Inflation Data Continues Paving The Way For (Eventual) Rate Cuts

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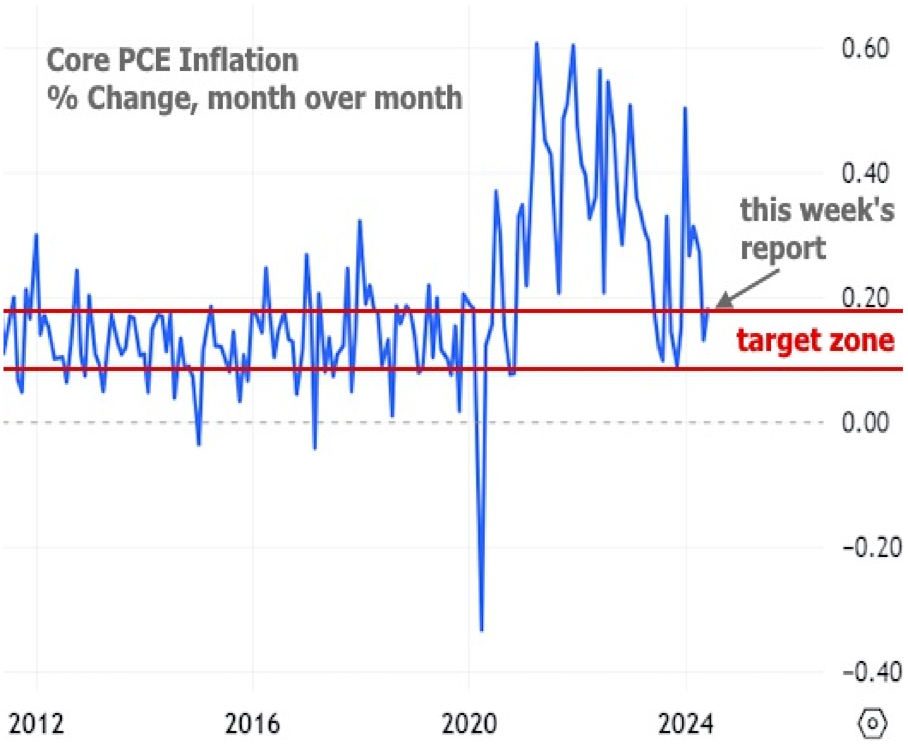
This week's most important economic data was the PCE price index which is the gold standard of big picture inflation measurement. For those hoping to see rates drop, it was important for PCE to confirm the progress seen in the CPI data (the other major inflation index that came out 2 weeks ago).

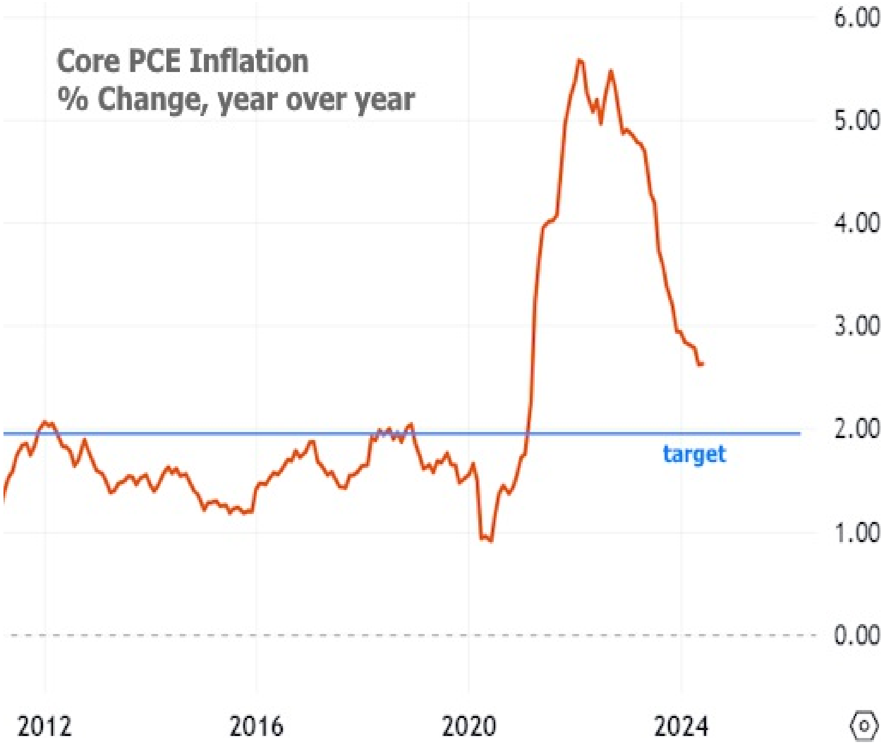
Spoiler alert: PCE confirmed the progress, but there are a few nuances.

