

US CORE CPI SURPRISES TO DOWNSIDE - ONLY MODEST NEAR-TERM FIRING

**Headline CPI advanced 0.4% m/m and 2.2% yr/yr in November due to a strong 3.9% gain in energy prices*

**Core CPI (excludes food and energy) rose 0.1% m/m (unrounded: 0.117%) after accelerating to 0.2% in October, lowering its yr/yr gain to 1.7% from 1.8% in the prior month (see Chart 1)*

**The three-month annualized change in the core CPI fell to 1.9% from 2.4%, and a sustained acceleration seems unlikely (see Chart 2)*

The core CPI was weighed on by both goods and services prices. Core goods prices fell by 0.1%, as an outsized 1.3% m/m decline in apparel prices (the third largest decline in the 70-year history of the series) outweighed strong gains in new vehicle and used cars and trucks prices. Apparel prices account for 3% of the CPI, and a monthly increase in December may not be enough to boost the yr/yr gain after the sharp November decline (see Chart 3). Strong storm-replacement demand seems to have finally given auto dealers some pricing power after a year of deep discounting (see Chart 4).

Core service prices (excludes energy) increased by only 0.17% m/m, one of its slowest gains in the last three years, due to sluggish shelter price gains and an outsized 0.8% **drop in physicians' services prices**. **There has been a marked deceleration in healthcare prices** this year, probably due to large uncertainty and changes to healthcare policy (Chart 5 and Chart 6).

Based on the change in the CPI, the Fed's preferred measures of inflation, the headline and core PCE deflators (scheduled for release on December 22) probably increased 1.8% yr/yr (from 1.6% prior) and 1.5% yr/yr (from 1.4% prior), below the Fed's 2% target but still much improved from the prolonged H1 weakness.

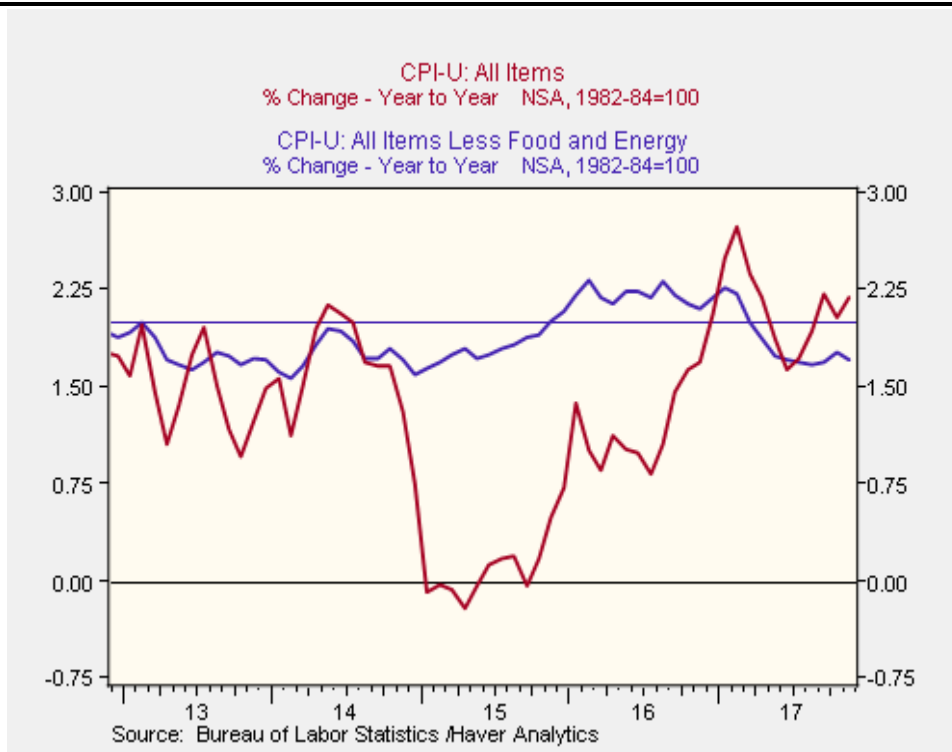
Although the top-line core CPI number surprised to the downside, it appears that the weak gains were concentrated in a few categories, as 38 of 62 main categories increased, more widespread than the 28–34 categories increasing each month between March and June (see Chart 7). This trend suggests that the soft patch in inflation from early in the year has passed but that the firming inflation will be uneven, but modest, on the whole.

