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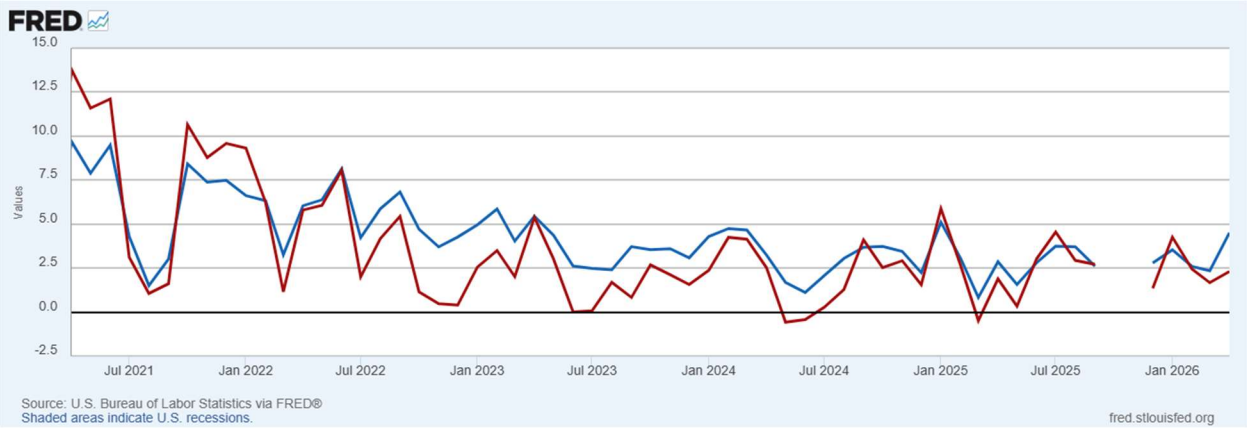
The Bright Silver Lining in the Inflation Data

Hidden away among the hot inflation readings of the past few days is a piece of very good news. **Core-CPI inflation, ex-shelter, was just 2.3% in April** (all figures m/m, annualized), following March's 1.7% reading. This is in sharp contrast to April's 7.7% headline CPI rate, its 4.5% core-CPI rate (blue in figure 1), and its torrid 12.3% core-PPI reading. We are not dismissing these, especially the PPI reading. Nevertheless, the inflation outlook is much better than is being reported.

Our forecast remains that in addition to the current spike in headline measures, higher energy prices will have modest pass through to core-inflation readings well into the summer. The April CPI fits our view. The large jump in core-CPI was driven by an outlier shelter reading with owner equivalent rents rising at a 6.3% annualized rate. This is up from 3.4% in March and is the highest since April 2023. Owner equivalent rents account for 33% of core-CPI and is simply a survey asking homeowners how much they would expect to rent their home for. **Given other housing data, the surge in shelter inflation is almost surely noise and not a sign of anything real in the housing market**. Figure 1 shows that core-CPI, ex-shelter (red in Figure 1), remains on a downward trend. Beyond this, there are signs of a mild pass through to core-inflation. Transportation services are the part of core-inflation most sensitive to energy prices. These are up 7.3% and 4.0% in March and April respectively.

Figure 1: Core CPI ex-Shleter, and Zillow's Housing Price Index



While we are sanguine about this week's CPI report, April's producer inflation reading is more concerning. Core-PPI jumped from 2.7% in March to 12.3% in April. The biggest driver was distributive services, a sector which is sensitive to fuel costs and comprises over a quarter of core-PPI and which rose at a 38.5% annualized rate. PPI is much noisier than CPI, but some of this reading will be felt in core-CPI in the coming 2-3 months.

The Bigger Question Will Be Answered in the Late Summer and Fall

The ongoing rise in inflation is an expected and inevitable consequence of much higher crude oil prices. The bigger question, however, is whether this represents a spike in prices or the renewal of sustained inflation. Since the 1980s, previous energy price spikes have proven to be the latter. **The current environment of high interest rates, weak hiring, and slow growth outside of business investment makes us 80% confident that inflation will not outlast the rise in energy prices.** Nevertheless, we want to highlight potential red flags that would change our mind, beyond the obvious of hot core-inflation readings continuing into the fall.

The first would be a larger rise in inflationary expectations 3-5 years ahead. The 5-year breakeven rate (the difference between the ordinary 5-year Treasury yield and the 5 year inflation protected Treasury yield) has jumped to 268 bps following Thursday's PPI reading. This places it near the upper bound of its 2023-2026 range**. A lasting and further rise to 300 bps or higher would be cause for significant concern.** Survey measures are more reassuring. The New York Fed's 5 year-ahead survey of inflationary expectations, for example, was stable at 3.1% in April.

Second, it is important, albeit not surprising, that wages have only risen about 0.37% combined in March and April, well below inflation. **Lower real wages mean that households' balance sheets are being adversely affected which, down the road 2-6 months, will have a disinflationary effect.** Given the state of the labor market, it is unlikely that wages will accelerate in response to inflation. If they do, however, then we will be wrong and the Fed will likely react by raising rates out of fears from a wage-price spiral. Finally, and related to our prior point, the labor market has shown some very tentative signs of life this year. If this accelerates, inflation could also have more staying power than we expect

We Await Kevin Warsh's Comments

It is a tricky time for Kevin Warsh to take over as Chairman of the Fed The past week of FOMC member comments make clear that the bulk of the FOMC has no appetite for rate cuts until the current spike in prices passes. We are particularly struck by the lack of attention the

FOMC is paying to the role of shelter in artificially pushing inflation readings up. Assuming that Warsh still wants to cut, it would be counterproductive for him to advocate for one right away. This might force the rest of the FOMC to dig in and push any rate cuts into 2027. Warsh would be wise to instead tie the next rate cut to two to three core-inflation readings where m/m measures are close to 2%. We still expect this to occur in the fall paving the way for a rate cut in October or November. **We remain 85% confident that the FOMC's next move will be a rate cut rather than a rate hike.**

-Paul Shea

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