US CPI Eases, But Here's Why The Fed Is Flying Blind On Inflation

U.S. CPI (m/m%; y/y%), February:
Actual: 0.2 / 1.5
Scotia: 0.3 / 1.5
Consensus: 0.2 / 1.6
Prior: Unrevised from 0.0 / 1.6

U.S. Core CPI (m/m%; y/y%), February :
Actual: 0.1 / 2.1
Scotia: 0.3 / 2.1
Consensus: 0.2 / 2.2
Prior: Unrevised from 0.2 / 2.2

- **US CPI decelerated a touch on both headline and core by coming in lower than consensus expected and in line with my estimates for both.** Headline CPI eased to 1.5% y/y and core CPI pulled back to 2.1% y/y. Breadth was mixed. The broad takeaway is that there is nothing really terribly new here to the Fed's narrative.
- **Indeed, who cares about CPI. More seriously, the Fed is arguably flying blind on what is happening to price pressures because the shutdown effects have driven an unusual two-month wedge between freshness of its preferred PCE gauges versus CPI.** I'll therefore wait to reserve judgement on what's happening to inflation as the Fed sees its until we get core PCE gauges for January and February. I find a lot of the commentary on the implications to today's CPI update (and the one before it) ignore Fed-101 in that the CPI is not a terribly good inflation measure relative to the superior PCE gauge that we simply don't have readings for in 2019. To be standing here in March with no inflation data of relevance to the Fed merits caution indeed, but there is still two-tailed risk to that caution.
- Core CPI has decelerated from a recent peak of 2.4% y/y in July to 2.1% now. **I think a significant driver of the deceleration has been pass-through of a strong dollar if it passes through to PCE which is a big caution (more later).** By corollary, this flags uncertainty going forward given how much stronger the dollar has been that we had anticipated over the past year. The broad dollar index sharply appreciated throughout 2018 and then began to wane from December through to the end of January before going on another upward trend since then. Fed estimates suggest that a 10% appreciation in the broad dollar index shaves ½% off core PCE within six months and just over ¼% within one year as the effects dissipate. There are no immediate near-term signs that the broad dollar is going to weaken and so this is a significant risk to our inflation and hence Fed views over H2.
- **For now, the readings support the Fed's contention that there is no immediate source of inflation pressure that merits a response in the face of the Fed's uncertainties that are governing the outlook.** There are also no immediate sources of pressure to adjust policy in the other direction and we'll have to wait for how this translates into the Fed's preferred PCE inflation gauge on March 29th. Core PCE did not peak as high as core CPI last

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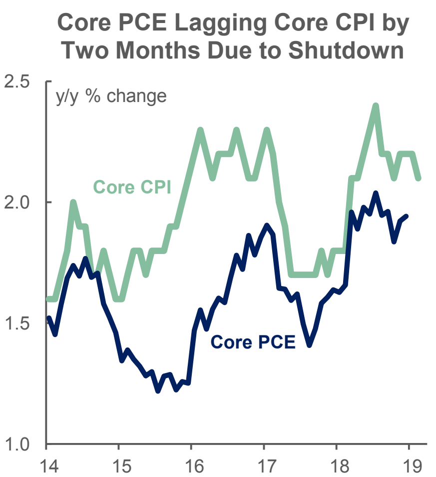
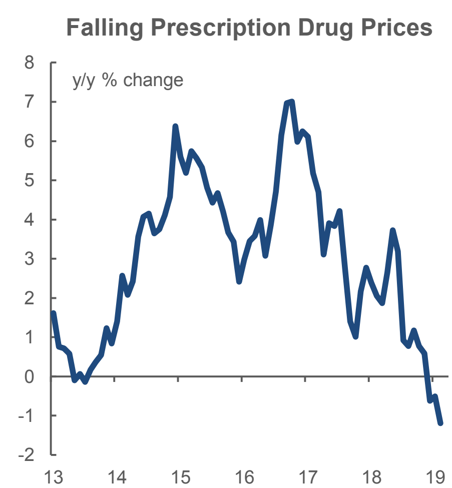
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

