WELLS FARGO

Special Commentary — June 5, 2024

# May CPI Preview: Incremental Improvement

Economist(s)

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## Summary

April marked a step forward in getting inflation back on a downward path after price growth picked up in Q1. Yet the FOMC will need to see inflation downshift further in order to gain the "greater confidence" needed to eventually reduce the fed funds rate. May's CPI report is unlikely to suggest inflation is rapidly approaching the Fed's target, but it should at least offer more evidence that the first quarter's flare-up has subsided.

We estimate headline CPI rose 0.1% in May, which would mark the smallest monthly gain since last October thanks in part to an unusual drop in gasoline prices for this time of year. Excluding food and energy, the CPI likely advanced 0.3% again in May, with the drivers little different from April. Core goods prices likely fell another tenth or two amid the ongoing slide in vehicle prices and a modest decline in other core goods. Prices for core services look to have increased 0.4% for a second straight month amid the slow moderation in housing and other services inflation.

Another 0.3% monthly increase in core CPI would nudge the year-over-year rate down to a three-year low of 3.5% and point to core PCE inflation edging down to 2.7% in May. Inflation as measured on a year-ago basis likely will hold at these rates through year-end amid unfavorable base effects. That said, we continue to look for monthly readings to gradually trend lower as inflation pressures subside. The slow pace of improvement may not be enough to convince some Fed officials over the next few months that inflation is headed back to target on a sustained basis.

**May 2024 Forecast**

| | Wells Fargo Economics | | | Consensus | |
|---|---|---|---|---|---|
| *Seasonally Adjusted* | **MoM (%)** | **3-M Ann. (%)** | **YoY (%)** | **MoM (%)** | **YoY (%)** |
| **CPI** | 0.10 | 3.2 | 3.3 | 0.1 | 3.4 |
| Food | 0.14 | 1.0 | 2.1 | - | - |
| Energy | -2.05 | 0.7 | 3.5 | - | - |
| **Core CPI** | 0.28 | 3.8 | 3.5 | 0.3 | 3.5 |
| Goods | -0.16 | -1.7 | -1.8 | - | - |
| Services | 0.42 | 5.5 | 5.4 | - | - |
| Primary Shelter | 0.39 | 5.0 | 5.5 | - | - |
| "Super Core"* | 0.45 | 6.2 | 5.2 | - | - |
| *Not Seasonally Adjusted* | **Index** | **MoM (%)** | **YoY (%)** | **Index** | **MoM (%)** |
| **CPI** | 314.301 | 0.2 | 3.3 | 314.346 | 0.2 |

Forecast as of: June 05, 2024; Bloomberg Consensus
*Core services CPI excluding rent of primary residence and owners' equivalent rent (i.e., excluding "Primary Shelter")

Source: U.S. Department of Labor, Bloomberg Finance L.P. and Wells Fargo Economics

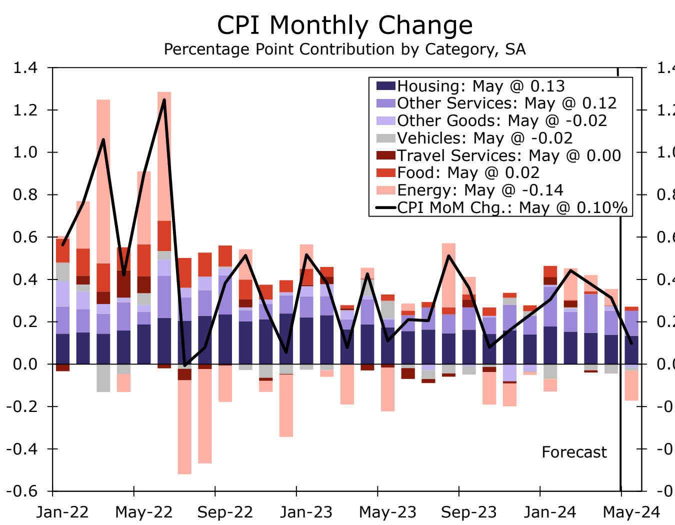
## May CPI: Inflation Likely No Worse but Not Meaningfully Better than April

April marked a step in the right direction for getting inflation back on a downward path. After surprising to the upside for three consecutive months with 0.4% gains, core CPI rose 0.3% to match consensus expectations. Core PCE inflation also eased up a little, with April's 0.25% rise smaller than the 0.36% monthly average in the first quarter. While April delivered more palatable inflation readings relative to the first three months of the year, core CPI and core PCE nonetheless rose at one-month annualized rates of 3.6% and 3.0%, respectively. Thus, we see a need for even softer inflation readings over the next few months to keep prospects of a Fed rate cut this year alive without a marked weakening in the labor market.

