Longview on Friday: “US Inflation: Regime Change Underway”

Below is a round-up of Longview related views/research & trade ideas – this is published most Fridays, and updates key themes and highlights key pieces of (often contrarian) research. Feedback, as always, is appreciated.

From CPI ‘Stickiness’ – To ‘Deflation’?

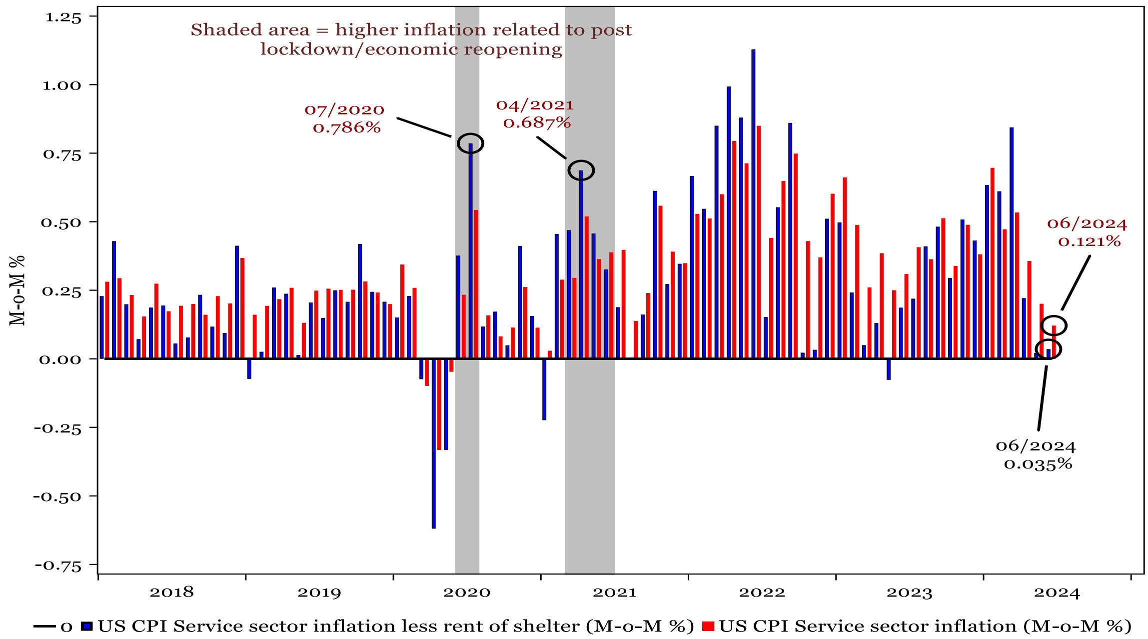
Markets were obsessed about the stickiness of US inflation at the start of this year. That obsession was centred around service sector prices.

In particular, **(i)** there was no inflation elsewhere (goods has been deflationary for most of the past two years, see below); **(ii)** services CPI had accelerated to high levels over the prior 12 months (FIG 1); and **(iii)** it's the ‘type’ of inflation that the Fed is able/willing to control (i.e. service sector price pressures are ‘domestically generated’).

Services inflation therefore sat at the heart of Fed policy debate.

Following yesterday's CPI report for June, though, there have now been **three months of weak monthly service sector readings** (FIG 1). The average of those three readings is now +0.2% m-o-m (in line with ‘normal’, pre-pandemic levels). Excluding shelter, the average is only +0.1% M-o-M, which is <u>on the low side</u> vs. pre-2020 levels....

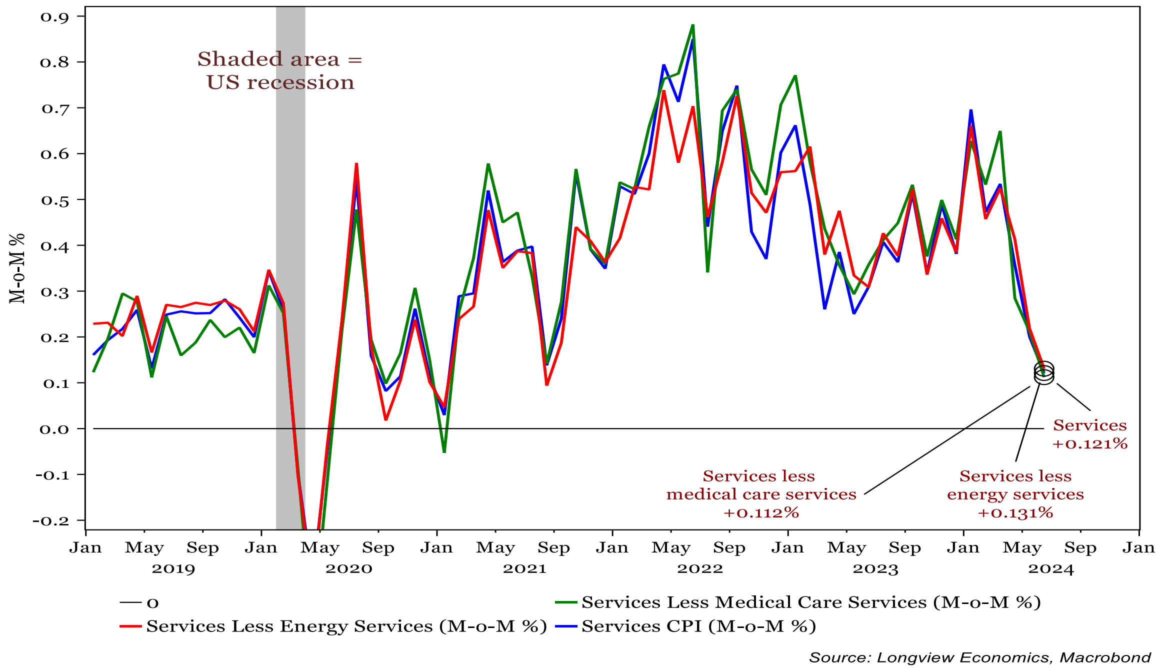
<u>**FIG 1:** US CPI Services vs. services less rent of shelter (M-o-M %)</u>



