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iFlow

MACRO MORNING BRIEFING

July 15, 2024

Slowing Inflation - Good News for the Fed

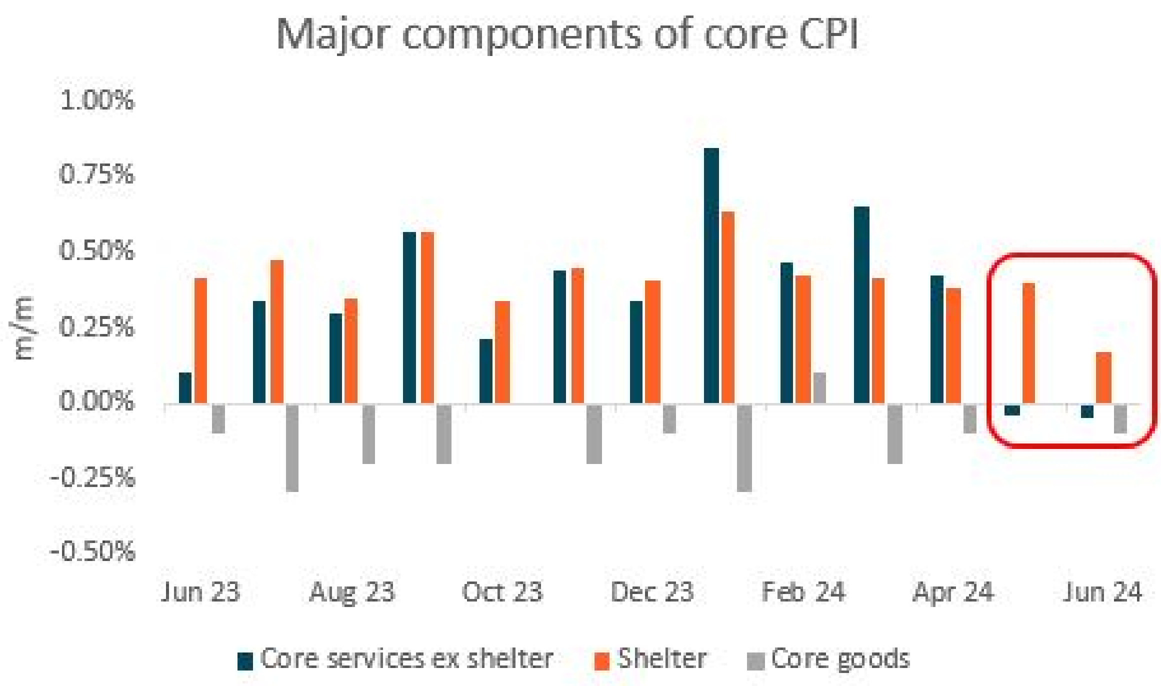
- CPI inflation for June decelerated, bolstering our September rate cut call
- Core services, shelter and goods prices all behaving better
- iFlow shows equity investors selling inflation exposure

Looking Good for September

Last Thursday's good news on CPI inflation makes us ever more convicted that the FOMC will cut interest rates at its September 18 meeting. The overall index was down -0.1% m/m, and the core was up just +0.1%, both below consensus expectations of 0.1% and 0.2%, respectively. Combined with slowing data on the real economy, and Chair Powell's Congressional testimony, in which he stated, "elevated inflation is not the only risk we face," we feel that progress on both elements of the Fed's dual mandate is conspiring in favor of policy easing.

Perhaps the best news in the CPI data, aside from the two main measures discussed above, was that services inflation is not just decelerating, but actually falling. The core services ex-shelter index, which had been sticky and a focus of the Fed's attention recently, has posted negative readings for two straight months, down -0.4% in May, and -0.5% in June. Shelter itself, a major element in the index by weight (nearly 36% of the CPI overall), increased by a modest 0.2%, the slowest increase since January 2021. Core goods prices, the third major element of core CPI, were negative over the month, the 10th time in the last 13 prints this was the case.

