

US Watch

December CPI Inflation: Stubborn services, but the door is open for a March cut

CPI inflation firmer than expected

The December Consumer Price Index (CPI) report was stronger than expected. Headline and core CPI beat consensus expectations and were a few basis points stronger than our own forecasts. In terms of the numbers, headline inflation rose by 0.3% (0.303% unrounded, consensus 0.2%, BofA 0.26%). The slightly stronger number reflected core coming in a few basis points above our expectations (0.31% versus 0.27%) and a larger increase in energy prices than we expected. That said, the report still suggests that inflation is cooling as core inflation on a three-month annualized rate edged down a tenth to 3.3% and the y/y rate fell below 4%. Moreover, some drivers of the strength this month, particularly used cars, should fade in coming months. Overall, the report leaves us comfortable with our expectation for the Fed to cut rates by 25bp in March.

Two sides of the coin

As we flagged in our preview, the CPI data continue to show a divergence between goods and services inflation. Core goods inflation was flat on the month, owing largely to increases in used cars and new car prices. Used car prices should fall in coming months given the decline in wholesale prices. Core goods ex used cars fell by 7bps. Improvement in supply chains has helped drive disinflation in core goods.

Core services, meanwhile, rose by 0.4% m/m, effectively in line with our expectations. Shelter remains a source of sticky inflation, as prices rose by 0.5% m/m owing to a 0.5% increase in OER and a 0.4% increase in rents. Despite significant moderation in asking rent inflation, CPI rents continue to run above pre-pandemic levels. We suspect that this reflects regional dynamics as rents in the Northeast have proven firmer, but it also may be due to rents still playing catch-up to the level of asking rents.

Additionally, core services ex rent and OER was firmer than we expected, increasing by 0.4% m/m. The details point to broad-based strength in services inflation as medical care services and recreation services inflation accelerated on the month. The strength in medical care services inflation partially reflects health insurance continuing to increase by roughly 1.1% m/m. This is largely a function of the BLS' methodology. That said, inflation for hospital services and professional services was relatively strong. We have seen rapid hiring in the sector, and an aging population could contribute to sustained inflation in this sector. Meanwhile, the strength in recreation services inflation is most likely demand driven.

The ongoing divergence between goods and services inflation should keep the Fed from declaring victory on inflation. It likely cannot take much credit for the decline in goods inflation. Until we see further progress on services inflation, the Fed will likely be worried about upside risks to inflation. That said, the overall progress towards the 2% target is undeniably encouraging and should allow the Fed to begin easing policy rates. (Continued on next page)

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Glossary

BLS = Bureau of Labor Statistics

CPI = Consumer Price Index

ex = excluding

NSA = Not Seasonally Adjusted

OER = Owners' Equivalent Rent

OIS- Overnight Indexed Swap

PCE = Personal Consumption
Expenditures (Price Index)

PPI = Producer Price Index

Core PCE first read-through

Importantly, what matters most to the Fed is PCE inflation. CPI data is a key input into the calculation of PCE inflation. Based on today's data, it appears that we could see another large wedge between core PCE and core CPI. Indeed, we estimate that core PCE inflation could come in at 0.12% -0.15% m/m in December. If core PCE were to come in at these levels, then the likelihood of the first cut in March would increase, in our view. We note that we will have a more complete picture of the PCE print tomorrow after the PPI data are released.

The door is slightly more ajar for a cut in March

In terms of the Fed, we think that today's report and importantly the read-through to PCE inflation will keep the Fed on track to cut by 25bp at its March meeting. We will learn more tomorrow, and there are still more CPI reports before the March meeting, but the progress on inflation has been significant enough to warrant a start to the cutting cycle.

