FINANCIAL MARKET SNAPSHOT

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Inflation Insights: What you need to know about the current inflation landscape

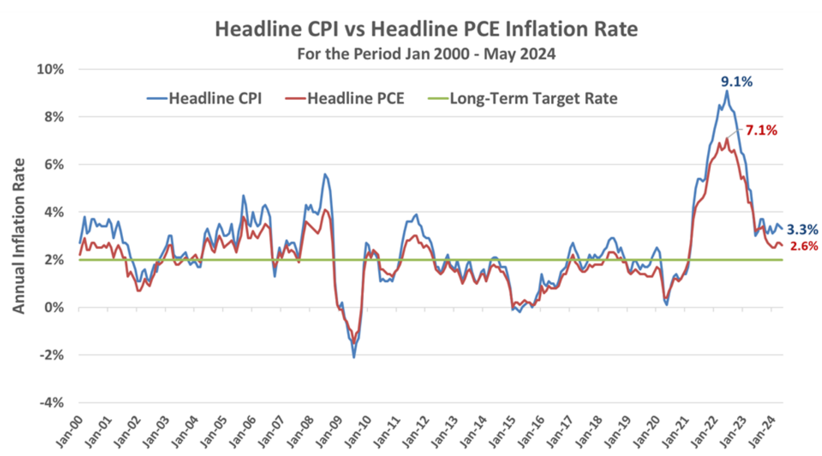
In this edition of the Market Snapshot, we're taking a brief look at inflation, which has become a central topic of discussion in the news and among U.S. consumers. A high inflation rate can create substantial uncertainty about the future, causing consumers to worry about further price increases, which can lead to reduced spending and potentially higher saving as a precaution against potential financial difficulties.

While the rate of inflation has been declining, the overall price level remains relatively high by more recent historical standards, leading to public concern. Any disconnect between economists and the public likely lies in how they perceive inflation. Economists focus on the rate of inflation, which has decreased over the past year. However, the public is more concerned about the level of prices, especially when it comes to essentials, like groceries.

In fact, a recent Economist/YouGov survey showed 22% of consumers identified inflation/prices as their most important concern, compared with only seven percent who cite jobs and the economy. A January 2024 survey from "Data for Progress," similarly found that 68% of those who put inflation and prices first named the cost of food as their principal concern, followed by housing (17%), utilities (8%), and gas (3%).

What Is Inflation? What has the Average Annual Inflation Rate been for Most of the 2000s?

Inflation means that, over time, consumers can buy less with the same amount of money. Inflation typically rises slowly and is often unnoticed by consumers. In fact, from January 2000 through December 2021, the "headline" Consumer Price Index (CPI) increased on average 2.1% annually, while the "headline" Personal Consumption Expenditures Index (PCE) increased on average just 1.8% annually.



Sources: The Bureau of Labor Statistics and The Bureau of Economic Analysis

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A moderate amount of inflation indicates a healthy economy, as growing demand for goods and services pushes prices slightly higher, benefiting workers through increased wages driven by higher demand for labor. In an economic growth phase, demand often exceeds supply, allowing producers to raise prices and increasing inflation, described as "too many dollars chasing too few goods," which reduces the purchasing power of money. As economic growth slows, demand eases, and the supply of goods increases relative to demand, leading to a decline in the inflation rate, a process known as disinflation.

Price changes in specific goods, such as oranges affected by frost or parking during a sporting event, are due to supply or demand shifts and are not considered inflation, as these price increases are usually temporary and affect only a few items. Inflation, involving widespread price increases, poses challenges for people on fixed incomes, as their money doesn't stretch as far, forcing them to cut back on non-necessities like travel, movies, or dining out, and, if inflation is high, even on necessities like utilities and food.

How is Inflation Measured?

So how can we tell when inflation is happening and by how much? We do so by looking at the prices of many items over time. Government statistical agencies regularly gather information about the prices of thousands of goods and services. They then organize the prices into categories such as "transportation" and "apparel." These prices are combined into various categories and reported in various price indexes.

