HIGHTOWER

FARR MARKET COMMENTARY

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Looking a Gift Horse in the Mouth

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The US Bureau of Labor Statistics released their monthly Consumer Price Index report Wednesday morning, and boy did the markets like what they saw. Inflation was 0.0% for the month. Huzzah! Inflation is defeated! Even the sky isn't a limit!

Well, not so fast.

Certainly the CPI report is a positive development after two quarters of economic contraction. The fight against inflation led by the Federal Reserve and their tightening of monetary policy has made headway. Fuel prices in particular have fallen, and with that a great deal of pressure on the American consumer has been relieved. Looking deeper into the data, the picture is more nuanced than the headlines might suggest. The Fed's inflation fight is far from over, consumer are still under pressure, and any declaration of victory is premature.

We have heard from the Federal Reserve and Chair Jerome Powell repeatedly about the Fed looking at core inflation numbers for guidance to the longer run path of inflation. The core number, which excludes the energy and food categories, is at 0.3%, well above the 0.0% headline number. Just as the core number has lagged behind the monthly headline number over the past year as the impacts of soaring gas prices slowly work their way through the economy, the core number now remains higher as gas prices fall precipitously. Annualizing the core inflation number of 0.3% per month increase, gives us a rate 3.7%, and while that is below the 5.9% prices have increased in the last twelve months, it is still well above the Fed's inflation target of 2%.

Food, where inflation remains stubbornly high, and energy are highly volatile, even on a month-to-month basis. The Fed focuses on the ex-food and energy number not because food and energy don't matter (and certainly not because they "don't care") but because changing monetary policy, which may take months to impact the real economy, based solely on a headline number is illogical. The sudden drop in energy prices doesn't mean inflation is over any more than the surge in energy prices earlier in the year signaled sustained double digit, seventies-style, stagflation.

Selected CPI Categories, July 2022

Category	Percentage of CPI makeup	Change July 2021-July 2022	Change June 2022-July 2022
All Items	100.0%	8.5%	0.0%
Food	13.4%	10.9%	1.1%
Food at home	8.3%	13.1%	1.3%
Food away from home	5.1%	7.6%	0.7%
Energy	9.2%	32.9%	-4.6%
Energy Commodities (includes gas & oil)	5.6%	44.9%	-7.6%
Energy Services (includes utilities)	3.6%	18.8%	0.1%
All Items Less Food & Energy	77.4%	5.9%	0.3%
Commodities (non food & energy)	21.1%	7.0%	0.2%
Services (non energy)	56.3%	5.5%	0.4%
Shelter (includes rents & mortgages)	32.1%	5.7%	0.5%

Source: Bureau of Labor Statistics

Diving into the data we see that shelter costs continue to rise at 0.5% per month, an annualized rate of 6.2% and 5.7% above July 2021 levels. This means that if the rate holds month over month, we will see more inflation in shelter costs in the coming year than in the year just passed. Given the continuing increase in interest rates, and the fact that rent increases tend to lag increases in housing prices, it is reasonable to assume the shelter component of inflation (over 30% of the entirety of CPI) will continue to rise for months. Commodities, which in the CPI data includes clothing, automobiles, and other consumer products, saw a drop in the inflation rate from last month. Still, the annualized rate is above the 2% annualized target the Fed is trying to hit and 7% higher than last year.

Just as many market participants and pundits discussed the "Powell Pivot" after the most recent FOMC meeting, I fear wishful thinking is getting the better of many. If you can remember back to the distant days of yore, and by that I mean two weeks ago, Jerome Powell stated that he thought rates were in the range of neutral. At no point did he declare victory over inflation or the end of the tightening cycle. Indeed, to quote Chair Powell directly, "our focus is continuing . . . to be on using our tools to bring demand back into better balance with supply in order to bring inflation back down. . . We also said that we expect ongoing rate hikes will be appropriate and that we'll make decisions meeting by meeting." The consensus among FOMC members is that rates will need to rise another 1.25- 1.5% to a median projection of 3.8% by the end of 2023, as shown in the most recent (June) "dot plot." The CME FedWatch tool, essentially a market that reflects the consensus of the trading community, projects Fed Funds to rise another 1% to a rate of 3.5% by mid-2023. The Fed and the markets both agree that more to be done to get inflation down to target, and in spite of the encouraging headline number in this week's CPI report, investors should expect tightening to continue as well.

The Federal Reserve is not done, and until such time as the data indicate that inflation is broadly subdued, the "all-clear" will not sound. The size and frequency of rate hikes will likely to slow, but until we see core inflation across multiple data sets – PPI and the Fed's preferred PCE, as well as CPI – at or near 2%, the Fed will continue to tighten the monetary supply in its part to fight inflation. I have known Jerome Powell for twenty years, and he is studious, lawyerly, and disciplined in his thinking. I assure you he isn't doing a victory lap after one good CPI headline report. Rates may be closer to the end point of the cycle than the zero where we started, but it may well be this time next year before Chair Powell stands at the podium and says, "job done."

I am often accused of being a curmudgeon, and I'll take that. I am certainly pleased with the CPI report, but it is my job to balance the totality of the information we have, and consider the unknowns, the information that we don't have. The plausible thesis that we are now in a consolidation period above the June bottom and will rise from here has certainly gained momentum. Equally plausible to my mind is the counter-thesis that the next negative data set will trigger a retracement to the lows, and perhaps even punch through to establish a deeper bottom. The old dictum, "don't fight the Fed," is still in effect either way. Don't let the emotion of good market day following a good report cloud your judgement and throw caution to the wind. We are ever cautious with our clients' investments, always assessing threats while evaluating opportunities.

Peace,
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