All Three Major Core CPI Components Behaving Better of Late

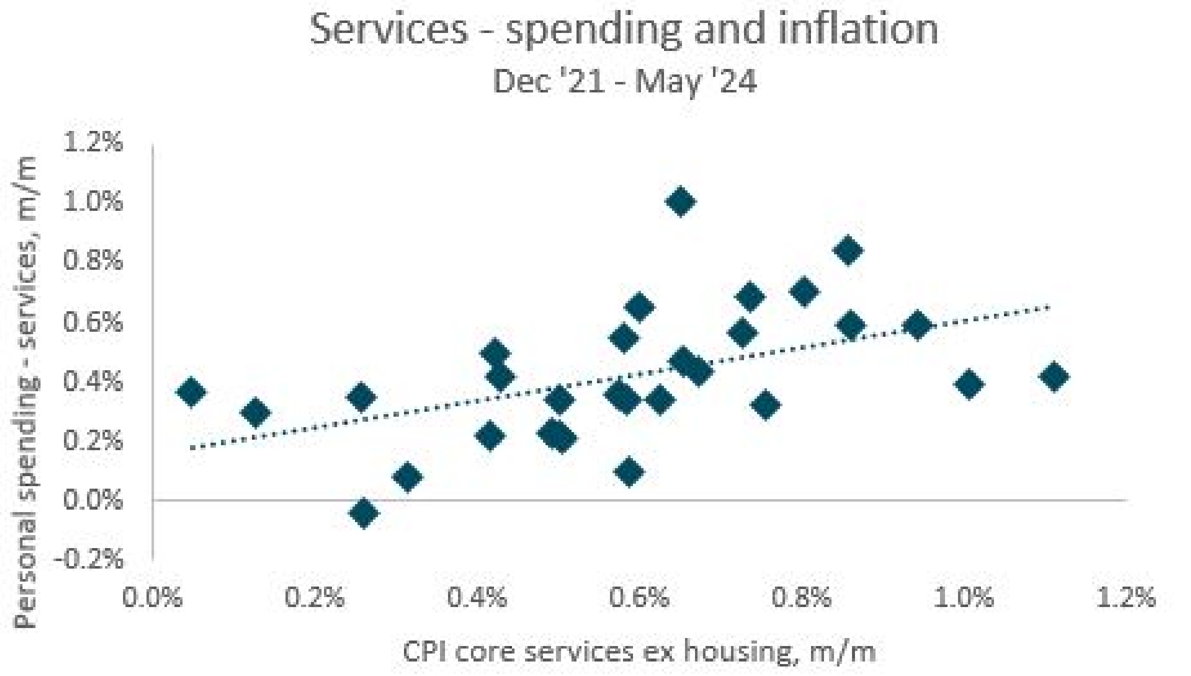


Source: BNY Mellon Markets, Bureau of Labor Statistics

These developments in price behavior are more or less in line with what we expected going into the summer months. Our view has been that the labor market is not just coming back into better balance between supply and demand (a line stolen from the Fedspeak over the last several month). We now view it as in balance, something confirmed by Chair Powell in his testimony earlier last week, a notable difference from the previous language.

This weakening in the labor market has led to slower personal spending and retail sales, which has taken demand pressures off prices. In particular, services spending has sharply decelerated in recent months. This slowing on the demand side has coincided with the slowing service prices we described above. The chart below plots the monthly change (since December 2021) in personal spending on services with that of the core CPI services index (ex-shelter). The relationship is clear.

Slower Service Demand Matters to Services Prices

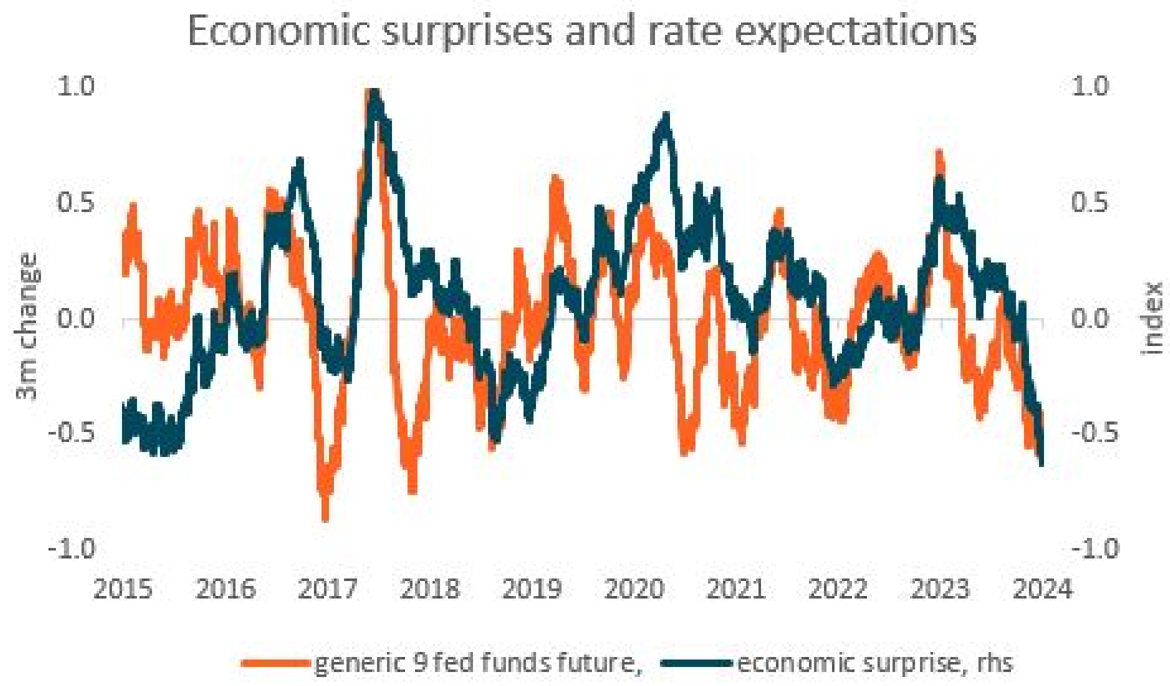


Source: BNY Mellon Markets, Bureau of Economic Analysis, Bureau of Labor Statistics

More generally, the overall economy is slowing – as we have noted. Not so much or so quickly (for now) to make us fear an imminent recession, but enough to make the dual mandate – jobs and prices – appear more balanced and increase the market's expectation of a September rate cut. The chart below shows the Bloomberg Economic Surprise Index (a measure of data misses/beats relative to consensus expectations) falling quickly. To no small degree, this index has an obvious mean reversing quality – when economic times are good, data expectations get more and more exuberant, eventually setting the bar for data beats too high, and the downside misses increase. Same in the other direction. Nevertheless, it's clear that the data are increasingly missing to the downside. Plotted against the data surprise index, we show the 3-month change in the generic 9th federal funds futures – a measure of changes in medium term policy expectations, and the fit is impressive.

