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The Journey from Peak Inflation

By: Nicholas Rilley, CFA, Investment Manager and Strategy Analyst

The path back to 2% inflation is a difficult one for policymakers. As the old quip goes: “I wouldn’t start from here”. The good news is that US headline CPI eased to a lower-than-expected 8.5% year-over-year in July, down from a four-decade high of 9.1% in June. The index was flat on a month-on-month basis as gasoline prices fell by 7.7%. Barring another painful energy price shock, it is highly likely that the US has reached peak inflation.

However, the speed with which it falls and the level at which it settles has become very important when considering the outlook. Inflation forecasts have been upgraded substantially. At the beginning of the year, the median forecast for US inflation was 4.4%, however that estimate is now around 8%. To highlight just has severe the price pressure has become, in just the first seven months of the year, prices have increased by 6.3%. Considering the target is 2% over the full twelve months, it is unsurprising then that recent rhetoric from central bankers has contained a degree of panic.

Plenty has been written about where inflation pressures have come from, with energy, food and housing being significant contributors. The good news is that the combination of easing demand for durable goods post the pandemic, easing supply chain pressures and lower commodity prices are likely to reduce inflationary pressures over coming months. In addition, recent small business surveys have reported a drop in the number of companies reporting and planning higher prices.

Furthermore, market-based indicators suggest that inflation will moderate meaningfully in the next two years. Inflation-protected security pricing shows that the 5-year breakeven, a rough proxy for inflation estimates over the next five years, has fallen from a March peak of 3.74% to 2.70%. While this is still above the 2% inflation target, it suggests that policy is already working to bring down inflationary pressures. Furthermore, the pricing in inflation derivatives shows that the market implied probability of inflation being above 3% over the next five years has fallen from a peak of 70% to around 45%.

However, the labour market and wage growth both remain strong and we know that the Federal Reserve keeps a close eye on this. There are good reasons for this as aggregate wage growth is a very important variable for spending and also rent, which has a high weighting in the CPI basket. Rent inflation should now moderate, but will probably slow gradually given lags in the data as existing leases are reset at higher market rates.

One of the most notable aspects to financial markets at the moment is that the fall in bond yields and recovery in equity markets since June suggest markets are pricing in a fall in inflation but without a severe slowdown in growth. This would be a “soft landing” scenario, which according to many analysts and commentators, has become highly unlikely given the lack of historical precedent.

Markets were quick to latch onto Fed Chair Powell’s assertion in July that policy rates at 2.25%-2.50% are close to their “neutral” level. However, a number of Fed officials have pushed back on this dovish interpretation, with San Francisco Fed President, Mary Daly, emphasising that while there has been some improvement in inflation, it is too early to “declare victory” and there is still “a lot of work to do”.

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One interpretation of the market's sanguine view is that Fed policy will pivot at the first signs of weakness when the unemployment rate rises. Markets are currently pricing a peak in Fed Funds of around 3.75% in May 2023, before pricing interest rate cuts which would take the policy rate back down to 3.25% by the end 2023.

Getting core CPI inflation to between 3 and 4% from the current 5.9% level should be fairly easy as pandemic distortions unwind. However, getting inflation all the way back down to the 2% target is going to be difficult as the labour market would need to cool significantly.

The Fed's calculus is currently relatively straight forward given that inflation is so far above target and the labour market is strong. Things will potentially get a lot more difficult if inflation remains elevated but unemployment picks up. The market expects that the Fed would react to this so-called stagflation backdrop by pivoting to interest rate cuts, but whether they do would be fundamental to the outlook if this situation arises.

The US does not have the same energy price pressures as Europe, so a "soft landing" is still a possibility. Indeed, as bond yields, mortgage rates and commodity prices have fallen over recent months, the probability of this positive outcome has increased. However, bringing inflation all the way back down to 2% may well require a more severe demand slowdown, which would pose a real challenge for policymakers.

No policymaker would dare admit it at this point as any dovish messaging would be counterproductive, but faced with a potentially more difficult trade-off between unemployment and inflation next year, the journey from peak inflation may well end with the Fed accepting an implicitly higher inflation target.

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