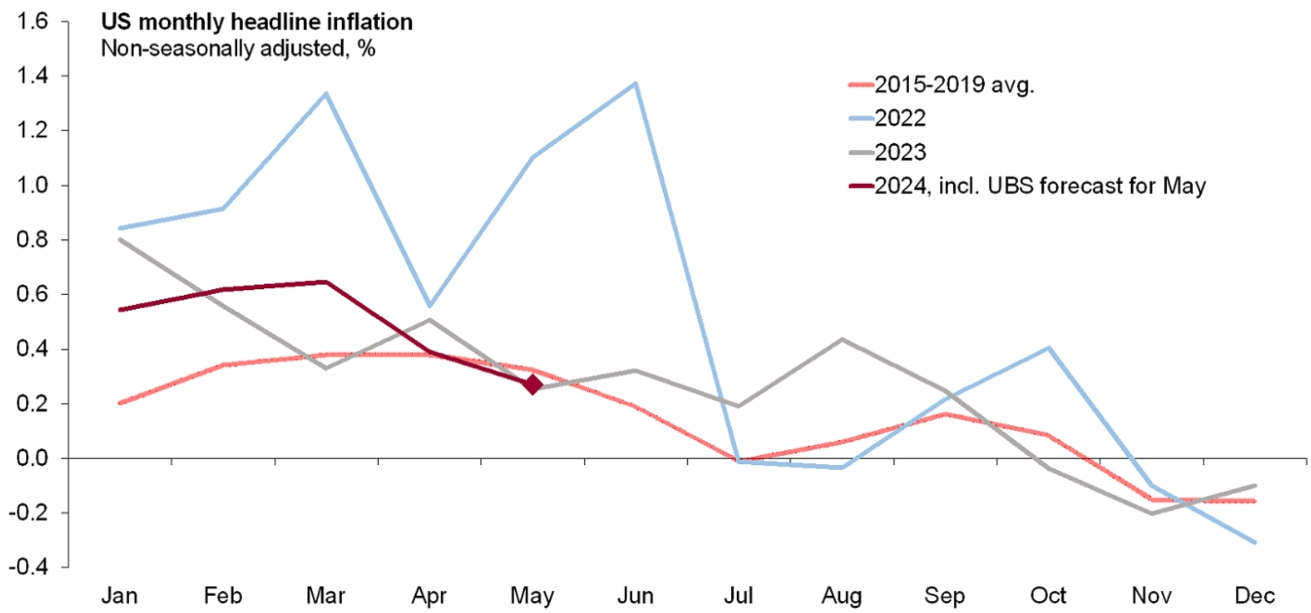

Non-seasonally adjusted CPI figures have been showing a disinflation trend that is slowly converging to the pre-pandemic trend. (UBS)

Inflation is coming down, really

29 May 2024, 2:03 pm CEST, written by UBS Editorial Team

Seasonal adjustment issues, due to the pandemic, have complicated the analysis of inflation data. In this note we focus on non-seasonally adjusted figures, and show how consumer price dynamics seem to be returning to their pre-pandemic trend.

Why does the BLS seasonally adjust, tough?

Authorities seasonally adjust in order to reduce the volatility that it is inherent in the data. In the case of inflation, the volatility is due to consumers and firms' calendar-driven behavior. Note that monthly inflation always appears higher in the beginning of the year (given annual price adjustments), and lower at the end of the year (owing to year-end sales). Seasonal adjustment attempts to correct for these extraordinary CPI moves, smoothing the data, and enabling analysts to see the real underlying economic trend.

But now, seasonal adjustment is actually complicating the analysis

This is because the COVID-19 pandemic lead to massive volatility in data series. Note that annual headline inflation in the US went from 0.1% y/y in May 2020 to 5% y/y in May 2021; a change of 490bps in just 12 months. The aftermath of these massive swings is that a certain degree of ambiguity appears to be present in the seasonal adjusted CPI series. As such, economists — including those within UBS — have suggested a focus on the non-seasonally adjusted series.

Reviewing the graph — In the chart above we analyze monthly inflation (non-seasonally adjusted)

The pink line (2015-2019) is the pre-pandemic average, a time in which annual headline inflation averaged 1.5% y/y — a rather contained inflation level and below the Fed's target.
The light blue line (2022) shows how post-pandemic upward inflation pressures were present.
The gray line (2023) — albeit with certain upside surprises — clearly shows inflation approaching the pre-pandemic benchmark.

Year to date (2024), the red line displays a somewhat encouraging inflation behavior. Our in-house estimates suggest that May — similar to April — will be a monthly print rather in line with the pre-Covid trend. This, coupled with a better balance in the labor market, supports our call that the Fed will likely start loosening its monetary stance in 2H24. As a reference, we project 50bps of cumulative cuts this year, with the first easing move taking place in September.

Bottom line

Given our expectation of disinflation, our macro base-case accounts for lower interest rates and yields over the next 12 months. In this backdrop, we continue to favor investment grade corporates, TIPS, Agency MBS, and CMBS.

On the equities front, we remain optimistic given healthy revenue and earnings growth. We therefore recently increased our year-end S&P 500 target to 5,500, roughly 4% above current levels. More specifically, we favor the tech sector and industrials, given strong AI momentum and the ongoing improvement in manufacturing business sentiment. From a size standpoint, we still like small caps, which have scope to outperform when the Fed pivots and as earnings growth broadens.

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