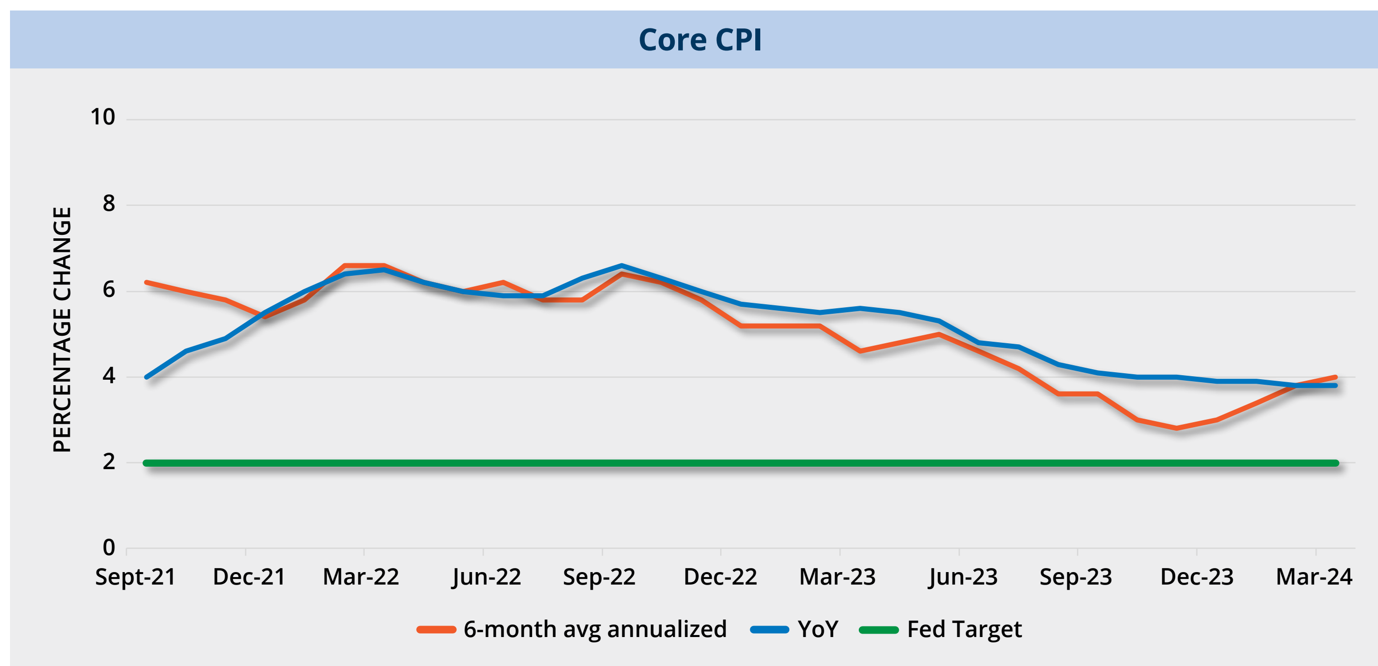
The Fed's Inflation Conundrum

Carpenters spend years learning the trade, but one simple, yet important lesson can be taught day one. The adage 'measure twice, cut once' saves even the novice woodworker from costly mistakes. Much to the dismay of wary market participants, the Fed appears to be following the same rule of thumb as it contemplates cutting its policy rate.

A voracious rally in stocks and bonds occurred during the fourth quarter of 2023, which can be attributed to the anticipated Goldilocks scenario of cooling inflation and strong economic growth in the U.S. What seemed at times an unlikely outcome during most of the rate hiking cycle appeared to be quickly becoming the base case outlook priced into financial markets.

At the December meeting of the Federal Open Market Committee (FOMC), Chair Jerome Powell all but confirmed that the next move by the Fed would be a cut. Downward trends in monthly inflation data fueled optimism that the Fed's 2% inflation target was within reach.



Source: Bloomberg, 5/3/24

Meanwhile, the presumed toll on economic growth from the Fed's hawkish stance had yet to materialize. To the contrary, the US economic growth was accelerating. In 2023, the pace of growth nearly doubled from 2.2% during the first half of the year to 4.2%[1] in the second half. But, while investors were ready to pop champaign entering 2024, policymakers were not ready to celebrate.

Exactly what inflation milestones they were waiting for to start easing policy was never, and perhaps never will be, exactly clear. It appeared their intention was to wait for more data that confirmed the encouraging trend. Unfortunately, that would not materialize in the first four months of 2024.

As hotter inflation data rolled in, it caused investors to reevaluate the outlook for monetary policy and ultimately the attractiveness of owning bonds. The Bloomberg Aggregate Bond Index shed -3.3% year to date through April 30th.

