AGRON NICAJ
US Economist

Economic Research Office

T: +1 (646) 357 6180
E: anicaj@us.mufg.jp

MUFG Bank, Ltd.
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A proactive Fed

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- July's core CPI growth was in line with expectations, accelerating slightly on a monthly basis but consistent with 2% price growth. Aggregate inflation is closing in on the Fed's target, but underlying inflation may be more elevated. In July, price growth was positive for all major services sub-components, except for medical care, where outpatient hospital services exhibited the largest single month price decline in history. These extreme and unusual monthly movements are apparent in other components as well, contributing to noise in the data and to monthly volatility. There may still be inflation persistence, supporting that the Fed is likely not behind the curve.

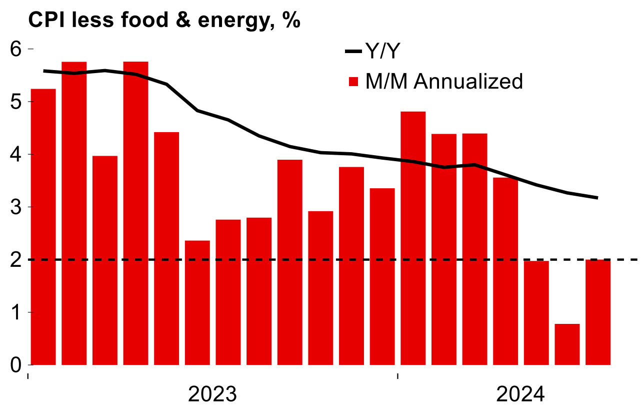
Moderate growth in core prices

Annual growth in core CPI eased to 3.2% in July, down from 3.3% in June. On a monthly basis, growth accelerated to an annualized 2%, in line with consensus forecasts and consistent with the Fed's long run target (Chart 1).

The FOMC explicitly targets an average of 2% inflation in the long run, which from an annual growth perspective, they remain far from achieving. However, from month-to-month, growth has been at or below 2% for three consecutive months. This likely doesn't fully satisfies the Fed's defined and stated goal, but aggregate inflation is certainly moving in the right direction where prices are not growing at an excessive rate and the risk of deflation remains very low.

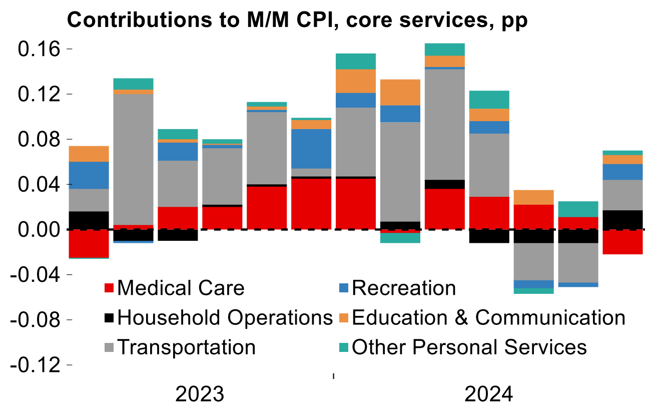
This should give the Fed more confidence to initiate the first rate cut at the next FOMC meeting. Markets are certainly expecting them to do just that, having fully priced in at least a 25 bps cut in September. While satisfying market demands isn't part of the Fed's mandate, an unwelcomed surprise would weaken confidence in their forward guidance. However, a rate cut in September would most likely be a proactive measure to avoid a recession, rather than a reaction to weak economic data. The Fed is likely not behind.

