US August CPI still shows some inflation pressures remain

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The August CPI inflation readings were generally in-line with expectations with overall CPI moderating to 2.5% YoY from 2.9% the previous month and Core CPI remaining steady at 3.2% YoY. However, on a month-on-month basis, while overall inflation was 0.2%, **Core inflation was higher than expected at 0.3% MoM.**

The higher than expected Core inflation was mainly due to rising shelter inflation, which increased to 0.5% MoM, the strongest level since January. Shelter inflation has remained stubbornly high and seems to be stabilizing around 5% on a year-on-year basis (August was 5.2% YoY). Shelter makes up 35% of overall inflation so if it remains at higher levels, this would make the Fed's 2% target very difficult to achieve. Pre-pandemic, Shelter was generally in the 2-3% range.

Looking at Services ex Shelter also showed some worrying trends. Core Services ex Shelter is at 4.5% YoY, which is down from 5% in March, but is up from 3.6% a year ago. On a month-on-month annualized basis, it has been increasing the past 3 months to 3% from below 0% in May. With both Shelter and Core Services ex Shelter maintaining higher levels, overall Core Services remained steady at 4.9% YoY and increased to 0.4% MoM.

While Services is still running high, other parts of inflation have been showing much better progress. Food inflation was 2.1% in August and has been around 2% for much of this year. Energy, which is much more volatile was -4% YoY in August due to falling gas prices. And Core Goods was at -1.9% YoY and -0.2% MoM as New and Used Cars, Recreational Goods, and Education Goods are all in a deflationary trend now.

The Fed and financial markets had been shifting focus from inflation to the jobs market over the past few months, as the unemployment rate has been rising and with the assumption that inflation was largely under control. **The CPI report is a reminder that inflation is not yet fully under control and that a return of inflation is a risk which cannot be discounted. We believe this means the Fed can start cutting rates at its September 18 meeting, but will do so by 0.25% and that further rate cuts will also be at a 0.25% pace.** Accelerating the pace of rate cuts to 0.50% per meeting would increase the risks of a return of inflation, which the Fed will want to avoid.

The Fed meeting next week (September 18) will see the Fed start its rate cutting cycle from its current rate of 5.25%-5.50%. We believe it will reduce its rate by 0.25%. Perhaps more importantly, the Fed will also be updating its economic projections, which include its outlook for where Fed rates could be by the end of this year, end of 2025, end of 2026 and for the longer-term. Current market implied pricing indicates the Fed will cut rates by over 1% by the end of this year to 4.25% and by 2.6% by the end of 2025 to reach 2.75%. And then for the Fed rate to reach 2.5% by the end of 2026. We believe these market assumptions are too aggressive and that the Fed will only indicate 0.75% in rate cuts this year and for the Fed rate to reach 3.5% by the end of 2025 and perhaps 3% by the end of 2026. If we are correct, market pricing may adjust in the following days and weeks with yields rising from current extremely low levels.

