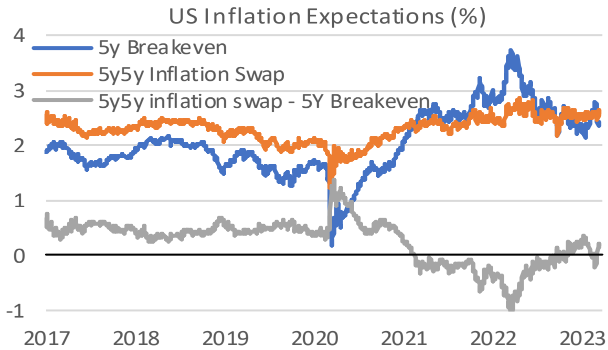
Source: Bloomberg, MNI

(The PCE measures will typically lag CPI by one month in this publication)

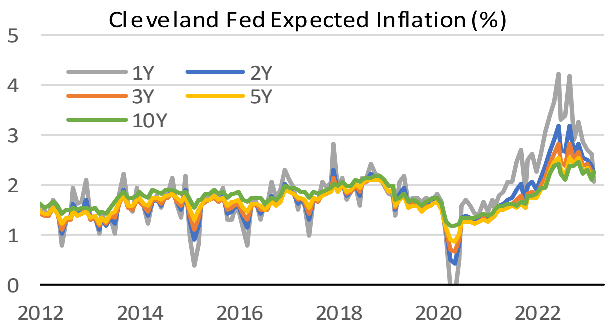
Inflation Expectations



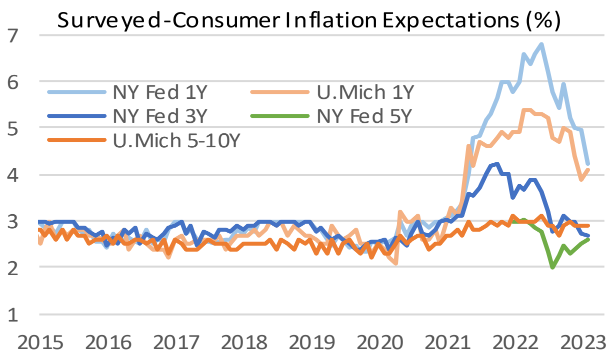
Source: Bloomberg, MNI



Source: Bloomberg, MNI



Model using Tsy yields, inflation data, inflation swaps & survey-based measures of expectations. Source: Cleveland Fed, MNI



Source: Bloomberg, MNI

Select excerpts of analyst summaries of the February CPI report:

ABN AMRO: Base Case That Fed Hikes 25bp Next Assuming Market Conditions Continue To Ease
- The strength in core inflation was driven by shelter and core services, with recreation and car insurance making the biggest contributions to the latter. In contrast, core goods disinflation continued, while medical services continued to make a negative contribution due to a methodological quirk that is likely to continue weighing on inflation over the coming months.
- We expect M/M core CPI readings to remain stubbornly firm for at least 2-3 months. The core goods disinflation of the past few months is expected to go into reverse, given rebounding wholesale used car prices. Core services inflation is also expected to remain firm given persistent strength in unit labour costs.
- Our base case is that the Fed indeed hikes by 25bp next week, taking the target range for the fed funds rate to 4.75-5.00%. This assumes that market conditions continue to ease over the coming days following aggressive moves by the authorities to stem the fallout from the SVB failure.

BMO: Fed Likely Needs To Hike By 25bps Next Week
- An acceleration in core consumer prices is not what the Fed wants to see while it's handling a financial crisis, and will likely need to raise rates by 25 bps next week.
- In fact, futures markets are now pricing in material odds of such. But the Fed is also caught between the rock of stubborn inflation and a hard place of financial instability, which likely rules out a 50bp hike. That was the odds-on favourite after Powell's testimony last week...but that was so last week.
- Core services excluding energy and the two rent measures, which loosely tracks Powell's 'supercore" PCE metric, also rose 0.5% (i.e., this is not just a rent story), picking up from two monthly 0.4% advances. The 3-month annualized rate vaulted to 5.2% from 4.1%, while the yearly rate eased only a tenth to 6.1%, or still three times the rate consistent with price stability.

