

US Watch

February CPI Inflation: Services inflation softens, but goods surprise to the upside

Services inflation softens, goods surprise to the upside

The February Consumer Price Index topped expectations, rising by 0.4% m/m (0.442% unrounded) at the headline and 0.4% (0.358% unrounded) at the core. We and consensus were looking for increases of 0.4% and 0.3%, respectively. As a result, headline inflation ticked higher by one-tenth to 3.2% y/y while core dropped to 3.8% from 3.9% previously.

On net, we view the underlying details as largely favorable for our outlook for further disinflation as the miss relative to our expectations came from surprise increases in core goods prices, while services inflation decelerated. We doubt deflation in core goods prices has ended and, in turn, view softer services inflation as a favorable development.

What gap between OER and rents?

The January CPI report contained a historically large divergence between OER and rental inflation, with OER rising 0.6% on the month versus 0.4% for rents. An important question for the February CPI report was whether this divergence would continue, threatening our outlook for further disinflation in shelter in 2024. In February, OER rose by less than rents (0.44% vs 0.46%, respectively), suggesting January's divergence may be a one-off deviation. Overall, shelter inflation rose by only 0.4% in February, down from 0.6% in January, and in line with prior prints.

Core services ex OER and rent slows, but remains firm

Core services decelerated to 0.5% m/m in February, with core services less energy services and rent of shelter rising by 0.5%. The latter was down two-tenths from January. On a y/y basis, this category was up 4.5%, in line with the January reading, but above readings in prior months. Whether February represents a near-term peak in this grouping remains to be seen. The good news is core services ex OER and rent slowed in February, but the bad news is it remains firm overall.

Goods prices surprise to the upside

The services side of the report was largely in line with our expectations. The main reason for the miss relative to our expectation was core goods, which rose (0.1% m/m) for the first time since May 2023. Three categories surprised relative to our expectation, including used cars and trucks (+0.5% versus our forecast for -0.8%), apparel (+0.6% versus our forecast for 0.0%), and other goods (+0.7% versus our forecast for -0.1%).

The main question, in our view, is whether the February CPI report signals that deflation in core goods has stopped. We doubt this is the case. While we expect the pace of goods deflation to slow in 2024, we think there is room for goods prices to decline further. Hence, we are willing to look through the surprise rise in goods prices this month and take a stronger signal from services disinflation.

(Continued on next page)

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Glossary

CPI = Consumer Price Index

PPI = Producer Price Index

PCE = Personal Consumption
Expenditures (Price Index)

OER = Owners' Equivalent Rent

NSA = Not Seasonally Adjusted

OIS- Overnight Indexed Swap

Core PCE tracking at 0.3% m/m

Based on today's CPI release, we currently estimate core PCE inflation to print at 0.3% m/m in February. This is a preliminary estimate that assumes categories where we do not have information on yet will see prices persist at recent trends. We will have more complete estimate after Thursday's PPI report.

Fed implications: June remains a reasonable base case

On net, we think this CPI is a favorable report with respect to our outlook for monetary policy. We find good news in the deceleration in services inflation and the February data suggest the OER-rent deviation from January is a one-off event. Both rose at a similar pace in February. The deceleration in services inflation – against the backdrop of resilient growth and solid employment gains – should give the Fed some additional confidence that the economy is not overheating.

We temper this good news with the uncertainty raised by the surprise increase in core goods prices. This could leave some on the FOMC wondering whether goods deflation has run its course. If so, then there is a risk that the median FOMC member only forecasts two rate cuts this year in the forthcoming March Summary of Economic Projections, as opposed to three currently.

That said, the Fed has said they need services inflation to moderate further in case goods deflation has ended. The February CPI report has this flavor. Hence, while it would have been an unambiguously favorable report had goods prices met our expectation for a decline, we read developments on February inflation as continuing to support out outlook for a rate cut cycle that starts in June.

