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Is the Inflation Fight About to Turn Painful?

BY GREG IP

We may look back on October's consumer-price index as an inflection point, when the balance of risks flipped toward a painful rather than painless inflation cure. The consumerprice index rose 0.4%, and the core index, which excludes food and energy, rose 0.3%. Anything over 0.2% is incompatible with the Federal Reserve's 2% target, and this was the third 0.3% increase in a row.

Prior hot readings could be chalked up to something specific— energy, or used cars, or cellphone plans. Not this one.

You can see this in two Cleveland Fed measures that remove outliers. The median CPI, which tracks the component whose expenditure weight is in the 50th percentile of price changes, rose at a 3.7% annual rate. The trimmed-mean CPI, which excludes the 8% fastest- and 8% slowest-rising components by weight and averages the remainder, rose 4.5%. Though volatile, those suggest the current core inflation rate is more likely to go up than down in the near future.

That core rate is 2.8% using the CPI, and 3.1% using the Fed's preferred index. The optimists (myself included) thought inflation was underpinned by one-off shocks such as tariffs and energy and, as those pressures faded, would painlessly fall back to 2%. That may still happen.

Here's why that is looking less likely. First, those supply shocks are filtering into a pretty broad range of categories, not just the usual suspects like airfares, and taking their time about it. Goldman Sachs predicts the residual effects could continue through the first half of 2027.

Second, temporary price bumps become persistent when companies have pricing power, which they do now with solid economic growth and buoyant financial markets. The missing ingredient is wages, which, despite low unemployment, are growing sluggishly. But when you include benefits, labor costs don't look so tame. And it may only be a matter of time before wages follow prices.

If inflation were headed to 2% on its own, the Fed would only have to tap the brakes lightly. If it is stuck around 3%, the Fed actually has to create some slack in the economy, through slower growth and higher unemployment. That will involve considerably higher interest rates.

How much pain could that involve? The 2-year Treasury yield, a barometer of future Fed actions, is 0.25 percentage point below the 10-year yield. If it rises above the 10-year yield (an "inverted yield curve"), it is time to start thinking about recession. *This appeared in the WSJ Economics newsletter. To subscribe to the newsletter, go to wsj.com/newsletters.*

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