BofA: Financial Markets Have Increased Uncertainty About Near-Term Outlook But Expecting 25bp Hike
- In our view, the report continues to illustrate the sticky inflation problem the Fed is currently facing.
- Given the Fed's focus on core services ex housing services, it will not be encouraged by core services ex rent and OER advancing by 0.5% M/M in February.
- Financial markets have increased uncertainty about the near-term policy outlook; however, today's report supports our view for a 25bp hike in March.

CIBC: Core Service Inflation Keeps 25bp Hike In Play Next Week, With Another 25bp In May
- Absent fresh news on banking issues from here to their decision date, the Fed is likely to press on with a 25bp hike this month, and a final 25bp move at the subsequent meeting.
- Price pressures were just too heated, as core inflation accelerated to 0.5% m/m, a tick above consensus. Increased housing inflation was a key driver, but other services including recreation, household operations, and airfares added to the momentum. The Fed's preferred gauge of underlying price pressures tied to the output gap, core services excluding housing, accelerated to 0.45% M/M, leaving the 3-month annualized pace at 4.5%.
- The banking issues will mostly have served to take a more aggressive path off the table. With the impact of past rate hikes still materializing, and slower shelter price increases imminent, core inflation could still fall below 3% in the latter part of the year.

Citi: Watching PPI Details For PCE Implications
- Most importantly, various non-shelter services prices remained strong and even picked up. We were surprised by some weakness in physicians services prices, but this could be a delayed reflection of Medicare sequestration cuts that began at the start of the year, and it will still be the prices in PPI data (which differ from those in CPI) that will matter for PCE inflation.
- Airfares rebounded substantially in February after diverging from PPI airfares (although it is PPI that will be input into PCE).
- Consistent strength of other non-shelter services such as recreation and personal services should continue as long as the labor market remains very tight. At 55% of core PCE, these prices will remain the key focus of the Fed, with little signs yet of easing.

Commerzbank: Large Fed Hike Probably Off The Table And Even Small One Has Become Uncertain
- US inflation further in February from 6.4% to 6.0%, but the underlying price pressure is hardly easing.

- The CPI inflation figures and the strong labor market data published on Friday would have actually sealed a rate hike, possibly a large one, at the FOMC meeting next week. Now, in the short term, the Fed has to make a trade-off between the need to raise rates to meet its inflation target and the risks this may pose to fragile banks. It is not yet possible to judge with any certainty how this assessment will turn out. However, a large rate hike is probably off the table, and even a small one has become uncertain.

DB: Maintaining Expectation Of 25bp Hike In March As Volatility Offsets Data Strength

- The February CPI data came in a bit stronger than our expectations, with headline and core rising by 0.4% and 0.5% respectively. In general, the composition of the print also came in largely as expected, with strength in most goods combined with still elevated rental prints, declining medical services prices, and gains in other core services.
- Diverging trajectories for health care inflation between the CPI and PCE measures argue for greater focus on core services excluding rent, OER, and medical care in the former. This showed some acceleration in price gains from January (+0.9% vs. +0.7%).
- Absent the recent turmoil in the banking sector, this data would likely have pushed the Fed to re-accelerate their pace of rate hikes at the March meeting.
- However, given recent volatility, real-time risk management and the experience last year around the beginning of the Russia-Ukraine war argue for a more moderate increment or even pausing being more likely. As such, we have for now maintained our expectation for a 25bp hike at the March meeting.

GS: Non-Housing Core Services Strong By Partly On Airfares Jump

- February core CPI rose 0.45% M/M, somewhat above consensus and its recent trend. The Y/Y rate nonetheless fell one tenth to 5.5%.
- Core services prices excluding rent and OER rose a strong 0.50% M/M, though some of the strength reflected a jump in airfares.

ING: Fed Probably Inclined To Hike 25bp But Contingent On Calm Being Restored To Financial System

- US core inflation came in hotter and has nudged expectations for a rate hike higher. While the Fed is probably inclined to hike 25bp, this is contingent of calm being restored to the financial system. Financial stability risks always trump near-term inflation worries.
- Irrespective of this, the fallout from recent events will inevitably lead to a tightening of lending conditions which will weigh on growth and inflation.
- Despite the strength in today's core inflation measure, we expect inflation to slow rapidly through 2H23 as the decline in house prices, which is leading to a flat lining in new rent agreements eventually feeds through into the CPI.
- Longer term our view on the high chance of rate cuts before year-end has only been reinforced by recent developments.

