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US core service inflation keeps 25bp Fed hike in play next week

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Consumer Price Index (monthly change, %)	Feb 2023	Jan 2023	Dec 2022	Nov 2022	Oct 2022	Sep 2022	Feb NSA YoY%
All items	0.4	0.5	0.1	0.2	0.5	0.4	6.0
Ex-food/energy	0.5	0.4	0.4	0.3	0.3	0.6	5.5
• Ex-food	0.4	0.5	0.1	0.1	0.5	0.4	5.5
• Ex-energy	0.4	0.4	0.4	0.3	0.4	0.6	6.1
Energy	-0.6	2.0	-3.1	-1.4	1.7	-1.7	5.2
Services	0.5	0.6	0.7	0.4	0.4	0.8	7.6
Housing	0.5	0.8	0.7	0.5	0.6	0.7	8.2
Fuels & util.	-1.4	1.6	0.9	-0.3	0.0	0.9	11.1
Food/beverages	0.3	0.5	0.5	0.6	0.7	0.7	9.2
• Food	0.4	0.5	0.4	0.6	0.7	0.8	9.5
Apparel	0.8	0.8	0.2	0.1	-0.2	0.0	3.3
Transportation	0.2	0.4	-1.6	-0.7	0.7	-0.4	2.6
Medical care	-0.5	-0.4	0.3	-0.4	-0.3	0.7	2.3
Recreation	0.9	0.5	0.2	0.5	0.8	0.1	5.0
Education, comm.	0.1	0.4	0.1	0.7	0.0	0.1	1.0
Other good, serv.	0.9	0.6	-0.1	0.7	0.5	0.3	6.1
Commodities	0.2	0.4	-0.7	-0.2	0.6	-0.2	3.6

Source: Haver Analytics.

- Neither rain, nor snow nor some trouble spots in banking will fully deter the US Fed from raising rates next week, as February inflation reminded markets today. Price pressures were just too heated, as core inflation accelerated to 0.5% m/m, a tick above the consensus expectation. An increase in the pace of housing inflation was a key driver behind that, but other services including recreation, household operations, and airfares added to the momentum. Adding food and energy back into the mix showed that the overall CPI advanced by 0.4% m/m, in line with the consensus expectation, which included a sizable drop in energy service prices. That left the annual rates at 6.0% and 5.5% for headline and core inflation respectively, representing a deceleration from the prior month's pace. The Fed's preferred gauge of underlying price pressures tied to the output gap, core services excluding housing, accelerated to 0.45% m/m, leaving the three-month annualized pace at 4.5%. That sets the stage for a 25bp hike at next week's FOMC, as the banking issues were likely just enough to stand in the way of a 50bp move.
- Shelter prices reaccelerated on a surge in hotel rates and a tick up in the rent of primary residence category. Inflation in the owners' equivalent rent measure remained steady on the month and slightly off its peak. There will be softness in the cards for rent measures by mid-year, as new rental rates have eased in line with the cooling in the housing market, and the CPI index picks that impact up with a lag. The increase in hotel prices coincided with an increase in

airfares despite lower fuel oil prices, and seems to suggest still solid demand for discretionary travel services, another factor supporting a likely Fed hike next week.

- Other services categories generally were uncomfortably hot, as discretionary areas including pet services, streaming services, events admissions prices, and financial services, all rose by more than 1.0% m/m. That was contrasted with flat core goods prices, which balanced plummeting used car prices against increases in apparel, new cars, and medical care goods. Inventory-to-sales ratios at the retail level, outside of the auto sector, are approaching pre-pandemic levels, showing that goods sectors have come into better balance as demand has slowed for goods and inventory levels have improved.
- Although gasoline prices increased as expected, there was an 8% drop in utility bills, despite the boost to demand from the move towards more normal winter temperatures in February. Starting in March, Californians will see a credit on utility bills which could extend the downward pressure from that category. Restaurant prices remained hot, increasing by 0.6% m/m, as higher labor costs were passed through to consumers. That compares to a more modest 0.3% increase in grocery store prices as food commodity prices have come down lately. The extension of the grain deal between Russia and Ukraine should keep a lid on raw food prices, some of which are well off their peaks, but consumers are unlikely to see outright declines given that costs for transportation and wholesaling, as well as labor, feature into retail prices.

Implications & actions

Re: Economic forecast — Absent fresh news on banking issues from here to their decision date, the Fed is likely to press on with a quarter point hike this month, and a final quarter point move at the subsequent meeting. The banking issues will mostly have served to take a more aggressive path off the table. With the impact of past rate hikes still materializing, and slower shelter price increases imminent, core inflation could still fall below 3% in the latter part of the year.

Re: Markets — The strength in core service prices increased the odds of a rate hike from the Fed next week, with just over 25bps being priced in, and that prevented a further depreciation in the USD.

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