Comerica Economic Alert

■ Bill Adams ■ Waran Bhahirethan

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CPI Slows in May, Meaning No Hike Expected From the Fed This Month

- **The May CPI report was largely as expected, with cooler increases of the total and core indexes.**
- **The Fed will likely hold interest rates steady at their June 14 decision.**
- **The economy and job market are expected to soften further in the second half of 2023, further slowing inflation and eventually leading the Fed to start lowering interest rates by early 2024.**
- **But if high inflation persists in the face of slower growth, or growth proves more resilient than expected, the Fed may keep rates higher for longer than expected.**

The CPI rose 0.1% in May, matching the 0.1% consensus forecast which was also Comerica's call. Food prices rose 0.2%, while energy prices fell 3.6%. The core CPI excluding food and energy rose 0.4%, also matching the consensus and Comerica's forecast. Within the core index, new vehicle prices fell 0.1%, used car and truck prices rose 4.4%, and medical care service prices fell 0.1%. Shelter was up 0.6%, with rents of primary residence and owners' equivalent rents up 0.5%, and lodging away from home up 1.8% after falling 3.0% in April.

From a year earlier, CPI slowed to 4.0% from 4.9% and was a hair below the 4.1% forecasted both by Comerica and the consensus. In the same terms, inflation by the core CPI index slowed to 5.3% from 5.5% in April and matched Comerica's forecast; this was a hair above the 5.2% consensus. Core CPI is down from a peak of 6.6% in September 2022. May saw the slowest year-over-year increase in the total CPI since March 2021, and the slowest increase in the core CPI since November 2021. Inflation has slowed dramatically since it peaked at 9.1% last June, largely reflecting gasoline prices coming down since then, as well as slower food price increases since February.

Core CPI has slowed much less, but that partly reflects how the CPI measures shelter costs. The index measures them from a survey that tends to lag indexes of rents for new leases or indexes of house prices, which surged in 2021 and 2022 but have cooled recently. This lag is expected to make inflation in the CPI's shelter component slow considerably over the next year. For a timelier measure of inflation's underlying trend that isn't distorted by the lag of measuring shelter prices, the Fed is monitoring prices of non-energy services excluding shelter: They rose 0.2% in May after 0.3% in April and March and 0.4% in February. From a year earlier, non-energy consumer services excluding shelter rose 4.6% in May, down more than two percentage points from their September 2022 peak to the slowest in more than a year.

In short, the CPI report showed inflation cooling in line with expectations. For the Fed, that is probably enough for them to hold interest rates unchanged at their June 14 decision, which would be the first decision without a hike since early 2022. However, the Fed's policymakers are warning a rate hike is still possible in the second half of 2023, and that they expect to hold interest rates high for a while to ensure inflation continues to slow. The Fed is concerned inflation may have built up momentum since the pandemic struck and could reaccelerate once the big swings in energy prices (pushing inflation higher in 2022, then lower in 2023) drop out of the index. Chair Powell often discusses his memories of the Great Inflation of the 1970s and is determined to avoid repeating the Fed's

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mistake of cutting rates too early back then, only to see inflation re-accelerate. The Fed seems slightly more likely to hold rates steady at its next few decisions than to hike, but it is a close call; a hot jobs or CPI report for June could be enough for them to decide on a hike in July.

With that said, next month's CPI report will likely be on the cooler side again, since producer prices are rising more slowly than consumer prices. The Producer Price Index for Final Demand rose 2.3% from a year earlier in April and the consensus forecast for the May report is for an even more modest 1.5% increase. In addition to some differences in the weightings of the consumer and producer price baskets, the profit margins of businesses that sell to consumers are a big contributor to the divergence between inflation experienced by producers and by consumers. Margins will probably be steady to narrower in the next few months as the economy grows slower than its long-run potential, likely causing year-over-year increases in the CPI to move closer to the PPI.

Beyond the next few months, the inflation outlook largely depends on how resilient the economy proves in the second half of the year. After a large tightening of monetary policy since early 2022, the economy's most likely path is a modest contraction of real GDP as businesses run down excess inventories, and as activity slows in the sectors that are most sensitive to interest rates like construction and manufacturing. The unemployment rate will likely tick higher over the next 12 months, further softening businesses' pricing power, and slowing inflation further. If so, the Fed could begin to reduce interest rates around the turn of the year.

But economic growth has proven more resilient than expected over the last year and delivered stronger job growth than expected. Also, some measures of inflation expectations are higher than before the pandemic, creating the risk of a self-fulfilling prophecy of higher trend price increases. If growth surprises to the upside in the next few quarters, or inflation stays high despite the economy downshifting to a lower gear, the Fed could further raise interest rates in the second half of 2023 and keep them high into 2024.