Inflation Handbook:
Core Prices — More Disinflation Across Key Areas

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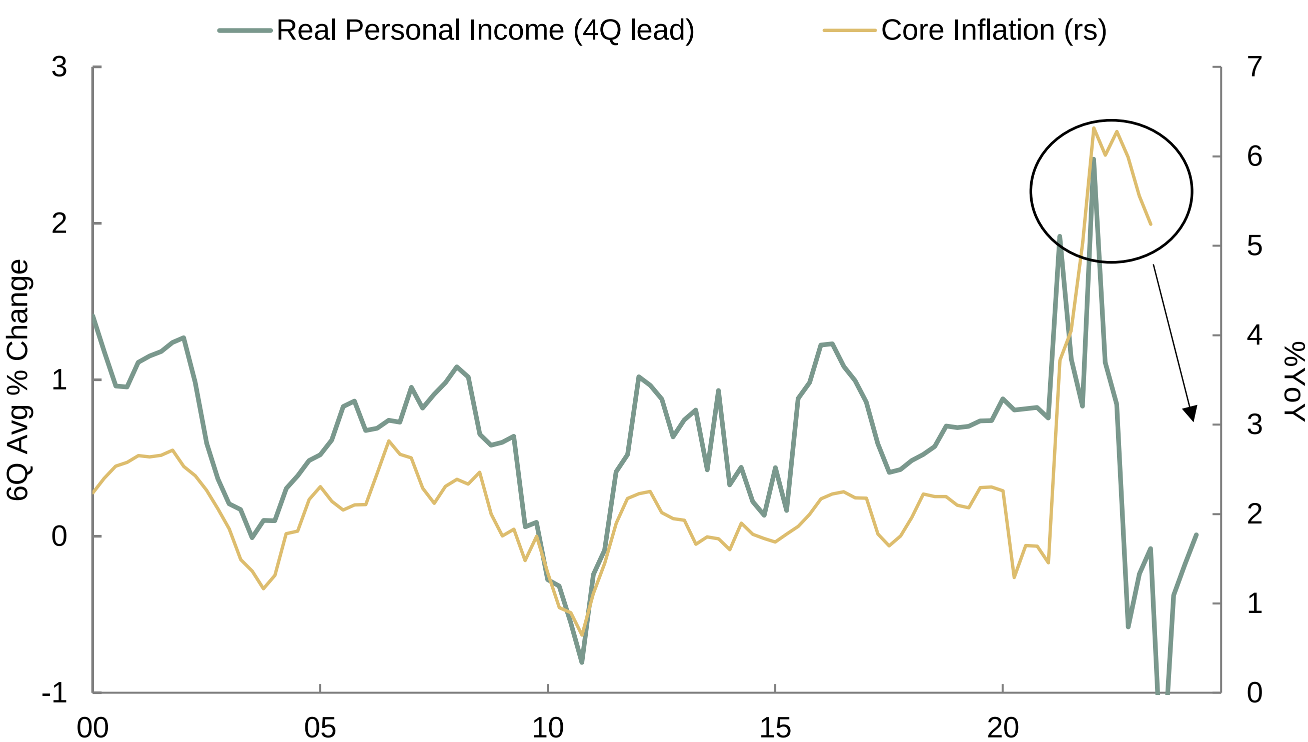
Introduction

Early last summer, we argued that inflation was primed to slow broadly as the result of both a supply side over-response and slowing demand. Our view is that many of these forces will continue to soften core prices in the months ahead. Here we discuss the key inflation forces we are monitoring and outline our core inflation forecast.

