July 15, 2024

Morning Briefing

Immaculate Disinflation!

Check out the accompanying chart collection.

Executive Summary: In congressional testimony last week, Fed Chair Powell sounded more dovish than he has this tightening cycle. That clinched financial markets' growing expectation that the Fed would cut the federal funds rate as early as September. We believe so too. Now that inflation is closing in on the Fed's 2.0% target, Fed officials are increasingly focused on keeping the unemployment rate low. … From today's vantage point, it's clear that "immaculate disinflation"—the lowering of inflation without a recession—is possible, as we had predicted back in September 2022.

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The Fed: Powell Is Pleased. For the past couple of years, Fed Chair Jerome Powell acknowledged that the Fed's tight monetary policy, aimed at subduing inflation, might cause a recession. However, he repeatedly held out hope that there might be a narrow path along which inflation moderated down to the Fed's 2.0% inflation target without causing a recession. During his congressional testimony on monetary policy last Tuesday and Wednesday, he reiterated: "There is a path to getting back to full price stability while keeping the unemployment rate low." Then he declared: "We're on it. We're very focused on staying on that path."

That testimony certainly sounded more dovish than Powell has been this tightening cycle. When he was asked directly whether he felt that the Fed was getting close to achieving its 2.0% inflation target soon, he said, "I do have some confidence of that." But then he hedged by saying, "I am not ready to say that yet." Recent data has been encouraging, Powell told lawmakers. He emphasized that the Fed now had a more balanced view of its dual mandate with the risks of a higher inflation outlook equal to the risks that unemployment will move higher.

On Thursday, June's lower-than-expected CPI inflation report convinced the financial markets that inflation was heading in the right direction and rapidly approaching the Fed's 2.0% target. That in turn suggested to investors that the first cut in the federal funds rate (FFR) since the Fed started tightening back in March 2022 would occur during September of this year. We now agree with that assessment. On Thursday, bonds rallied while the stock market rally broadened as some money came out of the MegaCap-7 stocks (Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla), boosting the Russell 2000.

Here are a few related developments:

(1) *Federal funds rate futures.* On Thursday after the CPI report, the federal funds rate futures market signaled two 25bps cuts in the FFR over the next six months and five over the next 12 months (*Fig. 1* and *Fig. 2*).

(2) *Yield curve*. Both the 2-year and 10-year US Treasury yields fell after Powell's testimony and after the CPI report (*Fig. 3*). The yield curve remained modestly inverted at 32bps (*Fig. 4*). The 10-year yield held at 4.20% on Thursday. Since November 2022, the yield has visited and revisited 4.25% five times (*Fig. 5*). The 10-year TIPS yield edged back below 1.96% on Thursday (*Fig. 6*).

(3) *Real federal funds rate.* The real FFR rose to 2.36% in June as the headline CPI inflation rate fell to 3.0% y/y, while the FFR was 5.30% (*Fig. 7*). The average over time of this real rate was 1.00% since the late 1950s. Some Fed officials have argued that monetary policy will effectively become more restrictive if inflation continues to fall while the FFR remains unchanged. That may be one of the reasons that Fed Chair Powell has turned more dovish.

(4) *Unemployment rate.* Now that inflation is heading toward the Fed's 2.0% target, Fed officials are giving more weight to the unemployment rate in the context of their dual mandate to keep both inflation and unemployment low. The unemployment rate has risen from a low of 3.4% during April 2023 to 4.1% during June of this year (*Fig. 8*).

The jobless rate is inversely correlated with the FFR. The diehard hard-landers observe that, in the past, gradual increases in the unemployment rate were precursors of a big jump in the jobless rate as a result of recessions. These hard-landers see weakness in other recent labor market indicators as well, such as job openings and initial and continuing unemployment claims. But where they see weakness, Eric, Debbie, and I see a return to business as usual; we argue that the labor market may be simply normalizing following the turmoil of the pandemic, not weakening ominously.

(5) *Unemployment claims*. Initial unemployment claims fell 17,000 to 222,000 (sa) in the week ended July 5, while continuing claims slipped 4,000 to 1.852 million (sa) in the week ended June 28 (*Fig. 9*). In our opinion, claims are following new post-pandemic trends that haven't been fully reflected in the Bureau of Labor Statistics' seasonal adjustments. Over the rest of the summer, we expect to see an easing of recent concerns that claims may be starting to signal a recession.

By the way, the weekly insured unemployment rate has remained flat at 1.2% since March 2023 (*Fig. 10*). So it has yet to confirm the modest upturn in the official monthly unemployment rate that's been going on since April 2023.

