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DECODING

US inflation: the slowdown has begun

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After reaching its highest levels since the early 1980s and provoking a reaction from central banks unparalleled since the same period, US inflation now seems to be clearly in a phase of slowdown. This will not be without consequences for the Fed policy.

Inflation at the highest level since the early 1980s

In the United States, inflation accelerated sharply from the end of 2021 due to a combination of factors: rising energy and food prices (exacerbated by the war in Ukraine), shortages in the labor market (partly because of the "great resignation"), shortages of semiconductors that disrupted car production, housing shortages, excess savings stimulating demand, etc. A study by the San Francisco Fed[1] shows that the acceleration in US inflation over the past 18 months stems from almost as much supply factors as demand factors.

At their peak in June 2022, consumer prices (CPI) were up 9.1%, more than 4 times the Fed's 2% inflation target. This prompted the Fed to begin the fastest rate hike cycle since the early 1980s (the famous "Volcker shock"). Fed funds were thus raised by 375 basis points between March and November 2022. This ultra-rapid monetary tightening had many consequences. Among the most important:

- The dollar appreciated very strongly, in large part because the Fed's actions have been stronger than that of the other major developed central banks,
- Real rates have risen sharply (the 10-year real rate has risen by 250 basis points since the first rate hike, which is significantly more than during the "taper tantrum" episode in 2013), which has penalized "growth" stocks,
- A very marked slowdown in the real estate market, with a collapse in the number of transactions and the first price reductions for 10 years.

But as we will see below, a number of elements suggest that inflation is now in a phase of marked slowdown.

See Appendices – Graph 1 and 2

For energy and food, towards the dissipation of base effects

Although the energy crisis has affected the United States less than Europe, the US energy CPI in 2022 experienced an increase of a magnitude similar to the oil shocks of the 1970s, largely due to the rise in prices at the pump. The fall and then the stabilization of the latter (partly caused by the depletion of 180 million oil barrels from strategic stocks by the Biden administration) allowed a sharp drop in the contribution of energy to inflation. Assuming a stabilization of energy prices in the United States, even at relatively high levels, the energy-related base effects would dissipate markedly from the start of 2023.

With regard to food prices, their evolution is closely linked to that of energy prices and a slowdown in energy prices should automatically induce a slowdown in food prices. In addition, it has been observed in recent decades that the CPI for food was about 6 months behind the FAO food price index, but the latter began to decelerate markedly a few months ago (it

[1] Shapiro A., 2022, « Decomposing Supply and Demand driven Inflation », Fed of San Francisco working paper n°2022-18.

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went from +30% year-on-year in April to +2% in October). Food should therefore also contribute to slowing inflation.

See Appendices – Graph 3 and 4

For core inflation, several reasons to expect a deceleration

Core inflation, i.e. inflation excluding energy and food, was up 6.3% year-on-year in October. Of this 6.3%, 3.4% was attributable to "housing excluding energy", 1.3% to "transport excluding energy", 0.5% to healthcare.

The "housing excluding energy" CPI, which is therefore unquestionably the heavyweight of underlying inflation, has risen very strongly this year, largely because property prices have experienced a historically strong increase over the past two years: +43% at the end of 2019 and mid-2022! The very brutal monetary tightening by the Fed resulted in a very sharp halt in the real estate market (transactions collapsed and prices began to fall for the first time in ten years). Rents, recorded on the market by private institutions, have also slowed sharply. The progression of the "housing excluding energy" CPI, which lags these figures by around 8 to 12 months, should therefore peak rather soon.

See Appendices – Graph 5

Another reason to expect a core inflation slowdown relates to car prices. The shortages of semiconductors that emerged during the covid crisis have strongly affected automobile production, which has caused the price of cars to rise sharply. The recent improvement in the situation for automobile production has started to drive down car prices: the Manheim index (price of used vehicles) was down 10.6% year-on-year in October and the index JD Power (new vehicle prices) stabilized. The "transport excluding energy" CPI usually lags these private indices by a few months and its contribution to the core CPI should therefore also fall sharply.

See Appendices – Graph 6

For methodological reasons, the "health insurance" CPI (0.9% of the consumption basket monitored by the BLS) should be down over the next few months and this should contribute to a drop in the core CPI of more than 0.3 points over the next 6 months.

See Appendices – Graph 7

Finally, the strong appreciation of the effective dollar in 2022 lowers the price of imports, which will also constitute a factor of disinflation in the coming months.