***The first quarter's inflation flare-up has likely subsided.***

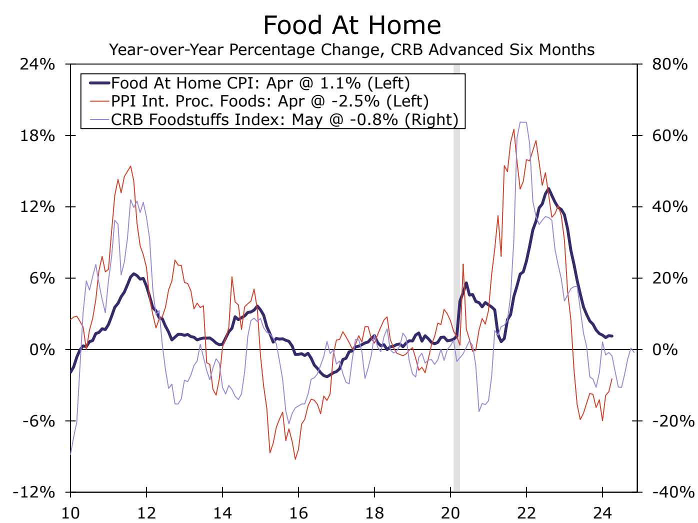
May's CPI report is unlikely to suggest inflation is rapidly approaching the Fed's target, but it should at least offer more evidence that the first quarter's flare-up has subsided. We estimate headline CPI rose 0.1% in May, which would mark the smallest monthly gain since October. Meantime, core CPI likely advanced 0.3% again in May, which would nudge the year-over-year rate down to a three-year low of 3.5%.

Figure 1




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

Figure 2




Source: U.S. Department of Labor, Commodity Research Bureau and Wells Fargo Economics

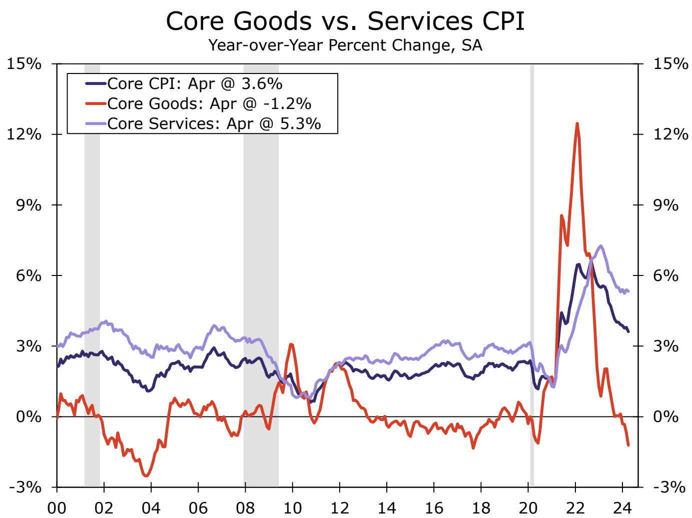
***A slide in gasoline prices in May should make for a tame headline reading for the month.***

May's tame headline reading should be helped by a slide in gasoline prices last month (Figure 1). The average price of a gallon of gas according to AAA fell two cents in May, which should translate to nearly a 3.5% decline in energy goods prices on a seasonally-adjusted basis. In contrast, we expect food inflation to have picked up slightly. While price increases for food-away-from home likely moderated, grocery prices look to have been little changed after a drop in April—the largest since 2020—that was driven in part by the volatile fruit & vegetable sub-category. Even amid somewhat firmer grocery pricing in May, the decline in food-related commodities and producer prices for intermediate food inputs over the past year point to food-at-home inflation remaining fairly tame in the months ahead (Figure 2).

