June Commentary

"Close Enough for Government Work" and Cherry Lollipops

Last month, the Bureau of Labor Statistics (BLS) announced there was no inflation in May. They reported that the Consumer Price Index (CPI) was flat, the Producer Price Index (PPI) was slightly negative, and the Import and Export Prices experienced nice declines. In other words, prices didn't go up in May. And just last week, on July 12, the BLS announced that (CPI) for June 2024 had fallen by 0.1%. This negative reading was better than analysts expected and probably assured the Federal Reserve would cut the overnight lending rate by the end of the third quarter.

You and I might be wondering where the BLS buys its groceries because prices don't seem to be moving down at the grocery stores near my house. At the risk of sounding cynical, I'm here to tell you something: Your and my real-life experiences at the grocery store, clothing store, local home improvement store, mechanic, or restaurant don't seem to matter to the BLS. If you have started buying bone-in chicken thighs instead of boneless, skinless breasts because you can't afford the latter, too bad. Suppose your financing costs or credit card balances have skyrocketed; tough luck. Truth be told, the BLS does a poor job of tracking changes in debt service obligations caused by higher interest rates. For instance, while a new car might cost slightly more this year than last, interest rates on a new car loan are significantly higher. This higher borrowing cost represents real dollars to you and me but doesn't enter the official inflation data quickly. Nor do the smaller serving sizes at restaurants or on most foodstuffs, which is now commonly called "shrinkflation." Let's assume a box of pasta is $2 for a 9-oz. box. If the company reduces the amount in the container to 7 oz. but still charges $2; guess what? That technically isn't inflation—you are just getting 22% less for the same price.

Then there is the fact the CPI measure is, in reality, a substitution basket. I mean that as we spend more or less on a particular item, its weight in the CPI equation changes. Let's assume a staple in your diet is New York strip steak. Unfortunately, it has increased in price so much that you start eating flank steaks instead. As a result, the weighting of NY strips in the CPI formula decreases, and flank steaks' weighting increases. Imagine this keeps happening until you are eating Vienna sausages off a toothpick. While I can think of a few worse things, there is no argument there is a vast disparity between NY strip steaks and over-processed sausages on a stick. However, due to how the CPI calculation works, inflation might very well be easing, but your standard of living and perhaps quality of life has plummeted. Admittedly, my steak example is pretty extreme and assumes that more costly products don't respond to decreases in consumer demand. They do, for sure. However, it's important to note that the CPI reading tracks what the BLS believes the consumer is buying. Regardless, the BLS still includes it in its methodology if we aren't buying them. How often have you put something back at the grocery store when you saw the price and picked a cheaper, less appealing product? That is the substitution basket at work!

The government employs legions of people to track prices and calculate the official inflation figures. It follows a unique methodology and set of rules, and what it says goes.

I could ramble on about how the government's inflation gauges don't reflect the U.S. consumer's reality, but it is pointless. The official data is what the official data is, and the BLS will never say, "Our methodology is flawed and doesn't accurately reflect the consumer's actual experience." Here is the lowdown: None of the government's data is 100% accurate. There is no way they can headcount every single job in the economy each month of the year. It would be impossible to call every known household and every H.R. department at every employer in the country. Likewise, should we believe it precisely tracks the price of every item at every store across the country and knows the exact weighting of each item in the CPI equation? In fact, all of the economic data releases are good faith estimates using data only an organization the size of the U.S. government can provide. These readings and others like them are meant to be directional and "close enough." No one should think they are foolproof, because they aren't. However, they are usually directionally accurate ("usually" being the operative word in this sentence). Furthermore, they are the best we have. So, if you spent your money in June on every item with the same weight as the CPI report, then yes, your inflation rate went down. Other than that unlikely occurrence, we cannot know if things get cheaper at the individual household level. How many trips did you make to the grocery store? Fill up at the gas station? Get your car repaired or an oil change? Did you buy any macaroni and cheese in June? Take Fido to the vet? Buy an airline ticket? Since no one spends their money precisely the same way, the CPI measurement is imperfect, at best. However, it should be directionally accurate.

So, are consumer prices moderating or plateauing? Yes, I believe they probably are at this point. And since the Federal Reserve is focused on relative price stabilization and less on absolute prices, the recent slowdown in price increases likely means the FOMC will cut the overnight lending rate in September. You know, if the BLS says there isn't any inflation, guess what, there isn't any inflation. Your and my monthly budgets be darned. In fairness, though prices remain astoundingly elevated for nearly every item we need or use, they aren't rising as rapidly as they were. So, believe it or not, that means inflation is coming down. The reason: Inflation is relative to price levels, even though real-life prices are absolute when it comes to spending. This is why most Americans have a hard time believing when economists say, "inflation is coming down," or that "it isn't a big issue now." The last time I checked, you and I purchase things with actual dollars and cents, not relative ones. That is, unless you are leeching off a relative. Ha!

With this in mind, the recent inflation data is undoubtedly blazing a path for the Federal Reserve to cut the overnight lending target sooner rather than later. The Fed's concern is and has been that prematurely cutting the overnight rate might cause inflation to reignite. That would be bad in relative and absolute terms and could cause the U.S. economy to fall into recession. Clearly, no one wants this to happen, but one might ponder whether the Fed's cure is worse than the ailment. After all, the average consumer, small businesses, and potential homebuyers needed relief yesterday! The thing with inflation is this: Once it gets into the system, it generally doesn't go away quietly. You can think of it as an infection or non-viral illness. You typically need a course of antibiotics to eliminate the bacteria from your system and keep it from returning. Oh sure, the illness might go away on its own; however, an effective regime of the right medicine should work more quickly. Just like stopping your prescribed meds before you've taken every dose, it doesn't make a lot of sense to complain about the Federal Reserve not cutting rates if we believe the government has underestimated the CPI and other inflation gauges. The higher prices are, the more we want and need the monetary policies to tamp them down. While a short-term period of higher prices could indicate an increase in consumer demand, a long-term period will usually erode an economy's purchasing power and ability to invest prudently. Said another way, a little inflation isn't always a bad thing, but we don't want it hanging around forever. Stable prices are almost always preferable, allowing consumers, investors, and businesses to plan their spending more effectively and confidently. As such, the Fed faces difficulty deciding when and how much to cut the overnight rate. If deflation becomes a problem, they have proven they know how to flood the market with cash. That appears to be much easier than draining excess liquidity from the system. After all, which do you think is more difficult: giving a child a lollipop or taking it away from them?

At the end of the day, it's all rather amusing. Not that the BLS announced the CPI fell 0.1% in June 2024. And certainly not that this will likely be the final signal the Fed needs to begin lowering interest rates, because I'm convinced the markets will respond favorably and boost economic activity. The perplexing thing is that this decision will be based on guesstimates, arbitrary sample sizes, and what many would consider incomplete information. I would argue that any reasonable person would agree it is an imperfect process. However, it's the best system we have, and the only one we will likely ever have. So, if the BLS announces inflation is easing, let's do our best to accept it at face value. I think sucking on a Cherry Ice Blow Pop might help me do just that.

Until next month—

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