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TD Economics

Data Release: Inflation reaches a two and a half year high in December

- Inflation rose above 2% for the first time since 2014 in December as consumers paid more for shelter and gasoline. The annual (year-on-year) inflation rate was 2.1%, up from 1.7% in November, as prices rose 0.3% on the month – right on expectations..

- The price of gasoline rose 3% in December, as the cost of crude oil rose back above $50/bbl. Energy costs are no longer keeping inflation low, with the price of gasoline now 9% above the year ago levels and natural gas for home heating is about 8% higher.

- Americans may be paying more for energy, but they are getting a break at the grocery stores. A stronger U.S. dollar has lowered the cost of many imported foodstuffs, and food prices have been flat or lower since last May.

- Price pressures in the core also heated up slightly in December, rising 0.2% - also as expected. Once again, shelter was a key part of the story, as prices were 0.3% higher in December. The cost of renting and owning a home has been rising steadily over the past couple of years. Annual inflation for shelter is 3.6%, outpacing overall core services inflation (services excluding energy), which was 3.1% in December.

- Still, core goods prices remained subdued in December (+0.0% on the month), partly due to the lofty greenback. Key imported consumer goods, like apparel, have seen prices fall for two straight months.

Key Implications

- With inflation topping 2% for the first time since the collapse in oil prices, December's inflation report will likely garner some headlines. However, inflation has long been expected to rise as the downward pressure from energy prices moves into the rear view, with today's report very much in line with expectations. Higher energy prices are expected to be a key driver taking headline inflation to 2.5%-3.0% range over this year.

- Core price pressures did tick up in December, but at 2.2% the annual pace is within the range it has hovered around for a year now. In December the Fed telegraphed a relatively slow rate of pace hikes for this year and today's number does not raise any alarm bells that the Fed would need to accelerate the pace, particularly since its preferred inflation gauge, the core PCE deflator was even more subdued, rising 1.7% in November from the year prior.

- We remain confident that given the pick-up in wage pressures in the U.S. economy, core inflation pressures are beginning to bubble up, and that the Fed will gradually take rates higher over the next two years. In the hopes of getting a clearer outlook for the Fed, markets' attention will likely now shift towards Chair Yellen's speech in San Francisco later today.

Leslie Preston, Senior Economist
416-983-7053

@TD_Economics