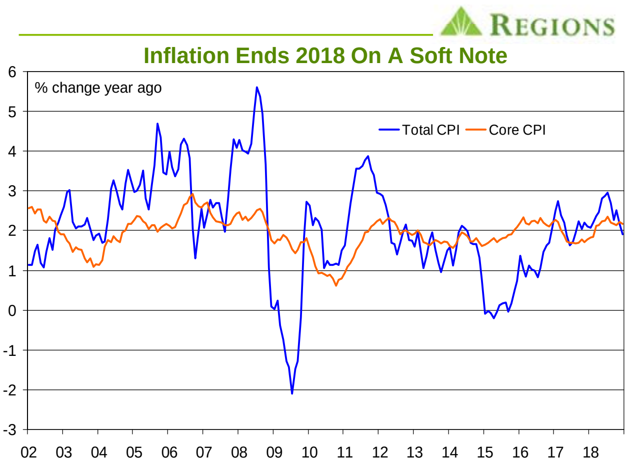
ECONOMIC UPDATE
REGIONS
January 11, 2019

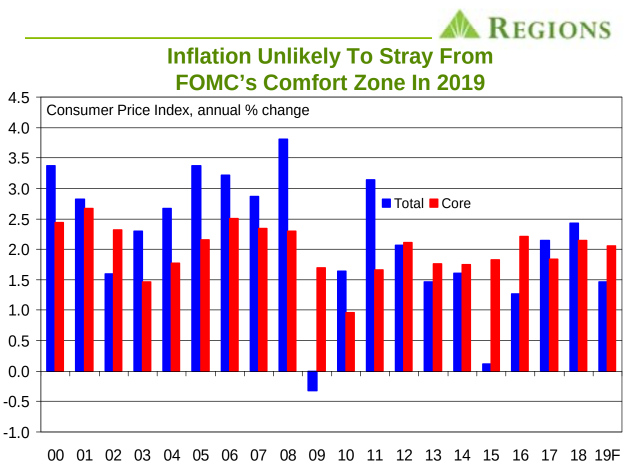
December Consumer Price Index: Inflation Ends 2018 On A Soft Note

- The total CPI <u>fell</u> by 0.1 percent (-0.057 percent unrounded) in December; the core CPI was <u>up</u> 0.2 percent (0.210 percent unrounded)
- On a year-over-year basis, the total CPI was <u>up</u> 1.9 percent and the core CPI was <u>up</u> 2.2 percent in December

The total CPI fell by 0.1 percent in December while the core CPI rose by 0.2 percent, each matching the consensus forecast (we expected a 0.2 percent decline in the total CPI and a 0.2 percent increase in the core CPI). On an over the year basis, the total CPI is up 1.9 percent and the core CPI is up 2.2 percent. Steep declines in retail gasoline prices will pull headline inflation lower in the early months of 2019, meaning core inflation will be a more relevant indicator of underlying inflation pressures. As 2018 ended, however, core inflation was lacking clear direction and is unlikely to muster enough upward momentum over the course of 2019 such that the FOMC would be compelled to push the Fed funds rate up at a faster pace. Instead, inflation is likely to remain tame enough to afford the FOMC the option of a patient pause, which is the policy stance incorporated into our baseline 2019 forecast.

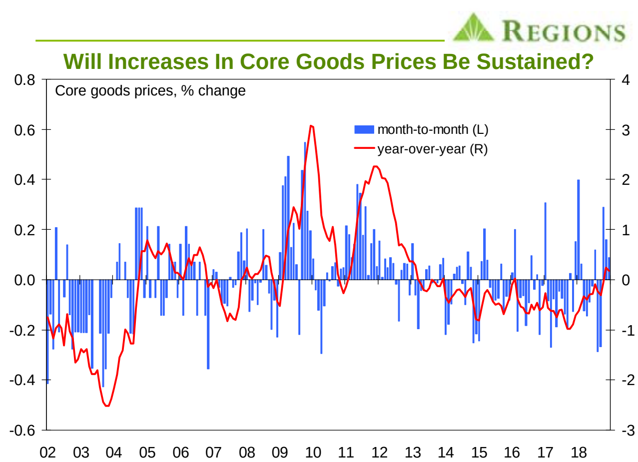


For 2018 as a whole, the total CPI increased by 2.4 percent and the core CPI increased by 2.1 percent, each matching the forecast published in our January 2018 *Monthly Economic Outlook*. Aside from energy – retail gasoline prices rose by 13.6 percent on an annual average basis – there were scant signs of inflation pressures. Indeed, for many of the key CPI components, the December/December increase was less than the full-year increase, meaning that inflation pressures were abating as 2018 came to a close. As seen in our middle chart, we do not look for inflation to stray from the FOMC's comfort zone in 2019. We think energy prices will be enough of a drag early in the year to hold headline CPI inflation below 2.0 percent for 2019 as a whole, and we look for core CPI inflation to be up by just 2.06 percent, though by year-end we think core inflation will be running at 2.3 percent. In other words, while there is no shortage of things to worry about on the economic front in 2019, inflation is not one of them.



As for the December CPI data, the broad energy index was down 3.5 percent, with retail gasoline prices down 7.5 percent and prices for home heating fuels down 7.8 percent – these are month-to-month changes. Given that retail gasoline prices have continued to slip thus far in January, gasoline will again be a drag on the total CPI this month. The 0.4 percent increase in food prices surprised us to the upside, hence our miss on our forecast of the total CPI. Prices for food consumed at home were up 0.3 percent while prices for food consumed away from home rose by 0.4 percent (the unrounded increase of 0.399 percent is the largest monthly increase since September 2015).

Medical care costs rose by 0.3 percent in December, leaving them up 2.0 percent year-on-year, which also proved to be the full-year 2018 increase. Both market rents and owners' equivalent rents rose by 0.2 percent in December, though the unrounded 0.196 percent increase in market rents is the smallest since February 2014. For each category, the year-on-year increase in December was below the full-year average, which is in line with our forecast of decelerating rent growth in 2019 acting as a brake on core inflation. Core goods prices were up 0.1 percent in December, leaving them up 0.2 percent year-on-year. December marks the second straight months in which core goods prices were up year-on-year, and if that doesn't sound so noteworthy, what makes it so is that this is the first such instance since 2013. We routinely point to medical care costs, rents, and core goods prices as the "big three" drivers of core inflation, and the patterns we're seeing in rents and core goods prices are in line with our forecasts. In contrast, we don't have much of a sense of where medical care costs are heading this year.



Labor costs also loom as a wild card for inflation in 2019. Service providers – restaurants, hotels, and others – have the latitude to pass along higher labor costs, and with further hikes in minimum wages taking effect this month, the CPI data for these categories will bear watching. While core services inflation was stable over the back half of 2018, this is a potential pressure point in 2019. On the whole, however, we expect inflation pressures to remain fairly muted in 2019.

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