

US CPI JUMPS, CONSUMERS TAKE BREATHER, BOTH TRENDS UNLIKELY TO CONTINUE

**Amid financial market concerns about bond yields and heightened attention on U.S. inflation, the headline consumer price index (CPI) in January rose 0.5% m/m while core (excluding food and energy) rose 0.3% — almost rounding up to 0.4% (0.349% unrounded) — both above consensus and placing their yr/yr increases at 2.1% and 1.8%, respectively (see Charts 1 and 2)*

The rise in January was driven in part by one-time increases, so we caution against **reading too much into one month's report and are skeptical that these outsized gains will continue*

**Retail sales in January slipped 0.3% m/m, reflecting inclement winter weather and consumers taking a break after a bumper holiday shopping season*

CPI

January's jump in the core CPI is unlikely to be sustained: 1) surprises came from the 1.7% gain in apparel prices, which have been on a lower trend over the last three years, and outsized gains in motor vehicle insurance and medical care services prices, which are volatile and likely to be reversed (see Chart 3); and 2) in 2017, the CPI recorded its biggest increase in January with paybacks in subsequent months, and in most recent years there have been outsized increases in January that subsequently simmer down (see Chart 4). Note that lower retail gasoline prices so far in February are on track to weigh on the headline CPI in the next report.

Nevertheless, inflation is beyond its trough and, fueled by the acceleration in economic activity (nominal spending), we expect inflation to rise modestly in 2018. Stronger aggregate demand for goods and services is providing businesses some flexibility to raise product prices — and to grant wage increases — but improving productivity gains will constrain broader inflationary pressures.

The details of the January CPI suggest that the Fed's preferred measures of inflation, the PCE price index, likely increased 0.4% m/m in January, resulting in a 1.7% yr/yr gain, with a 0.3% m/m increase on its core (excluding food and energy), resulting in a 1.5% rise in yr/yr terms. The PCE deflator data will be released on March 1.

Although we do not expect inflation to materially overshoot the Fed's 2% longer-run target, in addition to stronger aggregate demand, key factors point toward further moderate inflation pressures: 1) one-time factors that reduced measured inflation in 2017 will roll off yr/yr changes, such as the prices of cellphone service that could add 0.2 percentage points to 12-month inflation in March; 2) the PPI (scheduled) for release tomorrow has already firmed, indicating that price pressures in the supply chain pipeline are beginning to build, and this has been supported by anecdotal evidence; 3) the weaker U.S. dollar should lead to rising prices of imports.

Retail sales

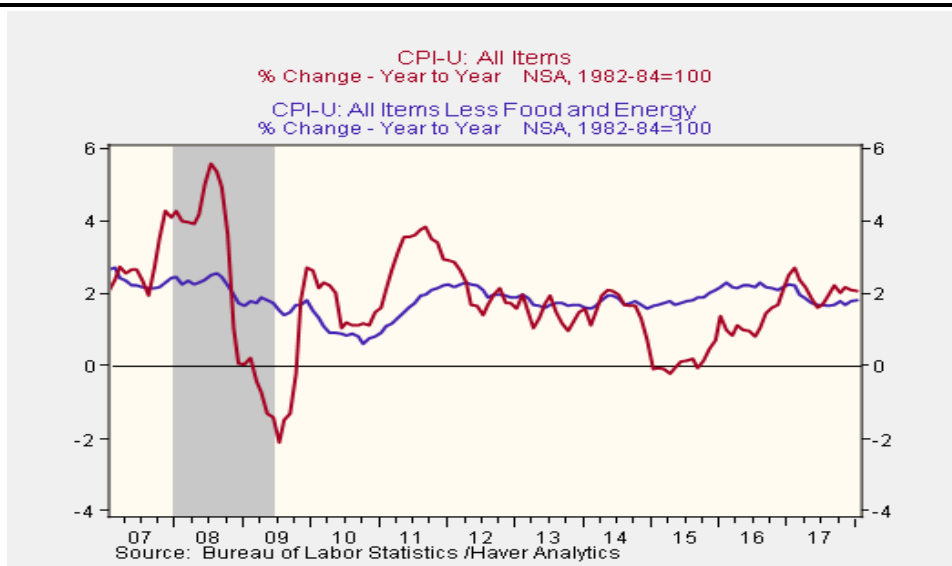
Retail sales were soft in January. Inclement weather likely dragged on retail sales early in the year, and consumers seemed to take a breather after a bumper holiday season. Indeed, sales in weather sensitive sectors such as building materials (-2.4%) and food services and drinking services sales (0%) and sporting goods (-0.8%) were soft.