JPM: Continue To Look For 25bp Hike At Upcoming FOMC

- Overall, the recent inflation strength should keep pressure on the Fed to tighten policy as the FOMC heads into next week's policy meeting, and we continue to look for a 25bp hike at the upcoming March meeting.
- The persistent strength in core services inflation away from rent (which generally has come along with surprising continued tightness in the labor market) has been one of the main surprises in the inflation data over the past few months. We do think that the underlying inflation trend will moderate over time, in part because of cooling in core services prices away from rent, but this slowing likely will require additional softening in the labor market.
- Preliminary core PCE estimate of 0.31% M/M for 4.6% Y/Y.

MS: Data Firmly Support 25bp Hike Next Week, Risk Of More Elongated Hiking Cycle Than Last Hike In May

- A generally strong reading across the services points to resilient inflation pressures for the Fed.
- Shelter inflation still has to show signs of turning decisively and core services ex-housing accelerated. However, the large increase in airfares in the CPI will not feed through to PCE, pointing to less upside pressure in the Fed's preferred inflation gauge.
- We see the data firmly supporting another 25bp rate increase in March, and risks of a more elongated tightening cycle beyond our current forecast of a last hike in May.
- Incorporating inputs from CPI, core PCE inflation seen at 0.36% M/M vs 0.57% prior, headline at 0.32% M/M vs 0.62% prior. We will finalize our forecast tomorrow with the release of PPI for February.

NWM: Keep To Latest View Of Fed Pause Next Week Due To Mounting Financial Stability Concerns

- The Feb CPI report had few surprises. While the latest inflation data are not "good" news for the Fed, the results don't alter our latest expectations for a pause at next week's FOMC meeting due to mounting financial stability concerns.
- Within the details of the core measure, core services firmed on the month (up 0.6% versus 0.5% in January), as shelter costs and travel-related prices (namely, airfares and hotels) surged in February.
- Over the course of the next few months, rent growth should begin to show at least some preliminary signs of moderation, as continued weakness in new rent leases finally begins to feed through in the CPI sample.
- Medical care services prices fell another 0.7% in Feb. The BLS's bi-monthly pricing methodology (some geographical regions are captured in odd months and some in even months) likely captured the annual resetting of Medicare Part B reimbursements in some regions in Feb. However, weakness in medical care services prices in the CPI will not feed through to the core PCE deflator.
- We will finalize our core PCE deflator estimates after the February PPI report (headline PPI: +0.5% and core PPI: +0.3%), but at this point expect a 0.4% M/M gain (vs initial estimate of 0.3%)

Pantheon: Not Good Enough To Stop The Fed Hiking Next Week, Provided Markets Are Calm

- Had airline fares not jumped by 6.4%, reflecting the temporary surge in fuel prices in January - it has now fully reversed - the core print would have been 0.4%
- The Y/Y rate for core services inflation is declining painfully slowly, dipping only a tenth in Feb to 6.2%. The peak was 6.5% in September. This is not sufficient progress to placate Fed hawks, even if - as we believe - the downshift in wage growth will depress core CPI services inflation over the course of the next year.
- Assuming markets stay calm and no more banks fail, we think the Fed will hike by 25bp next week, and will raise their terminal rate forecast by 25-to-50bp. To be clear, we think further hikes now are unnecessary; the lagged effect of the increases over the past year are enough to push inflation back to target, but Fed officials have been unwilling so far to accept this argument and until last week they appeared set on further hikes. Recent events make a strong case for a pause until May, but at this point that would be a pleasant surprise rather than our base case.

RBC: 25bp Hike Coming Short Of More Stress Coming From Banking System

- Details behind the CPI prints were firmer. Based on our diffusion measure, the breadth of inflation pressure in the U.S. widened in early 2023 after improving through much of last year. Powell's preferred inflation gauge – core services ex-rent also grew at a faster 0.5% monthly pace, matching the increase in core CPI.
- Moving forward, the fact that most of the near-term strength in monthly CPI still reflects past increases in market rents suggests core readings should continue to come down. BLS estimated that the CPI rent measure lags market observed rents by roughly 4 quarters – yearly growth in those market rent measures has already peaked in February 2022.
- Interesting trends looking at services prices for "needs" vs "wants". This month, airline fares, hotels, and admissions to sporting events, were all up by more than 1ppt m/m. Meanwhile, "needs" such as daycare, moving & storage expenses, and motor vehicle maintenance & repair all ticked down.
- Our sense is Powell is axed to go in March. So short of more stress coming from the banking system between now and next week's FOMC meeting, a 25bp increase is coming.

