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Disinflation momentum is building

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- Momentum is building for continued disinflation. Though annual growth in core CPI remains well above the 2% target, monthly growth has been virtually zero in June and July when excluding potential outliers like shelter and used autos. Even the stubbornly high median CPI fell considerably on a month-to-month basis in July, suggesting that disinflation is more widespread.
- It's not immediately clear why price growth has been so low in June and July. The labor market remains strong by historical standards and consumer spending is proving to be resilient in the face of inflation. Some "normalization" of prices is likely occurring in the auto industry, helping to contribute to the strong overall disinflation. But for many other items, the drivers are not so obvious. So far, the data supports a Fed pause in the next FOMC meeting, but there are many other important data releases until then.

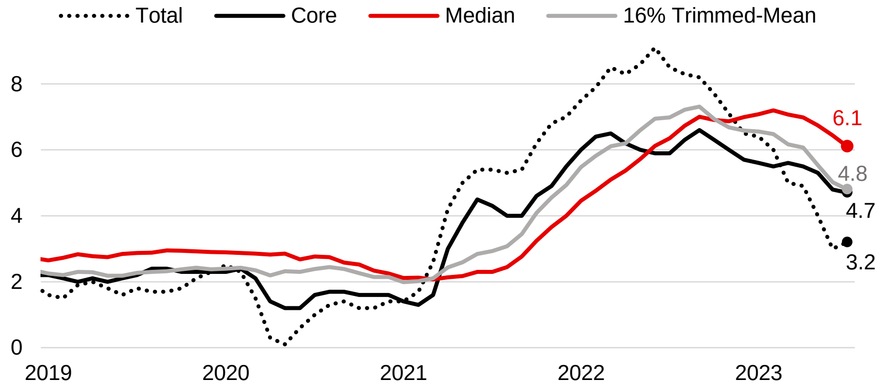
Summer of disinflation

Both June and July are proving to be strong months for disinflation. Annual price growth in core CPI fell to 4.7% in July, down from 4.8% in June and 5.3% in May. Shelter was a major contributor in July, but even excluding it, services inflation was positive for the month. Conversely, core goods inflation was negative in July.

When excluding potential outliers, inflation is showing even stronger signs of slowing down. Annual growth in core CPI less shelter and used autos fell to 3.4% in July, down from 3.5% in June and 4.2% in May. And even when using the more robust trimmed-mean CPI, which excludes outliers less subjectively, annual inflation fell to 4.8% in July.

It isn't immediately clear what is contributing to this accelerated disinflation. There are certainly some spending categories that are experiencing a "normalization" of prices. The auto industry is a prime example, where supply and demand are becoming more balanced. Persistent supply chain issues continue to ease which is allowing inventories to grow, and higher borrowing costs are taming demand. This is allowing inflation in new autos, specifically, to continue its downward trend.

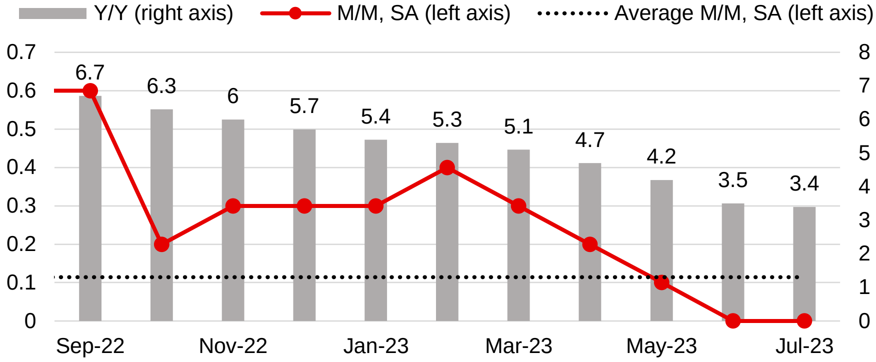
Momentum is building for further disinflation
CPI, % Y/Y



Source: BLS, Cleveland Fed, MUFG Bank Economic Research

Virtually no monthly inflation when excluding some outliers

Core CPI less shelter and used autos, % change



Note: Average monthly change is from 2010-2019
Source: BLS, MUFG Bank Economic Research

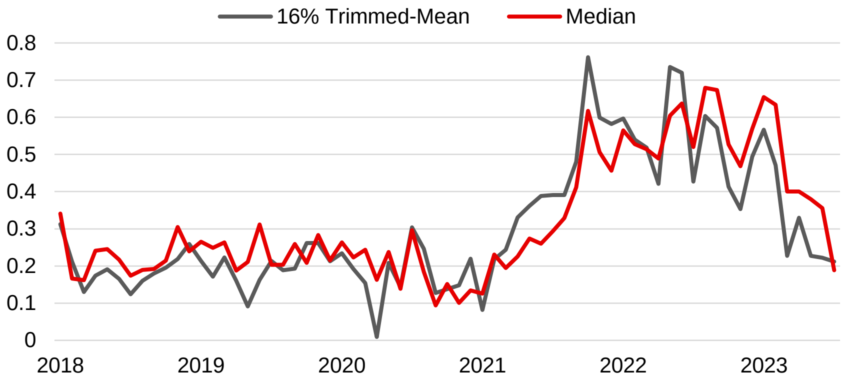
However, services inflation related to the auto industry is much different. Price growth in motor vehicle maintenance and repair has plateaued at around 8% on a 6-month annualized rate and price growth in motor vehicle insurance has reached nearly 20% as of July (at a 6-month annualized growth rate). It's unclear how or if these costs associated with owning a car will contribute to demand for autos going forward.

Slowing price growth is widespread

The median CPI is potentially a better indicator of inflation because it treats all spending categories equally, representing growth in the underlying price level that affects all consumption. With item weights excluded, the median CPI is less distorted by price disturbances in highly weighted items, and it has proven to be much more stubborn than core CPI or the trimmed-mean CPI. But even so, July showed strong disinflation in the median CPI, with monthly growth falling below 0.2%.

Disinflation was widespread in July

CPI, % M/M



Source: Cleveland Fed, MUFG Bank Economic Research

The median CPI is not without its faults, but the significant drop in July likely reflects how widespread disinflation was for the month. The question now is how long this can continue for. If June and July prove to be a trend, a soft landing seems more likely than not given the current strength of the labor market. But given how often inflation optimism has been shattered over the past couple of years, it is also entirely possible that we could see a rebound in price growth after the summer. Inflation in discretionary spending categories should be followed closely to detect emerging trends, as they better represent aggregate demand, and the impact monetary policy is having on price growth.

So far, the evidence is supporting a Fed pause at the next FOMC meeting. Disinflation has been strong for 2 consecutive months, but more data is set to be released between now and September 20. July's PCE will shed more light on the trajectory of inflation.

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