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Economics Group

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It's Been a Hot Summer for Core Inflation

The 0.3% gain in the August core CPI puts the index up a torrid 3.4% pace the past three months. Despite running in line with the Fed's target, the pickup is unlikely to dissuade the FOMC from easing next week.

Goodbye Goods Deflation

Lower energy and grocery store prices led to a tepid 0.1% rise in CPI prices, but core inflation came in hot again in August. Prices excluding food and energy rose 0.3% for a third consecutive month, pushing the three-month annualized pace of core inflation to a 13-year high of 3.4% and 2.4% over the past 12 months.

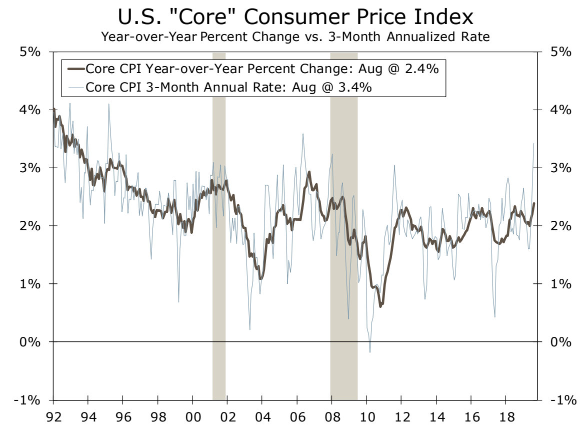
There were a few categories that suggest the torrid pace registered again in August is unlikely to persist. For example, used auto prices registered a third straight monthly gain of nearly 1% or more, but the CPI used vehicle index tends to lag auction prices, which are once again softening. Also, airfare prices, one of the most volatile components of services, rose 1.7% after a 2.3% gain last month. With oil prices in a tight range, we would anticipate airfare inflation to ease up in coming months.

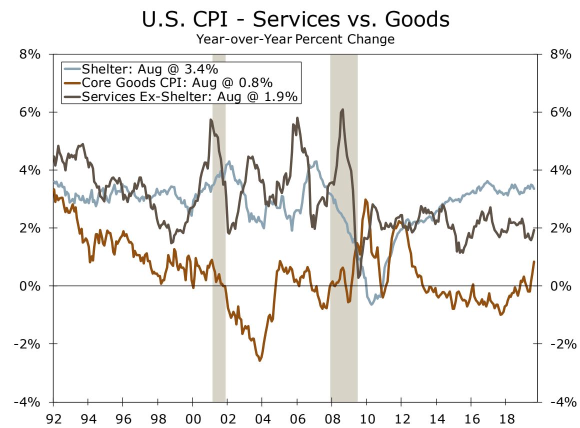
Some cooling in housing costs in August, if sustained, also point to core inflation letting off the gas in coming months. Shelter costs, which have been the primary driver of services inflation, rose a sub-trend 0.2% in August with softer reads on rental price increases as well as owners' equivalent rent.

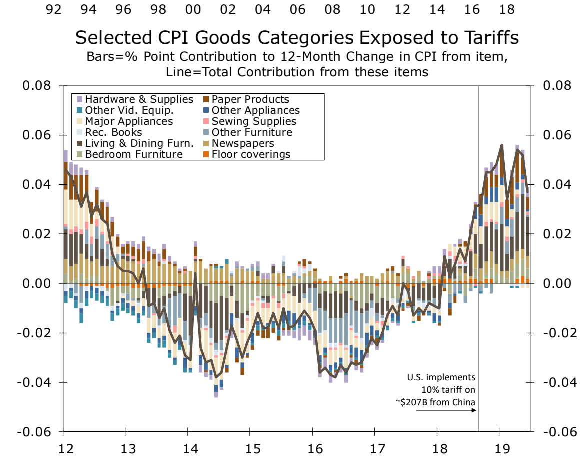
Other categories, however, picked up the baton. Medical care costs rose 0.7% and were the largest contributor to August's rise. Most notably, the disinflationary impulse coming from core goods deflation has ended. Core goods prices increased again in August and are up 0.8% over the past year—the largest one-year gain since 2012. This comes even before the majority of consumer goods imports from China are subjected to tariffs. But for those categories of consumer goods that were exposed in initial rounds and have already seen tariff rates jump to 25%, the cost of import taxes is clearly getting passed on. As illustrated in the bottom chart, the lift to headline inflation coming from tariffed categories has ramped up over the past year, Still, these categories are only contributing about 0.05 percentage points more to the 12-month rate of inflation than they have in the prior six years.

Not Enough to Dissuade the FOMC from Easing

Overall, today's report shows inflation running in line with the Fed's target. Inflation as measured by the core CPI deflator tends to run 0.2-0.3 points higher than the core PCE. This is unlikely to reverse the Fed's recent easing bias, however. The lift to inflation from tariffs should prove temporary, lifting prices initially but not in perpetuity (unless inflation expectations become unanchored as a result, a prospect we doubt). We believe the Fed is more concerned about the trade war's impact on the economy's growth prospects, and therefore the outlook to inflation further down the road. What's more, the FOMC has a playbook for reining in inflation if it gets too high. It has struggled, however, with driving sub-target inflation higher. For a Fed already implicitly shifting toward an "average inflation" target regime, the recent pickup to a rate essentially at its target may still prove insufficient.







Source: U.S. Department of Labor and Wells Fargo Securities

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