Rates and FX: Financial market reaction

On net the rates market perceived the inflation print as reducing urgency and extent of rate cuts. While initially rates were little changed to modestly lower, price action later reversed. The print came in close to what we/ consensus had expected and was a modest disappointment vs the CPI fixing. However, the market likely focused on a still firm core services ex-housing component and the rebound in core goods inflation. Inflation compensation increased by 2-3bps across the curve as the market sees more uncertainty around the disinflation path ahead. Pricing for a June rate cut is modestly lower post print at around 17bps (around 70% implied probability) and 84bps of cuts are priced in total this year. The terminal rate of the cycle also moved higher by 5bps, proxied by the 3y1y.

We held our 2y inflation swap long position into the print but suggested clients who have been long lighten up given relatively aggressive market pricing for Feb CPI vs consensus (see: [Feb CPI FAQ](#)). Our BofA Econ projection for CPI is still above where market sits over the next year, which we think is largely driven by market expectations for faster pace of services disinflation. Commodity upside risk also a tailwind to the position.

The USD experienced intra-day volatility on back of the print, with the DXY settling in 0.25% higher on net. From an FX market perspective, the upside print (relative to expectations) appears to be enough for now to halt but not materially reverse/offset the selloff last week. Indeed, the FX market overall seems somewhat eager to sell dollars, as recently evidenced by last week's depreciation on back of Chair Powell's testimony, which was more-or-less in line with his previous communications. That said, Powell did not appear overly alarmed by the January suite of upside inflation data, which gave credence to the contingent seeing those prints as more one-off and distorted by January effects and weather. Today's CPI print does reflect some confirmation of noisiness with the January data, but with core goods deflation moderating and other services components still ticking up/elevated, it likely throws a bit of cold water on any hopes for incremental dovish messaging at next week's

FOMC. The USD's net rally today is directionally consistent with the rise in UST yields and Fed pricing noted above.

Exhibit 1: CPI Forecast vs actual

Core CPI came in firmer than we expected owing to an increase in core goods

	February Forecast		
	Actual	Forecast	Error
NSA Index (level)	310.326	310.312	0.014
Headline CPI (All Items)	0.44%	0.42%	0.02%
Food	0.0%	0.2%	-0.2%
Energy	2.3%	2.2%	0.1%
Core CPI	0.36%	0.31%	0.05%
Core goods	0.11%	-0.20%	0.31%
Household furnishings and supplies	-0.3%	-0.1%	-0.2%
Apparel	0.6%	0.0%	0.6%
Transportation commodities less motor fuel	0.1%	-0.4%	0.5%
<i>Of which:</i>			
New vehicles	-0.1%	-0.2%	0.1%
Used cars and trucks	0.5%	-0.8%	1.3%
Medical care commodities	0.1%	-0.1%	0.2%
Recreation commodities	-0.2%	-0.1%	-0.1%
Other recreational goods	-0.7%	-0.6%	-0.1%
Education and communication commodities	0.2%	-0.5%	0.7%
Alcoholic beverages	0.0%	0.1%	-0.2%
Other goods	0.7%	-0.1%	0.7%
Core Services	0.46%	0.46%	-0.01%
Shelter	0.4%	0.5%	0.0%
<i>Of which:</i>			
Rent	0.5%	0.4%	0.1%
Lodging away from home	0.1%	1.0%	-0.9%
OER	0.4%	0.4%	0.0%
Water and sewer	0.5%	0.5%	-0.1%
Medical care services	-0.1%	0.4%	-0.5%
<i>Of which:</i>			
Health insurance	0.4%	1.2%	-0.7%
Transportation services	1.4%	0.8%	0.6%
<i>Of which:</i>			
Airfares	3.6%	2.0%	1.6%
Recreation services	0.5%	0.3%	0.2%
Education and communication	0.5%	0.3%	0.1%
Other personal services	-0.6%	0.3%	-0.9%

Source: BLS, BofA Global Research, Haver Analytics

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Exhibit 2: CPI heatmap (%m/m)

