

Flash Note

US CPI update – Costlier T-shirts

The underlying inflation pick-up is not as bad as it looks

Pictet Wealth Management - Asset Allocation & Macro Research | 14 February 2018

January core CPI inflation was firm, as the index rose 0.35% m-o-m. The y-o-y print was unchanged at 1.8%.

A sharp increase in apparel costs (1.7% m-o-m) drove much of the increase, with some notoriously-volatile sub-indices, such as leased cars, providing a further boost.

In our view, underlying price pressures are not as bad as the high core inflation print suggests. But the trend is definitely for stronger core inflation as US growth remains solid.

The CPI will likely validate many Fed officials' view that continuing the tightening cycle is appropriate. We still expect four rate hikes this year, more than the Fed's current plans for three.

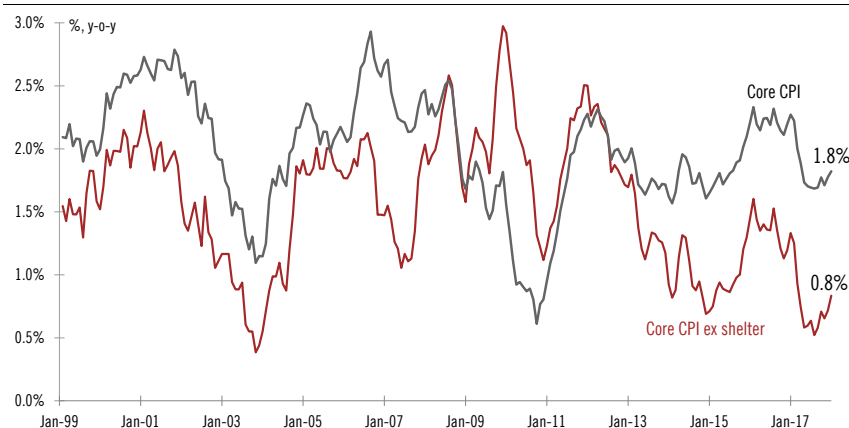
In January, there were bargains if you were buying a new car, flying, staying at a hotel or going to college. But it was not a great month if you were buying clothes, purchasing car insurance, leasing a used car, being admitted to hospital, or eating at a burger restaurant (and even worse if you added extra tomatoes, they were up... 16.5% y-o-y in January).

All in all, January's seasonally-adjusted core CPI rose a **very solid 0.35% m-o-m**, up from 0.24% in December and 0.12% in November. **The y-o-y print remained at 1.8%** (due to base effects).

Was inflation that bad? Probably not. January is always a difficult month to gauge because of the **seasonal adjustment**: the sharp increase in apparel prices (1.7% m-o-m, the biggest monthly increase since February 1990) appears particularly suspicious and may fall back again next month. The other big gainers were **car insurance** (+1.3% m-o-m), **hospital services** (+1.3%), and **leased cars and trucks** (+1.3%). All of these are particularly volatile elements, so it may be just a matter of **unfortunate congruence**. Meanwhile, rent prices continued to show robust growth (+0.3% m-o-m). The price of a haircut – a good anecdotal gauge of underlying inflation – rose 0.5% m-o-m, but the y-o-y print was a **still-measured 1.8%**, in line with the core CPI print.

While there are signs of **inflationary pressures firming**, and of **medical costs finally accelerating**, we think January's core CPI data exaggerates the underlying trend. **We maintain our annual forecast of 2.1% core CPI inflation in 2018**, with a slight upside risk (core CPI rose 1.8% in 2017).

Chart 1: Core CPI inflation, % y-o-y (and core CPI ex shelter)



Source: Pictet WM-AA&MR, Thomson Reuters.

AUTHOR

Thomas COSTERG
tcosterg@pictet.com
+41 58 323 3963

Pictet Group
Route des Acacias 60
CH - 1211 Geneva 73
www.pictet.com

Worth watching what happens at burger restaurants

As noted above, we are inclined to believe that the 0.35% m-o-m core CPI print exaggerates the underlying rise in inflation pressures, even though we believe that **core CPI inflation should increase gradually in the coming months** (and exceed 2% on average this year) as GDP growth picks up (our 2018 forecast is for 3% annual growth).

We note there are still many CPI categories exhibiting ongoing weakness, with **structural drags from globalisation and technology still at play**. For instance, the price for household appliances, which are mostly imported, was down 0.6% m-o-m (-1.4% y-o-y) in January. The price of telephone services was down 0.1% m-o-m (-6.6% y-o-y).

This being said, signs that **labour market tightness** is starting to feed through to some prices (and are being passed on to consumers) are also worth watching. Perhaps the area that deserves the closest attention is the 'food away from home' (i.e., restaurant) category, which rose 0.4% m-o-m in January (and 2.5% y-o-y). In particular, 'limited service meals and snacks' rose 0.5% m-o-m, and the **y-o-y print was a robust 2.9%**. We will monitor this category going forward as it may be a source of **upside risk to our inflation forecast**, particularly if the labour market for service jobs is tighter than we expect.

Meanwhile, the drop in the new cars sub-index (-0.1% m-o-m) is a potential **'red flag' for the car market**, as demand is stagnating and it seems car dealers are becoming more aggressive with discounts. As an aside, the increase in leased car prices may be due to rising financing costs, rather than stronger demand. As the Fed increases rates, loan providers pass on the increase in funding costs to consumers. More **aggressive discounts on new cars** in coming months are a key **downside risk** to our inflation forecast.

