

US CPI Indicates Core PCE Remains Well Below The Fed's Target

- **Headline and core CPI were firmer than consensus expected**
- **Headline CPI picked up on gas prices**
- **Core CPI was unchanged; consensus had expected it to soften**
- **Fed's preferred core PCE gauge likely remains well below target**
- **Shelter and health insurance continue to dominate the narrow drivers**
- **Markets ignored the release and stayed focused on the coronavirus**

US CPI, headline/core, m/m % change, SA, January:

Actual: 0.1 / 0.2

Scotia: 0.2 / 0.2

Consensus: 0.2 / 0.2

Prior: 0.2 / 0.1

US CPI, headline/core, y/y % change, January:

Actual: 2.5 / 2.3

Scotia: 2.5 / 2.3

Consensus: 2.4 / 2.2

Prior: 2.3 / 2.3

Headline (2.5% y/y) and core CPI (2.3% y/y) inflation came in firmer than consensus expected and in line with Scotia's estimates for both. The details continue to suggest that core PCE inflation remains well below the Fed's 2% policy goal. Treasuries and the USD shook off the release with all of the market focus remaining on the coronavirus concerns.

The gap between core CPI and core PCE inflation likely remains wide (chart 1). Core CPI suggests that core PCE is likely to be unchanged at 1.6% y/y and could face marginal downward pressure when we get the figures at month end. The Fed will remain dovishly focused upon undershooting inflation.

On a weighted contribution basis to the year-over-year change in overall prices, CPI inflation continues to be primarily driven by shelter and health insurance (chart 6, next page). Shelter is contributing a weighted 1.1 percentage points to the headline inflation rate of 2.5% y/y and 1.1 points to the 2.3% core CPI inflation rate. It therefore accounts for 44% of total inflation and 48% of core CPI inflation. Going forward, chart 2 continues to demonstrate how this source of inflation should come under renewed downward pressure because we know that the highly correlated driver is the lagged change in repeat sale home prices which has been decelerating.

Gas prices were up by 7.4% y/y in January which was a sharp acceleration from 0.9% y/y the prior month. With a 3.36% weight in CPI, this category added 0.2% to the year-ago headline inflation rate in January versus December and explained the headline CPI acceleration.

Auto prices are turning less and less inflationary within CPI in the US. New vehicle prices were flat (0.1% y/y and 0% m/m). Used vehicle prices had been a

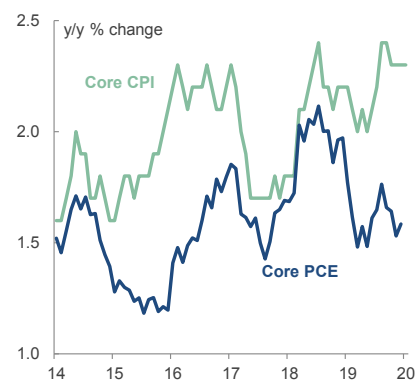
CONTACTS

Derek Holt, VP & Head of Capital Markets Economics
416.863.7707

Scotiabank Economics

derek.holt@scotiabank.com

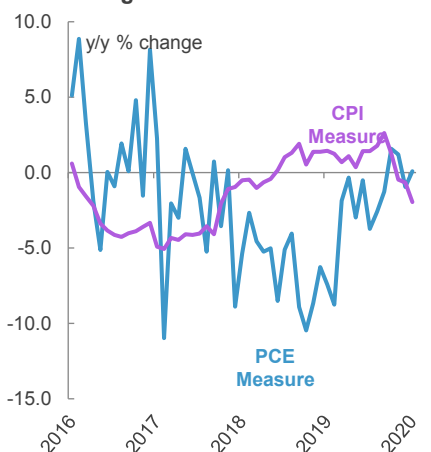
Core PCE Inflation Remains Low



US Core CPI Could Face Downside Risk



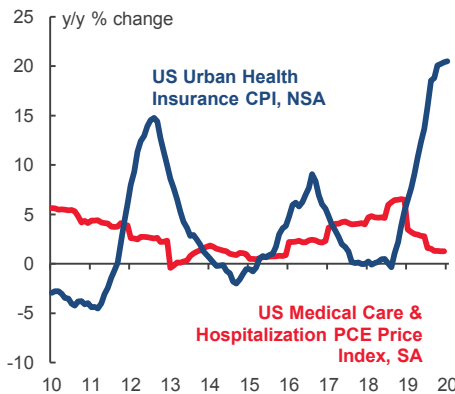
Waning Used Vehicle Price Inflation



mild source of upward pressure on CPI but this effect has dropped out (chart 3). Used vehicle prices are now down by -2% y/y and -1.2% m/m versus a peak rate of +2.6% y/y in September. This swing since September has knocked 0.1% off of y/y headline CPI in weighted terms.