Inflation: Nearly Impossible Mission Almost Accomplished. During the spring of 2022, Debbie and I predicted that inflation was peaking: "In our scenario, the PCED headline inflation rate peaks during H1-2022 between 6%-7%. Led by consumer durable goods prices, it moderates to 4%-5% during H2-2022. Next year, it falls to 3%-4% as persistently rising rent inflation offsets moderation in other consumer prices." We wrote that in our April 19, 2022 *Morning Briefing*. We expected that goods inflation would decline faster than rent inflation. In our September 11, 2023 *Morning Briefing*, we predicted that inflation would fall to 2%-3% in 2024.

We first wrote about "immaculate disinflation" in the September 6, 2022 *Morning Briefing*:

"Is immaculate disinflation possible? History shows that inflation rarely falls on its own without a recession. But we don't think history necessarily has to repeat itself (despite how often it rhymes). … What seems to be different this time (so far) is that the credit system is less vulnerable to a credit crunch than it was in the past. The result is what we now have: a rolling recession hitting different sectors of the economy at different times; we expect it to bring inflation down without precipitating an economy-wide downturn."

Since the start of the year, we've forecast that the PCED inflation rate will fall to 2.0% by the end of this year (*Fig. 11*). So far, so good. June's CPI report suggests we are still on the right track:

(1) *CPI vs PCED.* The CPI is released by the Bureau of Labor Statistics (BLS) a couple of weeks before the PCED comes out for each month. The PCED measure is compiled by the Bureau of Economic Analysis (BEA). The components of the CPI are used to calculate the

PCED. Most of the component series are identical. A few differ because different methods are used to estimate them by the BLS and by the BEA. Many of the component series have different weights.

The core CPI inflation rate closely tracks the core PCED inflation rate. However, on average since 1960, the former has exceeded the latter by 0.5 percentage points (*Fig. 12*). During May, the core CPI was up 3.4% while the core PCED rose 2.6%. June's core CPI was released last week showing an increase of 3.3%.

(2) *Durable goods.* Much of the discrepancy between the two consumer price measures is attributable to durable goods consumer prices, which have increased 1.0 percentage point faster in the CPI than in the PCED since 1960 (*Fig. 13*). That might be mostly attributable to "hedonic" price adjustments in PCED durable goods prices to reflect the fact that today's durable goods have numerous features that improve on those of older versions.

During May, the durable goods CPI was down 3.8% while the durable goods PCED fell 3.2%. June's durable goods CPI was released last week showing a decrease of 4.1%.

(3) *Medical care services.* Another significant divergence between the CPI and PCED core inflation rates is attributable to medical care services (*Fig. 14*). The former has exceeded the latter by 0.7 percentage points since 1960. During May, the CPI and PCED measures of medical care services both rose 3.1% in May. June's CPI measure of this component was up 3.3%.

There's a big discrepancy between hospital fees in the CPI and PCED (*Fig. 15*). The former reflects the out-of-pocket costs paid by consumers, while the latter also reflects the costs that are covered by health care insurance and government health care programs.

(4) *Health insurance.* Another major wild card is health insurance. The CPI measure is convoluted and extremely volatile. The PCED measure is much less so and more sensible.

(5) *With and without shelter.* Last but not least, shelter inflation is finally moderating too, boding well for overall inflation. As noted above, June's headline and core CPI fell 0.1% m/m (3.0% y/y) and rose 0.1% m/m (3.3% y/y). Excluding shelter inflation, both indexes are down to only 1.8% y/y (*Fig. 16*)!

Rent inflation as measured in the CPI is falling, catching up to lower market rent inflation. Shelter (which accounts for one-third of the CPI) rose just 0.2% m/m (5.2% y/y) in June, its slowest monthly pace since January 2021. The three-month percentage change in shelter's two major components—rent of primary residence and owners' equivalent rent—suggest that their y/y readings will continue to fall (*Fig. 17*).

Calendars

US: Mon: NY Empire State Manufacturing Index -5.50; Powell; Daly. **Tues:** Retail Sales Total & Core -0.2%/0.1%; Business Inventories 0.4%; NAHB Housing Market Index 44; Atlanta GDPNow 2.0%; Import Prices 0.2%; API Weekly Crude Oil Inventories. (FXStreet estimates)

Global: Mon: Eurozone Industrial Production -0.9%; Germany Retail Sales 0.0%; Eurogroup Meetings. **Tues:** Eurozone ZEW Economic Sentiment 48.1; Germany ZEW Economic Sentiment 41.2; Italy CPI 0.2%m/m/0.9%y/y; ECB Bank Lending Survey; German Buba Monthly Report; ECOFIN Meetings; Eurogroup Meetings. (FXStreet estimates)