Strong economic momentum, continued job growth, tight labor supply and a low unemployment rate, likely new tax legislation, and the running-off of some idiosyncratic factors in CPI suggest that inflation will pick up next year. This expectation supports our forecast for the Fed to raise its policy rate four times next year after increasing it today.

Note that, although higher prices at the gas pump boosted the headline CPI in November, retail regular gasoline prices are down so far in December and on track to subtract from the headline CPI in the next report.

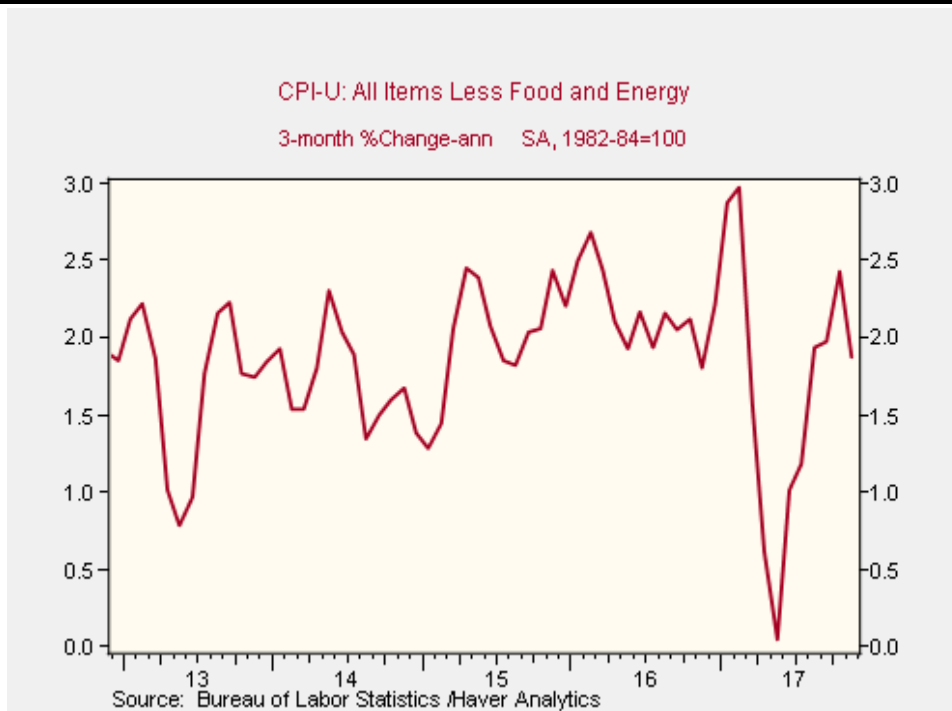
13 December 2017

Chart 1: CPI - All items and CPI - Less Food and Energy (year-over-year, %)