We are firmly convicted that we're heading toward the first rate cut in the cycle in September and expect a further reduction in the funds rate in December. After that, it's a question of how quickly the economy slows in late 2024 and into 2025. Our view is for some slowing in the labor market and broader economy in general, but overall GDP growth only modestly below its trend rate of 1.8%-2.0%.

Data Surprising to the Downside, Bolstering Rate Cut Expectations



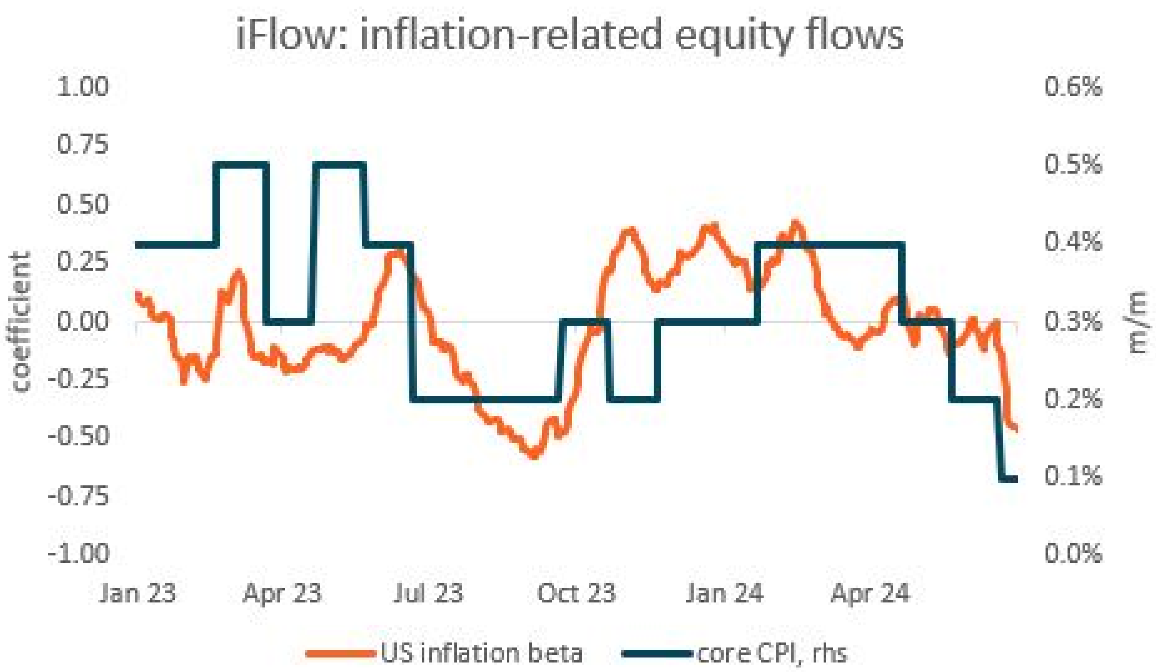
Source: BNY Mellon Markets, Bloomberg

The official macro data aren't the only things making us breathe a sigh of relief on inflation developments. We can use our iFlow data to get a sense of how equity investors view the outlook for prices. Below we plot a measure of inflation expectations calculated from US equity flows by industry. For each of the 74 GICS level 3 industries, we determine to what degree they are correlated with breakeven inflation from the TIPS market. If an industry's return increases with inflation expectations or decreases, in other words. We then rank those industries' returns by their inflation correlation. We then look at which industries are receiving the most inflow or outflow, ranking each industry on that metric. The correlation of the ranks is our measure of inflation-related equity flows.

In other words, if an industry sees high returns under high inflation regimes, and investors are putting their money into that industry, that would indicate that there is an inflation trade going on. We plot the correlation of these ranks (flows with inflation-related returns) every day to generate a time series of investor views on future inflation expressed through flows.

The chart below shows a significant drop in these inflation-related flows; investors are not buying inflation protection or exposing themselves to inflation-related equities to the same degree as before. We also plot core CPI monthly. There is some relation between what investors think about inflation via the equity market and actual inflation outcomes. This is merely more corroboration for us that inflation concerns are receding, paving the way for cuts this autumn.

iFlow Shows Equity Investors Trimming Inflation Exposure



Source: BNY Mellon Markets, iFlow

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Please direct questions or comments to: iFlow@BNY.com

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