***Core goods prices look poised to fall by 0.1%-0.2% in May, which would leave prices 1.8% lower than a year ago.***

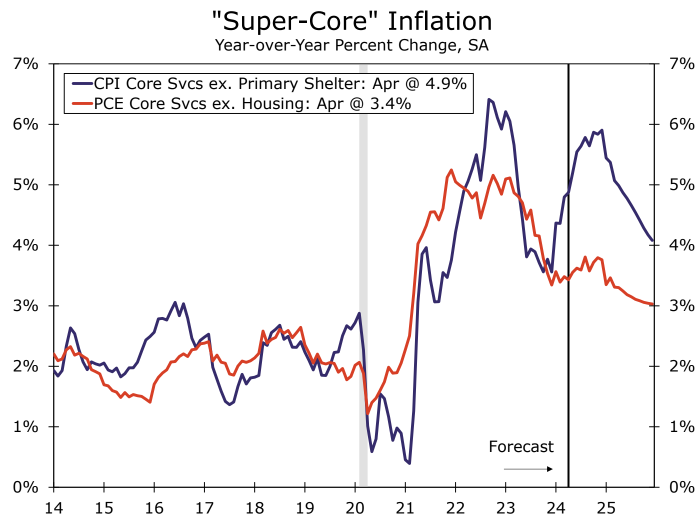
Excluding food and energy, May's increase in CPI is likely to look fairly similar to April. We look for another 0.3% increase in the core (0.28% before rounding versus 0.29% the prior month), with the drivers little different. Core goods prices look poised to fall by 0.1%-0.2% again in May, which would leave prices 1.8% lower than a year ago. Prices for new and used vehicle prices are unlikely to fall as sharply as they did in April. However, we see scope for a steeper decline in "other" core goods as April's 1.2% jump in apparel prices partially unwinds and prices for household and recreational goods fall somewhat further.

Figure 3




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

Figure 4




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

May's picture for core services inflation is also likely to look similar to April. We look for another 0.4% increase with the composition unlikely to be materially different. The downward trend in "spot" rents suggests the monthly pace of rent of primary residences and owners' equivalent rent should continue to cool. Meantime, core services ex-housing inflation (i.e., the CPI "super-core") looks to have been only marginally firmer last month (0.45% in May versus 0.42% in April). Price growth for medical services was likely a little stronger, but growth in motor vehicle insurance and personal services likely moderated.

***Though the CPI "super-core" looks to have been only marginally firmer last month, the year-over-year rate would rise from 4.9% to 5.2%, a 14-month high.***

Even with a similar-sized monthly increase in the CPI super-core compared to April, the year-over-year rate would rise from 4.9% to 5.2%, a 14-month high. While we estimate the PCE super-core for May will edge up only a tenth or two on a year-ago basis, the CPI measure is poised for a larger upswing through the end of the year due a number of methodological differences between the two measures, including the measurement and weighting of health and motor vehicle insurance (Figure 4).

## Inflation Pressures Broadly Subsiding, but Need to See It in Key Categories

Looking ahead, it is not only the 12-month change in super-core inflation that will suggest progress on inflation has stalled this year with price growth still uncomfortably high. The year-over-year rates of both headline and the traditional core are likely to be little changed through the remainder of the year whether measured by the CPI or PCE deflator (Figure 5). That said, we see scope for core inflation to trudge lower on a quarterly annualized basis. Range-bound prices for food and energy commodities and more incremental improvement in supply chain pressures will make overall progress slower-going than over the past year, but we see few signs of inflationary pressures building. The jobs market continues to gradually cool, tamping down wage growth. Meantime, growing signs of consumer strains, such as the recent weakening in real spending and ongoing rise in delinquencies, are making it more difficult for firms to raise prices.

Figure 5

| Wells Fargo U.S. Inflation Forecast | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Actual | | | | Forecast | | | | | | | |
| | 2023 | | | | 2024 | | | | 2025 | | | |
| | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q | 1Q | 2Q | 3Q | 4Q |
| CPI (YoY) | 5.7 | 4.0 | 3.6 | 3.2 | 3.2 | 3.3 | 3.1 | 3.2 | 2.9 | 2.6 | 2.6 | 2.5 |
| *QoQ Annualized* | 3.8 | 3.0 | 3.4 | 2.7 | 3.8 | 3.4 | 2.6 | 2.9 | 2.7 | 2.3 | 2.3 | 2.5 |
| Core CPI (YoY) | 5.5 | 5.2 | 4.4 | 4.0 | 3.8 | 3.6 | 3.7 | 3.6 | 3.3 | 3.0 | 2.9 | 2.8 |
| *QoQ Annualized* | 4.9 | 4.7 | 3.0 | 3.4 | 4.2 | 3.8 | 3.3 | 3.0 | 2.9 | 2.8 | 2.7 | 2.7 |
| PCE Deflator (YoY) | 5.0 | 3.9 | 3.3 | 2.8 | 2.6 | 2.7 | 2.5 | 2.6 | 2.4 | 2.2 | 2.2 | 2.2 |
| *QoQ Annualized* | 4.2 | 2.5 | 2.6 | 1.8 | 3.4 | 2.9 | 2.1 | 2.2 | 2.4 | 2.1 | 2.0 | 2.1 |
| Core PCE Deflator (YoY) | 4.8 | 4.6 | 3.8 | 3.2 | 2.9 | 2.7 | 2.8 | 2.9 | 2.6 | 2.4 | 2.4 | 2.3 |
| *QoQ Annualized* | 5.0 | 3.7 | 2.0 | 2.0 | 3.7 | 3.1 | 2.5 | 2.3 | 2.5 | 2.4 | 2.3 | 2.2 |