A combination of factors means that we can now think that the slowdown in US inflation is now firmly under way. In this context, the Fed will therefore modify its monetary tightening policy: after four 75 bp rate hikes, the pace of rate hikes will now slow down. Several communications from members of the Fed Board seem to confirm this. Statements by Christopher Waller, who has been a hawk among hawks this year and who has often been pessimistic about the inflation outlook, support this: according to him, recent positive developments on the inflation front mean that the Fed may switch to 50 bps rate hikes or even 25 bps rate hikes if these positive developments continue. Even if questions can always arise within the FOMC, the era of "always more aggressive" from the Fed seems to be over now.

While US inflation should slow down in the coming months, it is likely to be higher in the coming years than in the 2010s but also more volatile, for example due to demographic phenomena (labour shortages that settle), meteorological phenomena (for example, destruction of crops or drying up of waterways) or even energy (energy prices made more volatile by a disorderly energy transition).

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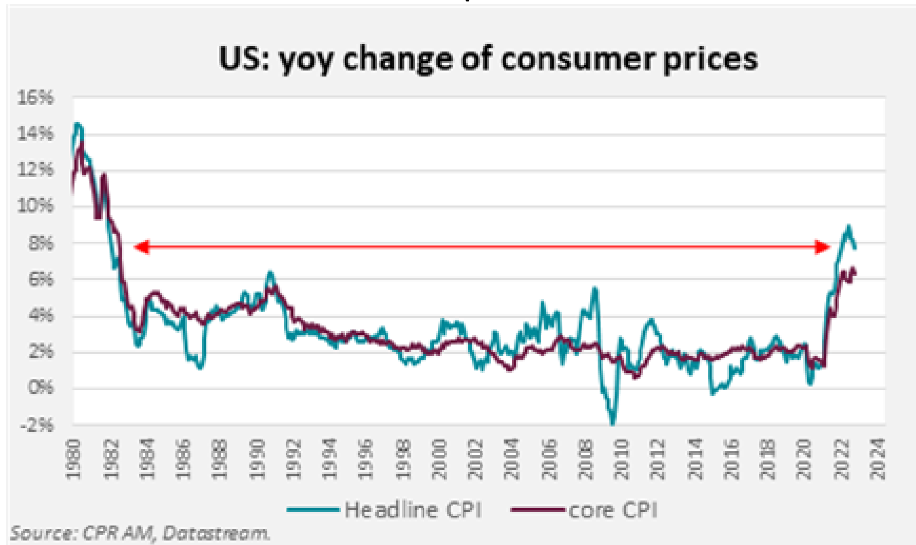
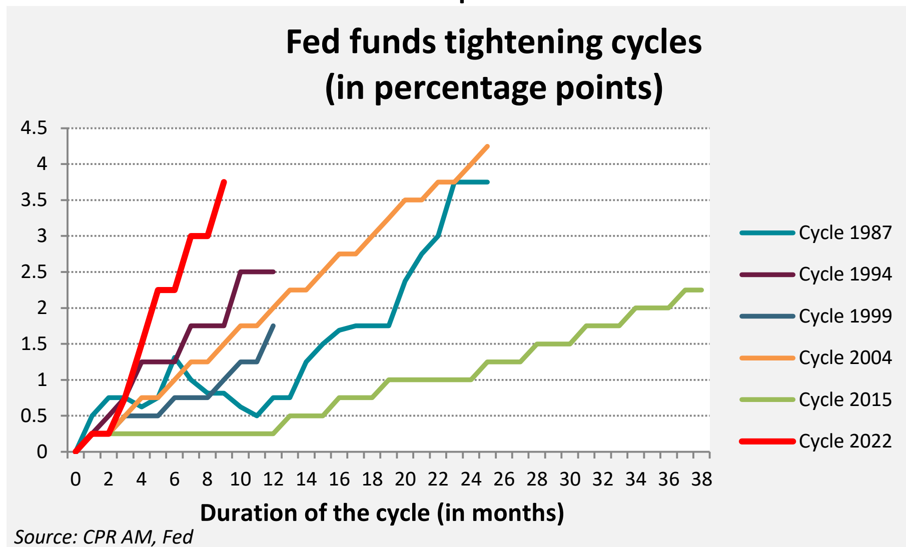
Appendices

