



## **US: SOFT REPORT ON THE SURFACE, DETAILS A LITTLE MORE BUOYANT THOUGH**

- **U.S. headline CPI index rose by a modest 0.2% M/M, while the annual pace of consumer inflation declined to 2.6% Y/Y.**
- **Core consumer prices declined on a monthly basis for the first time since 1982, falling by 0.1% M/M. As a consequence, the annual pace of core inflation declined to 1.6% Y/Y.**
- **On a six-month trend basis, core prices are at their lowest level since 1965!**

U.S. consumer prices rose by a less than expected 0.2% M/M in January (up 0.167% to three decimal places), following the 0.1% M/M gain recorded in December. Annual headline inflation, however, declined to 2.6% Y/Y from 2.7% Y/Y in December, which was softer relative to the Street's expectation for an advance to 2.8% Y/Y. The big story in the report was in core prices, which declined by 0.1% M/M, representing the first time since 1982 that core prices have outright declined on a monthly basis. As a consequence, the annual pace of core consumer price inflation declined to 1.6% Y/Y from the 1.8% Y/Y reading seen in the December report. The six month trend in core prices, which fell to 0.8% from 1.4% in December, is now sitting at its lowest level since 1965 (when a six month trend of 0.6% was achieved). This fact underlies our main working assumption for U.S. core consumer prices, which is that the broader trend in 2010 is for core prices to remain soft and drift persistently lower as second round pricing effects remain muted due to the large degree of slack circulating in the economy.

Despite the decline during the month, the details of the report skew the interpretation as prices were not as soft as they appear on the surface. Most of the softness in both

the headline and core measures was a result of weak housing prices (which has the highest weighting in the index at 42.0%), falling by 0.3% M/M. Owners equivalent rent (OER), which is a sub-category of housing declined by 0.1% M/M, further contributing to the weakness in the broader category. Additionally, there was some weakness seen in recreation (-0.1% M/M) and apparel (-0.1% M/M) prices. On the flip side, there were decent gains in transportation costs (1.3% M/M), which were pushed higher due to the 4.4% M/M rise in gasoline prices. Moreover, there was also strength seen in outright energy prices (2.8% M/M), medical care costs (0.5% M/M), education and communication prices (0.3% M/M) and food & beverages (0.2% M/M).

Expectations going into the report were for core prices to be soft, though the actual print relative to consensus was somewhat of a surprise. It is a big deal that core prices printed negative for the first time since 1982, though we do not think this will or can be sustained going forward. This is even more surprising of an outcome when one considers that most other advanced nations have shown some recent inflation strength. Having said that, while we don't expect core prices to remain negative, our view for the remainder of the year is for core prices to trend lower, underscoring the large degree of slack in the U.S. economy. Headline prices, while soft on the surface, were actually stronger when looking at the details of the report. Housing was the culprit this month, though with the extension of the homebuyers tax credit and the new measures soon to be outlined by the Obama administration on a second housing stimulus effort, this should be a short-lived trend. From a policy perspective, this report has only a slightly dovish interpretation, and thus won't meaningfully affect the Fed's monetary policy stance.

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