

CPI Inflation Watch

December US CPI Inflation preview: A soft 0.3% m/m print**Headline and core CPI to be aligned**

For the December US Consumer Price Index (CPI) report, we forecast headline and core CPI rose by 0.3% m/m (0.26% m/m and 0.27% m/m respectively). Unlike October and November, energy inflation should be more neutral (+0.2% m/m) resulting in similar prints for both core and headline. Based on our forecast, the y/y rate for headline would increase by two-tenths to 3.3%, and core would tick down a tenth to 3.9%. The headline NSA index, meanwhile, should print at 306.634 (See Exhibit 1 for our detailed forecast table).

Our forecast would also mean a slight deceleration in the three-month annualized rate of core CPI from 3.4% in November to 3.2% in December, while the six-month annualized rate would be 3.1%. In our view, the report will continue to show progress towards the Fed's 2-percent target. However, unlike the core PCE inflation data—the Fed's preferred measure of inflation—core CPI is not quite at the finish line.

A tale of two inflation readings: goods vs. services

Within core, we expect core goods and core services to continue to paint two different pictures. On the one hand, we look for core goods prices to decline for a seventh consecutive month (-0.2% m/m), owing in part to a decline in used cars and trucks. That said, we also look for declines in other major components of core goods. Beyond December, the scope for further declines may be blunted in part by rising shipping costs due to issues in the Red Sea and low water levels in the Panama Canal.

On the other hand, we expect core services prices to increase at 0.4% m/m or 5.0% annualized over the last three-months owing in large part to sticky rents. While rent inflation has eased from the peak and asking rent inflation points to further declines, the CPI data has proven to be more stubborn. We expect this persisted in December in part due to different regional dynamics as rents in the Northeast remain firmer than other parts of the country. Excluding rent and owners' equivalent rent (OER), we expect core services prices rose by a still elevated 0.3% m/m compared to 0.4% m/m in November. In short, services inflation likely remained sticky-high in December.

Do the details matter anymore?

In recent weeks we have fielded several questions on whether the composition of inflation matters. Here we offer our answer. We do think composition matters when judging whether we are on a path to persistent price stability. Much of the disinflation in recent months has been driven by deflation in core goods prices, which, in our view, is unlikely the primary result of tighter Fed policy. Therefore, it is something that the Fed should not rely on to continue. Meanwhile, inflation for both shelter and core services excluding housing services have shown some progress, but the current run-rates remain above pre-pandemic levels. That said, with inflation so close to target—and at target depending on what time frame of core PCE one looks at—the composition of inflation will continue to be deemphasized by Fed participants.

(Continued on next page, Forecast table on next page)

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Implications for the fed funds path and market pricing

A CPI report in line with our forecast would continue to signal ongoing progress towards the Fed's 2-percent target. Therefore, in our view, it would keep the Fed on track for 100bp of cuts this year beginning with a 25bp cut in March and continuing at a quarterly cadence thereafter. A soft 0.3 m/m is unlikely to move current Fed pricing much, if at all.

If core CPI were to come in stronger than we expect, at say a strong 0.3% or 0.4% m/m, then market expectations for a March cut would likely be reduced, perhaps to 50% or below. Moreover, Fed participants would likely take note of both an acceleration in inflation and the stronger average hourly earnings data. Therefore, a stronger-than-expected core CPI print could keep the Fed in wait-and-see mode.

Last if core CPI were to come in weaker than we expect, at say 0.1% m/m or a soft 0.2% m/m, then market expectations for a March cut and total cuts this year would likely increase. Based on recent Fed speak, the Fed is clearly ready to cut rates based solely on the inflation data. A January start would likely still be too early, but a soft CPI report may stoke conversations about a faster pace of cutting than what we currently expect.

