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US Economics

CPI Inflation: Higher Than Expected

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Core CPI inflation surprised to the upside in January, and underlying details point to a solid reading for this month's core PCE index. Core goods prices were particularly strong, but appear to reflect—at least in part—lingering seasonality issues around the turn of the year.

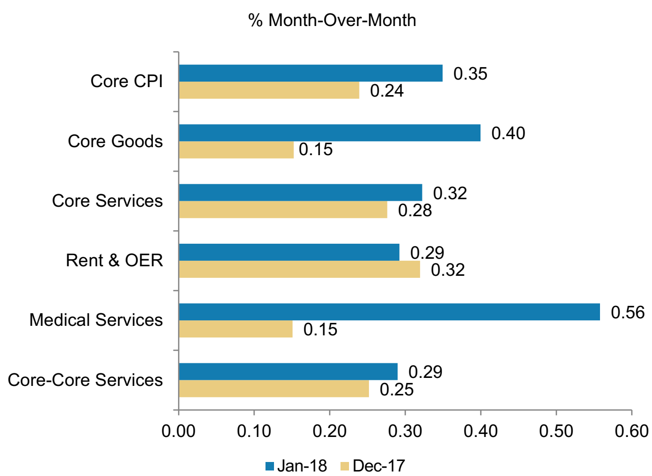
			% Month/Month			
Key CPI readings	Cons.	MS	Jan-18	Dec-17	Nov-17	6m avg
Headline CPI	0.3	0.33	0.54	0.20	0.34	0.34
Core CPI	**0.2**	**0.22**	**0.35**	**0.24**	**0.12**	**0.21**
3 decimal			0.349	0.239	0.121	
1M annualized			4.3	2.9	1.5	
3M annualized			2.9	2.3	1.9	
6M annualized			2.6	2.2	2.0	
Core Goods			0.40	0.15	-0.13	0.02
Core Services			0.32	0.28	0.18	0.27
Rent & OER			0.29	0.32	0.27	0.29
Medical Services			0.56	0.15	-0.06	0.20
Core-Core Services			**0.29**	**0.25**	**0.14**	**0.26**
1M annualized			3.5	3.1	1.7	
3M annualized			2.8	2.7	2.7	
6M annualized			3.2	2.9	2.4	

Core Goods Drive Upside, But Seasonality Lingers

Core CPI surprised to the upside in January, rising 0.349% month-over-month vs. Morgan Stanley's 0.22% estimate and Bloomberg consensus of 0.2%. That result kept the year-over-year rate at 1.8%, overcoming a tough base effect from January 2017.

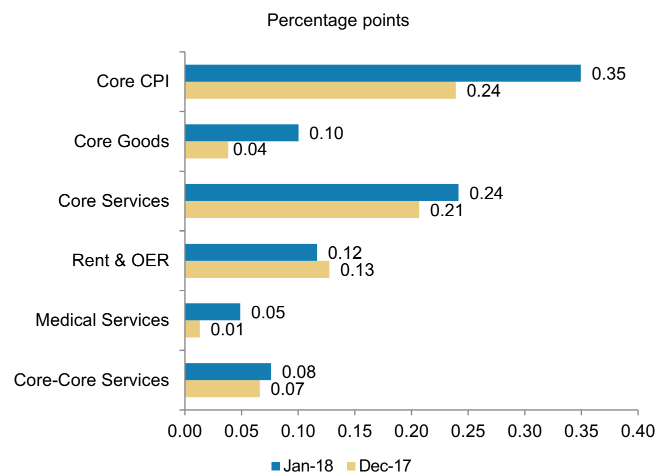
Upside was driven by core goods, which rose 0.40%M in January vs. 0.15% in December, the biggest increase since October 2009 and a rare respite from deflation in that category (Exhibit 1 and Exhibit 2). Strength in core goods was broad-based, but apparel stood out with a 1.7% gain—the largest since 1990 amidst a general deflationary trend—that contributed 0.06pp to monthly core CPI. New vehicles prices, on the other hand, fell in January after what appears to have been a boost from the effects of last year's hurricanes.