Source: Longview Economics, Macrobond

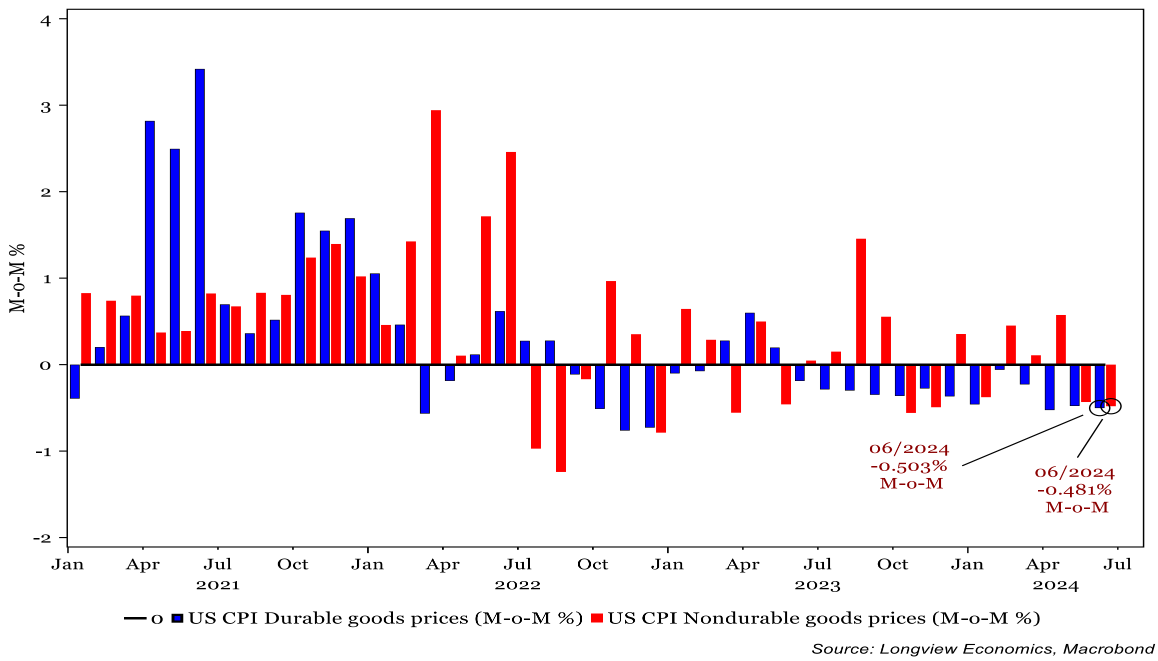
...and stripping out energy and medical care services (i.e. other large, and sometimes volatile, price categories), gives a similar message. That is, **underlying inflationary pressure in the US economy has (significantly) decelerated** in recent months (FIG 2).

FIG 2: Services shown with 'ex-energy' & ex-medical care' services (M-o-M %)



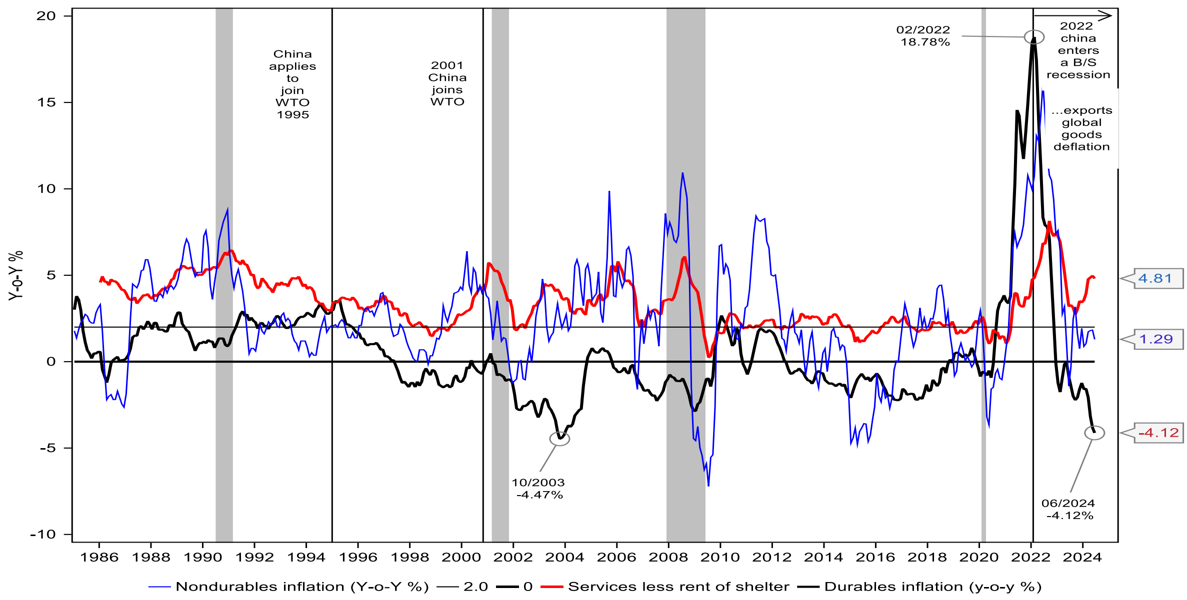
That switch in service sector inflationary pressure has therefore been the key source of change at the margin for CPI readings. Indeed goods prices have (mostly) remained deflationary in recent years (FIG 3)....

