U.S. CPI Preview: November 2022

MNI View: Can Cars Drive A Core CPI Slowdown?

By Chris Harrison

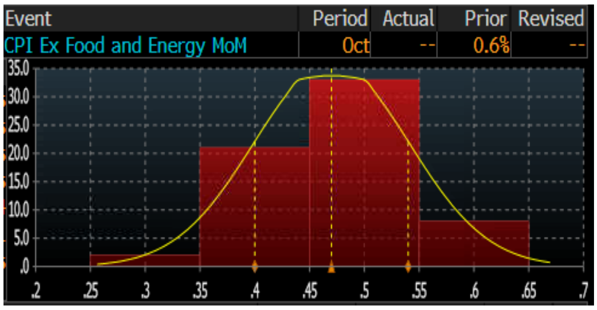
SUMMARY

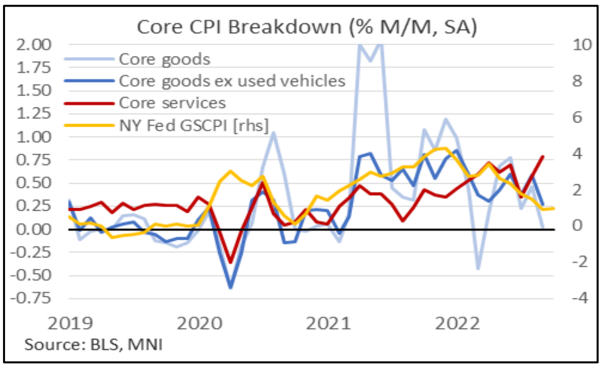
- Core CPI inflation is seen slowing slightly to 0.5% M/M in October after surprise persistence at 0.58% in Sept. The analyst survey is skewed slightly lower although the Cleveland Fed Nowcast implies upside risk.
- The bulk of the expected moderation in October core is seen coming from used cars declining at a faster pace and a health insurance reset. So it'll likely be changes outside of these components that are of note, especially service components with rents expected to continue to increase extremely strongly.
- A similar 0.1-0.2pt beat to last month could see a delay in the Fed's anticipated downshift to 50bp hikes into 2023 or augur a longer string of hikes, either way pushing the terminal rate higher still and driving a sharp flattening in the Treasury curve.

Core CPI Seen Up 0.5% M/M With Downside Risk

- Core CPI is seen rising 0.5% M/M in October but with the survey skewed to some downside risk with 23 of 64 analysts seeing 0.4% M/M or below. On the flipside, the Cleveland Fed nowcast points little change at 0.57% M/M following two months of undershooting.
- If consensus is accurate, it will nudge core Y/Y inflation 0.1pt below its fresh cycle high of 6.6% Y/Y after the surprise acceleration in Sept, with continued large base effects lowering the headline to 7.9% Y/Y.
- Core sequential moves remain in focus, especially after a failure to step down in September - indeed surprisingly nudging up from 0.57 to 0.58% contrary to consensus of 0.4%, prompting a more than 25bp increase in market pricing of the Fed's terminal rate.
- The bulk of the expected moderation in core CPI is seen coming from used cars following wholesale prices lower and a health insurance reset (**see sequential drivers expectations section below**) so it'll likely be changes outside of these components that are of note.
- Easing in automobile supply chain pressures is helping the decline in used car prices, but an easing in broader pressures along with USD strength should help ex-auto core goods inflation moderate.
- With service price inflation ramping higher, focus will be on the usual rent measures and signs of continued underlying strength in other categories.

	Sept *actual*	October *consensus*
Core	0.58%	Median 0.5%, av 0.47%
Headline	0.39%	Median 0.6%, av 0.62%
Core Y/Y	6.6%	6.5% (off 6.6% peak)
Headline Y/Y	8.2%	7.9% (off 9.1% peak)





Analyst Expectations Of Key Sequential Drivers (vs prior month M/M)