The Fed views core prices as both the best indication of underlying supply/demand imbalances and the purest inflationary signal. Recently, Fed Chair Powell has focused in on core services prices ex housing to determine when their inflation mandate has been satisfied. <u>Inflation, broadly speaking, has broken lower especially for the items that are most central to Fed decision making and households' bottom lines.</u>

Relief Coming for Core Prices

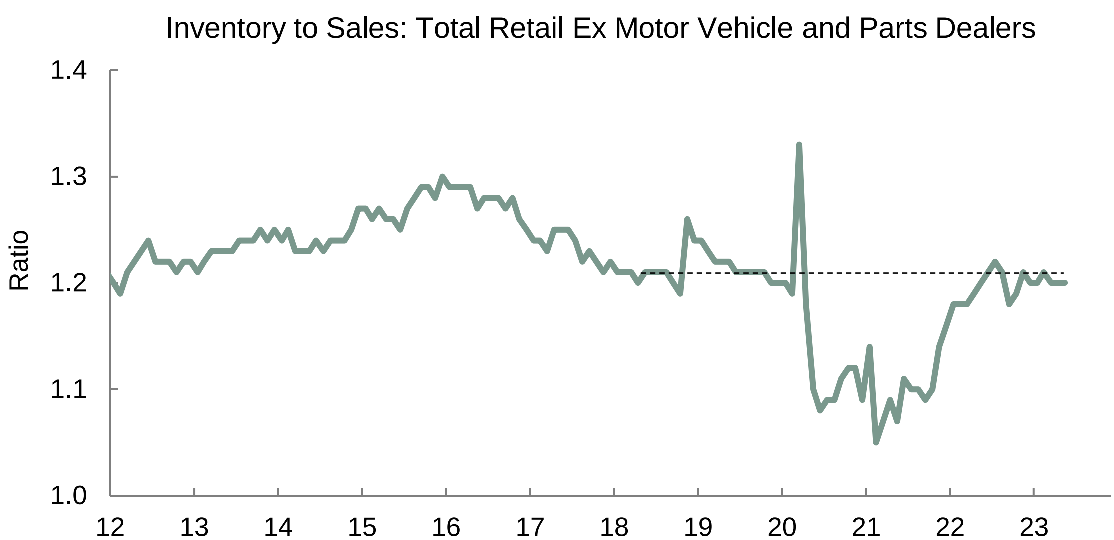
The best predictor of core inflation (which strips out volatile food and energy prices) is the trajectory of real personal incomes. Why? As purchasing powers rise, people spend more, and when they spend more, firms raise prices. Empirically, this process takes one year (shown below). <u>The real income data suggests that core prices should print at 3.2% YoY by the end of 2023 (from 4.7% at present) before heading to 1.5% by yearend 2024.</u>