Rates and FX: Financial market reaction

Following the print, the inflation curve flattened, with the front end moving higher, while the real yield curve bull steepened. Breakevens were supported by stronger-than-expected goods components and services that remain firm. Since just before the print, market pricing for a cut in March moderated to 55% from around 70% previously, and total cuts in 2024 declined by around 7bps to 137bps in total. Front-end inflation swaps widened following the data, but the 1y point still is well below the near-term path of inflation that BofA Global Research economists expect. Still, firm core CPI but a more muted read-through to PCE should be supportive for TIPS longs as PCE allows the Fed to cut but CPI proves stickier than priced.

The USD has directionally sustained its initial rally on the release, amid intra-day volatility, rising roughly between 0.25% and 0.75% higher than other G10 currencies, with higher-beta FX (NZD, AUD, SEK) underperforming. The dollar move was consistent with the broad rise in rates, though market pricing still suggests a modestly greater probability than not for a March cut. From an FX perspective, today's CPI keeps alive the risks of inflation coming in stickier this year, while the market on balance generally seems primed for steady disinflation being a headwind for the USD. Consensus as well as our own forecasts call for USD depreciation over the course of the year against most G10. However, with markets expecting earlier and more aggressive start to the cutting cycle by the Fed (compared to other G10 central banks), we do see risks that the process could take a bit longer should inflation readings disappoint expectations, amid a softening but still healthy labor market.

Exhibit 2: CPI Forecast versus Actual (SA % m/m unless specified otherwise)

Below we compare BofA Global Research Economics' bottoms-up CPI forecasts to actuals

	December Forecast		
	Actual	Forecast	Error
NSA Index (level)	306.746	306.634	0.112
Headline CPI (All Items)	0.30%	0.26%	0.05%
Food	0.2%	0.2%	0.0%
Energy	0.4%	0.2%	0.2%
Core CPI	0.31%	0.27%	0.04%
Core goods	0.00%	-0.16%	0.16%
Household furnishings and supplies	-0.4%	-0.1%	-0.3%
Apparel	0.1%	-0.1%	0.2%
Transportation commodities less motor fuel	0.3%	-0.3%	0.6%
<i>Of which:</i>			
New vehicles	0.3%	0.1%	0.2%
Used cars and trucks	0.5%	-1.0%	1.5%
Medical care commodities	-0.1%	0.2%	-0.3%
Recreation commodities	-0.5%	0.0%	-0.5%
Other recreational goods	-0.5%	-0.5%	0.0%
Education and communication commodities	-0.2%	-1.2%	1.0%
Alcoholic beverages	0.3%	0.2%	0.1%
Other goods	-0.6%	0.4%	-1.0%
Core Services	0.44%	0.42%	0.02%
Shelter	0.5%	0.5%	0.0%
<i>Of which:</i>			
Rent	0.4%	0.5%	-0.1%
Lodging away from home	0.4%	0.0%	0.4%
OER	0.5%	0.5%	0.0%
Water and sewer	0.1%	0.3%	-0.2%
Medical care services	0.7%	0.3%	0.4%
<i>Of which:</i>			
Health insurance	1.1%	1.1%	0.0%
Transportation services	0.1%	0.6%	-0.5%
<i>Of which:</i>			
Airfares	1.0%	0.0%	1.0%
Recreation services	1.1%	0.2%	0.9%
Education and communication	0.2%	0.1%	0.1%
Other personal services	0.1%	0.3%	-0.2%

Source: BofA Global Research, Bureau of Labor Statistics, Bloomberg

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Exhibit 3: CPI heatmap (%m/m)