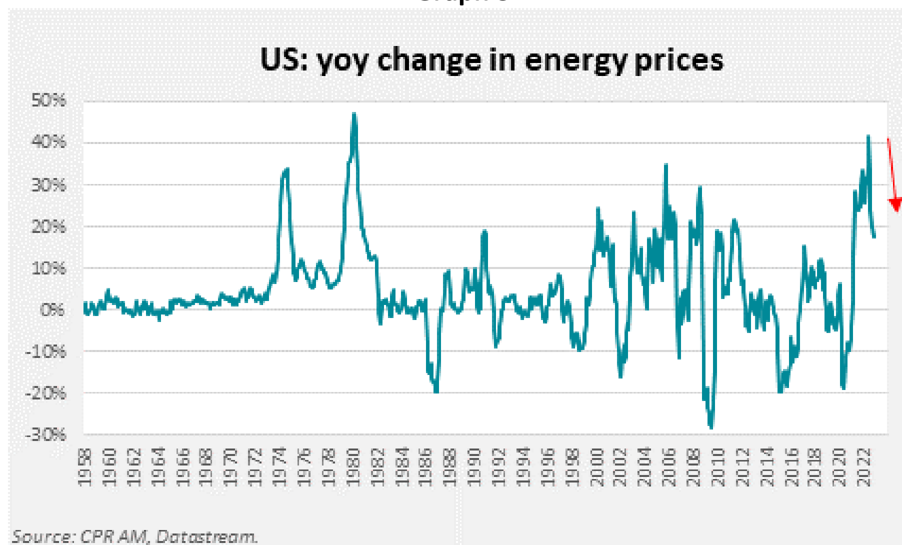
Graph 1



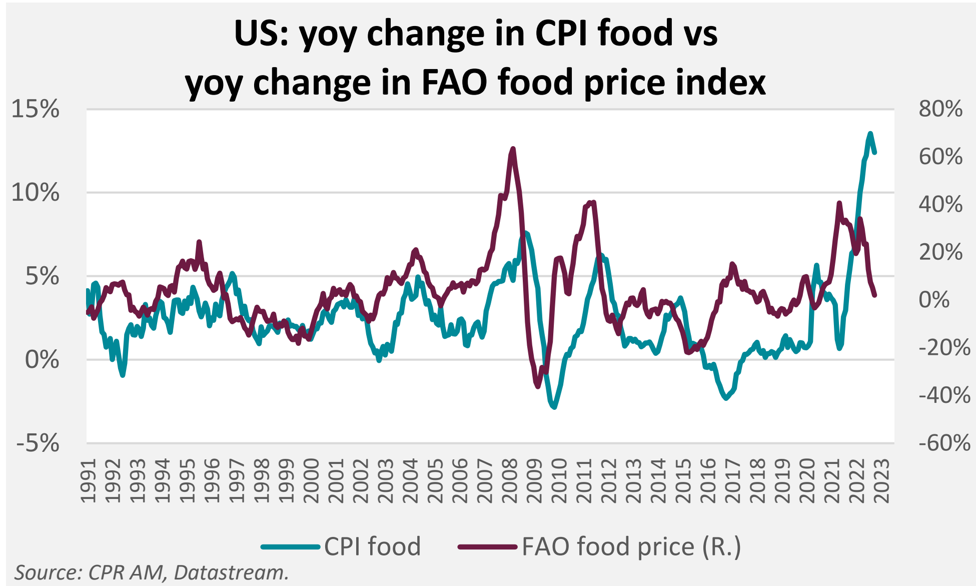
Graph 2



Graph 3

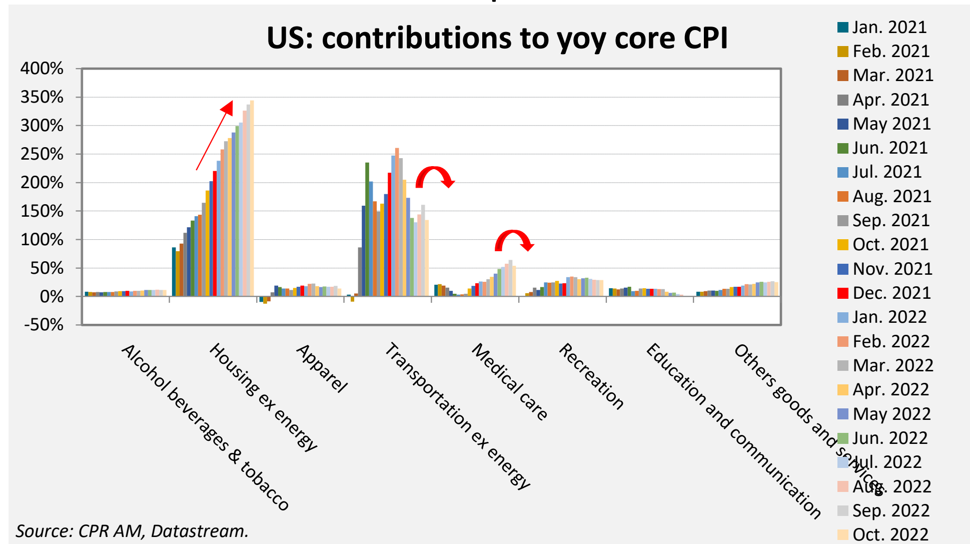


Graph 4



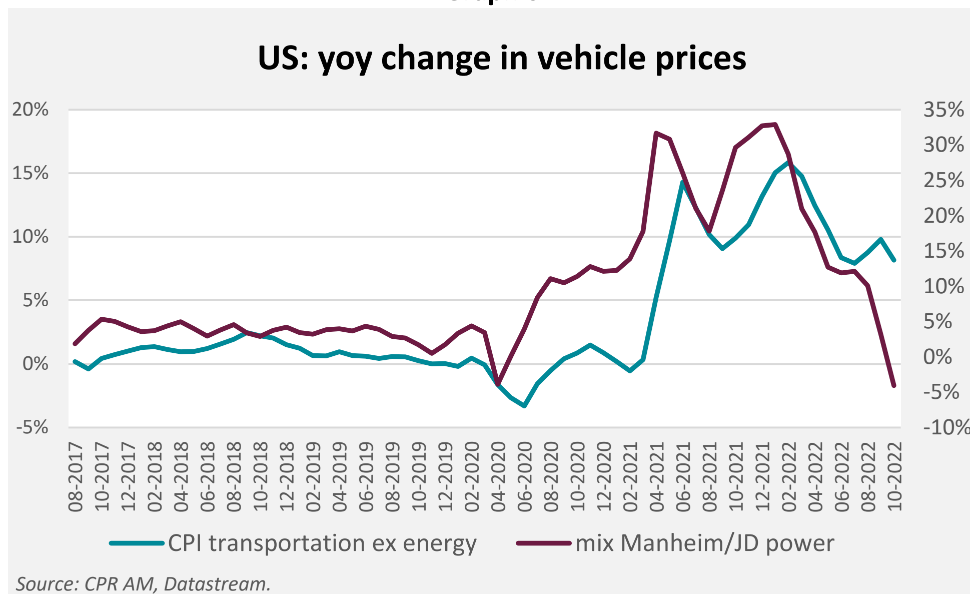
