

Economics Group

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Soft Inflation Favors Insurance Cuts by the Fed

Both headline and core prices rose 0.1% in May. Core inflation is likely to bounce back modestly in the coming months, but the overall trend remains tame and supports the case for “insurance” cuts by the Fed.

Echoes of 2017 Core Inflation Soft Patch

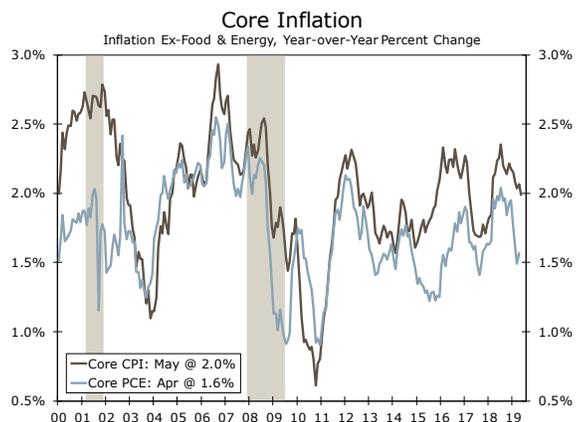
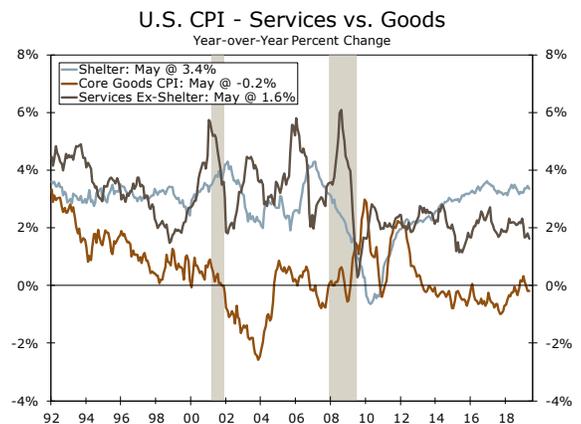
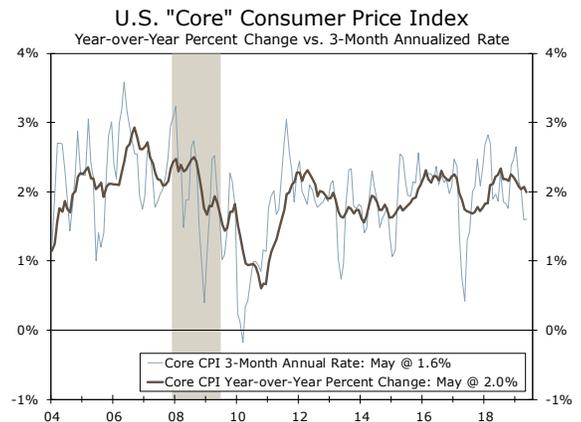
Inflation remained tame in May, with the Consumer Price Index advancing just 0.1%. The headline was held down by a 0.6% drop in energy prices as costs for gasoline, electricity and gas services all fell. Food prices, in contrast, rose 0.3% amid increases at both grocery stores and restaurants, and are up 2.0% over the past year. Nevertheless, the renewed weakening in energy prices sent headline inflation down a tick to 1.8% on a year-ago basis.

Inflation, excluding food and energy, was also soft in May. The core index increased 0.1% for a fourth consecutive month (0.11% before rounding). On a three-month annualized basis, core prices are increasing at the slowest pace in about two years.

Similar to that period, the recent weakness appears to be due in part to methodology changes, most recently apparel prices—as compared to wireless services in 2017—which suggests the current soft patch exaggerates the trend. Shelter costs also slowed during the late spring of 2017, as was the case in May. The modest price increase in shelter—up 0.2%—looks like payback for the past two months’ run of robust 0.4% gains. Weakness was concentrated in rental housing, but with vacancies near multi-decade lows, we suspect the trend is not materially softening. Ex-shelter, services inflation held up, with medical services prices increasing 0.5% and airfares rebounding 2.0%.

Services continue to be the primary driver of core inflation, spurred by the tight housing and labor markets. The deflationary impulse from core goods eased up a bit in May, however, with the index declining just 0.1%. Apparel prices were flat after two months of large declines, while household furnishing prices were up 0.3%. The impact from tariffs remains minimal thus far with the Trump administration directing tariffs largely to intermediate goods. Only a few finished consumer goods categories have been impacted, most recently furniture and bedding (up 2.4% year-over-year vs. an average decline of 1.1% over the past decade), but this category accounts for less than 1% of the CPI. Used car prices also fell sharply again in May in continued contrast to auction prices.

Overall, the inflation environment remains benign. The Fed’s preferred inflation measure, the core PCE deflator, had slowed more noticeably than core CPI early this year due in large part to the way in which healthcare and investment services are accounted for. Yesterday’s report on producer prices, the source data for these categories in the PCE deflator, showed both categories picking up again. As a result, core PCE is on track to rebound, but the tepid rate of core CPI inflation points to the Fed’s measure merely catching up, and not a sustained acceleration. We expect PCE inflation will continue to struggle to meet the FOMC’s target, contributing to the FOMC’s willingness to deploy “insurance” rate cuts later this year.



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