Strategy Indicators

Global Stock Markets (US$ Performance) (*link*): The US MSCI index rose 0.9% for the week and ended the week 0.3% below its record high on Wednesday. The AC World ex-US index outperformed with a w/w gain of 2.1% to a 30-month high and is just 4.7% below its June 15, 2021 record high. EM Latin America was the best performing region last week with a gain of 4.3%, followed by EAFE (2.3%), Europe (2.2), and the AC World ex-US. EM Asia was the worst regional performer, albeit with a gain of 1.5%, followed by EMEA (1.6), EM (1.7), and EMU (2.1). Among the major selected country markets that we follow, Mexico performed the best last week with a gain of 8.1%, followed by Hong Kong (5.4), Switzerland (3.1), Sweden (3.0), and China (2.8). The worst country performers last week: Korea (-1.1), India (0.5), France (1.5), and the United Kingdom (2.1). The 17.3% ytd gain for the MSCI United States remains well ahead of the AC World ex-US index (8.3). EM Asia is ahead of the pack as the leading region ytd with a gain of 13.7%, which puts it ahead of EM (9.8) and the AC World ex-US. The worst performing regions so far in 2024: EM Latin America (-12.8), EMEA (2.5), Europe (8.1), EAFE (8.1), and EMU (8.2). Looking at the major selected country markets that we follow, Taiwan is far and away the best ytd performer with a gain of 34.4%, followed by India (19.0), the United States, Japan (10.9), and Spain (9.9). The worst performing countries so far in 2024: Brazil (-17.5), Mexico (-9.2), Hong Kong (-9.1), France (1.1), and Korea (2.0).

US Stock Indexes (*link*): Forty-three of the 48 major US stock indexes that we follow rose w/w, up from 22 rising a week earlier. The Russell 2000 Value index was the best performer with a gain of 6.6%, ahead of Russell 2000 (6.0), S&P 600 SmallCap Value (5.8), S&P 600 SmallCap Equal Weighted (5.6), and S&P 600 SmallCap Pure Value (5.5). The Russell 1000 Growth index was the worst performer with a decline of 0.4%, followed by Nasdaq 100 (-0.3), Nasdaq Industrials (-0.3), Russell 3000 Growth (-0.2), and S&P 500 LargeCap Growth (-0.1). Looking at their ytd performances, 43 of the 48 indexes are higher so far. That's up from 37 indexes a week earlier, but down from 47 at the end of March. The S&P 500 LargeCap Growth index is the best performer so far in 2024, with a gain of 27.4%, ahead of Russell 1000 Growth (24.2), Russell 3000 Growth (23.5), Nasdaq Composite (22.6), and S&P 400 MidCap Pure Growth (22.2). The worst performing major US stock indexes ytd: S&P 600 SmallCap Pure Value (-4.2), Dow Jones 20 Transports (-2.4), S&P 600 SmallCap Value (-1.8), S&P 400 MidCap Pure Value (-1.5), and S&P 600 SmallCap Equal Weighted (-0.4).

S&P 500 Sectors Performance (*link*): Ten of the 11 S&P 500 sectors rose last week, and six were ahead of the S&P 500's 0.9% gain. That compares to six sectors rising a week earlier when three were ahead of the composite index's 2.0% gain. The outperformers last week: Real Estate (4.4%), Utilities (3.9), Materials (3.0), Health Care (2.6), Industrials (2.4), and Financials (2.0). The underperformers last week: Communication Services (-3.6%), Consumer Staples (0.1), Consumer Discretionary (0.4), Energy (0.5), and Information Technology (0.5). The S&P 500 is up 17.7% ytd, with 10 of the 11 sectors in positive territory but only two ahead of the index. That's down from five sectors ahead of the index during mid-May. Information Technology is the best ytd performer, with a gain of 33.4%, ahead of Communication Services (26.3). These sectors are lagging the S&P 500 so far in 2024: Real Estate (-0.3), Materials (5.7), Energy (8.2), Health Care (8.7), Consumer Staples (8.7), Industrials (8.9), Consumer Discretionary (9.6), Utilities (12.4), and Financials (12.5).