Headline and core CPI rose by 0.4% in February

Jan-24 weight	Component	Feb-24	Jan-24	Dec-23	Nov-23	Oct-23	Sep-23	Aug-23	Jul-23	Jun-23	May-23	Apr-23	Mar-23
100.0	Headline CPI	0.442%	0.31%	0.23%	0.16%	0.08%	0.36%	0.51%	0.21%	0.21%	0.11%	0.43%	0.08%
13.6	Food	0.02%	0.39%	0.21%	0.17%	0.29%	0.19%	0.24%	0.19%	0.16%	0.22%	0.03%	0.10%
6.6	Energy	2.3%	-0.91%	-0.21%	-1.56%	-2.13%	1.15%	4.36%	-0.02%	0.49%	-2.96%	0.74%	-2.70%
79.8	Core CPI	0.358%	0.39%	0.28%	0.31%	0.24%	0.32%	0.23%	0.23%	0.19%	0.36%	0.47%	0.32%
18.8	Core Goods	0.11%	-0.32%	-0.06%	-0.22%	-0.03%	-0.23%	-0.21%	-0.33%	-0.09%	0.42%	0.44%	0.20%
16.9	Core Goods ex Used Cars	0.06%	0.08%	-0.16%	-0.44%	0.03%	-0.01%	0.03%	-0.16%	-0.01%	0.02%	0.06%	0.31%
3.5	Household Furnishings and Supplies	-0.31%	-0.13%	-0.32%	-0.53%	-0.11%	-0.30%	0.03%	-0.20%	-0.19%	-0.23%	-0.35%	0.38%
2.5	Apparel	0.55%	-0.70%	0.00%	-0.64%	0.01%	-0.35%	0.15%	0.13%	0.15%	0.20%	0.26%	0.23%
6.1	Motor Vehicles & parts	0.10%	-1.11%	0.31%	0.47%	-0.22%	-0.65%	-0.54%	-0.56%	-0.23%	1.09%	1.10%	0.02%
3.7	New Vehicles	-0.10%	-0.04%	0.18%	-0.01%	-0.06%	0.24%	0.22%	-0.03%	-0.05%	-0.09%	-0.14%	0.32%
1.9	Used Cars and Trucks	0.52%	-3.37%	0.59%	1.37%	-0.41%	-1.79%	-1.86%	-1.47%	-0.60%	3.19%	3.23%	-0.58%
1.5	Medical Care Commodities	0.09%	-0.61%	-0.12%	0.46%	0.42%	-0.29%	0.56%	0.51%	0.19%	0.65%	0.46%	0.59%
2.1	Recreation Commodities	-0.20%	0.77%	-0.54%	-0.60%	0.15%	0.33%	-0.44%	-0.78%	-0.31%	-0.06%	0.27%	0.20%
0.9	Education and Communication Commodities	0.24%	0.62%	-0.19%	-2.55%	-1.27%	0.33%	-0.70%	-1.25%	-0.07%	-0.20%	-0.18%	-0.50%
0.9	Alcoholic Beverages	-0.05%	0.27%	0.12%	-0.09%	0.32%	0.60%	-0.02%	0.20%	0.06%	0.46%	0.42%	0.11%
1.4	Other Goods	0.67%	0.32%	-0.51%	0.04%	0.93%	0.55%	0.21%	0.46%	0.20%	0.60%	0.19%	0.63%
61.0	Core Services	0.46%	0.66%	0.38%	0.46%	0.34%	0.52%	0.38%	0.43%	0.31%	0.33%	0.48%	0.38%
26.6	Core Services ex Rent and OER	0.47%	0.85%	0.34%	0.44%	0.21%	0.57%	0.30%	0.34%	0.09%	0.08%	0.35%	0.22%
36.2	Shelter	0.43%	0.63%	0.41%	0.45%	0.34%	0.57%	0.35%	0.48%	0.41%	0.54%	0.48%	0.53%
26.8	Owners' Equivalent Rent of Residences	0.44%	0.56%	0.42%	0.49%	0.42%	0.50%	0.42%	0.50%	0.47%	0.53%	0.57%	0.50%
7.7	Rent of Primary Residence	0.46%	0.36%	0.39%	0.44%	0.47%	0.46%	0.48%	0.47%	0.48%	0.52%	0.58%	0.49%
1.4	Lodging Away From Home	0.15%	1.78%	0.15%	-0.47%	-2.23%	2.81%	-2.13%	0.19%	-1.16%	0.98%	-1.86%	1.41%
1.1	Water & Sewer & Trash Collection Services	0.45%	1.10%	0.14%	0.37%	0.24%	0.26%	0.45%	0.51%	0.40%	0.60%	0.36%	0.33%
6.5	Medical Care Services	-0.05%	0.70%	0.50%	0.50%	0.20%	0.25%	-0.04%	-0.31%	-0.06%	-0.05%	-0.06%	-0.51%
6.3	Transportation Services	1.39%	0.97%	0.09%	1.03%	0.89%	0.72%	1.61%	0.82%	0.44%	0.26%	0.51%	0.88%
0.8	Airline Fares	3.57%	1.40%	0.86%	-0.22%	0.69%	0.25%	2.26%	-3.89%	-5.80%	-3.50%	-2.16%	0.64%
3.3	Recreation Services	0.45%	0.39%	1.15%	0.06%	0.11%	0.52%	-0.11%	0.71%	0.42%	-0.03%	0.74%	0.01%
5.0	Education and Communication Services	0.45%	0.42%	0.16%	0.10%	0.02%	0.06%	0.09%	0.25%	-0.27%	-0.11%	0.07%	0.26%
1.5	Other Personal Services	-0.62%	0.95%	0.11%	0.29%	0.26%	0.64%	0.70%	-0.07%	0.23%	0.47%	1.52%	0.47%

