Advisory Blog

Timely insights on the issues that matter most to advisors and their clients

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Fed | Income | Inflation | Markets and Economy

Inflation Continues to Boil, with No Simmer in Sight

By: Andrew Szczurowski, CFA | July 14, 2022

Boston - The sun is the center of our solar system and the nonfarm payroll report used to be what the bond market and the Federal Reserve revolved around. While we don't have our own James Webb Space Telescope, there is no doubt the monthly Consumer Price Inflation (CPI) report is at the center of the bond and Fed universe now.

CPI surprises to the upside

The highly anticipated CPI report on July 13 exceeded almost every economist estimate, with headline inflation rising 1.3% month over month and 9.1% year over year. We would have to go back to 1981 to see headline inflation at these levels. Core CPI excluding food & energy prices also surprised to the upside, rising 0.7% month over month and 5.9% year over year.

Coming into the report, everyone knew that rising energy prices from the spike in oil and gas in May and early June would show extremely elevated energy inflation contributions: Energy was up 7.5% month over month. While the recent sharp decline in oil will provide some relief to consumer wallets in the coming months, now other sectors are also starting to boil:

- General food prices rose 1% month over month and are up more than 10% over the past year.
- Apparel prices increased 0.8% month over month.
- New and used vehicle prices gained 0.7% and 1.6%, respectively, month over month.
- Even motor vehicle insurance rose 1.9% month over month, and motor vehicle repairs were up 2% month over month.

Home prices and rent in the spotlight

Last but not least, it is well televised how much home prices have risen over the last two years. Just in the past 12 months, the Case-Shiller Home Price Index has increased 21% year over year. What is less well known is that while shelter makes up 32% of the Core CPI index, there has been a long — roughly 12 month — lag between moves in home prices and moves in the rent component of the index, which makes sense because rents are typically renewed once a year.

Many large metro areas saw a short-term decline in rents at the beginning of the pandemic. Now, however, higher housing costs, taxes, insurance, mortgage rates and so on are finally starting to push through to the shelter/rent component of CPI, which rose 0.6% month over month to 5.6%. Much more substantial gains are likely ahead given the lag from home prices to rent.

This highlights one of the Fed's challenges over the coming months: Even as goods prices could potentially decline, prices in many parts of the service sector are likely to stay elevated.

Airfares provide one bright spot

It's not all bad though, if we want to take one positive away from the CPI report. For anyone lucky enough to have a plane arrive at its intended destination, airline fares fell 1.8% after rising over 30% over the previous two months. However, this isn't hedonically adjusted, as economists say, to account for all the recent flying headaches.

Implications for the bond market

So what does it mean for the bond market? In my view, if the nonfarm payroll report on July 8 didn't solidify another 75-basis-point rate hike in July from the FOMC, this inflation report certainly leaves no doubt that at least 75 basis points will be coming. In fact, the market is now pricing in over a 50% chance of a 100-basis-point hike from the FOMC on July 27.

The U.S. Treasury curve flattened massively, as we would expect after such a high inflation report leads the market to price in an even more aggressive Fed in 2022 —with the year-end federal funds rate now at 3.61%. The 2 year-10 year Treasury curve is now inverted by 21 basis points — the most inverted level since 2000.

What is harder to understand is the bond market's confidence that the Fed will bring inflation under control so quickly over the next five months, as reflected in the expectation that the Fed will be cutting rates in early 2023. Looking at the Eurodollar curve, the market is now pricing in almost a full 25-basis-point cut in the first quarter and over three cuts by year-end 2023.

While cuts would inevitably come one day — if the economy's in a recession and inflation has returned to normal — it's hard to see the Fed declare victory over inflation with rate cuts two quarters from now. Not when policymakers are on thin ice over their credibility to fight inflation after letting it run at the highest rate in four decades.

Bottom line: Today's high inflation report is likely to force the Fed to keep trying to slam the breaks on the economy to cool inflation. Market participants may want to bear in mind that this is not the same Fed who yielded to every risk asset decline over the past few cycles. This cycle they are behind the curve on inflation.

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