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US CPI: Another disappointing one for the Fed

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Consumer Price Index (monthly change, %)	Mar 2024	Feb 2024	Jan 2024	Dec 2023	Nov 2023	Oct 2023	Mar NSA YoY%
All items	0.4	0.4	0.3	0.2	0.2	0.1	3.5
Ex-food/energy	0.4	0.4	0.4	0.3	0.3	0.2	3.8
• Ex-food	0.4	0.5	0.3	0.2	0.2	0	3.7
• Ex-energy	0.3	0.3	0.4	0.3	0.3	0.2	3.6
Energy	1.1	2.3	-0.9	-0.2	-1.6	-2.1	2.1
Services	0.5	0.5	0.7	0.4	0.5	0.3	5.3
Housing	0.4	0.4	0.6	0.3	0.4	0.3	4.7
Fuels & util.	0.5	0.7	1.2	0.2	0.8	0.2	3.3
Food/beverages	0.1	0.0	0.4	0.2	0.2	0.3	2.2
• Food	0.1	0.0	0.4	0.2	0.2	0.3	2.2
Apparel	0.7	0.6	-0.7	0	-0.6	0	0.4
Transportation	0.8	1.4	-0.6	0.1	-0.2	-0.7	4.0
Medical care	0.5	0.0	0.5	0.4	0.5	0.2	2.2
Recreation	-0.1	0.2	0.5	0.4	-0.2	0.1	1.8
Education, comm.	0	0.4	0.4	0.1	-0.3	-0.2	0.2
Other good, serv.	0.4	-0.3	0.5	0	0.4	0.6	4.7
Commodities	0.1	0.4	-0.3	0	-0.4	-0.3	0.6

Source: Haver Analytics.

- Today's above-consensus inflation report – the third in a row – means you don't have to be a BLS "super user" to know that the Fed will be in no rush to cut rates. Core CPI prices rose 0.4% m/m, unchanged from the month prior, and one notch above consensus expectations. Headline inflation also came in at 0.4% in March and above expectations of a 0.3% increase. In year-over-year terms, headline inflation ticked up three notches to 3.5% and core inflation stayed unchanged at 3.8%. Services prices stayed elevated at 0.5% in the month reflecting both hot non-shelter and shelter costs. Core goods prices declined by 0.2% in the month. Today's data means the risk of higher and persistent underlying inflation is the Fed's number one priority once again, even though inflation is not that far above target. The big question for the FOMC is what is behind this pickup in inflation to start 2024. Powell seems to be believe residual seasonality is playing a big role and that still seems plausible. But it is now very hard to also discount the risk that firm demand in the economy is keeping service prices elevated with solid consumer spending and a jobs market that just keeps on giving. That will keep the Fed on hold until the dust settles.
- When will that be? We still expect that to happen in the coming months because broader forces still portend softer service prices due to disinflation in goods and falling housing costs. Shelter inflation, 35% of the CPI basket, stayed roughly unchanged in the month but this was likely propped up but more idiosyncratic elements such as home

insurance. Owner's equivalent rent (OER), the largest component in shelter, was unchanged in the month and rent inflation actually ticked down one notch. Higher single family home prices, and their large weight in both OER and rent, have meant that the slowdown in shelter costs has been slow but we remain confident that this process will just take time as market based-measures of rental prices are showing either no inflation or mild deflation. This will increasingly push against the upward force of higher single family homes and push down rental inflation materially, and the Fed knows this. There are likely more downside risks in this category and this is being underappreciated.

- But the real challenge for the Fed is non-housing service inflation which increased by 0.6% m/m in the month, down slightly from 0.8% in February. The trend in this component, which is the largest in the PCE basket, should be a bit unnerving for the FOMC. On a 6-month annualized basis, non-housing service inflation is running at 6% and has been rising essentially since the late summer. In March, the increases were led by transportation, household operations and medical services.
- The Fed needs non-housing services to cool to sustainably reach 2% and while today's data are unambiguously disappointing, there are still reasons to expect that to occur down the road. Wage gains, which likely contribute materially to this component, have been softening for a while and although the labor market is producing jobs at a rapid clip, a material part of this is supply-driven and there is evidence of cooling labor demand. The unemployment rate is at or slightly above its equilibrium level, job vacancies outside of small firms are back to normal and the hiring and quits rate are below pre-pandemic levels. Also, the San Francisco Fed decomposition of supply and demand forces of core PCE inflation point to the January and February readings as being mostly driven by supply. Their latest tool, that looks at how responsive prices are to monetary policy also shows that most of the elevated inflation until recently has been due to those components that are least responsive.
- The Fed will of course not be fully convinced of any of those reasons until it actually starts to see non-housing services shift down, as this is still a very data-dependent FOMC. So certainly the risk bias is going to be different after today and we should see a bit less emphasis on the dual mandate. The Fed will is also paying closer attention to PCE which is subject to revisions and has broader inputs from import prices and PPI. Our early estimate is a 0.3% reading for core PCE.
- Part of the slow down in core PCE will come from the softness in core goods prices, which has a greater weight in PCE than in CPI. Core goods CPI prices returned to deflationary territory in March in large part due to the drop in car prices. Both new and used car prices dipped in the month. Excluding used cars, core goods prices were about flat in the month. The rebalancing in the auto sector still has more room to run as dealers continue to offer promotions and need to build some inventory. Supply chain pressures, as measured by the NY Fed index, continue to also suggest softness in broader core goods price measures.

Implications & actions

Re: Economic forecast — Today's report is another disappointing one for the Fed and will reinforce their data-dependent character. We continue to expect the Fed will ease in the second half of this year but the risk of fewer than three cuts has increased after today.

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

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