January 14, 2020

US Core Inflation Remains Tame and Narrowly Driven

- **Core CPI suggests little pressure on the Fed's preferred core PCE gauge**
- **Headline inflation accelerated primarily due to gasoline prices**
- **Higher inflation also came from medical care, apparel prices**
- **Disinflationary factors included used vehicles, services**
- **Housing, health insurance explain 60% of all US inflation…**
- **...which reflects idiosyncratic factors, not Phillips curve influences…**
- **…as broader sources of inflation remain very muted**

US CPI, headline/core, m/m % change, SA, December:
Actual: 0.2 / 0.1
Scotia: 0.3 / 0.2
Consensus: 0.3 / 0.2
Prior: 0.3 / 0.2

US CPI, headline/core, y/y % change, December:
Actual: 2.3 / 2.3
Scotia: 2.4 / 2.3
Consensus: 2.4 / 2.3
Prior: 2.1 / 2.3

US CPI inflation continues to indicate little pressure on the Fed's preferred core PCE measure of inflation. The absence of material inflation pressure and the very few drivers of inflation continue to tilt the policy discussion toward a neutral-dovish stance. Going forward, core inflation may face downside risk, as discussed in yesterday's release of our forecasts for US monetary policy (here).

Due to various methodological differences, core CPI tends to overestimate underlying price pressures as reflected in core PCE. The degree of overstatement is running around 0.7 percentage points in year-ago terms. If core CPI is stable at 2.3% y/y then by corollary it may hold that core PCE remained stable last month at around 1.6% y/y (chart 1). Overall, the Fed's preferred inflation gauge is likely still running well below target.

Gasoline was expected to be the dominant swing factor in terms of driving higher headline inflation and it was. A 3.9% weight on the 2.8% m/m and 7.9% y/y rise in gasoline prices added 0.1% m/m and 0.3% y/y to headline CPI. Absent this, headline would have been 0.1% m/m (instead of 0.2) and 2.0% (instead of 2.3% and lower than 2.1% prior).

In weighted terms, the dominant influences upon inflation remain rent of shelter (+3.3% y/y, 33% weight) and health insurance (+20.4% y/y, 1.3% weight). Rent of shelter accounts for about 50% of all US inflation and when combined with health insurance they account for 60% of total inflation. US inflation cannot be modelled by relying upon broad output gap or Philips curve drivers absent a bottom-up components approach that is narrowly slanted to two main drivers.

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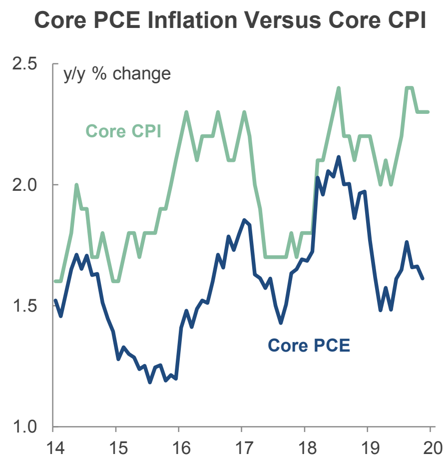
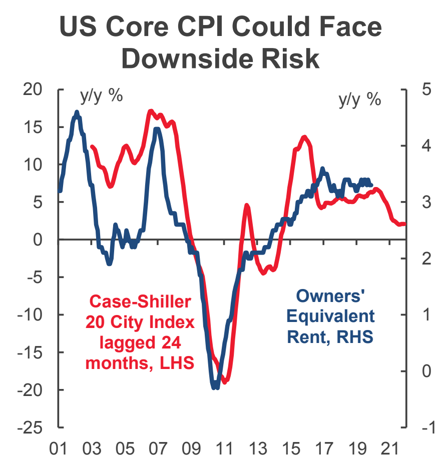
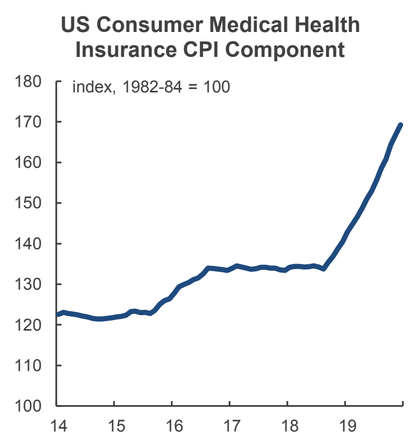


Sources: Scotiabank Economics, BLS, BEA.



Sources: Scotiabank Economics, BLS, Bloomberg.



Sources: Scotiabank Economics, Bloomberg.

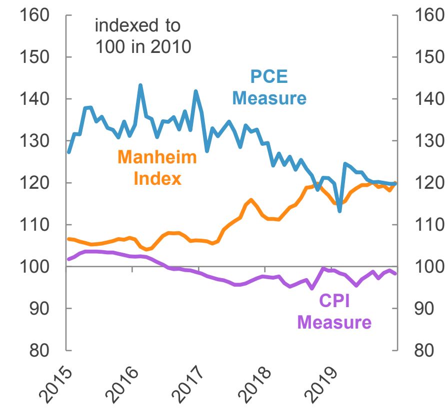
Chart 2 shows how the OER part of shelter is likely to be under disinflationary influences over 2020. OER accounts for most of the rise in the rent of shelter component to CPI along as it carries about a 24% weight in CPI. Rent of primary residence carries an 8% weight and is rising at a similar 3.7% y/y pace.

