US Core Inflation Surprises Higher Again!

- **Core CPI increased by more than expected**
- **The market reaction was dirtied by simultaneous ECB headlines...**
- **...as Treasuries cheapened, before returning to focus on liquidity..**
- **...while the dollar retained post-release appreciation**
- **70% of the y/y rise in CPI and core CPI is not due to base effects**
- **There was high breadth to the acceleration…**
- **...but autos and housing played the largest roles**
- **The Fed needs to sound less certain about transitory factors…**
- **...and consider both transitory upside and downside pressures**

US headline CPI, y/y % change // m/m % change SA, May :
Actual: 5.0 / 0.6
Scotia: 4.5 / 0.4
Consensus: 4.7 / 0.5
Prior: 4.2 / 0.8

US core CPI ex-food and energy, y/y % change // m/m % change SA, May:
Actual: 3.8 / 0.7
Scotia: 3.3 / 0.2
Consensus: 3.5 / 0.5
Prior: 3.0 / 0.9

Base effects? Oh please. Transitory? We'll see, but it's not obvious that price pressures will prove to be fully fleeting. For now, we have yet another upside surprise to core CPI inflation to evaluate and markets didn't take it so well. See the tables above for the prints as both headline and core inflation came in higher than expected.

Markets

The US 10 year Treasury yield's reaction was a bit dirtied by the fact that the ECB press conference was unfolding around a similar time frame to markets taking down the inflation figures, but the cheapening tendency before the data that drove the 10 year yield up by about 3bps this morning got an added instant boost with about another 3bps rise immediately following the release. That has since all been reined in likely due to a return to the liquidity pressures that have been driving yields lower over recent weeks (see the morning Daily Points). The USD appreciated a touch post-release and has remained firmer since then.

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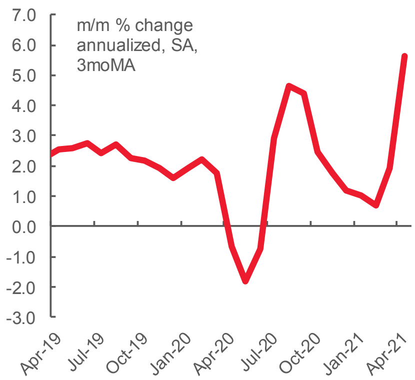
Chart 1

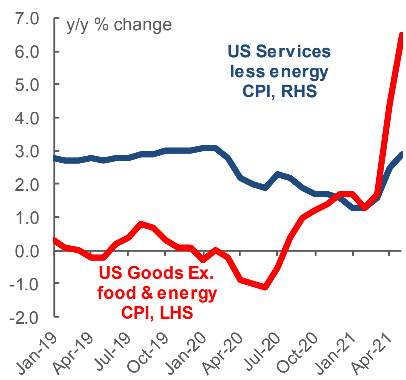
US Core CPI Inflation



Sources: Scotiabank Economics, BEA.

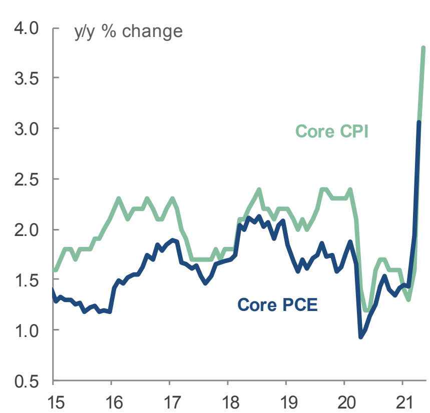
Chart 2

US Goods vs. Services Inflation



Sources: Scotiabank Economics, US BLS.

Chart 3 US Core PCE & CPI



Sources: Scotiabank Economics, BLS, BEA.