FIG 3: US durable and non-durable goods CPI inflation (M-o-M %)



...While on a Y-o-Y basis the deflationary pressure in 'durable goods' has become particularly marked in the past 18 months (FIG 4). That reflects PPI deflation in both China and Europe and, in the case of China, the **deflationary forces of a balance sheet recession**.

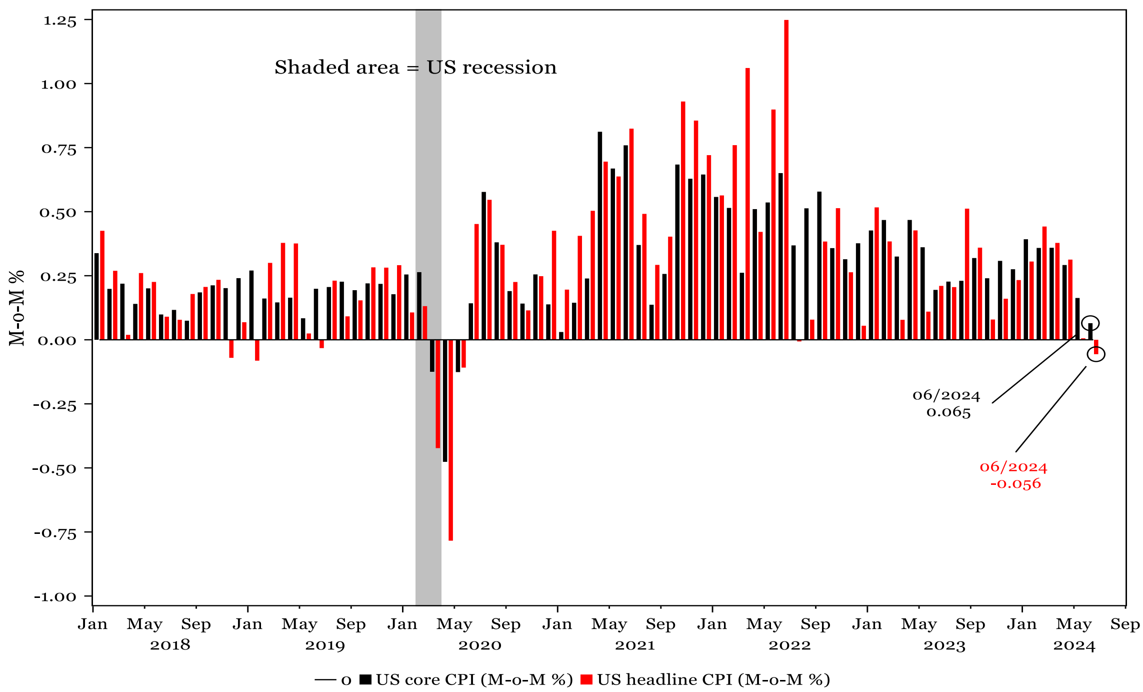
FIG 4: Nondurable and durable goods inflation vs. services CPI (Y-o-Y %)



Source: Longview Economics, Macrobond

Reflecting all of that, both **US core & headline readings have swung lower** in the past three months, with the monthly headline measure turning deflationary in June (for the first time since the pandemic), and with the core reading at just +0.065%.

FIG 5: US core & headline CPI readings (M-o-M %)



Source: Longview Economics, Macrobond

Furthermore, inflation readings in almost all of the key categories is low relative to their history (i.e. on our standardised Y-o-Y heatmap, table 1)...

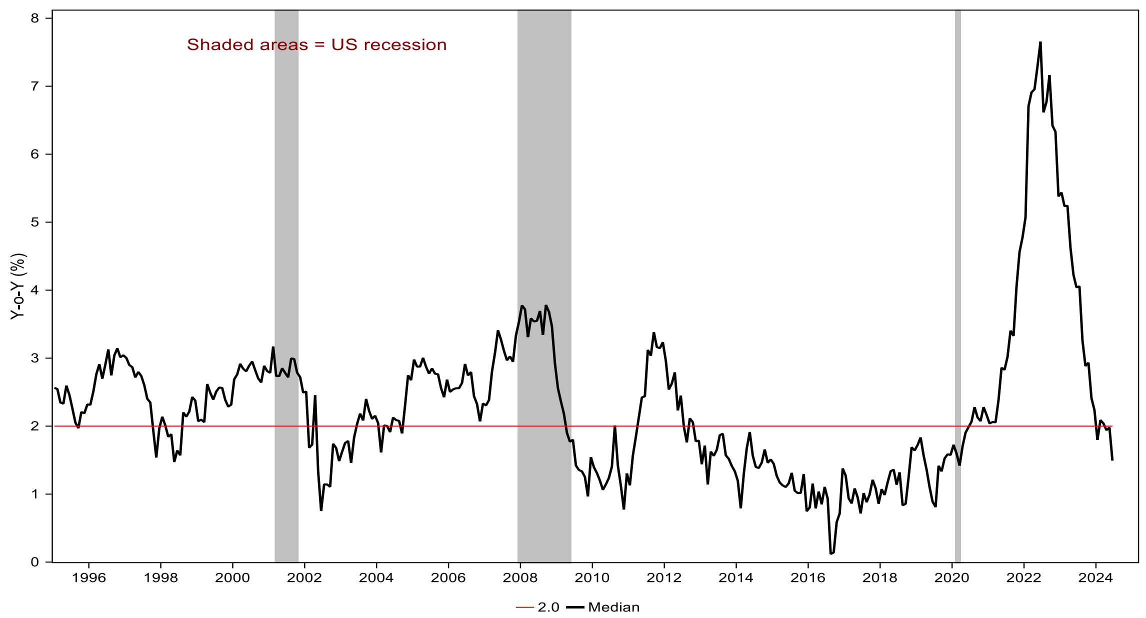
Table 1: US CPI inflation heatmap (Y-o-Y %, standardized)

