Turning the Fed's Inflation Rubik's Cube on its Head

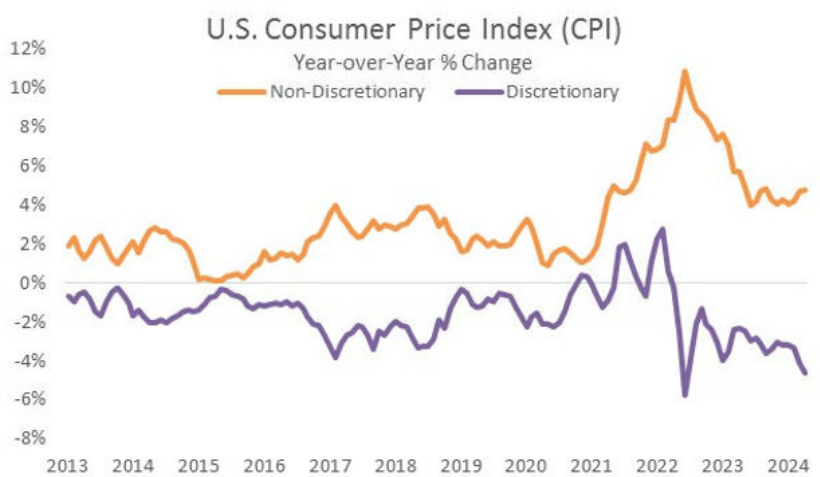
Last week's U.S. inflation report was highlighted by yet another modest slowdown in inflation. Since peaking in June 2022, headline inflation has slowed from a 9% annual pace to just over 3%. Core inflation – which excludes volatile food and energy costs – also continued to grind lower, but at 3.4% remains stubbornly elevated relative to the Federal Reserve's (Fed) goal of roughly 2%.

Stock markets reacted well to the inflation data, breaking out to new all-time highs. Yet consumer confidence – which historically tends to track closely with stock market performance – remains subdued versus its pre-COVID peak.

Later that same day the Fed surprised markets by announcing that not only were they choosing to again forego a rate cut, but they were also reducing their expectations for the number of cuts to take place the second half of the year to just one. While stocks closed trading at a record high that day, the Fed's hawkish announcement suggests that they are still struggling to solve their inflation Rubik's Cube.

Reconciling slower overall inflation, a bullish stock market, a nervous consumer, and a still-cautious Fed may require turning this Cube on its head and looking at inflation from a different perspective. Breaking headline inflation into its components and aggregating them into non-discretionary (i.e. goods and services households must spend money on) and discretionary (i.e. non-essential expenditures for most households) provides an interesting new perspective on the disconnect between slowing headline inflation and the consumer.

The chart below illustrates the annual growth rate of non-discretionary expenses (orange line), such as food at home, medical care (both for humans and pets), shelter, education, and vehicle maintenance/insurance/fees. While the pace of inflation for these essentials has slowed, they continue to rise at a roughly 5% annual rate – still outstripping wage gains.



Non-Discretionary: Essential goods and services, including food at home, energy, medical care, shelter, vehicle maintenance/insurance/fees, veterinary services, tuition and other education costs, phone services, haircuts, legal services, funeral expenses, and financial services. Discretionary: food away from home, household furnishings, apparel, airfare, vehicle rentals/leases, recreation goods and services. Source: Bureau of Labor Statistics, S&P Global, Piper Sandler, O'Brien Wealth Partners, as of 4/30/24.

At the same time, prices for discretionary goods and services (the purple line), which includes eating out, clothes, airfare, and travel (to name a few components), are in outright deflation – having fallen by roughly 5% over the past year.

Put differently, inflation is cooling in part because the average household is being forced to spend less on treats because they are still struggling to afford their needs.

This vantage point better explains consumer nervousness and why the Fed is being cautious. Quite simply, a lack of qualified workers is creating a supply shortage in many essential service industries. This dynamic leaves the Fed in a tricky position, as they cannot create more doctors, nurses, or veterinarians, and raises the potential for inflation to be higher, on average, going forward.

We see the following potential long-term implications for financial plans and for investment portfolios from these worker shortages if they are not resolved:

- When running retirement cash flow need simulations, assume a higher average future inflation rate.
- Stocks still tend to outperform higher inflation, and therefore are valuable in diversified portfolios.
- Bonds tend to move in tandem more with stocks, but still provide income and capital preservation.
- Balanced portfolios remain optimal but tend to deliver more volatile performance than in lower inflation periods.

To be sure, our base case is that the Fed will ultimately get inflation back under control, but these underlying trends highlight a risk that we are monitoring closely.

We hope you are all taking care and staying healthy. If there are any changes in your personal or financial situation that might impact your investment objectives, or if you have any questions and would like to talk, please contact your Advisor.

Your O'Brien Team