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Economics Group

WELLS FARGO SECURITIES

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CPI Inflation Remains Tame in June

As financial market focus intensifies over the price environment, CPI inflation came in below consensus expectations in June, reinforcing the Fed's interest as they evaluate future monetary policy tightening action.

Another Soft Month

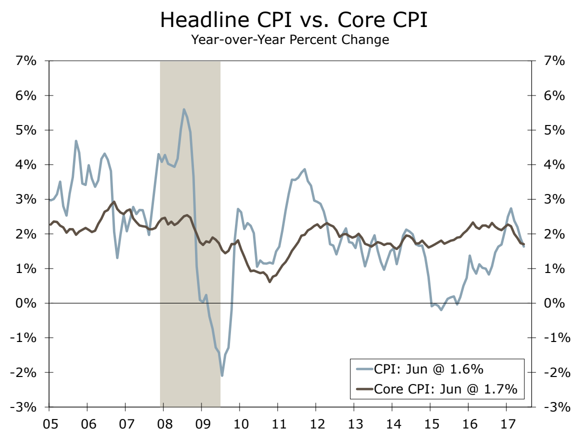
On balance, consumer inflation has registered soft performances over the prior four months and June was no exception as headline Consumer Price Index (CPI) was unchanged. The flat monthly performance was lower than the consensus expectation, and reinforces the view that the price environment exhibits little upward momentum as we enter the second half of the year. Year-over-year, headline CPI has steadily declined from its 2.7 percent recent high in February to its current reading of 1.6 percent.

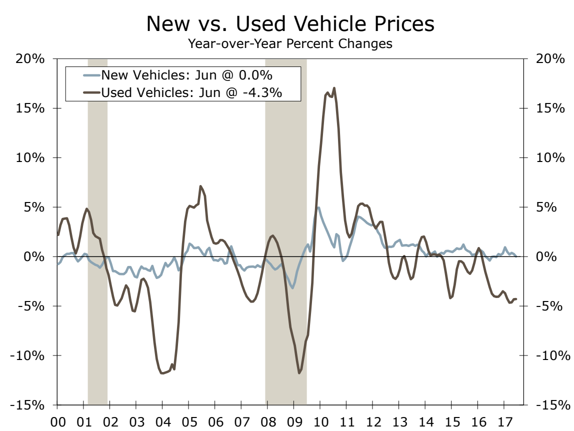
Looking at the two components that can heavily influence the headline, the energy index declined for the second straight month, -1.6 percent, as all three component indices fell. The food index was unchanged on the month, after registering gains over the previous five months.

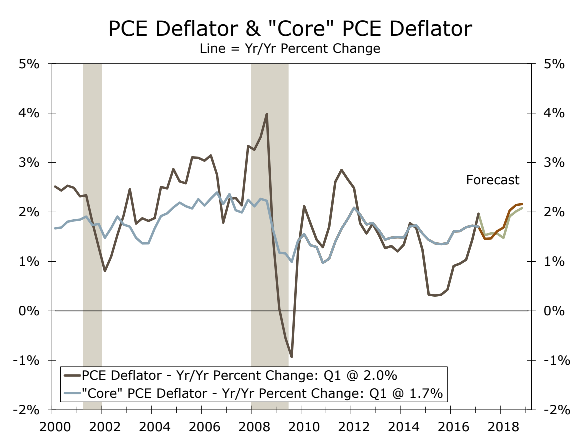
Excluding food and energy, the core CPI rose 0.1 percent on the month, the third consecutive increase at that below trend pace. A perennial group of components accounted for the softer-than-expected gain with apparel declining for the fourth straight month, new & used cars falling for the sixth consecutive month, airfares contracting for the third straight month, and wireless services down for the fourth consecutive month. That said, some of the larger components of core CPI saw larger price gains, including rent and owners' equivalent rent both rising 0.3 percent and medical care services also advancing 0.3 percent on the month. The three month annualized rate of core CPI firmed to a 1.0 percent pace, but remains below the 1.7 percent year-over-year pace and, therefore, suggest there is little upward pressure on core consumer inflation as Q3 unfolds.

Inflation Performance Takes Pivotal Role to Future Rate Hikes

At this past week's monetary policy testimony before Congress, Chair Yellen reiterated the Fed's view that the "recent lower reading on inflation are partly the result of few unusual reductions in certain categories of prices." Today's report placed more pressure on that view as a broad base of components shows little sign of let up. That said, officials did cut their 2017 headline and core PCE deflator projections–their preferred measures of consumer inflation–in the June economic outlook (down to 1.6 percent and 1.7 percent year-over-year, respectively, for Q4). We too have recently lowered our consumer inflation projections, taking headline and core CPI down to 1.8 percent and 1.9 percent year-over-year, respectively, in Q4 (we also cut our headline and core PCE deflator projections to 1.6 percent year-over-year each in Q4). Our updated forecasts generally agrees with Fed officials' sentiment that recent weakness should not be extrapolated into the second half of the year, but that any gains are also likely to be limited. There is a lot of runway left before the December FOMC meeting where we believe the Fed may be in position to hike interest rates again, but a return to a quickening pace of inflation is critical to that call.







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

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