There are two common measures of inflation in the US today: the Consumer Price Index (CPI) released by the Bureau of Labor Statistics and the Personal Consumption Expenditures Price Index (PCE) issued by the Bureau of Economic Analysis. The CPI probably gets more press, in that it is used to adjust social security payments and is also the reference rate for some financial contracts, such as Treasury Inflation Protected Securities (TIPS) and inflation swaps. However, the Federal Reserve states its goal for inflation in terms of the PCE – something you should keep in mind!

What is the Consumer Price Index (CPI)?

The Consumer Price Index, produced by the Bureau of Labor Statistics (BLS), is the most widely used measure of inflation. The primary CPI is designed to measure price changes faced by urban consumers, who represent 93% of the U.S. population. However, it's an average, and doesn't reflect any particular consumer's experience. Everyone's basket of goods tends to be different. For example, a family of four's basket of goods and the inflation on them could be very different than that of a couple of "empty nesters."

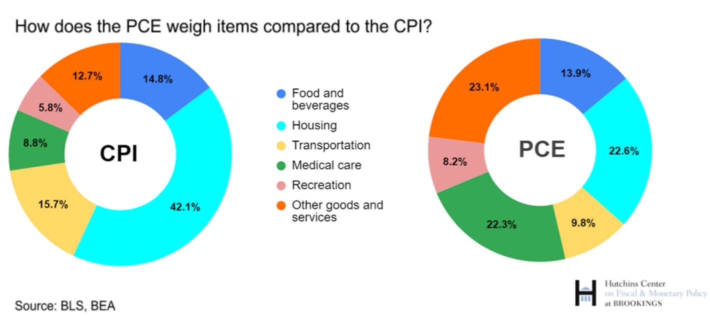
The CPI is constructed each month using 80,000 items in a fixed basket of goods and services representing what Americans buy in their everyday lives – from gasoline at the pump and apples at the grocery store to cable TV fees and doctor visits. The BLS uses a survey of American families called the Consumer Expenditures Survey to determine which items go in the basket and how much weight to assign to each item. Different prices are weighted according to how important they are to the "average" consumer. For instance, Americans spend more on chicken than tofu, so changes in the price of chicken have a greater impact on the CPI.

What is the Personal Consumption Expenditure Price Index (PCE)?

The PCE price index is also known for capturing inflation (or deflation) across a wide range of consumer expenses and for reflecting changes in consumer behavior. The latter is an important difference. For example, if the price of beef rises, shoppers may buy less beef and more chicken. Also, BEA revises previously published PCE data to reflect updated information or new methodology, in hopes of providing consistency across decades of data that's valuable for researchers. The "core" PCE price index is primarily used for macroeconomic analysis and forecasting and is the preferred inflation metric that the Federal Reserve uses in formulation monetary policy.

What Accounts for the Difference Between the Two Inflation Measures?

Both indexes calculate the price level by pricing a basket of goods. If the price of the basket goes up, the price index goes up. But the baskets aren't the same, and it turns out that the biggest differences between the CPI and PCE arise from the differences in their baskets.



Source: The Brookings Institute

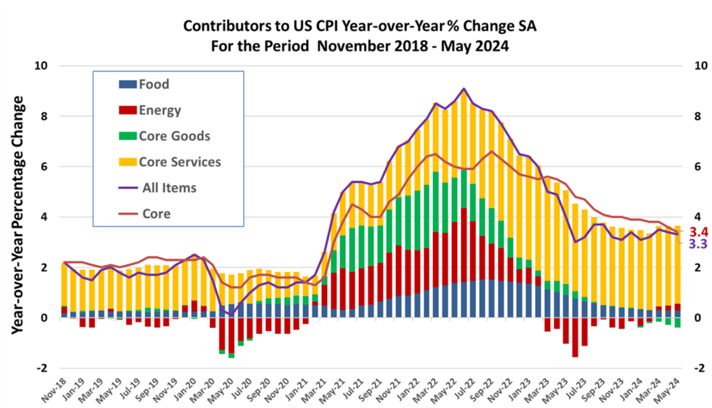
The first difference is sometimes called the "weight effect." In calculating an index number, which is a sort of average, some prices get a heavier weight than others. People spend more on some items than others, so they are a larger part of the basket and thus receive more weight in the index. For example, spending is affected more if the price of gasoline rises than if the price of limes goes up. As the cart above shows, the two indexes have different estimates of the appropriate basket. Moreover, the CPI is based on a survey of what households are buying; while the PCE is based on surveys of what businesses are selling.

