

AWAITING THE INFLATION TRIFECTA...

COMMENTARY

FEBRUARY 2025

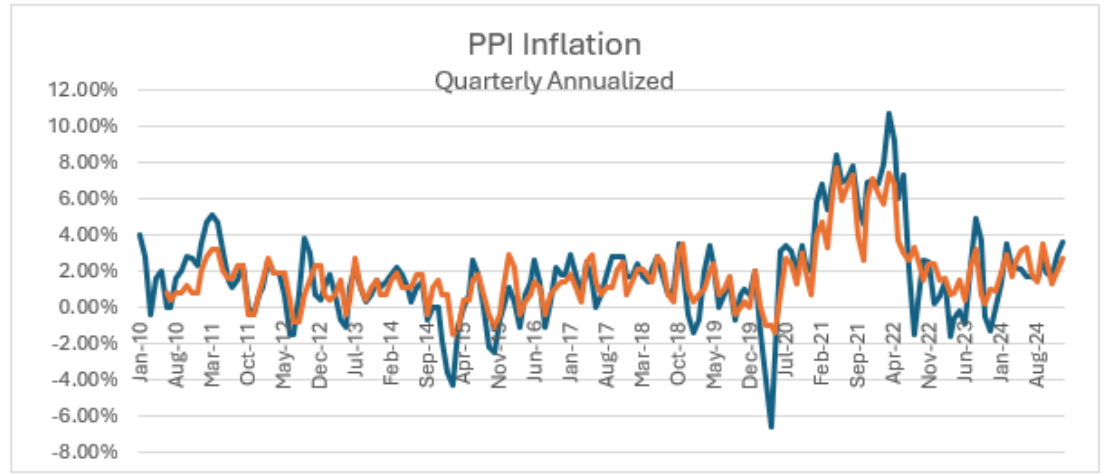
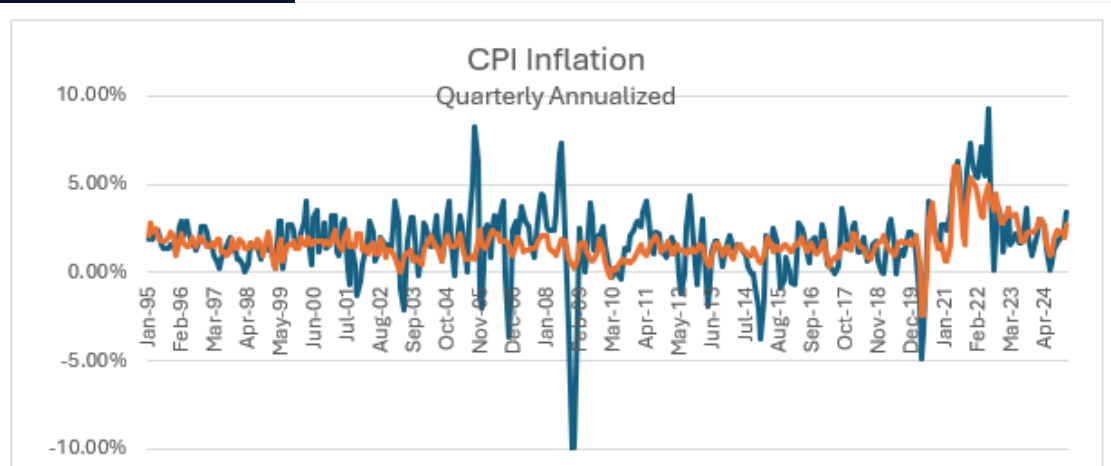


Figure 1- Source: US Bureau of Labor Statistics and FactSet

Two inflation readings hit recently that seem to have thrown some cold water on the market's expectation for lower interest rates. Whether the focus was on consumer prices (CPI)¹ or producer prices (PPI)² and whether one was looking at "core" inflation (removing the impact of more volatile food and energy prices), the inflation readings were stronger than expected and seem to be moving away from the Fed's stated 2% goal.

As we have previously indicated, it made little sense to us that the Fed's stated inflation goal was based on a number that was unsupported by historical data – particularly for a Fed that has been (and remains) so data dependent.