- **Medical care (-ve):** Medical care service inflation should see a significant, mechanically driven step down as source data for the health insurance sub-component have their annual reset (a factor that will remain in place until Sep'23). Other components of medical services likely remained strong, but Morgan Stanley nevertheless see -0.04% after +0.99% for medical care, dragging 0.1pt off core CPI M/M inflation alone.
- **Autos (-ve):** Used car prices are still 50% above pre-pandemic levels and whilst they began declining at a faster pace in September, they did so more slowly than some analysts expected at -1.1% M/M. Various analysts expect a decline of 2-2.5% in October although NatWest see -0.7%. Further, new car inflation

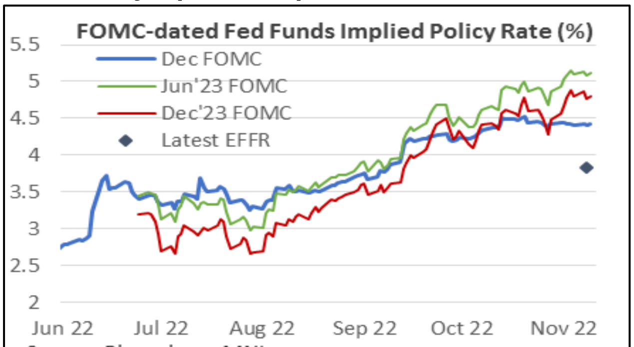
might have slightly slowed from the 0.7% M/M in Sept, with the combination also potentially pulling down overall core by as much as 0.1pts.

- **Shelter (small -ve):** Rent measures have continually surprised to the upside, most recently hitting new cycle highs in Oct of 0.81% for OER and 0.84% for rents. Bearing the propensity to surprise in mind, analysts see OER ranging from 0.7-0.81% M/M and rents ranging from 0.78-0.84% M/M, i.e. potentially some moderation but still extremely strong as CPI rents continue to converge upward toward market rates.

- **Non-core: Energy (+ve):** Headline CPI is likely supported by energy prices bouncing circa +2% after the -2.1% drag in Sep and -5% declines in Jul-Aug.

Potential Implications: Downside Bias To Survey And Post-NFP Rally Opens Scope For Hawkish Reaction

- After a fourth consecutive 75bp hike from the FOMC last week, the market leans towards a downshift to 50bp clips in December, with 57.5bp priced and a cumulative 97bps covering the following meeting in February.
- A similar surprise to last month, when core CPI bucked the moderation expected by nudging up from 0.57 to 0.58% contrary to consensus of 0.4%, could see that firm to another 75bps in December with the eventual downshift delayed into 2023, or instead a longer string of 50bp hikes that equally push the terminal rate higher.



Source: Bloomberg, MNI

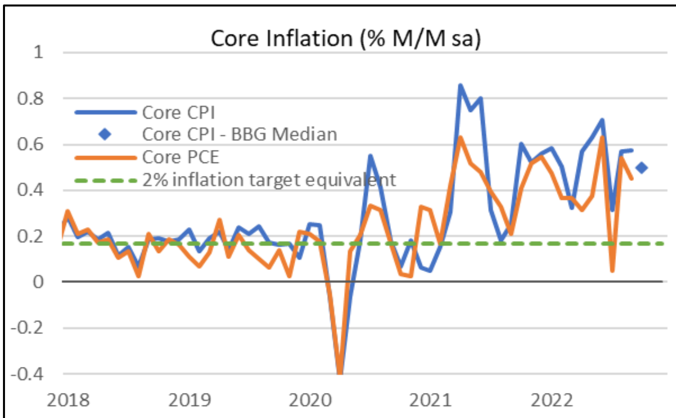
- Alternatively, a downside surprise could see further growing odds of a 50bp hike although this might not be seen as locked in with further payrolls and CPI releases before the Dec FOMC.
- Last month's beat saw the market terminal rate close more than 25bp higher at 4.92% on the day.
- This time around we approach with a terminal effective rate of 5.1% in June, off highs of 5.2% shortly before last week's payrolls, and is seen only dropping to 4.8% by end-2023, above the 4.6% median dot for 2023 from the Sept SEP after guidance of such from Powell's press conference.
- There is scope for the terminal rate to increase further on a hawkish report, although starting from high base above 5% could see the Treasury curve flatten even more sharply as recession fears mount.

