Wealth Management

July 11, 2024 | CPI Report Card

CPI GRADE

A+

Inflationary pressures not only cooled further in June but posted the first outright monthly decline since the depths of the pandemic in 2020.

Headline and core inflation both fell to, or below, the Fed's 2% target in the 2nd quarter, setting the stage for a potential first rate cut in September, in our view.

Key Julyl Release Dates:

Consumer Price Index (CPI)
July 11

Producer Price Index (PPI)
July 12

Import Price Index (IPI)
July 16

Personal Consumption Expenditures (PCE, the Fed's preferred inflation gauge)
July 26

RBC WM Inflation Report Card
July 26

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Do three months of soft inflation data make a trend? In our mind, and clearly in the minds of market participants, the answer is yes. Measures of headline and core inflation both came in below nearly all estimates based on the Bloomberg Consensus Survey, with headline prices falling month-over-month for the first time since May 2020.

The Federal Reserve has been looking for "greater confidence" that inflation remains on track back toward the 2% annual target, and after solid inflation data over the course of the second quarter, we suspect that most at the Fed will feel that they now all but certainly have it.

A resumption of disinflationary progress paired with recent, and notable, softening in the labor market backdrop could likely set the stage for a September Fed rate cut, in our view.

Key Stats: Headline inflation fell -0.1% in June compared to consensus looking for a +0.1% rise; the monthly pace equal to a 2.0% annual rate is +0.2% per month. That brought the annual inflation rate down to 3.0% compared to consensus of 3.3%. 3.0% marks another fresh low since inflation peaked at 9.1% in June 2022.

Core inflation, excluding the volatile food & energy components, rose just +0.1% in June against consensus looking for +0.2%. The annual rate fell to 3.3%, again a fresh low since core inflation peaked at 6.6% in September 2022.

Core goods prices, especially for new & used cars, have now been declining on an annual basis for the past six months. But the more encouraging disinflationary progress has been on the services prices front in the past couple of months.

Core services prices rose just +0.13% in June as recent pressures emanating from housing and insurance costs appear to have finally broken. As we discuss in detail on the following page, softer inflation data is mostly a ''good news is good news story', but falling airfares carry the risk that 'good news is bad news' as it relates to the economic growth outlook.

Airfares dropped 5.0% in June, and are down 5.1% over the past year, as carriers warned this week that the outlook for the summer travel season could look soft as consumers pull back on spending amid a glut of capacity following the post-pandemic boom.

Impact on the Fed: At the June Fed meeting, policymakers were essentially split between projections of one and two rate cuts this year, though the signal from that meeting was muddied by the fact that the previous CPI report was released just prior to its conclusion.

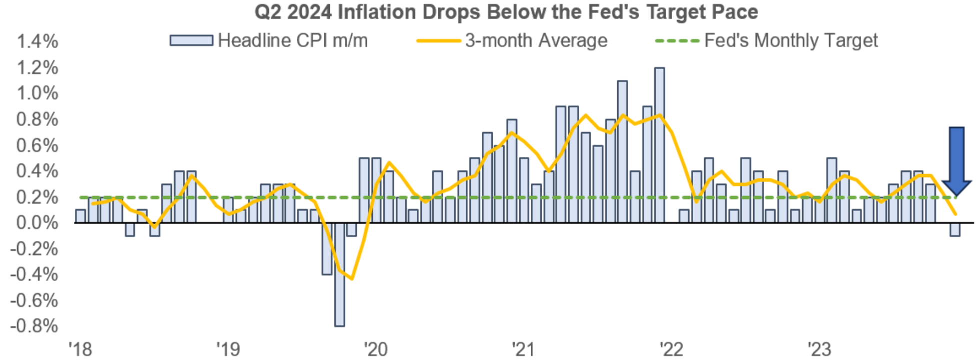
Though the Fed has been laser focused on inflation, in recent months we have sensed that focus shifting to the other side of its dual mandate: maximum employment. Fed Chair Powell noted this week during congressional testimony that "elevated inflation is not the only risk we face. The latest data show that labor-market conditions have now cooled considerably from where they were two years ago—and I wouldn't have said that until the last couple of readings."

Given that it now appears that inflationary pressures have also cooled considerably, we feel confident that the Fed will use its next meeting on July 30-31 to set the stage for a first rate cut at the September 17-18 meeting.

Market Reaction: Treasury yields have dropped sharply this morning. The 2-year Treasury note yield is down 13bps to 4.49%, the lowest since March. The benchmark 10-year Treasury yield is also down more than 10bps to just 4.18%. The chances of a September rate cut now stand at 100%, up from 50% a month ago.

Inflation Outlook: As noted on the following page, the leading indicators we track continue to flag low risks of another inflation reacceleration, and that further disinflationary progress remains in the pipeline.

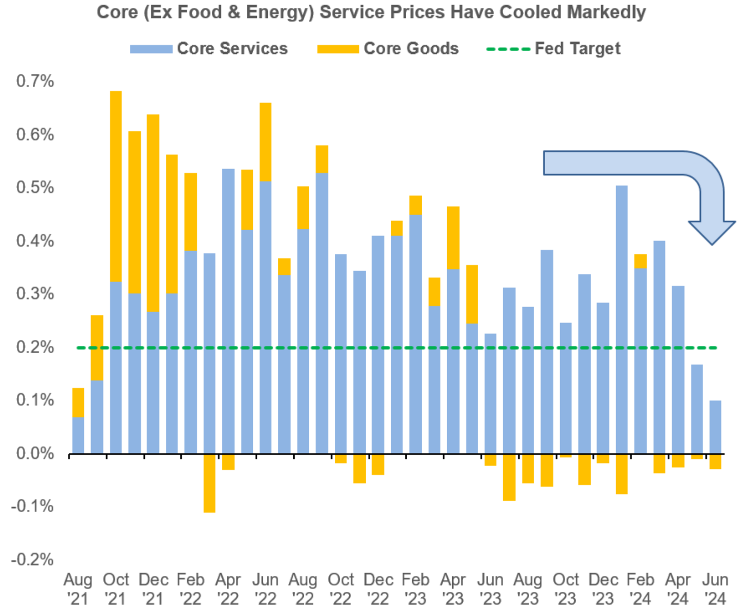
Q2 2024 Inflation Drops Below the Fed's Target Pace



