Economics

Economic Indicator — January 15, 2025

December CPI: Hotter Headline, but Healthier Core

Summary

Consumer price inflation was hot in December, rising 0.4% in the month on the back of higher food and energy prices. Excluding food and energy, the inflation picture looked better. The core CPI rose 0.23%, in line with economist forecasts and marking a slowdown from the pace that had prevailed over the previous few months. Fairly flat prices for core goods and slower inflation for items like medical care helped to push core CPI down to 0.2% from its recent run rate of 0.3%.

That said, when looking through the month-to-month noise, the inflation data have been fairly stubborn in recent months, neither gathering nor losing speed. The 12-month change in the core CPI (+3.2%) is more or less the same as the three-month annualized rate (3.3%). The picture looks a bit better for the Fed's preferred inflation metric, the core PCE deflator, where we project December inflation to be 0.2% month-over-month and 2.8% year-over-year. But, this marks only a modest slowdown relative to the 3.0% core PCE inflation registered in December 2023, and it is still well above the central bank's 2% inflation target.

Accordingly, and given the more resilient labor market data seen over the past couple months, we have revised our expectations for the federal funds rate outlook. We now expect two 25 bps rate cuts by the FOMC this year, in September and December, down from the three cuts we anticipated coming into the year. If realized, the target range for the federal funds rate would be 3.75%-4.00% at year-end 2025. We will publish additional details and a full economic forecast update tomorrow in our flagship Monthly Economic Outlook publication.

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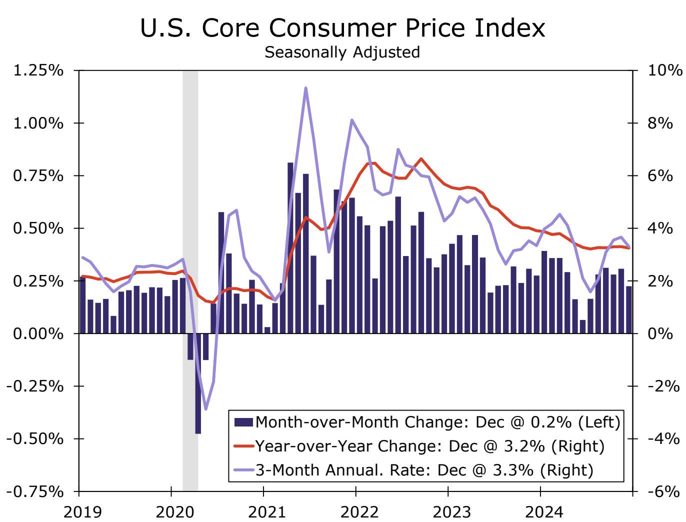
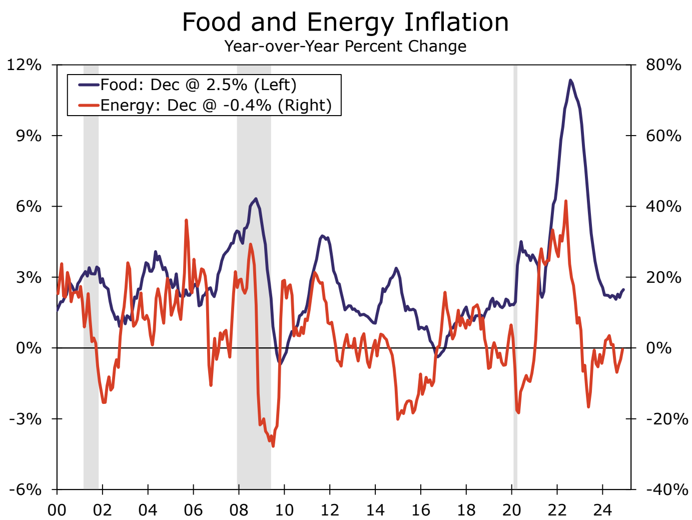


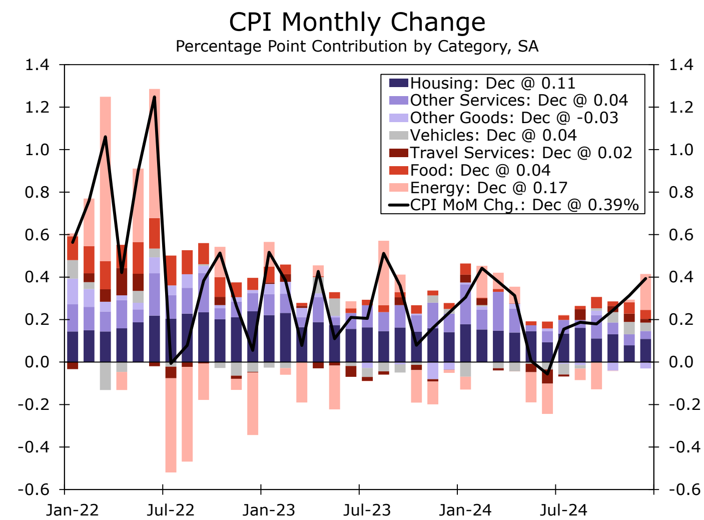
Source: U.S. Department of Labor and Wells Fargo Economics

More Work To Do in 2025

The Consumer Price Index finished 2024 in hot territory, rising 0.4% in December and roughly matching the largest monthly increase of the year. Higher gasoline prices (+4.4%) and food prices (+0.3%) contributed to the robust gain in the headline index. Despite the strong reading for food and energy prices in December, inflation in these categories was relatively subdued over the entirety of 2024 (chart). Gasoline prices were 3.4% lower in December 2024 compared to 2023, while food prices were up 2.5%, a smaller gain the 3.9% increase in average hourly earnings. Note that this masks some divergences beneath the surface for individual categories. As an example, prices for eggs at the grocery store rose 3.2% in December and 37% over the past year amid a bird flu epidemic outbreak that has constrained supply. Total CPI inflation was 2.9% in the 12-months ending in December, a modest improvement from the 3.4% rate registered in December 2023 and consistent with a moderate pace of real wage gains.



