First Trust
Monday Morning OUTLOOK

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Has the Inflation Threat Passed?

The best news last week was that inflation came in below expectations for June. Consumer prices rose a moderate 0.2% for the month, while producer prices increased only 0.1%.

That was good news for both stocks and bonds, because it made it less likely the Federal Reserve would raise rates multiple more times this year, in turn reducing market perceptions about the risk of an eventual recession. Meanwhile, the news boosted the markets' odds the Fed would be in a more aggressive rate cutting mode in 2024, not necessarily because the economy would be weak but because inflation would be low.

We think the optimism is overdone. The M2 measure of the money supply has dropped in the past year and we think that drop is starting to gain traction, including in the form of lower headline inflation.

Historically as Milton Friedman taught the world many decades ago, fluctuations in the money supply – up or down – tend to affect the real economy first and inflation rates about a year later. But, fortunately for him, Uncle Milty never had to live through a COVID Lockdown and subsequent Reopening. The sample size on how monetary policy interacts with a COVID Lockdown/Reopening is (barely) one, and we wouldn't be surprised at all if the unique nature of this business cycle has distorted the normal pattern of money affecting the real economy first and inflation a year later.

The CPI is up 3.0% from a year ago, a remarkable improvement from the peak 9.1% gain in the year ending in June 2022. But don't expect another tepid headline inflation number for July itself. Oil prices have been persistently higher so far this month.

Core inflation hasn't improved nearly as much as headline inflation. Core prices, which exclude food and energy, are up 4.8% from a year ago versus a 5.9% gain in the year ending in June 2022.

If the M2 measure of money (next reported Tuesday July 25) declines further, then, yes, perhaps better inflation news is ahead, including a continued decline in core inflation, as well. But it's hard to see a drop in core inflation down to the range of 2.5% or below unaccompanied by some significant economic pain. In the past several decades a drop in core inflation of 1.5 percentage points or more over the course of two years has always been associated with a recession. Now the Fed is projecting that size drop in core inflation in about one year, not two.

If core inflation drops substantially, that also means many businesses will find their pricing power is less than they expected. That should undercut corporate profits and restrain business investment.

Yes, there has been a boom in the construction of manufacturing facilities in the past year or so, largely due to government policies focused on building out tech-related manufacturing capacity domestically. But those resources are being pulled from other sectors and eventually the artificial government-induced spike in that sector will peter out. Remember, the government can be good at *temporarily* picking winners: the economic planners in Japan picked consumer goods and had a good run; even the planners in the Soviet Union were pretty good at building nuclear weapons. But, ultimately, artificial booms in certain sectors due to government policies don't end well. We don't expect this one to be different.

The bottom line is that if the Fed keeps the money supply trending down it will succeed in bringing inflation down. But we remain skeptical it can pull that off while leaving the economic expansion intact.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
7-17 / 7:30 am	Empire State Mfg Survey – Jul	-3.5	**-3.2**	1.1	6.6
7-18 / 7:30 am	Retail Sales – Jun	+0.6%	**+0.5%**		+0.3%
7:30 am	Retail Sales Ex-Auto – Jun	+0.4%	**+0.5%**		+0.1%
8:15 am	Industrial Production – Jun	0.0%	**0.0%**		-0.2%
8:15 am	Capacity Utilization – Jun	79.5%	**79.6%**		79.6%
9:00 am	Business Inventories – May	+0.2%	**+0.2%**		+0.2%
7-19 / 7:30 am	Housing Starts – Jun	1.478 Mil	**1.450 Mil**		1.631 Mil
7-20 / 7:30 am	Initial Claims – Jul 15	240K	**240K**		237K
7:30 am	Philly Fed Survey – Jul	-10.0	**-17.0**		-13.7
9:00 am	Existing Home Sales – Jun	4.210 Mil	**4.200 Mil**		4.300 Mil