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Economics Group

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Surge in July Core CPI Is Mere Catch Up

Inflation surged 0.6% in July, underpinned by the largest gain in the core index in more than 50 years. Yet the jump reflects unwinding of the pandemic-induced price cuts this spring. Weak demand will keep the trend tepid.

In Reverse

Inflation staged quite a comeback in July. Consumer prices jumped 0.6%, with an equally large and significantly rarer gain in the core index. Yet July's increase does not mark the start of sustained pickup in inflation. Instead it is merely catching up from declines this spring.

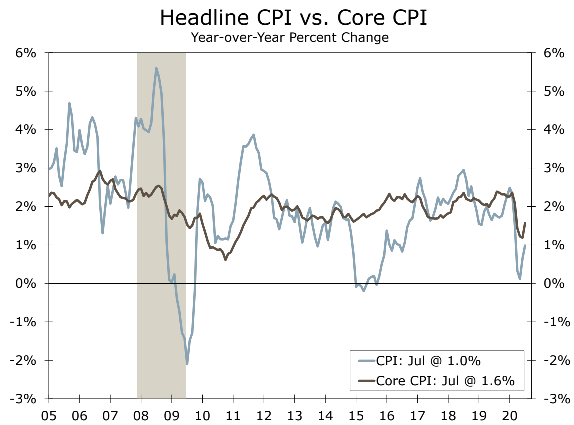
Core inflation is typically the focus of policymakers since it strips out the highly volatile energy and food components. But parts of the core index are also quite volatile, especially in today's age when technology enables businesses to alter prices inexpensively. Many of those categories have also been at the epicenter of the COVID crisis, and after steep cuts this spring were able to gain back some pricing power in July. For example, airfares jumped 5.4%, lodging away from home rose 1.2%, car rentals increased 4.0% and apparel rebounded 1.1%. Other pandemic-induced price declines also unwound, including a 9.3% leap in motor vehicle insurance and 1.3% increase in new and used vehicles now that households are driving more. With a good bit of ground recovered but consumer buying patterns still altered as the virus circulates, gains in in the coming months are likely to be more modest.

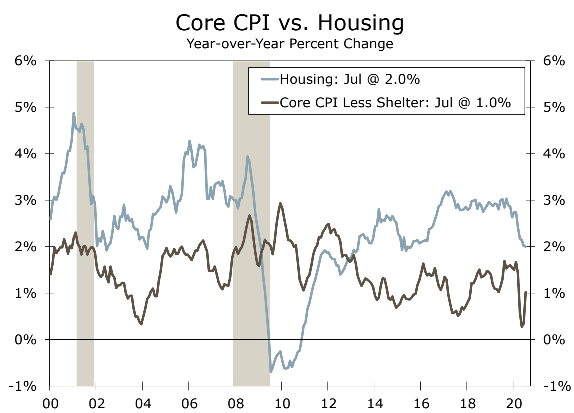
Support from one key component of the CPI—housing—is also beginning to weaken. Rent of primary residences rose 0.2% in July, as did the owner-owned component. That marks a slightly stronger gain than last month, but trails behind the pre-pandemic trend. With only one-in-six of housing units in the sample surveyed each month, changes in housing market conditions take longer to show up than categories purchased more frequently. We expect shelter inflation to remain weak as job losses have skewed toward renters. Working from home has allowed some white-collar workers to consider less expensive markets and home price appreciation slows.

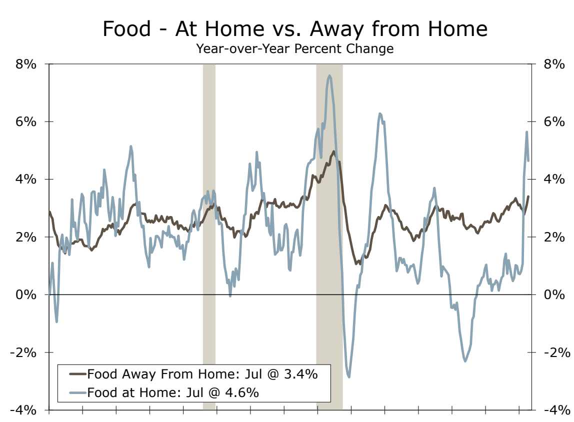
At the same time, price changes are settling down in areas that got a boost from stay at home orders—namely grocery stores. Prices for food at home fell 1.1% in July as supply chain issues have alleviated to an extent.

Settle In for a Prolonged Period of Weak Inflation

Despite the sharp rise in July, weak demand will keep a lid on inflation in the coming months. Even as employment has recovered ground since the spring's widespread shutdowns, the labor market remains in tatters. Many households are unable or unwilling to spend amid the more tenuous jobs situation, questions over the amount and duration of unemployment benefits and continuing risk of COVID. Low inflation expectations will also make the Fed's job of 2% inflation harder in this environment. While expectations have perked up a bit recently, they remain depressed by historical standards and are unlikely to have much staying power as the soft inflation environment persists. We expect core CPI, which runs a few tenths hotter than the core PCE deflator, to remain below 2% though 2021.







Source: U.S. Department of Labor and Wells Fargo Securities

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