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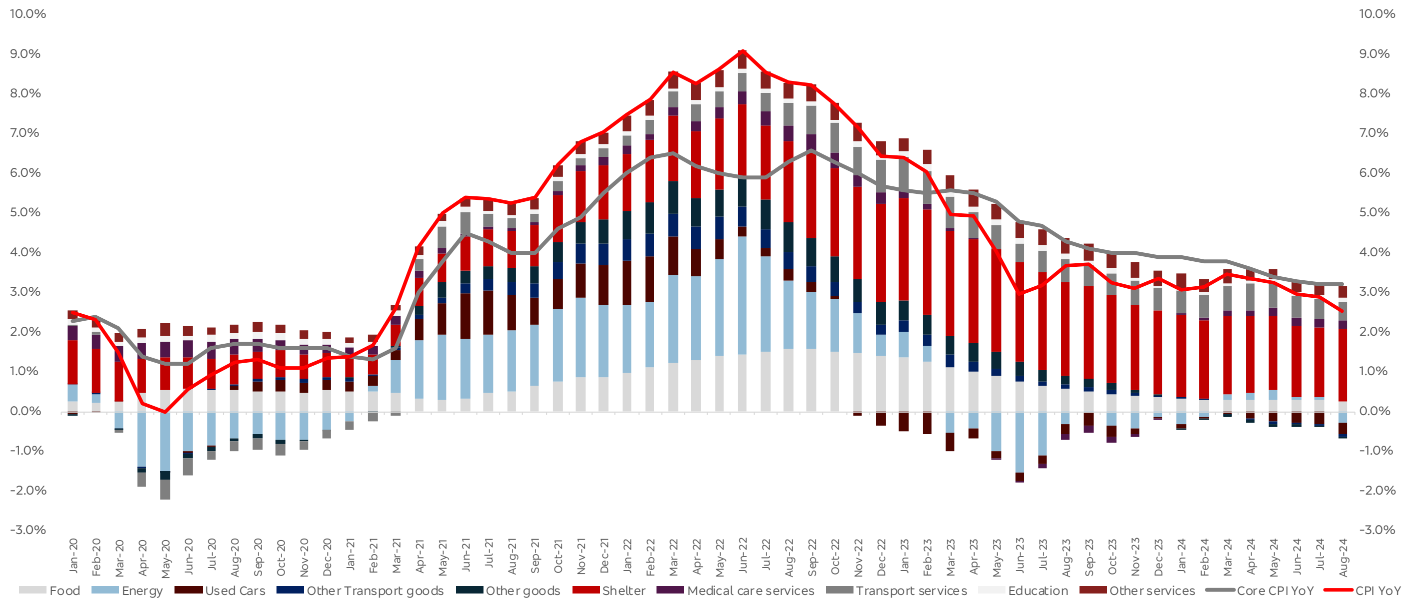
CPI falls to 2.5% YoY with Core CPl steady at 3.2% YoY



Services inflation still high with Shelter at 5.2% and Core Services ex Shelter at 4.5%

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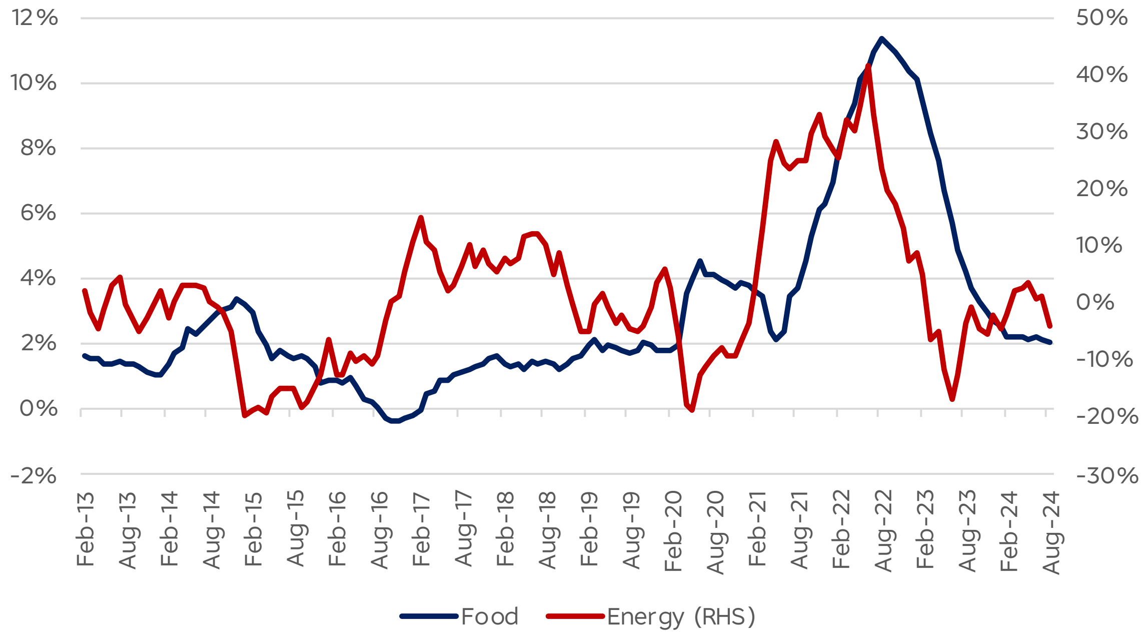
Food steady around 2%, Energy is now negative with falling gas prices



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