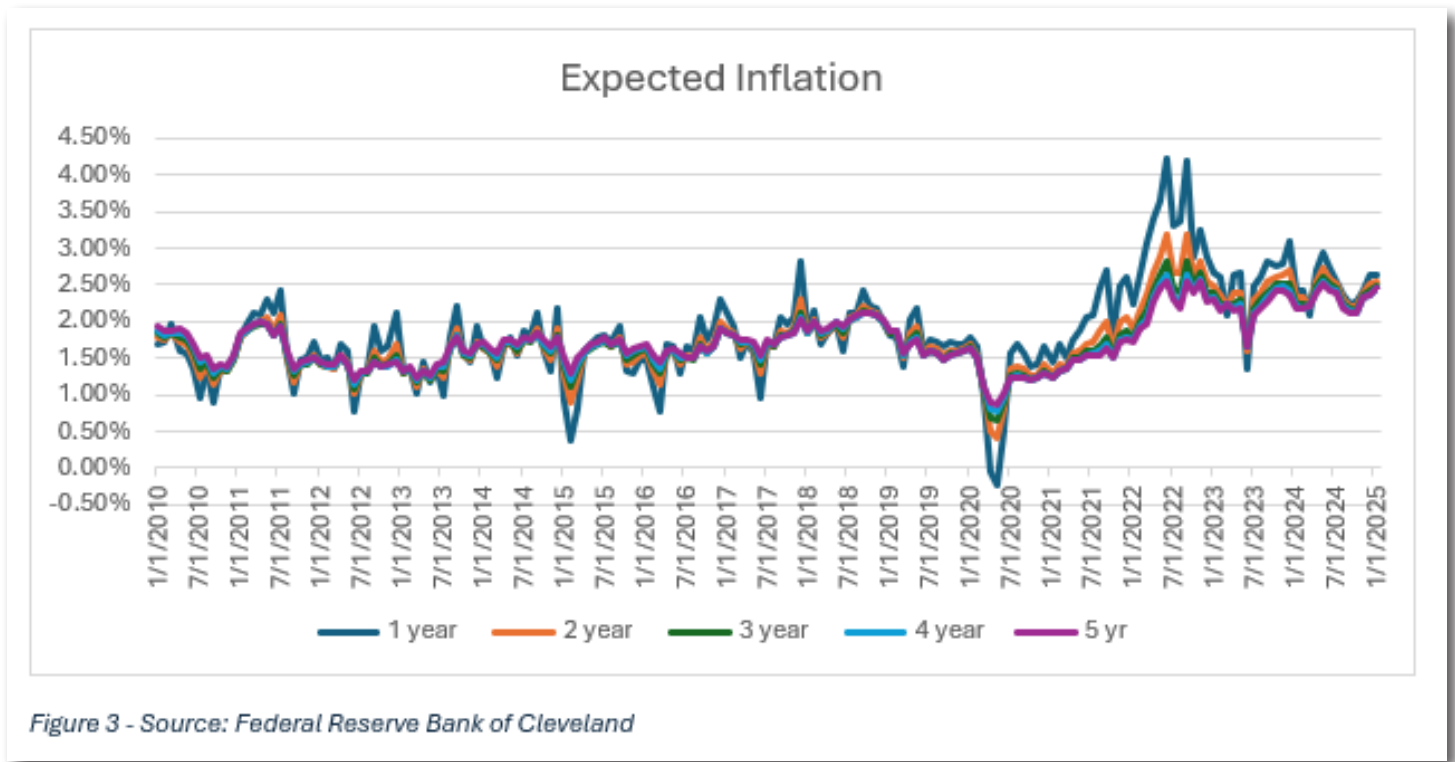
While Core PCE (Personal Consumption Expenditures after removing the impact of food and energy prices) is the Fed's preferred gauge of inflation, it has also remained stubbornly above the 2% target rate on a quarterly average basis (though it did touch the target in 2023 and, very briefly, in 2024). We will await the second estimate of Q4 GDP at the end of February to see if we get the inflation trifecta (all three measures rising) but would point to another measure (expected inflation) as a potential warning.

The Federal Reserve Bank of Cleveland does a quarterly survey of inflation expectations over the next twelve months and that data is also not supportive of lower inflation. As you can see from the chart below, the market expects the inflation rate to be well above its 2% target...



Figure 2 - Source: Federal Reserve Bank of Cleveland

...and its not just the survey data showing expected inflation higher than the target rate. The chart below shows 1,2,3,4 and 5-year expected inflation rates as calculated by the Federal Reserve Bank of Cleveland.



The big question in our mind is this: If CPI and PPI inflation (on a core basis) are staying above the 2% inflation goal and if expected inflation is above the 2% goal, is it realistic to think that the Fed will be successful in getting to 2%? A similar question is: If inflation remains higher than expected is it realistic to expect lower interest rates?

We think that the answer to both is, "No".

1. The Consumer Price Index (CPI) is a measure of the average change over time in the prices paid by urban consumers for a market basket of goods and services.
2. The {Producer Price Index (PPI) program measures the average change over time in the selling prices received by domestic producers for their output.

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