Weekly Economic Brief

12 July 2024 | Principal Economist's View

US inflation dragon suffers a blow

Weakest monthly core CPI reading in the US since 2021 builds case for Fed rate cuts

The emergence of the inflation dragon over 2021-22 and the subsequent central bank rate hikes to contain it have dominated the financial market landscape for the past few years. The first quarter of 2024 was no exception, with the US economy marred by a surprise pick-up in inflation momentum. This clearly delayed plans of policy easing by the US Federal Reserve over the first half of 2024.

However, recent inflation outturns emanating from the US have been far more encouraging. The latest CPI reading for June surprised to the downside, with headline prices dropping 0.1% over the month. This saw the year-ended inflation rate fall from 3.3% to 3.0%, the equal lowest outturn seen since March 2021.

While lower gasoline prices were partly behind the fall in June, the far more promising aspect were signs of weaker underlying inflationary pressures. Excluding food and energy prices, the core CPI was surprisingly tame, rising just 0.1% over the month. This was the softest monthly outturn since January 2021. In year-ended terms, the core CPI inflation rate eased from 3.4% to 3.3% in June, again the lowest outturn since 2021.

Importantly, the details of the CPI report revealed a broad-based moderation in underlying price pressures. Core goods prices continued to fall over the month, largely due to a moderation in auto prices, while core services price inflation excluding housing rent also fell following sharp gains earlier in the year. Housing rents (both primary and owner-occupier) are also finally showing signs of a meaningful moderation in growth, rising just 0.3% over the month, down from 0.4% in each of the prior three months. The long-foreshadowed moderation in housing rents is important, as they tend to be a stickier component of the CPI, and incoming data on new leases suggests this more moderate pace of rental growth should continue beyond June.

Looking through the details, there are some reasons to suspect that the moderation of inflation evident in June may modestly overstate the underlying trend in prices. In particular, outsized falls in airfares (-5%) and lodging away from home (-2%) are unlikely to be repeated. Nonetheless, even excluding these factors there is clear evidence of diminishing inflation pressures in the US over recent months.

To highlight the recent improvement in inflation momentum, one only needs to look at the annualised rate of core CPI inflation over the past three-month period that has slowed to just 2.1% in June, down from an elevated 4.5% seen in the prior three-month period to March.

The incoming inflation data will no doubt be welcomed by the US Federal Reserve. In his semi-annual testimony to Congress this week, Fed Chair Powell noted "*…the most recent inflation readings, however, have shown some modest further progress, and more good data would strengthen our confidence that inflation is moving sustainably toward 2 percent."* The subsequently released CPI report provided the 'more good' data that the Fed was looking for.

While Powell's testimony was very similar to previous messaging, there was a minor change in emphasis around the balance of risks with increased focus on the softening labour market and economic data. In particular, Chair Powell noted that "*We know that reducing policy restraint too soon or too much could stall or even reverse the progress we have seen on inflation. At the same time, in light of the progress made both in lowering inflation and in cooling the labor market over the past two years, elevated inflation is not the only risk we face. Reducing policy restraint too late or too little could unduly weaken economic activity and employment."*

Given our expectations of an ongoing moderation in inflationary pressures and further softening in the labour market, we continue to expect two rate cuts by the US Federal Reserve in 2024, with the first commencing in September. Financial markets have adopted a similar view, pricing in a rate cut in September and almost 2½ cuts by December. Although policy will need to remain restrictive for some time to ensure the inflation dragon is well and truly slayed, the progress seen to date should allow the Fed to move towards lowering rates in September.