Headline and core CPI rose by 0.3% m/m in December

Nov-23 weight	Component	Dec-23	Nov-23	Oct-23	Sep-23	Aug-23	Jul-23	Jun-23	May-23	Apr-23	Mar-23	Feb-23	Jan-23
100.0	Headline CPI	0.303%	0.10%	0.04%	0.40%	0.63%	0.17%	0.18%	0.12%	0.37%	0.05%	0.37%	0.52%
13.4	Food	0.21%	0.22%	0.30%	0.23%	0.24%	0.24%	0.11%	0.20%	0.02%	0.01%	0.39%	0.51%
6.7	Energy	0.4%	-2.29%	-2.45%	1.52%	5.58%	0.11%	0.60%	-3.59%	0.56%	-3.52%	-0.56%	1.97%
79.8	Core CPI	0.309%	0.28%	0.23%	0.32%	0.28%	0.16%	0.16%	0.44%	0.41%	0.38%	0.45%	0.41%
20.8	Core Goods	0.00%	-0.30%	-0.09%	-0.39%	-0.10%	-0.33%	-0.05%	0.55%	0.57%	0.18%	-0.01%	0.07%
18.2	Core Goods ex Used Cars	-0.07%	-0.56%	0.01%	-0.08%	0.07%	-0.18%	0.00%	0.00%	0.04%	0.33%	0.38%	0.46%
4.2	Household Furnishings and Supplies	-0.36%	-0.66%	-0.18%	-0.28%	0.32%	-0.35%	-0.27%	-0.41%	-0.40%	0.37%	0.76%	0.51%
2.5	Apparel	0.10%	-1.29%	0.10%	-0.76%	0.20%	-0.03%	0.31%	0.29%	0.27%	0.26%	0.81%	0.83%
7.5	Motor Vehicles & parts	0.32%	0.51%	-0.37%	-0.88%	-0.29%	-0.54%	-0.17%	1.49%	1.45%	-0.04%	-0.90%	-0.71%
4.2	New Vehicles	0.27%	-0.06%	-0.09%	0.30%	0.27%	-0.08%	-0.03%	-0.12%	-0.22%	0.38%	0.18%	0.23%
2.5	Used Cars and Trucks	0.49%	1.58%	-0.80%	-2.53%	-1.23%	-1.34%	-0.45%	4.42%	4.45%	-0.88%	-2.77%	-1.94%
1.5	Medical Care Commodities	-0.12%	0.46%	0.42%	-0.29%	0.56%	0.51%	0.19%	0.65%	0.46%	0.59%	0.15%	1.06%
2.2	Recreation Commodities	-0.52%	-0.61%	0.15%	0.29%	-0.44%	-0.78%	-0.36%	-0.05%	0.29%	0.24%	0.44%	0.12%
0.8	Education and Communication Commodities	-0.19%	-2.55%	-1.27%	0.33%	-0.70%	-1.25%	-0.07%	-0.20%	-0.18%	-0.50%	-0.77%	-0.09%
0.8	Alcoholic Beverages	0.30%	-0.14%	0.17%	0.81%	-0.01%	0.12%	0.01%	0.51%	0.47%	0.14%	-0.28%	0.41%
1.3	Other Goods	-0.59%	0.11%	1.09%	0.48%	0.12%	0.30%	0.08%	0.59%	0.24%	0.53%	0.74%	0.77%
59.1	Core Services	0.44%	0.47%	0.34%	0.57%	0.39%	0.35%	0.25%	0.40%	0.36%	0.45%	0.62%	0.55%
25.3	Core Services ex Rent and OER	0.40%	0.44%	0.22%	0.61%	0.37%	0.19%	-0.01%	0.24%	0.11%	0.40%	0.50%	0.36%
35.2	Shelter	0.46%	0.45%	0.33%	0.65%	0.29%	0.44%	0.37%	0.56%	0.42%	0.56%	0.76%	0.74%
26.0	Owners' Equivalent Rent of Residences	0.47%	0.50%	0.41%	0.56%	0.38%	0.49%	0.45%	0.52%	0.54%	0.48%	0.70%	0.67%
7.7	Rent of Primary Residence	0.42%	0.48%	0.50%	0.49%	0.48%	0.42%	0.46%	0.49%	0.56%	0.49%	0.76%	0.74%
1.1	Lodging Away From Home	0.39%	-0.93%	-2.45%	3.65%	-2.97%	-0.34%	-2.01%	1.80%	-2.96%	2.70%	2.26%	1.20%
1.1	Water & Sewer & Trash Collection Services	0.09%	0.32%	0.26%	0.24%	0.48%	0.46%	0.40%	0.58%	0.33%	0.27%	0.79%	0.85%
0.9	Household Operations	0.00%	0.00%	#N/A	#N/A	-1.14%	1.79%	0.78%	-1.19%	#N/A	#N/A	#N/A	#N/A
6.4	Medical Care Services	0.71%	0.60%	0.32%	0.32%	0.06%	-0.40%	-0.02%	-0.05%	-0.14%	-0.50%	-0.70%	-0.68%
6.1	Transportation Services	0.12%	1.06%	0.83%	0.69%	1.96%	0.34%	0.13%	0.84%	-0.18%	1.38%	1.14%	0.85%
0.5	Airline Fares	1.00%	-0.39%	-0.91%	0.28%	4.89%	-8.09%	-8.11%	-2.95%	-2.55%	3.96%	6.38%	-2.15%
3.1	Recreation Services	1.11%	0.06%	0.08%	0.50%	-0.07%	0.77%	0.46%	-0.09%	0.74%	0.01%	1.19%	0.73%
4.8	Education and Communication Services	0.16%	0.07%	0.02%	0.07%	0.08%	0.29%	-0.27%	-0.15%	0.07%	0.29%	0.21%	0.45%
1.5	Other Personal Services	0.11%	0.29%	0.26%	0.64%	0.70%	-0.07%	0.23%	0.47%	1.52%	0.47%	1.06%	0.54%