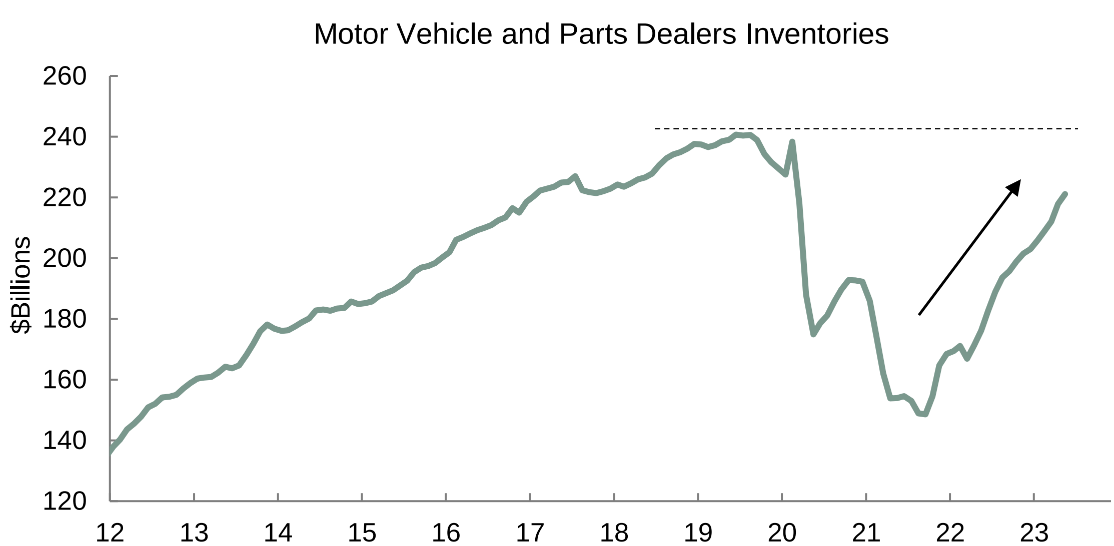


Sources: BEA, BLS, Haver, SMBC Nikko

Goods Supply Back to Normal — Disinflationary

Retail inventories are finally back to normal levels relative to sales. This comes after record inventory growth in 2021 and near record growth rates yet again in 2022. The lone sector which has yet to fully recover is autos, where inventories are quickly recovering at the same time that rising interest rates should dampen demand. This is key to our view that goods inflation will move materially lower.



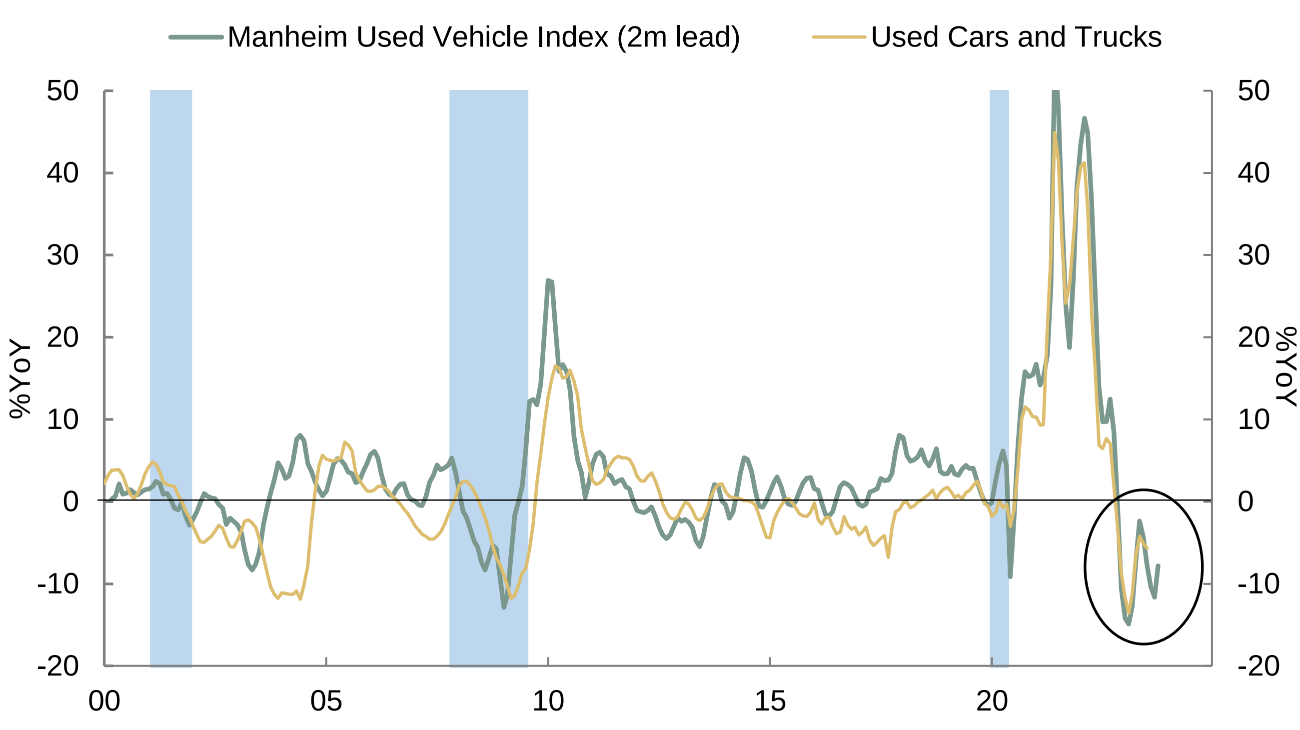


Sources: Census, Haver, SMBC Nikko

Autos — Disinflationary

Although used car and truck prices only carry a 2.8% weight in the consumer price index, do not forget that back in 2020 and 2021, auto prices were the canary in the coal mine as the sector was the first to succumb to widespread supply chain backlogs. Eventually this plagued the broader economy.