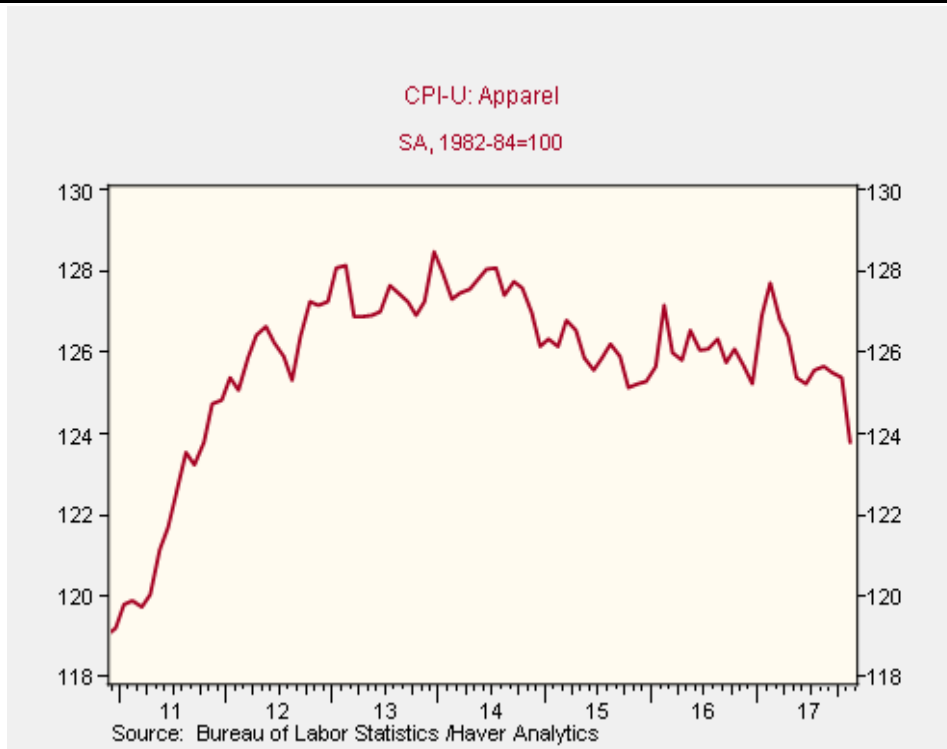
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 2: CPI: All Items Excluding Food and Energy (three-month, annualized % change)



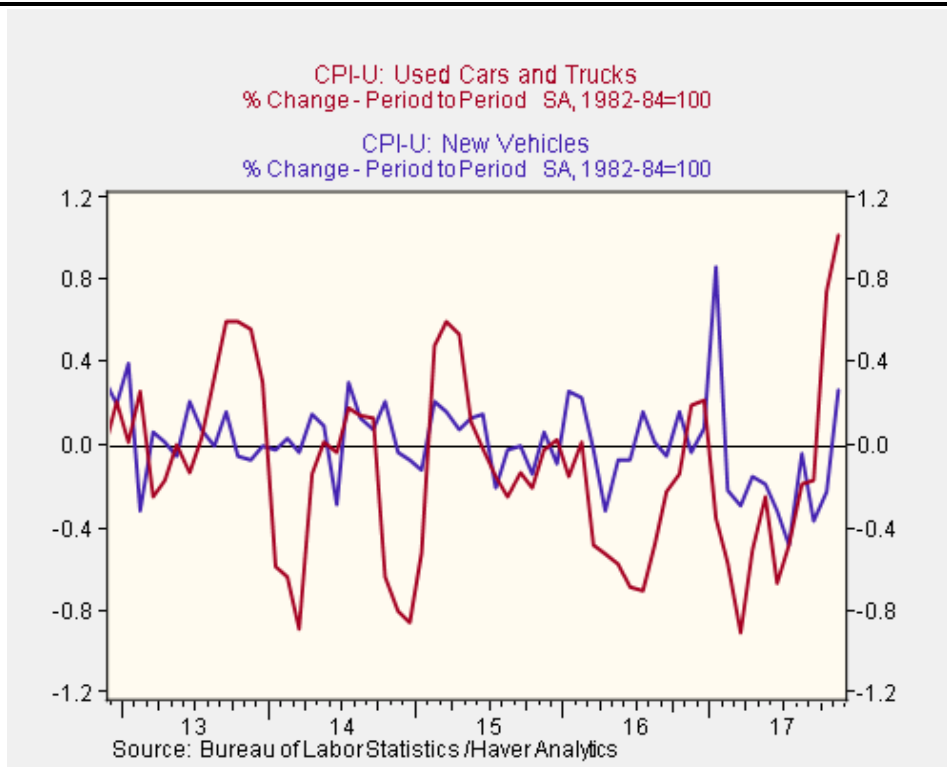
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 3: CPI: Apparel