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Control retail sales (excludes food services and drinking places, gasoline stations, autos and building materials sales), which is measured directly into GDP, was flat in January and revised lower in both November and December. This suggests a downward revision to consumption and GDP growth in Q4. **January's control retail sales is tracking toward a 1.2% quarterly annualized rise**, but better gains are expected in February and March. Importantly, retail sales are only roughly one-third of total consumption while two-thirds are services.

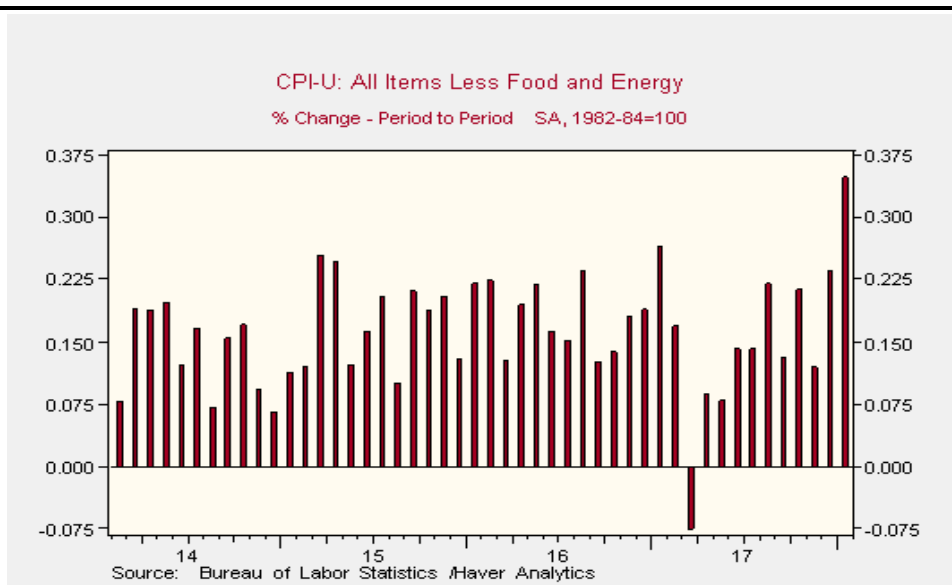
We continue to forecast sustained healthy growth in consumption in 2018. On the negative side, a sustained decline in equity prices and fall in confidence would dent the propensity to spend, but other factors are positive: further gains in employment, wages, and personal income are expected; and tax cuts will add to disposable income (see Charts 6 and 7). Changes in tax withholding schedules are expected to be implemented this month, which will increase take home pay for most households.

