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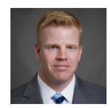
The Inflation Battle May Not Be Over

October 2023

Asset Allocation Insights



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KEY INSIGHTS

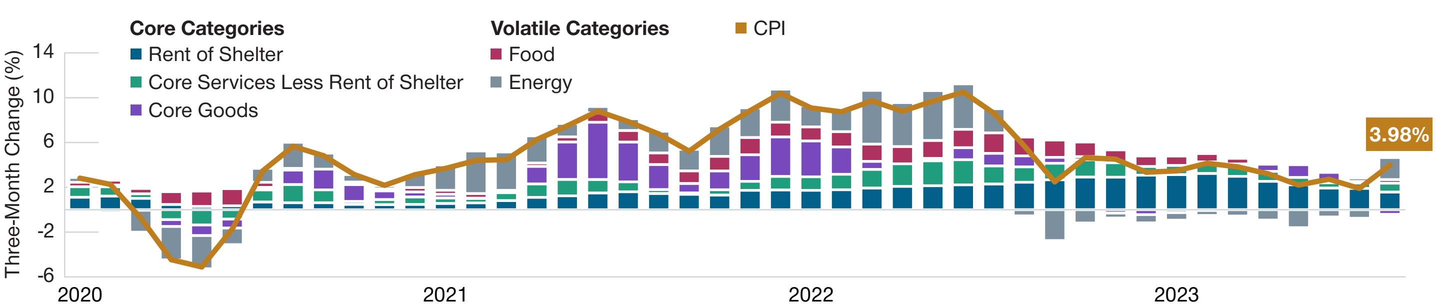
- U.S. inflation has declined from its June 2022 peak, leading some to speculate that the Fed could soon switch to a more accommodative monetary stance.
- We believe that an upward trend in some inflation categories, such as energy, could mean higher interest rates for longer than expected.

The U.S. Consumer Price Index (CPI) has trended steadily lower since peaking at 8.93% in June 2022. Despite higher readings in July and August 2023, core CPI—which excludes the volatile food and energy categories—has continued to decline. This has led to some speculation that the Federal Reserve could soon switch from raising interest rates to cutting them.

CPI data are reported on a year-over-year basis to help limit seasonal effects and the impact of short-term events that may prove temporary. While these readings have been encouraging, shorter-term trends that typically offer more information about the current state of inflation are concerning. The three-month CPI moving average from July to August rose from 1.90% to 3.98% (Figure 1).

Short-Term Trends Show That Progress Has Been Moderating

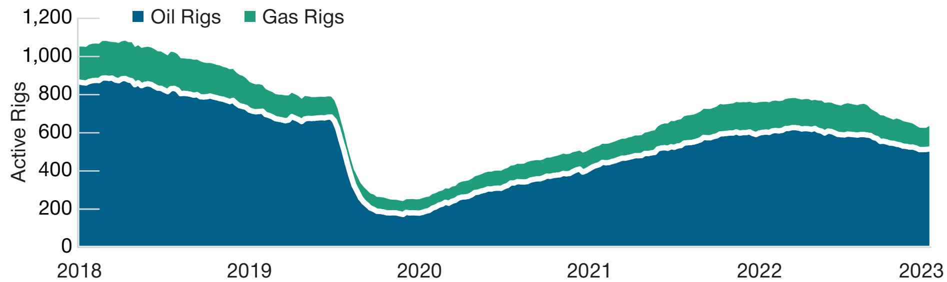
(Fig. 1) Contribution to CPI* by category—three-month moving average



January 2020 through August 2023.
Past results are not a reliable indicator of future results.
Sources: Bureau of Labor Statistics/Haver Analytics. Bloomberg Finance L.P.
*Consumer Price Index (CPI) measures the monthly change in prices paid by consumers and is a widely used measure of inflation.
A moving average is a statistic that captures the average change in a data series over time.

Oil Prices Could Remain Elevated

(Fig. 2) Active U.S. Oil and Gas Rigs



September 15, 2018, through September 15, 2023.
Source: Bloomberg Finance L.P.

Notably, inflation from the shelter category, which made up 34% of the U.S. CPI basket as of August 2023, has been declining, and forward-looking indicators imply a continuing downward trend. However, other categories are facing upward pressure in the near to medium term. In particular, the energy category's 12-month streak of negative contributions turned sharply upward in August after oil prices spiked higher.

Energy sector fundamentals point to elevated oil prices. The global supply response to higher oil prices has been modest. Meanwhile, the number of active U.S. oil and gas rigs—a useful predictor of energy supply trends—has been decreasing. Oil inventories also have been falling rapidly, and there are early indications that productivity gains in the U.S. oil patch may have peaked after increasing for more than a decade (Figure 2).

Going forward, we believe that the tug of war between easing shelter prices and rising costs in other categories, such as energy, could pressure the Fed to keep rates higher for longer than many investors expect. As a result, our Asset Allocation Committee recently added to real assets, which include a large allocation to energy-related equities, and decreased the position in long-term U.S. Treasury bonds, which could face headwinds if interest rates remained elevated for an extended period.

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