THE WEEKLY **U.S.** ECONOMIC MONITOR

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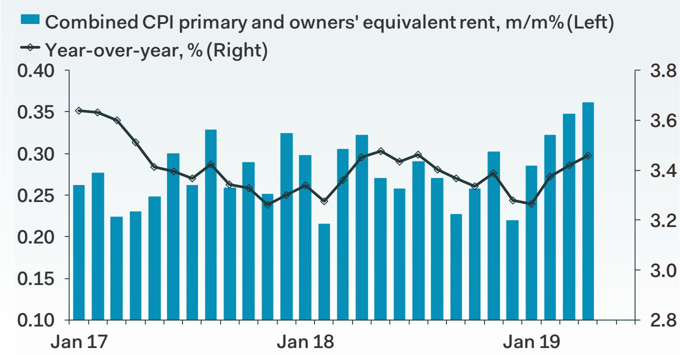
The April core CPI was depressed by apparel and used auto prices; they won't keep falling...

...But the acceleration in rents and non-rent services, driven by wages, has further to run.

The core PCE deflator likely rose 0.2% in April, supporting Chair Powell's "transient" view of Q1.

Inflation in Rents and Other Services is Rising; Further Gains Ahead

CAN THE ELEVATED MONTHLY GAINS IN CPI RENTS CONTINUE?



The core CPI inflation rate rose in April to 2.1% from 2.0%, thanks to unfavorable rounding, despite the below-consensus 0.14% month-to-month print. *The three-month annualized rate, though, dipped to just 1.6%, the lowest since 2017.* To be clear, the three-month annualized rate is volatile—it dropped to 0.4% from 2.4% between February and May 2017, for example, and then rebounded to 2.5% by October—but markets are looking for reasons to push the Fed towards easier policy, and the third straight 0.1% core print seem to fit the bill.

We think this is the wrong interpretation of the data, because the forces which have constrained the core CPI in recent months likely will prove temporary, while the forces working in the background to push it higher will persist. Accordingly, we continue to expect core CPI inflation to be close to 2½% by the year-end. The gap between core CPI and core PCE inflation will widen, but the latter will rise too. That, in turn, means that the Fed has much less room for maneuver this year than markets want to believe.

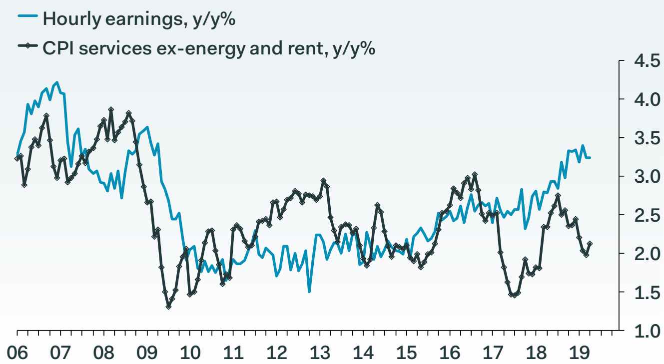
The most important single development in the core CPI in recent months is the upturn in the rate of increase of rents, both primary and owners' equivalent, which together account for a huge 41% of the index. The numbers drew our attention in March, when the month-to-month increase, 0.35%, was the biggest in 12 years. The April increase, though, was slightly *bigger,* at 0.36%. It's hard to argue that breaking a 12-year old record in successive months is mere chance, especially when the fundamental drivers of rents point unambiguously to faster increases.

The vacancy rate is extremely low, and with multi-family construction having peaked, it's quite likely to hit new multi-decade lows. At the same time, the pace of wage increases is rising, and most people pay their rent with their wage income. *Landlords aren't dumb; they will want some of their tenants' extra cashflow, and the low vacancy rate means they won't be shy about asking.*

Our model suggests that the quarterly annualized run rate for CPI rents should now be about 4%, and on track to reach 4½% by the year-end. If that happens smoothly, year-over-year rent inflation will hit 4.1% by the fourth quarter, rising from 3.4% in the first quarter. *That would be enough to lift core CPI inflation by 0.3 percentage points, other things equal.*

The upturn in wage growth, though, also will put upward pressure on a host of other labor cost-sensitive components of the CPI. The year-over-year rates of increase in the three components we highlighted in our preview of the CPI report—medical services, education,