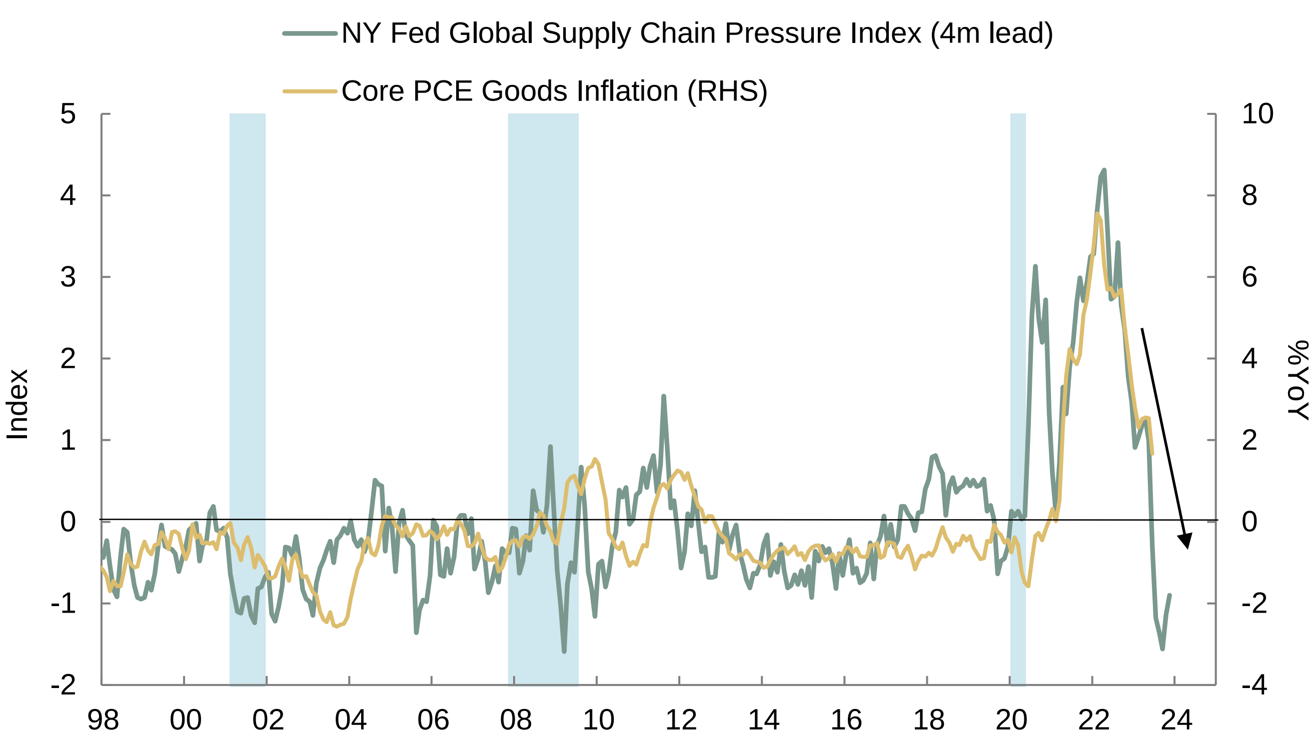
Used car and truck prices are now down 5.6% YoY, and down almost 9% from their January 2022 peak. As judged by the Manheim Used Vehicle index, which tends to lead the BLS' measure of used car prices by approximately two months (shown below), autos inflation should continue to soften. The lesson here is that supply chain issues are diminishing and thus prices are softening too. <u>Could this again be a leading indicator of inflation? We think so.</u>