Date	All Items	Housing	Food	Apparel	Transport	Medical Care	Recreation	Edu. & Comms*	Other	Legend
6/2024	-0.2	0.0	-0.6	-0.3	-0.5	-0.6	0.0	-0.8	-0.3	3.0
5/2024	-0.1	0.1	-0.6	-0.3	-0.2	-0.7	0.0	-1.0	-0.5	
4/2024	-0.1	0.1	-0.6	-0.1	0.0	-0.9	0.1	-1.0	-0.3	2.0
3/2024	0.0	0.1	-0.6	-0.4	0.1	-1.0	0.4	-1.2	-0.1	
2/2024	-0.1	0.1	-0.6	-0.6	-0.2	-1.3	0.6	-1.1	-0.1	1.0
1/2024	-0.1	0.1	-0.5	-0.6	-0.4	-1.5	1.2	-1.4	0.3	
12/2023	-0.1	0.2	-0.4	-0.2	-0.2	-1.7	1.2	-1.4	0.2	0.0
11/2023	-0.1	0.3	-0.4	-0.1	-0.5	-1.8	1.0	-1.4	0.2	
10/2023	-0.1	0.3	-0.2	0.4	-0.6	-2.2	1.6	-0.7	0.5	-1.0
9/2023	0.1	0.4	-0.1	0.3	-0.2	-2.4	2.2	-0.5	0.4	
8/2023	0.1	0.4	0.0	0.5	-0.4	-2.2	1.9	-0.6	0.3	-2.0
7/2023	-0.1	0.6	0.2	0.5	-1.2	-2.0	2.3	-0.4	0.4	
6/2023	-0.2	0.6	0.5	0.5	-1.6	-1.8	2.5	-0.5	0.5	-3.0

Source: U.S. Bureau of Labor Statistics (BLS). **Education & Communication.* MACROBOND

...while, consistent with that, median inflation has fallen sharply and, for the first time since the pandemic, is convincingly below 2% Y-o-Y (see FIG 6)...

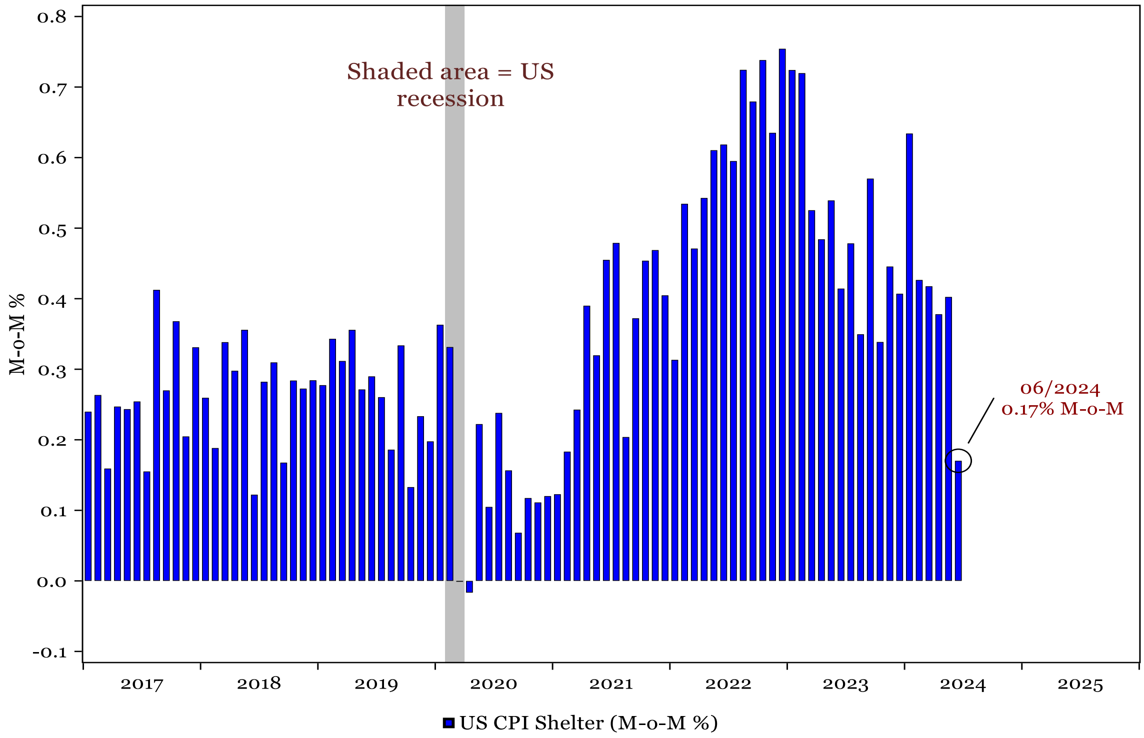
FIG 6: US median inflation (Y-o-Y, shown with US recession bands)



Source: Longview Economics, Macrobond

...and, encouragingly, shelter decelerated sharply last week (to one of its lowest readings in the past five years)...

