Opinion **US inflation**

There's one inflation gauge that bucks the trend

The New York Fed's often overlooked UIG believes US inflation is past its peak

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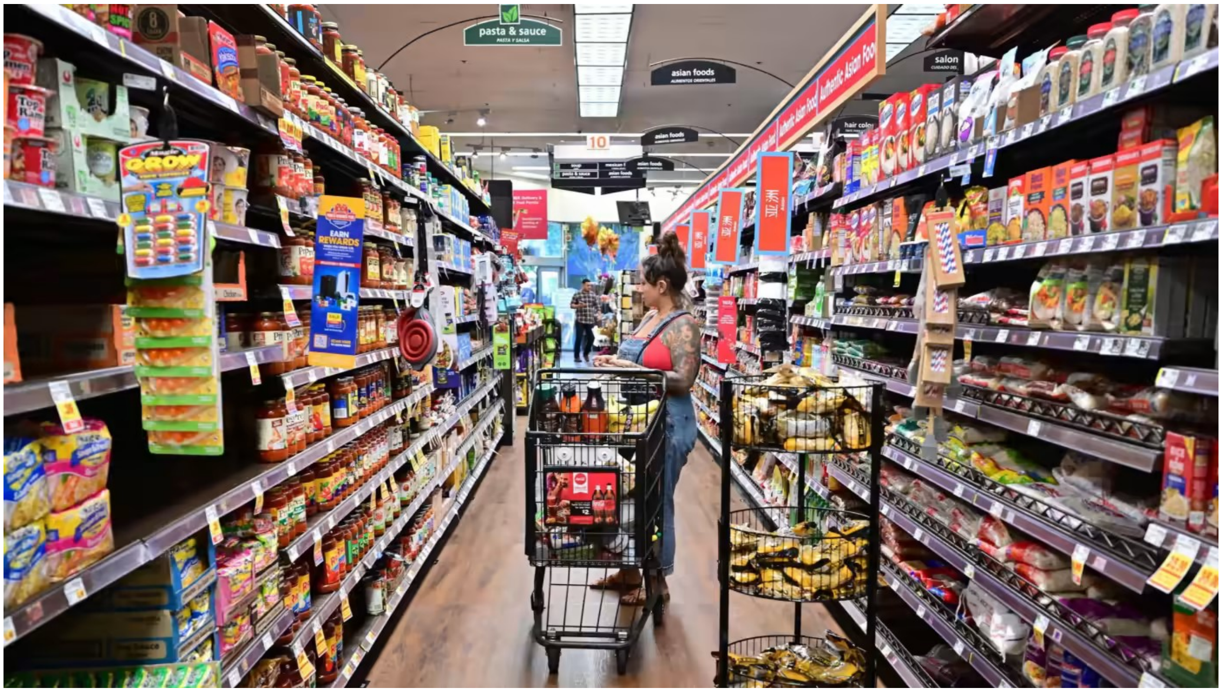

The consumer price index and the personal consumption expenditures index include the prices of volatile items such as energy and food © Frederic J Brown/AFP/Getty Images

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Whenever there’s an economic consensus on anything, it’s worth considering how it might be wrong. There seems to be general agreement that inflation and rates will be higher for longer, and “team transitory” has been defeated. But what if we are at an inflection point on inflation? This is the question policymakers should be asking. By one key measure, inflation in the US has already peaked. In fact, it peaked in March, the same month that the Federal Reserve began raising the benchmark rate.

The New York Fed’s underlying inflation gauge has largely been ignored for decades. That’s understandable, and not just because of the snoozer of a name. There wasn’t any significant underlying inflation in the years after the global financial crisis. While the Fed and financial markets are fixated on the 2 per cent inflation target, the UIG isn’t primarily a level forecast. Its real value is in predicting inflection points. It correctly anticipated the lasting high inflation we are now observing. And while it’s still high, the UIG is suggesting it will be abating.

The media and the public are obsessed with the consumer price index, while the Fed’s target is based on the personal consumption expenditures index. Both can be “noisy”, since they include the prices of volatile items such as energy and food. But they are not the only price measures. The Atlanta Fed tracks nine other indices for inflation that aim to strip out noise. They show inflation somewhere between 4.7 and 7.3 per cent in September.

Most of these gauges remove data to try to identify underlying inflation. Core CPI excludes energy and food costs, for example, while trimmed mean and median measures strip out components with the largest changes in prices to smooth out the index. But the risk with these indices is that they can miss large price moves — up or down — that could be a signal of inflation changing direction.

The UIG is constructed differently, removing noise rather than items from the index. The idea is that movements in trend inflation happen alongside related changes in the trends of other economic and financial factors. The index looks at moves in prices, the labour market, financial markets and the real economy every month and checks the historical data going back to 1995 to see if similar moves had previously lasted at least a year. If so, they are included in that month’s UIG and if not, they are filtered out as noise.

You really can’t use the UIG to forecast the level of inflation, as has sometimes been suggested. Where it matters is in showing when the inflation trend is changing, and on this it has a decent track record in both normal and unprecedented times. When CPI hit a peak in 2018, for example, UIG clearly showed the peak while core CPI and trimmed mean and median indices suggested inflation would continue rising. In mid-2009, UIG showed a trough in inflation while the other measures took another year to reach a nadir.

What about during the pandemic? Core CPI did a good job of signalling a bottom for inflation in mid-2020 before rising, but dipped in the third quarter last year, wrongly suggesting that inflation would come down. The trimmed mean and median inflation indices failed to indicate a shift towards higher inflation, showing a trough more than six months after CPI and core CPI.

UIG found a bottom roughly in line with headline CPI and then started a steady climb upwards, rightly ignoring the slump in the third quarter of 2021. Of these metrics, it provided the earliest and most reliable signal for a rise in underlying inflation.

The Fed is now looking for signs that trend inflation has peaked and that monetary tightening is bringing inflation back towards its target. Much to its alarm, core inflation dipped in the second quarter of this year before accelerating in August and September. Median and trimmed mean inflation have been on a steady upward climb, with no signs of stabilisation. But the UIG peaked in March 2022, stabilised at high levels and has been gradually falling since July.

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All the different gauges for inflation suggest it is way above the Fed's target. But we know monetary policy works with long and variable lags, and there is a danger overtightening could spark a recession. The central bank aims to look through transitory factors and set policy based on the underlying trend. The UIG shows the trend is finally starting to reverse course. With rates now restrictive, that suggests it's time for Fed officials to consider slowing their tightening path.