Sources: Manheim, BLS, NBER, Haver, SMBC Nikko

Supply Chains — Deflationary

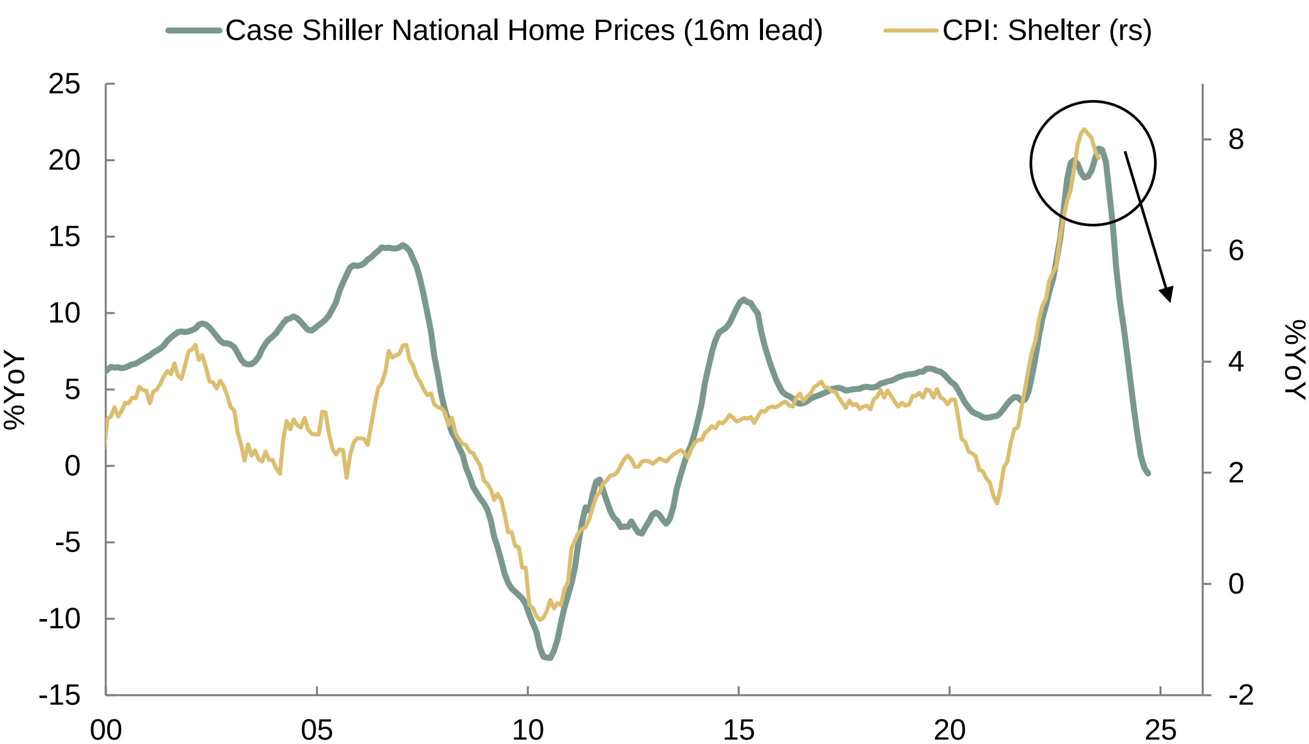
We see auto prices as a leading inflation indicator because they are sensitive to supply chain inefficiencies and interest rates. As for the former, the Federal Reserve Bank of New York has created a supply chain pressure index which leads core goods prices by four months. Amidst a variety of factors influencing goods prices, <u>this one suggests that we could be looking at outright goods *deflation* by yearend!</u>