US Economic Indicators

CPI (*link*): Headline CPI fell in June for the first time since the start of the pandemic, while the core rate posted its smallest gain since August 2021, with the yearly rates easing for both measures. *Headline* CPI fell 0.1% in June, following no change in May and slowing steadily from March's 0.4%, while core prices edged up 0.1% last month, also slowing steadily from March's 0.4%. On a *year-over-year basis,* the *headline* rate dipped to 3.0%, matching its lowest rate since March 2021 and down from June 2022's peak rate of 9.1%. Meanwhile, the *core* rate continues to ease, falling to 3.3%—the lowest rate since April 2021; it peaked at 6.6% during September 2022. *Goods inflation* fell 0.4% y/y in June, with durable goods prices falling 4.1% y/y, down from the 18.2% peak in January 2022, while the rate for nondurable goods is at 1.3%, down from 14.4% in June 2022. *Services excluding energy services* is drifting lower, though remains relatively high at 5.1%, well above rates a couple of years ago. Looking at *durable goods* prices, there's lots of red, with the yearly percent changes for motor vehicle parts & equipment (-1.0%), major appliances (-3.6), furniture & bedding (-4.6), and used cars & trucks (-10.1), though the latter's decline is widening again after narrowing sharply from its -13.6% rate last February. Meanwhile, the yearly rate in new vehicle prices (-0.9) slipped below zero in March (-0.1) for the first time since mid-2020 and continued its decline through June. Here's a snapshot of yearly rates for some key *nondurable goods* prices from highest to lowest: recreational commodities (9.4% y/y), medical care commodities (3.1), food (2.2), apparel (0.8), and housekeeping supplies at zero. Energy prices showed a yearly gain in March (2.1) for the first time since February 2023 and moved higher through the 12 months through May (3.7), until these prices fell 2.0% in both May and June, lowering the yearly rate to 1.0% in June. It had bottomed last June at -16.7%. Turning to services inflation, *rent of shelter* remains high, though the yearly rates are easing from their recent highs in April 2023: rent of primary residence (5.1% from 8.8%) and owners' equivalent rent (5.4 from 8.1). Turning to *non-housing-related services*, the yearly rate of transportation service (9.4% y/y) remains high, near the top of its recent high, though is down from its peak rate of 15.2% during October 2022, while the rate for recreation services (3.4) continues to ease. Meanwhile, the yearly rate for education & communication services (2.0) is holding near its recent high, while the medical services (3.1) rate moved further above zero in May after moving above in January for the first time since last April; it was at a recent low of -2.6% during September. The rate for other personal services moved up to 4.8% in June from 4.0% in May—which was the lowest rate since October 2021.

PPI (*link*): Both the headline and core PPIs were above expectations in June, led by services prices. *Final demand* rose 0.2% in June (vs 0.1% expected), following no change in May and a 0.5% acceleration in April. June's yearly inflation rate was 2.6% (vs 2.3% expected)—the largest gain since the 2.7% increase March 2023 and up from May's 2.2%. It was at a recent low of 0.8% in November. The gain in *core prices* was 0.4% (vs 0.2% expected), with the yearly rate rising to 3.0% (vs 2.5% expected) and above May's 2.3%. Excluding trade services from the core group, the rate was eased to 3.1% from 3.3% in May—which was the highest since last April. *Final demand services* in June accelerated

0.6%, double May's 0.3% and matching April's 0.6% gain, which was the biggest monthly gain since last July. The services' yearly rate edged rose to 3.5%, the highest since February 2023 and up from 1.8% at the end of last year—which was the lowest since January 2021. *Final demand goods* fell for the third time in four months, by 0.5% in June and 1.2% over the period. Over 60% of June's increase in final demand goods can be traced to a 5.8% decline in gasoline prices. The yearly rate dipped down to 1.0% in June after moving up for four successive months, from -1.5% in January to 1.6% in May. The PPI for *personal consumption* ticked down to 2.9% y/y in June from May's 15-month high of 3.0%; it was at 0.9% in November. The yearly rate for *personal consumption excluding food & energy* rose from a recent low of 2.1% in November to 3.3% y/y in June—which was the highest since April 2023. The former and latter reached record highs of 10.4% and 8.1%, respectively, in March 2022.

Consumer Sentiment Index (*link*): Consumer sentiment was little changed in mid-July for the second straight month, while inflation expectations improved. The *consumer sentiment index* edged down 2.2 points in mid-July (to 66.0 from 68.2), well within the margin of error and more than 30% above its trough in June 2022—though it remains stubbornly subdued, according to the report. The *current conditions* measure fell to 64.1 in mid-July from 65.9 in June, while *expectations* slipped to 67.2 from 69.6. *Year-ahead inflation expectations* eased for the second month to 2.9% from 3.0% in June and 3.3% in May; in comparison, these expectations ranged between 2.3% and 3.0% during the two years prior to the pandemic. Meanwhile, *long-run inflation expectations* registered 2.9%, down from 3.0% in each of the prior three months, remaining remarkably stable over the last three years. However, these rates remain somewhat elevated relative to the 2.2%-2.6% range seen the two years pre-pandemic. Joanne Hsu, director of consumer surveys, noted: "Nearly half of consumers still object to the impact of high prices, even as they expect inflation to continue moderating in the year ahead." When asked about the upcoming election, "consumers perceived substantial uncertainty in the trajectory of the economy, though there is little evidence that the first presidential debate altered their economic views."

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