

WisdomTree MINDS ON THE MARKETS



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Could the ‘I’ in AI Stand for Inflation?

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Even if the Middle East war does find a lasting settlement, the specter of inflation appears poised to hang over the markets. Indeed, while employment data had, up until recently, been the primary focus for investors, arguably, inflation reports have now moved into the ‘leaderboard’ position.

For the money and bond markets, the recent increase in Treasury yields was definitely a by-product of the ‘inflation trade’. While rising energy prices had been the catalyst for the initial wave of bond market selling, it was the latest readings for CPI and PPI that created a heightened sense of concern that price pressures were potentially spreading into the broader macro landscape beyond oil and gas prices at the pump.

As a reminder, the Producer Price Index (PPI) measures prices at the wholesale level while the Consumer Price Index (CPI) gauges inflation for the nation’s retail sector. The data for both of these indicators were for April, so it offered a glimpse of inflation trends from a broader perspective and what was potentially transpiring outside of the immediate effects of the war-related energy price surge.

CPI is arguably the more closely watched inflation indicator, and for April, it revealed higher than expected readings for both headline and core on a year-over-year basis. In fact, it is possible that both of these measures could eclipse the +4% threshold (headline) and +3% threshold (core) for May. In terms of PPI, overall wholesale prices rose by +6% on an annualized basis, representing the fastest pace since 2022. Not to be outdone, core PPI posted a yr/yr gain of +5.2%, also its highest reading in over three years.

That brings us to the Fed’s preferred inflation gauge, the PCE Price Index. Did the trifecta occur? Why yes, it did. While the month/month readings came in a bit less than expected, core PCE’s gain of +3.3% year/year matched consensus estimates and has accelerated notably from the +2.6% that was witnessed a year earlier and now stands 1.3 percentage points above the Fed’s target.

Outside of rising energy prices potentially working their way through the broader economic setting, is there any other key factor investors should be watching? In our view, the answer is AI.

Typically, when you read articles about AI and inflation, the primary focus tends to be on the future benefits from productivity gains. However, what can often get overlooked is the potential for demand pressures in the short term. In other words, we have to ‘get there’ first before the economy can possibly enjoy a more favorable setting for inflation. And by ‘getting there’, a massive buildout needs to occur which will impact electricity, infrastructure-related costs, hardware, and don’t forget the huge amount of water that is required for the process.

As we have seen from recent Fed-speak, inflation has also seemingly become job #1 for the policymakers. A growing number of FOMC members over the last week or so have gone on record emphasizing this part of their dual mandate while giving less attention to the employment aspect.

Much like sentiment in the bond market, Fed officials not named Warsh appear to be growing less confident that the recent uptick in inflation, dare we say, is “transitory.”

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