US inflation may have peaked, but it remains a threat

US inflation fell to 8.5% in July, down from 9.1% the previous month. But structural, not transitory, forces are pushing inflation higher. It could be around for some time yet.

by: Alex Rankine  17 AUG 2022

Petrol prices slumped by 7.7% in July
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Has US inflation finally peaked? Annual inflation fell to 8.5% in July, down from 9.1% the previous month. The fall was driven by a 7.7% month-on-month slump in US...
petrol prices in July. The data prompted traders to conclude that the Fed might not have to raise interest rates as aggressively as feared. Strong employment data – the economy added half a million jobs in July – has also encouraged bets that the economy may dodge a recession. The S&P 500 index has gained 11% in a month.

Even if the US has passed the peak, it will be some time before inflation comes back down to earth. As Campbell Harvey of Research Affiliates points out, there has been so much inflation in recent months that even if prices now remain flat for the rest of the year – an unlikely scenario – then headline annual inflation will still be at more than 6% in December.

**Inflation is structural, not transitory**

And structural forces (such as de-globalisation) are pushing prices higher. The data “gives as much reason for consternation as for celebration”, says The Economist. Annual core inflation – a measure that strips out volatile food and energy prices – is running at 5.9%, the same as the previous month.

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The strong labour market is fuelling pay growth, with wages up by an annual 5.2% over the past three months. That suggests price rises are becoming embedded in the economy, heralding “structural” rather than “transitory” inflation. While the headline numbers were good, “inflation remains both broad-based and far above the Fed’s target”, says James Mackintosh in The Wall Street Journal. Investors’ optimism is misplaced – “there’s no sign the Federal Reserve will change its mind and agree with investors that rates should come down again next year”.

https://moneyweek.com/economy/us-economy/605238/us-inflation-may-have-peaked-but-it-remains-a-threat

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Equity traders are also failing to price in the effects of the coming slowdown on corporate earnings, which they blithely expect to continue rising this year and next. Bond markets seem to be expecting “one sharp round of tightening – comprised of a rise in short-term interest rates to just above 3%” that will “be enough to bring inflation down to 2.5% with stable growth and no dent in earnings”, says Bob Prince of Bridgewater Associates.

That looks optimistic, says John Mauldin in his *Thoughts from the Frontline* newsletter. “Bond investors seem to have a great deal of faith that the Fed... will make inflation recede sharply and soon.” Markets usually know better than individuals, but there has been so much central bank intervention in the bond market that arguably “it is no longer a market in any meaningful sense”. Central bankers are likely to lose their nerve when recession bites, slashing rates too early even while inflation is not back under control. The result? “Extended stagflation is our most likely destination.”
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