June 12, 2019

US Core CPI Implies Core PCE Is At Evans' Trigger Point

- The drop in core CPI inflation may portend a further drop in core PCE…
- ...which is the Fed's preferred inflation gauge…
- ...that at 1.5% y/y could land right on the level at which Chicago Fed's Evans signalled unease
- The debate over divergent sources for used vehicle prices continues

U.S. CPI (m/m%; y/y%), May:
Actual: 0.1 / 1.8
Scotia: 0.1 / 1.9
Consensus: 0.1 / 1.9
Prior: Unrevised from 0.3 / 2.0

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

- The case for the Fed to shed stronger easing signals next week got stronger with this report. US core CPI decelerated to 2.0% y/y in line with my estimate. That may portend further downward pressure upon the Fed's preferred—and much lower—core PCE gauge on June 28th. The initial market reaction put a bid to the front-end of the US Treasury curve that has been sustained in a volatile range, but sold the USD yet this effect has since turned.
- Why may CPI have this effect upon the Fed? As the updated accompanying chart demonstrates, core PCE undershoots core CPI by quite a lot. So far this year, core PCE has been 0.4–0.5% lower than core CPI which is somewhat greater than the post-crisis average. By inference, core PCE may follow core CPI lower and drop from about 1.6% y/y in the April report to 1.5% in the May report. That would put it bang on what Chicago Fed's Evans once mused on April 15th of this year would be a trigger point to get more worried about undershooting the Fed's inflation objective.
- By component, see the weighted contributions to month-ago price changes in the accompanying second chart. Seasonally adjusted prices on a month-ago basis were weighed down by used vehicle prices (-1.4% m/m), energy (-0.6% m/m) as gas prices were less of a positive influence, fruits and vegetables (-0.8% for a second sharp drop), medical care commodities (-0.4%), recreation (-0.3%) and apparel & upkeep (-0.05%).
- By component, upside influences came from shelter (+0.2%, 0.4% prior) that included a 0.26% m/m rise in owners' equivalent rent. Prices were up for public transportation (+1.9%), medical care services (+0.5%) mostly through hospital services, food and beverage prices (+0.3%), food (+0.3%) that came through higher prices for meat/poultry/fish/eggs (+0.8%) as well as higher cereals & bakery products (+0.4%) and higher dairy products (+0.7%). Alcohol prices were up 0.4% with a small weight.

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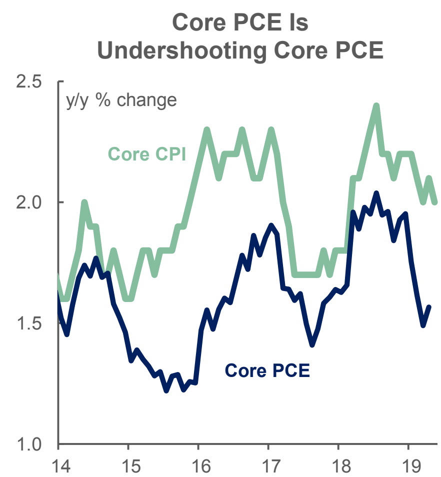
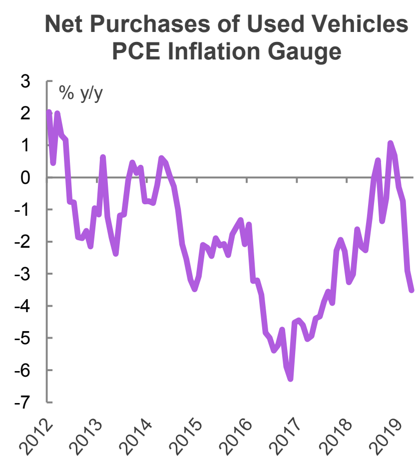


Sources: Scotiabank Economics, Bloomberg.

- **Preliminary estimates for June CPI (the next report a month from now) aren't any better.** June's headline CPI is forecast to decelerate again to 1.7% y/y from 1.8% with core CPI hanging in at 2.0%. At the present trend spread of about 0.5% **this implies that core PCE will hang around 1.5% in not only the May report but perhaps also the June report**. Recall that while he may be inclined to be among the more dovish FOMC members, that kind of reading would nevertheless equal Evan's trigger point for the Fed to get worried about risks to price stability. This estimate for June is based upon base effect shifts, seasonality, gas (on headline) and momentum arguments plus the assumption that the various differences between cpi and pce remain unchanged (see morning note for elaboration on these differences).

- **If there is an area to challenge whether inflation readings are quite as soft as they appear then it may continue to focus upon how used vehicles are captured.** This isn't enough of a difference maker to reject soft core prices, but it's worth addressing again. The used vehicles category was subjected to a methodological change in January of last year (details here). The used vehicles sample size was increased and captured on a month-ago basis instead of the three-month moving average that was used before January of last year. **There remains debate over the suitability of the used vehicles price sources.** CPI uses the National Automotive Dealers' Associations' Official Used Car Guide instead of, say, the Kelley Blue Book or Black Book or Manheim gauges. None of these sources make quality adjustments or depreciation adjustments that are made in CPI after taking the NADA data as a starting point. The differences, however, can be very large. Used vehicle prices as captured in PCE for instance are falling by over 3% y/y whereas the Manheim gauge is up 4% y/y. Again, the latter doesn't make depreciation or quality adjustments, but do such adjustments really explain a seven percentage point spread in a single year?

Source: Scotiabank Economics, BLS.



Sources: Scotiabank Economics, BEA.