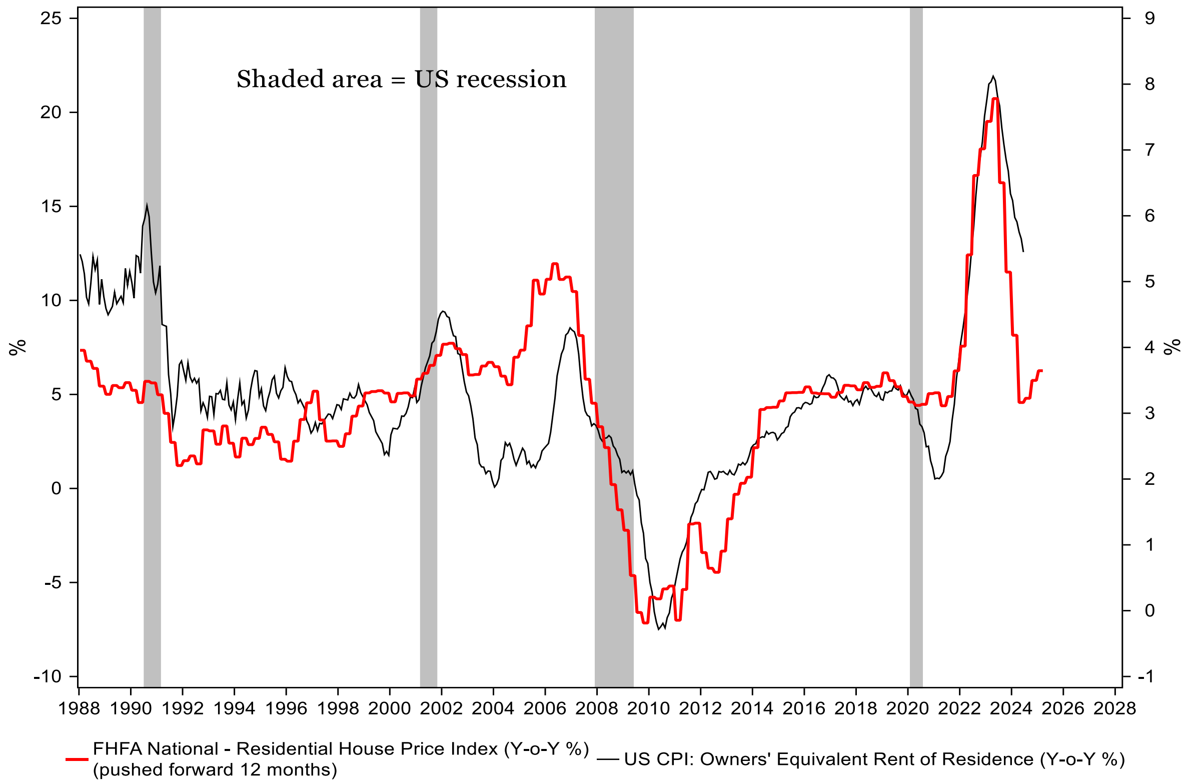
FIG 7: US shelter inflation (M-o-M %), shown with US recession bands



Source: Longview Economics, Macrobond

...and is therefore behaving as one would expect (i.e. continuing to follow house price growth – with the usual 12 month lag, see FIG 8).

FIG 8: US house price inflation (**pushed forward 12m**) vs. US shelter inflation



Source: Longview Economics, Macrobond

US Inflation: Where next?

"Global Services Inflation to Remain Sticky, Slowing Pace of Rate Cuts"

Source: Fitch Ratings, May 2024 (available HERE)

"We should fear a sticky inflation mess"

Source: FT Alphaville, March 2024 (available HERE)

The key question, therefore, is: Why has inflation cooled? And, linked to that: Is softer inflation 'transitory' (again) – or is it here to stay?

Many, of course, have this year made the case for persistently higher inflation, which lasts for a number of years (e.g. see quotes above). Naturally, a few softer inflation prints don't necessarily signal a change in the inflation regime (as they would no doubt argue). Indeed, as FIG 1 above shows, there have been several bouts of softer inflation in recent years (lasting for a handful of months) – only to be followed by a reacceleration in CPI pressures.

The key question therefore still stands: Why has inflation fallen?

The answer, in our view, is twofold.

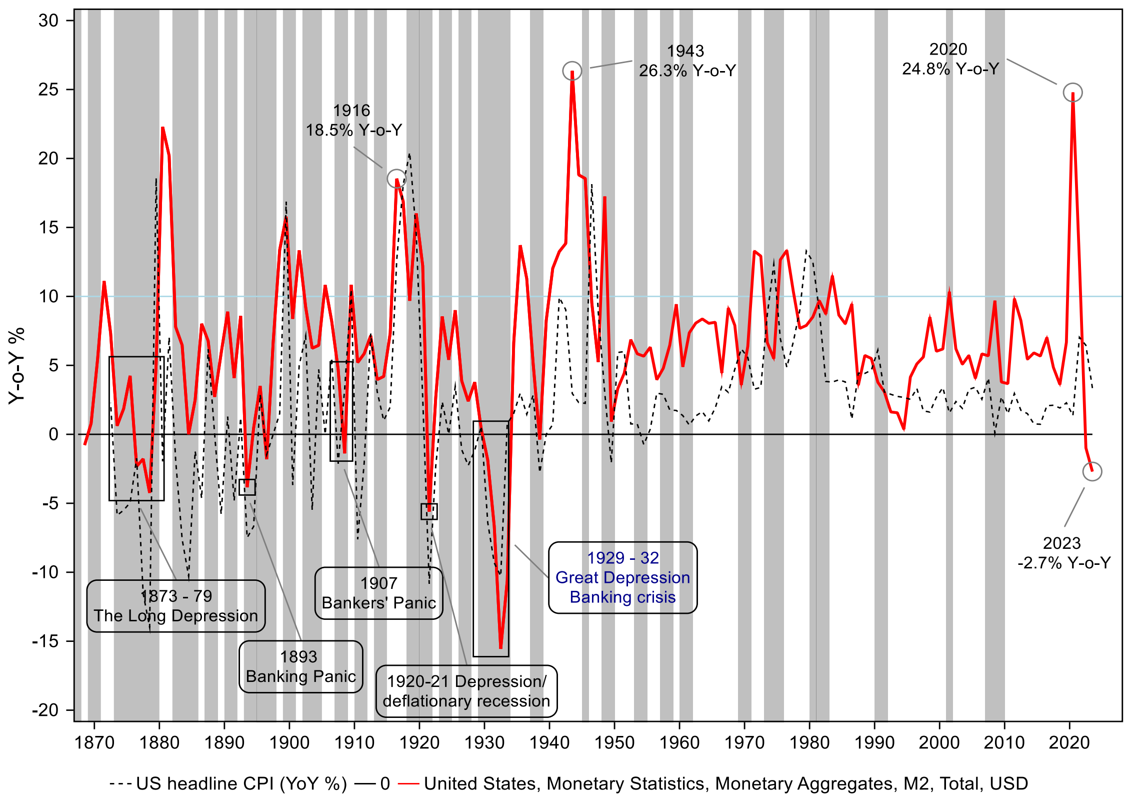
1. **Post pandemic inflation has been (largely) driven by monetary factors. Those monetary factors have reversed.**

As we highlighted, the monetary environment during and after the pandemic is similar to that of the late 1800s through to the early 1940s. It's the correct parallel for today (i.e. much more so than the 1970s).

