



Economics Group

Sarah House, Senior Economist
sarah.house@wellsfargo.com • (704) 410-3282

August CPI: No Need to Batten Down the Hatches for Inflation

Consumer prices rose 0.2% in August, but moderated to 2.7% on a year-ago basis as gains in energy have eased. Core inflation came in a bit soft, but the trend remains gradually higher and should keep the Fed on track.

Inflation Remains Within Fed’s Comfort Zone

August consumer price inflation came in a bit softer than markets were expecting, with headline CPI increasing 0.2% and the core advancing 0.1%. The modest gain in core inflation comes on the heels of a strong print for July (0.24% before rounding), and does not shake our confidence that the underlying trend in inflation remains upward given rising input costs, including labor.

That said, core inflation’s climb is likely to be gradual as underscored by today’s report. For example, core goods prices fell for the first time in three months, down 0.3%. Apparel was the largest drag in this segment (down 1.6%), and hints at renewed downward pressure on core goods prices in the coming months from the recent strengthening in the dollar.

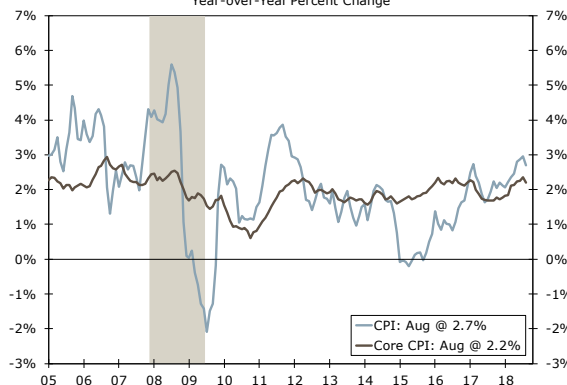
Tariffs, of course, remain an upside risk. Consumer goods would be impossible to avoid if the tariffs on an additional \$200 billion from China go into effect, but given that the amount of items at risk equate to less than 2% of consumer spending, and contracts or demand concerns may lead importers to absorb at least some of the tax, the impact on inflation would still be rather small.

Core services inflation softened relative to July, increasing 0.2%. The weaker gain stemmed from declines in medical care as prices for physician services remain under pressure and hospital prices edged down. Yet costs for housing and transportation services continue to rise. In addition to transportation services, vehicle prices rose for a third straight month. Prices could get a further boost from replacement demand following Hurricane Florence, similar to prices after Hurricanes Harvey and Irma last fall.

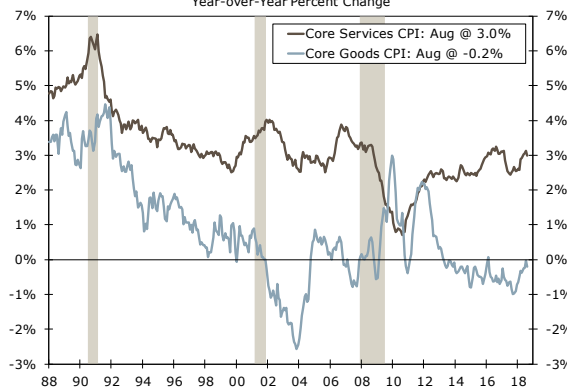
Where we see more risk of a near-term slowdown is outside the core index. While a 1.9% increase in energy prices helped lift the headline in August, we expect oil prices to decline through the end of the year, before rising again in 2019. Food prices ticked up 0.1% last month as the cost of eating out rose 0.2%. Yet food-related commodity prices have been declining since May as retaliatory tariffs on U.S. exports and record harvests have increased supply expectations in the United States. With changes in food-related commodities taking about six months to show up at grocery stores, we expect to see prices for food at home to slip again late this year/early next year.

In many ways, the current inflation environment is just what the Fed wants to see. Core inflation has slowly moved back up to levels consistent with the FOMC’s target. Yet there are few signs of inflation blowing far past the Fed’s comfort zone and forcing the Fed to raise rates faster than expected; inflation expectations—especially longer-term views—have been little changed. We see core CPI running around 2.3% through the rest of this year before picking up in 2019.

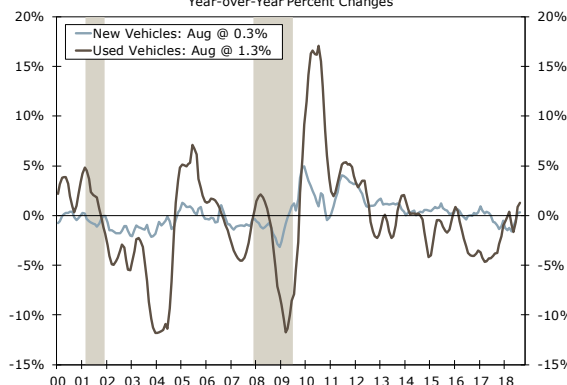
U.S. Headline CPI vs. Core CPI
 Year-over-Year Percent Change



Core Goods vs. Core Services CPI
 Year-over-Year Percent Change



New vs. Used Vehicle Prices
 Year-over-Year Percent Changes



Wells Fargo Securities Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Senior Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Sarah House	Senior Economist	(704) 410-3282	sarah.house@wellsfargo.com
Charlie Dougherty	Economist	(704) 410-6542	charles.dougherty@wellsfargo.com
Erik Nelson	Currency Strategist	(212) 214-5652	erik.f.nelson@wellsfargo.com
Michael Pugliese	Economist	(212) 214-5058	michael.d.pugliese@wellsfargo.com
Ariana Vaisey	Economic Analyst	(704) 410-1309	ariana.b.vaisey@wellsfargo.com
Abigail Kinnaman	Economic Analyst	(704) 410-1570	abigail.kinnaman@wellsfargo.com
Shannon Seery	Economic Analyst	(704) 410-1681	shannon.seery@wellsfargo.com
Matthew Honnold	Economic Analyst	(704) 410-3059	matthew.honnold@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com
Dawne Howes	Administrative Assistant	(704) 410-3272	dawne.howes@wellsfargo.com

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