Another aspect of the baskets that leads to differences is referred to as "coverage or scope." The CPI only covers out-of-pocket expenditures on goods and services purchased. It excludes other expenditures that are not paid for directly. Examples include medical care paid for by employer-provided insurance, Medicare, and Medicaid. These are, however, included in the PCE.

Finally, the indexes differ in how they account for changes in the basket. This is referred to as the "formula effect," because the indexes themselves are calculated using different formulae. The details can get quite complicated, but the gist of the matter is that the PCE tries to account for substitution between goods when one good gets more expensive. Thus, if the price of bread goes up, people buy less bread, and the PCE uses a new basket of goods that accounts for people buying less bread. In contrast, the CPI uses the same basket as before.

What Caused the Spike in Inflation?

In 2020, the Covid-19 pandemic caused global lockdowns and travel restrictions, disrupting supply chains and leading to delays and increased costs. The US government and Federal Reserve implemented fiscal and monetary measures, including stimulus checks and expanded unemployment benefits, boosting disposable income and consumer spending, which drove up demand and prices. Labor shortages and higher wages also contributed to price increases. During lockdowns, spending shifted from services to goods, leading to higher prices for home-related items. As restrictions eased, a gradual shift back to services spending occurred, driven by a desire for normalcy, increasing demand and prices in sectors like travel, dining, and entertainment. This transition was influenced by the pace of reopening, consumer confidence, and economic factors.



Source: Bureau of Labor Statistics

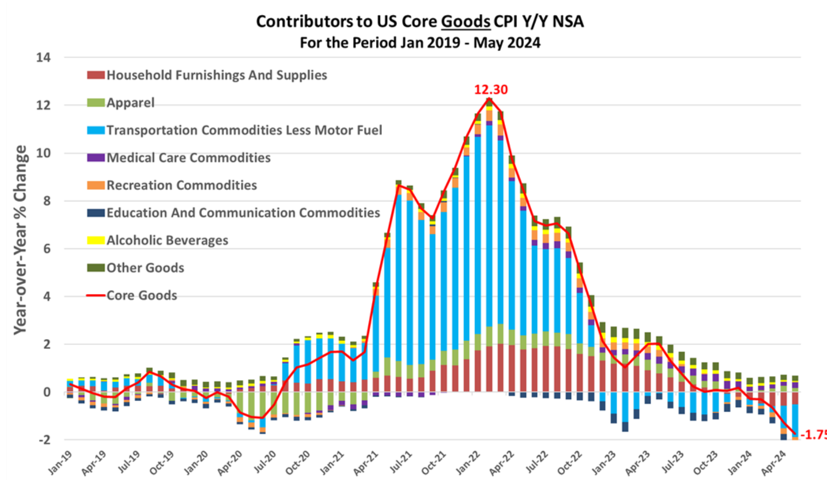
Where does the Inflation Rate Stand Today?

The Consumer Price Index – a key measure of underlying US inflation – stepped down for a second month in May, a pleasant surprise for Federal Reserve officials looking for signs that they can start to lower interest rates. Both the headline and core CPI both came in lower than the consensus expectations in May. Headline CPI was flat m/m, corresponding to a year-over-year change of 3.3% (vs. 3.4% prior). Declining energy prices drove the headline print, with gasoline prices falling 3.6% in May on a seasonally adjusted basis.

The core consumer price index — which excludes food and energy costs — climbed 0.2% from April, Bureau of Labor Statistics figures showed. The year-over-year measure rose 3.4% (vs. 3.6% prior), cooling to the slowest pace in more than three years. Economists see the core gauge as a better indicator of underlying inflation than the overall CPI.

Is Goods Inflation Still Rising?

Not really. It might not feel like it but core goods prices were flat month-over-month in May. A key driver was a seasonally adjusted 0.5% drop in new-car prices (vs. -0.4% prior), though used-car prices gained 0.6% (vs. -1.4% prior). Prices declined for many goods such as recreation commodities and electronics, as businesses slash prices with households pulling back on discretionary spending. Apparel prices fell, likely due to declining import prices as the dollar appreciated in May.



