

11 January 2019
Article

US inflation: Follow the core

US headline inflation was depressed by the plunge in energy prices, but we should be focusing on the core rate, which will be pushed higher by rising labour costs in the months ahead

Contents

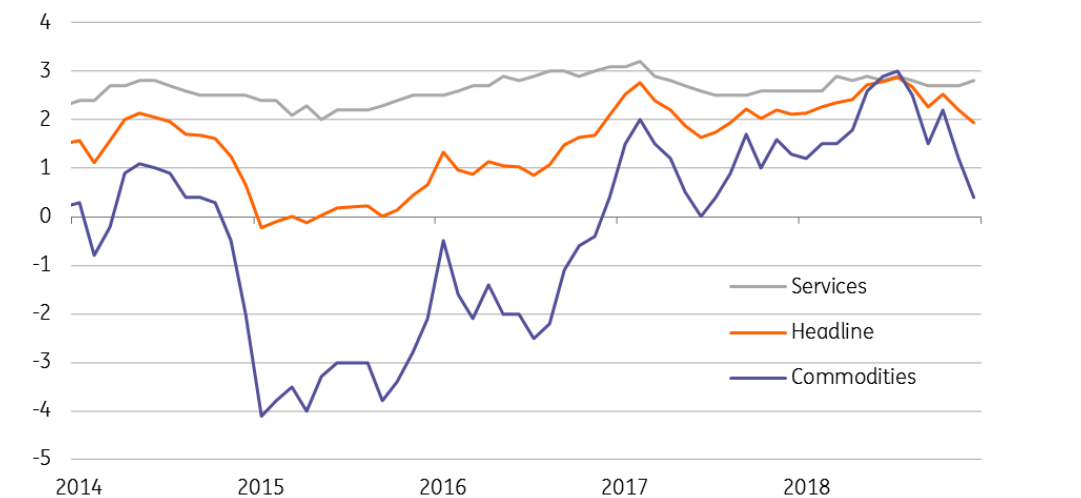
- Goods versus services
- Labour market pressure to push core inflation higher
- The Fed isn't finished...

Goods versus services

Headline inflation for December was, as widely expected, dragged lower by the plunge in gasoline prices seen through the fourth quarter. It fell 0.1% month-on-month in December, leaving the annual rate of US inflation at 1.9%, the lowest since August 2017. However, the core rate, which excludes the volatile food and energy components, has risen 0.2% MoM and 2.2% year-on-year, and remains above the Federal Reserve's medium-term target.

In terms of the big categories, energy prices fell 3.5% MoM because of those gasoline price declines, which in turn contributed to a 2% MoM drop in transportation costs, while tobacco prices fell 0.4% MoM. Contributing on the upside, food posted a relatively hefty 0.4% MoM rise, while recreation jumped 0.6% MoM (sewing machines up 7.1% MoM and sporting goods up 4%!!) and medical care was up 0.3%.

US headline inflation (YoY%)

