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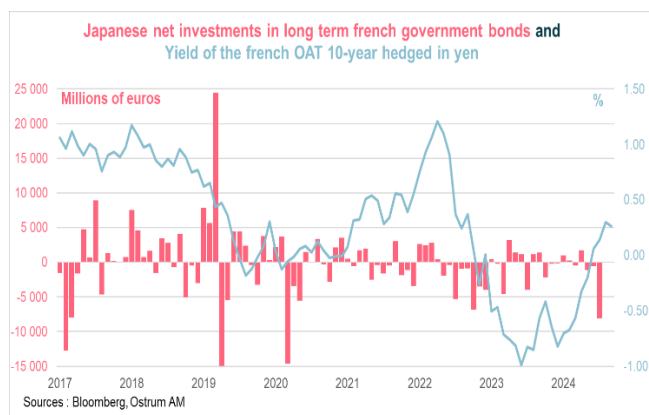
● **Topic of the week: New corporate pricing strategies vs. old inflation measures**  
by Axel Botte

- One of the key choices for central banks is the inflation reference. The Fed opted for the PCE deflator over the better-known CPI in 2012 when the FOMC defined its price stability objective as 2% inflation;
- PCE is more representative of what it is in the broader economy, whilst CPI is closer to out-of-pocket expenses;
- Measuring inflation is hard, and price indexes may not always fit the consumer experience with the evolution of the cost of living;.
- Furthermore, new corporate pricing strategies enabled by big data collection have resulted in personalized pricing that likely make overall inflation measurement more difficult;
- This could both complicate the conduct of monetary policy and explain the resilience in corporate margins as firms are better able to unveil consumers' willingness to pay.

● **Market review: Fed : starting easy?**  
by Axel Botte

- The ECB cuts deposit rates by 25 bp as expected;
- The Fed will lower rates, with expectations of a 50 bp move rising towards the end of the week;
- Sovereign spreads tighten amid solid demand for 30-Yr Italian BTPs;
- World stocks rebound in the wake of US technology stocks.

● **Chart of the week**



Political turbulence in France has created some distrust abroad. Japanese investors, who had already reduced their presence in the French debt market over the past several years, sold the equivalent of 8 billion euros in July. Despite the tensions on the spread, the yield on the 10-year OAT hedged in yen for 12 months remains below the yield of the 10-year Japanese government bond (JGB) at 0.26% compared to 0.85%. The intervention of the European Central Bank (ECB) through the reinvestments of the PEPP (Pandemic Emergency Purchase Programme) has likely mitigated the selling pressure from Japan.

● **Figure of the week**

**63**

China decided to raise the retirement age to 63 years for men from 60 years previously. Women's retirement is also increased by 3 years to 58 years. The measure will take effect in January 2025, but will be implemented gradually. Source: Xinhua News Agency

- **Topic of the week**

## New corporate pricing strategies vs. old inflation measures

The Federal Reserve’s dual mandate includes a price stability objective defined as 2% PCE inflation since 2012. Inflation is hard to measure and there is a range of price indexes to choose from. The Fed uses the personal consumption expenditure deflator (PCE) which differs from the consumer price index (CPI), both in terms of category weightings and methodology. In turn, market participants pay more attention to CPI releases, which come earlier and are used as reference for TIPS. That may create gaps between the Fed’s inflation outlook and market forecasts. Moreover, a new era in corporate pricing strategies may blur inflation measures and make CPI/PCE estimates less reliable.

### Guided by the stars under a cloudy sky

Jerome Powell famously described the conduct of monetary policy as navigating by the stars under cloudy skies. Activity cannot be observed in real time, but the price stability objective may represent an even greater challenge for policymakers. There is a large number of stars (inflation indexes) with lots of methodological clouds. Furthermore, a new era in corporate pricing strategies, enabled by big data collection, may render current inflation gauges less reliable as policy guidepost.

### The choice of an inflation reference matters

**The Fed’s preferred price gauge is the PCE deflator**

Price stability has long been part of the Fed’s dual mandate. Yet the Fed did not have an official inflation yardstick nor a formal numerical target until 2012. Former Fed Chairman Alan Greenspan once labelled the popular consumer price index a ‘poor’ measure of the cost of living. At the time, the Fed seemingly had an official target to keep core PCE inflation between 1% and 2%. In 2012, Ben Bernanke went on to pick the headline PCE deflator as the Fed’s inflation benchmark. The choice of PCE over CPI matters.