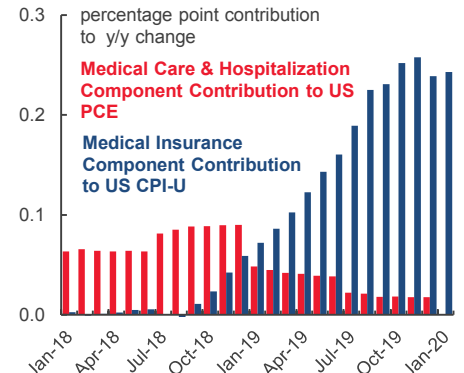
Health insurance CPI remains the second hottest source of CPI inflation on a weighted basis and is contributing about 0.25 percentage points to total inflation on a year-ago basis. This component was up by 20.5% y/y and another 1.7% m/m but the weight is about 1.17% in CPI. Recall that health insurance in CPI has been heading sharply higher but the same has not been true in PCE in raw terms and especially in weighted contribution terms (charts 4, 5). CPI only takes account of direct spending on health insurance by households whereas PCE also includes spending on their behalf by employer and government plans. Nevertheless, we're getting the first tentative signs of a top in this driver of CPI.

US Medical Care Insurance Inflation



Sources: Scotiabank Economics, US BLS, US Bureau of Economic Analysis.

Weighted Contributions to US CPI and PCE



Sources: Scotiabank Economics, US BLS, US Bureau of Economic Analysis.

Prescription drug prices were up by only 2.5% y/y and down 0.4% m/m

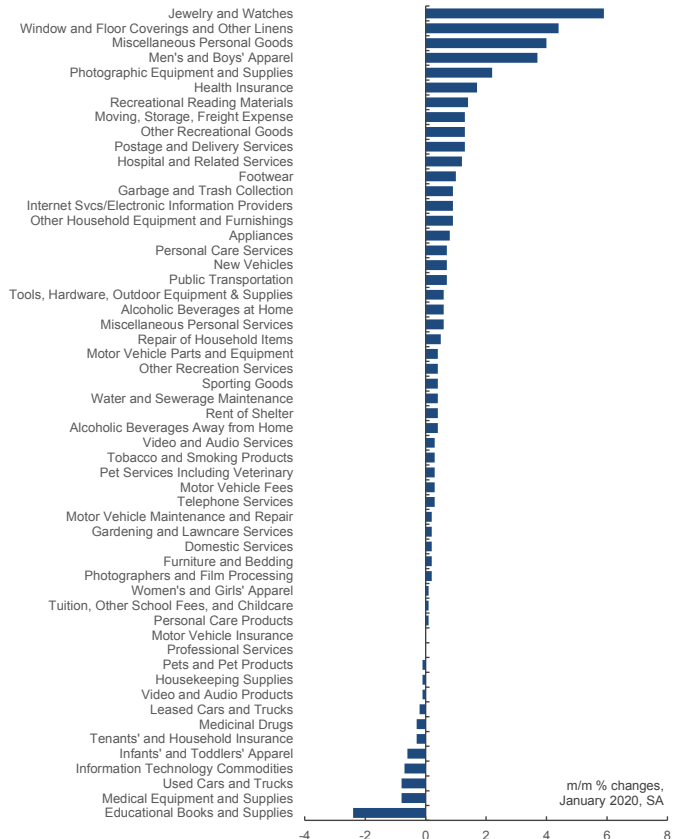
Upward pressure also came from apparel prices (+0.7%), services (+0.4%) and a little firmer OER (+0.3%).

January Weighted Contributions to Headline CPI



Source: Scotiabank Economics, BLS.

Monthly Changes in US Headline CPI Categories



Sources: Scotiabank Economics, BLS.

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