WELLS FARGO

Economic Indicator — August 10, 2022

July CPI: Foot Off the Gas

Summary

Consumer price inflation surprised to the downside in July, with the headline index flat over the month and core prices rising 0.3%. Falling prices for gasoline, used autos and travel service categories such as airline fares, car rentals and lodging away from home helped cool monthly inflation from the torrid pace seen in May and June. Unlike the previous two CPI reports, today's CPI release provides some welcome news for members of the FOMC. That said, monetary policymakers have made clear that they need to see clear evidence of a *sustained* slowdown in inflation before pivoting on monetary policy. To that end, core CPI is still up 5.9% year-over-year and has grown at a 6.8% annualized pace over the past three months. In our view, it will take several more soft inflation prints before the FOMC begins to feel confident that it is getting price pressures in check. At least a 50 bps rate hike at the September FOMC meeting remains the most likely outcome.

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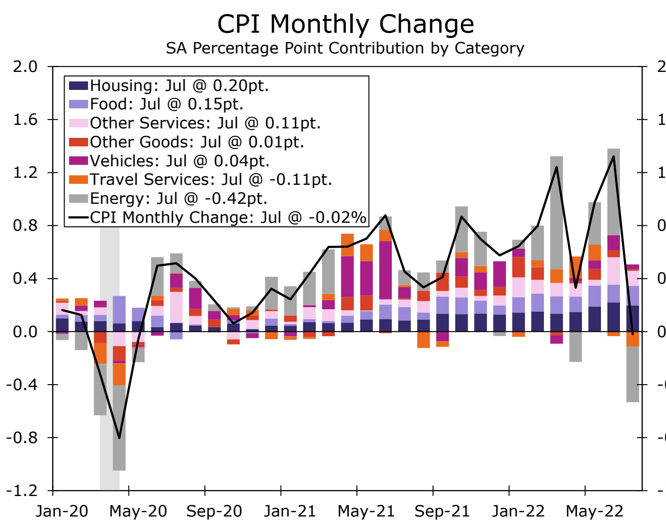
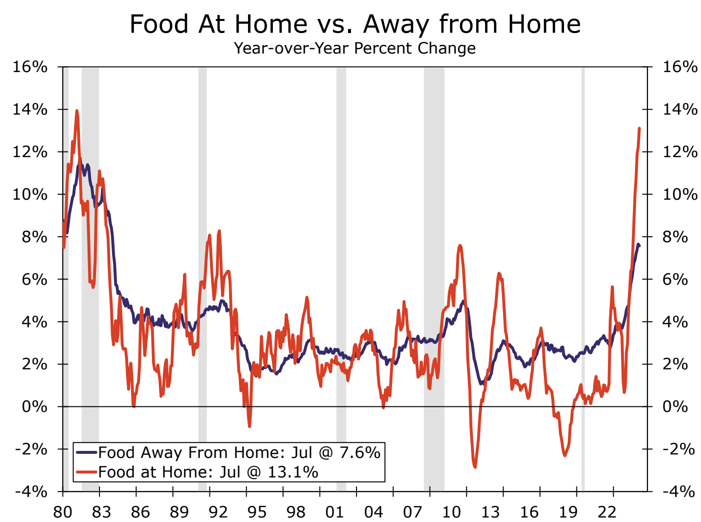
Relief at the Pump, but Not at the Grocery Store

CPI inflation in July cooled from the scorching hot pace seen in May and June. Consumer prices were unchanged in July, the smallest month-over-month change since May 2020. On a year-ago basis, prices were up 8.5%, down from the 9.1% year-over-year pace registered in June. Falling gasoline prices were a major contributor to the slowdown in price growth. Motor fuel prices were down 7.6% in July on a seasonally adjusted basis. Through the first half of August there has been some additional relief at the pump, and we would not be surprised to see another sizable decline in motor fuel prices in next month's CPI release. Energy services inflation also eased to just 0.1% from 3.0% and 3.5% in May and June, respectively, as natural gas prices receded in early July.

Grocery store shoppers did not see similar relief when checking out. Consumer prices for food at home rose 1.3%, another robust print that pushed the year-over-year increase to 13.1%, the highest since 1979. Food away from home prices rose a smaller but still-hot 0.7%. We expect some moderate cooling in food price growth to eventually take hold as agricultural commodity prices have declined in recent months and transportation costs have eased a bit. However, for the time being food inflation remains one of the biggest squeezes on households' already constrained budgets.