Scotia: Remains A Strong Case To Hike 25bps, Not Buying Pause Let Alone Cut

- Most of a 25bp Fed hike is back to being priced for next Wednesday's decision in the wake of an upside surprise to core CPI and further evidence of stabilizing markets.
- I'm still not buying the case for the Fed to pause next week—let alone cut. That seemed to be an overly hasty and impulsive view in the markets. There remains a strong case to hike 25bps, my expectation.
- If the FOMC is uncomfortable with most of a hike being priced then watch for a media plant in blackout like they did last summer, but that would be more likely closer to the meeting if at all. Powell does not like to surprise markets on game day with the here-and-now decisions.
- On the future guidance, the FOMC may not go as high with revised terminal rate projections in next week's dot plot as they would have otherwise, but it would be a misstep in my opinion for them to signal panic and abandon the fight against inflation at the first whiff of trouble. Trouble that is being contained.

TD: 25bp Rate Hike Most Likely Option

- Importantly, the firmer core CPI reading reflected another robust M/M increase in the services segment, which saw sticky shelter prices as the main culprit. We also expect goods inflation to turn positive again in the near term, adding to upside risks for core price dynamics.
- Having ring-fenced the Fed funds rate setting policy from financial stability concerns through the BTFP, the Fed will most likely refrain from pushing up the pace of hiking in this new environment of heightened volatility.
- This makes a 25bp rate hike at the March meeting the most likely option, in our view, given strong Jan/Feb readings on core CPI and payrolls, as well as the Jan core PCE. Beyond March, we are currently projecting a 5.75% terminal rate, but the Fed funds rate outlook has become highly uncertain in this new environment.
- Given the lagged impact from private-rents data and the CPI series (due to the BLS methodology), we believe we are going through the final passthrough of peak strength to the CPI series, though we acknowledge this process has taken longer than initially anticipated. We now expect shelter inflation to reach a peak on a y/y basis in Q2 but, in the meantime, it will continue to bounce around month-on-month within an elevated price range.

UBS: Progress On Slowing Monthly Core CPI Has Stalled

- Progress on slowing monthly core CPI increases has stalled in the recent months.
- Using data from today's CPI we project headline PCE prices rose 0.35% M/M in Feb and core 0.39% M/M, leaving the headline at 5.1% Y/Y with core unchanged at 4.7% Y/Y. Tomorrow's PPI and Thursday's import price releases could alter these estimates notably.

Unicredit: Banking System Stress Sees Stick To Call Of 25bp Hike Next Week

- The January CPI report was not the blip that many had hoped for, with consumer inflation rising strongly in February too. Core inflation represents the greatest source of concern, continuing to head in the wrong direction, recording the second straight month of acceleration.
- Today's strong CPI report, combined with the mixed February employment report, might well have tipped the balance in favor of a 50bp hike. However, the stress in the banking system has clearly changed the balance of risks in favor of a more prudent approach. We stick to our view that the Fed will hike rates by 25bp next week. This is in line with market expectations.

Wells Fargo: 25bp Hike Still A Distinct Possibility If Financial Stresses Ease

- Consumer price inflation did not show many signs of cooling in the February CPI. Beyond some pockets of improvement, core CPI inflation remained entrenched at uncomfortably high levels.
- In isolation, the labor market and inflation data clearly argue for another 25bp hike at the March 22 FOMC meeting, but significant developments in financial markets and the banking system cloud the outlook.
- Policymakers have taken meaningful steps to address the financial system challenges, such as the Fed's new bank lending facility and making all depositors whole at the aforementioned two banks. If the medicine proves effective, we suspect the Fed will continue to gradually tighten monetary policy in the months ahead. But, with more than a week to go until the next FOMC meeting, a 25bp hike is still a distinct possibility if financial stresses ease.

