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Weekly Commentary

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Macro View

By Hubert Marleau

The Inflation Inflection is Real:

The biggest takeaway of the week was the May CPI report, which showed clearly that overall inflation has cooled and that the details pointed toward softer readings going forward. The headline consumer price index climbed 0.1% to reach an annual rate of 4%, coming below expectations. This reflects the slowest pace of growth since March 2022, and it is 5.1% less than the 9.1% y/y peak of last June. The 3-month annualized rate slowed to 2.43%, with the 6-month and 9-month annualized rates of 3.25% and 3.66% respectively.

Meanwhile, the so-called core consumer prices, which exclude volatile food and energy categories, climbed 0.4% in May, registering a year-over-year increase of 5.3%, down from 5.5% in April and the 6.6% peak of last fall. Progress on this front appears slow because an earlier surge in housing-rental prices is still showing up in those inflation figures. There was a whopping 4.4% monthly increase in used vehicle prices, which is unsustainable. In contrast, May new vehicle prices fell by 0.3% for the second straight month.

Excluding these two items, super core CPI, a closely watched metric by the Fed, was up only 0.09% in May, trending at an annualized rate of 2.3% over the past 3 months. Moreover, other price gauges declined in May. Producer prices, a prelude to future consumer prices, fell 0.3% from April, recording a y/y increase of only 1.1%, the lowest since December of 2020. Import prices decreased 0.6%, declining 9 times over the past 12 months.

In the wake of the May CPI and PPI data, the simple read-through is that the inflation inflection, which we wrote about for months on end, is real. There is a decent chance that June will bring the first 0.2% m/m in core CPI print since August 2021, and year-over-year CPI increase that could be as low as 3.1%. Why?

First, soaring shelter costs are the main reason for the sideways behavior of the core price increase, which has been rising at an annual rate of 5.0% over the past 3 months and has remained sticky at that level throughout the year. Shelter costs, representing 43% of the core CPI, increased by 0.6% in May and were 8.0% higher than a year ago. Excluding shelter costs, consumer prices would have only risen by 2.1%, with core prices up 3.4%. However, this trend won't last.

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Private sector data clearly indicates a significant decline in rent increases. The Zillow rent measure showed a 4.8% increase from the previous year in May, down sharply from the 17% surge observed in February 2022. Justin Lahart of the WSJ wrote about an experimental measure constructed by Commerce and Labor Department staffers, aimed at addressing the

lagging aspect of shelter price data. This measure suggests that in the quarters ahead shelter inflation will fall toward zero.

Second, supermarket food prices increased only 0.1% in May, following decreases of 0.3% in March and 0.2% in April. Agricultural commodity prices and freight costs, both of which affect food costs, offer glimmers of hope that the trajectory will remain encouraging.

Third, oil prices have weakened over the past 2 months, sliding to $69 per barrel, which is $10 less than they were last April. This reflects weak demand for energy from China. Ed Morse, Citigroup's global head of commodity research, does not think that China is going to ramp up its demand anytime soon to bolster global crude demand and push prices any higher than they are now. He claims that there is plenty of supply out there, and demand elasticity with GDP growth has fallen significantly, given the structural change in how much oil is needed to fuel the world economy. BCE Research claims that oil demand growth expectations imply global economic growth of 3.5%, which may be too optimistic. Indeed, global growth is more likely to be around 1.75%. In this respect, BCE foresees further downside for oil prices. Moreover, there are a lot of oil producing hubs around the world. While Opec is expected to support the market for oil, the appetite to cut production appears low and market interventions are usually reactions.

Given that pipeline pressures are abating, and lower energy and food prices have brought huge relief for consumers, the demand for compensation by wage earners should lessen. Consequently, a slew of surveys and market metrics show that a meaningful reduction in inflation expectations has occurred. First, the NY Fed's Underlying Inflation Gauge (UIG), which captures sustained movements in inflation from information contained in a broad set of price, real activity, and financial data, currently has an estimate of 3.0% from May, a 0.4% point decrease from April and 2.5% lower than peak. Second, the swap market is predicting that inflation will run at the annual rate of 1.8% in a year from now. MacroStrategy Partnership pointed out in a note to subscribers: "The Atlanta Fed's GDPNow estimate of the PCE deflator fell to a seasonally adjusted annualized rate of 0.892, down from 6-, 12- and 24-month average of 3.068%, 2.685% and 3.67% respectively. Whilst it has dipped to these lows before, this time it is not far from trend."

Thus, the policy makers made the right to skip a rate increase after 10 successive hikes. This decision is likely to be maintained as a full stop, despite signals from both the monetary authorities and the market suggesting that there could be more hikes. According to the CBOE FedWatch Tool, market traders are assigning a 60% chance of a hike in July. However, whether or not that happens will totally depend on the incoming inflation data.

Macro View cont.

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The bottom line is that the Fed wants to gather more information to determine the appropriate policy rate. While it is likely that there will be no rate cut in 2023, it is suspected that the Fed is

intentionally portraying a hawkish stance. Indeed, intriguing to see all members voted in favor of a pause, and yet nearly everyone of them foresees two more rate hikes.

MacroStrategy Partnership has introduced an innovative concept called "Duration Weighted Inversion," which involves multiplying the duration of the yield curve (2-year minus 10-year) by the average inversion level observed over the same period. In this case, the duration is 248 days, with an average inversion of 55.8 basis points. The calculation yields a significant value of 13,590.

To provide context, let's compare this figure to previous periods of Fed tightness. In 1988/89, 65 in 1988, 6295 in 2000, 1894 in 2006.07 and 12 in 2019. The only time when the number was greater than 13,590 was in the early 1980s.

Based on these historical comparisons, it can be inferred that the current level of Fed tightness is sufficient to control inflation without adversely affecting the economy. The bond market appears to be messaging a combination of cooler inflation and moderate growth. Moreover, recent shifts in the yield curve suggest long term bond yields are rising at a faster pace than very short-term yields, signaling that the economy remains stable as inflation subsidies.

Considering these factors, it is speculated that the policy rate may stabilize at 5.13% for the next few months. I think it's a safe bet. As a matter of fact, the financial markets have started to count the cost of incessant tightening. Should the swap market prove to be correct that inflation could be as low as 1.85% in a year from now, keeping the policy rate at 5.13%into 2024 would raise the real cost of money to 3.28%. Acknowledging that the potential for real growth of the U.S. GDP is around 2.25%, the economy would not be able to handle a policy rate of 5.13%. The Fed would be forced into a hurried policy rate reversal or be willing to tolerate a recession.

Since the S&P 500 crossed the Rubicon to enter bullish territory at 4200, the benchmark has relentlessly increased another 5.0% to close at 4410 on Friday last. Its performance will likely stall over the summer. The market needs a breather and will insist on confirmation that inflation will continue to fall. However, its upward trajectory should resume this Fall, given that the S&P 500 EPS is expected to increase to $250 in 2024 from $225 this year.

Huber Marleau's 'Macro View'

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