Inflation And The Reaction Function

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Any hope that an emollient Federal Reserve could emerge at Wednesday's rate-setting meeting was dashed by May's blowout inflation report. While the rise in the consumer price index's core measure eased to 6.0% year-on-year, all eyes were on the headline rate, which rose a more-than-expected 8.6%. The core reading may tell us about long-term inflation trends in the US, but it is unlikely to budge the Fed which, over the last two years, has pivoted to become more reactive to events. Perhaps the real worry in this report was the widening gap between the headline and core rates, as this points to the Fed having to tighten monetary policy through a period of flagging demand.

The Fed has become more reactive to events and so is likely to mainly focus on the headline rate of inflation

After adopting a revised inflation targeting framework in 2020, the Fed chose to focus more on the here and now, and less on longer-term forces. This was the lesson it took from underestimating deflationary forces in the 12 years after the 2008 crisis. Its chair, Jay Powell, recently said he must see "clear and convincing" evidence of inflation coming down before reassessing his now hawkish policy stance. Hence, the Fed is only likely to factor in lower core inflation to its decision making once the headline rate is clearly headed back towards 2%. As a result, there is almost no chance of the Fed getting worried about weakening demand and so turning more dovish.

The relative shift between core and headline inflation can be seen in price moves for lumber and oil

In the near term, it seems likely that headline inflation could stay high, while core inflation moderates. A good indicator of this trend is the relative annual performance of oil and lumber prices (see chart overleaf): oil prices are the key swing factor in headline CPI and lumber prices a good proxy for core CPI, as they reflect households' demand in the interest rate-sensitive housing sector which leads household spending on durable goods by six-nine months.

As Louis has argued, high oil prices stem not only from the Ukraine war but underinvestment in production capacity that will not be easily fixed (see Today's Malthusian Crisis Is Tomorrow's Political Crisis). Also, energy prices are soaring at a time when China's economy is weak due to Covid lockdowns. Imagine, if this situation changed and demand was high globally.

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US CPI rose 8.6% YoY in May, from 8.3% in Apr	Higher than 8.3% expected; core CPI rose 6.0% YoY, from 6.2%	High measured inflation and high inflation expectations will keep pressure on Fed to tighten
University of Michigan consumer sentiment index fell to 50.2 in Jun, from 58.4 in May	Below 58.0 expected	Rising gas prices and a falling stock market not good for consumer sentiment
China's aggregate finance rose RMB2.8trn in May, vs RMB0.9trn in Apr	Above RMB 2trn expected; total credit rose 10.5% YoY; new loans rose RMB1.9trn vs RMB0.6trn	Financing demand, particularly mortgages, remains weak
India's industrial production rose 7.1% YoY in Apr, from 2.2% in Mar	Above 2.2% expected	Solid recovery momentum, supports the case for RBI to continue monetary tightening

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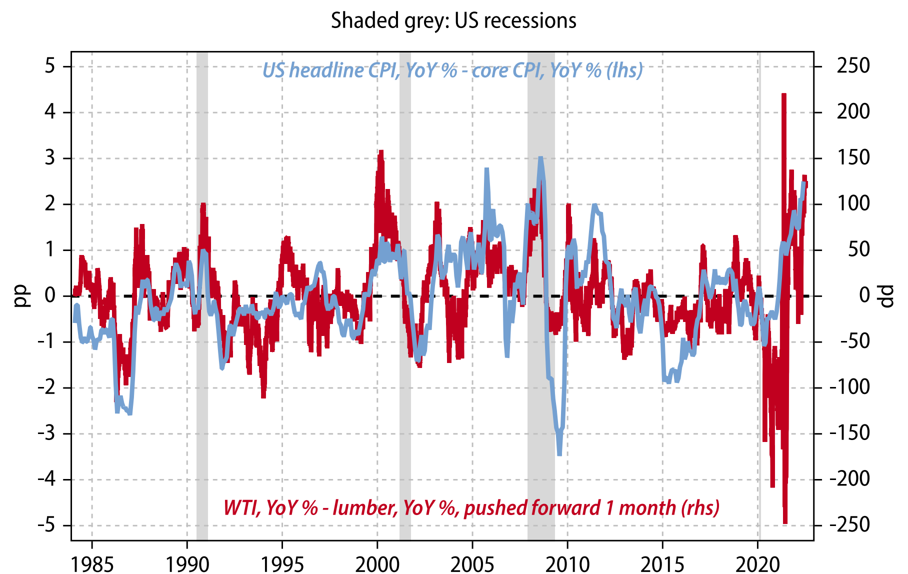
For their part, lumber prices have fallen -60% in the last three months as rising real yields caused US housing affordability to crater. Moreover, real yields seem set to rise further, as shown by the "Wicksellian spread" (the gap between the private sector's return on invested capital and the cost of that capital). This measure of economic health (see **Gavekal Indicators Dashboard**) is set to narrow as a result of (i) ROIC falling due to rising labor costs, and (ii) the cost of capital rising on Fed tightening (see **Time To Extend Duration?**). This situation points to lumber prices—and by extension core CPI—having more downside. The wider economy is also deteriorating, as shown by falling business activity measures and higher initial jobless claims.

US recessions have usually coincided with headline inflation being meaningfully above the core rate

Hence, as headline and core rates of inflation diverge, the Fed will have to suppress already weakening domestic demand in order to get headline inflation back to 2%. The more aggressively it does this, the higher the chance of a recession (see **The Fed's Soft Landing Play**). It is thus not surprising that US recessions have historically coincided with headline CPI being meaningfully higher than core CPI—as is the case today. I still think that, on balance, the US economy will avoid a recession in the near term, but the risk has risen materially (see **The Road To Recession**).

The Federal Reserve is caught between a rock and a hard place



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