CURRENT MARKET NEWS

CPI Inflation – Coming in hot, but better to wait for the PCE inflation reading

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The Consumer Price Index (CPI) measure of inflation surprised to the upside in April, increasing 0.3% on the month and 8.3% on the year. More troubling, the “Core CPI” which strips out food and energy increased 0.6% on the month and 6.2% on the year. Notable increasing categories included Food (+0.9% month, +9.4% year), Shelter (+0.5% month, +5.1% year), and a whopping Airfare print which is probably no surprise to anyone booking travel recently (+18.6% month, +33.3% year).

One encouraging aspect was the softening of goods inflation where “Commodities Less Food and Energy” showed only a 0.2% monthly increase which was paced by decreases in the prices of Apparel (-0.8% month) and Used Cars and Trucks (-0.4% month). Other subcategories in this space also exhibited a downtrend over the past three months. On net, however, the market was unforgiving. Even if “peak” inflation looks in place, the market assessed that it’s a far cry from meaningfully lower inflation.

Before passing judgement on the coming direction for inflation, however, it is important to wait for the PCE (Personal Consumption Expenditure) measure of inflation that is set to release on May 27th. The biggest difference is that while CPI is a “fixed basket” of goods, the PCE takes into account how money is actually being spent. Consumers substituting less expensive goods, delaying purchases, or otherwise adjusting spending patterns will put downward pressure on PCE to the extent those actions are widespread. This incorporation of consumer behavior is the primary reason why the Federal Reserve considers PCE a better measure of inflation than CPI. People may make these changes to spending patterns begrudgingly and CPI may better account for our collective angst, but PCE tallies up the effect on our pocketbook.

In the current environment, we do believe that companies are facing pushback and substitution behavior at the consumer level. This is likely to have a dampening effect on inflation which should show up first in PCE inflation before migrating to CPI inflation. There’s also evidence – both anecdotal and data driven – that supply chain woes are easing which should soften inflation in the coming months.

At present, there is a high degree of pessimism and frustration with inflation – and rightly so. The Fed has now shifted to inflation fighting mode, and the current CPI release did not clearly point to a downward trend. We believe, however, that PCE inflation will provide better insights on whether inflation has peaked and is declining or has peaked but is “sticky” at a high level. We are very cautiously optimistic but recognize that a new trend could still take time to develop.

The market’s patience, however, has worn thin in the face of so much uncertainty – inflation, Fed interest rate hikes, Ukraine war impacts, and slowing global growth. For the moment, volatility reigns. In times like this, it is important not to get caught up in a one-way narrative. Growth may indeed be slowing, but the U.S. trajectory continues to look stable. China and Europe are dragging down international growth, but China’s President Xi Jinping has pledged all out efforts to stimulate the economy in the second half of the year. And market sentiment, a contrarian indicator, has moved to the lowest range of readings which has typically preceded market improvements on a medium-term basis. Undoubtedly, the current environment presents challenges and there are multiple factors in play. The prospects for market stabilization, however, should come into view more clearly this summer and be aided by what we expect will be better inflation readings.

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