Exhibit 1: Month-Over-Month Growth in Major Core CPI Components



Source: Bureau of Labor Statistics, Morgan Stanley Research

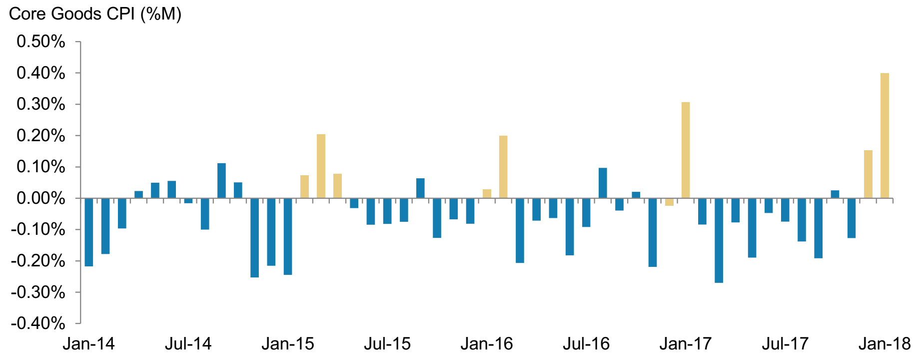
Exhibit 2: Contributions to Month-Over-Month Growth in Core CPI



Source: Bureau of Labor Statistics, Morgan Stanley Research

While core goods strength was broad-based, it also appears to reflect lingering seasonality issues. Since 2015, seasonally-adjusted core goods growth around the turn of the year has considerably outpaced prior and subsequent trends (Exhibit 3). Growth averaged +0.14%M in February/March 2015 vs. a prior six-month average of *negative* 0.11%M; +0.11% in January/February 2016 vs. a prior average of -0.06%; and 0.14% in December 2016 and January 2017 vs. a prior average of -0.07%. This trend appears to have continued this year, with core goods CPI rising 0.15% in December and 0.40% in January compared to a six-month moving average of -0.09% through November. **This seasonal trend points to weaker core goods prints ahead.**

Exhibit 3: Core goods prices appear to reflect lingering seasonality issues



Source: Bureau of Labor Statistics, Morgan Stanley Research

Core services inflation also picked up, rising 0.32% in January vs. 0.28% in December and contributing 0.24pp vs. 0.21pp (Exhibit 2). The acceleration in core services was driven primarily by medical services, which carries a 7% weight in core CPI and rose 0.56% vs. 0.15%. Heavily-weighted rent and owners' equivalent rent components moderated to 0.29% from 0.32%. Our forecasts see a gradual deceleration in rents weighing down on overall inflation throughout 2018, after recently elevated readings likely reflected effects of the recent hurricanes on demand for shelter. When viewed with the deceleration in new vehicle prices, **hurricane effects appear to be gradually receding from the data, clearing the way for cleaner reads on core inflation in the coming months.**

The key downside surprise in core services was in hotel prices, which dropped 2.0% and shaved 0.02pp off core CPI. Hotel prices have been particularly volatile in the CPI data, so we'd be hesitant to extrapolate January's reading forward.

Excluding the rent and medical services categories, **"core-core services"—our preferred gauge of domestic price pressures—picked up to a solid 0.29% from 0.25%**, above its six-month average of 0.26%. Core-core services has been a strong contributor to inflation since August 2017, pointing to some **momentum in underlying domestic price pressures**.

Translating CPI into PCE

Incorporating this month's CPI inputs, our preliminary forecast for January core PCE inflation is 0.25%M (0.245%, rounding down to 0.2%), **holding the year-over-year rate at 1.5%**. Headline PCE inflation should rise 0.35%M (rounding down to 0.3%), lowering the year-over-year rate to 1.6% from 1.7%.