Table 1: Financial market movements: 4 - 11 July 2024

EQUITY INDEX	LEVEL	CHANGE	10-YR GOVERNMENT BOND	YIELD	CHANGE	FOREIGN EXCHANGE	RATE	CHANGE
S&P 500	5,584.5	0.9%	US	4.21%	-14.9 bps	US Dollar Index (DXY)	104.44	-0.7%
Nikkei 225	42,224.0	3.2%	Japan	1.09%	0.9 bps	USD-JPY	158.84	-1.5%
FTSE 100	8,223.3	-0.2%	UK	4.07%	-12.3 bps	GBP-USD	1.292	1.2%
DAX	18,534.6	0.5%	Germany	2.46%	-14.5 bps	EUR-USD	1.087	0.5%
S&P/ASX 200	7,889.6	0.7%	Australia	4.37%	-4.1 bps	AUD-USD	0.676	0.5%

Source: Bloomberg

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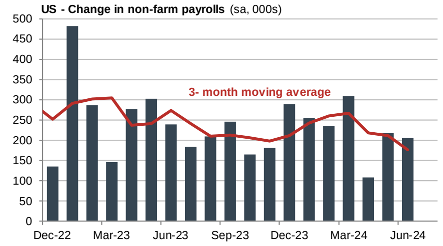
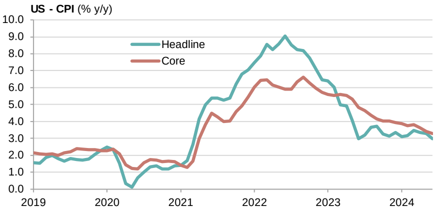
Economic update by region

United States

US labour market remains healthy, but further signs of cooling emerge

- The US labour market has shown further signs of easing, with the 206k rise in non-farm payrolls in June offset by backward revisions totalling 111k in the previous two months. Additionally, the unemployment rate increased to 4.1% in June, rising above 4% for the first time since January 2022.
- The June print for CPI gave further evidence of continued moderation in inflationary pressures, with the total CPI index declining by 0.1% over the month. CPI excluding food and energy (the core measure) also moderated over the month, growing by 0.1% in June compared to 0.2% in May. In year-ended terms, the headline inflation rate moderated from 3.3% to 3.0%, while the core inflation rate eased from 3.4% to 3.3%.

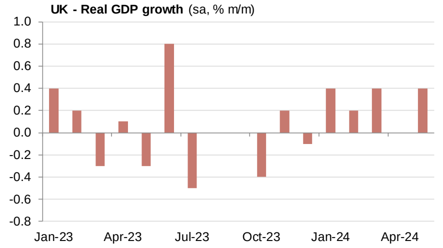




Euro area/United Kingdom

UK economy continues to recover

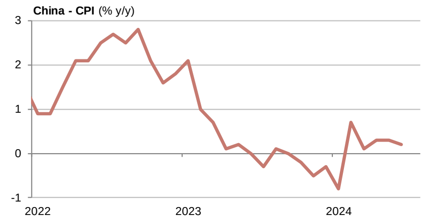
- UK real GDP is estimated to have grown by 0.4% in May, an improvement on the zero-growth recorded in April. Over the three months to May, GDP has grown by 0.9%, the strongest rate of growth since 2022. The UK economy continues to emerge from the recession it experienced in the second half of 2023.
- The volume of euro area retail sales edged up by 0.1% in May partially reversing April's modest fall of 0.2%.



China/Japan

Chinese inflation remains subdued

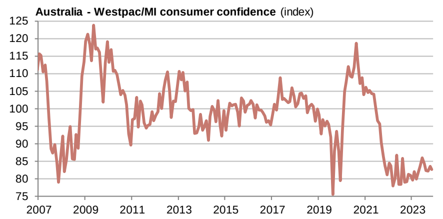
- Inflationary pressures remain weak in China with the headline rate of inflation moderating to 0.2% in June from 0.3% in May. The rate of producer price inflation fell to -0.8% in June marking the 21st consecutive month of deflation in producer prices. However, there are some signs of a moderation in deflationary pressures with producer prices recording their slowest rate of decline since January 2023.



Australia/New Zealand

Confidence amongst Australian consumers remains depressed

- The Westpac consumer sentiment index declined by 1.1% to an index level of 82.7 in July indicating that Australian consumers continue to remain very pessimistic. The decline was driven by fears of persistent inflation and the prospect of a cash rate hike caused by the upside surprise in the May CPI print.
- The NAB business confidence index rose by 6 points in June to +4 points following a slip into negative territory in May. In contrast, business conditions declined by 2 points over the month driven primarily by a fall of 5 points in employment conditions.



Sources: Refinitiv, QIC