

May CPI: Confidence Boost

Summary

Today's CPI data were surprisingly soft and will be welcomed by the FOMC as it concludes its two-day meeting this afternoon. Headline CPI was unchanged in the month, the first flat reading since July 2022. Falling energy prices and a very modest increase in food prices helped to keep headline CPI in check. Core CPI increased by a "low" 0.2% (0.16% before rounding), the smallest increase since August 2021. Sticky services inflation finally showed signs of easing, registering 0.2% amid price declines for airfares (-3.6%), motor vehicle insurance (-0.1%) and lodging away from home (-0.1%).

On balance, the May CPI data were encouraging across the board. Tame inflation for food and energy bodes well for consumer spending power, while the deceleration in core CPI suggests that the underlying inflation trend remains firmly downward. The core CPI has risen 3.4% over the past year, the smallest 12 month change since April 2021. That said, inflation remains above the Fed's target, and there have been enough false starts in the past that the FOMC likely will need to see at least a couple more rosy inflation reports to gain the "greater confidence" needed to start reducing the federal funds rate. The materials and post-meeting press conference from the FOMC's meeting later today will shed more light on how the Committee sees inflation evolving alongside its employment mandate, and we expect the median participant on the Committee to project two 25 bps rate cuts by year-end.

Economist(s)

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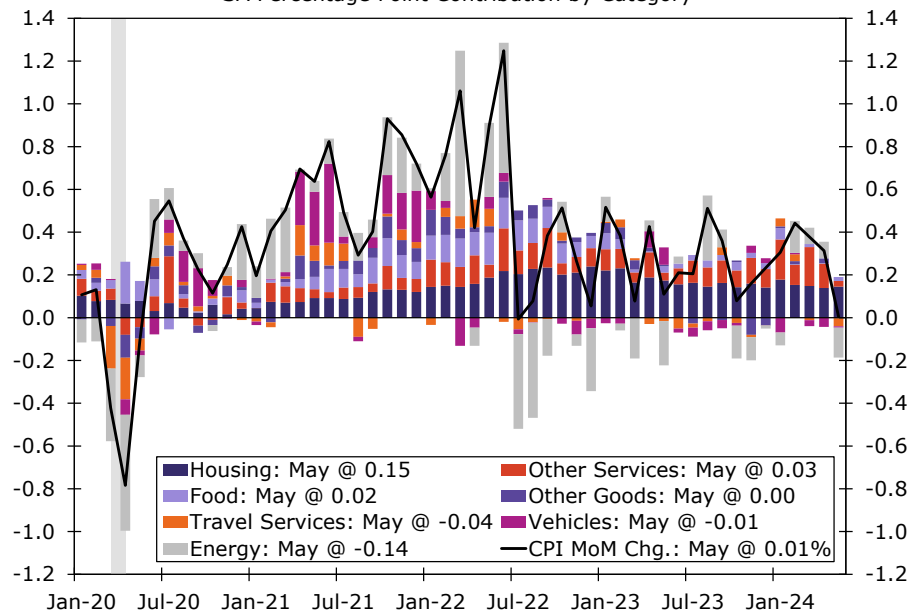
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CPI Monthly Change

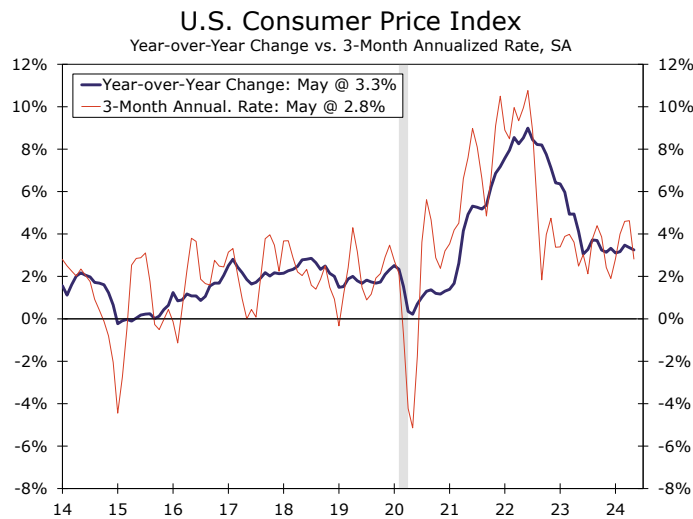
SA Percentage Point Contribution by Category