Exhibit 4: Translating CPI into PCE

	Jan-18	Weight in:	
	%M	Core CPI	Core PCE
Core Goods	0.40	25%	26%
Rent & OER	0.29	40%	18%
Medical Services (CPI)	0.56	9%	3%
Core-Core Services	0.29	26%	37%

Note: Core PCE weights don't sum to 100% given that PCE includes inputs from the PPI (not listed here).
Source: Bureau of Labor Statistics, Bureau of Economic Analysis, Morgan Stanley Research.

The driver of our core PCE forecast is the core-core services gauge, which rose 0.29% in January and carries a 37% weight in core PCE. The strength in core goods will also contribute meaningfully to core PCE this month (Exhibit 4)

Rental prices and owners' equivalent rent (OER) only carry a ~18% weight in core PCE (vs. 41% in core CPI), so the relative softness in rents in the CPI has a more muted effect when translated into the PCE price index this month.

Lastly, the exceptional rise in medical services prices within the CPI hardly factors into PCE, as most PCE healthcare inputs are sourced from the Producer Price Index (to be released tomorrow, Thursday 8:30 AM ET). PCE healthcare inflation has been subdued at a ~0.1% monthly pace, as reimbursement rates have been capped by law at very little growth.

We will further hone our forecast for January core PCE inflation following the release of the PPI report tomorrow.

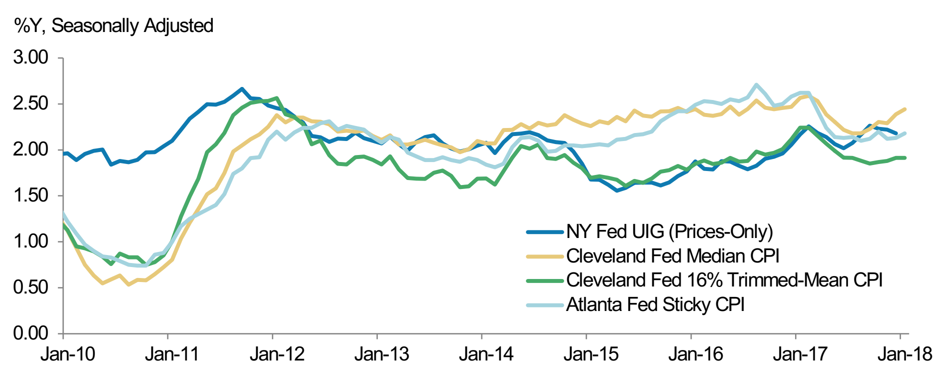
Measures of Trend Inflation

Overall, trend inflation appears to have firmed somewhat in recent months. The three-month annualized rate of growth in core CPI rose to 2.9% in January from 2.3% in December, and six-month annualized growth rose to 2.6% from 2.2%.

Most alternative measures of trend inflation have also been on a gradual upward path. In January, the Cleveland Fed's median CPI rose 0.05pp to 2.4%Y while the trimmed-mean CPI was flat at 1.9%Y. The Atlanta Fed's sticky CPI rose 0.05pp to 2.2%Y. The New York Fed's Underlying Inflation Gauge (UIG), which produces two separate measures of trend inflation, is slated for release this afternoon but has decelerated in recent months, from 2.3%Y in September to 2.2% in December (Exhibit 5).

More broadly, we expect core inflation to continue to be held back by longer-term factors such as technology and depressed goods prices, limiting the effects of a domestic Phillips curve (see US Economics & Rates Strategy: What's Eating Away at Inflation?). These dynamics will be pushing against a lower trade-weighted dollar path since early 2017, which should provide upward pressure. We expect the attainment of the Fed's 2% inflation goal to be a tough slog, but FOMC participants will likely look favorably upon the recent inflation data and conclude that their forecast for 2018 (1.9% core PCE 4Q/4Q) remains intact.

Exhibit 5: Measures of Trend Inflation



Source: Federal Reserve Banks of New York, Cleveland and Atlanta, Morgan Stanley Research

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