Weekly Market Commentary
September 18, 2023

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A raft of key economic data filled the calendar this week and, while some ran afoul of forecasts, the general narrative regarding the economy and monetary policy remained intact. If you're a gambling person, you would have hit the jackpot had you correctly predicted that both the consumer price index and retail sales rose 0.6 percent in August. The odds of a double six occurring with one roll of two dice is precisely 0.028 percent, a chance occurrence that is about as meaningless as the outsized headline reading for retail inflation and sales last month. Both increases exaggerate underlying trends, and neither will alter perceptions of policymakers or investors regarding the economic and inflation backdrop.

Simply put, both the CPI and retail sales, which are reported in current dollars, received a big boost from higher gasoline prices. The surge in pump prices accounted for more than half the 0.6 percent CPI surge – the strongest monthly increase in more than a year – and more than 70 percent of the increase in retail sales. Subtract gasoline, and the retail sales gains comes to a far more modest 0.2 percent. Likewise, the increase in the CPI would be cut in half, absent the rise in fuel costs, which would be spot-on with the 0.3 percent average increases, excluding gasoline, over the past 10 months. The Federal Reserve will look through the distortions created by surging energy prices when it meets next week. We, along with the consensus, do not expect policymakers to make any change in interest rates at the meeting, but all eyes will be laser focused on the new set of economic projections coming out of the meeting. Given the stronger-than-expected economic backdrop that evolved since the last SEP was released at the June meeting, the prospect for additional rate hikes at one of the two remaining policy meetings this year is very much alive.

To be sure, most interest rate traders still believe that the last rate increase taken at the July meeting will be the last of the rate-hiking cycle. Still, no one at the Fed is declaring victory in the inflation fight and there remains a palpable fear of easing off the brakes before there is clear evidence that the trend towards the two percent inflation target is firmly underway. Although more than four decades have passed, the premature easing during the 1970s that allowed the inflation embers to reignite is still fresh in the minds of many Fed officials. Hence, despite the outsize influence of energy prices, the uptick in the year-over-year headline inflation rate, from 3.3 percent to 3.7 percent, seen in the latest CPI report is a hiccup that could unsettle some Fed officials. Keep in mind that inflation is a process that unfolds in a nonlinear fashion, and policymakers have been stung by misleading price slowdowns a few times during this inflation cycle that were not sustained.

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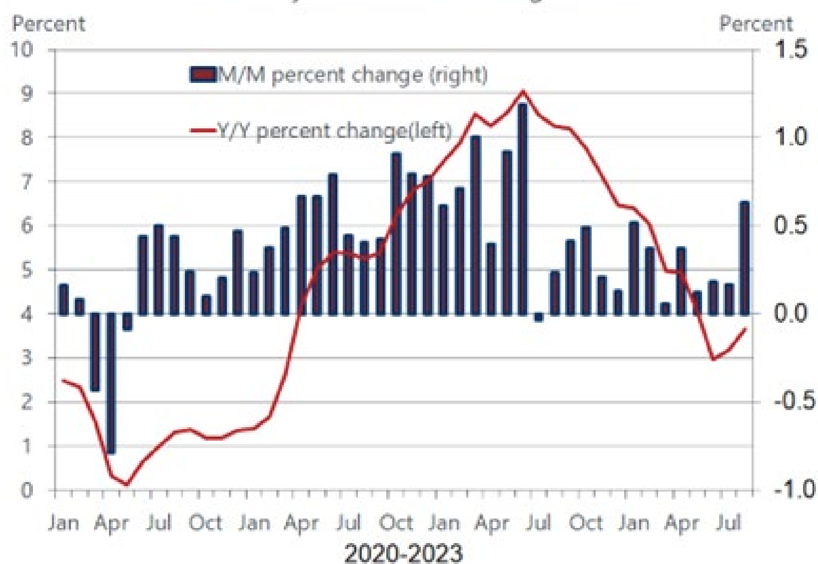


