US Core CPI Defies Hedonics Driven Expectations

U.S. CPI (m/m%; y/y%), January:
Actual: 0.0 / 1.6
Scotia: 0.1 / 1.5
Consensus: 0.1 / 1.5
Prior: 0.0 / 1.9 (Revised from -0.1 / 1.9)

U.S. Core CPI (m/m%; y/y%), January :
Actual: 0.2 / 2.2
Scotia: 0.2 / 2.1
Consensus: 0.2 / 2.1
Prior: 0.2 / 2.2 (Unrevised)

- **US core CPI inflation came in unchanged but higher than both consensus and markets expected at 2.2% y/y.** The yield on the 2 year US Treasury note increased by about 2bps following the report but the whole Treasury curve cheapened by a similar amount. Market-based inflation expectations edged a little higher including the 5y5y inflation swap that climbed a touch to 2.2% and the ten year TIPS break-even rate increased by 2–3 bps. The latter has risen from a low of 1.68% on January 3rd to 1.87% now but is a soft gauge of inflation expectations at best. Broadly speaking, the hard inflation data and the market-based metrics lean significantly in favour of our view that the Fed may have over-reacted to market turmoil in late December among other considerations. More strongly, the activity and inflation readings do not in the slightest way support market pricing for any chance of a rate cut. Inflation pressures remain on a CPI basis with the Fed's preferred core PCE reading due for an update on March 1st. Core CPI typically tracks higher and a reasonable estimate for core PCE inflation is to expect an unchanged resilient 1.9% y/y pace of increase (see chart 1).
- The month-ago core inflation reading was resilient at 0.2% m/m for the fourth consecutive month. The sources of the inflationary pressure exhibited breadth. **In weighted terms, the contributions to year-over-year inflation were heavily skewed to housing but with numerous other categories also contributing (see chart 5).**
- **Many economists had anticipated some influence of hedonic quality adjustments to how prices for various telecommunications services were captured in this report, but the effects were uncertain going in and directionally opposite to what some had anticipated. Simply put, there was no disinflationary influence from the quality adjustments to prices this time around. The weights on the affected categories were quite small in any event such that this influence was more hype than substance.** More on the hedonic adjustments is explained more fully by the BLS here. The affected categories performed as follows:
    - ◊ **Land line telephone services:** prices were up 0.5% m/m seasonally adjusted but with limited influence given only a 0.57% weight in CPI.
    - ◊ **Internet services and electronic information providers:** these prices were up 0.3% m/m SA, but again, they only carry a 0.8% weight in CPI.

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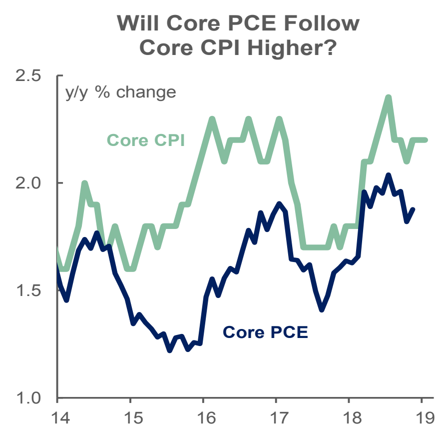
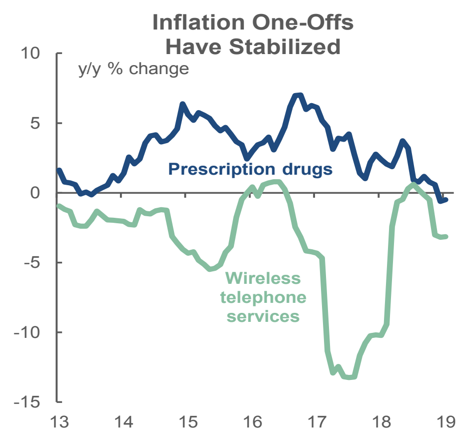
Chart 1



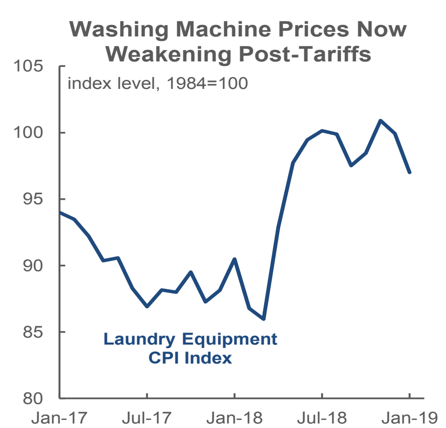
Sources: Scotiabank Economics, Bloomberg.