Source: BofA Global Research, Bureau of Labor Statistics

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Exhibit 4: CPI heatmap (%y/y)

Headline CPI rose by 3.4% y/y in December, and core rose by 3.9% y/y

Nov-23 weight	Component	Dec-23	Nov-23	Oct-23	Sep-23	Aug-23	Jul-23	Jun-23	May-23	Apr-23	Mar-23	Feb-23	Jan-23
100.0	Headline CPI	3.35%	3.14%	3.24%	3.70%	3.67%	3.18%	2.97%	4.05%	4.93%	4.98%	6.04%	6.41%
13.4	Food	2.70%	2.95%	3.30%	3.69%	4.25%	4.86%	5.74%	6.69%	7.65%	8.50%	9.49%	10.13%
6.7	Energy	-2.02%	-5.44%	-4.53%	-0.45%	-3.62%	-12.47%	-16.74%	-11.66%	-5.06%	-6.42%	5.19%	8.70%
79.8	Core CPI	3.93%	4.01%	4.03%	4.15%	4.35%	4.65%	4.83%	5.33%	5.52%	5.59%	5.54%	5.58%
20.8	Core Goods	0.09%	-0.04%	0.02%	-0.03%	0.39%	0.93%	1.41%	2.02%	2.08%	1.59%	0.96%	1.29%
18.2	Core Goods ex used cars	0.38%	0.73%	1.44%	1.64%	2.02%	2.54%	3.10%	3.67%	4.00%	4.23%	4.22%	4.37%
4.2	Household Furnishings and Supplies	-0.95%	-0.34%	0.69%	0.91%	1.68%	2.24%	3.24%	4.08%	4.77%	5.79%	6.33%	6.37%
2.5	Apparel	0.97%	1.08%	2.61%	2.32%	3.09%	3.18%	3.07%	3.47%	3.65%	3.25%	3.26%	3.06%
7.5	Motor Vehicles & Parts	0.04%	-0.90%	-2.10%	-2.29%	-1.92%	-1.27%	-0.75%	0.12%	-0.30%	-1.82%	-3.18%	-2.26%
4.2	New Vehicles	1.02%	1.33%	1.87%	2.53%	2.92%	3.50%	4.07%	4.66%	5.42%	6.12%	5.83%	5.78%
2.5	Used Cars and Trucks	-1.31%	-3.75%	-7.14%	-7.99%	-6.64%	-5.64%	-5.15%	-4.22%	-6.56%	-11.15%	-13.58%	-11.62%
1.5	Medical Care Commodities	4.74%	4.98%	4.70%	4.24%	4.45%	4.13%	4.21%	4.42%	4.01%	3.59%	3.19%	3.39%
2.2	Recreation Commodities	-1.20%	-0.62%	-0.37%	0.25%	-0.08%	1.02%	1.96%	2.73%	2.90%	3.16%	2.85%	3.27%
	Education and Communication												
0.8	Commodities	-7.21%	-7.89%	-7.07%	-7.32%	-8.12%	-7.84%	-7.10%	-6.88%	-8.29%	-10.17%	-10.47%	-10.26%