Perhaps most importantly, this week's PCE data covers the same time frame as the CPI data two weeks ago. In other words, it's not quite as awesome as 2 consecutive months of "mission accomplished" levels of inflation (which has now arguably been cemented for June), but it's nonetheless an important milestone in the path toward rate cuts.

What exactly does "mission accomplished" mean? This simply refers to Fed's 2% annual inflation target, typically tracked via Core PCE which excludes more volatile food and energy prices. In order to hit 2%, monthly inflation readings need to average roughly .17%. This time around, it was .182%--definitely in the historical range of on-target inflation from before the pandemic.



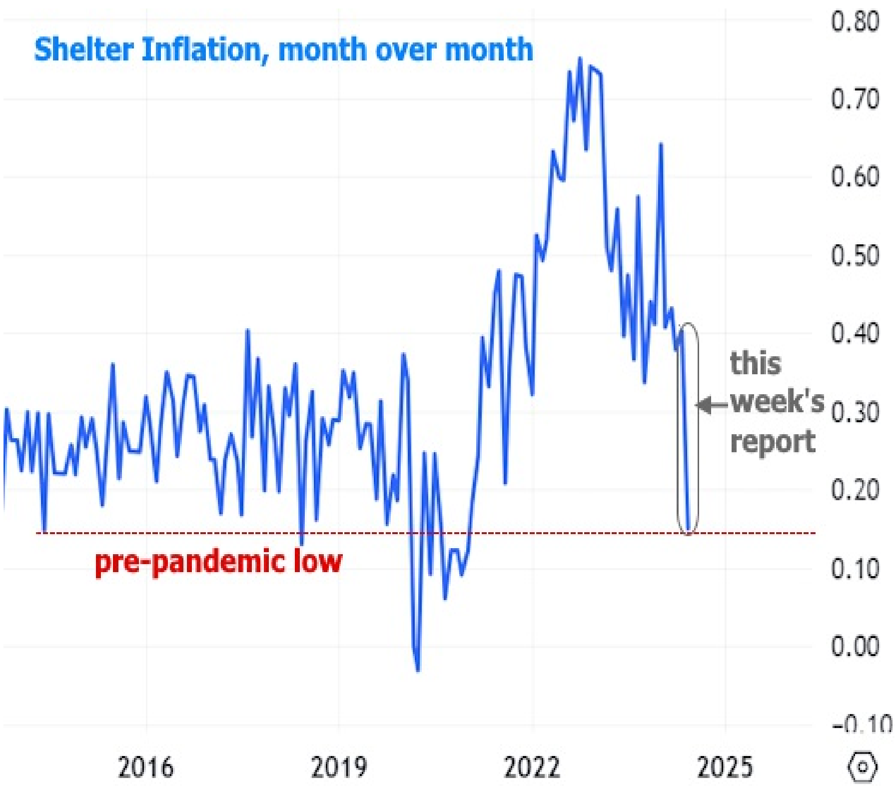
While the chart above makes it look like victory has been achieved, the inflation target is technically an annual thing, so we need to see more months in the target zone before the year over year number falls into line.