Latest Fedspeak on inflation:

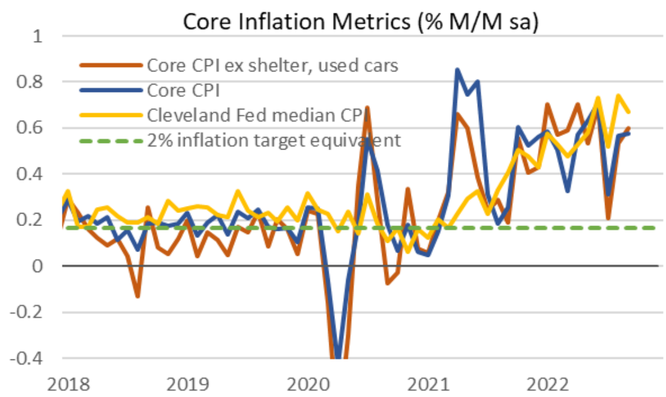
Powell	Nov 2 press conf	**On a downshift in the hike pace being contingent on a string of better inflation data between now and the December meeting:** "We do need to see inflation coming down decisively. And good evidence of that would be a series of down monthly readings. Of course, that's what we'd all love to see. But…I've never thought of that as the appropriate test for slowing the pace of increases or for identifying the appropriately restrictive level that we're aiming for… we'll take into account the full range of analysis and data that bear on that question, guided by our assessment of how much financial conditions have tightened, the effects that tightening is actually having on the real economy and on inflation, taking into consideration lags, as I mentioned." "Longer-term inflation expectations appear to remain well anchored […]. But that is not grounds for complacency; the longer the current bout of high inflation continues, the greater the chance that expectations of higher inflation will become entrenched. […] We're now 18 months of this episode of high inflation. We don't have a clearly identified scientific way of understanding at what point inflation becomes entrenched. So the thing we need to do from a risk management standpoint is to use our tools forcefully but thoughtfully and get inflation under control, get it down to 2%, get it behind us."
Barkin ('24)	Nov 7 Nov 4	"Inflation should come down but don't expect its drop to be immediate or predictable" "[Business leaders] still view their increased pricing power as temporary. They see it as an episode, not a regime change" "Conceivable Fed lands up above 5% but it's not a plan"
Collins ('22)	Nov 4	"The median path in September's Summary of Economic Projections can be taken as a starting point of my current thinking, with the possibility of a higher path depending on incoming information" "With rates now in restrictive territory, I believe it is time to shift focus from how rapidly to raise rates, or the pace, to how high – in other words, to determining what is sufficiently restrictive". "Down the road, when we get there, in my view we'll need to shift again to focus on how long to hold rates at that level."

		Options should include 75bps as well as smaller moves, with smaller moves option appropriate.
Daly ('24)	Oct 21	"Rental price inflation is very slow but takes a while to fully move through. New leases are lower in price but it takes a long time for new leases to be generated so that you get an average lease that's lower in value. Those things are in train in the inflation data, we don't want to be too reactive to those pieces of inflation because you can easily find yourself overtightening into an unforced downturn."
Harker ('23)	Oct 20	"Above all, I want to stress that we must remain data dependent and flexible on policy. What we really need to see is a sustained decline in a number of inflation indicators before we let up on tightening monetary policy. And again, we need to make sure inflation expectations don't become unanchored."
Kashkari ('23)	Oct 18	"Core services inflation -- which is the stickiest of all -- keeps climbing, and we keep getting surprised on the upside...if we don't see progress in underlying inflation, or core inflation, I don't see why I would advocate stopping at 4.5%, or 4.75%, or something like that."

