ECONOMIC UPDATE

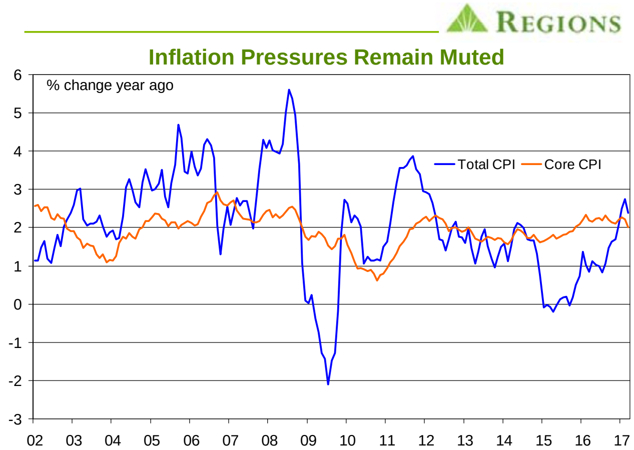
REGIONS

April 14, 2017

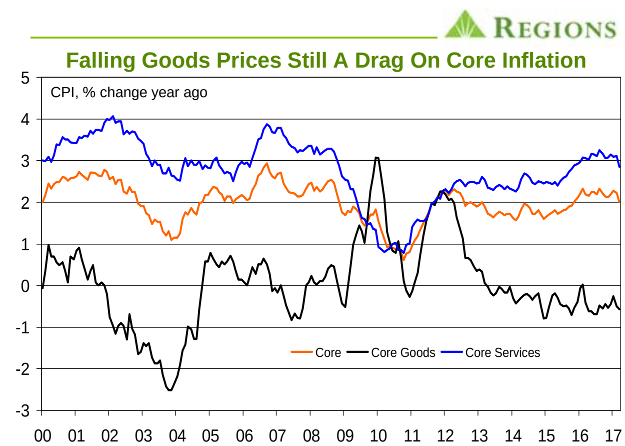
March Consumer Price Index: Underlying Inflation Pressures Remain Muted

- The total CPI fell 0.3 percent (-0.288 percent unrounded) in February; the core CPI was down 0.1 percent (-0.122 percent unrounded).
- On a year-over-year basis, the total CPI was up 2.4 percent and the core CPI was up 2.0 percent in March.

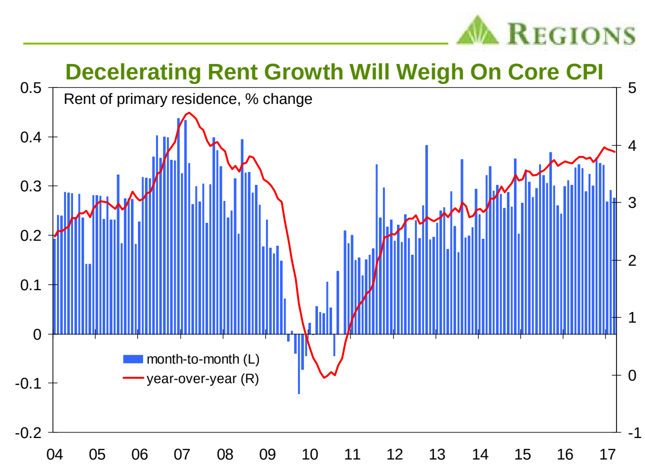
Inflation was much tamer in March than had been anticipated. The total CPI fell by 0.3 percent and the core CPI fell 0.1 percent, the first monthly decline in the core CPI since January 2010. The consensus forecast was for the total CPI to be unchanged, and our forecast was for a 0.1 percent decline. As with much of the top-tier data, the CPI data for Q1 were muddled by a considerable degree of seasonal adjustment noise, thus making it difficult to draw meaningful conclusions from the month-to-month changes. More broadly, however, we have noted that accelerating headline inflation over the past several months would not be sustained, as it mainly reflected increases in energy prices off of notably low levels, and we noted that once we got beyond March the over-the-year comparisons would become more difficult, i.e., reported headline inflation would begin to decelerate. Nothing we see in the data leads us to change that conclusion.



One underlying theme that we have been pointing to for some time now, however, is the behavior of rents. This is a story that can easily get lost in what has been a considerable degree of noise in the data, but we think it important to highlight it. We have for some time now been voicing concerns over the apartment market, specifically, that what has been solid growth in demand has been offset by supply growth that, in many markets, is excessive, and we are only seeing the early implications of that. Growth in market rents has decelerated, but thus far this has been a gentle deceleration. What is helping prop up growth in market rents is the single family segment of the rental market, which now accounts for a larger share of the BLS's survey of market rents given the higher share of the rental stock accounted for by single family homes. That said, as more and more rental apartments come on line over coming quarters, we expect waning rent growth in this segment will have more of a pull on overall market rents. What is less clear to us, however, is the behavior of owners' equivalent rents, which in essence captures what homeowners feel they could charge were they to put their homes up for rent. We've always held the behavior of owners' equivalent rents was closely aligned with the rate of house price appreciation, but of late the two have moved in opposite directions, i.e., house price appreciation has picked up as growth in owners' equivalent rents has slowed.



Why this matters is that rents account for over 40 percent of the core CPI. For some time now rent growth has been a key driver of core inflation but slowing rent growth means less momentum for core inflation. To that point, core inflation excluding shelter has been steadily decelerating and came in at just 0.96 percent in March. If we are correct on rents, ex-shelter core inflation will remain tame. One potential offset, however, is core goods prices. To be sure, core goods prices fell once again in March and have fallen year-on-year in 47 of the past 48 months. But, with prices of non-petroleum imported goods beginning to firm, thanks in part to a softening U.S. dollar, it could be that core goods prices will turn higher over coming months. While this will not totally negate the impact of decelerating rent growth, it will nonetheless provide some support for core inflation.



Apparel prices fell 0.7 percent in March, but this comes after sizeable increases in the prior two months – this is one area where considerable seasonal adjustment noise has impacted the data. On a not seasonally adjusted basis, retail gasoline prices were up 1.1 percent in March, but this was a much smaller increase than is typical for the month of March, which resulted in a reported decline of 6.2 percent in the seasonally adjusted data, which was a notable weight on the total CPI. Prices for wireless telephone service fell 7.0 percent in March, which means that "can you hear me now?" guy may have to find yet another gig in the near future. In contrast, prices for food purchased at grocery stores have firmed over the past two months, but yet remain down 0.9 percent year-on-year.

Though the March data overstate the case, underlying inflation pressures remain muted. This will give the FOMC confidence that they can proceed at a gradual pace of Fed funds rate hikes with little danger of falling behind the curve on inflation.

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