Source: BofA Global Research, Bureau of Labor Statistics

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Exhibit 3: CPI heatmap (%y/y)

Headline CPI rose by 3.2% y/y in February and core rose by 3.8% y/y

Jan-24 weight	Component	Feb-24	Jan-24	Dec-23	Nov-23	Oct-23	Sep-23	Aug-23	Jul-23	Jun-23	May-23	Apr-23	Mar-23
100.0	Headline CPI	3.15%	3.09%	3.35%	3.14%	3.24%	3.70%	3.67%	3.18%	2.97%	4.05%	4.93%	4.98%
13.6	Food	2.23%	2.57%	2.70%	2.95%	3.30%	3.69%	4.25%	4.86%	5.74%	6.69%	7.65%	8.50%
6.6	Energy	-1.90%	-4.56%	-2.02%	-5.44%	-4.53%	-0.45%	-3.62%	-12.47%	-16.74%	-11.66%	-5.06%	-6.42%
79.8	Core CPI	3.75%	3.86%	3.93%	4.01%	4.03%	4.15%	4.35%	4.65%	4.83%	5.33%	5.52%	5.59%
18.8	Core Goods	-0.33%	-0.31%	0.12%	0.03%	0.05%	0.01%	0.44%	0.94%	1.39%	2.04%	2.03%	1.47%
16.9	Core Goods ex used cars	-0.21%	0.08%	0.39%	0.76%	1.45%	1.64%	2.00%	2.53%	3.08%	3.67%	4.00%	4.20%
3.5	Household Furnishings and Supplies	-2.26%	-1.34%	-0.95%	-0.34%	0.69%	0.91%	1.68%	2.24%	3.24%	4.08%	4.77%	5.79%
2.5	Apparel	-0.04%	0.06%	0.97%	1.08%	2.61%	2.32%	3.09%	3.18%	3.07%	3.47%	3.65%	3.25%
6.1	Motor Vehicles & Parts	-0.32%	-0.76%	0.04%	-0.90%	-2.10%	-2.29%	-1.92%	-1.27%	-0.75%	0.12%	-0.30%	-1.82%
3.7	New Vehicles	0.44%	0.74%	1.02%	1.33%	1.87%	2.53%	2.92%	3.50%	4.07%	4.66%	5.42%	6.12%
1.9	Used Cars and Trucks	-1.77%	-3.47%	-1.31%	-3.75%	-7.14%	-7.99%	-6.64%	-5.64%	-5.15%	-4.22%	-6.56%	-11.15%
1.5	Medical Care Commodities	2.95%	3.00%	4.74%	4.98%	4.70%	4.24%	4.45%	4.13%	4.21%	4.42%	4.01%	3.59%
2.1	Recreation Commodities	-1.25%	-0.64%	-1.20%	-0.62%	-0.37%	0.25%	-0.08%	1.02%	1.96%	2.73%	2.90%	3.16%
0.9	Education and Communication Commodities	-5.61%	-6.56%	-7.21%	-7.89%	-7.07%	-7.32%	-8.12%	-7.84%	-7.10%	-6.88%	-8.29%	-10.17%
