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US CPI: Unambiguously good news

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Consumer Price Index (monthly change, %)	May 2024	Apr 2024	Mar 2024	Feb 2024	Jan 2024	Dec 2023	May NSA YoY%
All items	0.0	0.3	0.4	0.4	0.3	0.2	3.3
Ex-food/energy	0.2	0.3	0.4	0.4	0.4	0.3	3.4
• Ex-food	0.0	0.4	0.4	0.5	0.3	0.2	3.4
• Ex-energy	0.2	0.3	0.3	0.3	0.4	0.3	3.2
Energy	-2.0	1.1	1.1	2.3	-0.9	-0.2	3.7
Services	0.2	0.4	0.5	0.5	0.7	0.4	5.2
Housing	0.3	0.2	0.4	0.4	0.6	0.3	4.6
Fuels & util.	-0.1	-0.3	0.5	0.7	1.2	0.2	4.6
Food/beverages	0.1	0.0	0.1	0.0	0.4	0.2	2.1
• Food	0.1	0.0	0.1	0.0	0.4	0.2	2.1
Apparel	-0.3	1.2	0.7	0.6	-0.7	0.0	0.8
Transportation	-1.1	0.7	0.8	1.4	-0.6	0.1	2.9
Medical care	0.5	0.4	0.5	0.0	0.5	0.4	3.1
Recreation	-0.2	0.2	-0.1	0.2	0.5	0.4	1.3
Education, comm.	0.0	0.2	0.0	0.4	0.4	0.1	0.5
Other good, serv.	0.2	0.4	0.4	-0.3	0.5	0.0	3.8
Commodities	-0.4	0.2	0.1	0.4	-0.3	0.0	0.1

Source: Haver Analytics.

- Today's inflation data was unambiguously good news for the Fed, and will frame the conclusion of the FOMC meeting later today. Core CPI prices rose 0.2% m/m in May, one notch below consensus and the April report, indicating a return to mild price pressures for the second straight month. Headline inflation also came one tick below expectations, coming in flat in month-over-month terms. In year-over-year terms, headline inflation came down one notch to 3.3% in May, and core came down two ticks to 3.4%. The below consensus reading was mainly due to services prices edging down two notches to 0.2% in the month, as non-housing services softened in the month. That bodes well for the core PCE reading for the month, given the higher weight of non-housing services in the Fed's preferred gauge. Core goods prices were flat in the month. Price pressures are moderating and while the Fed will be pleased with more evidence of progress resuming, the message from Powell later today will be that it is still not enough. The FOMC will want to see more progress to feel confident before normalizing policy. But today's data, along with a gradually softening labor market trend, keeps the door open for a September cut which is when we have penciled in the Fed's first cut.
- As of writing, the market is not far from our view with nearly two full cuts priced in by December, with September the expected start. While there will be more bumps along the way, the past two months of inflation data and the gradual

cooling trend in the labor market -- particularly seen in the JOLTS data -- suggests Powell and the rest of the FOMC should show greater confidence at the press conference later this afternoon.

- The main reason inflation came below expectations was because non-housing services inflation cooled further, and that was largely because of a sharp pullback in transportation services. Transportation services, and in particular auto insurance premiums, have been the fly in the ointment over the past few months as insurers have had to hike premiums to adjust to the combination of rising car prices and higher incidents of car accidents. Transportation services account for about a quarter of non-housing services in CPI and were running at a red hot 1% m/m average pace from July to April which was adding 0.1%-points to m/m core CPI inflation. That's massive and most of the reason for above-target inflation the past few several months. For us, that is a clear indication that inflation was not demand-driven, something also born out in the myriad of analytical measures of underlying inflation produced by the SF Fed. In May, transportation services prices fell by 0.5% m/m and non-housing services was flat in the month after averaging a 0.5% monthly pace over the prior three months (or a 6% three-month annualized pace).
- Such low readings are unlikely to be sustained but we think it is also unlikely that car insurance, and transportation services as a whole, will durably stay at the pace seen over most of the past year or so. Three reasons. First, car prices are starting to normalize at very high levels, so insurers are close to or have caught up with this moving target. In other words, the relative-price adjustment looks close to complete. Second, insurers have hiked enough such that their profitability is well on the path to being restored as evidenced by their stock prices. Third, they won't have room to pass-on a lot more with wage growth cooling. Non-housing services will stay bumpy, and car insurance premiums will likely jump up next month, but the trend will gradually become more manageable. We also don't see a high risk of second-round or knock-off effects from a sectoral shock like this one, given the labor market is cooling and most measures of inflation expectations have or are on the path to normalizing. The Fed has been very quiet about this, likely because they don't want to solicit comparisons to days of "team transitory" where they spoke about a few components causing higher inflation. They probably want to be sure that higher transportation costs won't drive up costs elsewhere.
- Shelter inflation was actually a bit disappointing in the May report. Shelter was unchanged at 0.4% or a 5.5% six-month annualized pace, where it has essentially stood since the late summer of 2023. The grind down continues to be glacially slow, with rental inflation ticking up modestly from April (0.39% vs 0.35% in April) and Owner's Equivalent Rent (OER) looking very stable at a 0.4% pace. The feed-through of market rents for multi-family, which remains low, is coming up against high single-family home prices. It is still reasonable to expect some further disinflation in shelter, but likely not that much. The Fed can live with that so long as non-housing and goods remain tame as they have a larger weight core PCE, but how much rate cuts stoke the housing market as the Fed eases policy will be an important check on fast it can move. The ingredients for a hot housing market are there, with an old housing stock and households clearly want to live in single family homes given the greater ability to work-from-home.
- Core goods were flat in the month, largely because used car prices ticked up modestly in the month, which is normal volatility for that category. Stripping out used cars, the rest of core goods fell a bit further in deflationary territory with prices declining by 0.1% in May. Supply in the global goods market remains robust even with strong US demand for durables. New car prices are continuing to drop, declining by 2% on a six-month annualized basis as of May.

Implications & actions

Re: Economic forecast — Today's report is a another good one for the Fed but they will want to see more progress to feel confident in easing, and we expect they are close. We continue to expect the Fed will ease twice this year -- in September and December.

Re: Markets — Both bond yields and the greenback fell as core inflation eased more than expected.

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