ECONOMIC UPDATE
REGIONS
June 14, 2017

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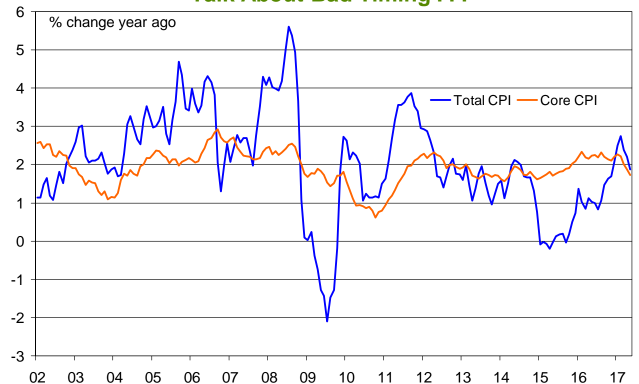
May Consumer Price Index: Talk About Bad Timing . . .

- The total CPI fell 0.1 percent (-0.128 percent unrounded) in May; the core CPI was up 0.1 percent (0.063 percent unrounded).
- On a year-over-year basis, the total CPI was up 1.9 percent and the core CPI was up 1.7 percent in May.

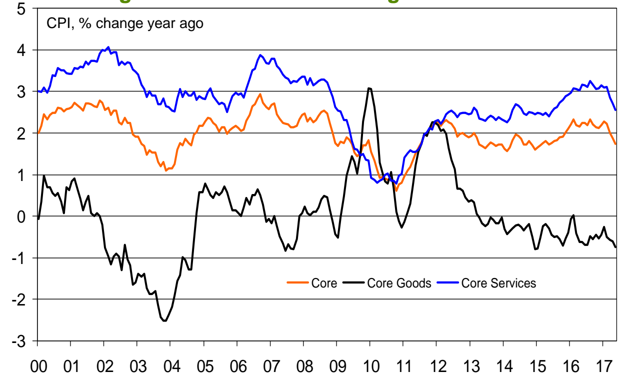
They say that in life, timing is everything. To the extent that adage also applies to central banking, the May CPI report comes at a really awkward time for an FOMC that later today will almost surely announce another 25-basis point increase in the Fed funds rate target range mid-point. The total CPI fell by 0.1 percent in May while the core CPI was up a smaller than expected 0.1 percent and that thanks only to some friendly upward rounding. This leaves the total CPI up 1.9 percent and the core CPI up 1.7 percent year-on-year. To be sure, the FOMC's 2.0 percent target rate is not to be taken literally, i.e., that inflation comes in at exactly 2.0 percent each and every month, but instead represents a center point for modest monthly swings in either direction. The problem for the FOMC, however, is that inflation has now decelerated in each of the past three months and is moving away from, not towards, the 2.0 percent target. An even bigger problem is that this is true not only for headline inflation, which to some extent can be dismissed as simply reflecting energy prices, but also for core inflation. And while we fully expect the FOMC to characterize this deceleration as "transitory" in their comments later today, the details of the CPI report raise many questions as to whether this is truly the case.

Talk About Bad Timing . . .



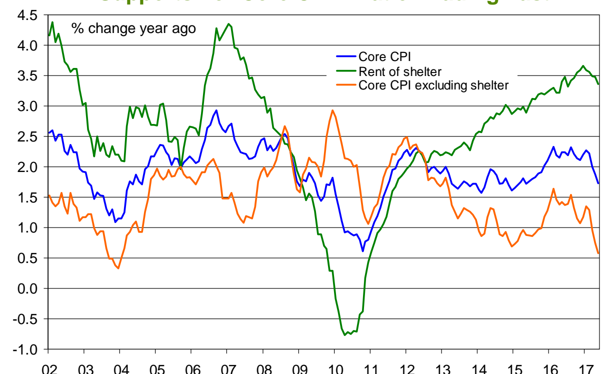
Energy costs were down 2.7 percent in May, with retail gasoline prices down 6.4 percent – not seasonally adjusted prices fell 1.4 percent, which is atypical for the month of May, meaning that the decline in unadjusted prices was amplified by the seasonal adjustment process. Air fares were down 2.7 percent in May, which contributed to the 1.8 percent decline in the broader public transportation category. Apparel prices, which we no longer even pretend to understand, fell by 0.8 percent, a third consecutive monthly decline which leaves them down 0.9 percent year-on-year. Food prices were up 0.2 percent, with prices for food consumed at home up 0.1 percent and prices for food consumed away from home were up 0.2 percent. While the rate of decline is slowing, prices for food consumed at home have been down year-on-year for 18 consecutive months. As we expected to be the case, prices for cell phone service plans were up modestly in May. Recall that sharp declines in service plans had acted as a significant weight on core inflation over the past few months, but those declines have largely run their course.

Falling Goods Prices Still A Drag On Core Inflation



That of course was a main support for the argument that the deceleration in core inflation was transitory. We can't, however, find many more factors to support that argument. Core goods prices were down an additional 0.3 percent in May, leaving them down 0.7 percent year-on-year, the 48th year-on-year decline in the past 49 months. While many analysts have argued that the pass-through effect of a stronger U.S. dollar was washing out of core goods prices, hence supporting faster core inflation, that effect has been more persistent than many had assumed. At least in our view, another factor, quite independent of the relative strength of the U.S. dollar, weighing on core goods prices is what remains a very high degree of unused industrial capacity around the globe that enables producers to sustain increases in output without sparking inflation pressures.

Supports For Core CPI Inflation Fading Fast



We have for some time argued rents would transition from being a key driver of core inflation to being a drag on core inflation. Rent growth is indeed slowing, but the rate of that deceleration remains moderate, which reflects still robust growth in rents on single family homes offsetting a deceleration in growth of apartment rents that will become increasingly pronounced over coming months. Vehicle prices, new and used, declined further in May and will continue to decline over coming months with sales moving further from their cyclical peak. More troubling for those who argue the recent deceleration in inflation is transitory is the behavior of services prices, which have risen at a slower pace over recent months, thus acting as a drag on non-shelter core inflation.

Sure, the May CPI report comes at an awkward time for an FOMC poised to announce a rate hike later today. More significantly, however, the deceleration in inflation will call into question the outlook for further rate hikes over the remainder of 2017.

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