The CPI Report:
Anticipating the 4Q24 Surge and 1Q25 Fall

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Fed Chair Jerome Powell led the news cycle with remarks a few months ago during his Jackson Hole address. In effect, he said, 'Success! The time has come.'

According to the transcript, Powell offered with confidence, “Inflation is now much closer to our objective, with prices having risen 2.5 percent over the past 12 months. **After a pause earlier this year, progress toward our 2 percent objective has resumed. My confidence has grown that inflation is on a sustainable path back to 2 percent.” [emphasis added]**

Reading closely, he told the markets, investors, consumers, and businesses, "...now much closer...[a]fter a pause...progress toward our 2 percent...resumed...on a sustainable path back to 2 percent.” There was no indication from Powell that another pause in the downward trend for inflation may be imminent.

Most significantly, consider in your mind's eye how you expect CPI's "sustainable path" to appear as it proceeds from 2.5% to 2.0%.

Yet it was clearly visible in the data that the reported inflation rate during the fourth quarter of this year is likely to reverse and surge to near or above 3%. By the way, it's also clear from the data that the first quarter of 2025 should restore the downward trend in inflation.

Nonetheless, let's hope we get through this quarter and next quarter without a transient disruption in the financial markets and shaken confidence in the Fed.

LOOKING BACKWARD & FORWARD

Let's go back and explain the likelihood of an upcoming surge and fall in the reported CPI inflation rate. Figure 1 reflects the reported Y/Y CPI for each month since December 2023. The additional two columns and forward-looking rows provide real insights.

The center column is the month-over-month annualized rate for CPI (M/M). In other words, the Sep '24 value of 1.94% reflects the annualized rate from Aug '24 to Sep '24.

In contrast, the Y/Y column for Sep '24 reflects the inflation rate from Sep '23 to Sep '24.

Here's where the insight starts. The right column reflects the M/M rate for the corresponding month in 2023. In Sep '23, M/M CPI rose at an annualized rate of 3.02%. For Sep '24, M/M CPI rose by an annualized 1.94%.

Since the Y/Y rate is effectively the previous twelve months of the M/M rate, the Sep '24 Y/Y rate drops the Sep '23 M/M rate and includes the Sep '24 M/M rate.

FIGURE 1: CPI PAST & FUTURE

	CPI REPORTS BY MONTH *Annualized*		
	(reported) 2024 Y/Y	(reported) 2024 M/M	(falling off) 2023 M/M
Dec '23	3.4%		
Jan '24	3.1%	**6.74%**	10.03%
Feb '24	3.2%	**7.69%**	6.91%
Mar '24	3.5%	**8.04%**	4.05%
Apr '24	3.4%	**4.77%**	6.24%
May '24	3.3%	**2.01%**	3.06%
Jun '24	3.0%	**0.41%**	3.94%
Jul '24	2.9%	**1.40%**	2.31%
Aug '24	2.5%	**0.98%**	5.37%
Sep '24	2.4%	**1.94%**	3.02%
Oct '24	***2.5%***	***0.64%***	**-0.46%**
Nov '24	***2.8%***	***0.64%***	**-2.39%**
Dec '24	***3.0%***	***0.64%***	**-1.19%**
Jan '25	***2.6%***	***3.00%***	**6.74%**
Feb '25	***2.3%***	***3.00%***	**7.69%**
Mar '25	***1.9%***	***3.00%***	**8.04%**

The Sep '24 Y/Y inflation rate declined because the Sep '24 M/M rate was lower than the Sep '23 rate. The eleven months in between remained the same because this version of CPI inflation is not periodically revised.

The reported CPI rate of 2.4% declined from 2.5% in Aug '24 because 1.94% replaced 3.02% in the cumulative Y/Y measure.

The numbers in the center column are colored green and red. A green font is used when the new number is lower than the prior year's value, signifying a decreasing effect on Y/Y CPI. A red font is used when the latest number is higher, indicating an increasing effect on Y/Y CPI.

THE FOCUS

The next Fed meeting is less than a month away. All eyes and trading bets appear hopeful for an additional Fed funds rate cut.

The next CPI report is scheduled for release a week after the Fed meets. At this point, as reflected in the left column of Figure 1, the momentum in the CPI reports shows six consecutive decreases in the reported CPI rate since Mar '24.

BUT, an unstoppable force is about to meet an immovable object...

THE SURGE

The next three CPI reports will be influenced by the fourth quarter of 2023 (see the bold numbers in the right column of Figure 1). All three months at the end of last year had negative annualized M/M CPI reports. Cumulatively, CPI had annualized deflation of nearly minus 4% in the fourth quarter of 2023.

Any positive (or less negative) CPI inflation report over the next three months will raise the Y/Y CPI inflation rate. If all three months are positive (or just less negative than the values falling off), the financial markets will receive the trifecta of a point, a line, and a trend of rising inflation.

Looking a bit farther ahead, however, the first quarter of 2025 is set up for a reversal.

SCENARIOS

Let's dig into the numbers and explore a couple of scenarios.

Note the purple numbers in the middle column. The assumption of 0.64% for the next three months simply reflects the minimum annualized M/M to drive CPI to 3% by yearend (reported in Jan '25).

Keep in mind, the upcoming three monthly reports could be as negative as, or more than, the fourth quarter of last year. However, that would be unusual. Over the past five years (i.e., 60 monthly reports), 7% of the M/M reports during the first and second quarters were negative. The third quarter was more prone to negative M/M reports at 20%.

Interestingly, 53% of the months across five years of fourth-quarter months had negative M/M CPI reports. Yet, last year was the only year across the past five with a cumulative negative fourth quarter.

In summary for the fourth quarter, if the three annualized M/M CPI reports total more than 2%, the closely watched Y/Y rate will be driven above 3% by the Dec '24 report (released in Jan '25).

A cumulative total that is greater than minus 4% will drive Y/Y Dec '24 higher than today's reported 2.4%. A cumulative total between minus 4% and +2% will land Y/Y CPI for Dec '24 between 2.4% and 3.0%.

The inflation outlook improves in the first quarter. Even if the Dec '24 Y/Y report comes in at 3%, and if the annualized M/M reports across the first quarter of '25 average 3%, Y/Y CPI next March would be 1.9%.

The cumulative total annualized M/M during the first quarter of '24 was a whopping 22.5%! See the last three rows of Figure 1 for perspectives about this scenario.

TRANSITORY II?

The Fed likely knows this structural phenomenon, but it's surprising that Powell's comments have not hedged even a bit. It'll be interesting to see how Fed officials respond to the press and market pundits as this unfolds. A "but it's structural" explanation may remind too many people of the term "transitory."

Clearly, the scenario in the last six months of Figure 1 is not a forecast. Instead, the analysis uses simplified and subjective assumptions to illustrate key points. Reported CPI inflation will likely be lower in six months, but it may be a wild ride along the way!

UNCERTAINTY CONFRONTING THE MARKET

With such uncertainty confronting the market, this is a time to diversify risk by including investments across a broad spectrum of risk types. Diversifying investments with similar underlying risks will still concentrate portfolios with common risks.

As for fixed income investments, the analysis Bond Yields: Reasonable Expectations has been updated through September 30th. This analysis shows the historical spread between the 10-year Treasury Note and the CPI inflation rate.

The spread will likely swing quite a bit over the next six months. If it settles near the historical average, look for the 10-year to be near 4%, which is about where it is today. That said, as with most financial market statistics, the average rarely happens.

The next six months may be an opportune time to evaluate one's fixed income strategy. Investing is an ever-changing process; it rarely rests in an environment of stability.

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