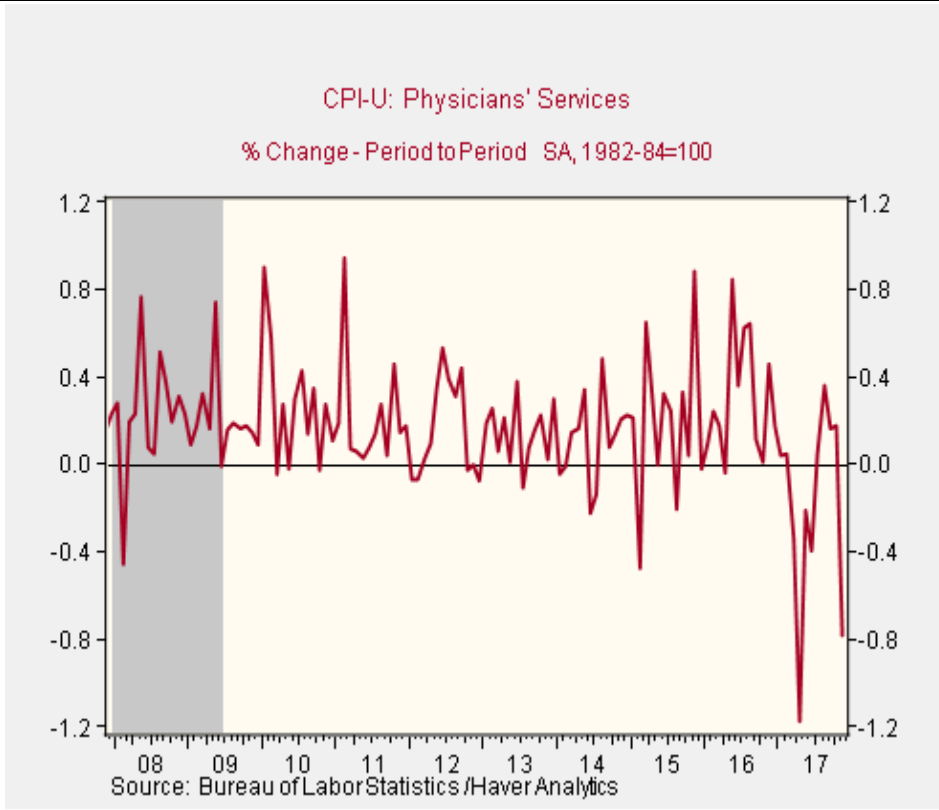
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 4: CPI: Used Cars and Trucks, and New Vehicles (month-over-month, %)