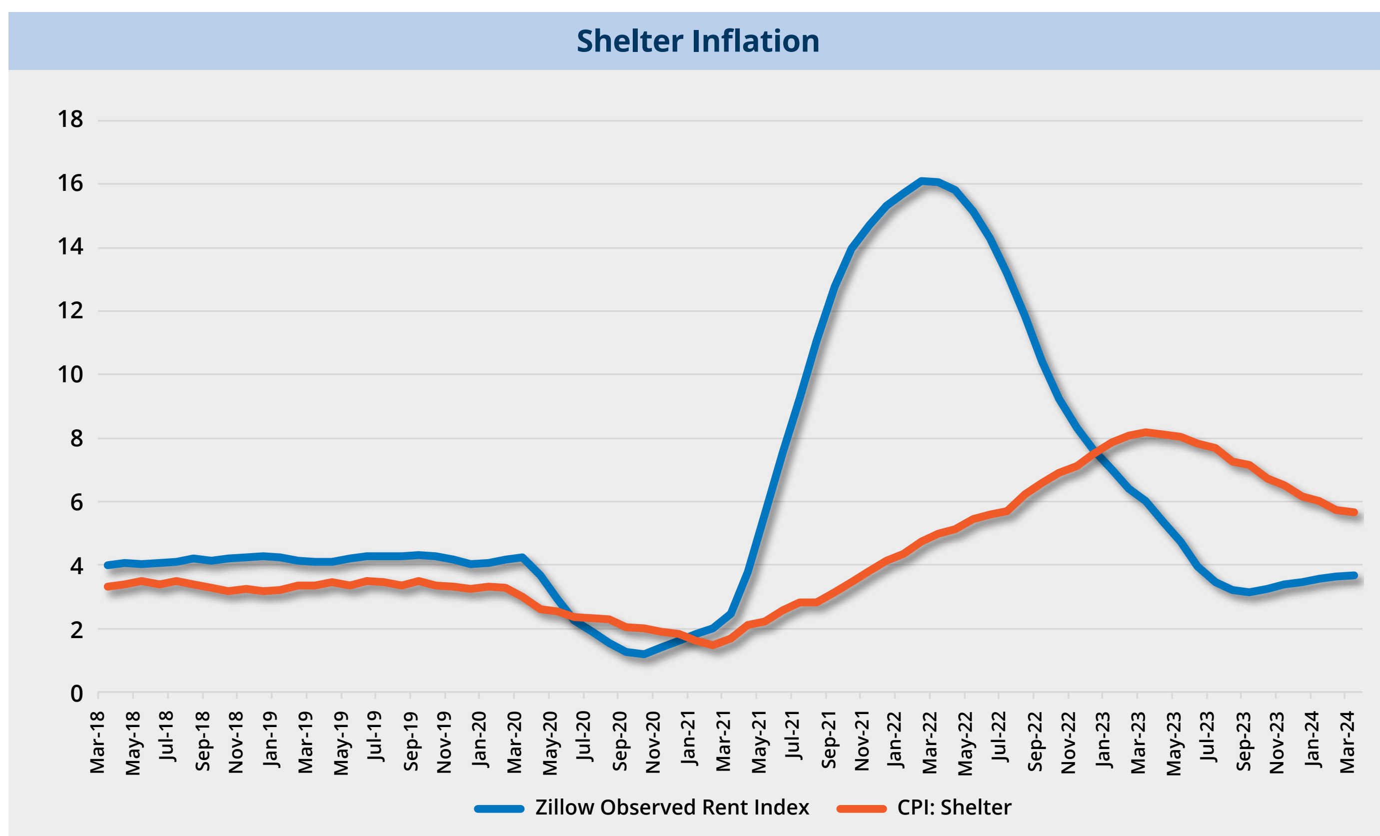
[1]Seasonally adjusted annualized rate

Core CPI data came in above expectations for three consecutive months, validating the Fed's caution about lowering rates too soon. Not only was a delay in rate cuts likely inevitable given the reversal; some policymakers were openly considering the potential need for another rate hike this year.

Keep Calm and Carry On

Powell attempted to strike a less hawkish tone in his May post-FOMC meeting press conference by suggesting that another hike was unlikely, however he was careful to qualify his remarks with his standard 'data dependency' caveat. This seemed to relieve some investor anxiety based on the positive reaction in the stock and bond markets.

One aspect of the recent inflation reports that have been complicating the view are the individual drivers. Core CPI grew 3.8% over the past 12 months through March. Shelter prices (mostly comprised of housing costs) accounted for 2.5%, or roughly two-thirds, of the total despite being approximately only a third of the Core CPI basket. Housing inflation is notoriously difficult to measure, and the calculation methodology used by the Bureau of Labor Statistics is known to lag real-time rental market conditions.



Source: Bloomberg, 5/3/24

Powell acknowledged this complication most recently in the May press conference by responding to a question on the topic by saying "So essentially there are a number of places in the economy where there are just lag structures built into the inflation process and housing is one of them."

An alternative measure of core inflation preferred by the Fed, the Core Personal Consumption Expenditures (PCE) Index, has half the weight in shelter compared to Core CPI. The weighting disparity is apparent with Core PCE a full 1% lower than Core PCE on a year over year basis through March.

