ECONOMIC UPDATE
REGIONS
June 12, 2018

May Consumer Price Index: Not Testing The FOMC's Tolerance Just Yet

- The total CPI rose by 0.2 percent (0.209 percent unrounded) in May; the core CPI was up 0.2 percent (0.171 percent unrounded)
- On a year-over-year basis, the total CPI was up 2.8 percent and the core CPI was up 2.2 percent in May

Both the total CPI and the core CPI rose by 0.2 percent in May as we and the consensus expected. On a year-over-year basis, the total CPI is up 2.8 percent, the largest such increase since February 2012, while the core CPI is up 2.2 percent, which is the fastest rate of core CPI inflation since February 2012. To be sure, headline inflation running at 2.8 percent is eye catching, but rather than a broad based build-up of inflation pressures, the details of the May CPI report show a continued divergence between goods prices and services prices, with shelter costs remaining far and away the main driver of services inflation. This is by no means to downplay the implications of rising shelter costs, which indeed is a topic we've discussed frequently, but instead it does point to the FOMC having more latitude to remain on a course of gradual Fed funds rate hikes than one might infer from simply looking at the print on headline inflation. Keep in mind that the FOMC's preferred gauge of inflation, the PCE deflator, shows the same basic pattern, i.e., some acceleration in both headline and core inflation, but with a more modest rate of inflation than the CPI shows. All in all, there is little in the data to show inflation accelerating beyond what the FOMC already has incorporated into their outlook.

Seasonally adjusted gasoline prices were up 1.7 percent in May, more than our forecast had anticipated, which in and of itself would have added roughly one-tenth of a point to the change in the headline CPI. After having declined by 0.5 percent in April, new vehicle prices rebounded in May, rising by 0.3 percent. Prices for used vehicles, however, sank further in May, with a 0.9 percent decline following a 1.6 percent decline in April. While a methodological change in the measurement of used vehicle prices implemented by the BLS in January is adding some volatility to this series, we think the bigger factor in used vehicle prices is that the temporary boost in prices seen in the wake of Hurricanes Harvey and Irma has run its course. With May marking the fourth consecutive monthly decline, what had been a persistent downward trend in used vehicle prices prior to the hurricanes is now back in force, and is likely to continue over coming months.

Core goods prices fell once again in May, with the 0.1 percent decline leaving them down 0.3 percent year-on-year, the 60th year-on-year decline in the past 62 months. What had been a weaker U.S. dollar seemed to give a boost to core goods prices in late-2017/early-2018, but with the dollar having reversed course so too have core goods prices. After having posted a 0.3 percent increase in April, at odds with seasonal patterns seen over the past several years, apparel prices were flat in May but are up 1.4 percent year-on-year, the largest such increase since August 2013. Prices for food consumed at home fell by 0.2 percent in May, giving back most of April's 0.3 percent increase, while prices for food consumed away from home were up 0.3 percent in May. This left the overall index of food prices unchanged in May and up 1.2 percent year-on-year. Both primary rents and owners' equivalent rents were up 0.3 percent in May, and on a year-on-year basis are up 3.6 percent and 3.4 percent, respectively. What is interesting is that growth in primary rents is gradually decelerating, which we expect will continue in the months ahead, but growth in owners' equivalent rents is picking up pace. This likely reflects, at least to some extent, the robust rate of house price appreciation over the past several months, which could bias owners' perspectives on the prospective rental value of their homes higher. To the extent house price appreciation remains as sturdy in the months ahead as it has been over recent quarters, growth in owners' equivalent rents will continue to accelerate. Given the outsized weight (better than 40 percent) of rents in the core CPI, however, this will act as a steady upward force on core CPI inflation, an effect not seen to nearly the same degree in the PCE deflator.

The build in inflation pressures, at least on the retail level, is more gradual than implied by the 2.8 percent print on headline CPI inflation. The FOMC was poised to raise the funds rate at this week's meeting either way, and we are not close to the point where the FOMC's tolerance for inflation topping their symmetric target is being put to the test.

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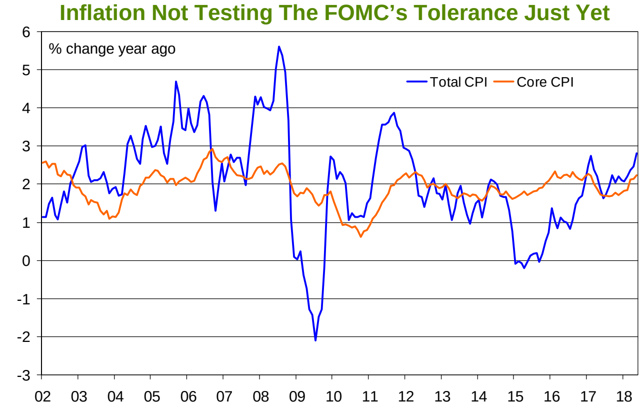
Inflation Not Testing The FOMC's Tolerance Just Yet



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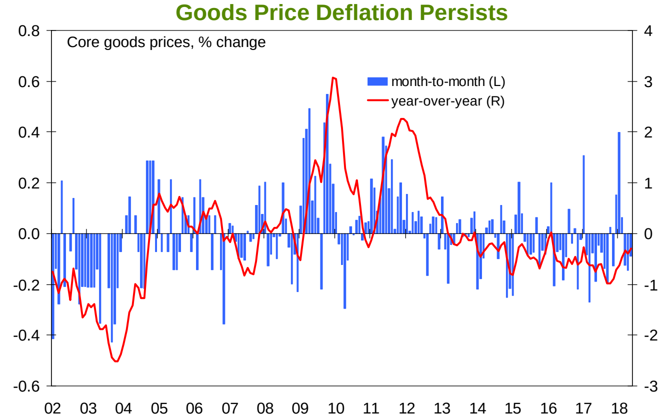
Goods Price Deflation Persists



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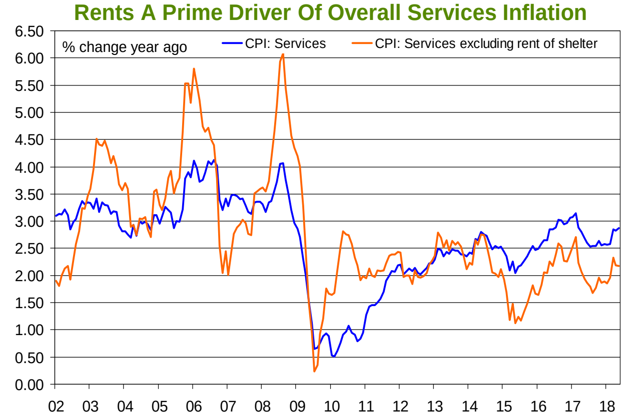
Rents A Prime Driver Of Overall Services Inflation



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