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Economics Group

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Core Inflation Remains Firm to Start the Year

As energy prices continue to weigh on the headline, core inflation held firm and is running consistent with the Fed's inflation goal.

Low Energy Prices Continue to Offset Gains Elsewhere

Headline consumer prices were unchanged in January for the third consecutive month. Another soft headline reading was to be expected given the recent decline in oil prices. Retail gasoline prices fell 5.5% in January and are down 10.1% from a year ago. Lower costs for electricity and natural gas services also pared back the headline's gain.

Food prices remained resilient, rising 0.2% and marking the third consecutive monthly gain. Recent gains have been driven by the food-away-from-home component, an apparent reflection of the recent strengthening of wage pressures which is pushing up worker compensation. However, with agricultural and livestock commodity prices edging lower over the past few months, food prices are likely to weigh on overall inflation in the near term.

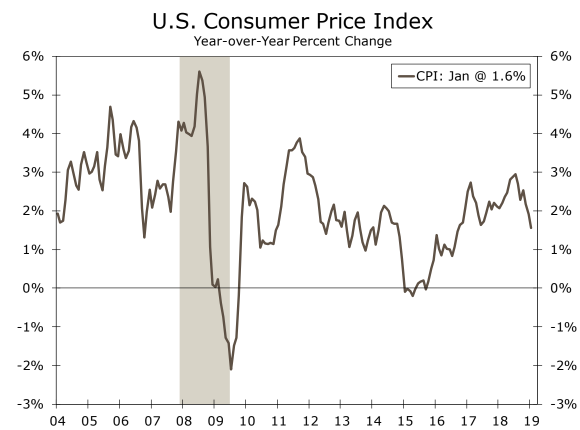
Underlying Trend in Core Inflation Remains Firm

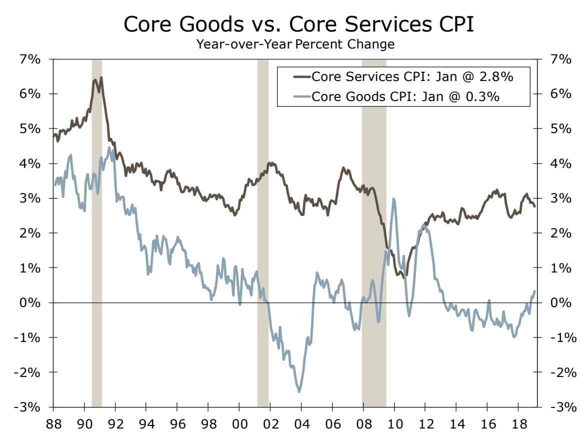
Core prices rose 0.2% in January for the fifth consecutive month, marking the longest streak in 11 years. Core goods prices unexpectedly increased 0.4% on the month, as apparel prices rebounded (1.1%) and new motor vehicle prices posted their first increase since July (0.2%). The trend in core services prices remains firmly intact, increasing 0.2% for the fifth straight month. The indices for rent and owners' equivalent rent both increased 0.3%, while lodging-away-from-home rose 0.5%. Medical care expenses were mixed, with physicians' services increasing 0.4%, prescription drugs unchanged and hospital services down 0.3%.

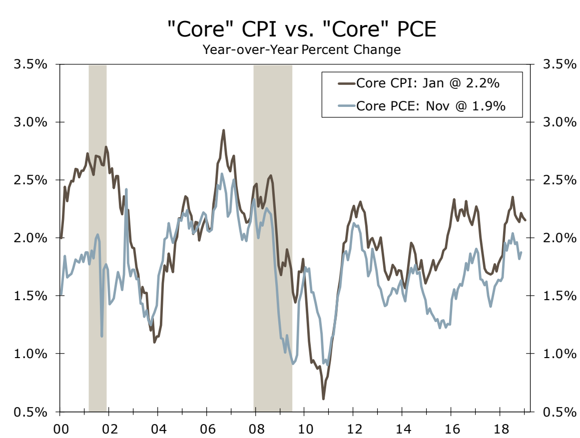
In recent years, January has been the strongest month for core inflation, as seasonal factors did not appear to fully adjust for companies raising prices at the start of the year. Revised seasonals released earlier this week suggest that is less of an issue today, with the average monthly increase in January revised down more than any other month.

Inflation Remains Contained

On net, the overall inflation environment continues to look benign as far as the FOMC is concerned. The 2.2% year-over-year rate of core inflation suggests no immediate pressure on the FOMC to lift rates again soon, but there are few signs of inflation buckling again either. With core inflation at a 2.7% annualized pace over the past three months, the recent trend remains firm. We expect headline inflation will dip further over the next few months due to the drop in both energy and food prices the past few months. Core inflation should move somewhat higher. A weaker dollar is expected to lend some support to core goods prices, while rising labor costs and a willingness among businesses to raise prices should underpin services inflation. We doubt inflation will get out of hand, however, as input cost growth has begun to ease and a modest revival in productivity is keeping higher labor costs manageable.







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

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