CIO Memo

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# U.S. CPI: Labor market keeps services sticky

## Key takeaways

- U.S. inflation continued its downward trend with the headline December Consumer Price Index (CPI) coming in at 6.5% year-on-year (YoY), down from the previous months reading of 7.1%. Core CPI, which excludes Food and Energy, also fell to 5.7% YoY.
- While headline prices fell in line with expectations, there continues to be concerns around Core CPI and in particular the Services and Shelter components, which continue to strengthen on a monthly basis.
- Markets responded positively with expectations of a downshift to a 25-basis points hike now fully 'priced in'. Philadelphia Fed President Harker also publicly supporting quarter-point increases "going forward".

## 1. What happened?

Today saw the latest release for CPI from the Bureau of Labor Statistics showing a YoY decline in consumer prices from 7.1% to 6.5% for December. This latest print continues the falling trend from the peak of 9.1% seen in June. Core CPI, which excludes Food and Energy, also showed a YoY decline of 5.7%, down from the previous reading of 6.0%.

The latest inflation data continued to show a widening gap between Goods and Services with the former continuing its YoY slowdown to 2.1% whilst the latter remaining persistently strong, moving higher to 7.0% YoY. When assessing the month-on-month (MoM) components, used car prices fell by -2.5%, its sixth consecutive monthly decline with the cost of airline travel also falling by -3.1%, its largest decline since August last year.

Energy prices continue to move lower, falling by -4.5%, its largest fall in four months. Fuel oil prices fell by -16.6%, their biggest decline since 1990 whilst gasoline prices also moved lower by -9.4%. Food prices continue to increase but are showing signs of slowing with Food at home prices increasing by 0.2%, their slowest rate since March 2021.

Shelter costs, which are the largest service component of CPI, continue to show their strength with a further increase of 0.8%. Within in the rental market, both rent and owners equivalent rent increased by 0.3% respectively. The cost of Medical Care services also increased for the first time in 3 months by 0.1%, driven predominantly by increases in the cost of hospital care.

Overall, the breadth of price increases seen in todays report also appears to be slowing down. According to the December CPI data, 52.7% of the underlying components were increasing in price by more than 4% on an annualized basis. This is a reduction from the previous months reading of 59.7%.

## 2. How did markets react?

In the buildup to the latest CPI data, markets were trading positively on the day with both US futures and European markets moving higher. Following the release, many indices pared back earlier gains as hope of weaker than expected CPI print failed to materialize. Overall, Equity markets responded positively to the prospect of less aggressive rate hikes from the Fed moving forward.

Within Fixed Income, Treasury yields across the curve all moved lower. At the shorter end, the 2Yr Treasury yield came down 6bps to reach 4.15% whilst 10Yr yields hovered around 3.52%.

Following the latest inflation data, Fed Funds Rate futures remained at 25-basis points for the first FOMC meeting of the year on February 1st.

## 3. What does it mean for investors?

Today's latest CPI print continues the positive trend for a third straight month, giving both investors and the Federal Reserve further evidence that the efforts taken to bring down inflation through aggressive tightening continue to show. Other factors such as a decline in supply chain pressures, falling commodity prices and increased discounting have also eased price pressures.

The FOMC have clearly stated that they wish to see a pronounced weakness in CPI data moving forward. Given today's print, there will now be increased debate around the Fed further reducing the size of the next Fed Funds Rate move to 25-basis points, following on from its downshift in December to a 50-basis point hike.

Alongside todays latest CPI print, President of the Philadelphia Federal Reserve, Patrick Harker, publicly supported the idea of raising the Fed Funds Rate by 25-basis points moving forward, before holding rates at around 5% until 2024.

With Headline CPI now moving lower, primarily driven by falling energy prices, more attention is being paid to Core CPI. The strength of the labor market, reinforced by the recent weekly jobless claims figures of 205,000, indicates that such tightness will continue to drive Service sector prices increases for some time to come.

Today's CPI print further shows that inflation is slowly being reined in by central bank action and that the Fed can again downshift its rate increases to 25-basis points. However, Chairman Powell and the FOMC will remain mindful of the persistent price rises seen in the Services sector as the labor market continues to strengthen.

## Glossary

The consumer price index (CPI) measures the price of a basket of products and services that is based on the typical consumption of a private household.

The Federal Reserve (Fed) is the central bank of the United States. Its Federal Open Market Committee (FOMC) meets to determine interest rate policy.

The NASDAQ index is a market-capitalization weighted index of around 3,000 equities listed on the Nasdaq exchange.

The S&P 500 Index includes 500 leading U.S. companies capturing approximately 80% coverage of available U.S. market capitalization.

Treasuries are bonds issued by the U.S. government.

USD is the currency code for the U.S. Dollar.

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