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TD Economics

Data Release: Another soft inflation reading in May presents a challenge for the Fed

- The headline consumer price index (CPI) fell 0.1% month-on-month in May. The main culprit was a 2.7% decline in energy prices, led by plummeting gasoline prices. That cooled inflation on a year-on-year basis to 1.9%, and marks the first reading below 2% since last November.

- With the drop in energy prices largely expected, all eyes were on core inflation, where a modest 0.1% increase continued the recent string of soft readings. Core inflation now sits at 1.7% year-on-year, the lowest reading in two years.

- Core inflation remained modest as many categories saw price declines. These included apparel (-0.3%, m/m), airline fares (-2.7%), communication (-0.2%) and medical care services (-0.1%). Still, looking at broader core services, prices were up 0.2% in May, stronger than the previous two months' pace.

- The key shelter index, which accounts for one third of the CPI basket, rose 0.2% on the month, as rents rose 0.3%, and owner-occupied housing increased 0.2%. Shelter costs are up 3.3% over the past 12 months, and have been a key factor lifting services inflation over the past two years.

- More surprising was another decline in core goods prices (-0.3%). That marks the third monthly drop in a row, and leaves prices 0.8% lower than a year-ago. The U.S. dollar has generally weakened so far in 2017, but this is not yet showing up in higher prices at the consumer level.

Key Implications

- While May's inflation report was not likely to sway the Fed from its rate hike later this afternoon, today's report will likely give the Fed pause as it considers rate hikes over the remainder of the year. We take some reassurance from the fact that prices for core services have firmed somewhat. And, while core goods prices continued to be weak in May, price pressures are building at the import and producer level. It is likely only a matter of time before these are passed on to consumers.

- Given these upstream price pressures, and an increasingly tight labor market, we expect inflation pressures to build through the remainder of the year. Particularly for goods inflation, where the dampening impact of a strong U.S. dollar is increasingly in the rear view mirror. Still, the fact that these price pressures are proving slow to show up does add considerable risk to further Fed hikes later this year.

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