Forecast as of: June 5, 2024
Note: All numbers are percent change.

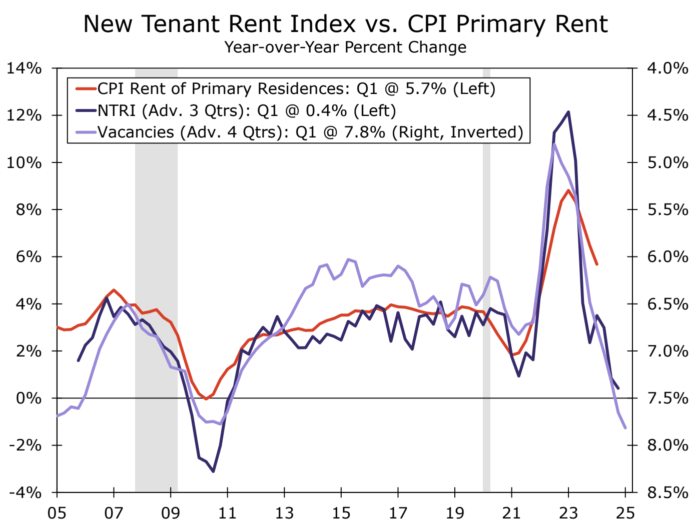
Source: U.S. Department of Labor, U.S. Department of Commerce and Wells Fargo Economics

***Primary shelter, which accounts for roughly one-third of the CPI, will be crucial to driving inflation low enough to enable the Fed to ease policy.***

While a softening labor market, more discerning consumer and smoother functioning supply chains should broadly put downward pressure on price growth ahead, a few specific components will be crucial to driving inflation low enough to where the Fed obtains the "greater confidence" it needs to eventually ease policy. Chief among them is shelter. Primary shelter accounts for roughly one-third of the CPI and 16% of the PCE deflator and is currently running about two percentage points faster than its pre-COVID rate.

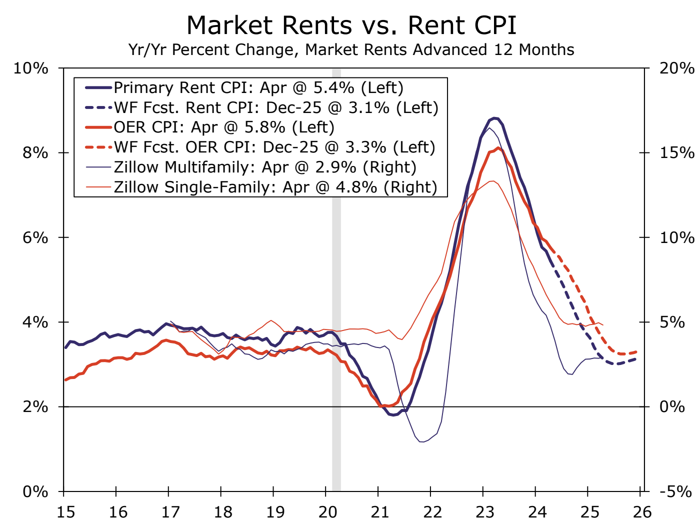
We estimate there remains significantly more shelter disinflation in the pipeline. Not only are private-sector measures of apartment rents running below pre-pandemic rates, but the apartment vacancy rate, which has historically led CPI rent of primary residence by ~3-4 quarters, has yet to peak this cycle. The Bureau of Labor Statistics' New Tennant Rent Index—a research series designed to measure what prices renters would face if they changed units every period, similar to private sector measures of "spot" rents—points to rent of primary residences slowing to less than 3% over the next year (Figure 6). Owners' equivalent rent (OER) will likely be more difficult to rein in given the structural shortage of single-family housing and elevated interest rates that are keeping some would-be buyers renting. However, with single-family units under-represented in OER relative to the owner-occupied stock, OER growth is still likely to be weighed down by softening in the multifamily market. We look for the 12-month change in primary rent growth to slow from 5.7% in April to around 3.0%-3.5% next summer, with rent of primary residences slowing more sharply than OER (Figure 7).

