

Morning Market Tidbits

Confidence to cut is based on knowing underlying inflation

In focus

The Fed has told us it needs “greater confidence” that inflation is “sustainably” moving toward 2% before it begins any rate cut cycle. While we are not exactly sure what combination of inflation data will give the Fed the increased confidence it seeks, we do have a view on what the Fed means by inflation that is consistent with its target. This is a concept the Fed refers to as “underlying inflation”, or the rate of inflation that should prevail when the economy is behaving normally with output equal to potential and unemployment equal to the natural rate.

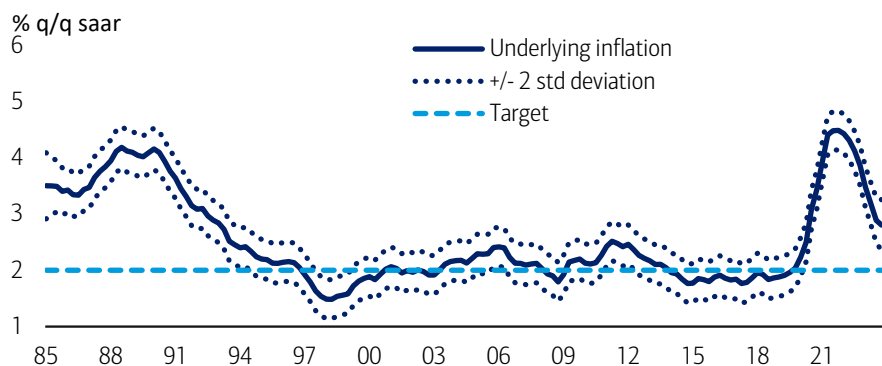
Understanding “underlying inflation” and where it is heading is important as the Fed determines when to start easing. If it keeps declining, the first rate cut should be in June as we expect. If it stalls, the Fed may be forced to delay.

Getting a clear signal on underlying inflation can be difficult. Economists generally approximate it through several well-known approaches that strip out volatile components. These include core inflation, trimmed mean measures of inflation, and sticky versus flexible price indices. Each excludes volatile categories to reveal where “underlying inflation” may be.

We think these measures are useful but flawed. For example, trimmed mean measures of inflation exclude outliers to reduce volatility. But if the distribution of price changes is skewed, then symmetric trimming of outliers may create bias. For example, if the distribution of monthly changes in the components of PCE inflation is skewed to the downside, as has been the case recently, then symmetric trimming of the outliers will trim more downside observations than upside, leaving the trimmed mean running above underlying inflation.

Exhibit 1: Underlying inflation versus the Fed's 2% inflation target (% q/q saar)

Underlying PCE inflation has fallen below 3.0%



Source: Federal Reserve, BofA Global Research

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PCE: Personal Consumption
Expenditures

In addition, these standard measures do not include information from inflation expectations, which are known to have important forward-looking information, and they do not control for the state of the business cycle. After excluding food and energy prices, core PCE inflation may be running hot or cold depending on the state of the business cycle, clouding any interpretation of where the sustainable rate of inflation may be.

We think a better ‘mousetrap’ for estimating underlying inflation – free of bias – can be constructed with actual and expected inflation data while controlling for the business cycle through a standard Phillips curve equation. This is what we detail in our report on [What lies beneath: underlying inflation and the confidence to cut](#).

We find that underlying PCE inflation has fallen from a peak of 4.5% annualized in late 2021 to 2.8% today (based on data through 4Q 2023). After accounting for the cyclical position of the economy, trends in actual inflation have moved underlying inflation lower. Inflation expectations have also played an important role in limiting the initial rise in underlying inflation and supported its subsequent decline. We think underlying inflation is “getting there” in terms of providing the Fed the confidence it desires, but more progress needs to be made.

If trends continue, underlying PCE inflation could fall to 2.3-2.6% by mid-year, supporting a first Fed cut in June. But the risk that it stops declining – or reaccelerates – is worth monitoring since the US economy continues to surprise to the upside. A more forward-looking Fed might put more weight on the signal from low inflation expectations and cut earlier, but this Fed is data-dependent and wants more evidence from actual price changes. Easing before June appears unlikely without evidence the economy is sharply weakening.

Market Action

The Asian equity markets that we cover closed mostly negative overnight. Looking at individual markets, the Indian Sensex, the Nikkei and the Korean Kospi were down 0.6%, 0.3% and 0.2% respectively. On the flipside, the Shanghai Composite and the Hang Seng rose 1.0% and 1.6% respectively.

As of 7:00 am ET, aggregate European stocks are down 0.1% and S&P500 futures are down 0.2%. In the bond markets, the US bond yields are down 1bp to 4.26%, and German Bund yields are up 1bp to 2.38%. The dollar index is at \$104.14. WTI crude oil prices are \$0.41 lower at \$76.63/bbl, and gold prices are at \$2028.33/oz.

Data Previews

FOMC Meeting Minutes

We expect the January FOMC meeting minutes to show that many Fed members remain concerned about the mix of inflation, where most of the disinflation is driven by falling goods prices while some services components remain sticky. Others are likely to remain concerned about wage growth. Finally, we will look to the minutes to see how much progress the Fed made on discussing balance sheet policies.

US GDP Tracking

Exhibit 2: BofA US GDP tracking estimate (% q/q saar)

1Q GDP tracking down a tenth from the official forecast to 0.9% q/q saar & 4Q down three-tenths to 3.1% q/q saar largely due to lower-than-expected January retail sales and downward revisions to November and December

Date	Data release	GDP	Final Sales	PCE	Res. Inv.	Struct	Equip	IPP	Gov.	Exports	Imports	Net exports (level)	CIPI (level)
2/14/24	BofA official GDP forecast	1.0	1.5	1.5	-0.5	-1.0	1.0	2.0	1.0	1.0	1.5	-912.0	67.5
2/15/24	Retail Sales	0.8	1.1	1.2	-0.9	-1.0	1.0	2.0	1.0	1.0	1.5	-915.8	66.6
2/15/24	Industrial Production	0.9	1.2	1.3	-0.9	-1.2	0.9	2.0	1.0	1.0	1.5	-915.8	66.6
2/15/24	Retail Inventories, Import Export Prices	0.9	1.1	1.3	-1.4	-1.5	0.8	2.0	1.0	0.2	1.4	-924.6	73.8
	GDP tracking	0.9	1.1	1.3	-1.4	-1.5	0.8	2.0	1.0	0.2	1.4	-924.6	73.8
	Contribution to GDP growth (pp)			0.8	-0.1	0.0	0.0	0.1	0.2			-0.2	0.0
	BofA official GDP forecast	1.0	1.5	1.5	-0.5	-1.0	1.0	2.0	1.0	1.0	1.5	-912.0	67.5

Source: BofA Global Research. Our GDP tracking estimate reflects the mechanical aggregation of incoming data that directly informs the BEA's GDP calculations. The process is distinct from our official published GDP forecast. Boldface cells indicate where data have implications for tracking estimates.

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