There is a range of inflation measures produced by government agencies, Fed branches and private institutions. Market participants tend to focus on the PCE deflator and the CPI. The scope of the two price indices is the key difference. The PCE index is the Fed’s preferred gauge as it better reflects what is in the broader economy. The CPI is rather a measure of out-of-pocket spending, which also has the advantage of being released around the 12<sup>th</sup> of the month, earlier than PCE. CPI thus helps shape expectations for the PCE released at the end of the month.

The PCE tracks the changes in the quality of consumer goods and household spending patterns over time better than the CPI. PCE also includes a greater share of government spending paid on behalf of consumers. Healthcare expenditure paid by government though the Medicaid program is in it. Conversely, the CPI is essentially based on a fixed basket of goods and services. Furthermore, public transfers indexed to inflation (such as

social security benefits, state minimum wage rates) are usually based on the CPI. In short, the CPI is more of a real-life index.

## Digging into the PCE-CPI wedge

The PCE reflects what is in the economy, CPI is more real-life expenses

The difference or wedge between the core CPI inflation and core PCE averaged around 30 to 50 bps before the pandemic. The gap widened to 1.8 percent in August 2022 but has now reverted to its long-run average of 0.4 percent.

There exist several factors explaining the wedge. The weight of housing in the PCE is 16% compared with 36% in the CPI. Although the shelter component of PCE uses the same data as CPI for rents and owner-equivalent rents, weight discrepancies have a significant impact on inflation levels. Medical care is also part of the story. Core services (ex-energy and shelter) also slowed much faster in PCE than in CPI. In sum, even as the PCE is built off CPI and PPI components, there are large differences in inflation measures stemming from the methodology.

Price imputation vs. out-of-pocket expenses

Price imputation is also a major source of discrepancy. That is where inflation measurement becomes a silly dark art. Households “consume” services without out-of-pocket expenses. Many prices are thus unobservable and almost 13% of the PCE have imputed prices. For example, imputed financial services, like free-checking and other services not charged, is linked to the spread between rates paid by banks on customer deposits and interest on excess reserves for instance. The Bureau of Economic Analysis hence uses a rough approximation of banks’ interest margins to ‘measure’ the price of banking services. When the Fed raises interest rates, financial service prices in the PCE may rise in tandem. Conversely, turmoil following the collapse of SVB last year reduced PCE inflation at the margin as banks were competing for deposits. Financial services also include expenses linked to fund management services. Higher stock prices raise fees and hence... PCE inflation. Methodologies to estimate air passenger fares can differ wildly between CPI and PCE. CPI derives airfare data from systematic routes whilst the PCE equivalent is from PPI revenue for passenger/mile. The CPI auto insurance index has been double its PCE equivalent at times.

Bad seasonal adjustment can be a source of policy error. Seasonal factor adjustment does not correct for seasonal price changes on a timely basis. Seasonal adjustment factors are updated and revised over time due to improvements in methodology and changes in spending patterns. Residual seasonality appears most pronounced for goods (about 2 thirds of overall seasonality).

Sometimes the inflation measure does a good job to separate the signal from the noise. The shelter component should arguably be inferred from market rents, which are more accurate and timelier than contracted rents. However, market rents are cyclical, sometimes very low in dire times or very high in recoveries, and therefore unreliable for policy purposes. Contracted rents over intertwined periods are smoother and less likely to result in false signals for policymakers.

## Old measures vs. modern corporate pricing

Personalized pricing may blur inflation

But there is more dark matter linked to recent improvements in corporate pricing strategies. It is a legitimate question to ask whether CPI or PCE represents what the

consumers' experience with junk fees, price gouging, surge prices, etc. No one likes to be discriminated against, nor do people like price changes. But consumers increasingly face situations where the pricing of a good or service is personalized. When consumers walk in a store, prices are public, and everyone ends up paying the same. However, offerings through mobile apps and websites will differ depending on your spending habits, revenue, zip code or when you need a taxi at a time when battery is low on your mobile. Corporations now collect a lot of consumer data, and therefore have great knowledge of the underlying marginal demand. Consumers have a good deal (a consumer surplus) when they purchase a good or a service at a price below their reservation price. With improved information about individual consumer demand, corporate pricing power is greatly enhanced. The supply curve does not cross demand at a single equilibrium point. Firms want to sell at the marginal bid price for as many consumers as possible. For producers, it is a matter of maximizing the willingness to pay.