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



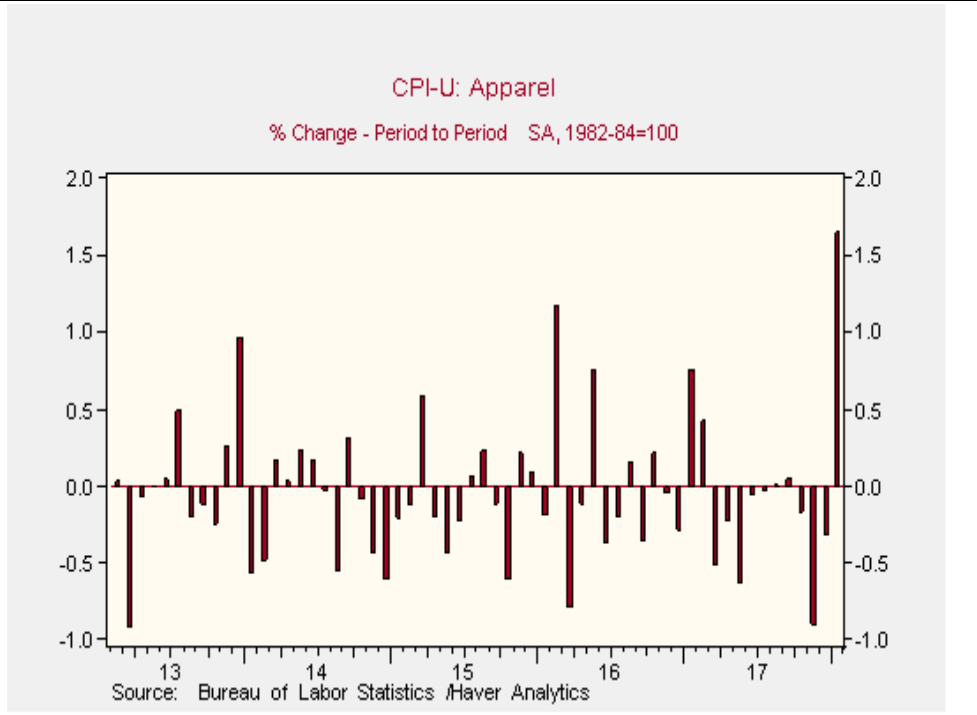
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

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



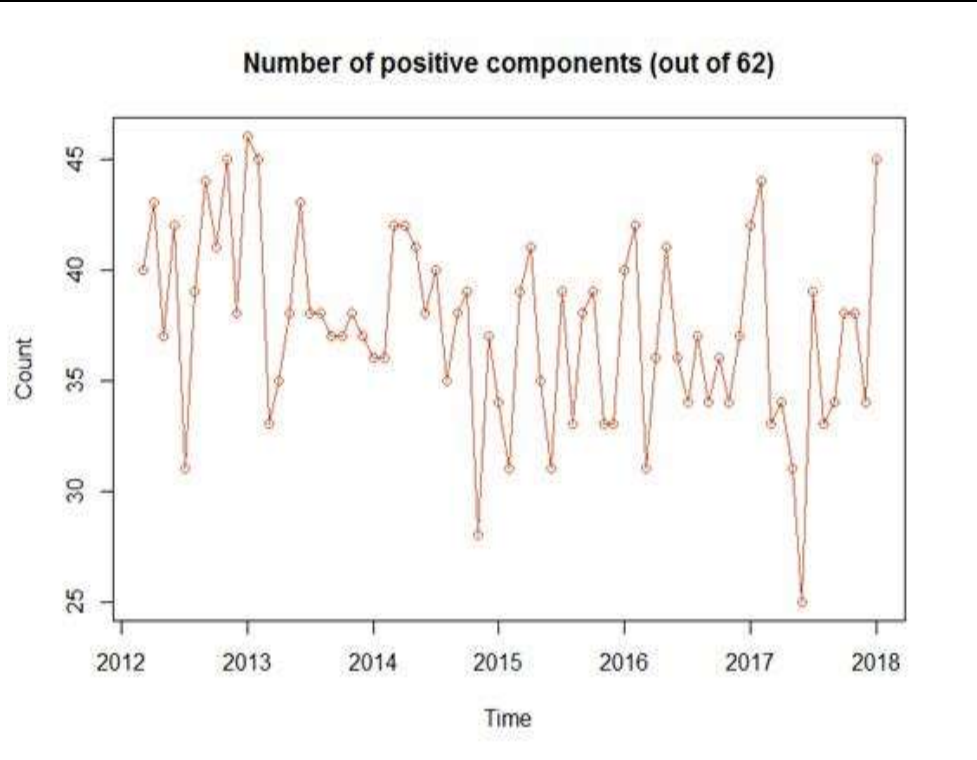
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 3: CPI: Apparel (month-over-month, %)



