# ECONOMIC UPDATE

REGIONS

August 10, 2018

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## July Consumer Price Index: Further To Run For Core Inflation

- The total CPI rose by 0.2 percent (0.171 percent unrounded) in June; the core CPI was up 0.2 percent (0.243 percent unrounded)
- On a year-over-year basis, the total CPI was up 2.9 percent and the core CPI was up 2.4 percent in July

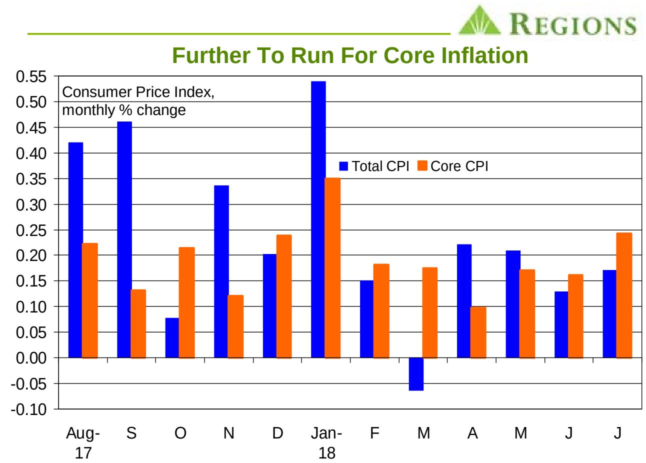
The total CPI rose by 0.2 percent in July, as we and the consensus expected, while the core CPI rose by 0.2 percent, in line with consensus but below our forecast of a 0.3 percent increase (even if just barely). This leaves the total CPI up 2.9 percent year-on-year, but at 2.94 percent headline CPI is basically a rounding error away from 3.0 percent; the core CPI is up 2.4 percent year-on-year, the largest such increase since September 2008. The question of course is where inflation goes from here. While we think July will prove to be the peak, at least for 2018, for headline CPI inflation, we see further upside room for core CPI inflation, and we'd suggest this is what the FOMC will be watching more closely. To be sure, the PCE deflator is the FOMC's preferred gauge of inflation and core PCE inflation tends to run 40-to-50 basis points below core CPI inflation, but the trends in the two series are the same and core PCE inflation will likely soon top 2.0 percent and could test the FOMC's tolerance for inflation running ahead of its objective.

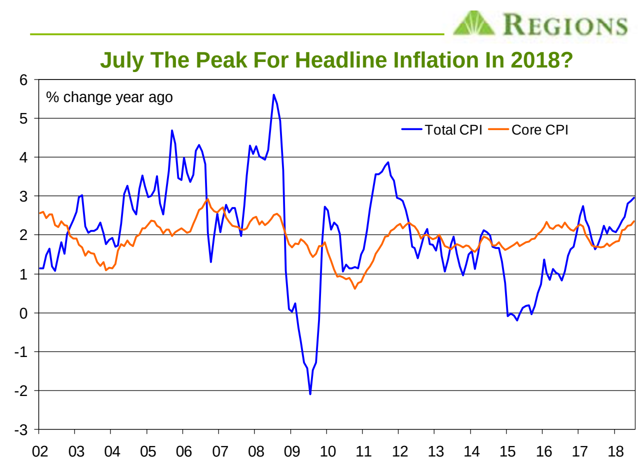
Gasoline prices were down 0.6 percent on a seasonally adjusted basis in July, with a larger than normal (for the month of July) decline of 1.4 percent on a not seasonally adjusted basis. Still, retail gasoline prices are up 25.4 percent year-on-year. The overall energy index was down 0.5 percent in July, but is up 12.1 percent year-on-year. As we anticipated, prices for new motor vehicles rose by 0.3 percent in July, but used car prices surprisingly (at least to us) jumped by 1.3 percent, following up a 0.7 percent increase in June. As to what is (apologies in advance) driving used car prices, that is an open question, whether this reflects market forces or whether the change, made in January, in the manner in which the BLS estimates used vehicle prices made this January is lending added volatility to the monthly data remains to be seen.

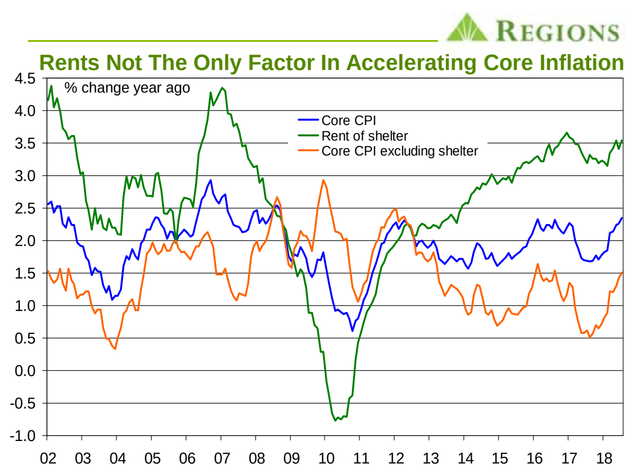
A main component of our forecast for a 0.3 percent increase in the core CPI was payback for the 3.7 percent decline in costs for lodging away from home in June. With just a 0.4 percent increase in July, however, there was less payback than we anticipated. Of more significance is the behavior of market rents. With each posting a 0.3 percent increase in July, market rents and owners' equivalent rents matched our forecast. Year-on-year, market rents are up 3.6 percent and owners' equivalent rents are up 3.4 percent. At present, healthy rent growth on single family homes is supporting growth in market rents, and growth in owners' equivalent rent has accelerated gently over recent months but not to the extent we have expected given what has been robust house price appreciation.

Rents, which account for over 40 percent of the core CPI, are not the only factor behind accelerating core inflation. Ex-shelter core inflation stands at 1.5 percent, which may seem tame but recall that a year ago it was running at 0.5 percent and the acceleration in subsequent months has been rapid. Core services prices are up 3.1 percent year-on-year as of July, the fastest pace in 18 months, and this pace will pick up over coming months. Service providers have more latitude to pass along higher input costs, primarily labor, than do goods producers, and we expect core services prices to be a steady source of upward pressure on core inflation. Core goods prices did post a modest advance in July, but were nonetheless down year-on-year for the 62nd time in the past 64 months. months. A stronger U.S. dollar will act as a weight on core goods prices, but the key unknown here is the extent to which tariffs will ultimately be imposed directly on consumer goods and the extent to which tariffs on raw and intermediate goods will at some point make their presence felt in prices of consumer goods. Medical care costs fell 0.2 percent in June – which kept the change in the core CPI at 0.2 percent rather than 0.3 percent – and the 1.9 percent year-on-year increase is the smallest such increase since February.

As base effects fade and energy is less of a support, we think headline inflation will drift lower over the remainder of 2018, though remaining above 2.0 percent. Our main focus, and we'd venture to say the FOMC's as well, will be core inflation which, whether measured by the CPI or the PCE deflator, we think has further to run to the upside.

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