

Why US CPI revisions could be a big deal (... or mean nothing at all)

Last year's update of CPI seasonal adjustment factors was a big deal, showing inflation momentum was stronger than thought at the end of 2022, catching both the market and the Federal Reserve off guard. Friday sees the 2023 update with the market watchful to what it may mean for the timing of the first Fed rate cut this year



The Bureau of Labor Statistics will publish the annual update of seasonal adjustment factors for consumer price inflation on 9 February

2023 seasonal adjustments changes suggested the Fed had more work to do

This Friday the Bureau of Labor Statistics will publish the annual update of seasonal adjustment (SA) factors for consumer price inflation, ahead of the January CPI report on 13 February. This will lead to revised MoM% CPI prints for the past five years using those adjustments. Importantly, the non-seasonally data doesn't change, so the full year YoY% numbers will remain unchanged.

Last year's revisions were more significant than usual in that they depressed the seasonally adjusted MoM% change for the first half of the year, but it led to upward MoM% revisions for the second half – it is important to remember that seasonal adjustments are a zero sum game over the course of a full year. This indicated that the encouraging moderation in monthly inflation rates

through 2022 was no longer so impressive and suggested that the Fed had more work to do to contain price pressures. Rate hike expectations increased, yields rose (contributing to the 2Y Treasury yield rising 60bp over subsequent weeks) and the dollar firmed.

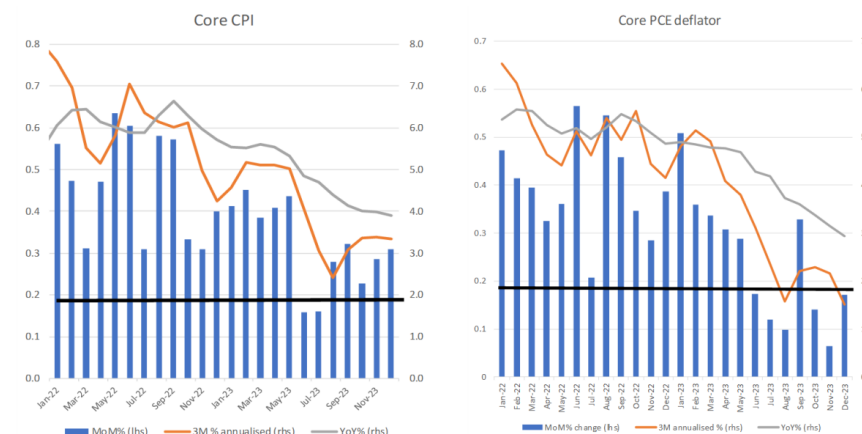
Why seasonally adjust?

Raw data often contains very strong seasonal patterns and seasonally adjusting it can offer a clearer view of what is happening in an economic cycle. For example, January is always a huge months for job losses post the festive period with payrolls typically dropping 2.5-3mn – consumers spend less on retail, eating out and entertainment after a spending splurge in November and December so seasonal workers are laid off. In the CPI report many services, such as insurance costs, have benchmark changes at the beginning of the year and prices tend to jump. By adjusting for these “knowns” we can gain a clearer picture of the underlying macroeconomic story.

Late 2022 inflation momentum was stronger than initially believed

The big changes in 2022 seasonally adjusted month-on-month data were that November became 0.3% MoM from 0.2% and December went to 0.4% MoM from 0.3%. Not huge changes, but these get massively amplified when you look at 3M annualised rates that the Fed have increasingly mentioned as an indicator of inflation momentum. The revisions meant that 3M annualised rate, initially calculated at 3.1% in December 2022, became 4.3% while headline CPI got bumped up from 1.8% to 3.3%! Given the Federal Reserve and markets were caught so off-guard, a couple of Fed officials have said they will carefully be watching them again this year, most notably Fed Governor Christopher Waller. The market has understandably taken note.

Core CPI versus core PCE - will the CPI report paint a picture closer to core PCE after these revisions?



Source: Macrobond, ING

Anything can happen in the hands of statisticians...

As these are purely statistical changes and not reflective of any changes in underlying data, we don't have a huge amount to go on in determining what will happen on Friday. It is possible that for the second year running it depresses MoM% in first half 2023 and raises it in second half 2023, which would diminish the chances not only of a March cut, but also a May interest rate cut. Conversely we could see seasonally adjusted MoM numbers revised up in first half 2023 and the second half revised down – reversing the story from last year – while leaving the full year 2023 number unchanged. If so that would give the Fed more confidence about inflation pressures dissipating. It would then also bring the story more into line with what the core PCE deflator report is saying – currently running at 1.5% annualised. Of course there is the option that there are no changes whatsoever. We can't say for certain.

That said the chart below shows the MoM change in the seasonally adjusted core CPI data less the MoM change in the non-seasonally adjusted (NSA) core CPI data. It effectively gives us the seasonal adjustment factors for each month that sum to zero over the whole year. You can see over the past five years the non-seasonally adjusted data (or raw data) post bigger MoM rises in January-April than the seasonally adjusted data while the reverse is the case later in the year, especially November and December.

Seasonally adjusted MoM core CPI less non-seasonally adjusted MoM core CPI - shows how the seasonal adjustment factor works



Source: Macrobond, ING

As you can see the November and December 2023 adjustments above are broadly similar to what we saw for the previous five years. What the revisions did last year was bring 2022 November and December difference between SA & NSA data back into line with history by revising the SA data up by 0.1pp in both months. Given everything for 2023 already looks broadly in line with historical patterns, it perhaps suggests Friday could be a bit of a non-event. That is our base case, but we have to remain open to the potential for a surprise that could meaningfully alter the markets view on the timing of Fed policy changes.

How Treasuries might react

The market is in a growing mood to continue to test higher for longer tenor yield; something we've been calling for. If it were to get an excuse to push this a bit more from a revision that was perceived to result in higher annualised inflation readings then some further upward pressure on yields could obtain. It should not be deterministic though, more likely a short-term impulse. The bigger impulse will come from the direction of travel for inflation trends generally. Assuming these continue to point down, then yields can't rise by too much.

The dramatic rise in the 2yr yield a year ago was not all do the revisions to CPI. We were going through an ongoing upward revision to the terminal peak for the Fed funds rate, and even though CPI inflation was well off the highs, and still falling, it was also still running in the area of 6%, and above the funds rate. There was far less market conviction at the time that the Fed could get inflation back to 2% in a timely fashion.

The 10yr Treasury yield moved from 3.5% to above 4%, which was a large move. But it was arguably too low to begin with. Fast forward to today and the 10yr Treasury yield is at a little over 4%, but practically all inflation metrics are now comfortably below that, leaving less room for re-weights to have a material effect. That said, an inflation friendly re-weighting would have a greater effect than unfriendly ones in our view, as the market is looking for excuses to wind the Fed up for rate cuts. There would still be an effect on unfriendly weightings, but likely less impactful.

Authors

James Knightley

Chief International Economist, US

james.knightley@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("ING") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group N.V. and its subsidiary and affiliated companies)*. The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is authorised by the Prudential Regulation Authority and is subject to regulation by the Financial Conduct Authority and limited regulation by the Prudential Regulation Authority. ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10

Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.

Additional information is available on request. For more information about ING Group, please visit <http://www.ing.com>.