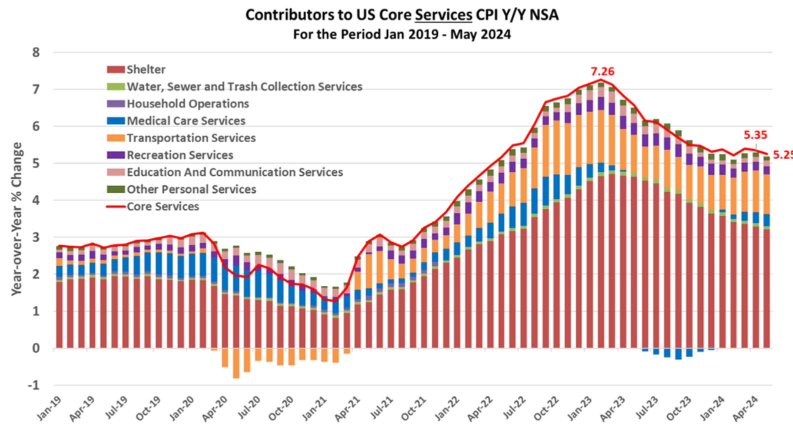
Source: Bureau of Labor Statistics

<u>Perhaps more importantly, the share of core goods and services experiencing outright deflation increased to approximately 51% in May (vs. 38% prior). Additionally, approximately 32% of core spending categories showed 4.0% annualized inflation or more – down significantly from 45% in April.</u>

Unlike services, a sustained decline in the price of goods over most of the past year has largely been providing some relief to consumers – though economists expect that to be a less reliable source of disinflation going forward.

So, It's Services Inflation that is the Problem?

Yes, core services inflation played a particularly prominent role in May's soft core CPI print. That category has been a major driver of price pressures in recent months. However, airfares dropped by the most in almost a year. Prices for cable, satellite and streaming services also declined by the most in nearly 20 years.



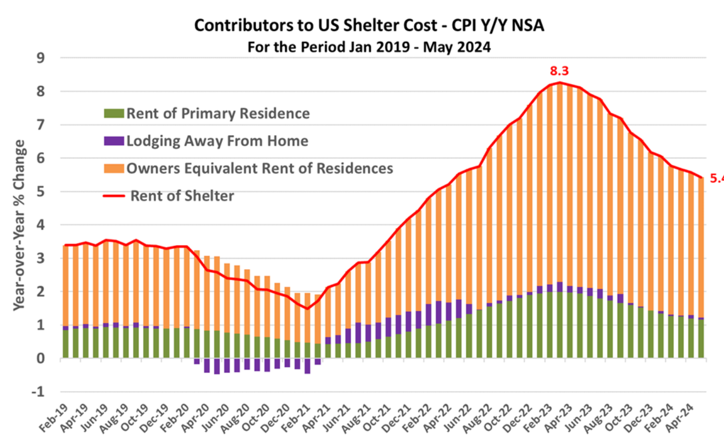
Source: Bureau of Labor Statistics

Core services inflation rose only 0.2% m/m, a significant cooling from the 0.4%-0.7% monthly pace over the past six months. Within core services, key contributors to the slowdown were auto insurance (-0.1% vs. 1.8%) and airfares (-3.6% vs. -0.8% prior). Recreation services (-0.2% vs. 0.3% prior) and other personal-care services (-0.3% vs. 1.1% prior) also saw price declines. A clear theme is that households are cutting back on discretionary spending.

Why has Shelter Inflation has been a Major Driver of Services Inflation

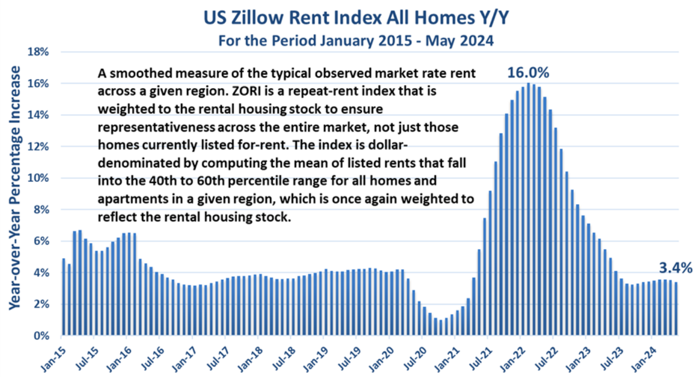
Shelter prices, which is the largest weighted category within services, climbed 0.4% m/m in May. "Owners' equivalent rent" – a subset of shelter, which is the biggest individual component of the CPI – advanced at a similar pace.

