# What If I'm Wrong About Inflation?

**Anatole Kaletsky**
akaletsky@gavekal.com

Yesterday's stunning US inflation report is a potential game-changer and asset markets rightly celebrated the possible miracle of painlessly defeating US inflation. If the next consumer price index release (on August 10) comes close to repeating yesterday's core inflation reading of just 1.9% annualized, I will have to abandon my prediction that the Fed would soon face a painful choice (see **Who's Got Inflation Wrong: Mr. Powell Or Mr. Market?**) between accepting permanently high inflation or deliberately causing a serious recession to bring inflation back to near 2%. I will also have to accept that my bearish view on both bonds and equities has been proven wrong. Instead, the "Goldilocks on steroids" scenario that I have presented as almost a *reductio ad absurdum*, will become a racing certainty (see **What If I'm Wrong? It Would Be NICE**).

It may be that the Fed does not have to choose between causing a serious US recession or brining inflation back to 2%

I am not yet prepared to change my mind based on this one piece of data—and I cannot resist pointing out that an even bigger market shock could materialize next month if July's inflation data reverses what may turn out to have been a mere statistical blip in June. But looking at the details of Wednesday's CPI report, I have to conclude that the evidence has shifted significantly in favor of the "immaculate disinflation" and economic soft landing that I had condescendingly dismissed as wishful thinking.

Such a scenario cannot be counted on but the evidence is shifting that way

The plunge in core inflation from May's annualized 5.4% to just 1.9% in June is only one data point (see left-hand chart overleaf), but it is worth taking seriously for two reasons. Firstly, because the sudden downshift in inflation pressure seems to be widespread among the components of the consumption basket. While falls in used car prices, airline tickets and hotel rates took much of the credit for the lowest core inflation reading since the Covid lockdowns, the really impressive features of yesterday's report were the big drops in all the aggregate price measures—trimmed-mean CPI, sticky CPI and median CPI—that offer much more reliable guidance on underlying inflationary pressures than any particular goods or services. In particular, the increase

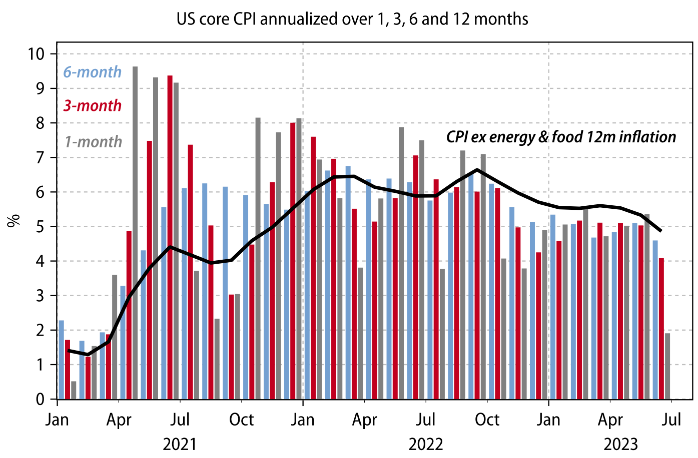
The plunge in core inflation data for June is worth taking seriously for two reasons