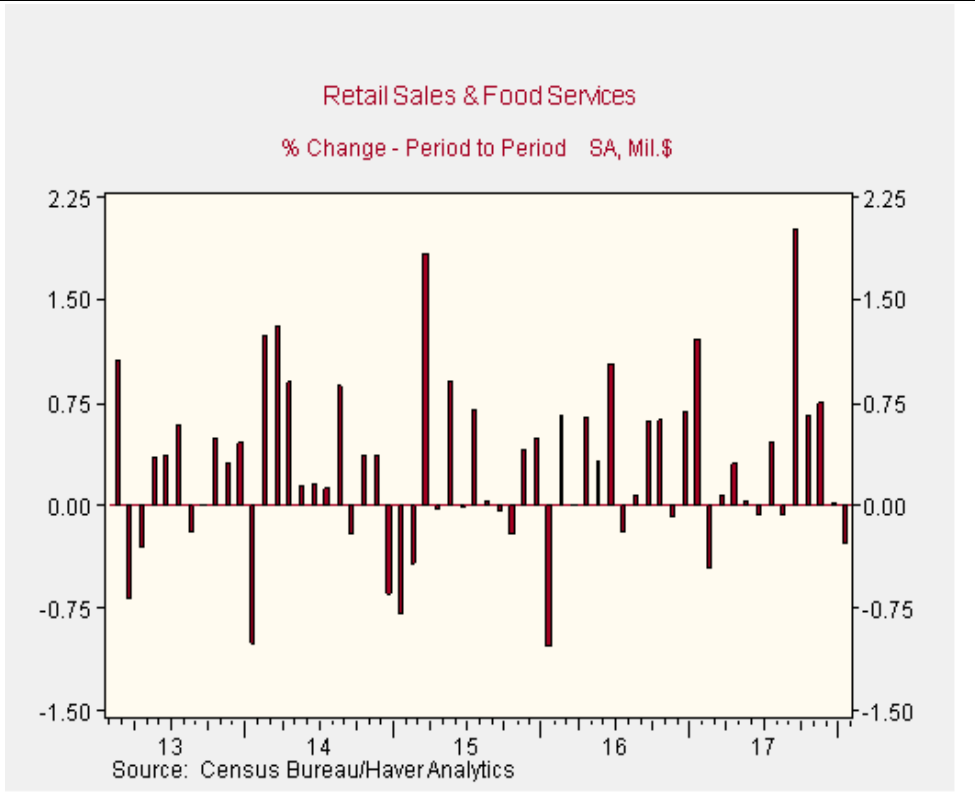
Source: Monthly data. Source: Bureau of Labor Statistics and Haver Analytics