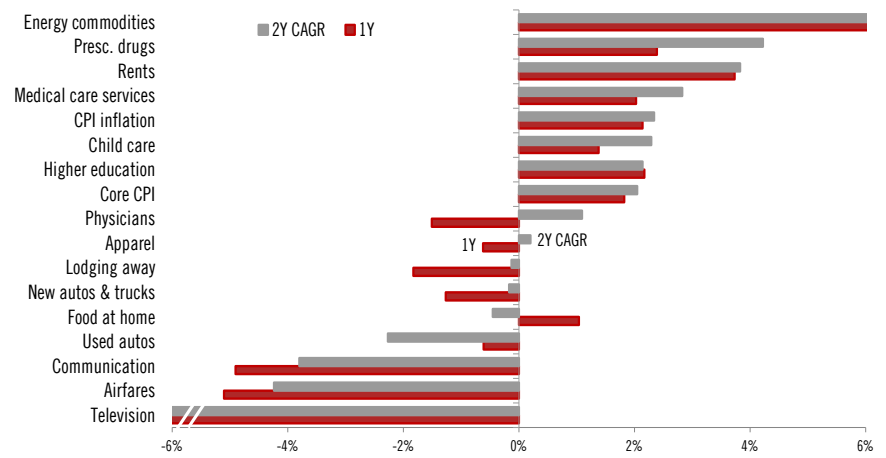
Federal Reserve outlook post-CPI data

We think the latest core CPI data are **unlikely to move the needle** much regarding Fed policy. In fact, even before the CPI's release, most Fed officials were already convinced about the **need to continue tightening** given the cyclical pick up in US GDP growth and the risk of **additional fiscal stimulus** from Washington DC. The sharp increase in core inflation is therefore likely to just **'validate' the Fed's existing (and more hawkish) stance**.

We think the Fed's focus is really on the **GDP picture**, which is now looking **much better than the Fed expected** at its last meeting in December. We think the Fed will **revise its 2018 growth forecast up**, and therefore might move up its dot plot at its March meeting to four quarter-point rate hikes this year from three.

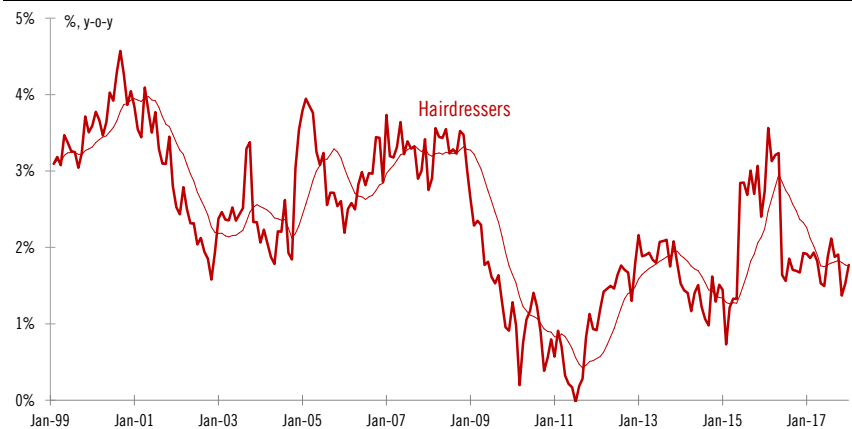
Our own forecast is still for four rate hikes this year and two next year.

Chart 2 : Selected CPI sub-indices, % y-o-y (and 2Y CAGR)



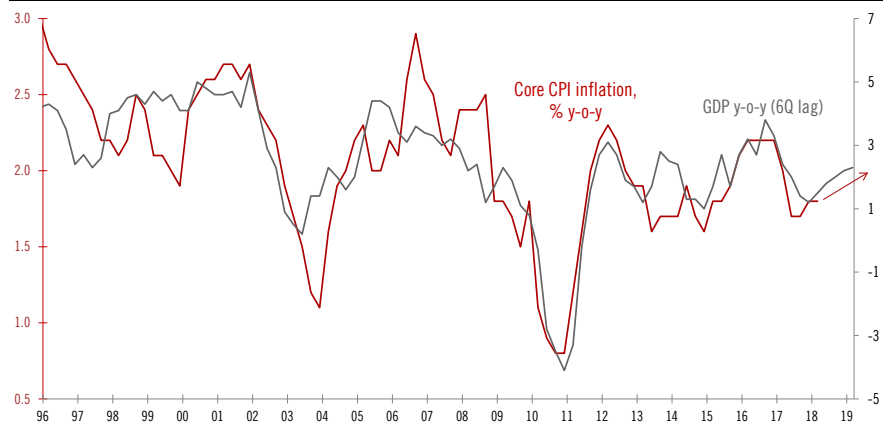
Source: Pictet WM-AA&MR, Thomson Reuters.

Chart 3 : CPI sub-index: hairdressers, % y-o-y



Source: Pictet WM-AA&MR, Thomson Reuters.

Chart 4 : Core CPI (% y-o-y) versus lagged GDP growth (% y-o-y)



Source: Pictet WM-AA&MR, Thomson Reuters.

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