Chart 1: Core CPI accelerated on a monthly basis in July, but remains consistent with 2% long-run growth



Source: BLS, MUFG Bank Economic Research Office

Chart 2: All major core services sub-components exhibited price increases, except for medical care services



Source: BLS, MUFG Bank Economic Research Office

By most metrics, the economy is still expanding at a healthy pace. Retail and food services sales grew by 1% in July, the strongest monthly growth since the beginning of 2023. This comes after strong consumer spending growth for both goods and services in Q2 of this year. In the labor market, the slowdown in employment growth and the rise in unemployment is more akin to normalizing than weakening. So far in 2024, growth in the unemployment rate has largely been from new and re-entrants to the labor force, and the uptick in job losers in July was predominantly temporary layoffs. The latest median estimate of the natural rate of unemployment from the Survey of Professional Forecasters is 4.4%, above the current 4.3% unemployment rate.

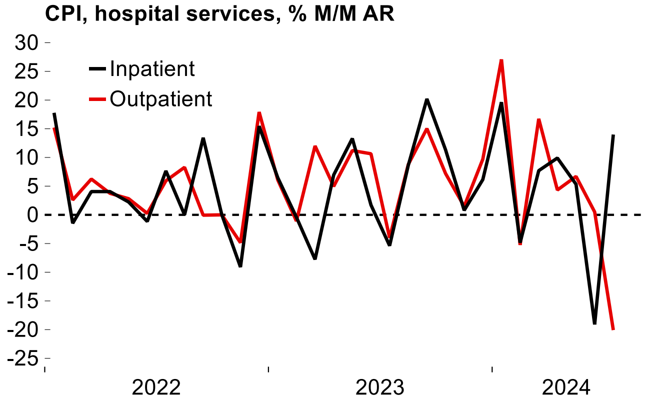
The resilience of the US economy is especially concentrated in the services sector, in both employment and personal consumption growth. Even July's CPI showed inflation "stubbornness" in core services, where every major services sub-component exhibited price increases, except for medical care (Chart 2).

This isn't necessarily an indication that inflation will accelerate in the coming months, since similar price dynamics were common from 2012-2019 when inflation was at 2%, but it does highlight (in conjunction with spending data) that demand is still relatively strong in the US.

Volatility introducing noise

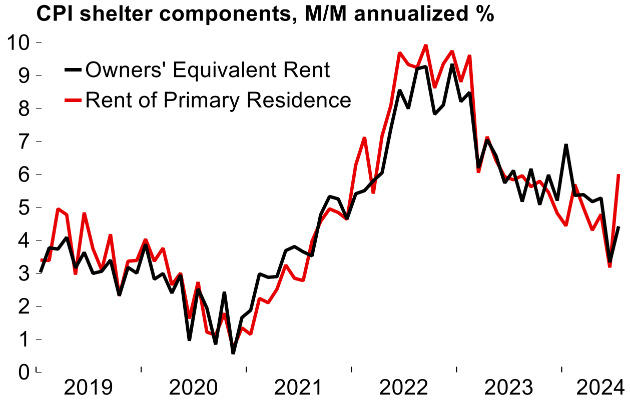
Extreme price movements highlight much of July's CPI. Within medical care services, outpatient hospital services exhibited the largest monthly price decline in history (Chart 3). The same was true for inpatient hospital services last month, where prices fell by the largest percentage in history, only to recover in July. We can expect the same type of recovery to happen with outpatient services, where price growth will return to a more "normal" level in August, but the cause of this volatility is likely related to noise in the data collection.

Chart 3: Price growth for outpatient services will likely recover next month after a historically large price decline



Source: BLS, MUFG Bank Economic Research Office

Chart 4: Rent inflation surged this month, contrary to what private sector measures of rent are showing