(Policy Team Insights follow below)

MNI Policy Team Insights

MNI INTERVIEW: Fed Likely To Hike 25BPs Next Week- Ex Official

By Jean Yung (published Mar 14)

(MNI) WASHINGTON - The Federal Reserve will likely approve a quarter-point interest rate increase next week as focus shifts from strong economic data to restoring confidence in the banking system, former senior Bank for International Settlements official and ex-New York Fed research director Stephen Cecchetti told MNI.

The possibility of a half-point hike -- even as strong job and inflation data warrant such a move -- appears out of the question. Pressing ahead with a rate increase after the collapse of Silicon Valley Bank and Signature Bank is a needed signal of Fed confidence in a financial system where the vast majority of firms are in good shape, he said. (See: MNI INTERVIEW: Ex-FDIC's Bair Sees Limited SVB Contagion Risk)

"I would try to get that message out as broadly, clearly and quickly as possible, and then I would raise interest rates. Does that mean you're probably going to go 25 now instead of 50 and then postpone further increases? Probably yes," Cecchetti said.

Pausing would be a "very bad signal," said Cecchetti, now a finance professor at Brandeis International Business School. "It would be read that you're really worried about the financial stability consequences of further interest rate increases and you're willing to compromise your inflation objective."

INFLATION REMAINS 'SUBSTANTIAL'

The U.S. banking system has buffers in place to absorb losses from bonds that have decreased in value as interest rates have risen, Cecchetti said. Yearly stress tests show banks will show "very modest losses, if any" as interest rates rise, he said.

"That doesn't mean people aren't worried. So the problem right now is you have to regain credibility for the authorities more than anything else," he said.

A pause in the Fed's hiking campaign isn't likely to do that, especially in light of stronger than expected jobs and CPI reports, he said. Inflation persistence is "really substantial," with shelter price indexes rising 8% over the year and dining out prices up 8.4%.

"What I would do is still raise interest rates and have a discussion of 25 versus 50. I would telegraph the terminal rate is still going to be closer to 6% than 5%," he said. "These data would unequivocally favor 50. It's hard to justify slowing down based on the idea there are financial stability concerns because 99.9% of the system looks fine."

MNI INTERVIEW: Ex-FDIC's Bair Sees Limited SVB Contagion Risk

By Pedro Nicolaci da Costa (published Mar 12)

(MNI) WASHINGTON - The collapse of Silicon Valley Bank is unlikely to create major waves of contagion or significantly disrupt the financial system as long as regulators manage the situation adequately, former FDIC Chair Sheila Bair told MNI on Sunday.

"It's a USD200 billion bank in a USD23 trillion banking industry, so if handled with care, I don't see it creating contagion," she said in an interview.

"It would be good and I'm sure the FDIC is focused on this, declaring what the uninsured dividend will be tomorrow. It looks like the bank had some very high quality assets, so the recoveries for the uninsured could be substantial."

She said SVB's downfall was the product of a classic run on the bank as the firm faced USD42 billion in withdrawals in 24 hours.

"As far as I can tell, Silicon Valley Bank wasn't insolvent. This was a bank run," said Bair, who headed the FDIC during the financial crisis of 2008.

She does not expect the FDIC to raise its cap on insured deposits above the $250,000 threshold to prevent similar runs on other institutions.

"I don't see there's a need to do that right now. If tomorrow the FDIC can announce a significant dividend to the uninsured to give the cash they need to make payroll. It should be at least 50%," she said.

WHITE KNIGHT

Bair said the best outcome, and one which the FDIC is likely still seeking, would be for regulators to find a buyer of last resort for the beleaguered bank.

"I really hope they're looking for a buyer and I really hope they find one. That would be optimal if they could announce tomorrow they have a buyer and the buyer is protecting the uninsured, I think that would calm things down really fast," she said.

"In situations like these there are no good options, only the least bad option. The advantage of getting a buyer to come in is you don't need to protect the uninsured deposits and you also could guarantee seamless provision of services."

Bair said she hopes these developments will prompt the Fed to think twice about pressing on with its aggressive interest rate hiking campaign, which has seen rates rise nearly 500 basis points in just a year.

"In December I said they should hit pause. They just need to wait, let this blow through. Accommodative policies create financial instability and then when you have to start tightening you can have a problem if not carefully managed," Bair said.