Sources: NY Federal Reserve, BEA, NBER, Haver, SMBC Nikko

Home Prices Lead Shelter Costs

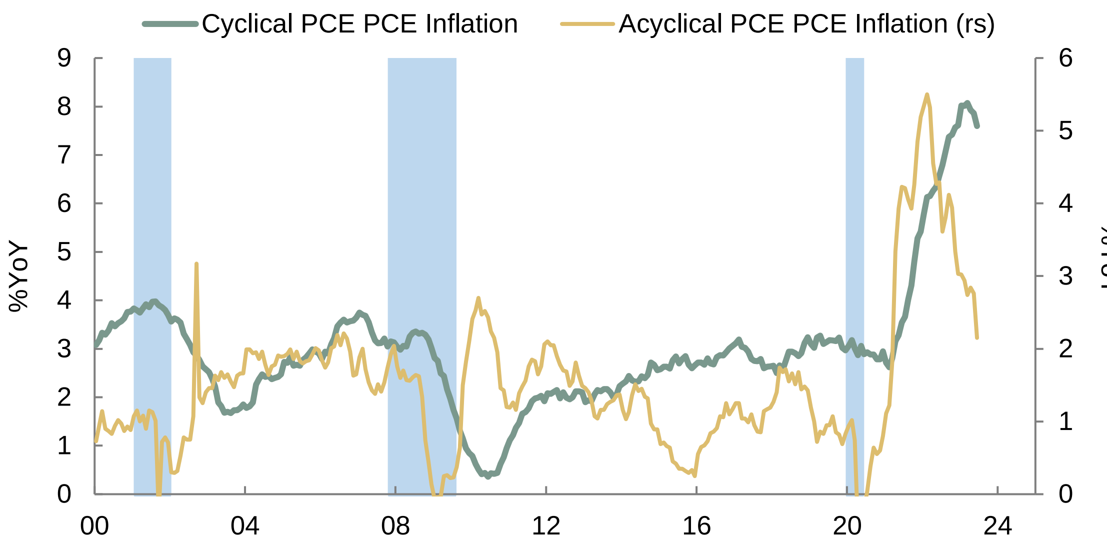
The single biggest component of the consumer price index is shelter with a nearly 35% weight. Where housing costs go, so too does overall inflation. As mortgage rates rose and the demand for home buying dropped, home prices decelerated markedly last year. This is key because historically, home prices lead the BLS' measure of shelter costs, as shown below. This relationship alone tells us that the biggest component of the consumer price index is just beginning a steep decent to somewhere in the 3%-to-4% range. Indeed, <u>modeling this relationship statistically suggests shelter costs should decelerate to 4.7% YoY by yearend 2023 (from July's reading of 7.7%), before falling to 3.3% by July 2024.</u>

