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US December CPI: core inflation surprises on the upside

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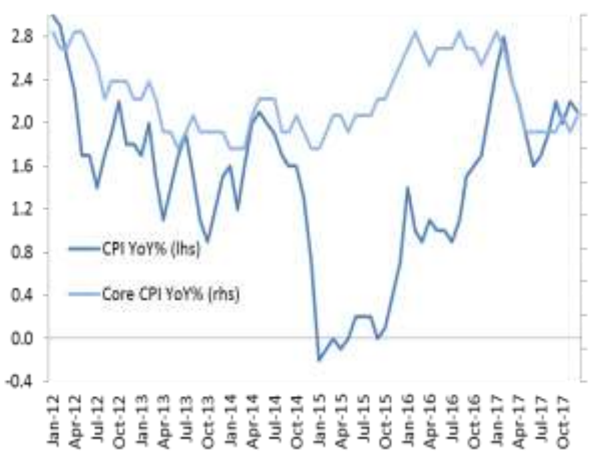
- In line with consensus estimate, headline CPI inflation decelerated to 0.1%MoM (+2.1%YoY) in December from 0.4%MoM (+2.2%YoY) in November (Figure 1), mainly on the back of a 1.2%MoM decline in the energy sector following a sharp 3.9%MoM increase in November. On the flipside, the food inflation index accelerated to 0.2%MoM in December from 0.0%MoM in the prior month, with both indexes for food at home and food away from home increasing. The shelter inflation index accounted for almost 80% of the monthly increase in the headline CPI, doubled its growth to 0.4%MoM in December compared to the previous month.

- Core CPI inflation was a one-tenth stronger than expected at 0.3%MoM (+1.8%YoY) from 0.1%MoM (1.7%YoY) in November, with broad-based strength across services (+0.3%MoM/+2.6%YoY) and goods (+0.2%MoM/-0.7%YoY). Although the sharp increase in auto prices due a surge in demand after the damages during the hurricanes had partially boosted core goods inflation in December, core goods are still in a deflationary path, with the traditional retail sector being under pressure amid technology-induced structural changes (Figure 2).

- Inflation pressures were modest in 2017, not only in the US but in most developed countries. After reaching a multi-month high of 2.3%YoY in January, upside pressures proved to be temporary and core CPI slowed down thereafter standing either at 1.7%YoY or at 1.8%YoY for eight consecutive months in the period May-December. With US GDP growth expected to bounce to 2.6% in 2018 (market consensus) from an anticipated 2.2% in 2017 —above potential GDP growth of around 1.75-2.00% for the second year in a row— the diminishing slack in the economy is likely to push inflation higher in the coming months.

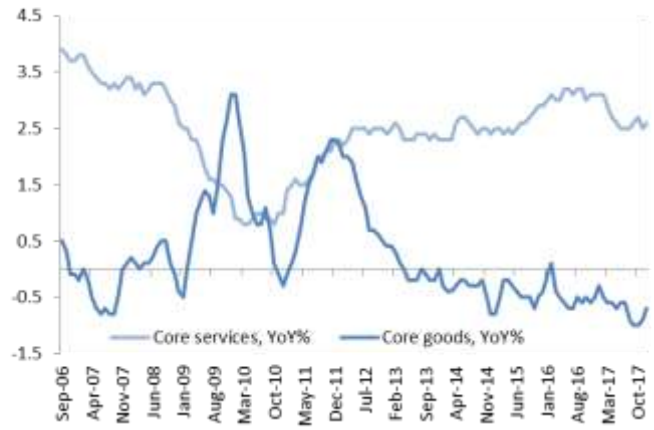
- Looking at some inflation-related data released lately, the Employment Cost Index (ECI) accelerated to 2.5%YoY in Q3 2017 from 2.2%YoY in Q4 2016, the highest since Q1 2015 (Figure 3). The unemployment rate stood at 4.1% in December for the third month in a row, the lowest since December 2000 and below the Fed's NAIRU estimate of 4.6%, from 4.7% in December 2016, pointing to continued tightening in the labor market. Adding to the above, prices for US imports increased 3.0% in 2017 after advancing 1.9% in the previous year, assisted by the USD's weakness against its major currency peers (Figure 4). However, other wage metrics pointed to weaker price pressures with average hourly earnings sliding to 2.5%YoY in December 2017 from 2.9%YoY in December 2016 (Figure 5). Adding to the above, inflation expectations have failed to improve significantly, raising the risk of persistently subdued inflation pressures (Figure 6). Tax reforms approved by Congress in late December, are likely to prove overall a neutral factor for inflation this year though shelter inflation may face some downward pressure due to the lower limit on state and local tax deduction. To sum up, though there seems room for a gradual acceleration in inflation in the months ahead, upside risks are likely to prove limited. Should this be the case, the Fed will continue to gradually withdraw policy accommodation with federal funds futures indicating two rate hikes by end-2018. A sustained upward trend in US inflation and/or wage growth is probably a key prerequisite for the Fed to purse a steeper path of rate hikes in the period ahead.