Chart 2



Sources: Scotiabank Economics, BLS.

Chart 3

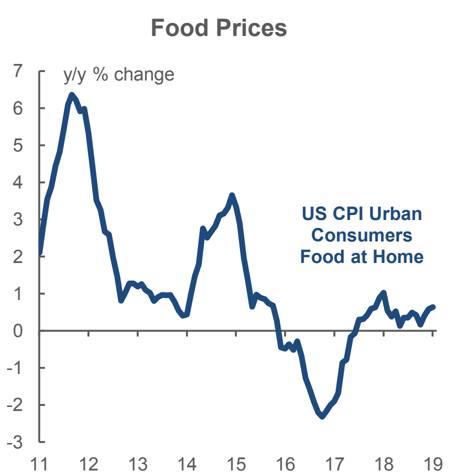


Sources: Scotiabank Economics, Bureau of Labour Statistics.

- ◊ **Cable and satellite television service:** These prices were up 0.2% m/m SA but with just a 1.5% weight in the CPI basket.

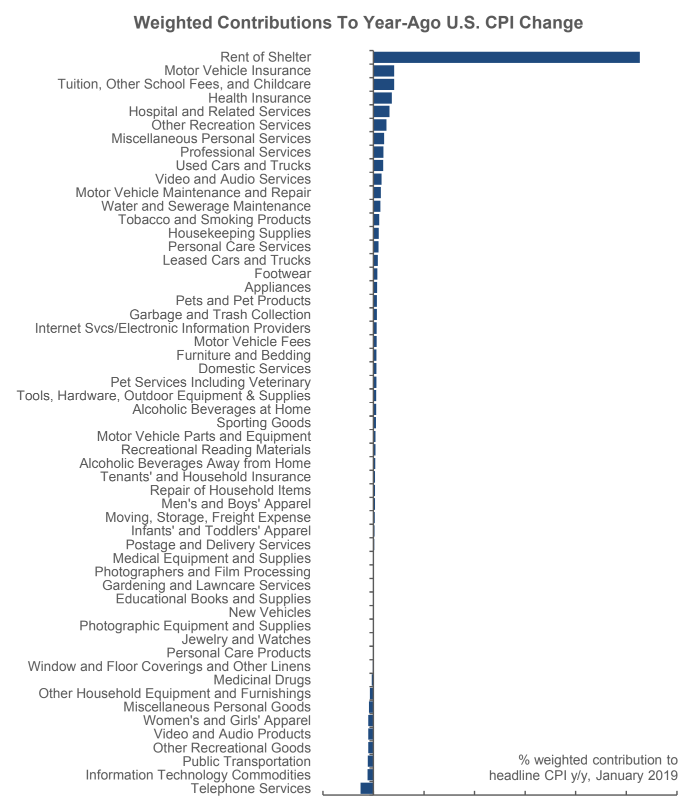
- Prior sources of volatility like wireless telephone services and prescription drugs remain mild drags on headline inflation in year-ago terms but stabilized in January versus December. The tariff pass-through on laundry machines is also stabilizing. See charts 2 and 3.
- **Gasoline prices fell 5.5% m/m and with a 3.7% weight in the basket this knocked 0.2% off the month-ago headline CPI inflation rate.** That explains the zero print for overall CPI in month-ago terms and is something monetary policy should look through. Indeed, total energy prices were a uniform drag across all categories including electricity prices that fell 0.6% m/m and up only 0.4% y/y while natural gas fell 0.3% m/m but is up 4.3% y/y. Total energy prices fell 3.1% m/m (-4.8% y/y) and carry a 7.35% weight in the basket.
- Food price inflation has been very mildly gaining of late. See chart 4.
- **Seasonally adjusted upside influences on the month-ago inflation rate included shelter costs** that were up by 0.3% m/m with about a one-third weight in the basket. Within shelter, rent was up 0.3% (7.9% weight) and owners' equivalent rent was up 0.3% m/m (24% weight). **Also, medical care services were up 0.3% m/m with a 7% weight as physicians' services were 0.4% m/m pricier.**
- Other sources of pressure came from **apparel prices** (+1.1% m/m) but they carry only a 2.96% weight.

Chart 4



Sources: Scotiabank Economics, Bureau of Labor Statistics, Statistics Canada.

Chart 5



Sources: Scotiabank Economics, BLS.