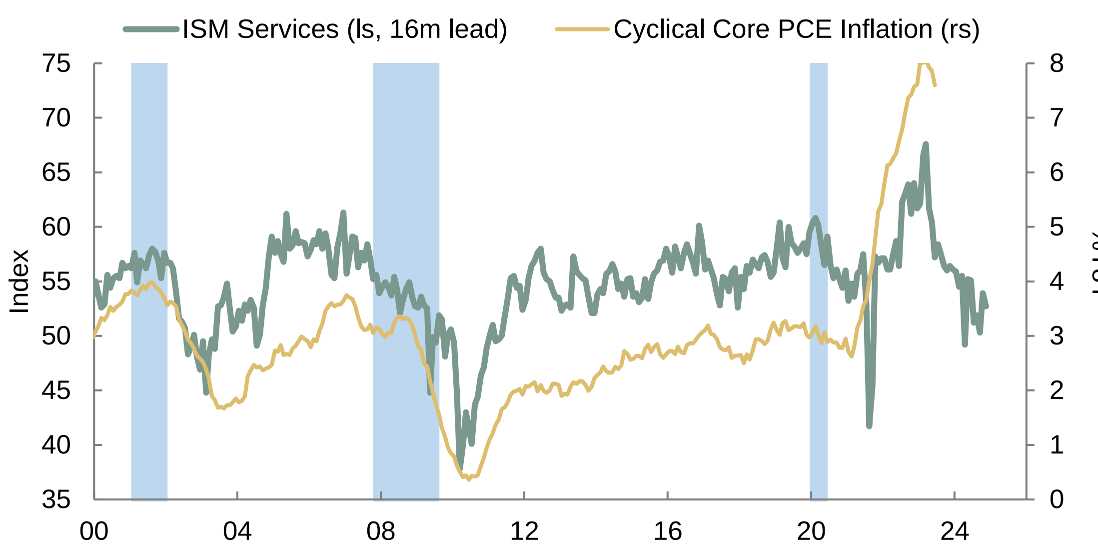


Sources: S&P, BLS, Haver, SMBC Nikko

Goods Prices are Last Shoe to Drop

Inflation can be broken up into a cyclical and acyclical component. Cyclical prices (e.g.: housing, manufacturing) are influenced by Fed policy while acyclical prices (e.g.: education and healthcare) have already plunged. As a result, cyclical prices are the last shoe to drop (see top chart). As monetary conditions tighten further, interest rate sensitive cyclical prices should disinflate. The ISM Services index leads these prices by 16-months and, statistically, suggests these prices should fall to 3.2% and 2.5% by yearend 2023 and 2024.