Hence, inflation is no longer a mere supply and demand issue. The BLS computes local CPI indices for many MSAs, but that is not detailed enough in a world of personalized or surge pricing. If surge pricing entices more supply of, say, taxi rides or destroys demand, higher prices would swiftly disappear. Yet, it is unclear what surge pricing or personalized pricing means for competitor responses and overall inflation over time.

New price strategies thus raise a number of questions. Does it silently unleash the inflation genie out of the bottle? The amount of data collected during covid and the associated increase in e-commerce laid the ground for the implementation of new algorithmic pricing strategies at retailers which may have played a role in the spread of inflation. Is the better-informed pricing strategy also the chief reason behind the resilience in corporate profit margins? Firms can surely experiment with different pricing strategies and put consumers to the test more easily.

Tracking the cost of living may be made even harder by other features of the digital economy. The subscription economy exposes inattentive consumers to silent inflation. Monthly payment increases may just go unnoticed by households. The development of buy now-pay later schemes raised the ability to pay for low-income households (as opposed to willingness to pay) but could tie price developments to interest rates, contrary to policymakers' assumption that higher rates lower inflation.

## Are there implications for inflation trading?

**CPI is tradeable, but, if it is less reliable as a cost-of-living gauge, can it still be an efficient inflation hedge?**

In the financial markets, CPI is the only tradeable consumer price index. This is because the US Treasury began issuing Treasury Inflation-Protection Securities (TIPS) in the late 1990s, well before the Fed chose the PCE deflator as its reference for inflation. CPI comes earlier in the month than PCE (which is partly priced off CPI), which fosters investor interest in inflation trading.

The inflation market conventions avoid some of the pitfalls of inflation indexes. The unrevised non-seasonally adjusted CPI is used for indexation of cash-flows of both TIPS and inflation swaps. The reference monthly CPI value is interpolated daily with a 2-month lag. Issues with index revisions, methodological changes with seasonality adjustment and potential delays in economic data releases (due to occasional government shutdowns) are normally avoided.

The relevance and accuracy of CPI as a measure of the cost of living is secondary to inflation traders. CPI fixings respond to changes in policy rate expectations, oil prices or risk aversion (demand for safe assets reduce breakeven inflation rates)... much more than to 'true' changes in the inflation outlook. However, pensions funds, insurance companies and other institutions with long-term liabilities tied to inflation cannot ignore the issues of misrepresentation of the cost of living. Inflation hedging via standard marketable CPI-linked instruments would be inefficient compared with real asset investments (real estate, commodities, equities).

## Conclusion

**The Fed's preferred inflation gauge is the PCE deflator. The PCE price index is theoretically superior to the popular CPI, but the CPI is arguably a better estimate of consumers' out-of-pocket expenses. Financial markets respond more strongly to CPI surprises than to PCE, which is released later and is partly derived from the CPI. But there are a lot of questions regarding the relevance of such inflation measures as companies explore new pricing strategies. Surge pricing for taxi rides, individualized pricing for airfares, fast changing prices on goods or sporting event seats make it harder for policymakers to get a hand on overall inflation. It could explain the resilience of corporate margins since covid as firms are better able to unveil consumers' willingness to pay.**

**Axel Botte**

- **Market review**

## **Fed : starting easy?**

**The ECB cut rates by 25 bps as expected as the FOMC looks set to start an easing cycle. Stocks rallied led by US technology even as the Japanese yen looks set for another rise past 140.**

The ECB unsurprisingly cut interest rates as expected last Thursday for a second time this year. The Fed is expected to do the same this week, with a possibility of a jumbo 50 bp reduction. Slower wage growth also fanned expectations of earlier cuts from the BoE. The easing bias is underpinning the bond rally to 3.65 % on 10-Yr note and below 2.20 % on Bunds. Lower yields help sovereign spreads lower. JGBs are caught in crossfires as the BoJ signaled its intentions to hike again. Credit appears fairly valued but a busy primary market is pressuring spreads. High yield was steady as equities regained performance after a tough start in September. The yen appreciation resumed with 140 now in sight. Gold is making all-time highs in a sign of lingering risk aversion.

The economic backdrop remains challenging in the euro area. The ECB lowered GDP growth by 0.1pp each year until 2026. The inflation outlook remains for a return to 2% before the end of 2025. Domestic pressures, with service inflation above 4%, persist so that core inflation forecasts have been rounded up. The ECB lowered the deposit rates by 25 bp to 3.50 % and narrowed the refi-depo corridor to 15 bp as announced earlier this year. There was no explicit guidance on the next steps, but rates will fall further in December. Christine Lagarde barely touched upon QT. PEPP reinvestments will stop at the end of the year under the current guidance. APP holdings will shrink by €667 billion by July 2026. Rate cuts make up for tighter quantitative policy. As regards the Fed, our take is a 25 bp cut but traders increasingly bet on 50-bp relief. The steady core CPI at 3.2% in August is a reminder that it is not all clear on the inflation front but the employment situation is central to the FOMC's decision.