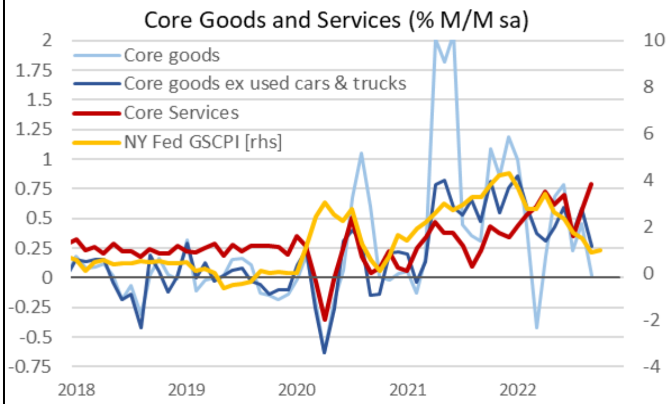
Recent Inflation Developments



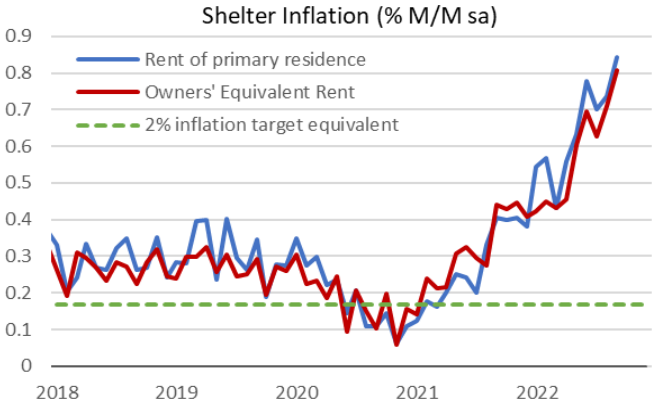
Source: BLS, MNI



Source: BLS, Cleveland Fed, MNI

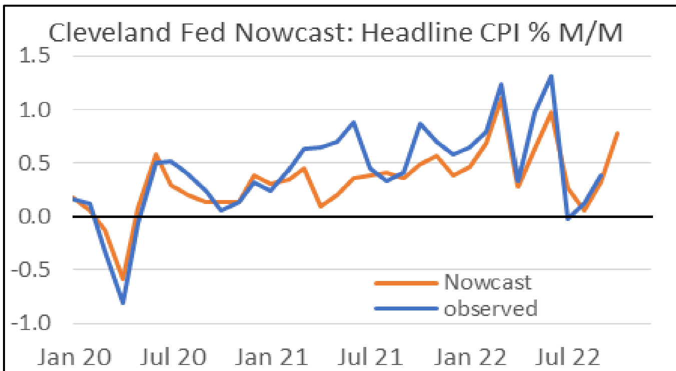


Source: BLS, NY Fed, MNI - GSCPI: Global Supply Chain Pressure Index

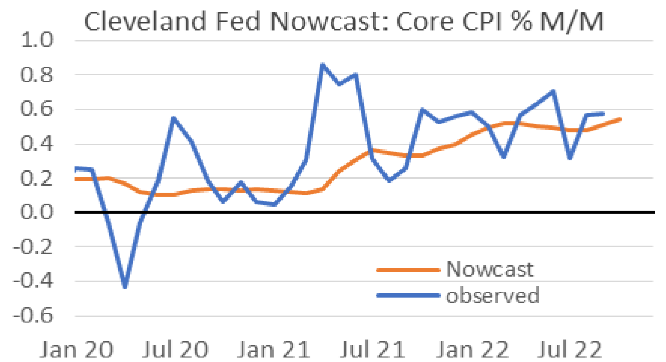


Source: BLS, MNI

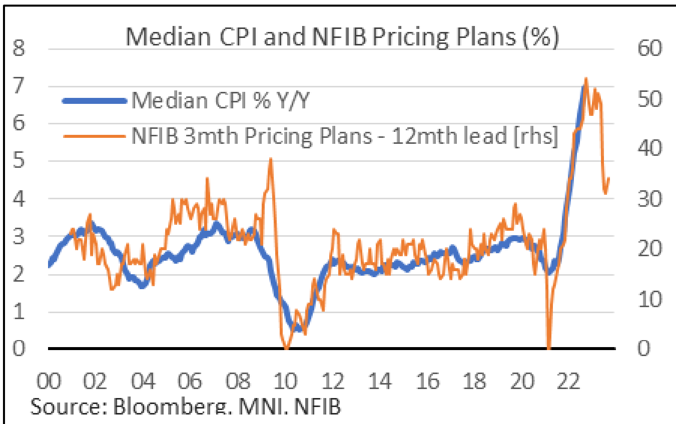
Full recap of Sept CPI report here: https://marketnews.com/markets/pdfs/mni-us-inflation-insight-oct-22-pushing-the-pivot-out-even-further