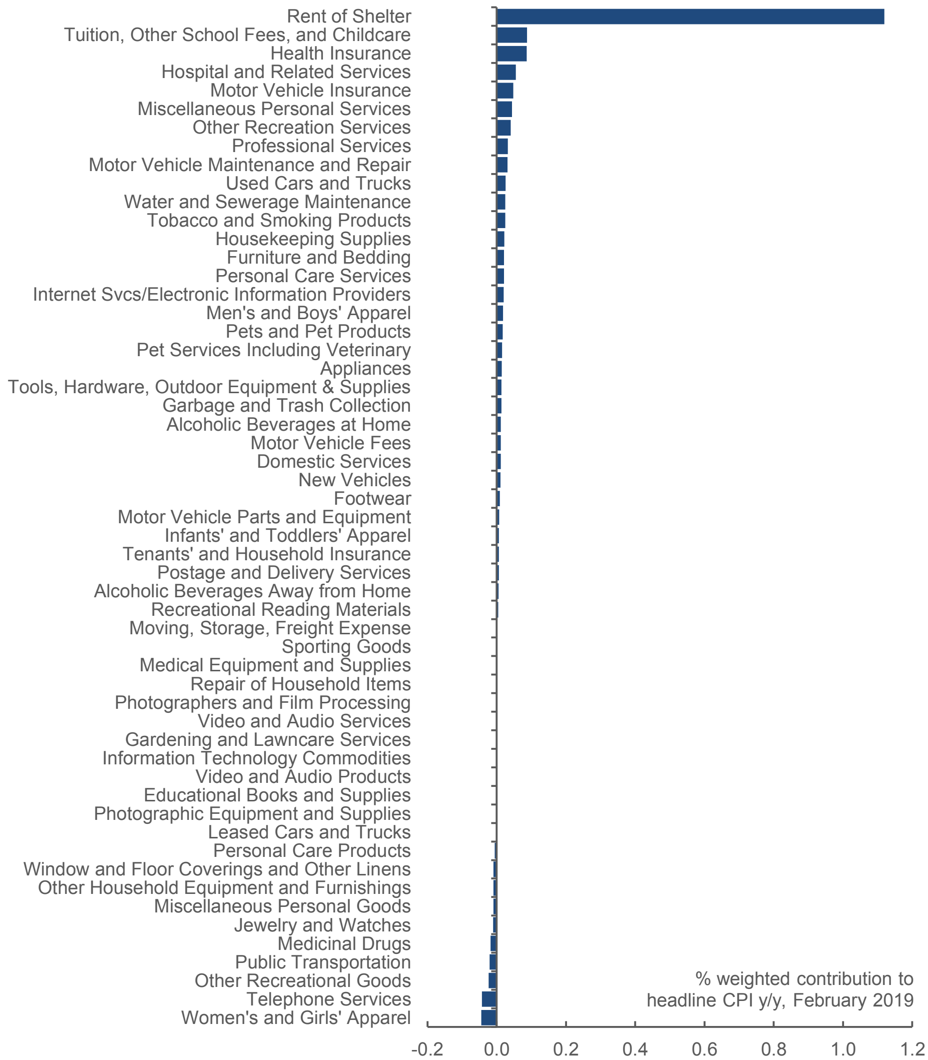


Sources: Scotiabank Economics, BLS.

Fall and may not be as sensitive to the influences upon CPI. For now, CPI matters to TIPS and little else until we get the PCE gauges. The connection between the two price measures is shown in chart 1. There are a lot of measurement differences between the two concepts (e.g. CPI underweights medical care and PCE adjusts weights dynamically as spending patterns shift as opposed to periodic weight adjustments in CPI) and so what happens to CPI doesn't necessarily translate well into PCE. In any event, we still only have PCE up until December thanks to shutdown effects. We need PCE for January on March 29th and then February soon thereafter to more thoroughly judge risks to inflation the way the Fed sees it. Soon after PCE for January and February finally arrives, we'll then be flying blind again as CPI for March arrives and PCE lags again.

- Underlying breadth arguments are mixed. Upside influences to the month-ago price changes came from food/ beverages (+0.4%), apparel (+0.3%), energy (+0.4%), OER (+0.3%). Downsides came from services (+0.1%), recreation (-0.4%), computers (-0.9%), medical care (-0.2%) and transportation (+0.1%). Chart 3 shows the weighted contributions to year-over-year CPI by basket component. For example, rent of shelter is the biggest contributor that is on its own adding a weighted 1.1% to year-ago CPI.
- Overall I don't think today's data changes anything for the inflation outlook. A first half softening isn't surprising but a second half stabilization with possible upward drift is feasible as: output gap effects have lagging positive influences; as real wage gains accelerate; and if the broad dollar stabilizes as a disinflationary influence. The dollar has been a lot stronger for longer than anticipated so its role in driving pass-through arguments to inflation is highly uncertain going forward.
- Prescription drug prices soared in month-ago terms but plunged in year-ago terms (see chart 2). Either way, they carry a modest 1.313% weight in CPI and fell by 1.2% y/y and 1% m/m. That shaves a negligible amount off headline CPI.
- I think there is a similar argument for the mixed influences of auto prices on the month-ago and year-ago readings. New vehicles carry a 3.74% weight and used vehicles are weighted at 2.4%. New increased 0.3% y/y and fell 0.2% m/m while used increased 1.1% y/y and fell 0.7% m/m.

Chart 3 **Weighted Contributions To Year-Ago U.S. CPI Change**



Sources: Scotiabank Economics, BLS.