0.9	Alcoholic Beverages	2.42%	2.29%	2.54%	2.90%	3.70%	4.24%	3.71%	4.10%	4.42%	4.77%	4.64%	4.53%
1.4	Other Goods	4.35%	4.40%	4.55%	5.10%	5.64%	5.11%	5.01%	6.09%	6.13%	6.58%	6.80%	6.91%
61.0	Core Services	5.24%	5.41%	5.30%	5.49%	5.50%	5.69%	5.90%	6.12%	6.15%	6.57%	6.83%	7.11%
26.6	Core Services ex Rent and OER	4.35%	4.37%	3.93%	3.89%	3.67%	3.82%	3.95%	4.05%	3.93%	4.55%	5.04%	5.73%
36.2	Shelter	5.74%	6.04%	6.15%	6.51%	6.72%	7.15%	7.27%	7.69%	7.83%	8.04%	8.11%	8.18%
26.8	Owners' Equivalent Rent of Residences	5.97%	6.23%	6.35%	6.68%	6.85%	7.08%	7.32%	7.66%	7.81%	8.05%	8.12%	8.04%
7.7	Rent of Primary Residence	5.77%	6.09%	6.47%	6.87%	7.18%	7.41%	7.76%	8.03%	8.33%	8.66%	8.80%	8.81%
1.4	Lodging Away From Home	-0.42%	0.98%	0.17%	0.85%	1.22%	7.33%	2.98%	6.04%	4.54%	3.41%	3.31%	7.26%
1.1	Water & Sewer & Trash Collection Services	5.32%	5.55%	5.19%	5.35%	5.34%	5.25%	5.82%	5.83%	5.71%	5.71%	5.41%	5.39%
6.5	Medical Care Services	1.07%	0.62%	-0.49%	-0.88%	-1.96%	-2.64%	-2.14%	-1.53%	-0.76%	-0.08%	0.41%	1.03%
6.3	Transportation Services	9.94%	9.53%	9.68%	10.06%	9.23%	9.05%	10.35%	9.03%	8.23%	10.18%	11.03%	13.88%
0.8	Airline Fares	-6.14%	-6.43%	-9.35%	-12.16%	-13.16%	-13.36%	-13.29%	-18.63%	-18.90%	-13.56%	-0.93%	17.79%
3.3	Recreation Services	4.49%	5.32%	5.65%	4.79%	5.71%	6.44%	6.10%	6.21%	5.92%	5.76%	6.39%	5.94%
5.0	Education and Communication Services	1.51%	1.27%	1.27%	1.37%	2.29%	2.45%	2.57%	2.72%	2.38%	2.79%	3.13%	3.25%
1.5	Other Personal Services	5.05%	6.83%	6.39%	6.12%	6.67%	6.78%	6.38%	5.95%	6.46%	6.67%	6.30%	5.25%

Source: BofA Global Research, Bureau of Labor Statistics

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