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TD Economics

Data Release: Inflation rises to highest rate since March 2012

- Inflation rose to 2.5% y/y in January, marking the fastest pace in the headline index since March 2012. This was somewhat stronger than the consensus estimate of 2.4%. On a seasonally adjusted basis, prices rose 0.6% on the month from the previous month – twice the rate of monthly rate of advance projected by consensus (+0.3% m/m). Consumers paid more for gasoline, shelter, apparel, and new vehicles in January.

- The price of gasoline was responsible for about half of the 0.6% m/m advance in January, rising 7.8% m/m, reflecting the pass-through from higher price for crude oil. Energy has returned to provide a significant boost to headline inflation, with prices for energy commodities up over 20% from year ago levels, and natural gas up about 10% during that time.

- Food prices fell for the fifth consecutive month on a year-on-year basis, driven down in January by a 4.9% y/y decline in the price of fruits and vegetables.

- Stripping away volatile food and energy prices, core CPI rose 2.3% y/y in January, with the index rising 0.3% on the month, driven higher by firm price growth in shelter, medical services, transportation, and apparel costs. Moreover, used vehicle prices declined -3.7% y/y in January, likely a reflection of a large stock of used vehicles that dealers have been unable to unload. On the other hand, prices for new vehicles rose +1.0% y/y in January.

Key Implications

- Headline inflation in January was well above 2% for the second consecutive month, owing largely to a much anticipated bump from the rising energy prices. Moreover, we anticipate that higher energy prices will remain a key driver behind the rise of headline inflation this year, which could see it top out just below 3% y/y by the third quarter.

- No matter which measure of underlying inflation you look at, price growth is firming. Core inflation (ex food and energy) rose 2.3% y/y, just above its average pace in the previous twelve months. The FOMC's preferred inflation gauge, the core PCE deflator has been more subdued, holding near 1.7% y/y over the previous five months, and about 0.1 percentage point firmer than price growth in early 2016. However, given the uptick in the core CPI, the core PCE measure for January could also firm.

- Overall, the price data will likely be interpreted in two different ways by the FOMC. On the one hand, higher headline inflation will generally be deemed as transitory, as the base-year effects from the rise in energy prices from the lows of early 2016 dissipate. We anticipate that once this factor falls out of the base year, headline inflation will return to a more subdued range as the past appreciation of the U.S. dollar works to temper price growth of largely imported consumer goods. On the other hand, the continued improvement in underlying inflation, driven in part by firming wage growth, will be interpreted by the Fed as a sign of a decreasing economic slack, and therefore confirm the need for a tightening of monetary policy. We expect the Fed will move by 25 basis points in June, and then again before the end of this year in order to prevent a persistent overshoot of its 2% target.

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