0.8	Alcoholic Beverages	2.54%	2.90%	3.70%	4.24%	3.71%	4.10%	4.42%	4.77%	4.64%	4.53%	4.92%	5.82%
1.3	Other Goods	4.55%	5.10%	5.64%	5.11%	5.01%	6.09%	6.13%	6.58%	6.80%	6.91%	6.96%	7.15%
59.1	Core Services	5.30%	5.49%	5.51%	5.69%	5.89%	6.12%	6.16%	6.57%	6.84%	7.12%	7.27%	7.17%
25.3	Core Services ex Rent and OER	3.91%	3.88%	3.70%	3.82%	3.95%	4.08%	3.94%	4.56%	5.05%	5.75%	6.11%	6.19%
35.2	Shelter	6.15%	6.51%	6.72%	7.15%	7.27%	7.69%	7.83%	8.04%	8.11%	8.18%	8.10%	7.88%
26.0	Owners' Equivalent Rent of Residences	6.35%	6.68%	6.85%	7.08%	7.32%	7.66%	7.81%	8.05%	8.12%	8.04%	8.01%	7.76%
7.7	Rent of Primary Residence	6.47%	6.87%	7.18%	7.41%	7.76%	8.03%	8.33%	8.66%	8.80%	8.81%	8.76%	8.56%
1.1	Lodging Away From Home	0.17%	0.85%	1.22%	7.33%	2.98%	6.04%	4.54%	3.41%	3.31%	7.26%	6.73%	7.69%
1.1	Water & Sewer & Trash Collection Services	5.19%	5.35%	5.34%	5.25%	5.82%	5.83%	5.71%	5.71%	5.41%	5.39%	5.25%	4.97%
0.9	Household Operations	0.00%	0.00%	6.70%	#N/A	4.79%	#N/A	5.21%	4.55%	8.01%	#N/A	#N/A	#N/A
6.4	Medical Care Services	-0.49%	-0.88%	-1.96%	-2.64%	-2.14%	-1.53%	-0.76%	-0.08%	0.41%	1.03%	2.15%	2.99%
6.1	Transportation Services	9.68%	10.06%	9.23%	9.05%	10.35%	9.03%	8.23%	10.18%	11.03%	13.88%	14.64%	14.63%
0.5	Airline Fares	-9.37%	-12.11%	-13.20%	-13.42%	-13.29%	-18.59%	-18.85%	-13.44%	-0.87%	17.70%	26.54%	25.56%
3.1	Recreation Services	5.65%	4.79%	5.71%	6.44%	6.10%	6.21%	5.92%	5.76%	6.39%	5.94%	6.34%	5.75%
4.8	Education and Communication Services	1.27%	1.37%	2.29%	2.45%	2.57%	2.72%	2.38%	2.79%	3.13%	3.25%	2.86%	2.77%
1.5	Other Personal Services	6.39%	6.12%	6.67%	6.78%	6.38%	5.95%	6.46%	6.67%	6.30%	5.25%	5.21%	5.34%

Source: BofA Global Research, Bureau of Labor Statistics

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