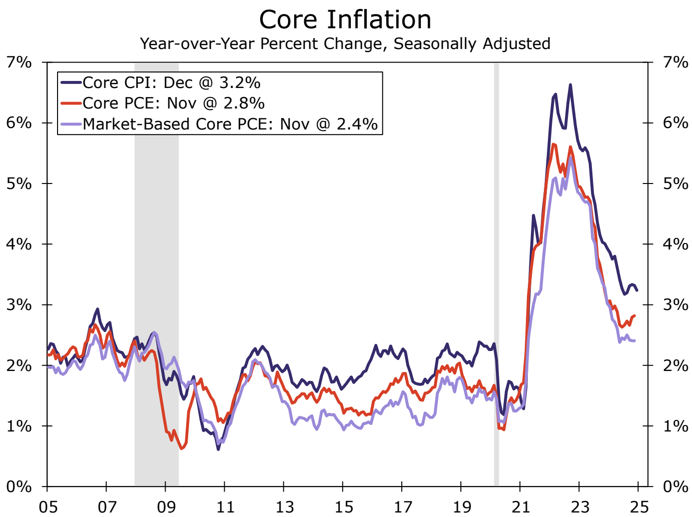
Source: U.S. Department of Labor and Wells Fargo Economics



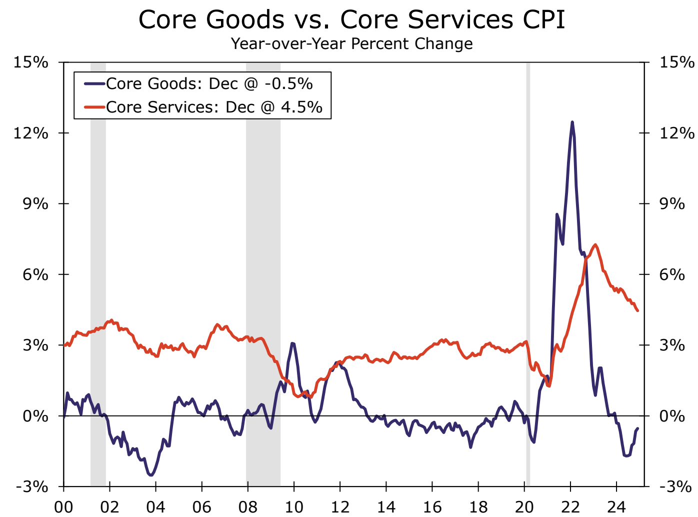
Source: U.S. Department of Labor and Wells Fargo Economics

Excluding food and energy, there was slightly better news on the price front. After advancing 0.3% in each of the prior four months, the core index rose 0.23%. As expected, the tamer reading was driven by a more modest rise in core goods prices, which were up 0.1%. New and used vehicle prices continued to rise in December, but at a slower rate than in November, while prices for the remainder of the core goods index fell 0.2%.

Core services prices increased 0.3%—in line with November. Primary rent growth (owners' equivalent rent and primary rent) reverted to its recent trend of 0.3% after slowing sharply in November. But excluding housing, core services advanced 0.2% amid more modest gains in medical care and other services like recreation, tuition and personal care.



Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Economics



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

Today's CPI report along with yesterday's December Producer Price Index suggest the core PCE deflator, the Fed's preferred measure to gauge the current trend in inflation, rose 0.21% in the final month of the year. That would leave the year-over-year rate at 2.8%, only marginally better than the 3.0% change registered in December 2023. The core CPI, however, has seen more improvement, moving from 3.9% to 3.2%, thanks to the moderation in primary shelter and auto inflation. Similarly, the market-based measure of core PCE also has pointed to a more meaningful slowdown in price growth over the past year (chart). This measure excludes categories where prices are imputed and not directly observed, and has been mentioned by Fed officials including Chair Powell with increasing frequency.

Nevertheless, progress in the fight against inflation has seemed to effectively stall in recent months. Over the past three months, the core CPI has risen at an annualized rate of 3.3%, little different than the 6-month and 12-month rates of 3.2%. The sideways move in core inflation in recent months comes as *de*flation in core goods has faded since the summer and offset the frustratingly slow pace of services *dis*inflation (chart).

The stubborn inflation readings over the past few months, alongside the stabilization in the labor market data, have led us to revise our expectations for the federal funds rate this year. We now expect two 25 bps rate cuts this year, in September and December, down from the three cuts we anticipated coming into this year. If realized, the target range for the federal funds rate would be 3.75%-4.00% at year-end 2025. We will publish additional details and a full economic forecast update tomorrow in our flagship Monthly Economic Outlook publication.

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