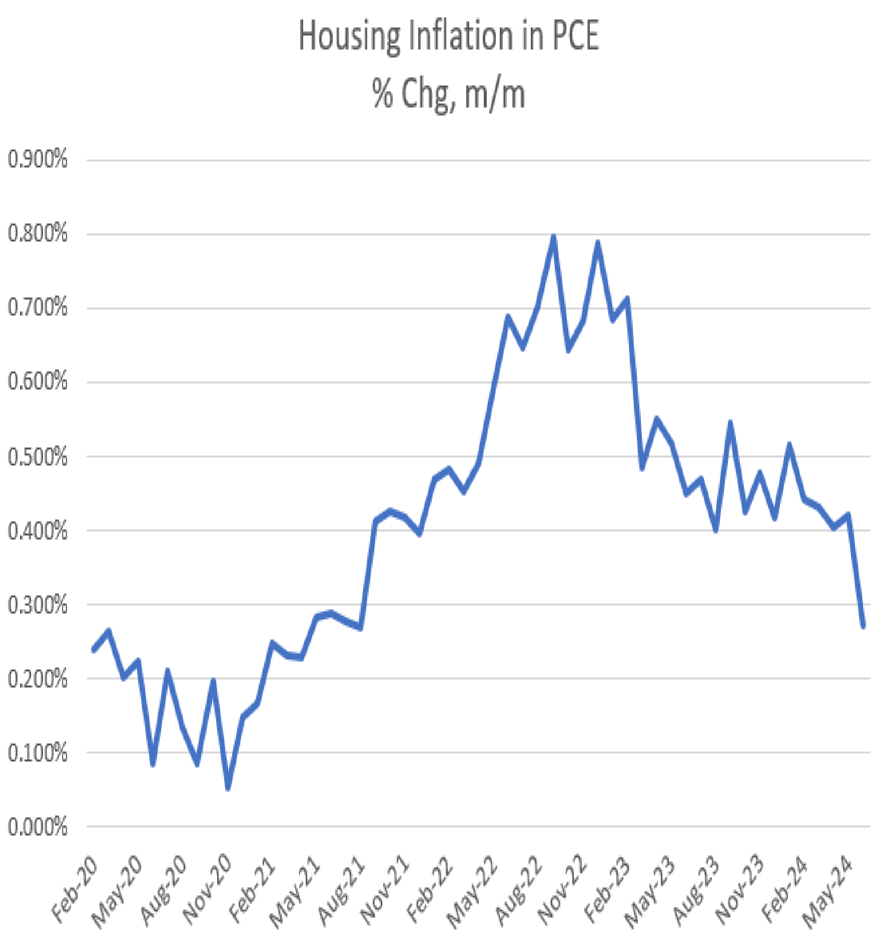
Even then, the Fed has clearly stated that the annual change doesn't need to hit 2% as long as they're confident that it will. Prior to this week's data, the average Fed member has expressed an increasing amount of said confidence. It's not thought to be enough for a rate cut at next week's Fed meeting, but it's widely believed to result in a September rate cut, as long as the data doesn't do anything crazy between now and then.

The Fed can also consider other aspects of the inflation data--especially in categories that have been stubbornly high while also accounting for a large proportion of the total. Housing is the by far and away the best example of this, accounting for about a quarter of all inflation in this week's data, and more than a third in the CPI data.

Here's how CPI's shelter component looked for June when we covered it 2 weeks ago:

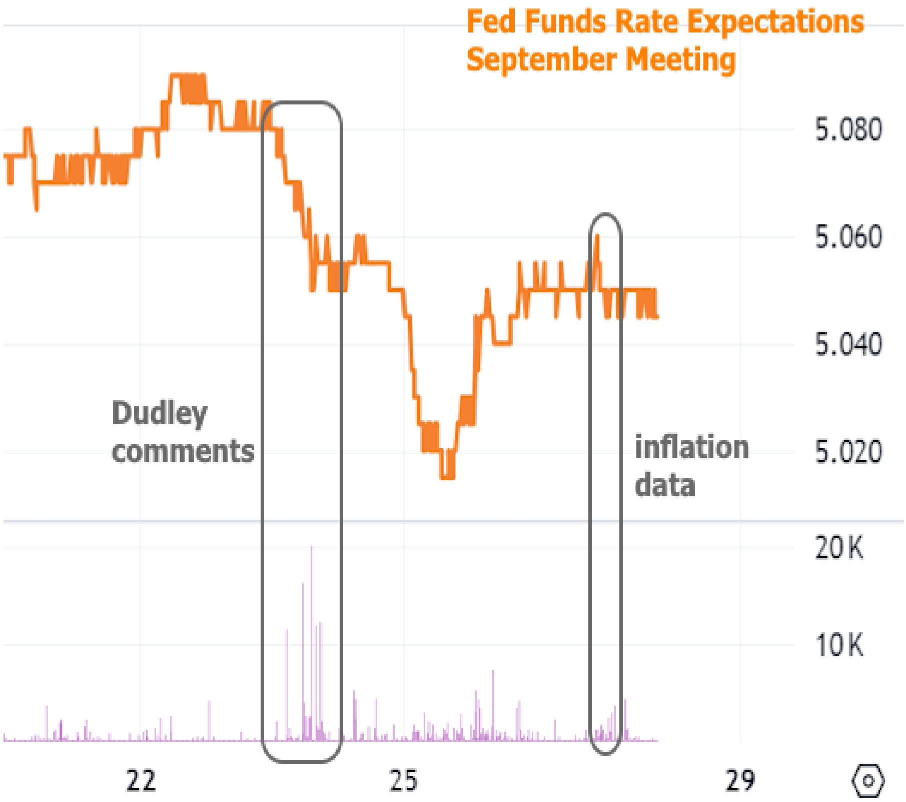


And here's how this week's PCE data confirmed the big drop in housing inflation:

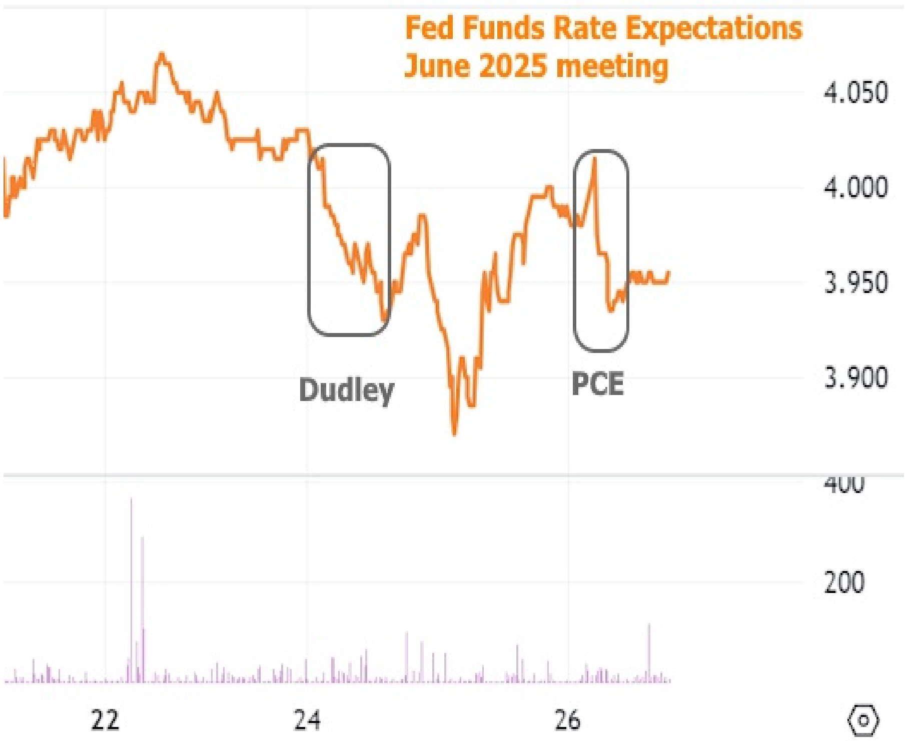


The scales of the two charts are different, but the message is the same: housing inflation dropped sharply to the slowest pace since it was still on the way up in 2021. If this stubborn ingredient is finally softening, it's hard to imagine the Fed being anything other than perfectly confident that it's time to start cutting rates. They wouldn't need to see any improvement in housing inflation from here. It would merely need to remain near these levels.

