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US CPI: We expect the Fed to raise rates in December

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Consumer Price Index (monthly change, %)	Sep 2023	Aug 2023	Jul 2023	Jun 2023	May 2023	Apr 2023	Sep NSA YoY%
All items	0.4	0.6	0.2	0.2	0.1	0.4	3.7
Ex-food/energy	0.3	0.3	0.2	0.2	0.4	0.4	4.1
• Ex-food	0.4	0.7	0.2	0.2	0.1	0.4	3.7
• Ex-energy	0.3	0.3	0.2	0.1	0.4	0.4	4.1
Energy	1.5	5.6	0.1	0.6	-3.6	0.6	-0.5
Services	0.6	0.4	0.3	0.3	0.3	0.2	5.2
Housing	0.6	0.3	0.4	0.3	0.2	0.2	5.6
Fuels & util.	0.7	0.6	0.2	0.3	-1.1	-1.1	-1.5
Food/beverages	0.3	0.2	0.2	0.1	0.2	0.1	3.7
• Food	0.2	0.2	0.2	0.1	0.2	0.0	3.7
Apparel	-0.8	0.2	0.0	0.3	0.3	0.3	2.3
Transportation	0.3	2.6	-0.1	0.2	-0.2	1.2	2.4
Medical care	0.2	0.2	-0.2	0.0	0.1	0.0	-1.4
Recreation	0.4	-0.2	0.1	0.1	-0.1	0.5	3.9
Education, comm.	0.1	0.0	0.0	-0.2	-0.2	0.0	1.0
Other good, serv.	0.6	0.4	0.1	0.2	0.5	0.9	6.0
Commodities	0.1	1.0	-0.1	0.1	-0.2	0.6	1.4

Source: Haver Analytics.

- Today's September CPI report came in broadly as expected, but all-items and core inflation figures mask a divergence between stronger services inflation, driven by higher shelter costs, that was offset by further weakness in goods prices. Core inflation rose by 0.3% m/m in September, in line with expectations. In year-over-year terms, core inflation came down to 4.1% from 4.3% the month. Headline prices rose 0.4% m/m, staying unchanged at 3.7% in year-over-year terms. The Fed's preferred measure of prices tied to underlying demand, non-housing services, saw a another strong increase of 0.5% in the month. Supply chain normalization and falling used car prices pushed down core goods prices to -0.4% in the month. Overall, this paints a complicated picture of strong demand-induced service inflation that is being offset weakening goods prices mainly due to the normalization in supply chains. While these forces are so far netting out not far from the Fed's target, underlying service inflation seems to be heating up, consistent with recent consumption and labour market data. Given the data dependent position of the Fed, we expect the FOMC to raise rates in December. We believe the Fed will elect to skip November to observe more data and assess the durability of the bond market tightening.

- Service inflation came in at 0.6% m/m, up significantly from 0.3% in August. This was driven by a material pick up in Owner's Equivalent Rent (OER) which rose 0.6% in September, up from 0.4% the month prior. OER had been range bound since March of this year, between 0.4% and 0.5%. OER tracks what it would cost the owner of a home to rent a similar place, as the CPI seeks to measure the cost of consumption rather than the value of the house (which is a form of investment). OER typically lags changes in market-based rental indices and house price measures. Researchers at the Dallas Fed have found the peak correlation between OER and house prices for example, took about a year and half. House prices have moderately turned up recently but market-based measures of rent continue to show slower rental inflation. This makes the increase in shelter costs surprising in today's release and an important element to watch going forward. It's also important to note that shelter costs have a much larger weight in CPI than in PCE, hence core PCE may come in slightly softer than today's core CPI.
- The core services ex. shelter group reported a second consecutive month of strength as well, rising 0.5% m/m after a 0.4% increase in the month prior. The increase was mostly broad-based across categories. Transportation services, other services and recreational services saw the largest increases. The pass-through of higher oil prices could be playing a role in higher readings but the main impulse behind the strength in this category is likely the tightness in the labour market.
- Core goods prices, however, weakened much further in September suggesting the normalization of supply chains and more restrictive monetary policy are working to feed through into prices. This was the fourth consecutive negative monthly reading and the largest monthly decline since March 2022. Used car prices dropped by 2.5% m/m, their biggest drop also since March 2022. Judging by the New York Federal Reserve's Global Supply Chain Pressures Index, further weakness in core goods prices is likely in the coming months even if the peak impact from monetary policy has passed.
- Energy prices rose a further 1.5% in the month, led by an almost 5% gain in fuel oils. Oil prices have pulled back in October suggesting energy prices will come down in next month's CPI. Food prices rose were steady rising in the month by 0.2% for the third consecutive month.

Implications & actions

Re: Economic forecast — The underlying detail in today's report suggest that demand-side price pressures are heating up and will likely require more restrictive monetary policy. As a result, we expect the Federal Reserve to raise rates in December, allowing some time for more data and to judge the durability of the tightening in the bond market.

Re: Markets — Bond yields and the greenback increased off today's data and sustained the increases since the release.

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