The bond rally continued towards 3.65 % on 10-Yr notes, amid steepening pressure. Many speculative accounts put on conditional bull steepeners. The key questions to sustain current bond valuations will be the size of the next Fed moves and the neutral rate endgame. The dot plot will hence be scrutinized by market participants. In the euro area, the Draghi report hinting at new EU borrowing worth 800 billion is facing pushback from governments. Bund yields track lower in keeping with downside risks to growth. Inflation breakevens have plummeted as Brent prices hit \$70. Two-year inflation swap rates hover about 1.7%. In sovereign bond markets, French 10-Yr spreads closed under 70 bp amid broad-based tightening. France's rating will nevertheless be under threat over coming weeks whilst Spain and Greece may be upgraded. Italy's 8 billion 30-Yr bond syndication drew considerable demand from investors, helping to push 10-Yr BTP spreads below the 140 bp threshold. SSA issuers borrowed €23.7 billion in total last week.

Euro IG credit spreads widened to 92 bp vs. swaps. Bond issuance totaled €24 billion, evenly split between financials and non-financials. Automobile issuers performed poorly, most notably German manufacturers exposed to China. High yield closed slightly wider although iTraxx Crossover performed well in keeping with the rebound in equities, again led by US technology names. In Europe, momentum plays outperformed.

**Axel Botte**



- Main market indicators

G4 Government Bonds	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Bunds 2y	2.2%	-2	-24	-21
EUR Bunds 10y	2.13%	-4	-11	+11
EUR Bunds 2s10s	-6.4bp	-2	+13	+32
USD Treasuries 2y	3.55%	-12	-50	-70
USD Treasuries 10y	3.64%	-6	-24	-24
USD Treasuries 2s10s	9.3bp	+6	+26	+47
GBP Gilt 10y	3.77%	-9	-16	+23
JPY JGB 10y	0.85%	-5	-14	-49
€ Sovereign Spreads (10y)	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
France	70bp	-2	-2	+17
Italy	136bp	-10	-5	-32
Spain	79bp	-3	-4	-17
Inflation Break-evens (10y)	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR 10y Inflation Swap	1.94%	-1	-8	-19
USD 10y Inflation Swap	2.3%	+3	-1	-11
GBP 10y Inflation Swap	3.4%	-6	-13	-14
EUR Credit Indices	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
EUR Corporate Credit OAS	121bp	+3	+0	-17
EUR Agencies OAS	65bp	+0	-2	-5
EUR Securitized - Covered OAS	60bp	-1	-3	-19
EUR Pan-European High Yield OAS	379bp	+1	-11	-20
EUR/USD CDS Indices 5y	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
iTraxx IG	53bp	-2	-1	-5
iTraxx Crossover	289bp	-12	-7	-25
CDX IG	50bp	-2	-1	-7
CDX High Yield	324bp	-14	-8	-32
Emerging Markets	16-Sep-24	1wk (bp)	1m (bp)	2024 (bp)
JPM EMBI Global Div. Spread	385bp	-3	-26	+1
Currencies	16-Sep-24	1wk (%)	1m (%)	2024 (%)
EUR/USD	\$1.112	0.679	0.880	0.8
GBP/USD	\$1.320	0.771	1.962	3.7
USD/JPY	JPY 140	1.824	5.210	0.5
Commodity Futures	16-Sep-24	-1wk (\$)	-1m (\$)	2024 (%)
Crude Brent	\$72.4	\$0.6	-\$6.4	-3.8
Gold	\$2 584.7	\$80.2	\$76.7	25.3
Equity Market Indices	16-Sep-24	-1wk (%)	-1m (%)	2024 (%)
S&P 500	5 626	4.02	1.29	18.0
EuroStoxx 50	4 829	1.06	-0.24	6.8
CAC 40	7 447	0.30	-0.03	-1.3
Nikkei 225	36 582	0.52	-3.89	9.3
Shanghai Composite	2 704	-2.23	-6.09	-9.1
VIX - Implied Volatility Index	17.16	-11.77	15.95	37.8

Source: Bloomberg, Ostrum AM

## Additional notes

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