ECONOMIC UPDATE

REGIONS

September 14, 2017

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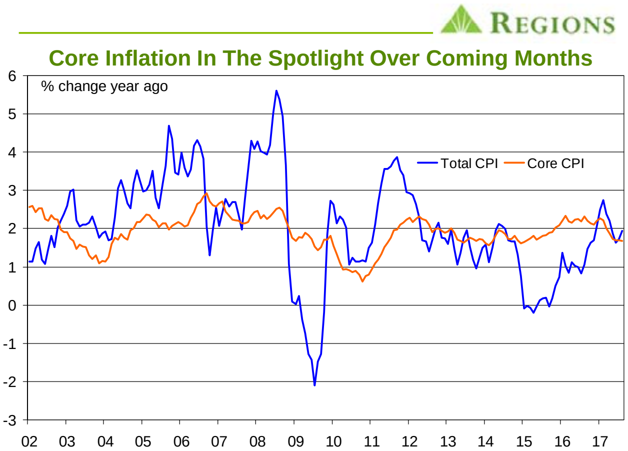
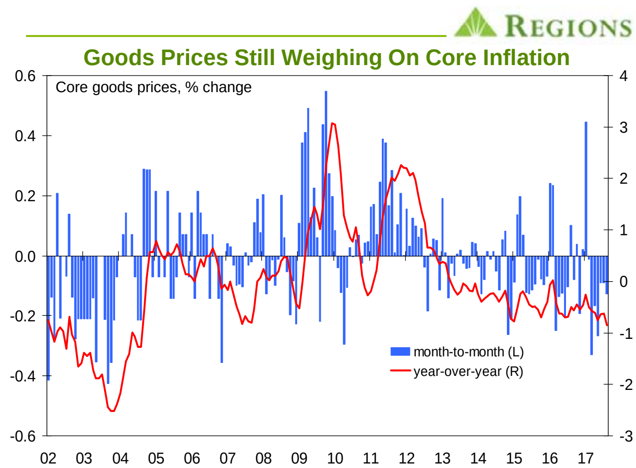
August Consumer Price Index: Harvey The Convenient, But Not The Correct, Explanation

- The total CPI rose 0.4 percent (0.402 percent unrounded) in August; the core CPI was up 0.2 percent (0.249 percent unrounded).
- On a year-over-year basis, the total CPI was up 1.9 percent and the core CPI was up 1.7 percent in August.

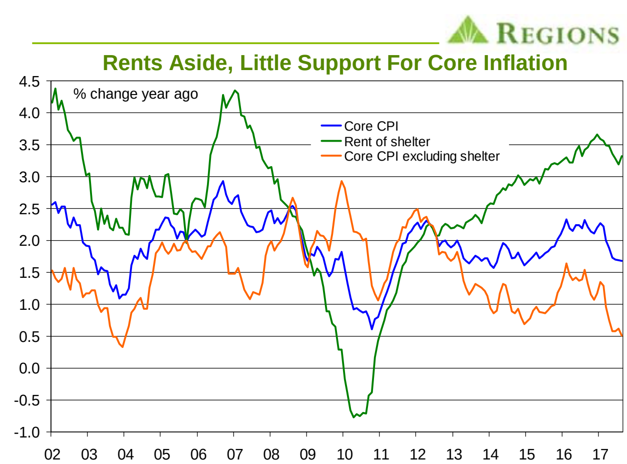
The August CPI report is yet another instance in which the convenient explanation is not necessarily the correct explanation. The total CPI rose by 0.4 percent in August, matching our above-consensus forecast, while the core CPI rose by 0.2 percent, also matching our forecast. Sharp increases in retail gasoline prices and market rents were the main factors behind the jump in the headline CPI and while both of these series will be impacted by Hurricanes Harvey and Irma over coming months, that is not the case with the August data. More broadly, the August CPI report offers scant evidence of inflation pressures, with core inflation remaining comfortably below 2.0 percent.



Many have been quick to pin the jump in retail gasoline prices on Hurricane Harvey, which knocked a considerable portion of the nation's refining capacity offline and disrupted pipeline flows. The problem with this explanation is that even prior to Harvey gasoline prices were up sharply in August, counter to normal seasonal patterns. As such, the 3.9 percent increase in gasoline prices on a not seasonally adjusted basis translated into a 6.3 percent increase on a seasonally adjusted basis. These are the month-to-month changes, with retail pump prices up 10.4 percent year-on-year. That Harvey came so late in the month means little, if any, of the impact was reflected in the August CPI data, but given that in the two weeks since Harvey hit retail gasoline prices have risen by 29 cents means we can expect a sharp increase in the headline CPI for September.



While our forecasts for the headline and core CPI were on the mark, we are nonetheless surprised by the extent to which rents jumped in August. Market rents were up 0.39 percent, exceeding our expectations even after allowing for an atypically soft 0.24 percent increase in July, while owners' equivalent rents were up 0.35 percent in August, the largest monthly increase since October 2006. We have noted before that what had been fairly tame growth in owners' equivalent rents seemed at odds with robust house price appreciation, but yet the increase in August was, to us, surprisingly large. It may seem tempting to dismiss the jump in rents seen in the August data as a one-off occurrence, especially given what had been a gentle deceleration in growth of market rents, but this is one area where the hurricanes may have an impact over coming months. Should displaced homeowners in Houston and various Florida markets flock to rental apartments, even on a transitory basis, this could lead to upward pressure on rents in the months ahead.



To the extent this is the case, it will make it even more difficult for analysts, not to mention central bankers, to get a true read of underlying inflation trends. Given that swings in gasoline prices will have an outsized effect on headline measures of inflation, core inflation will be in the spotlight over coming months. But, as we note above, what could be transitory upward pressure on rents could potentially distort the signal being sent by core inflation, particularly in the CPI data where rents account for over 40 percent of the core index. Still, the CPI data show that, outside of rents, there is simply very little upward pressure on inflation. Non-shelter core inflation slipped to 0.5 percent in August – yes, that is the year-on-year increase. One culprit here is medical costs, which rose just 0.1 percent in August after back-to-back increases of 0.4 percent. This leaves medical costs up 1.8 percent year-on-year, the smallest such increase since January 1965 (for the less technically inclined, yes, that is a long, long time). Core goods prices have been a persistent drag on core inflation, and this continued to be the case in August; core goods prices fell 0.13 percent, leaving them down 0.85 percent year-on-year, the 52nd over-the-year decline in the past 53 months. Apparel prices are working on a streak of their own, having declined year-on-year for the past four months.

The FOMC will see three more CPI reports before making a decision on interest rates at their December meeting. How much clarity those reports will bring, however, is an open question, even with the focus on core inflation. Still, those who have argued the recent deceleration in inflation is transitory may have a tough time making their case.

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