Source: CPR AM, Datastream.

Graph 5



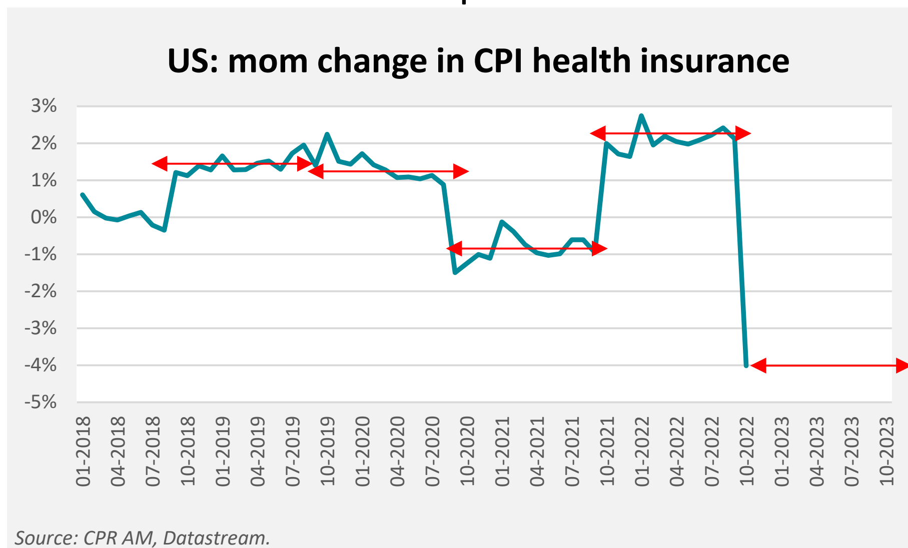
Source: CPR AM, Datastream.

Graph 6



Source: CPR AM, Datastream.

Graph 7



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