From 1860 – 1940, large spikes in M2 money supply growth were followed by sharp spikes in headline CPI. When money growth decelerated (or contracted), that was followed by significant disinflation (or deflation). At the time, those large swings reflected bouts of money expansion and contraction, as countries left (and then re-joined) gold standards, i.e. to print money to finance wars.

In recent decades, money creation has mostly been in commercial bank balance sheets to make mortgage loans. That's generated significant house price inflation. As such, while the correlation between 'CPI' and 'M2 money supply' appears to have broken down (in the past 60 years, see FIG 9), the **key monetary principal remains intact**. That is, newly created money generates inflation (somewhere in the financial system/economy).

FIG 9: US M2 money supply growth vs. headline CPI (both annual data, Y-o-Y %)

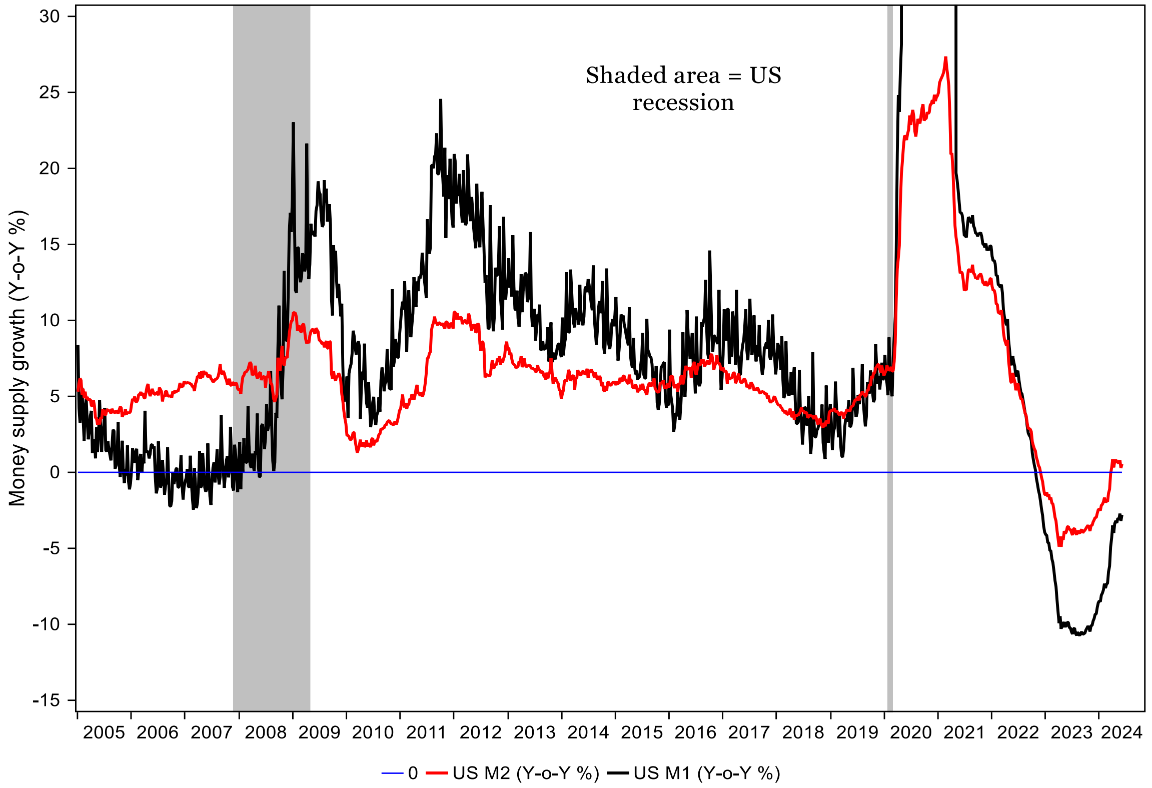


Source: Longview Economics, Macrobond

Newly created money by central banks post the GFC, for example, was used to buy financial assets (which inflated financial markets). In the pandemic, newly created money was used to monetize fiscal deficits (i.e. new money for the real economy). That generated CPI inflation (i.e. too much money chasing too few goods and services).

Those monetary dynamics, though, have been reversing in the past couple of years. In particular, key money supply measures (M1 & M2) have been contracting (FIG 10), and sowing the seeds for disinflationary pressure in the US economy, especially given a backdrop of tightening fiscal policy.