Source: BLS, MUFG Bank Economic Research Office

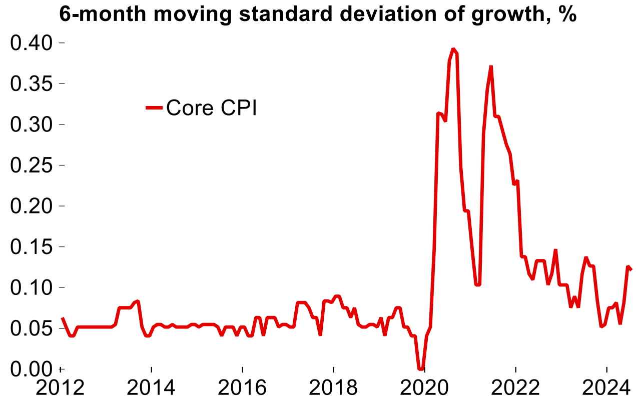
The shelter component also fell victim to extreme volatility where monthly growth in rent of primary residence surged by the largest margin in over 20 years (Chart 4). Private sector measures of new rents are reliable leading indicators of CPI rent (which captures new and existing rents), but a monthly increase of this magnitude is not seen in other data measuring rents or housing prices. This too is likely noise in the data.

In this instance, growth in one component helped to offset a decline in another, both of which are highly weighted in the CPI. This helped to bring aggregate inflation into some form of harmony around 2% monthly growth, but it does cloud the precise measure of underlying inflation, or the persistence of inflation that is driven by supply and demand dynamics that the Fed is attempting to target. It would be unwise to assume that noise in one inflation component will fully offset the noise in another in every month.

As noted earlier, the trajectory of annual inflation will not satisfy the Fed's explicit average price growth target of 2% by September, or even by the end of this year. For this reason, shorter growth horizons such as 1-month or 3-month price growth targets will likely be observed more closely. Persistent volatility (similar to July's CPI data) may distort signals of underlying price growth, making aggregate inflation measures such as core CPI less reliable from month-to-month.

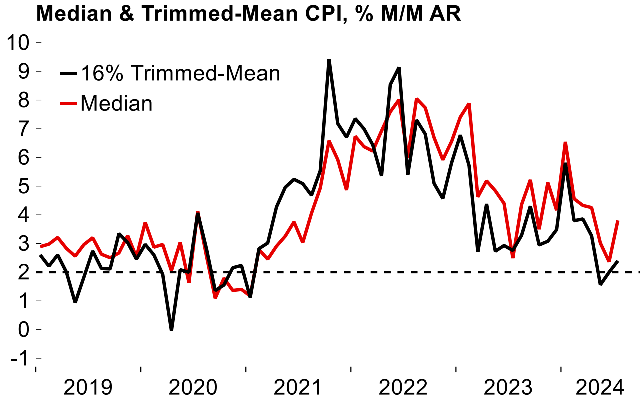
Shown in Chart 5, core CPI volatility, measured by the 6-month moving standard deviation of monthly growth, has increased in recent months above what was experienced in the decade before the pandemic. This doesn't point to inflationary pressures being persistent one way or another, but it does highlight how noise in the data can cloud the perceived trajectory of inflation.

Chart 5: Month-to-month core CPI **v**olatility is increasing, potentially distorting inflation signals



Source: BLS, Cleveland Fed, MUFG Bank Economic Research Office

Chart 6: The median CPI may be a better gauge of underlying inflation when volatility is high



Source: Cleveland Fed, MUFG Bank Economic Research Office

A better measure may be the 16% trimmed-mean CPI or the median CPI from the Cleveland Fed. Both measures look to eliminate noise, with the trimmed-mean CPI excluding the top 8% and bottom 8% of the price change distribution, and the median CPI only including the expenditure weight in the 50th percentile of the price change distribution. Shown in Chart 6, both measures show that inflation has come down from the start of 2024, but the median CPI points to more persistent price growth in recent months.

The evidence here still likely supports a September rate cut by the Fed, as inflationary pressures point to continued disinflation, and neither core, median, nor trimmed-mean CPI are showing evidence of a strong resurgence in monthly price growth. But the extent of monthly volatility and noise in inflation data should dispel the idea that the battle against inflation is conclusively won and that the Fed is behind the curve in cutting rates. The decision at the next FOMC meeting will likely still be a proactive one.

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