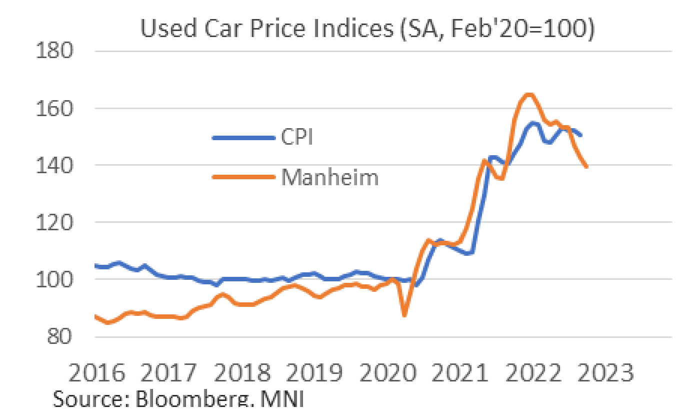


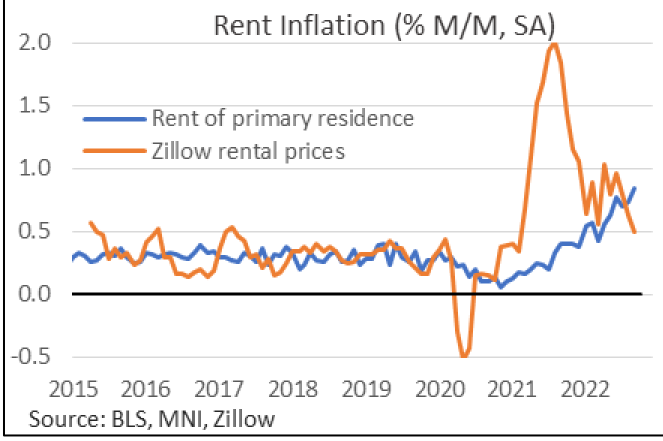
Source: Bbg, Cleveland Fed, MNI

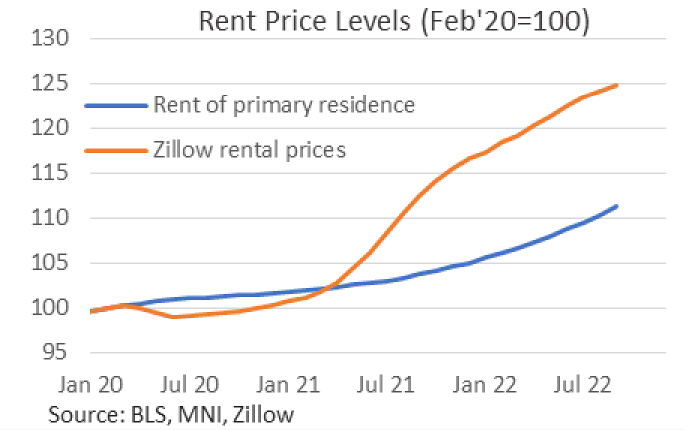


Source: Bbg, Cleveland Fed, MNI









October 2022 CPI Report: Analyst Previews

(In order of strongest to weakest for core inflation):

Scotia: Above Consensus With Core Services In Driving Seat

- Core CPI seen at 0.6% M/M (6.6% Y/Y)
- Used vehicle prices declined a bit, but the 4% weight on the category probably means at most a 0.1 ppt drag on total CPI. New vehicle prices were very little changed with a negligible effect on total CPI.
- Shelter costs—namely OER—will probably remain hot but with lagging downside effects of slipping repeat-sale house prices probably ahead into 2023.
- A major driver, however, is likely to be ongoing strong gains in service price inflation. 'Core' services excluding shelter comprise about one-quarter of the CPI basket and have unique challenges such as staffing and capacity issues continuing to drive hot inflation.
- Headline CPI seen at 0.8% M/M (8.1% Y/Y) with a 5% M/M SA increase in gas prices whilst food retail prices are expected to remain hot in a continuation of large gains dating back to early 2021.