The Fed Connection

Before turning to the individual drivers, it's worth considering a few points on how this may affect Fed-thinking. In short, the Fed's base effect argument is getting overwhelmed by data. Had we only been dealing with shifting base effects over the past couple of months, then year-over-year headline CPI would have risen from 2.6% in March before factoring in the m/m acceleration in prices through April and May to 3.3% y/y now. Instead we're at 5% y/y.

As for core, if we were only dealing with shifting base effects over the past couple of months, then core CPI would have risen from 1.6% y/y in March to 2.2% now and instead we're at 3.8%. Base effects are indeed playing a role, but only about 30% of the acceleration in headline and core year-over-year inflation rates since March can be explained by base effects with the other 70% of the rise explained by month-over-month changes.

It remains uncertain how durable these gains may prove to be. That in itself is a point against strident insistence that this is all transitory. It's too difficult to wean out potentially (but not certainly) transitory supply chain issues from reopening effects from stimulus effects. I still don't think we hold at numbers like these, but there is a good case for more persistence than the Fed is letting on. To be frank, the Fed's conviction to date sounds more like a macro hedge fund talking its position rather than a central bank focused upon risks.

The Numbers

The broad takeaway to what follows is that there is high breadth to US inflationary pressures when the numbers are decomposed. This observation is buttressed by the following points.

Chart 1 (front page) takes the month-over-month seasonally adjusted change in core CPI and annualizes that change to show price pressures free of year-over-year base effects. It applies a smoothed 3 month moving average to the volatile data. Without smoothing, annualized month-over-month core inflation was 8.3% in May after 5.6% in April.

Chart 2 (front page) shows that core goods price inflation is running off the charts and at a pace that cannot be explained by weakness a year ago. Goods price inflation is running at 6.5% y/y now after hitting a low of -1.1% last June. The chart also shows that services price inflation is accelerating and this area is likely to have greater upside as pandemic effects on less socially distanced services gradually ease. If some transitory factors that may be boosting goods price inflation at least partially abate this effect may coincide with an acceleration in services inflation.

Chart 3 (front page) shows the acceleration in core CPI as a guide to where core PCE is likely to go on June 25th. Core PCE is likely to land around 3 ½% y/y.

Chart 4 (next page) shows the weighted contributions to the year-over-year change in CPI by category. Vehicles—used and new — and related insurance premiums along with housing are the hottest drivers. Chart 5 does the same thing for the month-over-month weighted contributions to changes in CPI with a similar conclusion.