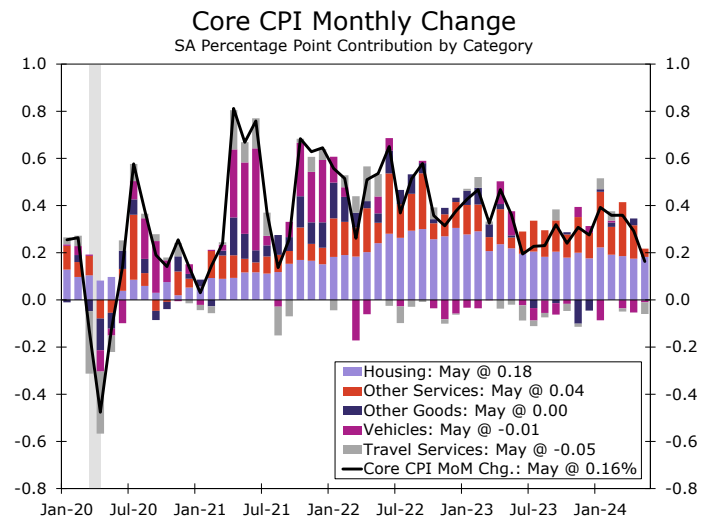
Source: U.S. Department of Labor and Wells Fargo Economics

Inflation Surprises to the Downside in May

Consumer prices were flat in May, a tenth softer than the consensus forecast and the first month in which the headline CPI did not increase since July 2022. A 2% decline in energy prices in May restrained inflation in the month, with gasoline prices sliding 3.6% and energy services prices falling a smaller 0.2%. Food prices posted a meager 0.1% increase, with flat grocery store prices partially offset by a 0.4% increase in prices for food consumed away from home. It is still early in the month, but so far there are preliminary signs that the slide in gasoline prices continued in June, which bodes well for another tame increase in headline inflation when the next CPI report comes around. The headline CPI has increased 3.3% over the past year, which marks an improvement on the 4.0% increase registered in May 2023 but is still about a percentage point faster than the pace prevailed on the eve of the pandemic.



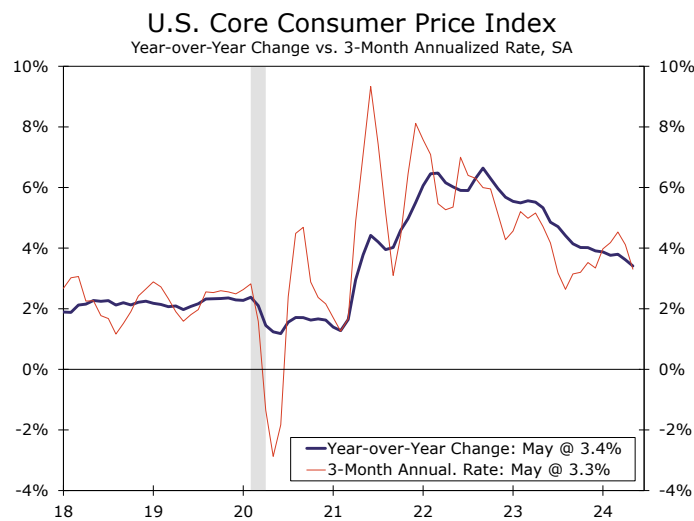
Source: U.S. Department of Labor and Wells Fargo Economics