Source: RBC WM, Bloomberg, BLS

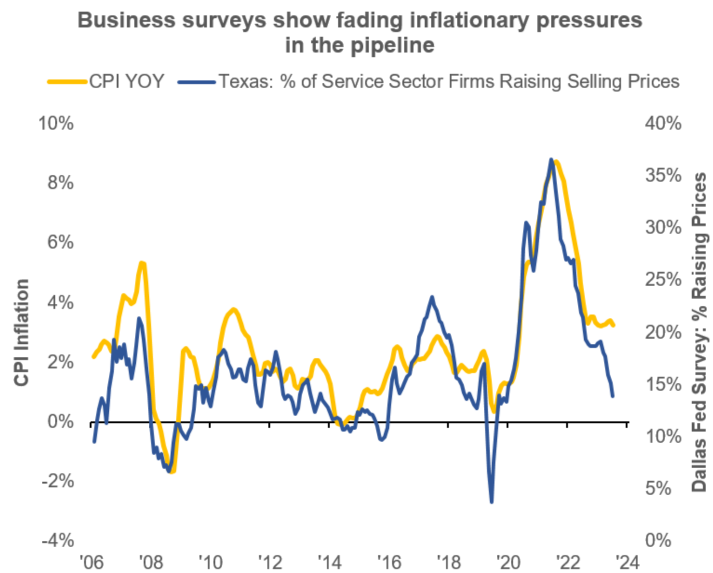
Charting the Data

- While the Fed pays close attention to price trends broadly, in recent months and quarters policymakers have been keenly focused on service sector inflation.
- As we have discussed frequently, the story of core services inflation of late has been a story about rent and auto insurance inflation, but both are lagged inflation indicators based on past price increases.
- And as expected, the story has turned the page to a more positive chapter. In June, shelter inflation contributed just +0.1% to the overall index, while motor vehicle insurance costs added a scant +0.04%. Overall, core services rose +0.13% in June, and are up 5.06% y/y, a fresh low since the peak of 7.26% in February 2023.
- However, airfares fell for the fourth month in a row. While positive for inflation, it may set off alarm bells as airlines have recently warned about soft consumer demand this summer, amid broader concerns that consumers are tightening their belts as excess savings have been run down.



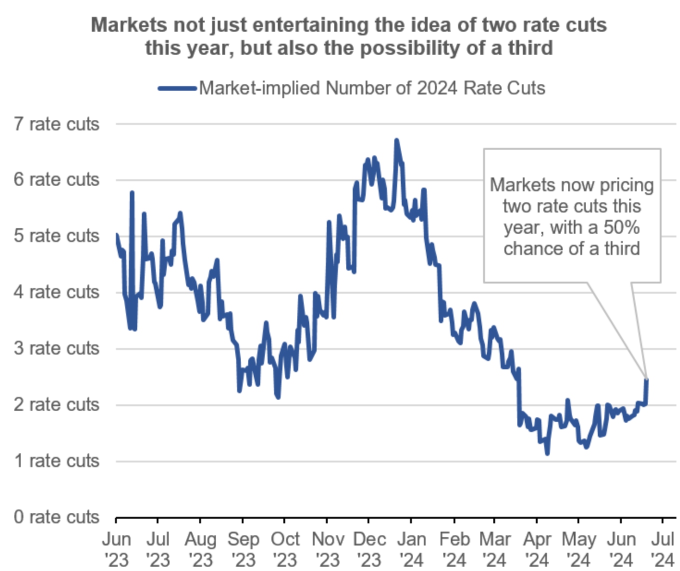
Source: RBC WM, Bloomberg, shows contribution to monthly changes

- As noted on the first page, we track a number of survey-based data on prices, most which have a high correlation with—and tend to modestly lead—official inflation statistics.
- This month, with the focus on services inflation, we once again look at the Dallas Fed Texas Service Sector Outlook Survey and its sub-index on the percentage of firms raising selling prices. Its correlation with CPI has been 80% since 2007.
- After a brief pause in recent months—coinciding with fears that disinflationary progress had stalled—it has continued to fall sharply.
- This index jibes with other survey-based measures of inflation, many of which are also pointing in the right direction. Putting it all together, we see few remaining sources of a potential reacceleration in inflation, supporting our call for a first Fed rate cut in September.



Source: RBC WM, Bloomberg; shows 3-month rolling averages

- Given the sustained positive developments on the inflation front in recent months, it should come as no surprise that markets are once again pricing multiple rate cuts this year.
- After the uptick in inflation over the first three months of the year, markets have waffled between one and two rate cuts by the end of 2024. Following the recent turn in inflation, markets are fully priced for two rate cuts this year, likely beginning in September followed by one in December.
- However, markets are pricing equal chances of a third rate cut—presumably delivered at the November meeting. However, while we agree with two cuts this year, in our view we would likely need to see a further deterioration in the labor market backdrop in order for the Fed to deliver three rate cuts at three consecutive meetings later this year.



Source: RBC WM, Bloomberg