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US CPI: Disappointing news for the Fed

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Consumer Price Index (monthly change, %)	Feb 2024	Jan 2024	Dec 2023	Nov 2023	Oct 2023	Sep 2023	Feb NSA YoY%
All items	0.4	0.3	0.2	0.2	0.1	0.4	3.2
Ex-food/energy	0.4	0.4	0.3	0.3	0.2	0.3	3.8
• Ex-food	0.5	0.3	0.2	0.2	0	0.4	3.3
• Ex-energy	0.3	0.4	0.3	0.3	0.2	0.3	3.5
Energy	2.3	-0.9	-0.2	-1.6	-2.1	1.2	-1.9
Services	0.5	0.7	0.4	0.5	0.3	0.5	5.0
Housing	0.4	0.6	0.3	0.4	0.3	0.5	4.5
Fuels & util.	0.7	1.2	0.2	0.8	0.2	0.5	1.4
Food/beverages	0.0	0.4	0.2	0.2	0.3	0.2	2.2
• Food	0.0	0.4	0.2	0.2	0.3	0.2	2.2
Apparel	0.6	-0.7	0.0	-0.6	0	-0.3	0.0
Transportation	1.4	-0.6	0.1	-0.2	-0.7	0.3	2.7
Medical care	0.0	0.5	0.4	0.5	0.2	0.1	1.4
Recreation	0.2	0.5	0.4	-0.2	0.1	0.4	2.1
Education, comm.	0.4	0.4	0.1	-0.3	-0.2	0.1	0.4
Other good, serv.	-0.3	0.5	0.0	0.4	0.6	0.6	4.7
Commodities	0.4	-0.3	0.0	-0.4	-0.3	0.1	0.3

Source: Haver Analytics.

- Today's above consensus inflation report was disappointing news for the Fed. Core CPI prices rose 0.4% for the second straight month, another upside surprise relative to the consensus, which was predicting a 0.3% reading. Headline inflation came in line with expectations at 0.4%. In year-over-year terms, headline inflation ticked up one notch to 3.2% and core inflation eased one notch to 3.8%. Core services prices decelerated to 0.5% as both shelter costs and non-housing services prices eased in the month. But it was an uptick in core goods prices to 0.1% that pushed the headline core number over the edge, ending a solid deflationary streak. Based on today's data we estimate that core PCE inflation in February will come in at 0.3% m/m but PPI will also be important for that estimate. In any case, that puts off the argument for imminent rate cuts. We have long called for the Fed to move later than most believed, with the first cut beginning in Q3 of this year. But two consecutive disappointing inflation reports puts our call for four rate cuts this year at risk, as a very data-dependent Fed could decide to ease more gradually.
- While core prices continued to rise at a 0.4% pace for the second month in a row, the drivers of that number were somewhat different this month. Shelter costs accounted for about half of the increase in core CPI and non-housing services about 40%. The remaining 10% came from core goods. In contrast, last month, about two-thirds came from

shelter and half from non-housing, while goods were a material drag on core CPI inflation subtracting about 0.1 percentage points from monthly inflation.

- The persistence of service inflation is the biggest question facing the US inflation picture and front and center in that debate is shelter inflation, which moderated by two notches in February to 0.4%. Shelter costs, despite widely anticipated to come down for a long time, have had an uneven and very slow climb down. The BLS provided a seminar earlier this month that shed some light on the differences between owner's equivalent rent (OER) and rental inflation. They explained that single family homes have a much greater weight in OER and the underlying prices for these homes have increased and been volatile. What's more, even in the rental inflation basket single family homes occupy a substantial share. The limited turnover of the housing market and high demand for single family homes, perhaps because of persistent work-from-home has partly offset the fall in market-based rents which are mostly of multi-family or apartment units. While we should continue to expect some slowdown in shelter, it will be uneven, volatile, and unlikely to go as far down as previously believed. But the good news is that shelter costs occupy a much smaller weight in PCE inflation.
- Non-housing services moderated in the month to 0.5% from a very high 0.9% the month prior. Most of this moderation however came from medical services costs, which pulled back after a very strong three-month uptrend. That appears to be the extent of the price resetting. The other categories mostly remained strong in the month which should be concerned to the Fed. While the labor market continues to rebalance and wage growth is decelerating, firms still feel comfortable passing on higher costs. Powell has spoken about the need to have greater disinflation in services to allow for a more sustainable path to target as there is less disinflation in goods prices. There has been very little progress on that front since the fall. This category also constitutes the largest part of the core PCE basket.
- Core goods prices picked up in the month, the first material gain since May 2023. Since then, goods prices have been in deflationary territory benefitting from the normalization of supply chains and restrictive monetary policy. Is this an inflection point for goods? The music will stop at some point, but it does not seem obvious that point is now. Goods demand may be starting to ebb, and the supply-demand balance could continue to support softer prices. Dealers are also offering incentives for cars and the lead-lag relationship between the used cars index, which rose by 0.5% in February, and the Manheim used car index suggests some further disinflation in used cars is still to come.

Implications & actions

Re: Economic forecast — Today's report is disappointing for the Fed and puts at risk our call for four rate cuts, with the possibility of fewer cuts this year. The Fed will retain its very data-dependent character and look for more cooling of the economy as it decides to dial back restrictive policy.

Re: Markets — Both bond yields and the greenback rose as core inflation surprised to the upside.

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