### Checking The Boxes

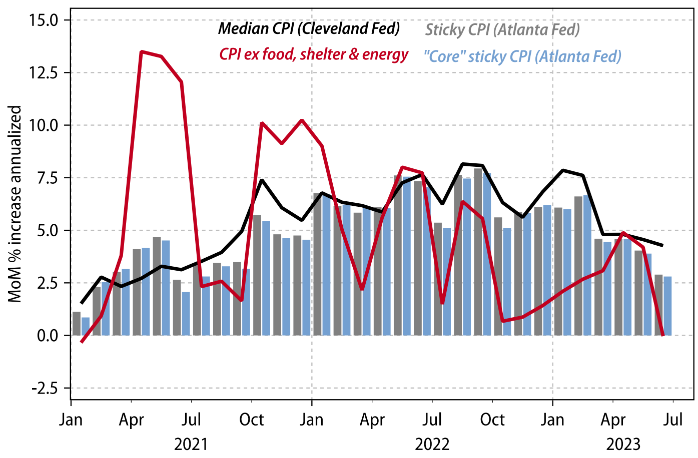
Our short take on the latest news

| Fact | Consensus belief | Our reaction |
|---|---|---|
| **US CPI rose 3.0% YoY in Jun,** from 3.1% in May | Below 3.1% expected; core CPI rose 4.8% YoY, from 5.3% | Perhaps the Fed will pull off the coveted soft landing after all, if disinflation and growth persist |
| **UK RICS house price balance fell to -46% in Jun,** from -30% in May | Below -35% expected | Rising mortgage rates hitting housing demand; trend to continue as BoE grapples with CPI |
| **China export growth fell 12.4% YoY in Jun in US$ terms,** down from 7.5% fall in May | Lower than 9.5% contraction expected; import growth contracted 6.8% in Jun | Export growth under pressure but a bottoming of the electronics cycle should help in 2H23 |
| **Indian CPI rose 4.8% YoY in Jun,** from 4.3% in May | Above 4.6% expected; core CPI unchanged at 5.2% YoY | Uptick in food prices will make RBI nervous; expect prolonged pause |

**Is CPI no longer stuck on a 4% to 5% plateau?**




**Underlying inflation gauges fell sharply in June**




in CPI excluding energy, food and housing fell to zero (see right-hand chart above). Meanwhile, the CPI inflation for all goods excluding energy and food, which had been accelerating sharply in the spring to an annualized rate of 7%, in the past two months dropped suddenly to below zero. The implication is that powerful disinflationary forces have started to act on the whole gamut of US goods and services.

Base effects will start being very favorable for US inflation from August onward

The second reason for taking yesterday's CPI report seriously is that some factors restraining inflation in June—especially rents, car prices and airline fares—should stay benign this month, while the potentially more inflationary forces—especially medical costs and energy prices—still show no sign of accelerating. If monthly inflation remains subdued in July, base effects from last year will make annual comparisons look very favorable from August onwards, and could suppress 12-month headline inflation all the way down to 2%, and core inflation to around 3% in the autumn. Those low 12-month inflation reports would, in turn, restrain year-end wage bargains and corporate pricing decisions, reducing the risk of a wage-price spiral that would otherwise stretch into 2024, and beyond.

If core inflation does subside to 3% in 4Q23, there will be major economic, political and financial effects

If core inflation does subside to 3% in 4Q23—and let me emphasize that I remain skeptical about such a benign outcome and will stay that way at least until after the July inflation report is published on August 10—the economic, political and financial effects will be immediate and dramatic. Starting with economics, the risk of a recession in 2024 will vanish, since real wages will be rising instead of falling. In fact, this process has already started. In addition to CPI data yesterday, it was also reported that inflation-adjusted average hourly earnings rose 1.2% from a year ago, the largest rise since March 2021. In politics, a return to low inflation and modestly rising real wages would greatly improve US President Joe Biden's reelection prospects.

Most importantly for investors, the financial and policy outlook would be transformed if US price stability is restored without a recession, or without interest rates having to be raised beyond 5.5-5.75%. As I have argued since January (see **Goldilocks And The Magic Money Tree**), if the worst inflation for 40 years can be overcome with the lowest real interest rate peak since the 1950s, and an economic slowdown so mild that it does not even increase unemployment, then assets valuations should move permanently to even higher levels than they reached in the Goldilocks decade before Covid. For during that wonderful decade, almost nobody believed that the low-inflation, zero-interest conditions would be sustained. Goldilocks was universally considered a financial fairy tale that was too good to be true. But if low inflation returns in 2024, then easy money, full employment and fiscal profligacy would have survived a series of inflationary stress tests far worse than anything likely to hit the world economy in the years ahead. So asset valuations that were widely viewed as unsustainable in the long run will likely be priced even higher because the ideal financial conditions of low inflation and near-zero real interest rates would have been empirically established as scientific laws of economics and permanent facts of life.

Goldilocks may end up not being considered a fanciful financial fairy tale, but a new reality of investment life

Let me repeat that I have not yet changed my mind about the economic and market outlook, despite the astonishingly benign June inflation data. I still do not believe that US price stability *has* been restored, nor that it *can* be restored without a serious recession. I still expect that the next CPI *will* reverse some, or all, of last month's progress and that such mean-reversion will shock investors, probably causing another leg of the bear market in both equities and bonds. If, however, US inflation *does* remain subdued, it will be necessary to reconsider. Even just one more month of very low US inflation *may* be sufficient to bet on a return to Goldilocks—and not just Goldilocks as a fairy tale, but Goldilocks as a scientifically-established, permanent fact of economic life.

There are still a good many ifs and buts in this assertion, but all should be made clear with upcoming data releases