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CPI Report Weighs Heavily on Fed Decision

Officials, divided on direction of rates, will look closely at new inflation reading

BY NICK TIMIRAOS

A single reading of consumer prices Friday morning could determine whether the Federal Reserve raises interest rates next week.

Note

Fed officials have been divided all summer over whether interest rates are high enough to bring inflation down to their 2% goal. Price readings were firmer than expected through the spring before easing in June and July. Friday's consumer-price index report, from the Labor Department, will show whether that improvement is the turn most officials have been forecasting or another false start in an inflation rate that has run above target for five years.

Economists expect core prices, which exclude volatile food and energy items, rose 0.2% in August. The gap between a number that forces the Fed's hand and one that lets it wait may be as slim as a tenth of a percentage point.

The Fed held rates steady at its last meeting in July. Three officials dissented in favor of raising rates, and others have since said they could join them if inflation doesn't improve. Chairman Kevin Warsh moved toward that camp in his speech at the Fed's Jackson Hole conference last month, saying he saw little evidence that borrowing conditions were restraining the economy and that the summer's better readings hadn't convinced him the underlying trend was improving.

Warsh didn't say what, exactly, would satisfy him. That has left markets testing the new chairman, said Vincent Reinhart, a former senior Fed economist: They have priced an increase he never promised, and he can either deliver it or explain why not.

Investors now put the probability of an increase next week at around 60%, up from 35% before the speech. "This is the double-dog daring you. This is straight schoolyard," said Reinhart, chief economist at BNY Investments.

Note

Investors have also taken their cues from Warsh's colleagues. Fed governor Christopher Waller last week argued against rushing into a rate increase if the August figures show inflation continuing to slow. He suggested he would vote to hold steady if core prices rose 0.2% in August, and would support an increase if the number 'comes in hot."

"What's the cost of waiting one meeting?" Waller said last week. "You want to take a chance to see if disinflation continues, but I'm not taking a big chance on it."

Officials who favor an increase say the risks ahead matter more than the last two or three readings. A war that has kept energy prices elevated for six months, new tariffs and an AI build-out straining supply will keep pressure on prices, they argue, whatever August shows.

The decision is easier at either extreme. A soft number Friday would validate Fed staff projections that monthly inflation readings should decelerate to levels consistent with 2% inflation now that tariff effects have rinsed through the system. A hot number would say the opposite—that the summer's improvement didn't stick—and leave Warsh little room to hold.

It's the ambiguous middle that could create a bind: a number soft enough to justify waiting but not soft enough to convince investors who have leaned toward an increase. Holding there risks putting Warsh back where July left him, explaining a decision with an unsatisfying rationale— the problem the Jackson Hole speech resolved.

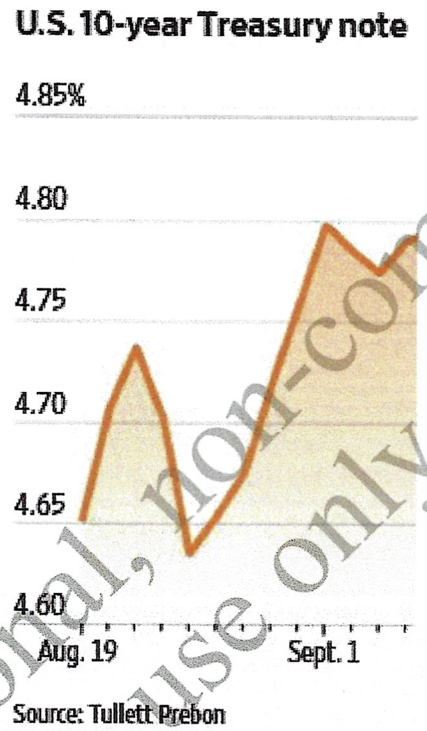
Warsh has argued for years that the Fed shouldn't tell markets what would prompt its next move, and he told the audience in Wyoming he was committed to a discipline rather than a decision. The effect was to convince investors a rate increase was coming while leaving them to work out for themselves what would produce one.

The dependence on a single report is at odds with what Warsh has said about how the Fed should work, but the alternative isn't obvious, said William English, a former senior Fed official now at the Yale School of Management.

"What else can policy depend on? It has to depend in the end on the data and your interpretation of the data," he said. Moreover, a monthly print isn't self-explaining: Officials have to strip out special factors to get at the underlying trend, which is what Warsh said at Jackson Hole he was watching.

What Warsh wants remains an open question. Steven Blitz of TS Lombard doesn't think Warsh wants to raise rates next week and read the Jackson Hole speech as an effort to reassure investors who had questioned his commitment to bringing inflation down. "Unless the data puts him in a corner where he absolutely has no choice but to hike, he will find a way not to hike," he said.

Joseph Lavorgna, a former Trump administration Treasury official now at SMBC Americas, heard the opposite. "Unless the data are very weak, I didn't think there was any way the Fed wasn't going to hike in September," he said.


U.S. 10-year Treasury note
4.85%
4.80
4.75
4.70
4.65
4.60
Aug. 19
Sept. 1
Source: Tullett Prebon