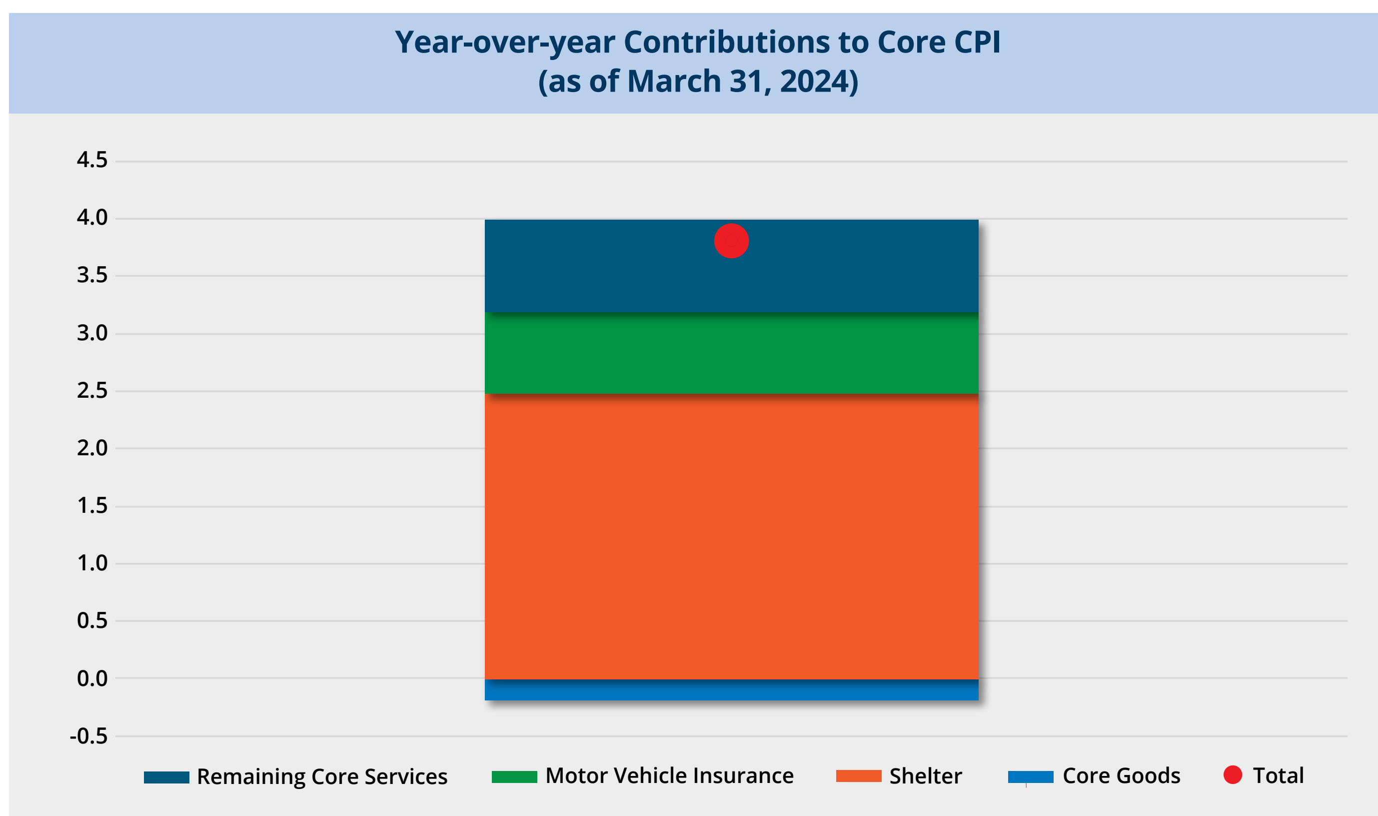
Taking into consideration shelter inflation's known lags and core goods prices exhibiting deflation, the Fed has put a spotlight on a narrow segment of the broad inflation landscape called non-housing core

services, otherwise known as "supercore." Stripping out housing from core services inflation one can observe the remaining hotspots in the inflation fire.

On a year-over-year basis through March supercore inflation has run up a blistering 4.8%. Yet, here too, the devil can be found in the details. The cost of auto insurance has increased 22% over the past year ending in March according to the BLS's measurement. At roughly 11% weight of the supercore measure, it accounts for approximately half of contribution to the measure's overall increase.

What's behind the surge in auto insurance premiums may also be delicately explained away by economists as a result of the lagged impacts of the past increases in auto parts and car prices. In other words, demand - the side of the inflation equation monetary policy aims to influence - is not the driving factor.

The combined effects of increases shelter in costs and auto insurance premiums account for 83% of the Core CPI increase over the past 12 months. Considering the nature and concentration of current inflation sources, Powell's hawkish temperance may not be so surprising.



Source: Bloomberg, BLS, 5/3/24

It appears that Chair Powell and his colleagues at the Fed recognize the unfamiliar predicament they find themselves in. Raising rates further in reaction to what amounts to past inflation is unlikely to make a difference and risks unnecessarily dampening economic growth momentum. At the same time, they cannot risk easing monetary policy without a clear and persistent downtrend in inflation. Like a diligent carpenter, future cuts will likely require full confidence in the measurement.

Until confidence is restored, we expect the Fed to standby leaving bond investors in limbo. In the meantime, Powell's projection that further hikes are unlikely to be necessary will mitigate some of the uneasiness market participants have felt recently.

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