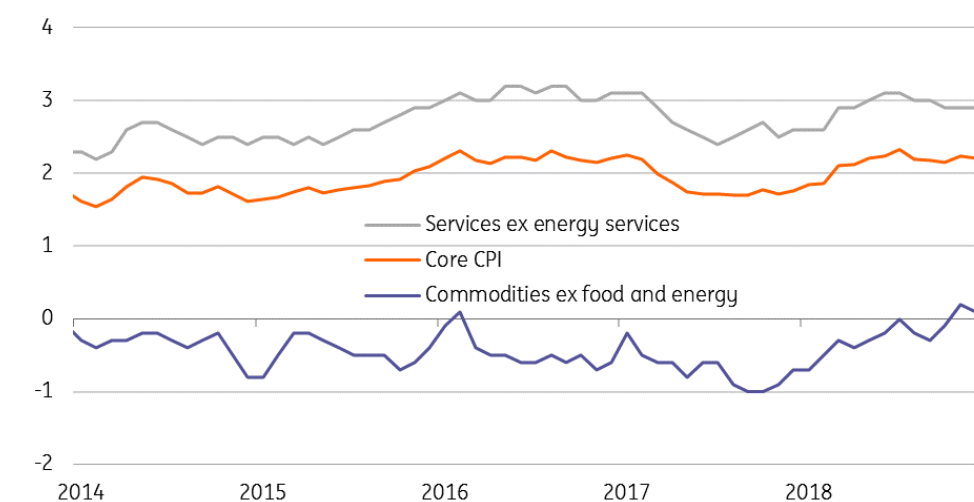


Source: HCSO, NBH

The divergence between goods and service sector inflation continues thanks largely to the energy story, but it does too when we exclude that key component. Goods prices ex- food/energy (0.1%

YoY) have to a certain extent been depressed by the strong dollar, but the shrinking amount of spare capacity in the economy means it has been grinding higher. Meanwhile, prices of services ex-energy (2.9% YoY) are being pushed higher by wage growth, given that labour is a major cost input and the competition for workers is intense.

Core inflation (YoY%)



Source: HCSO

Labour market pressure to push core inflation higher

The US economy does face more economic headwinds this year, but the strength in the jobs market provides strong underpinning while the 68 cent/gallon plunge in gasoline prices is an annualised \$100 billion boost to household cashflows. As such, we expect consumer demand to remain firm this year and that gives businesses the pricing power to pass on higher costs.

Given the US economy is dominated by the service sector and the biggest cost input is labour, wage developments will be a significant driver of core inflation. With the National Federation of Independent Business reporting that 39% of firms can't fill the vacancies they currently have- an all-time high- we suspect wage inflation will continue to push higher this year. Likewise, non-wage benefits (vacations days, signing bonuses and health and pension benefits) will also add to business costs. As such we see core inflation continuing to push higher, rising above 2.5% this summer.

The Fed isn't finished...

Fears over trade policy continue to dominate financial market sentiment, but if progress can be made in the China-US talks that extend the current tariff ceasefire (or possibly even see a resolution) then there is scope for a re-pricing of the outlook for Federal Reserve policy. We agree that there is likely to be a "pause" in 1Q19, but with growth looking respectable - above 2% - and where core inflation will soon be up above 2.5%, we believe the Fed will hike interest rates again in the summer.

James Knightley

Chief International Economist

+44 20 7767 6614

james.knightley@ing.com

Disclaimer

This publication has been prepared by the Economic and Financial Analysis Division of ING Bank N.V. ("**ING**") solely for information purposes without regard to any particular user's investment objectives, financial situation, or means. *ING forms part of ING Group (being for this purpose ING Group NV and its subsidiary and affiliated companies).* The information in the publication is not an investment recommendation and it is not investment, legal or tax advice or an offer or solicitation to purchase or sell any financial instrument. Reasonable care has been taken to ensure that this publication is not untrue or misleading when published, but ING does not represent that it is accurate or complete. ING does not accept any liability for any direct, indirect or consequential loss arising from any use of this publication. Unless otherwise stated, any views, forecasts, or estimates are solely those of the author(s), as of the date of the publication and are subject to change without notice.

The distribution of this publication may be restricted by law or regulation in different jurisdictions and persons into whose possession this publication comes should inform themselves about, and observe, such restrictions.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved. The producing legal entity ING Bank N.V. is authorised by the Dutch Central Bank and supervised by the European Central Bank (ECB), the Dutch Central Bank (DNB) and the Dutch Authority for the Financial Markets (AFM). ING Bank N.V. is incorporated in the Netherlands (Trade Register no. 33031431 Amsterdam). In the United Kingdom this information is approved and/or communicated by ING Bank N.V., London Branch. ING Bank N.V., London Branch is subject to limited regulation by the Financial Conduct Authority (FCA). ING Bank N.V., London branch is registered in England (Registration number BR000341) at 8-10 Moorgate, London EC2 6DA. For US Investors: Any person wishing to discuss this report or effect transactions in any security discussed herein should contact ING Financial Markets LLC, which is a member of the NYSE, FINRA and SIPC and part of ING, and which has accepted responsibility for the distribution of this report in the United States under applicable requirements.