ECONOMIC UPDATE
REGIONS
August 19, 2015

July Consumer Price Index: Raise Your Hand If You're Reasonably Confident

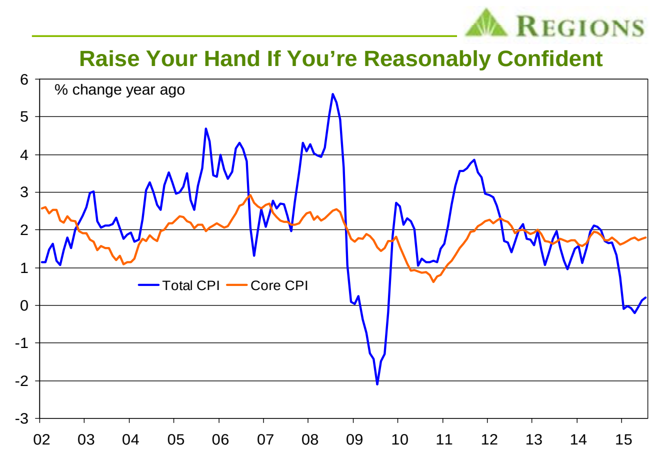
- The total CPI rose 0.1 percent (up 0.132 percent unrounded) in July; the core CPI was up 0.1 percent (also up 0.132 percent unrounded).
- On a year-over-year basis, the total CPI was up by 0.2 percent and the core CPI was up by 1.8 percent in July.

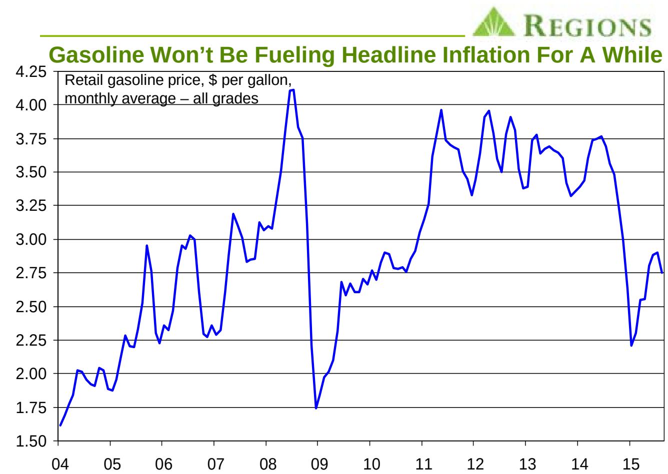
The total CPI rose by 0.1 percent in July, shy of the expected 0.2 percent increase and good for just a 0.2 percent year-on-year increase. The core CPI also posted a 0.1 percent increase in July, which translates into a 1.8 percent year-on-year increase. The overall story on inflation hasn't changed much, with dramatically lower energy prices weighing on the year-over-year increases in the total CPI, falling prices for goods, and core services the primary driver of core inflation. Even here, though, there is less to the story than meets the eye, as rising rents are responsible for most of what we are seeing in reported core inflation. Moreover, there is little to suggest the inflation story will change much in the months ahead, if anything, there are reasons to expect less, not more, inflation. To us, anyway, there is more cause for reasonable doubt than reasonable confidence that inflation will approach the FOMC's 2.0 percent target any time soon.

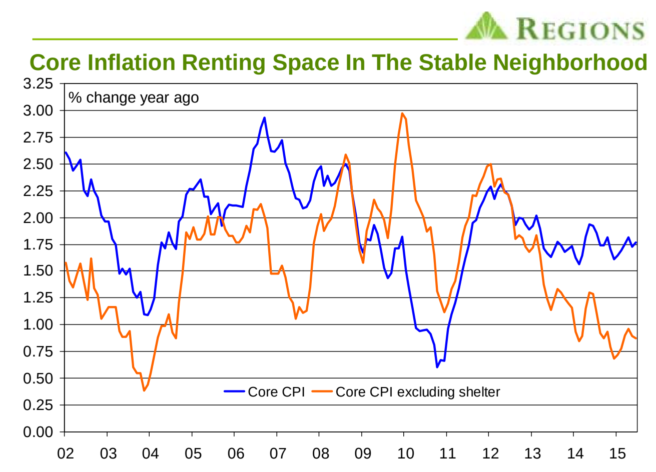
As measured in the CPI data seasonally adjusted retail gasoline prices were up 0.9 percent in July, which leaves them 22.3 percent below their year-ago level. Many have pointed to gasoline prices as a transitory factor weighing on headline inflation and argued that in time these effects will wash from the data and send headline inflation higher. Well, this may be a more lasting factor than had been assumed. The steep decline in crude oil price since mid-July points to lower retail gasoline pump prices, perhaps not immediately but certainly once we are through mid-September. Demand for gasoline tends to soften once we get past Labor Day, and September 15th marks the start of the switch to refiners producing the winter blends of gasoline, which are cheaper than the summer blends. As such, over the latter stages of 2015 gasoline could still be exerting a notable downward pull on headline inflation.

The seemingly obvious argument is to brush aside the effect of lower gasoline prices and point to what has been stable core inflation. But, again, we're not sure just how convincing of an argument this is once one gets underneath the print on overall core inflation. First, there is what is by now a long standing dichotomy between prices for core goods and core services. Prices for core goods have now fallen on a year-over-year basis for 28 consecutive months. Not only do we expect this streak to continue in the months ahead, but we expect the pace of that decline to accelerate as the U.S. dollar strengthens further. The most recent data on prices of non-oil imports lend some credence to our view. Prices for core services, in contrast, are rising and have settled in to a fairly narrow range centered on 2.5 percent. There are some who argue that as the labor market tightens and wage growth accelerates, so too will core services inflation, as services are highly labor intensive. As service providers are largely immune to global pressures and the effects of a stronger U.S. dollar, the argument is faster growth in labor costs will be passed along to consumers in the form of higher prices. While this is certainly plausible, we don't see it happening soon, as we expect an elevated degree of labor market slack to weigh on wage growth until at least mid-2016, which means a meaningful increase in core services inflation is unlikely before that point.

The bigger hole in this argument, at least in our view, is it overlooks the fact that rent growth is far and away the main factor propping up core inflation, or, more specifically, core services inflation. Rents account for roughly 42 percent of the core CPI, and with inflation in both market rents and owners' equivalent rents now boasting three-handles, core services inflation is being overstated. This is apparent in the bottom chart which shows core inflation excluding shelter costs (of which rents account for over 90 percent), which is running at a 0.9 percent pace, half of overall core inflation and even less relative to core services inflation. Moreover, if we are correct and new rental units are delivered at a faster pace over late 2015-early 2016, this will take some of the steam out of rent growth and act as a drag on core inflation. Against this backdrop, we find it hard to muster up much confidence inflation will firm up any time soon.







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