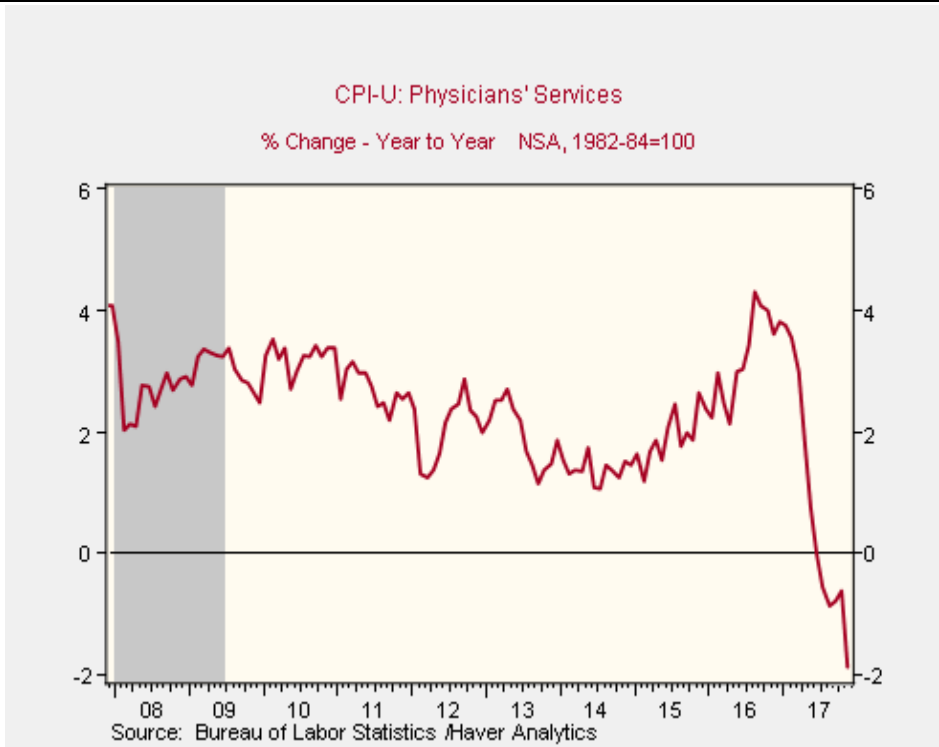
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 5: CPI: Physicians* Services (month-over-month, %)



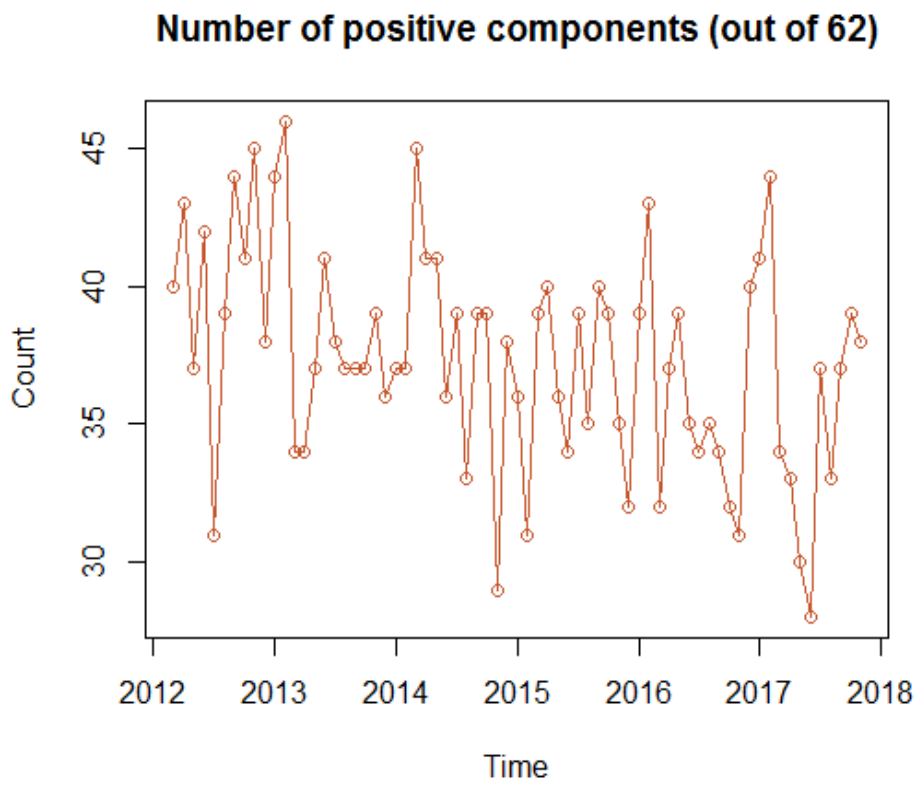
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 6: CPI: Physicians* Services (year-over-year, %)



Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 7: Number of CPI Components Increasing on a Month-Over-Month Basis



Source: Bureau of Labor Statistics and Berenberg Capital Markets

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