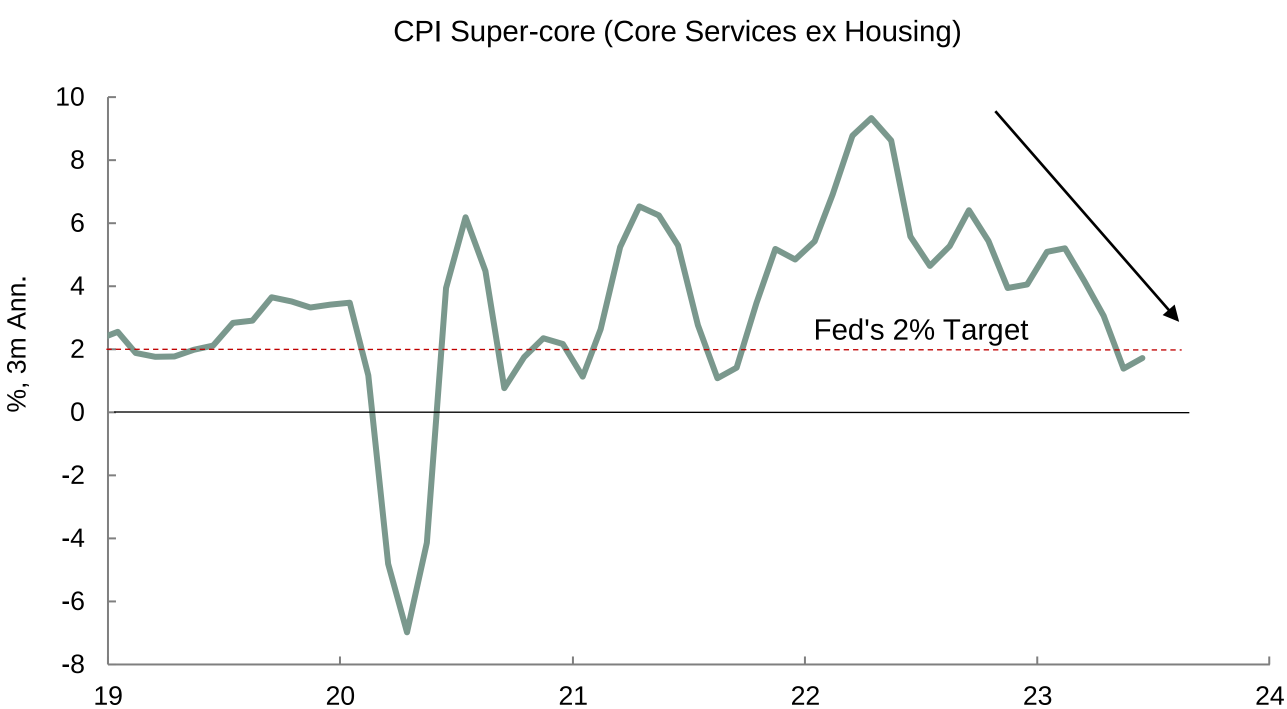




Sources: San Francisco Federal Reserve, ISM, NBER, Haver, SMBC Nikko

Fed's Preferred Inflation Metric Below 2%

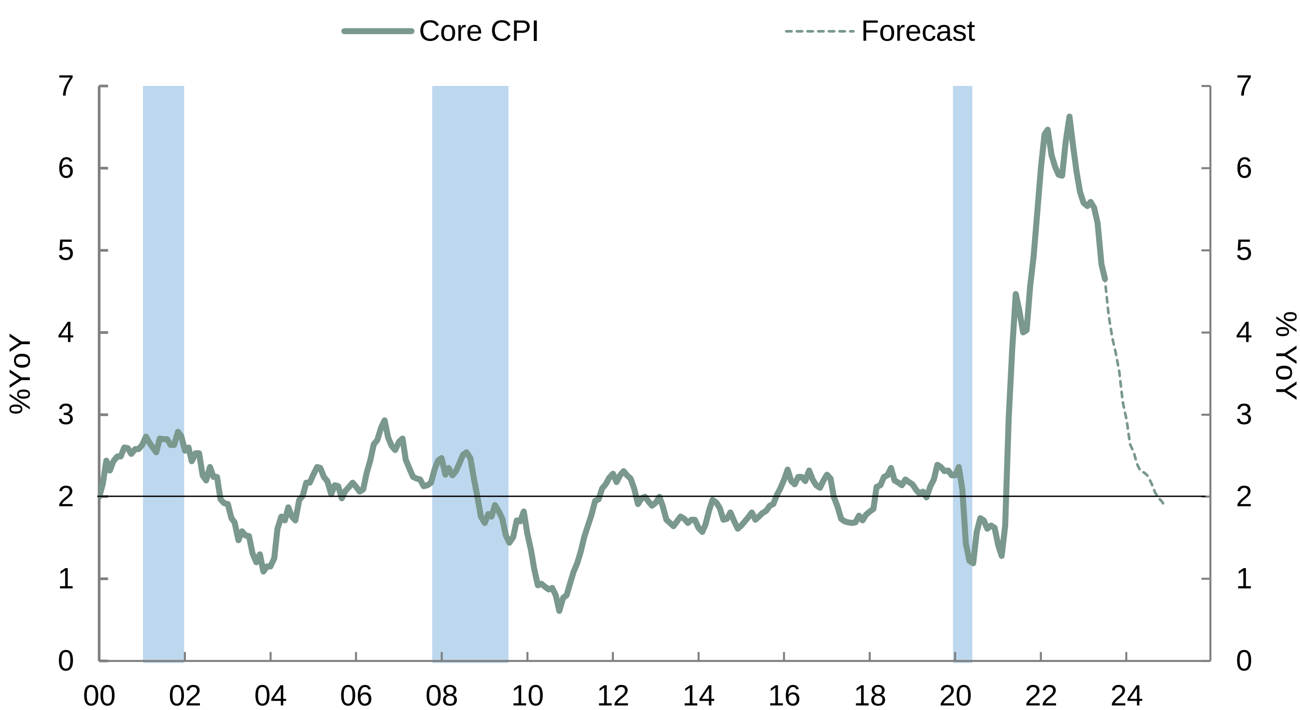
The Fed has homed in on core services prices ex housing as their preferred inflation indicator. On a three-month annualized basis, it has fallen precipitously from 9.3% in May 2022, to just 1.7% in July 2023. Notice how this has occurred despite unemployment remaining at 54-year lows, and flat for the last 12-months.



Sources: BLS, Haver, SMBC Nikko

Conclusion

As demonstrated here, both observed core inflation and its various drivers have fallen quickly this year. <u>These variables, and others, econometrically imply that core CPI will fall to 3.2% YoY by the end of 2023 and further decelerate to just 1.9% YoY by the end of 2024.</u> Such a result would mark a return back to the 2013-2019 average rate of core inflation (1.9%).



Sources: BLS, NBER, Haver, SMBC Nikko

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