Figure 6




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

Figure 7

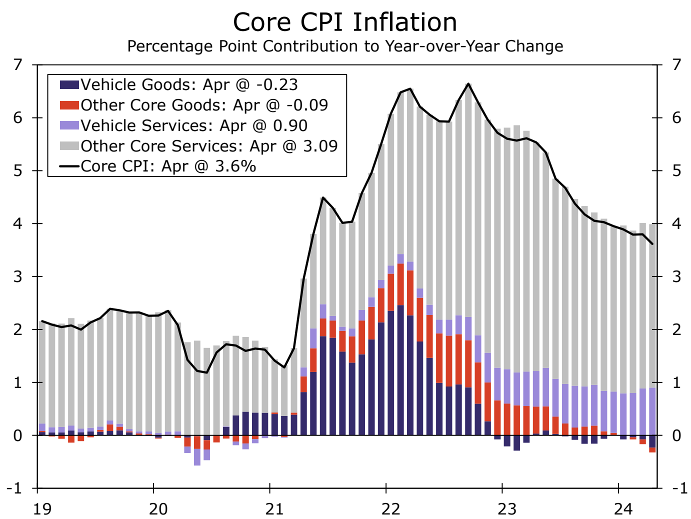



Source: U.S. Department of Labor, Zillow Inc. and Wells Fargo Economics

Slower shelter inflation will go far in reducing core CPI over the next year given its sizable weighting, but a moderation in motor vehicle insurance will also go a long way. Motor vehicle insurance has contributed 0.6 percentage points to the 3.4% rise in the overall CPI over the past year—the largest contribution since 1976. When combined with maintenance & repair and fees, vehicle-related services in total have contributed nearly one percentage point to core CPI inflation since last April (Figure 8). Yet motor vehicle insurance pricing looks set to ease over the second half of the year. Premiums as measured by the CPI now have risen more than used and new vehicles as well as parts & equipment since early 2020 (Figure 9). With insurance rates more adequate to cover costs and industry profitability improving over the past few quarters, we believe the monthly pace of motor vehicle insurance inflation as per the CPI has likely peaked, and a more moderate pace of increases lies ahead.

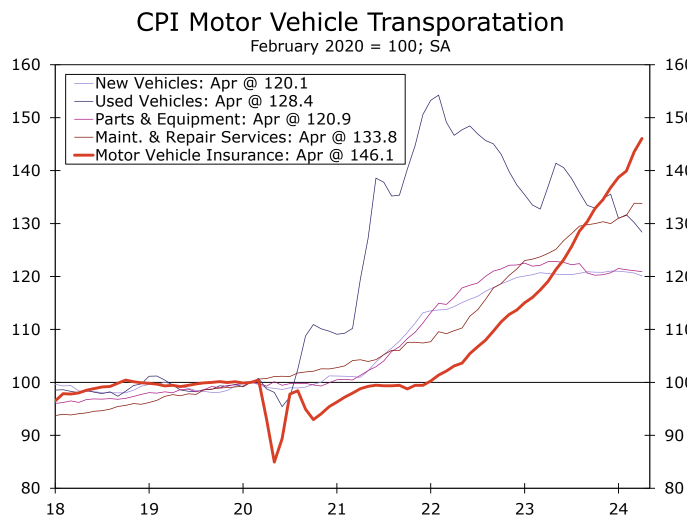
***A moderation in motor vehicle insurance will also go a long way in giving the Fed "greater confidence" that inflation is returning to target.***

Figure 8




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

Figure 9




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

The additional softening in shelter inflation and lessening need for car insurers to raise premiums would have a more limited impact on reducing PCE inflation, but these dynamics should also help core PCE inflation grind lower in the months ahead. Nonetheless, core PCE inflation is likely to continue to run above the Fed's target, with the three-month annualized rate not slipping below 2.5% until the early fall. Such tentative signs of further progress are likely to keep the FOMC cautious about easing the fed funds rate.

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