Figure 1: CPI and core CPI



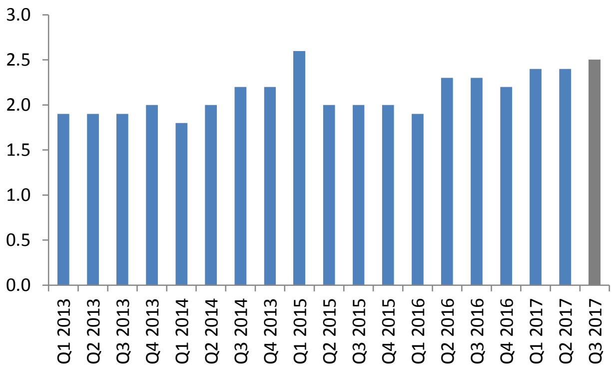
Source: Bureau of Labor Statistics (BLS), Eurobank Research

Figure 2: Core goods and services



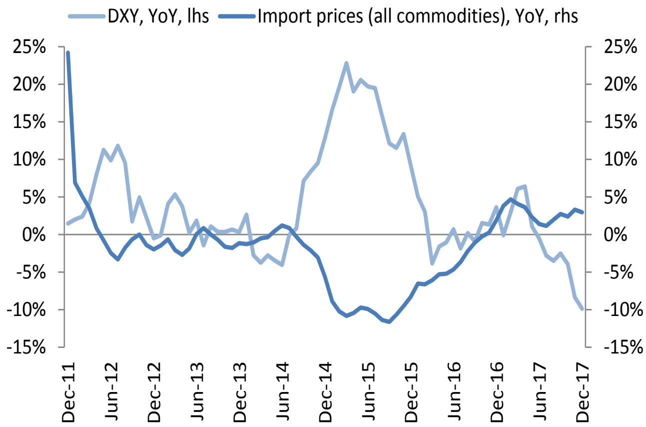
Source: Bureau of Labor Statistics (BLS), Bloomberg, Eurobank Research

Figure 3: Employment Cost Index (YoY%)



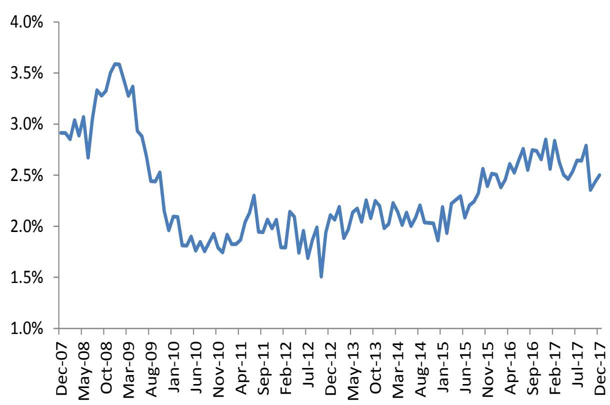
Source: Bureau of Labor Statistics (BLS), Eurobank Research

Figure 4: DXY Dollar Index and imports prices



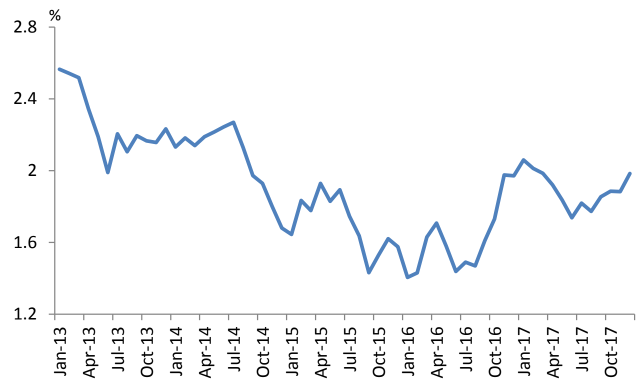
Source: Bureau of Labor Statistics (BLS), Reuters, Eurobank Research

Figure 5: Average hourly earnings (YoY%)



Source: Bureau of Labor Statistics (BLS), Eurobank Research

Figure 6: 10-yr Breakeven inflation rate



Source: Bloomberg, Eurobank Research

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