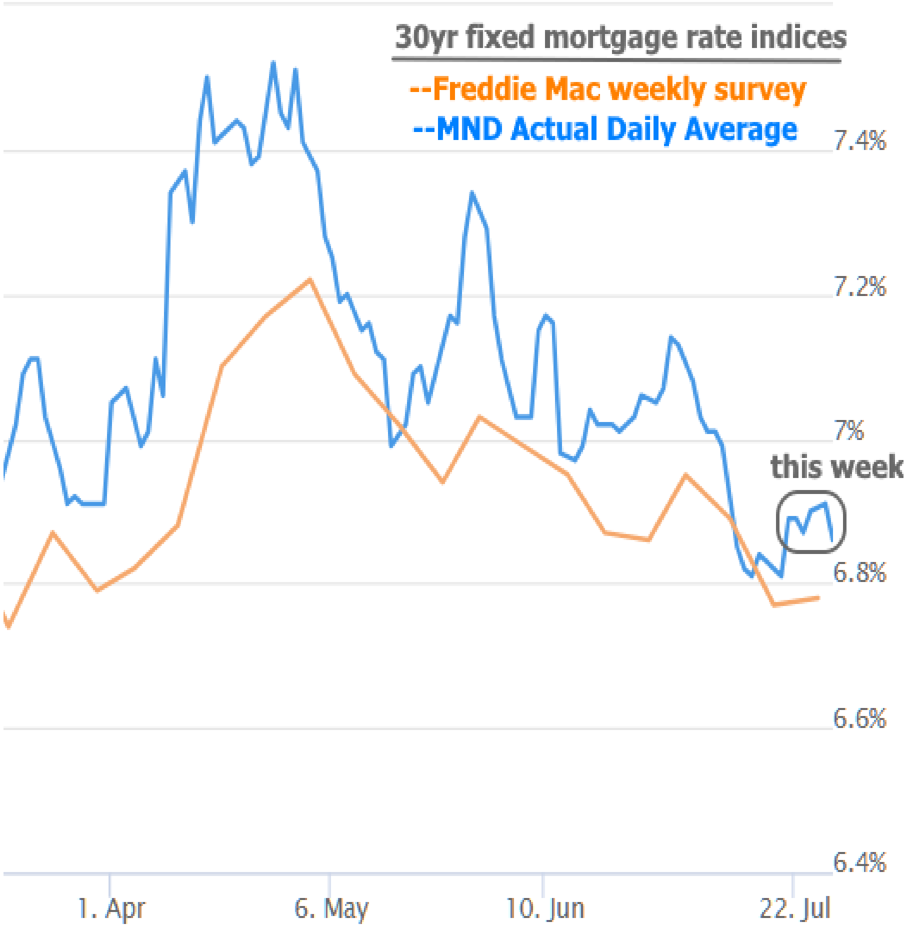
If all of the above sounds fairly compelling, there's a major curve ball to be aware of. While it's all true and while the conclusions are very much in line with the market consensus, it didn't have any impact on the odds for a rate cut in September. The only thing that made a dent in those odds this week was an op-ed from former NY Fed Pres William Dudley who said the Fed should cut even sooner.



The best way to take a swing at that curve ball would be to point out that the PCE data still mattered, but its effects on the rate cut outlook don't show up in near term Fed meeting months. If we change the chart above from September to next June, things make more sense.



Despite the important big picture milestone, movement in the bond/rate market was subdued yet again this week.



Volatility risks increase in the coming week with the arrival of more timely big ticket economic data. Friday's jobs report is always the headliner on the first week of a new month, but this time around, we'll also get a chance to hear from the Fed on Wednesday.

To reiterate, it's highly unlikely that the Fed opts to shock the market with a surprise rate cut, but precedent suggests that they'll do something to tee up a September cut if they're as convinced as the market is. This could either occur in the text of the policy announcement or in the press conference with Fed Chair Powell that follows 30 minutes later.