ECONOMIC UPDATE

REGIONS

October 18, 2016

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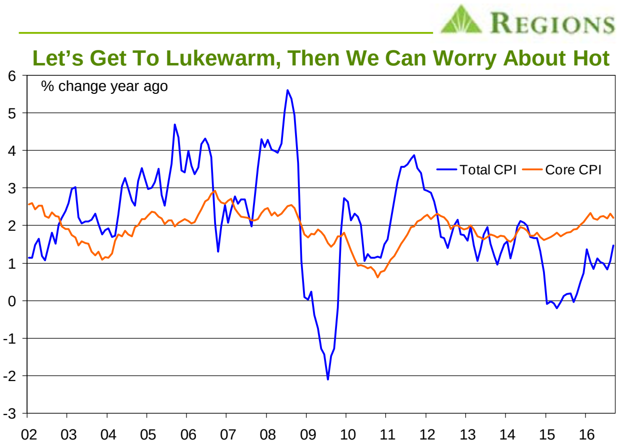
September Consumer Price Index: Let's Get To Lukewarm, Then We Can Worry About Hot

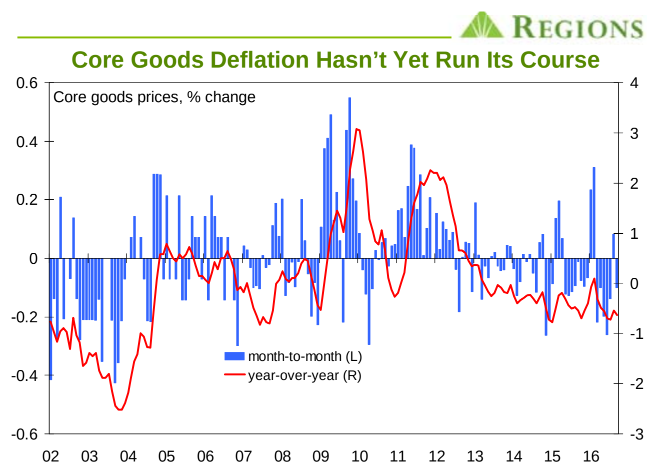
- The total CPI was up 0.3 percent (up 0.291 percent unrounded) in September; the core CPI was up 0.1 percent (0.112 percent unrounded).
- On a year-over-year basis, the total CPI was up 1.5 percent and the core CPI was up 2.2 percent in September.

The total CPI rose 0.3 percent in September, matching expectations, with gasoline and rents the primary drivers. Stripping out food and energy prices yielded a 0.1 percent increase in the core CPI, matching our below-consensus forecast. Year-on-year, the total CPI is up 1.5 percent, considerably faster than the 1.0 percent pace logged in August, but this to some extent reflects base effects – recall the CPI fell last September – which include a moderation in the over-the-year decline in retail gasoline prices. The core CPI stands 2.2 percent higher on an over-the-year basis. Rents and medical costs remain the prime sources of inflation pressure in the U.S. economy. For all the recent talk of letting the economy "run hot" the reality is we're not quite even at lukewarm yet.

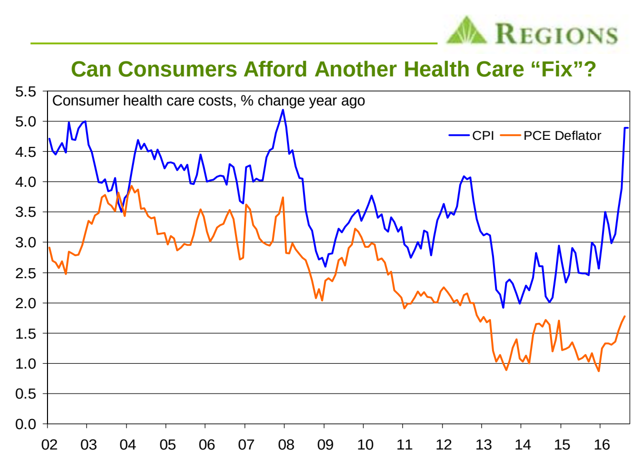


Gasoline prices had a material impact on the CPI as higher pump prices this September were magnified by seasonal adjustment factors. In other words, retail gasoline prices typically decline in the month of September, meaning the seasonal adjustment factors are geared towards falling, not rising prices. As a result, the 2.3 percent in unadjusted retail gasoline prices turned into a 5.8 percent increase after seasonal adjustment. This added two-tenths of a point to the total CPI in September. Year-on-year, retail gasoline prices are down 6.5 percent, the smallest such decline since October 2014.

It will come as no surprise that rents remain a source of upward pressure on the total CPI and, to a greater degree, the core CPI. What is different about September, however, is that owners' equivalent rents posted their largest increase – up 0.358 percent, unrounded – since October 2006. This leaves owners' equivalent rents up 3.38 percent year-on-year, the fastest such increase since May 2007. Market rents were up 0.288 percent, unrounded, in September, below their recent trend and up 3.7 percent year-on-year. We have looked for some moderation in the growth of market rents, reflecting softening rent growth in the rental apartment market, though rent growth on single family houses remains robust. It is too soon to know if September's gain in owners' equivalent rents is simply a one-off jump or whether faster house price appreciation is impacting owners' assessments of the rental value of their homes – this is, after all, how owners' equivalent rents are measured. With rents accounting for better than 40 percent of core CPI, these dynamics clearly matter, but with ex-shelter core inflation at 1.3 percent, take away rent growth and the inflation story reads much differently than implied by the headline numbers.



Our below-consensus forecast on the core CPI reflected our expectation that, after posting the largest monthly increase since November 1990 in August, medical costs would post a much more modest increase in September. This was indeed the case, with a 0.2 percent increase. Nonetheless, this still leaves medical costs up 4.9 percent year-on-year and, as seen in our bottom chart, growth in medical costs has accelerated sharply over the course of 2016. Keep in mind that in the CPI medical costs measure out of pocket costs to consumers for medical care, insurance premiums, drugs, and goods such as eyeglasses, while the PCE deflator is based primarily on revenues to service providers. Not only are consumers facing higher co-pays and deductibles, but the prices of underlying services, not to mention insurance premiums (up 8.4 percent year-on-year), are rising much more rapidly than has been the case for some time. Naturally during the election season there is considerable talk about "fixing" health care, once again we might add, but the question becomes whether or not consumers can afford another "fix" to the health care system.



Elsewhere in the data, food prices were flat, apparel prices were down sharply, and core goods prices were down once again and logged their 41st year-on-year decline in the past 42 months. To the extent the U.S. dollar strengthens over coming months, goods price deflation will remain a boon to U.S. consumers but a thorn in the side of retailers.

The 0.3 percent increase in the headline CPI stands out, but it is thinly based. We see little reason to expect a material acceleration in core inflation any time soon.

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