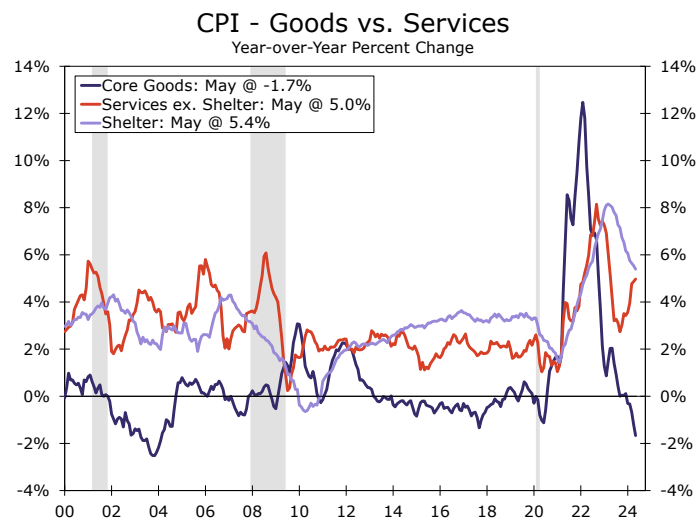
Source: U.S. Department of Labor and Wells Fargo Economics

May's downside surprise versus our expectations can be chalked up entirely to a softer-than-expected core reading. Excluding food and energy, prices rose a "low" 0.2% (0.16% before rounding) versus expectations for a 0.3% gain. Goods prices were flat over the month as a jump in prescription drugs and rebounds in used autos, motor vehicle parts & equipment and tobacco products offset price declines for new vehicles, apparel, and communication commodities. Although overall goods prices were somewhat firmer than expected (we looked for a decline of 0.1%-0.2%), the drivers of May's relative strength suggest there may still be scope for additional deflation in the goods sector. Auction prices point to used autos resuming their decline over the next couple of months, while prescription drug pricing and prices for tobacco products tend to move idiosyncratically.

More encouraging for the inflation outlook was a sharp slowdown in core services. Core services rose 0.2% in May, the smallest monthly gain since September 2021. Shelter disinflation remains painfully slow, with rent of primary residences and owners' equivalent rent each rising 0.4%, the same as in April. However, signs of services inflation cooling off more meaningfully were evident elsewhere. Excluding primary shelter, core services were flat over the month. While price increases for medical care were little changed, travel-related prices fell 1.4% over the month amid declines in airfare, lodging and car rentals. Meantime, motor vehicle insurance prices slipped 0.1%—the first outright decline since 2021 and a marked slowdown from the 1.7% average *monthly* increase over the past year. We view this as a sign that the more benign environment for goods inflation over the past year is finally feeding into services.



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



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

On balance, inflation continues to edge lower. Consumer prices have increased 3.3% over the past year compared to 4.0% this time last year. Similarly, the core CPI has eased to a year-over-year pace of 3.4% versus 5.3% last May. After strengthening in the first quarter, inflation appears to be back on a downward path, but there is still a bit more distance from its desired destination. Even with today's softer report for May inflation, the core CPI has increased at a three-month annualized rate of 3.3%. Details of today's report also point to the core PCE deflator—the Fed's preferred measure of inflation—not slowing as sharply in May given that some of the major drivers of the soft core CPI, such as airfares and motor vehicle insurance, are derived from the Producer Price Index. With today's data in hand, we estimate the core PCE deflator rose 0.24% in May, essentially on par with the 0.25% rise in April, but we will refine after tomorrow's release of the May Producer Price Index.

We see inflation pressures continuing to subside amid a cooling jobs market, an increasingly stretched consumer, and smoother-functioning supply chains, which should drive the monthly pace of inflation lower as the year progresses even if unfavorable base effects leave the year-over-year pace stuck near current levels. However, we think the FOMC will need to see at least a couple more inflation reports like this one before it feels confident enough to reduce the fed funds rate. The materials and post-meeting press conference from the FOMC's meeting later today will shed more light on how the Committee sees inflation evolving alongside its employment mandate, and we expect the median participant on the Committee to project two 25 bps rate cuts by year-end.

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