<u>FIG 10:</u> <u>US M1 & M2 growth (Y-o-Y %)</u>



Source: Longview Economics, Macrobond

2. **The labour market is rapidly loosening up. Wage inflation should therefore continue to trend down – and keep service sector CPI readings low/subdued.**

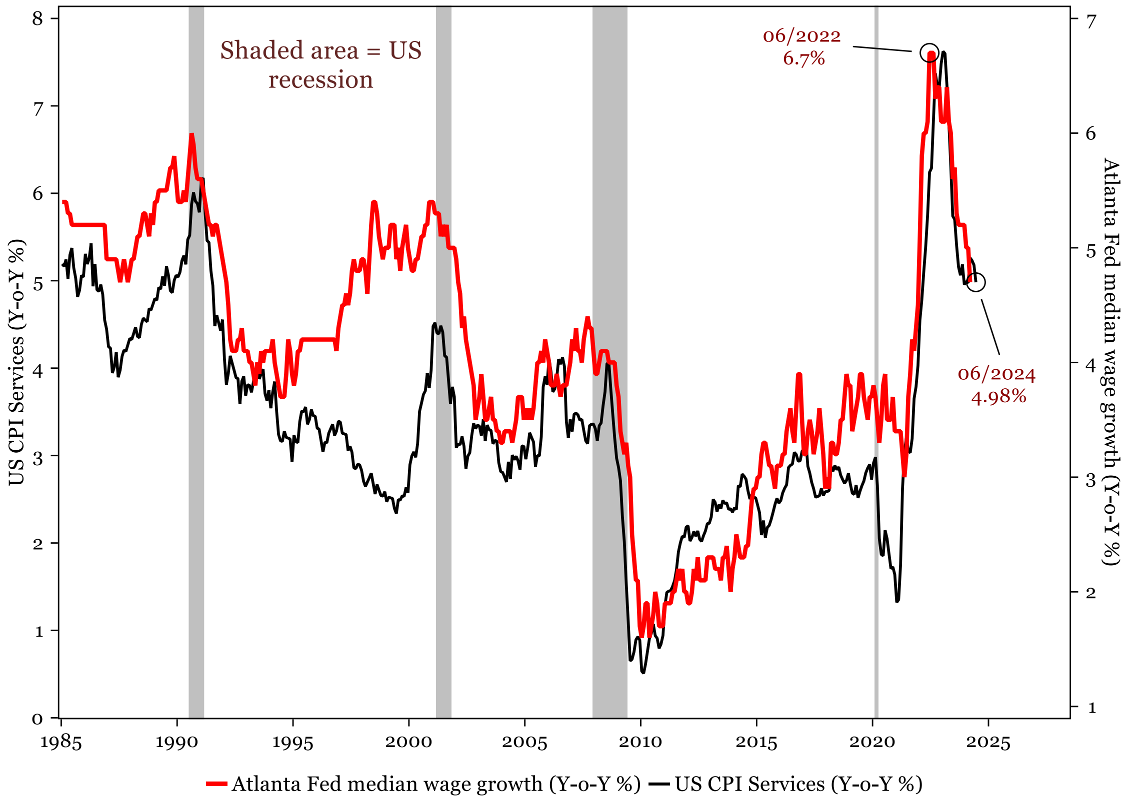
This week we outlined the evidence for an **ongoing** softening of labour market activity (for detail see Tuesday's publication, Monthly Global AA No. 43: "US Labour Market Risks Rising - Stay OW Treasuries").

In particular, as we show in the note, the 'early cracks' in the labour market are emerging. Those cracks are: (i) broad based across all the major leading indicators of the labour market; (ii) showing up in both 'hard' and 'soft' data, and (iii) evident in some of the key cyclically sensitive sectors of the economy (i.e. construction jobs).

With that, most of them are deteriorating in a way that is typical just ahead of a recession (i.e. generating recession warning signals). While recession is not our central view, those indicators, at a minimum, point to some further deterioration in US labour market activity, and therefore <u>wage inflation</u>.

Wage inflation is key, though, to the CPI equation. As the chart below shows, wage growth is the major driver of US services inflation (and, given the deterioration in the labour market, it should weaken further).

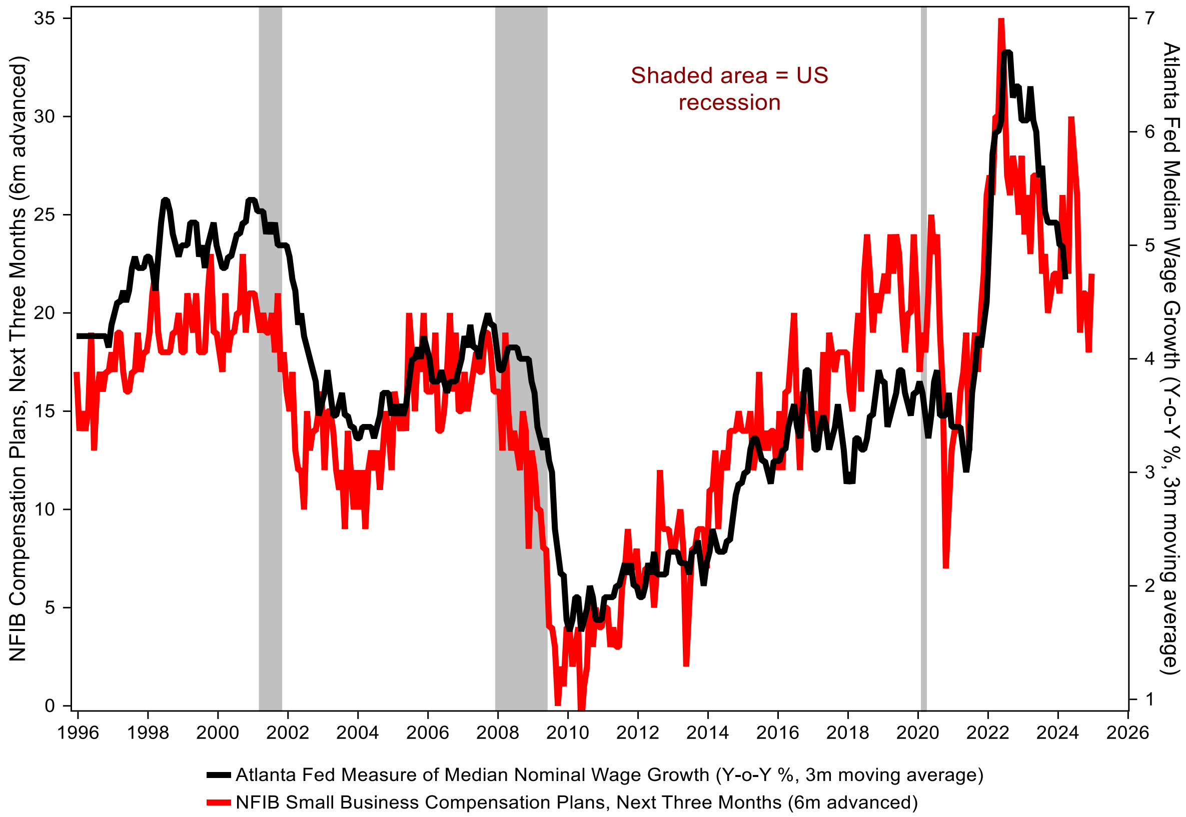
FIG 11: Atlanta Fed median inflation vs. US CPI Services less rent of shelter (both Y-o-Y %)