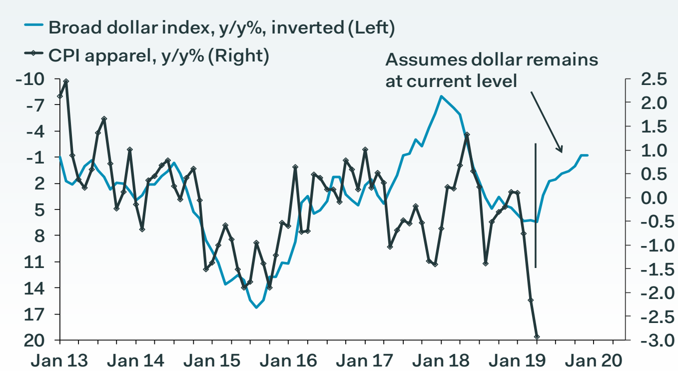
FASTER WAGE GROWTH WILL LIFT CORE CPI SERVICES INFLATION



and recreation—all rose in April. None of these numbers are alarming, yet, but the potential for a sustained acceleration in core CPI non-rent services is very real, as our next chart shows.

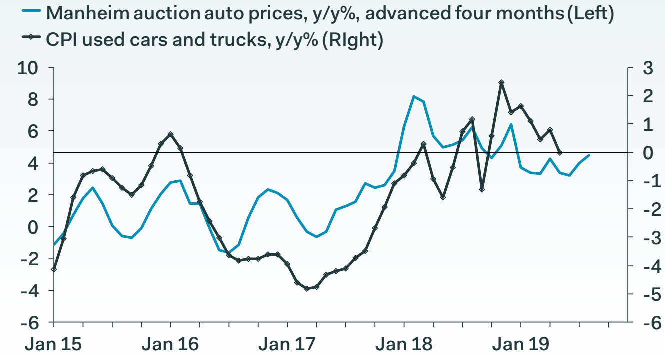
The downward pressure on the April core CPI was concentrated in apparel, where the 0.8% decline subtracted 0.03pp from the index, and used autos, where prices fell by 1.3%, subtracting 0.04pp. We expected stable apparel prices after their 1.9% March plunge, which coincided with a change to the methodology. It's possible that this effect spilled over into April too, though we can't know for sure. *Still, apparel prices are now down 2.9% year-over-year, much weaker than implied by the path of the trade-weighted dollar, so we'd be very surprised by further significant declines.*

APPAREL INFLATION IS UNLIKELY TO FALL MUCH FURTHER



Used auto prices, meanwhile, are finally coming back into line with auction prices, after overshooting substantially. Our next chart shows that the gap

CPI USED CAR INFLATION IS MOVING BACK INTO LINE



between the two measures has narrowed substantially in recent months, so further big declines in the CPI measure now seem unlikely. Auction prices are substantially higher than before Hurricane Harvey, so it's important not to think of the current downshift in the CPI measure as symptomatic of a sustained softening.

Whatever happens to the core CPI next month, we expect the month-to-month increase in the April core PCE to be bigger. The key driver of the divergence will be the financial services component, where a rebound in portfolio management charges—clearly signalled by the PPI—will add almost 0.1% to the core PCE. And the "financial services furnished without payment" component, the other major element of PCE financial services, could easily rebound too, though it's harder to predict month-to-month.

The weight of rents is much smaller in the PCE than the CPI, limiting the upside, but apparel and used autos also carry smaller weights in the PCE, so their downward impact will be smaller. Taking into account too the likely increase in PCE airline fares—measured differently to the CPI version—we think the April core PCE will be reported up 0.2%. ***After three straight sub-0.1% gains, averaging 0.06%, that would be strong evidence in favor of Chair Powell's view the Q1 numbers were distorted by "transient and idiosyncratic" factors.*** We agree; we doubt the underlying trend in core inflation has changed much since last fall.

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THIS WEEK IN BRIEF

Note: "**D**" prefix denotes Datanotes for these releases.

Monday, May 13

- **No significant data released.**

Tuesday, May 14

- **Redbook Chain Store Sales (5/11)/9:00 EDT**
We expect a modest correction after last week's above-trend **5.9%** year-over-year increase in same-store sales.

- **D: NFIB Small Business Survey (1)/6:00 EDT**
The rebound in the stock market in the first quarter ought to lift the NFIB index substantially; we expect the headline measure to jump to about **105** from 101.8. **Consensus: 102.3.**

- **Import Prices (4)/8.30 EDT**
Prices likely rose **0.5%,** boosted by oil. **Consensus: 0.8%.**

Wednesday, May 15

- **Mortgage Applications (5/10)/7:00 EDT**
The purchase applications index rebounded by 4.2% last week, to **270.2,** but that was less than we expected as Easter effects dropped out. We expect a further hefty gain this week.

