August CPI Raises the Odds of a Rate Hike Next Week

Matt Harris, CFA
HilltopSecurities Asset Management
Senior Portfolio Advisor
Senior Vice President
512.340.1845
matt.harris@hilltopsecurities.com

Scott McIntyre, CFA
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

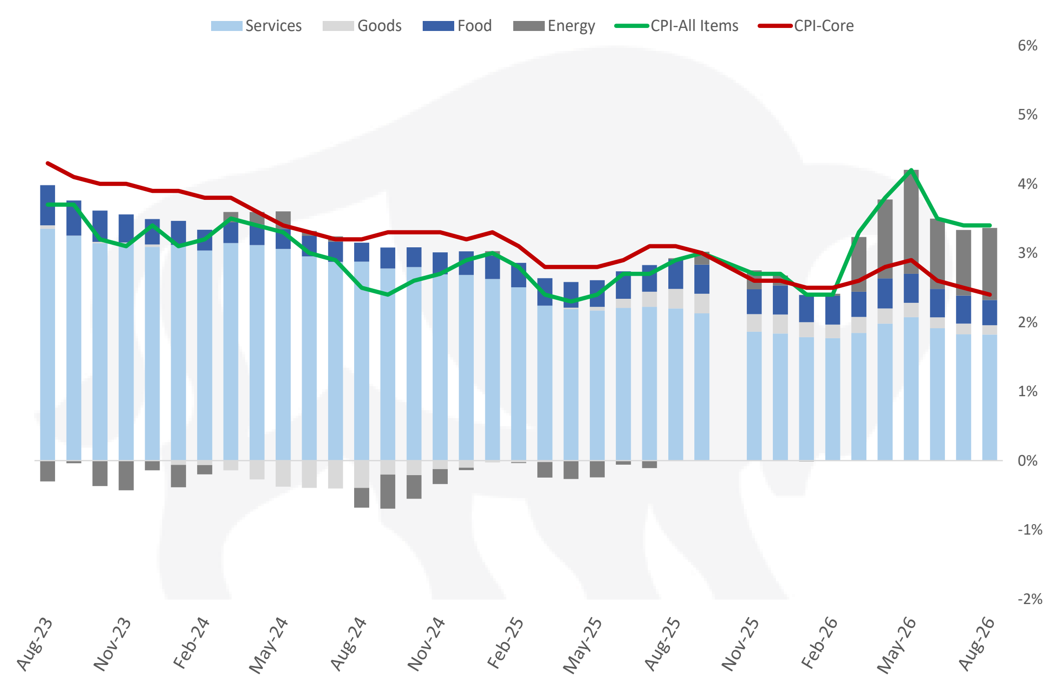
Greg Warner, CTP
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2012
greg.warner@hilltopsecurities.com

The August Consumer Price Index offered both the good and the bad. The good news is that underlying inflation continues to ease on an annual basis, with core CPI slowing to 2.4% year-over-year, its lowest reading since the spring of 2021. The bad news is that monthly inflation accelerated, energy prices moved higher again, and several of the categories that the Fed has been watching showed new signs of pressure.

Headline CPI rose 0.4% in August, matching expectations and increasing from July's 0.1% gain. Annualized inflation held steady at 3.4%. Much of the monthly increase came from energy, with gas prices rising 3.9% and accounting for more than one-third of the overall gain. Overall energy prices climbed 2.1% during the month, reinforcing concerns that the recent rally in crude oil could begin spilling over into broader inflation measures. Rising diesel prices, now above $6 per gallon, could add to those pressures as higher transportation and fuel costs work their way through freight, manufacturing, food distribution, and home heating expenses.

Core CPI, which excludes food and energy, increased 0.3% during the month, above the 0.2% consensus forecast and the largest monthly increase since April. Shelter costs also jumped, rising 0.3% after increasing just 0.1% in July. That rebound was disappointing for those hoping softer housing inflation would help offset the impact of higher energy prices.

Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

Headline CPI rose 0.4% in August, matching expectations and increasing from July's 0.1% gain. Annualized inflation held steady at 3.4%.

Several categories contributed to the stronger core reading. Prices increased for communications services, airline fares, education, used cars and trucks, and lodging away from home. Meanwhile, medical care and motor vehicle insurance declined during the month.

The AI tech buildout continues to show up in the data. Computer software and accessories prices rose 25.4% from a year ago, while wireless services increased 5.9% during the month alone. Some economists argue these technology-related categories, along with education costs, were responsible for a disproportionate share of the inflation surprise and support the case for a "one-and-done" rate hike rather than the start of a broader tightening campaign. Others are less convinced, saying that inflation has remained above the Fed's target for years and that one additional rate increase may not be enough to restore confidence that price stability has been achieved.

Fed officials are currently in their blackout period ahead of next week's FOMC meeting. Last month, Governor Christopher Waller said the August CPI report was going to be *crucial* to the upcoming rate decision, while Chair Kevin Warsh's July press conference and his hawkish tone at Jackson Hole have raised expectations that policymakers will tighten policy if inflation does not show signs of easing.

While annual inflation measures continue to improve, rising energy prices, firmer shelter costs, and a hotter monthly core CPI reading are likely to push the Fed to act.

The bond market viewed the report as strengthening the case for a hike. Markets are now pricing almost a 90% probability of an increase next week, and some analysts expect another before year-end. While annual inflation measures continue to improve, rising energy prices, firmer shelter costs, and a hotter monthly core CPI reading are likely to push the Fed to act.

Next week is Fed week. Before the decision, investors will get August retail sales on Wednesday morning, offering a look at the health of the consumer. The Empire State and Philadelphia Fed manufacturing surveys, along with housing starts and building permits, will also be released, but they will take a backseat to the FOMC meeting. The focus will be squarely on the Fed's rate decision, updated projections, and Chair Warsh's press conference as markets take in whether any action next week represents a one-off adjustment or the beginning of additional tightening.

Market Indications as of 9:26 A.M. Central Time

DOW	Up 493 to 52,557 (HIGH: 54,349)
NASDAQ	Up 316 to 26,398 (HIGH: 27,094)
S&P 500	Up 73 to 7,664 (HIGH: 7,799)
1-Yr T-bill	current yield 4.29%; opening yield 4.26%
2-Yr T-note	current yield 4.60%; opening yield 4.59%
3-Yr T-note	current yield 4.68%; opening yield 4.68%
5-Yr T-note	current yield 4.75%; opening yield 4.76%
10-Yr T-note	current yield 4.94%; opening yield 4.97%
30-Yr T-bond	current yield 5.33%; opening yield 5.38%