

Economics

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US CPI: More progress but at a slower pace

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Consumer Price Index (monthly change, %)	Dec 2023	Nov 2023	Oct 2023	Sep 2023	Aug 2023	Jul 2023	Dec NSA YoY%
All items	0.3	0.1	0.0	0.4	0.6	0.2	3.4
Ex-food/energy	0.3	0.3	0.2	0.3	0.3	0.2	3.9
• Ex-food	0.3	0.1	0.0	0.4	0.7	0.2	3.5
• Ex-energy	0.3	0.3	0.2	0.3	0.3	0.2	3.8
Energy	0.4	-2.3	-2.5	1.5	5.6	0.1	-2.0
Services	0.5	0.5	0.3	0.6	0.4	0.3	5.0
Housing	0.4	0.4	0.3	0.6	0.3	0.4	4.8
Fuels & util.	0.6	1.2	0.2	0.7	0.6	0.2	-0.2
Food/beverages	0.2	0.2	0.3	0.3	0.2	0.2	2.7
• Food	0.2	0.2	0.3	0.2	0.2	0.2	2.7
Apparel	0.1	-1.3	0.1	-0.8	0.2	0	1.0
Transportation	0.2	-0.6	-0.9	0.3	2.6	-0.1	2.9
Medical care	0.6	0.6	0.3	0.2	0.2	-0.2	0.5
Recreation	0.4	-0.2	0.1	0.4	-0.2	0.1	2.7
Education, comm.	0.1	-0.3	-0.2	0.1	0	0	-0.1
Other good, serv.	-0.2	0.2	0.6	0.6	0.4	0.1	5.5
Commodities	0.1	-0.7	-0.4	0.1	1	-0.1	0.8

Source: Haver Analytics.

- Today's December CPI showed mild price pressures and more progress of core inflation to the Fed's target but at a slower pace than the FOMC would have liked. Core prices rose by 0.3% m/m, in line with expectations and the November reading. Headline inflation was also 0.3%, above expectations of 0.2% gain and the 0.1% reading from a month prior. In year-over-year terms, core inflation fell one notch to 3.9% and headline inflation increased to 3.4% from 3.1% in November. Core services prices rose by 0.5% for the second consecutive month, with shelter inflation running at the same pace and having accelerated for three months in a row. The lags from supply chain normalization and restrictive monetary policy kept core goods prices flat in the month.
- The stickiness in shelter inflation will catch the eye of the FOMC but with a smaller weight in the Fed's preferred measure of inflation – core PCE – that likely will not be enough to hold back the gradual shift in the Fed's focus from price stability to its broader dual mandate objectives. Even though we are not fully there yet in year-over-year terms, the substantial progress on core inflation momentum will make the Fed less willing to tolerate a material slowing of the economy. We expect the Fed to start easing policy in the second half of this year.

- Shelter inflation, 35% of the inflation basket and the main component of core service inflation, rose by 0.5% m/m for the second consecutive month. Shelter inflation momentum (three-month annualized change) has been range bound between 5-6% since the summer. While well below their peak pace at the start of 2023, the pace is still running a percentage point to percentage point and half above the pre-pandemic pace. Our model of shelter inflation based on recent work by the San Francisco Federal Reserve and Fannie Mae, shows in a dynamic simulation that shelter inflation should have gradually moderated since the summer and be running at about half the pace it is currently at given how rental and house price indices have evolved. It may be that these measures are not reflective of the sample that the BLS is focused on given changes in the substantial changes in the housing market over the COVID period.
- The stickiness in shelter costs supports our view that the Fed will not ease policy until the second half of the year, at least partly to prevent stoking the housing market. But it is also important to note that the weight of shelter in CPI is substantially higher (35%) than in the Fed's preferred inflation gauge PCE (15%). This has actually been part of the reason behind a growing wedge between core CPI and core PCE inflation over the past eight months. Over 2010-2019, core CPI inflation momentum was on average 0.3 percentage points higher than core PCE inflation momentum. Since April of 2023, this gap has widened to 1 percentage point. Hence, CPI has been overstating inflationary pressure in recent months.
- The core services ex. shelter group continued to show moderate to strong price pressures, rising 0.5% m/m and has been in that range since August. However, price pressures were concentrated in recreation and medical services, with other categories showing modest increases. Fed speakers have generally paid less attention to this measure of underlying inflation recently, perhaps in part due to strength from medical services. The strength in this category likely reflects sector-specific developments rather than the influence in the broader labour market.
- Core goods prices were flat in December as the lags from normalization of supply chains and more restrictive monetary policy continued to feed through into prices. Prior to December, there was six straight months of deflation in core goods largely due to the substantial price level reversion in used cars. For the past two months, used car prices have rebounded slightly but broader disinflation remains in core goods excluding used cars. There are signs however that this trend will weaken soon. The New York Federal Reserve's Global Supply Chain Pressures Index has essentially normalized and the Manheim Used Car Price index has seen more modest declines. We estimate that changes in any given month in these indices affect core goods inflation with a lag of three to five months.

Implications & actions

Re: Economic forecast — Today's report reinforces our call that the Fed will be hold until the second half of 2024. There continued to be progress on core inflation today, but a slower pace. The substantial progress on core inflation achieved in the second half of 2023 sets the Fed up to be less willing to tolerate a material slowing of the economy.

Re: Markets — Both bond yields and the greenback rose as headline inflation surprised modestly to the upside and given the stickiness in housing.

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