Source: U.S. Department of Labor and Wells Fargo Economics



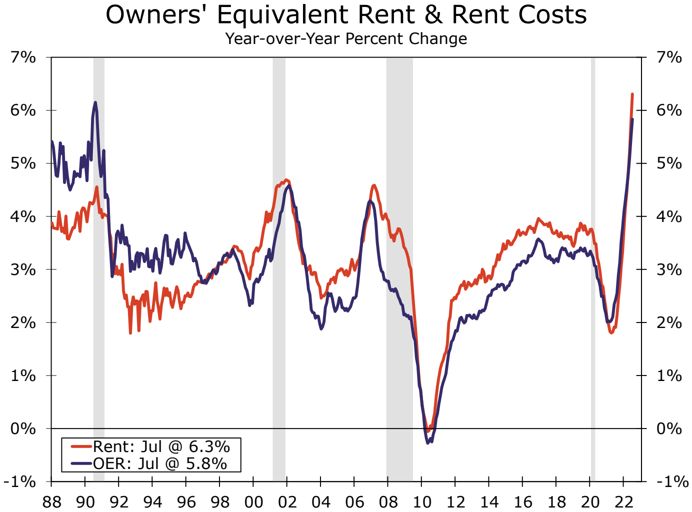
Source: U.S. Department of Labor and Wells Fargo Economics

Weary Travelers Finally Seeing Lower Prices

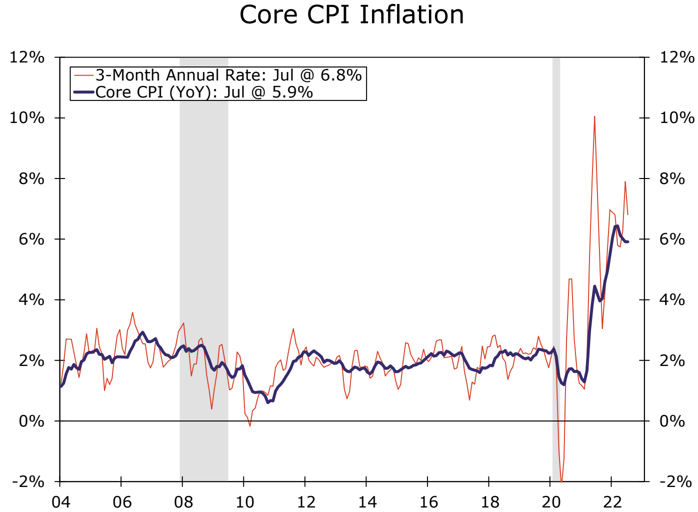
Excluding food and energy prices, “core” CPI rose just 0.3% in July, matching the slowest pace of monthly core inflation seen in 2022. Core goods inflation eased to 0.2% over the month. Modest deflation was seen in apparel and education and communication goods prices, a welcome development for back-to-school shoppers hitting the stores before the fall. Used car and truck prices also fell in July, declining 0.4%. However, not all goods categories showed clear signs of easing inflation. Prices for household furnishings rose 0.6%, a tenth higher than the 0.5% registered in June, while prices for new vehicles matched June's 0.6% growth.

Core services inflation was the biggest surprise in the release, increasing just 0.4% in July (generously rounded up from 0.35%). Travel-related “reopening” categories posted some sizable price declines. Airline fares fell 7.8% in the month, prices for lodging away from home declined 2.7% and rental car prices dropped 9.5%. Most of these categories have seen significant inflation in recent months and a reversal was not entirely unexpected. That said, the magnitude of the drops are notable and contributed to the downside miss for overall inflation.

Rent and owners' equivalent rent price growth both slowed by a tenth of a percentage point relative to June, increasing 0.5% and 0.6%, respectively. Inflation in these two categories remains high both on a monthly and year-ago basis, and we do not expect to see the year-over-year peak until later this year or even early next near. That said, these categories comprise a much larger share of the index and are far less volatile than many other service-oriented categories, such as airline fares. An inflection point in monthly inflation for rent and OER, should one become clear, would mark an important inflection point in the inflation story.



Source: U.S. Department of Labor and Wells Fargo Economics



Source: U.S. Department of Labor and Wells Fargo Economics

Journey of 1,000 Miles

Numerous members of the FOMC have made clear that they need to see compelling evidence that inflation is slowing on a *sustained* basis before pivoting on monetary policy. Today's CPI report is an important *first* step in that direction. Receding fuel prices are a welcome development, and when paired with the slowdown in core CPI, the Federal Reserve finally has an inflation print with some positive takeaways.

That said, it is important to remember that this is just one data point, and the past couple CPI reports have included significant upside surprises. In addition, there have been head fakes in the inflation data before, and we highly doubt the FOMC is ready to declare victory over inflation after just one softer-than-expected CPI report. Core CPI is still up 5.9% year-over-year and has grown at a 6.8% annualized pace over the past three months. The next CPI report will be released on September 13, just one week before the next FOMC meeting. A 75 bps rate hike at that meeting remains our base case, but the FOMC could go "just" 50 bps if that report provides additional evidence that inflation is slowing on a sustained basis.

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