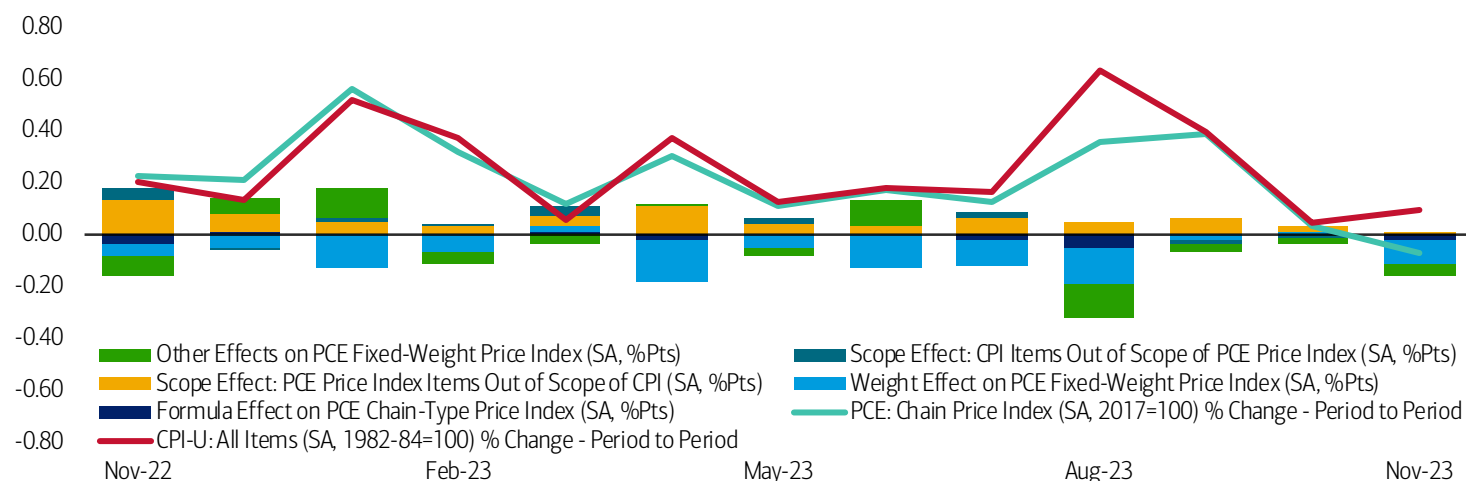
PCE inflation is the target not CPI

Importantly, the translation of the CPI data to the Fed's preferred measure of inflation, PCE will be what matters most to the markets and Fed policy. While data from the CPI report are the primary price series used in the calculation of PCE inflation, a significant portion of PCE inflation uses PPI (producer price index) measures of prices or other methods to estimate prices. Moreover, there are differences in scope and weighting between the two measures of inflation. Due to these differences the two measures of inflation do not always send the same signal.

Indeed, as we saw last month, it's entirely possible to have a relatively firm core CPI print (0.28% m/m) but a soft core PCE inflation print (0.07% m/m). This divergence was mostly a result in the differences in weights between the two inflation measures. PCE inflation has a higher weight on healthcare services and a lower weight on Housing services (rent and OER) than CPI. Therefore, any knee-jerk market reaction to the CPI report could be reversed depending on what the detailed numbers mean for PCE inflation.

Exhibit 1: Factors that explain the Wedge between % m/m changes in Headline CPI and PCE inflation (ppt)

In the last six months there has been a larger divergence in monthly measures of inflation owing largely to different weights and other effects which include seasonal adjustment differences



Source: Bureau of Economic Analysis, Haver Analytics

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Exhibit 1: CPI detailed forecast table

Below is our detailed CPI forecast for December

	% m/m		% y/y (SA) Previous month	3-month % ch. annualized	
	December Forecast	Previous month		December Forecast	Previous month
Headline NSA Index (level)	306.634	307.051			
Core NSA Index (level)	311.756	311.606			
Headline CPI (All Items)	0.26%	0.10%	3.1%	0.6%	2.2%
Food	0.2%	0.2%			
Energy	0.2%	-2.3%			
Core CPI	0.27%	0.28%	4.0%	3.2%	3.4%
Core goods	-0.16%	-0.30%	0.0%	-2.2%	-3.1%
Household furnishings and supplies	-0.1%	-0.7%			
Apparel	-0.1%	-1.3%			
Transportation commodities less motor fuel	-0.3%	0.5%			
<i>Of which:</i>					
New vehicles	0.1%	-0.1%			
Used cars and trucks	-1.0%	1.6%			
Medical care commodities	0.2%	0.5%			
Recreation commodities	0.0%	-0.6%			
Other recreational goods	-0.5%	-0.5%			
Education and communication commodities	-1.2%	-2.6%			
Alcoholic beverages	0.2%	-0.1%			
Other goods	0.4%	0.1%			
Core Services	0.42%	0.47%	5.5%	5.0%	5.7%
Shelter	0.5%	0.4%			
<i>Of which:</i>					
Rent	0.5%	0.5%			
Lodging away from home	0.0%	-0.9%			
OER	0.5%	0.5%			
Water and sewer	0.3%	0.3%			
Medical care services	0.3%	0.6%			
<i>Of which:</i>					
Health insurance	1.1%	1.1%			
Transportation services	0.6%	1.1%			
<i>Of which:</i>					
Airfares	0.0%	-0.4%			
Recreation services	0.2%	0.1%			
Education and communication	0.1%	0.1%			
Other personal services	0.3%	0.3%			
Additional aggregate (Calculated by BofA Global Research)					
Core services ex rent and OER	0.3%	0.4%	3.9%	4.0%	5.2%

Source: BofA Global Research, Bureau of Labor Statistics, Haver Analytics

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