For actual renters, the primary cost of shelter is straightforward: it's the actual rent they pay. But for homeowners, the situation is more nuanced. Instead of paying explicit rent, they "pay" themselves by forgoing potential rental income from their property. It's called owners' equivalent rent (OER) and isn't an actual out-of-pocket expense. It's essentially the implicit rent that owner-occupants would pay if they were renting their homes, excluding furnishings and utilities.



Source: Bureau of Labor Statistics

In May, primary rents and owners-equivalent rent was in line with many analyst expectations, increasing 0.4% m/m, the same as in April. However, market rents suggest both OER and primary-rent inflation will slow throughout 2024, with annual overall shelter inflation potentially falling to 4.0% by year-end (from 5.5% in April). However, the moderation in rent inflation has been slower than many analysts expected over the past year – flagging a risk that the disinflation process for housing rents may take longer than the market currently anticipates.

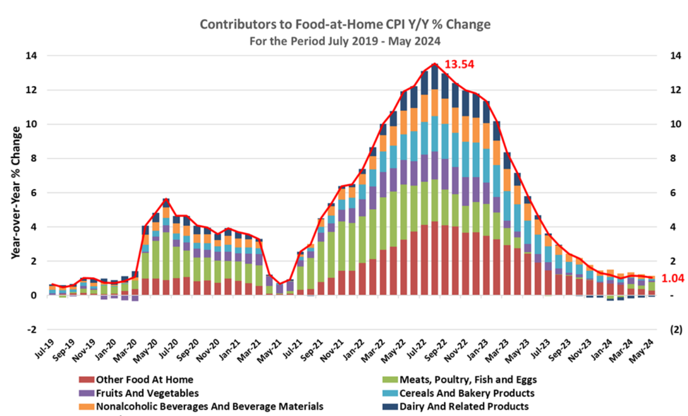


Source: Zillow

Perhaps a better real-time measure of the general rental rate growth is the Zillow Observed Rent Index (ZORI), which showed that observed rents were up by 3.4% in June compared to last year. That's slower than the pre-pandemic days of 2018 and 2019, when rents were strutting at around 4.1%. Consequently, current market rents suggest that shelter inflation should decline in the coming months.

What is the Inflation Rate of Groceries?

While still relatively high, grocery inflation has been cooling. On a year-over-year basis, grocery prices were up about 1% in May – and down from the 5.8% spike the previous 12-month period, according to Labor Department data. The Federal data showed certain food prices are dropping. Apples, for instance, are down more than 13% from a year ago, while ham is down 6%.



Source: Bureau of Labor Statistics

However, grocery prices are still up about 25% when compared to 2019, and high bouts of inflation in recent years are still fresh on many consumers' minds. Lower-income families and seniors have been hit the hardest with the New York Federal Reserve Bank noting they've experienced above-average inflation due to their higher proportional spending on food.

What is the Inflation Outlook?

As you're aware, we've experienced a period of elevated inflation over the past couple of years, impacting our spending patterns and various aspects of our economy. However, recent trends indicate inflation has been receding. This is a promising sign for several reasons.

First, with inflation cooling, we can hopefully expect prices for goods and services to stabilize in the not-to-distant future. This should mean less volatility in your day-to-day expenses and more predictability in your budgeting and financial planning.

Second, as inflation recedes, the purchasing power of your income and savings strengthens, helping to maintain the value of your money and supporting your ability to achieve your financial goals.

Lastly, as inflation recedes, the Fed is expected to cut interest rates. Lower interest rates can benefit borrowing costs for mortgages, loans, and other credit products, making large purchases and investments more affordable. Additionally, easing inflation can lead to increased confidence in the financial markets. Rest assured, we are closely monitoring these developments and continuously adapting to these changing market dynamics. If you have any questions or concerns, please don't hesitate to reach out. Together, we'll navigate these changes and make the most of the opportunities ahead.

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