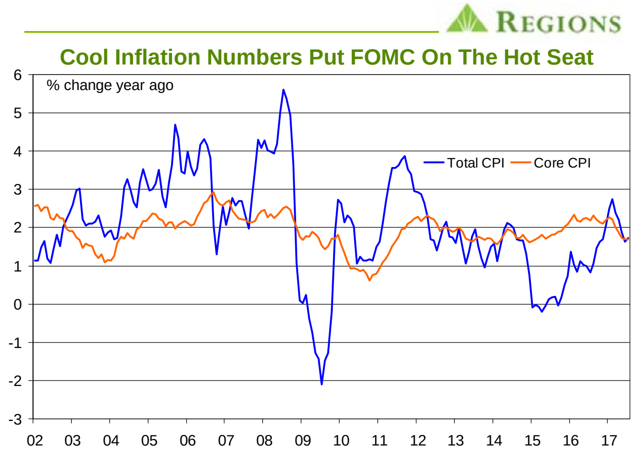
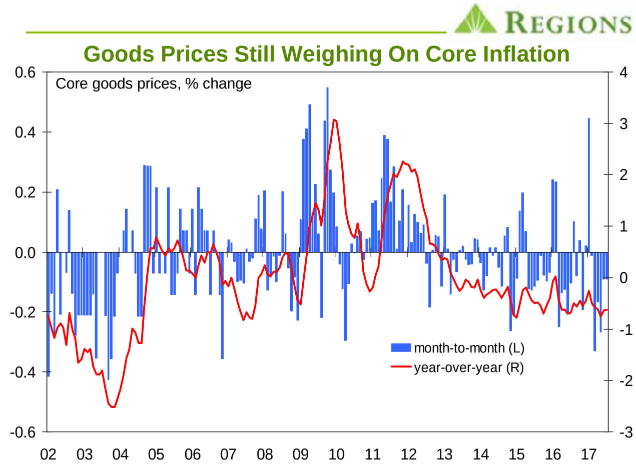
July Consumer Price Index: Cool Inflation Numbers Put FOMC On The Hot Seat

- The total CPI rose 0.1 percent (0.106 percent unrounded) in July; the core CPI was up 0.1 percent (0.114 percent unrounded).
- On a year-over-year basis, the total CPI was up 1.7 percent and the core CPI was up 1.7 percent in July.

If you're a central banker and your rallying cry on inflation becomes "at least it isn't getting worse" that may perhaps possibly be a sign that you maybe want to re-think your outlook. That of course depends on whether you think: a) it really isn't getting worse; and b) that it isn't getting worse means that it's about to start getting better. In any event, both the total CPI and the core CPI rose by 0.1 percent in July, each matching our below consensus forecasts. This leaves both the total CPI and core CPI up 1.7 percent year-on-year, which constitutes "not getting worse" in that at least inflation is not moving further away from the FOMC's 2.0 percent target rate. So there's that. Still unsettled, however, is the question of whether the deceleration in inflation over the past several months is transitory or structural, and the answer to that question will guide the path of the Fed funds rate going forward. Market participants seem increasingly convinced the run of soft inflation data puts the FOMC firmly on pause, and while we're on record in our view that there just aren't a lot of inflation pressures in the economy, we are also aware that between now and the December FOMC meeting – widely seen as the timing of the next funds rate hike if indeed there is another this year – there will be several more reports on inflation. So, as of today, nothing is settled one way or the other.

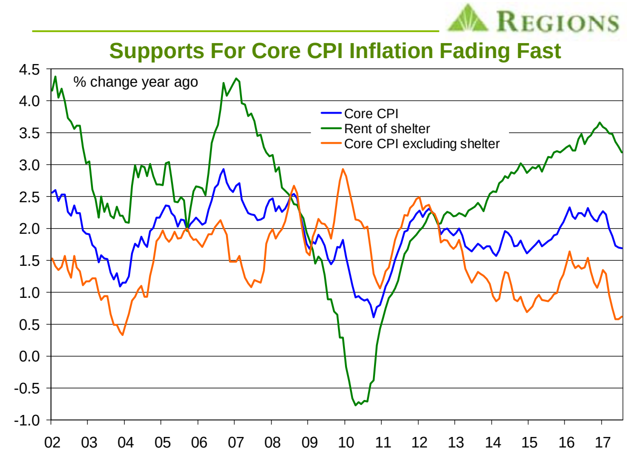


Energy costs were down 0.1 percent in July. Gasoline prices were a wash, with a 2.3 percent decline on a not seasonally adjusted basis translating into no change after seasonal adjustment. Prices for food consumed at home and prices for food consumed away from home both rose by 0.2 percent in July, leaving the broader food category also up 0.2 percent. As we anticipated would be the case, apparel prices were up 0.3 percent, ending a run of monthly declines but nonetheless leaving them down 0.4 percent year-on-year. Medical care costs were up 0.4 percent for a second consecutive month, which comes after a run of curiously weak prints in this category. Still, the details show an ongoing dichotomy between costs for hospital services rising at a rapid rate while prices for physicians' services continue to flounder, now down 0.6 percent year-on-year.



Shelter costs were up only 0.1 percent in July, thanks in part to a 4.2 percent decline in lodging prices, the largest monthly decline on record. The bigger story here, at least to us, is the 0.24 percent increase in the rent of primary residence category, the smallest monthly increase since December 2014. To be sure, this still leaves market rents up 3.8 percent year-on-year, but a key pillar of our forecast for muted core inflation has been our expectation that rent growth will decelerate. We haven't changed our view, but do think the extent of the slowdown seen in July may be a bit overstated. We'll also note that while apartment rents are likely to exhibit a more pronounced slowdown over coming months as what is the largest backlog of units under construction since the mid-1970s gets pared down, rents on single family homes continue to rise at a robust pace which will provide some support for the broader market rents category.

We also believe there will be less pass-through from a softer U.S. dollar into the inflation data, in the form of higher prices on core goods, than do many other analysts. As we have often noted, core goods prices have long been a material drag on core inflation, and this was again the case in July with core goods prices down by 0.1 percent, leaving them down 0.6 percent year-on-year. Aside from rents and core goods prices, those who argue inflation will accelerate over coming months have to account for what has been a steady deceleration in services prices. Indeed, non-shelter core inflation has slowed sharply, as seen in our bottom chart. Then again, July marked the third consecutive month in which non-shelter core inflation came in at 0.6 percent, so, sure, it isn't getting any worse.



As noted above, there are four more months of inflation data before the December FOMC meeting, so today's report settles nothing. We'd also say, however, that the burden of proof is on those who argue the recent deceleration in inflation is transitory. Cell phone service plan prices aside, the details of the CPI data suggest otherwise.

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