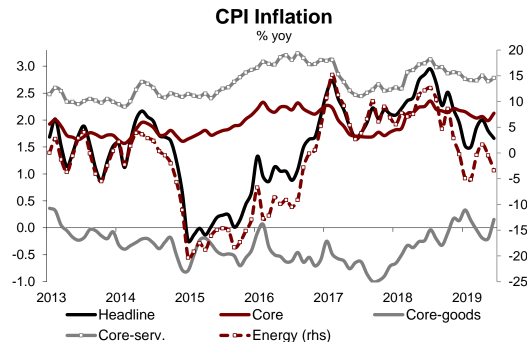
GENERALI INVESTMENTS

GIAM Macro & Market Research - Market Commentary

US core CPI inflation up to 2.1% in June. Powell’s Congress hearing points to a 25 bps cut.

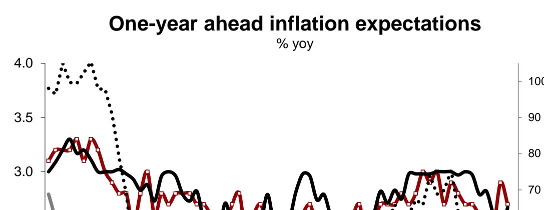
- **A higher than expected increase in the shelter and medical services components component lifted core CPI inflation to 2.1% yoy. The collapse in the energy component compressed the headline rate to 1.6%.**
- **The sectoral pattern is consistent with the fading of some transitory weakness, but the cyclical component of inflation is not reacting to labor market slack. Core inflation will undershoot the Fed target this year too.**
- **Meanwhile, inflation expectations remain subdued, also due to low oil prices and higher worries on growth.**
- **The weakness of inflation expectations was duly noted in the minutes of the June meeting, while Powell before the Congress stressed the risks around a still solid outlook. The tone appears consistent with a 25 bps cut in the July 31 meeting.**

June CPI data were broadly in line with expectations, showing a moderate increase in core rate and an oil driven contraction in headline inflation.

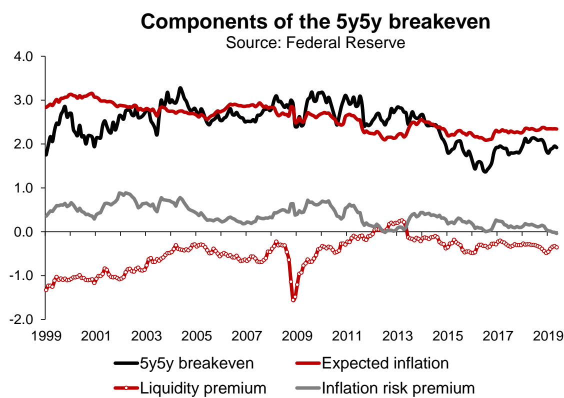


Fed’s favorite narrative of a gradually fading of the headwinds from the noncyclical components of inflation was partly confirmed by June CPI data. Year on year core inflation went up by 0.1 pp, to 2.1%. Large positive contributions came from shelter (which accelerated to 0.3% mom, to 3.5% yoy) and medical services (0.4% mom, 2.8% yoy), while used cars moved from two months of over 1% mom fall to a 1.6% increase (to 1.2% yoy) and apparel went back to positive mom growth, contributing decisively to bring back core goods inflation in positive territory. Given today’s CPI reading, we expect June’s core PCE inflation stable at 1.6%.
The bulk of the mild increase in core CPI inflation (to 2.2% by year end) we project should come from the acyclical component, as the weak response of the cyclical one to labor market slack is compounded by the downward pressure stemming from the weakening in unit labor costs, due to productivity pick up. As a result PCE inflation will undershot also this year the 2% target.

Fed’s worries about too weak expectations were confirmed by the latest readings of both survey and market based inflation expectations. Looking through some volatility induced by swings in fuel prices, indications from both the Michigan University and the NY Fed surveys still “*sit at the low end of a range that I consider consistent with our price-stability mandate*”, to quote a recent speech by vice Chair Clarida.



The 5y5y breakeven rate is down to levels last seen in mid-2017. According to a study recently published by the Fed, inflation expectations remain relatively well anchored but, and probably more worrying, the fall in breakevens reflects a more marked sliding in the inflation risk premium, i.e. the yield investors are willing to forfeit to insure against the risk that lower inflation is associated with weaker growth.



A much bigger concern over risks to growth rather than on weak inflation was clear in chair Powell's hearing before the Congress. Downside risks to an overall solid growth outlook have increased since the June meeting, especially those coming from the global economy, but Powell refrained from using too bleak tones: the growth outlook remains "solid" and the labor market in a very good shape.

In our viewl Powell took out any residual doubt on a rate cut in July, but the tone of the communication militates for an "insurance" cut of 25 bps rather than a "panic" one of 50 bps. Moreover, a gradual approach (a cut in July followed by another in September, which is our baseline) is consistent with the need to wait for the outcome a series of big political uncertainties that will be resolved over the coming months (trade negotiation, Brexit, Us debt ceiling). Finally,a 50 bps cut at a meeting when no new forecast are presented may increase uncertainty and the perceived risk of a bigger than expected slowdown.

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