ECONOMIC UPDATE

REGIONS

March 15, 2017

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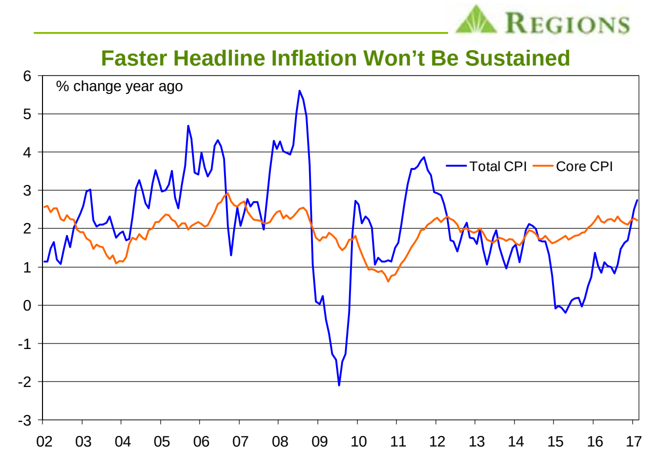
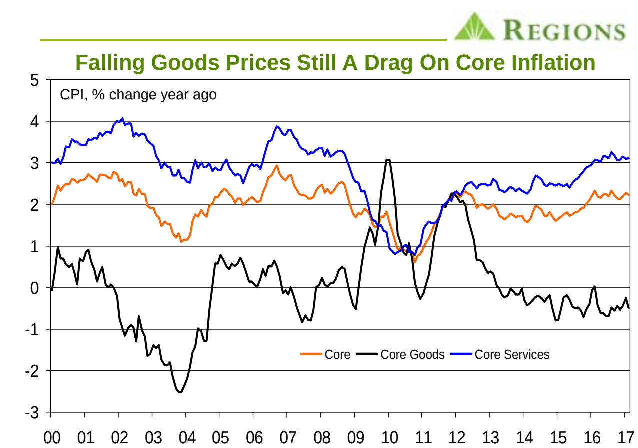
February Consumer Price Index: Faster Headline Inflation Won't Be Sustained

- The total CPI was up 0.1 percent (0.122 percent unrounded) in February; the core CPI was up 0.2 percent (0.205 percent unrounded).
- On a year-over-year basis, the total CPI was up 2.7 percent and the core CPI was up 2.2 percent in February.

The total CPI rose by 0.1 percent in February, a bit above our forecast for no change, while the core CPI was up 0.2 percent, matching our forecast. Still, anyone so inclined can point to the February CPI report as "proof" that the FOMC has fallen behind the curve on inflation, despite their oft-repeated assurances to the contrary. After all, the total CPI is up 2.7 percent year-on-year as of February and, yes, while this is indeed above the 2.0 percent rate the FOMC aims at, it is also not likely to be there long. Of more relevance is that core CPI inflation is running at 2.2 percent as of February, and there are reasons to think this pace won't be sustained. Either way, there are few signs that either headline or core inflation is set to accelerate and if indeed the FOMC does raise the Fed funds rate later today as is almost universally expected, doing so will help assure they remain ahead of the curve on inflation.



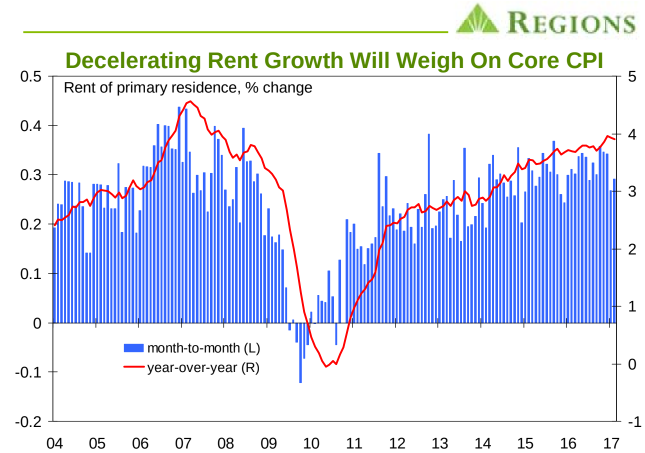
While energy prices fell 1.0 percent in February, with retail gasoline prices down a larger 3.0 percent, they are nonetheless significantly higher on a year-over-year basis, which is reflected in the headline CPI. Retail gasoline prices are up 30.7 percent year-on-year, with the broader energy category up 15.2 percent. Just as falling energy prices held down inflation in 2015 and early-2016, the reversal of those falling energy prices is now boosting inflation. The FOMC, and most of the rest of us, look through these energy fueled swings in headline inflation and focus on core inflation.



Apparel prices were up 0.6 percent in February after an outsized 1.4 percent increase in January. We think there is at least some degree of seasonal adjustment noise in measured apparel prices, but, even so, after the large back-to-back increases apparel prices stand just 0.4 percent above their year-ago level. Medical care costs posted a modest 0.1 percent increase in February, leaving them up 3.5 percent year-on-year with the rate of growth in medical care costs having decelerated sharply from late-2016 (note the CPI measures out of pocket costs to consumers). For what it's worth, the only two certainties in life, i.e., death and taxes, were more costly in February, with funeral costs up 0.5 percent and tax preparation fees up 1.1 percent, for a 4.5 percent over-the-year increase.

Food prices were up 0.2 percent in February, the largest monthly increase since August 2015. Of note is the 0.3 percent increase in prices for food consumed at home, ending a string of nine consecutive declines. But, on an over-the-year basis, prices for food consumed at home are down 1.7 percent, in contrast to the 2.4 percent increase in prices for food consumed away from home.

Prices for core goods fell slightly in February, leaving them down 0.5 percent year-on-year, the 46th such decline in the last 47 months. While many analysts argue the impact of a stronger U.S. dollar has largely run its cost on prices of traded non-energy goods, we've argued to the contrary and, to the extent the FOMC does follow through with funds rate hikes, that figures to push the U.S. dollar up further, thus ensuring ongoing deflationary pressures on core goods prices. As such, goods prices will remain a drag on core inflation.



Of far more significance in the path of core inflation is the behavior of rents, which account for better than 40 percent of the core CPI. Though it is often overlooked, rent growth on single family homes remains strong and, as such will provide some support for market rents. That said, apartments are easily the larger component of measured market rents in the CPI data, and what is decelerating rent growth in the apartment market means core CPI inflation could slow over coming months.

Though they will almost surely raise the Fed funds rate later today, the FOMC will not be doing so in response to the February CPI report. Instead of responding to concerns over accelerating inflation, the FOMC is simply paring down what is by now an unnecessary degree of monetary accommodation as core inflation remains fairly stable.

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