- **D: Retail Sales (4)/8:30 EDT**
The drop in auto sales, reversing the March jump, will be partly offset by higher gas prices, so total sales likely rose **0.3%.** Sales ex-autos likely rose **0.8%,** with the control measure up **0.7%. Consensus: Total sales 0.2%, ex-autos 0.7%, control 0.3%.**

- **D: Empire State Survey (5)/8:30 EDT**
The uptick in China's PMIs suggests that the Empire State index will rise to about **15,** from 10.1. **Consensus: 8.0.**

- **D: Industrial Production (4)/9:15 EDT**
The softening trend in manufacturing, calendar effects and much warmer-than-usual weather all point to output falling by about **0.7%.** Manufacturing output likely fall by **0.4%. Consensus: Total production 0.0%, manufacturing 0.1%.**

- **D: NAHB Homebuilder Survey (5)/10:00 EDT**
Recent gains in new home sales mean we expect the index to rise to **65,** a seven-month high, from 63. **Consensus: 64.**

- **Business Inventories (3)/10:00 EDT**
Inventories probably were **unchanged. Consensus: 0.0%.**

Thursday, May 16

- **D: Jobless Claims (5/11)/8:30 EDT**
Claims should dip to about **220K** from last week's 228K, in line with the underlying trend. **Consensus: 220K.**

- **D: Housing Starts (4)/8:30 EDT**
We look for clear rebounds, with starts rising more than 5% to **1,200K** from 1,139K, and permits up to about **1,330K** from 1,269K. **Consensus: Starts 1,209K, permits 1,290K.**

- **D: Philadelphia Fed Survey (5)/8:30 EDT**
The uptick in China's PMIs suggests that the Philly Fed index will rise to about **15,** from 8.5. **Consensus: 10.0.**

Friday, May 17

- **Index of Leading Economic Indicators (4)/10:00 EDT**
We expect a decent **0.4%** increase. **Consensus: 0.2%.**

- **D: Univ. of Mich. Consumer Sentiment (5p)/10:00 EDT**
The lagged effect of the rebound in the stock market should lift the index to about **101** from 97.2. **Consensus: 97.5.**

THIS WEEK'S FUNDING

Monday 13	Auction: $39B 3-month, $36B 6-month bills
Tuesday 14	Announcement: four-week bills, eight-week bills
Wednesday 15	Nothing
Thursday 16	Announcement: 3-month, 6-month bills (May 20) Announcement: 1-year bills (May 21) Announcement: 10-year TIPS (May 23) Auction: four-week bills, eight-week bills
Friday 17	Nothing

PANTHEON'S FINANCIAL FORECASTS

		End-month:			
	4:00pm Fri.	**Jun**	**Sep**	**Dec**	**Mar**
Fed funds target	2¼-to-2½	2¼-to-2½	2¼-to-2½	2½-to-2¾	2¾-to-3
2-yr	2.27	2.40	2.60	2.90	3.10
10-yr	2.47	2.60	2.80	3.00	3.20
30-yr	2.89	3.00	3.10	3.10	3.20
Curve 10-2	20	20	20	10	10
Curve 30-2	62	60	50	20	0
S&P 500	2,881	2,900	2,850	2,750	2,700
Dollar/Yen	109.9	111	110	110	110
Euro/Dollar	1.12	1.15	1.17	1.20	1.20
Sterling/Dollar	1.30	1.36	1.38	1.40	1.40

PANTHEON'S ECONOMIC FORECASTS

GDP	Q2	4.2%	2015 year:	2.6%
	Q3	3.4%	2016 year:	1.6%
	Q4	2.2%	2017 year:	2.3%
	Q1 first	3.2%	2018 year:	2.9%
	Q2 forecast	*2½%*	*2019 year:*	*2.2%*
	Q3 forecast	*2%*		

CPI	April 0.3% (2.0% y/y); core 0.1% (2.1% y/y)
	September forecast: 2.0% y/y; core 2.3% y/y
	December forecast: 2.3% y/y; core 2.5% y/y

Unemployment: June 2019: 3.6%; December 2019: 3.4%.

Federal budget: FY 19 forecast: -$950B (4.5% of GDP)