ECONOMIC UPDATE

REGIONS

August 16, 2016

July Consumer Price Index: Rents Rise Further, Goods Prices Fall Further

- The total CPI was <u>unchanged</u> (down .041 percent unrounded) in July; the core CPI was <u>up</u> 0.1 percent (0.088 percent unrounded).
- On a year-over-year basis, the total CPI was <u>up</u> 0.8 percent and the core CPI was <u>up</u> 2.2 percent in March.

The total CPI was unchanged in July, in line with expectations, while the core CPI logged a smaller than expected 0.1 percent increase – and needed some rounding help to do so. On a year-over-year basis, the total CPI was up 0.8 percent and the core CPI up 2.2 percent in July. Though the softness in the CPI in July is a bit overstated due to some transitory factors, such as a sharp decline in air fares, the bigger picture remains the same – inflation pressures remain muted and largely confined to rents and medical costs.

Energy was a main drag on the CPI in July, with the total energy index down by 1.6 percent in July (down 10.9 percent year-on-year). Not seasonally adjusted retail gasoline prices fell by 5.5 percent in July as measured in the CPI. While retail pump prices typically decline in the month of July, this year's decline was far larger than typical and, as such, swamped the seasonal adjustment factor, with seasonally adjusted pump prices down 4.7 percent and down a whopping 19.9 percent year-on-year.

The overall index of food prices was flat in July, as a 0.2 percent decline in prices for food consumed at home was offset by a 0.2 percent increase in prices for food consumed away from home. This dichotomy has been in play for some time now, with prices for food consumed at home down 1.6 percent over the last 12 months while prices for food consumed away from home are up 2.8 percent. These trends are also making themselves felt in the retail sales data, which are reported in nominal terms. Grocery store sales have been weak over the past several months, which is a reflection of falling prices. At the same time, many restaurants are seeing sales volumes dip as lower grocery store prices, particularly for prepared foods, are (forgive us, we can't help it) eating into restaurant sales. We've heard some analysts talking of a "restaurant recession" which may or may not prove to be the case. What they are missing, however, is the price dynamic driving shifts in consumption habits as these same analysts are instead taking this as a sign of weak consumer spending or, in some cases, election year uncertainty and general angst.

Failure to account for price changes has consistently steered many analysts, not to mention media accounts, wrong for some time now. Core goods prices have been falling on an over-the-year basis for more than three years now while falling month-to-month in 13 of the past 15 months. Note we are referring to core goods, i.e., excluding food and energy, prices, so this clearly is not a gasoline price story. One can scan through the details of the CPI reports and see broad based declines in prices for consumer goods. While this is good news for the consumer, it is making life challenging for retailers who are feeling more and more pressure on margins. It is, however, worth noting that non-energy import prices seem to be stabilizing which suggests core goods prices may also begin to stabilize over coming months. Still, this is a tenuous development at best and will not withstand another round of U.S. dollar appreciation such as would almost surely accompany a Fed funds rate hike by the FOMC.

Rents and medical costs remain the key drivers of core inflation. Note that rents account for over 40 percent of the core CPI and when shelter costs are excluded, core inflation is running at a more sedate 1.4 percent pace. In July, market rents and owners' equivalent rents were both up 0.3 percent, with over-the-year increases of 3.8 percent and 3.3 percent, respectively. We will note, however, that much of the momentum in rents is now being sustained by single family housing units, not rental apartments. Rents on single family homes continue to increase at a rapid rate, and what has been steady house price appreciation is likely biasing owners' equivalent rates higher.

Coming months will see the headline CPI stuck in a stand-off between rising rents and medical care costs on one side and falling prices for core goods, food, and gasoline on the other. As such, the path of the core CPI will be more meaningful to watch. Even so, we see little reason to expect a material acceleration in core inflation any time soon.

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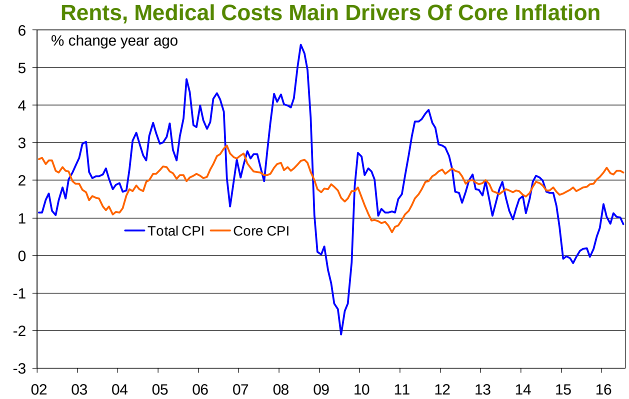
Rents, Medical Costs Main Drivers Of Core Inflation



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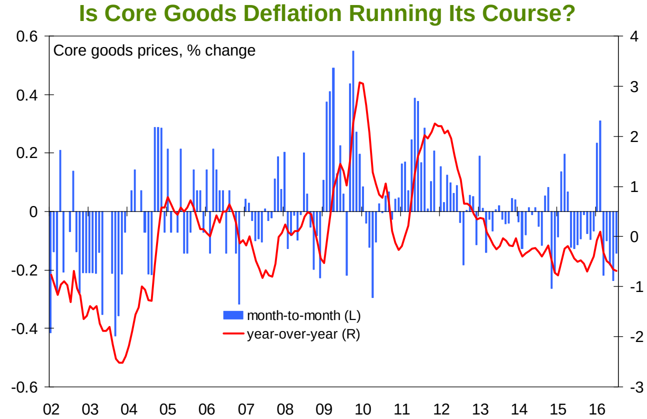
Is Core Goods Deflation Running Its Course?



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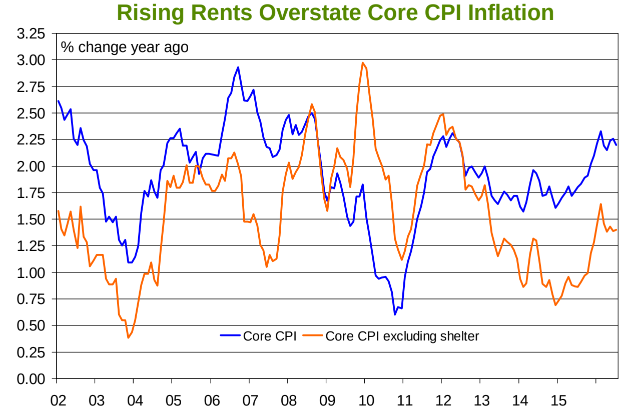
Rising Rents Overstate Core CPI Inflation



Regions Financial Corporation, 1900 5th Avenue North, 17th Floor, Birmingham, Alabama 35203
Richard F. Moody, Chief Economist • 205.264.7545 • richard.moody@regions.com