ECONOMIC UPDATE
REGIONS
January 12, 2018

December Consumer Price Index: Inflation Set To Jump In 2018?

- The total CPI rose 0.1 percent (0.149 percent unrounded) in December; the core CPI was up 0.3 percent (0.277 percent unrounded)
- On a year-over-year basis, the total CPI was up 2.1 percent and the core CPI was up 1.8 percent in December

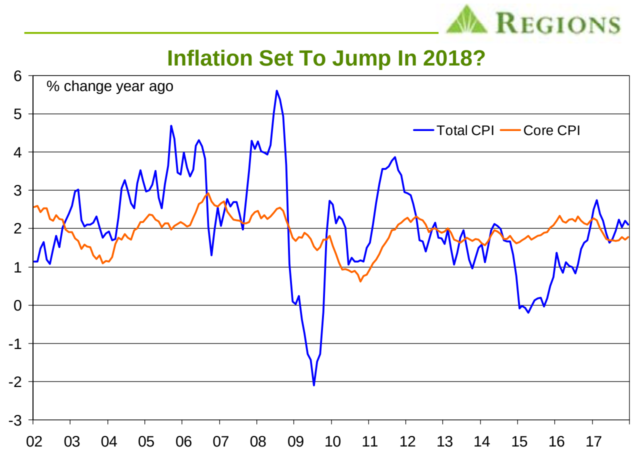
The total CPI rose by 0.1 percent in December, as we and the consensus anticipated. The core CPI, however, surprised to the upside with an increase of 0.3 percent. Our forecast of a 0.2 percent increase, which matched the consensus, was wrong footed by surprisingly large increases in rents and motor vehicle prices, both new and used. While on the surface inflation pressures remained fairly muted as 2017 closed out, the details of the December CPI report do raise some questions. While it seems a given that rising energy prices will push headline inflation higher over coming months, there is considerable uncertainty around the path core inflation will take in 2018.

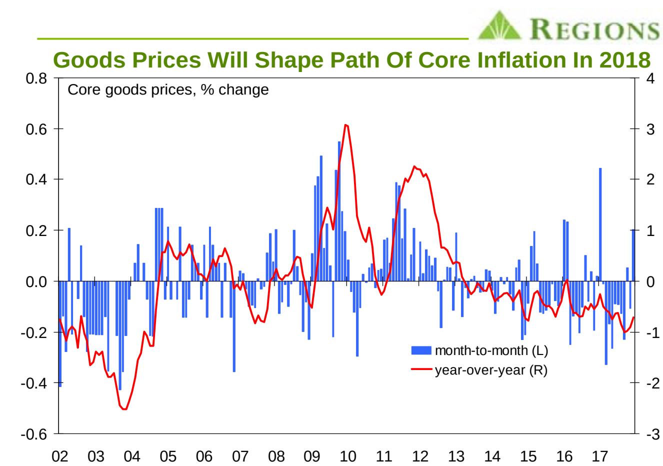
We've pegged three components that we think will be key determinants of the path of core inflation in 2018 – rents, medical care costs, and core goods prices. All three showed signs of life in December. Market rents were up by 0.36 percent in December, the largest monthly gain since October 2015, leaving them up 3.7 percent year-on-year. There are two threads to watch here in 2018. As we've discussed in our monthly notes on the residential construction data, there is a looming wave of new supply in the market for rental apartments, with the backlog of multi-family units under construction larger than at any time since the mid-1970s. But, the pace of completions remains notably slow, so the extent to which more of these units come on line will help shape the path of market rents in 2018. At the same time, however, rents on single family homes, which now account a higher share of the rental housing stock than has historically been the case, continue to rise at a robust pace, thus lending support to the CPI data on market rents. The other main component of the CPI measures of rents is owners' equivalent rents, which posted a 0.34 percent increase in December, leaving them up 3.2 percent year-on-year. If anything, we've been surprised that the increases in this category have not been larger, given the heady pace of house price appreciation, so this too will be a story line to follow in 2018.

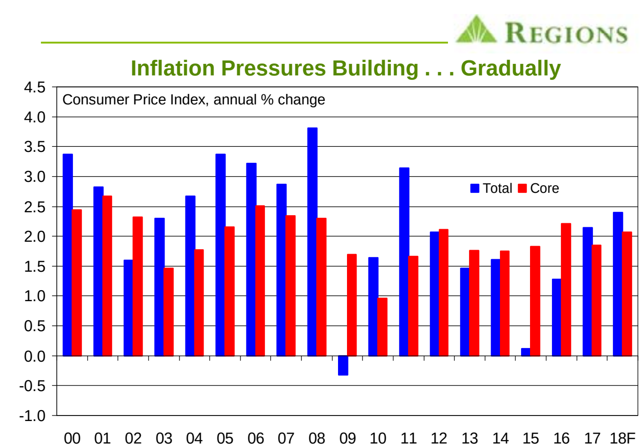
As we anticipated, core goods prices were up 0.2 percent in December, but nonetheless were down year-on-year for the 56th time in the past 57 months. Many analysts expect a weaker U.S. dollar to translate into rising core goods prices, and to some extent we agree with this. But, we think this will be less of a support to core inflation in 2018 than many are assuming will be the case, as we think ultimately the U.S. dollar will be little changed at year-end 2018 from where it started, even if there are sharp swings in the exchange value of the dollar in between. Medical care costs were up by 0.3 percent in December, but there is as of yet no clear pattern as the monthly changes in 2017 were all over the map. When, or, if, we get some clarity on the path of medical care costs we can refine our 2018 forecast for core inflation which, at present, stands right at 2.0 percent.

Prices of new motor vehicles rose by 0.6 percent in December, even more surprising is that prices for cars, which have increasingly fallen out of favor with consumers, rose by 0.7 percent. Prices for used motor vehicles rose by 1.4 percent, the third consecutive month with a sizeable increase. To some extent post-hurricane replacement buying has supported used car prices but, given the number of leases set to expire over coming months, it remains to be seen how long the recent strength of used vehicle prices holds up. As expected, gasoline was a drag on the December CPI, with prices down 2.7 percent on a seasonally adjusted basis. Still, for 2017 as a whole, gasoline prices posted a double-digit increase and seem set to post another sizeable increase in 2018. Food prices ended 2017 on a firmer note, with a 0.2 percent increase, but this reflects higher prices at restaurant as grocery store prices remain notably soft.

There has been considerable discussion of late over the outlook for inflation in 2018, which obviously will be a key factor in the FOMC's deliberations over the course of monetary policy. With energy prices pushing headline inflation up, whether, and to what extent, core inflation firms up will be the main story line to follow in terms of how monetary policy evolves over the course of 2018.







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