Mixed US CPI, But The Fed Is Still Flying Blind On Inflation

U.S. CPI (m/m%; y/y%), March:
Actual: 0.4 / 1.9
Scotia: 0.4 / 1.8
Consensus: 0.4 / 1.8
Prior: Unrevised from 0.2 / 1.5

U.S. Core CPI (m/m%; y/y%), March :
Actual: 0.1 / 2.0
Scotia: 0.3 / 2.1
Consensus: 0.2 / 2.1
Prior: Unrevised from 0.1 / 2.1

- US CPI registered a stronger than expected rise in headline pressures but a softer than expected core CPI reading. The slip in core CPI, however, did not have breadth as it was driven by a drop in clothing prices while other components were generally strong. Notwithstanding the update, the Fed is still flying blind on recent inflation in the US economy. There is certainly nothing here to play to the Fed rate cut camp in my view. A rally in US 2 year Treasuries coincided more with Draghi's more dovish remarks than the 8:30amET US CPI print.
- Recall that CPI is not the Fed's preferred inflation gauge. Core PCE is preferred for several methodological reasons you can review here. Core PCE, however, is seriously lagging thanks to the US government shutdown. It was 1.8% y/y in January but we don't yet have February PCE and we just got March CPI and so there is now a two-month lagging interval to the inflation measure that matters to the Fed. On April 29th we'll get both February and March PCE inflation figures at once so the inflation big bang will be at month end. This report just passes the time before then.
- This matters a lot because what happens to core CPI is not necessarily what happens to core PCE. Chart 1 demonstrates this point by way of the time varying differences between the readings, the rough but imperfect correlations and the fact that up to January core PCE was tracking softer than core CPI.
- My early read on the next CPI report points to 1.7–1.8% y/y headline and 2.1% y/y core. This is based on an assessment of shifting base effects, seasonality influences and gas prices. So today's jump in headline CPI and slip in core CPI could see the volatile readings flip around the other direction next time.
- Our house view is to expect a little firmer inflation by year end toward the Fed's 2% goal by the core PCE definition. Among the drivers are the following:
    - We haven't given enough time for the strong push into excess aggregate demand on the back of strong growth to influence inflation (see chart 2). The Phillips curve is not dead. The US abruptly moved into excess demand over the past year and growth for Q1 is exceeding gloomy views by so far remaining above potential GDP growth and thus pushing the US further into excess demand.

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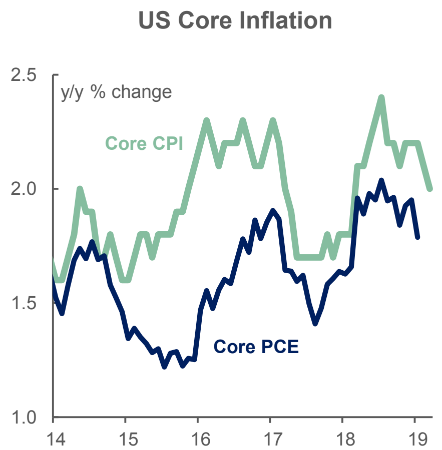
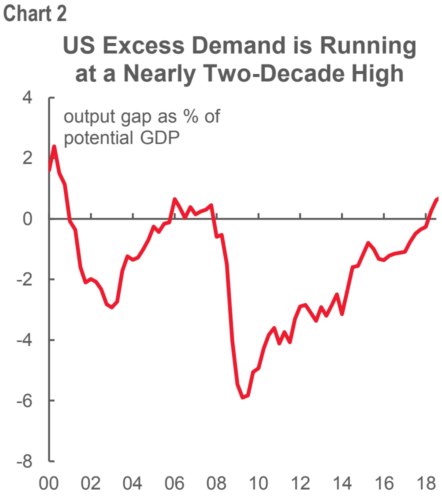
Chart 1



Sources: Scotiabank Economics, Bloomberg.

Chart 2

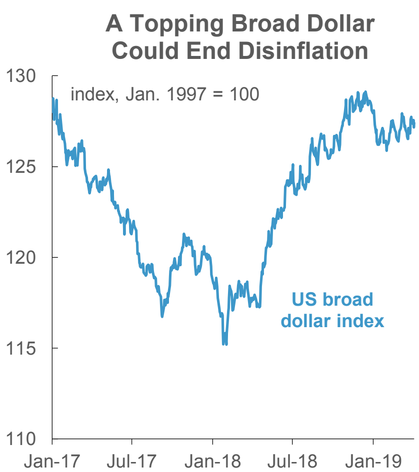


Sources: Scotiabank Economics, Congressional Budget Office.

- The broad dollar is levelling off in 2019 so far (see chart 3). The disinflationary influences of prior appreciation should level off and begin to support mild inflation if the levelling off continues or the dollar softens. The USD call remains key to the inflation forecast and the Fed forecast in this regard.

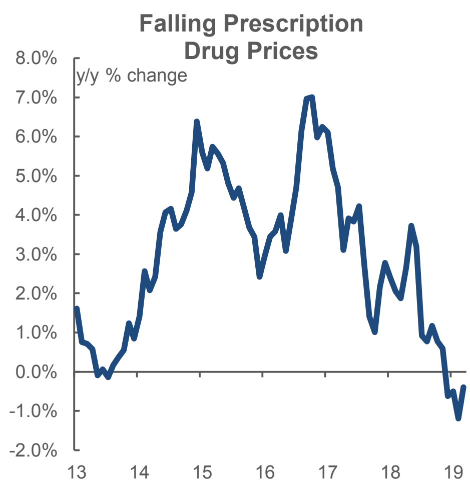
- Recall the Fed's rule of thumb on inflation and the dollar. Every 10% broad dollar rise leads to 0.5% lower core PCE inflation within six months and the effects dissipate to 0.3% within twelve months. The broad dollar appreciated by almost 10% last year but may have peaked in December. It then softened a touch and has been trending sideways for several months. Therefore by mid-year onward, the effects on inflation of last year's dollar rise should be ebbing. Then it's all up to the dollar forecast for the remainder of the year.
- Across components, there was some stabilization in prescription drug prices (see chart 4). In month-ago terms, clothing prices distorted the picture via a 1.9% m/m drop that dented core CPI by about 0.1% in weighted terms. All other categories were up. Energy prices were up 3.5% m/m. Services were up 0.3% with housing up 0.3% including a 0.3% rise in owners' equivalent rent. Food prices were up 0.2%. Medical care was up 0.3% in a reversal of the prior month's weakness. Recreation was up 0.3%.

Chart 3



Source: Scotiabank Economics, US Federal Reserve.

Chart 4



Sources: Scotiabank Economics, BLS.