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Economics Group

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December CPI Rises on Gasoline and Broad Gains in the Core

Consumer price inflation rose 0.3 percent in December on an increase in gasoline prices but also a solid 0.2 percent rise in core inflation. Inflation pressures are building, but not fast enough to alarm the Fed.

Energy Recovery Brings CPI Back Above 2 Percent

Coming in line with expectations, CPI inflation rose 0.3 percent in December. Headline CPI is now running above 2 percent for the first time since mid-2014, when the 2014-2016 collapse in oil prices began. As expected, gasoline prices were a major driver of December's increase, rising 3.0 percent. Lower natural gas prices and steady electricity prices, however, tempered the overall gain in energy costs.

Food prices were unchanged for a sixth straight month, but the flat headline continues to mask the divergent trends in prices for food bought for at-home consumption and eating out. Prices for food at home are down 2.0 percent over the past year amid declines across all major grocery categories, most notably a 5.4 percent drop in prices for meats, poultry & eggs. Prices for food away from home, on the other hand, continue to rise, but the pace has moderated in recent months.

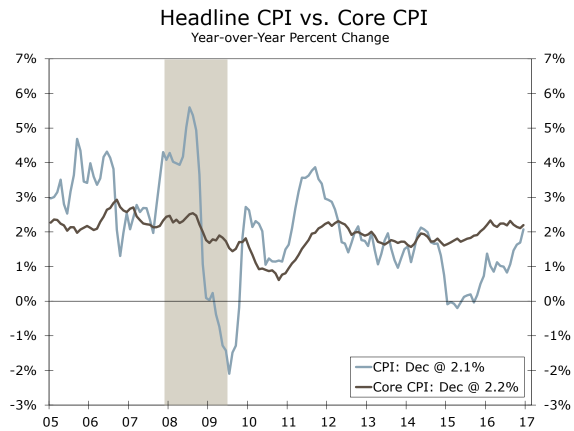
Outside of food and energy, prices continue to gradually increase. The core index rose 0.2 percent last month, bringing the year-over-year rate back up to 2.2 percent. Gains were fairly widespread, but once again were driven by the service sector. Core services inflation rose 0.3 percent in December on a rise in shelter costs of the same magnitude. Transportation services also provided a notable boost, increasing 0.6 percent on higher costs for motor vehicle insurance and airline fares. Out-of-pocket costs for medical care services edged up 0.1 percent last month and 3.9 percent over the past year.

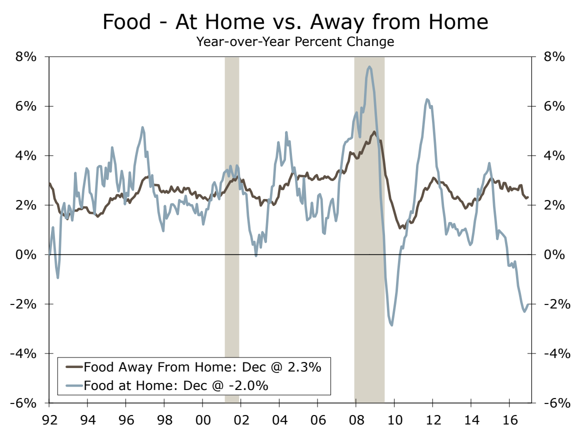
Pricing power in the goods sector remains more limited, but showed some improvement in December. Core goods prices were flat last month after declining 0.6 percent over the past year. A 0.7 percent drop in apparel prices offset gains in vehicle prices, medical goods, alcohol and tobacco.

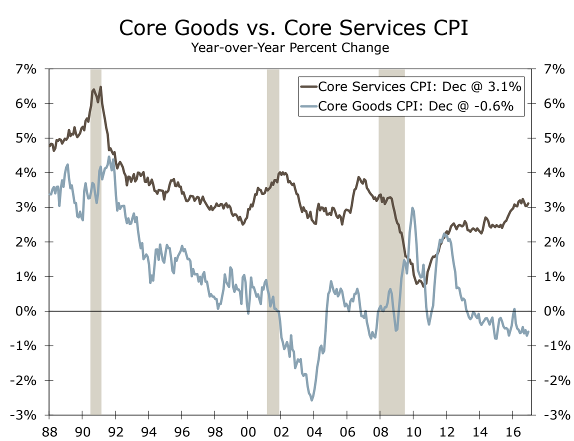
Gradual Gains in Core Inflation on the Horizon

Despite only temperate gains in core inflation over the past few months, we expect strengthening in the year ahead. Unit labor costs are rising as average hourly earnings, up 2.9 percent over the past year, are increasing at the fastest pace of the expansion and productivity growth remains tepid. As the labor market continues to tighten, we expect businesses, particularly in the labor-intensive service sector, to pass on a greater share of cost increases and generate higher inflation.

The pickup in core CPI, however, should remain fairly gradual and should not incite FOMC officials to ratchet up the pace of tightening currently outlined. The more closely watched core PCE deflator remains below 2 percent and, while also anticipated to rise this year, is not expected to breach the Fed's target until early next year. With consumer inflation expectations struggling to rebound and market based measures of inflation compensation still low relative to a few years ago, the Fed will likely remain cautious on the inflation front.







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

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