NatWest: Health Insurance To Drag -0.03pps From Core In Year Ahead After +0.10 Year Prior

- Core CPI seen at 0.5% M/M (6.5% Y/Y) after back-to-back 0.6% gains, but the moderation doesn't imply a meaningful step down in underlying inflation as its driven by medical care and used cars.
- Excluding medical care and used cars, core inflation is seen unchanged at 0.5% M/M.
- Rents seen 0.8% M/M & OER 0.7% M/M, whilst travel-related components are expected to see lodging away from home bounce back 3% after a lacklustre 0.1% in Aug and -1% in Sep with airfares +1.8%.
- Medical care CPI seen -0.2% M/M after +0.8% in Sept. Incorporation of updated health insurance providers' earnings ratio will begin to feed into the health care insurance component of the CPI October onwards. The CPI for health care insurance increased at an average monthly clip of +2.0% between Oct'21-Sep'22, but looks set for -3.6% average declines through Oct'22-Sep'23.

- That said, note the updated data is one component of health insurance CPI with the other out-of-pocket medical expenses, or the reimbursements that the insurance providers make for physicians, dentists, hospital services. At least some of the drag from the updated data within the health insurance CPI would be slightly offset by sustained increases in out-of-pocket medical expenditures. Therefore, after adding 0.1%pts per month to the core CPI between Oct'21 and Sep'22, we expect medical care prices to subtract -0.03%pt on average over the next 12 months.
- Used cars seen -0.7% after -1.1% in Sept, whilst new cars seen +0.6%.

CIBC: Continued Pressure From Shelter, Fed Likely To Hike Another 100bps

- Core CPI seen 0.5% M/M, reflecting continued pressure in the shelter price index as leases reset at higher rates, lagging housing market developments.
- High demand for other services likely added to that pressure, however, some easing in core goods prices could have been masked by the headline, as industry gauges of used car prices have fallen along with the fading of supply chain issues in that sector.
- Core prices could also decelerate ahead if supply chain improvements and the impact of past rate hikes on demand start to materialize. With inflation still set to remain elevated into 2023, the Fed will likely hike rates by another 100bps in order to contain inflation expectations and cool the labor market.
- Headline seen at 0.7% M/M (8.0% Y/Y) as relief from higher prices at the pump ended in October post-OPEC+ supply curtailments and was combined with broad price pressures in other categories.

Commerzbank: Softer Core Should Support Speculation Of Somewhat Slower Hiking Pace

- Core CPI seen easing to 0.5% M/M (6.5% Y/Y) from 0.6% although still very strong.
- Inflation has calmed for some goods that were in particularly high demand during the pandemic, with used car prices falling, whilst services are more in demand and becoming more expensive.
- Rents and OER, by far the most important expenditure item within the CPI, are rising ever stronger although the rates of increase are likely to level off in 2023, indicated by industry rents agreed in new leases, which show a lead over the more comprehensive official figures and are rising much more slowly.
- Accordingly, the October inflation report should fuel cautious optimism about the inflation outlook and support speculation of a somewhat slower pace by the Fed going forward. We expect a hike of only 50bp in Dec followed by two steps of 25bps each at the beginning of 2023.

MS: Core To Cool On Used Cars and Medical Services As Rents Pause

- Core CPI seen at 0.47% M/M (6.5% Y/Y) as lower used car prices, a mechanical step-down in medical services inflation, and no further acceleration in rents move it off its recent highs.
- Expect a continuation of the clear divergence between core goods and core services from Sept, with goods inflation trending lower on weaker demand and more plentiful supply, while services remain resilient outside of the medical category.
- Rents (0.84% M/M) and OER (0.81% M/M) seen unchanged from Sept and given the high level of persistence, are seen coming off only very slowly over the coming months even as high-frequency indicators have portrayed a softer rental market. High-frequency rent measures peaked in 4Q21, indicating that CPI measures should peak as well, though timing has remained difficult to pin down.
- Medical services have recorded very strong price increases for the last twelve months, peaking at 1.0% M/M/6.5% Y/Y in Sept. Strong price pressures have largely reflected a high run rate of health insurance prices, which the BLS calculates in a backward-looking fashion and is due for a reset in the October release. While other components will likely remain strong, the turnaround in health insurance inflation should push the medical services aggregate into mild deflation in a sharp swing (-0.04% after +0.99%).
- Airfares seen -0.47% M/M after +0.84% even though the series remains highly volatile whilst in core goods, used cars -1.8% and new cars +0.5%.
- Headline seen at 0.66%MoM (8.0%YoY), with energy prices rising 2.3% M/M after more than a 10% cumulative decline since June.