Source: Longview Economics, Macrobond

Indeed that's the message of the forward looking indicators on wage growth. Small businesses, for example, intend to dial back their 'compensation plans', which typically leads wage growth by ~6 months (FIG 12)....

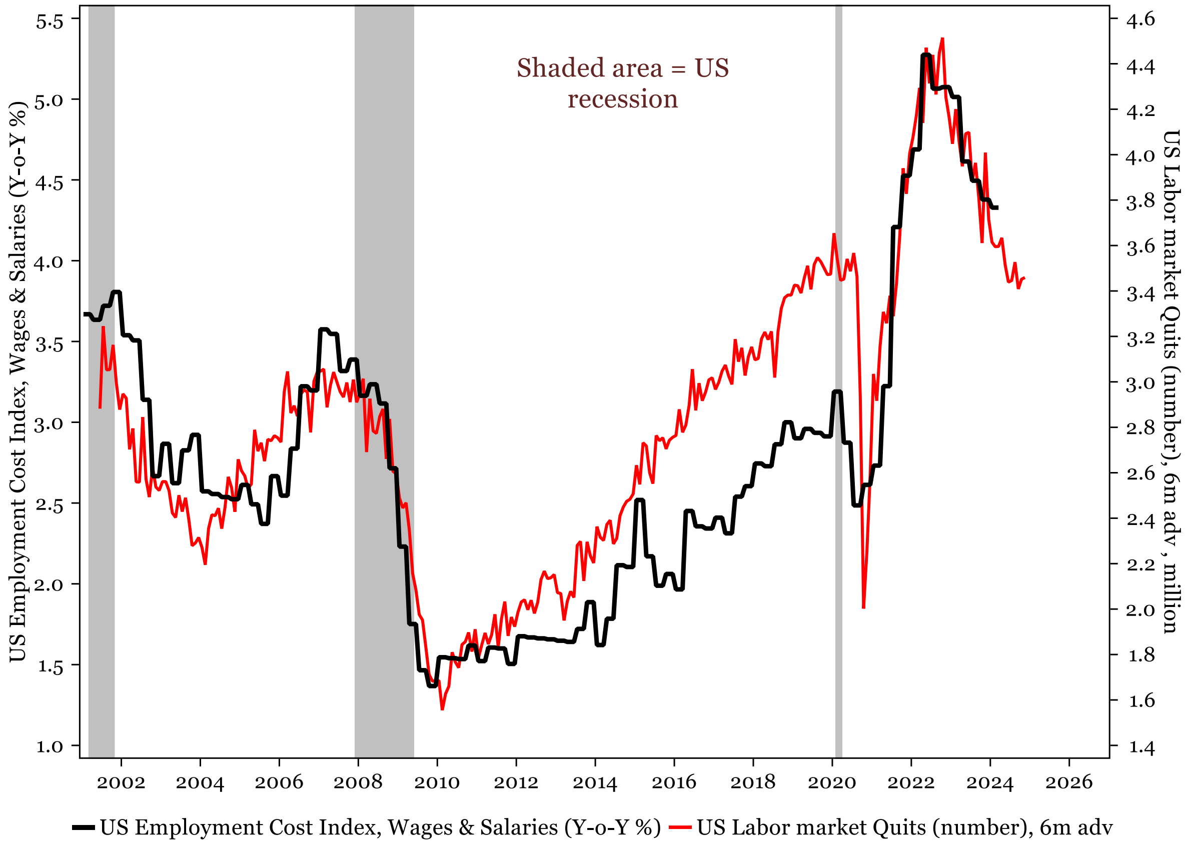
FIG 12: Small business compensation plans (next 3 months, **6m advanced**) vs. Atlanta Fed median wage inflation (Y-o-Y %, 3m moving average)



Source: Longview Economics, Macrobond

....While the number of 'quits' in the US continues to trend down (as the labour market loosens – and workers loose confidence about finding another job). As FIG 13 shows, that's usually followed by weaker wage growth (typically with a 6 month time lag).

FIG 13: US Employment Cost Index (wages & salaries, Y-o-Y %) vs. US job quits (number), **6 months advanced**



Source: Longview Economics, Macrobond

Having fallen sharply in the past three months, therefore, there's strong evidence that an **inflation regime change** is underway in the US (i.e. from CPI 'stickiness' – to disinflation, and potentially deflation). Soon US CPI readings will be back to the 2% target. The question is: Will they overshoot? And by how much?

Have a great weekend.

Kind regards,

Longview

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Monthly Global Asset Allocation No. 43, 9th July 2024:
"US Labour Market Risks Rising - Stay OW Treasuries"

Last week:

Longview on Friday, 5th July 2024:
"UK Election – And US Liquidity, How Much Is There?"

Monthly Global Asset Allocation No. 42, 3rd July 2024:
"OIL: Uptrend Ongoing (for now)"

Tactical Equity Asset Allocation No. 246, 2nd July 2024:
"All Eyes on Liquidity: How Much is Left?"

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