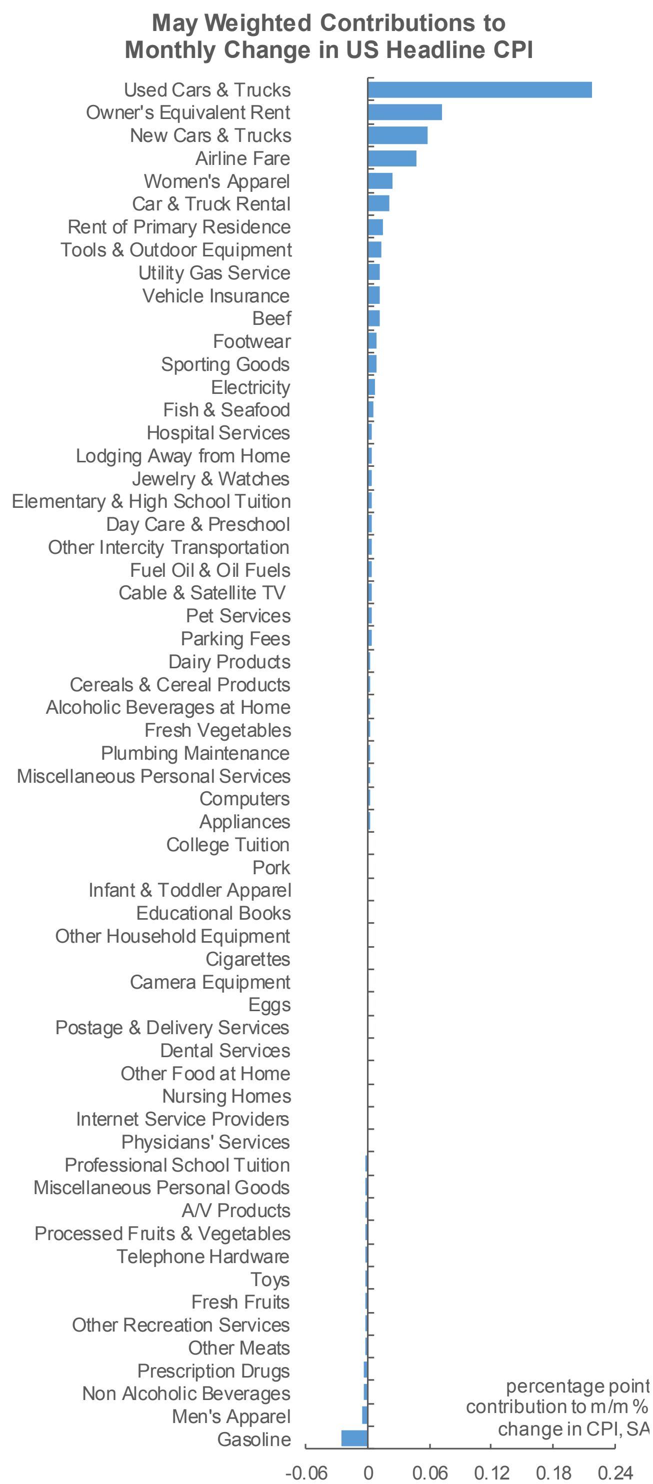
Charts 6–12 (page 4) show patterns across some individual contributions. One takeaway is that the earlier acceleration in food prices (at home, 7.7% weight) and medical care (~8% total weight) have fully subsided now. Prescription drug price inflation remains weak. Airfare, cellphone services, apparel and appliances are under upward inflationary pressure. Financial services price inflation has firmed compared to earlier weakness.

A point to these last slides is that when we talk of transitory drivers that may come off from present rates, we should also speak to what may be transitory weakness in other areas like the base effects operating against food price inflation that is unlikely to go away, or medical care price inflation that is unlikely to go away etc. Transitory doesn't just mean looking at the presently hot prices and dismissing them.

Chart 4

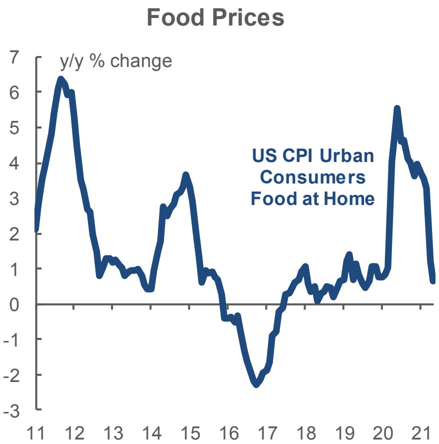
Source: Scotiabank Economics, BLS.