Chart 4: Number of CPI Components Increasing On a Month-Over-Month Basis



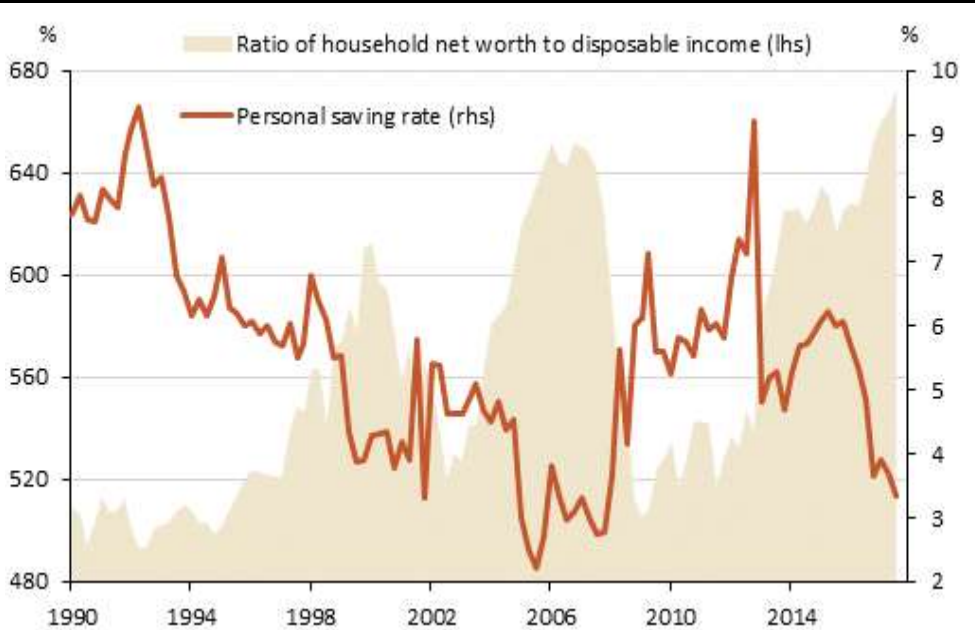
Source: Monthly data. Source: Bureau of Labor Statistics and Berenberg Capital Markets

Chart 5: Total Retail Sales (month-over-month, %)



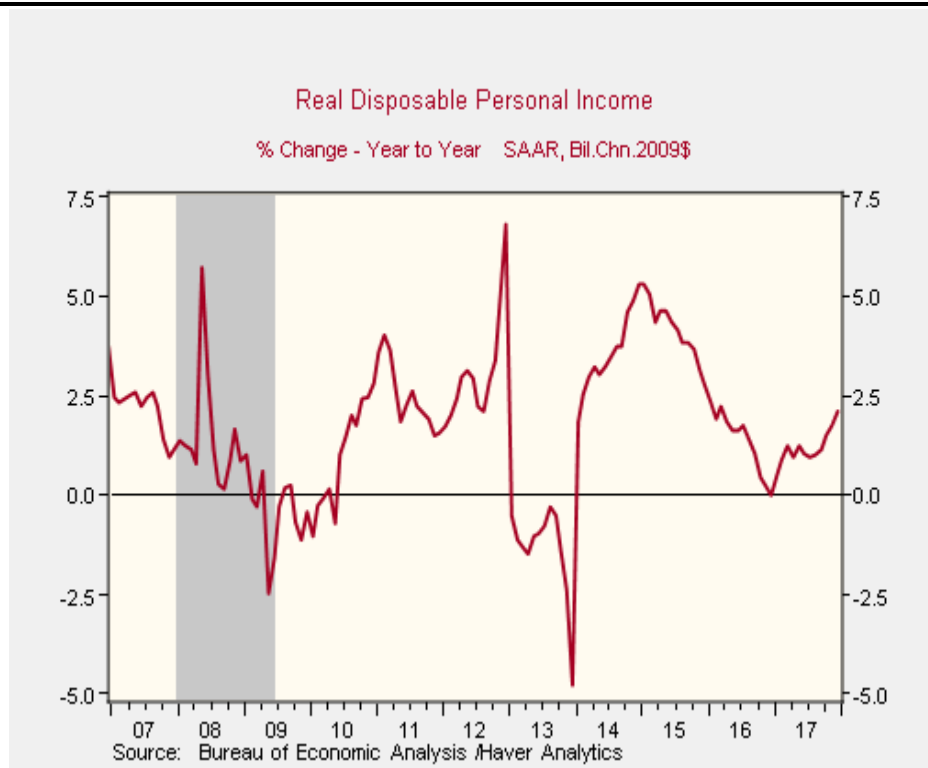
Source: Monthly data. Source: Census Bureau and Haver Analytics

Chart 6: US Household Net Worth and Personal Saving Rate



Source: Quarterly data. Source: Federal Reserve Board and Bureau of Economic Analysis

Chart 7: Real Disposable Personal Income (year-over-year, %)



Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

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