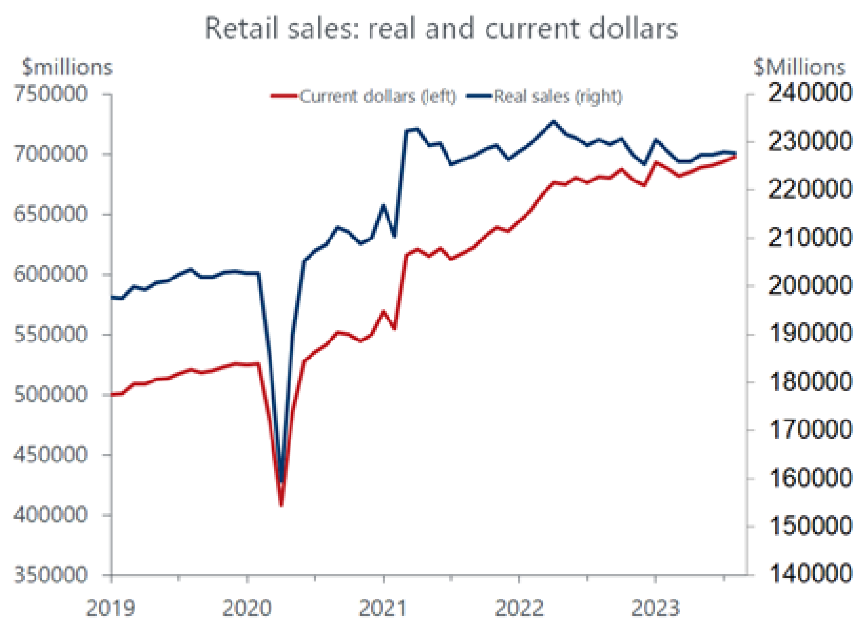
That said, the energy-induced spike in the consumer price index last month would be more worrisome if higher fuel prices fed through to the broader economy and boosted inflation expectations. So far, that is not the case. Indeed, the University of Michigan's latest survey of households released Friday morning showed that year-ahead inflation expectations fell in early September to the lowest level since March 2021, despite elevated gas prices. The short-term index can be noisy and is often revised when the survey for the full month is released. But encouragingly, longer term household expectations also fell to the lowest level in a year. For now, at least, the higher cost of fuel is taking a bigger toll on households' perception of the economy – potentially sapping strength from spending – than on their inflation concerns. From the Fed's point of view, that's probably a welcome development, as it strives to curb growth to reduce inflation.

But the climb in energy prices is having some ripple effects, particularly in sectors where energy costs loom large as an expense item. The airline industry, which is buffeted by rising fuel prices, is a prime candidate for this sort of pass-through, as airline fares jumped 4.9 percent in August following four months of declines. On a broader scale, the increase in the core CPI, which excludes volatile food and energy prices, kicked up to 0.3 percent last month from 0.2 percent in each of the previous two months. Compared to a year ago, the core measure did retreat to 4.3 percent from 4.7 percent, but core service prices, which excludes housing costs and which the Fed is closely following because they are heavily influenced by labor costs, increased by 0.5 percent last month, the strongest since January.

Overall, the September reading on inflation presented a mixed picture. At best, it didn't upend the disinflationary trend that has been underway over the past year. But it also confirmed that the road to two percent inflation is riddled with potholes, and driving the last mile will be bumpier than the journey so far. While the Fed may not raise rates again this year, it is not likely to cut them anytime soon, consistent with the prevailing mantra that rates will stay higher for longer. Underscoring this prospect is the economy's surprising resilience to the aggressive rate hikes over the past 18 months, something that has remained intact early in the third quarter thanks to the sturdy support of consumers. But like the September inflation reading, the latest report on consumer behavior is also flashing mixed signals.

Like the consumer price report, the headline increase in retail sales last month was stronger than expected, as the 0.6 percent gain was the largest in four months. But as noted earlier, the strength was entirely a product of surging gasoline sales, reflecting higher prices at the pump. Excluding service station sales, spending rose by a much more modest 0.2 percent. There are signs that the increased cost of filling up the tank diverted funds that would be used for other purchases. Online sales, for example, were flat in August and spending on furniture and sporting goods fell. Meanwhile, sales at bars and restaurants and department stores slowed considerably and the so-called control group of sales, which feeds directly into the GDP calculation, eked out a slim 0.1 percent increase, the weakest showing in six months.

Importantly, the 0.6 percent increase in overall retail sales was canceled out by the 0.6 percent increase in prices, so real purchases were virtually unchanged in August. However, sturdy consumer spending in July got the third quarter off to a strong start, which should translate into another solid growth rate of roundly three percent for the period even if households curb outlays in both August and September. From our lens, however, this should be the peak growth of the cycle, as the headwinds weighing on the economy are poised to gain traction. A big chunk of the excess savings accumulated during the pandemic has been depleted, job growth is slowing, borrowing has become much more expensive, students loan repayments have been restored and inflation has robbed the purchasing power of households.



Indeed, for the first time in six months, prices rose faster than wages in August, cutting real average hourly earnings by 0.5 percent during the month and leaving inflation-adjusted worker pay a slim 0.5 percent higher than a year ago. This is a trend that is clearly influencing wage negotiations surrounding the auto workers strike, which began this week. The once ubiquitous COLA clauses so prevalent during the 1970s have long been dormant as inflation (and union membership) has receded over the past 35 years. But the UAW has restored it as a key bargaining chip in its demands, reflecting the virulent inflation cycle that the Fed is desperate to bring under control before it more broadly infiltrates the mindset of workers.

Real average hourly earnings
Y/Y percent change
10
8
6
4
2
0
-2
-4
2008
2011
2014
2017
2020
2023