Chart 5



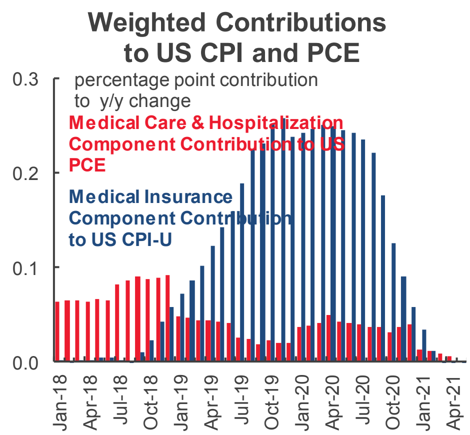
Sources: Scotiabank Economics, US BLS

Chart 6



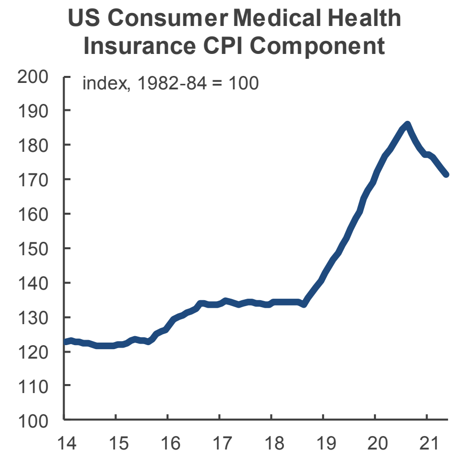
Sources: Scotiabank Economics, Bureau of Labor Statistics, Statistics Canada.

Chart 7



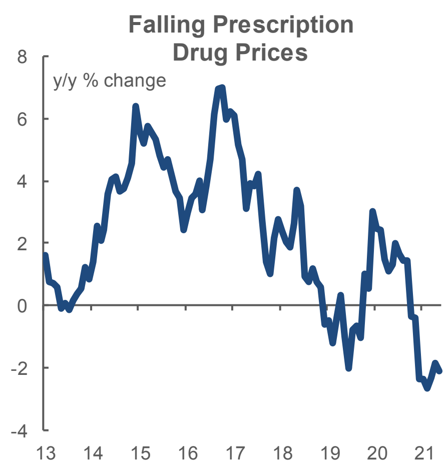
Sources: Scotiabank Economics, US BLS, US Bureau of Economic Analysis.

Chart 8



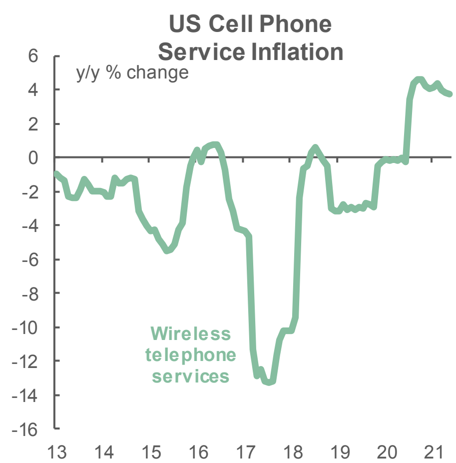
Sources: Scotiabank Economics, Bloomberg.

Chart 9



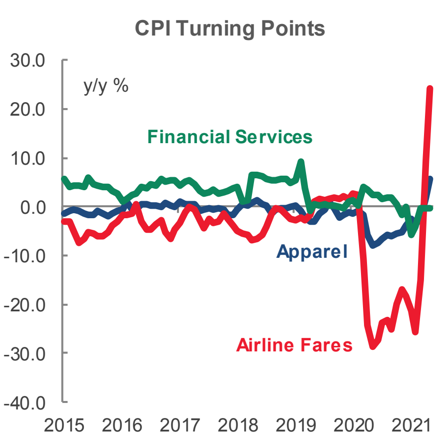
Sources: Scotiabank Economics, BLS.

Chart 10



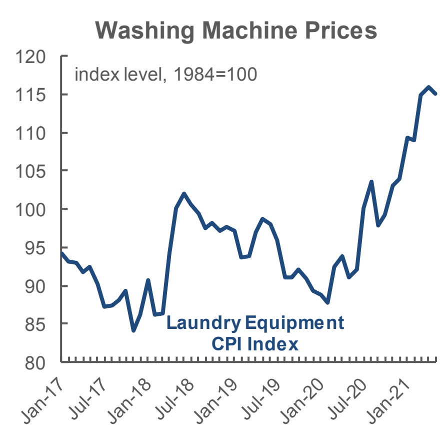
Sources: Scotiabank Economics, BLS.

Chart 11



Apperal & Airline Fares Index: 1984 =100
Financial Services Index: 1986 = 100
Sources: Scotiabank Economics. BLS.

Chart 12



Sources: Scotiabank Economics, Bureau of Labour Statistics.