Goldman: Another Very Strong Set Of Shelter Readings

- Core CPI seen 0.44% M/M, lowering the Y/Y rate by one tenth to 6.46%.
- We also look for another very strong set of shelter readings (rent +0.78%, OER +0.75%) as rents on renewing leases continue to converge upward toward market rates.
- Elsewhere, drags from used cars -2.5% on falling auction prices, a sharp negative swing in health insurance as annual source data is incorporated (assume -3% M/M nsa) and airfares -2% M/M sa.

- Continued strength in new car prices (+1.0%) reflects price increases on 2023 models, though we note that dealer incentives did rebound in the month, whilst assume another gain in car insurance, as carriers push through price increases to offset higher repair and replacement costs.
- Headline seen 0.49% M/M, reflecting higher gasoline and food prices, and 7.80% Y/Y.

Citi: Softer Core Likely Down To A Few Components, Obscuring Underlying Strength

- Core CPI seen 0.43% M/M after two months of 0.6% increases, with risks skewed to the upside as downside risks from used cars and medical insurance are already known.
- A somewhat softer increase in October core CPI could help provide cover for the Fed to slow to a 50bp hike in December but would obscure some of the continued underlying strength in inflation. A few key components will likely be responsible for the softer increase while most of CPI should remain very strong.
- Used cars -2.4% M/M following trends observed in wholesale prices, dragging just over 0.1pp from core CPI, but with upside risk that wholesale discounts are not fully passed on.
- Additionally in October, the usual annual change in data used to calculate the medical insurance component of CPI should see it drag -0.02pp from core CPI after +0.02pp over the last year.
- For services prices broadly, we would expect further strong increases of a somewhat uncertain magnitude as labor costs continue to be passed through to prices.
- Headline CPI seen 0.6%M/M, the strongest since June as retail gas bounced, with the Y/Y down to 7.9%.

ANZ: Encouraging Signs That Price Pressures Are Easing In Some Goods & Services But Too Elevated

- Core CPI seen 0.4% MM (6.5% Y/Y) with encouraging signs that price pressures are easing in some goods and services, but they remain too elevated. The cost of new rentals is easing, new and used car prices are softening, and health insurance premiums are set to fall from October.
- A confluence of factors should be driving goods inflation down, namely: supply bottlenecks are easing, commodity prices are moderating, shipping rates have slumped and the USD is strong.
- Headline seen 0.7% M/M, easing the Y/Y rate to 8.0%, with energy prices and food driving a wedge.

Barclays: Core CPI Needs To Very Significantly Surprise To The Upside To See 75bp In Dec

- Core CPI seen at 0.4% M/M in early signs of sustained deceleration after 0.6% M/M, with 6.6% Y/Y.
- It will reflect persistent downward pressures on medical services prices and deflationary pressures on core goods, as used car prices continue gradually to unwind their pandemic-related run-up.
- Even so, we expect housing rents to post another month of robust increases, keeping the level of inflation uncomfortably high for the FOMC. That said, we think that after Wednesday's carefully crafted Fed message, CPI would have to very significantly surprise on the upside, e.g., a further M/M acceleration of core CPI, for the Fed to implement another 75bp hike in December.
- Headline inflation seen accelerating from 0.4% to 0.5% M/M (8.2 to 7.8% y/y), reflecting the recent upturn in oil prices.

TD: Shelter Remains A Key Wildcard

- Core prices likely slowed modestly in Oct, but to a still strong 0.4% M/M pace (6.5% Y/Y).
- Shelter inflation likely remained the key wildcard, though we look for used vehicle prices to retreat sharply.
- Importantly, gas prices likely shifted from offering relief to the CPI in recent months to contributing to it in Oct, with headline at 7.9% Y/Y.