Chart 3 shows how the health insurance premiums component has skyrocketed since August 2018.

Inflation from prices for used cars and trucks has been ebbing. With a 2.3% weight on a swing from +2.6% y/y at the peak in September following an upswing since 2017 to -0.7% y/y now, this component has knocked about 0.1% off of headline year-ago CPI inflation. The seasonally adjusted PCE measure of used vehicle prices has been trending lower since last Spring. Chart 4 compares this component within CPI to PCE and the alternative Manheim index of used auto prices.

The change in year-over-year prices across individual components of the CPI basket is shown in chart 5. Chart 6 provides the same breakdown after applying CPI weights to the components.

US Used Car Pricing Trends According To Different Indices



Sources: Scotiabank Economics, BLS, Manheim.

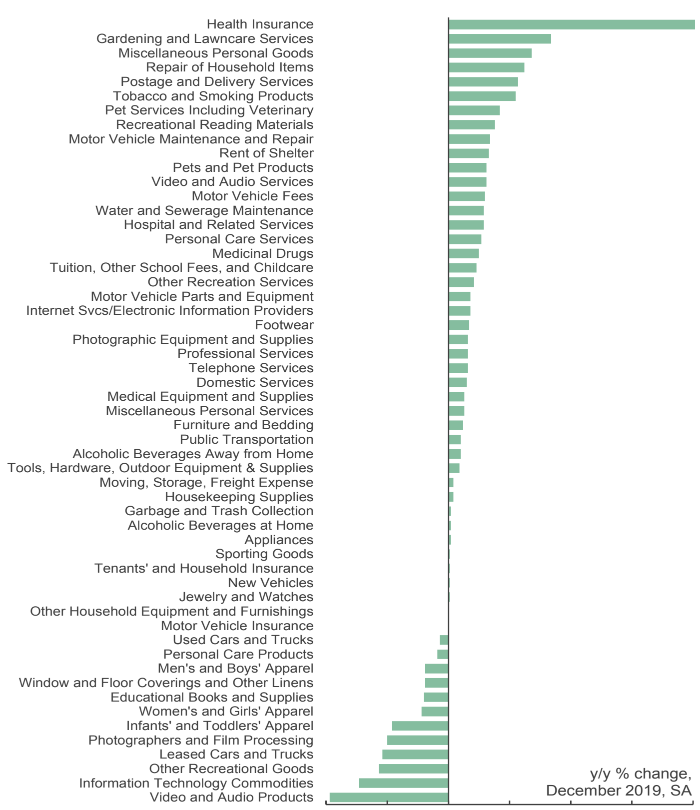
Medical care prices were up by 0.6% m/m and core PCE puts a bigger weight on medical spending than core CPI because PCE captures direct PLUS indirect spending by governments and employers. If indirect medical spending experienced similar price pressures as direct spending within CPI, then core PCE could put more of a weight on this driver.

The contribution from owners' equivalent rent was stable at 0.2% m/m but overall shelter cost inflation decelerated was because of a -0.1% m/m drop in prices for fuels and utilities versus the prior month's 0.4% m/m rise.

Cooler services inflation (+0.2%, 0.3% m/m prior) played a role in motivating slightly less upward influence upon overall inflation than was expected. Recreation, education, and 'other' goods and services all decelerated in month-ago terms.

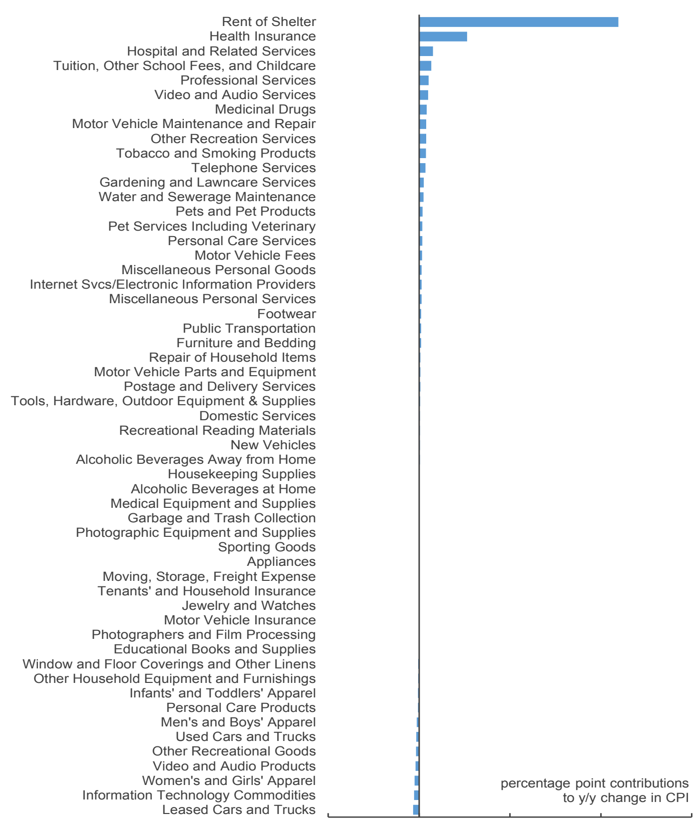
Apparel (+0.4% from 0.1%) and transportation (+0.5% from 0.3%) exerted upward pressure.

Changes in US Headline CPI Categories



Sources: Scotiabank Economics, BLS.

December Weighted Contributions to Headline CPI



Source: Scotiabank Economics, BLS.