JPM: Below Consensus With Many Of The Non-Rent Main Components Softer

- Core CPI seen 0.38% M/M with the year-ago rate cooling from 6.6% to 6.4% Y/Y.
- They think rental inflation will moderate eventually but not at this point in time, and forecast tenants' rent +0.83% and OER +0.76%, only fractionally softer than fresh cycle highs of September.
- Instead, relative weakness comes from many of the other main components. Used cars (-2.2%), new cars (-0.1%), airfares expected to have declined in October to weigh on public transportation (-2.2%), apparel (-0.2%) and communications keep trending lower (-0.1%).
  They also expect a noticeable downshift in medical care inflation in the CPI, with the BLS set to incorporate an annual update to source data used to estimate health insurance prices. Overall medical care prices seen just 0.1% in Oct, with a near-4% drop in health insurance prices being offset by gains in other related prices on net. This would represent a big shift from the past 12 months, which had monthly gains in medical care prices averaging 0.5% with health insurance prices up about 2% per month.

MNI Policy Team Insights

MNI INTERVIEW: Fed Set For ‘Lively Debate’ On Size of Dec. Hike

By Pedro Nicolaci da Costa*, published Nov 4*

(MNI) Washington - Federal Reserve officials may clash at the December meeting over whether to slow the pace of interest rate hikes despite persistently high readings for key inflation measures and a strong job market, former Richmond Fed research director John Weinberg told MNI.

“That’s going to be a lively discussion in December,” he said in an interview with MNI’s FedSpeak podcast following this week’s FOMC decision to raise interest rates by 75 basis points for a fourth consecutive meeting.

“There’s likely to be a number of committee members who think that even with the picture that we have now, as long as rates continue going up and are moving toward a sufficiently restrictive stance, that they can afford to slow the pace. So I wouldn’t be surprised to see them do that.”

Fed Chair Jerome Powell in his press conference this week emphasized that while the Fed is considering slowing the pace of hikes in the next meeting or two, that will likely mean a higher terminal rate than the 4.6% priced into the September SEP.

The FOMC also emphasized the need to make monetary policy “sufficiently restrictive” to bring inflation down from near 40-year highs back to the Fed’s 2% target.

“The real policy rate needs to be positive, it’s not now,” said Weinberg. “Inflation is falling more slowly than the committee had hoped, which means that by the time they get up to a nominal rate of say 4-½%, if inflation hasn’t cooled as much as they had expected, then the stance of policy is not going to be perhaps restrictive at all and maybe not sufficiently restrictive.”

He said that given current conditions rates are likely to peak around 5% as markets expect but the range of outcomes is wider than usual. (See MNI: Ex-Officials Now See Fed Rate Peak At 5% Or Higher)

UNDERLYING MOMENTUM

Echoing arguments from some Fed officials that the economy is strong enough to withstand the central bank’s aggressive tightening campaign, Weinberg said a recession may yet be avoided, and, if there is one, it would not be particularly deep.

“Even if monetary policy gets restrictive enough to contribute to some actual contraction in the economy, the economy is positioned to weather a policy shock like that and perhaps other typical real shocks,” he said.

“Household financials are in reasonably good condition, there's still some fiscal impetus in the pipeline, and all of these things should mitigate any recessionary effects on the economy. So I think if there is a recession in the next couple of years it will be pretty mild.”

The October jobs report out Friday corroborated that momentum, with the economy generating a stronger-than-expected 261,000 new jobs.

Still, Weinberg conceded that high uncertainty around prices means the Fed may yet face the challenge of entering a recession while inflation is still well above target.

“If we actually get recessionary forces emerging in the real economy, whether it’s caused by monetary policy or some other shock then the problem gets a lot trickier, because the committee’s tendency will be to want to provide accommodation in the face of significantly rising unemployment," Weinberg said. "And if inflation hasn't fallen sufficiently by then you could get into a ratchet problem which everyone wants to avoid."

MNI INTERVIEW: Service Prices Have Months Before Falling - ISM

By Evan Ryser, *published Nov 3*

(MNI) WASHINGTON - U.S. service prices have months before falling to considerably lower levels while growth will continue to moderate through early next year, Institute for Supply Management services chair Anthony Nieves told MNI Thursday.

"You'll see more of a movement and a fluctuation and this might show up a few months down the road on the services side with prices coming down," he said. Nieves noted the divergence in prices paid measures in the manufacturing report at 46.6 earlier this week versus services at 70.7 and expects the fall in service prices to come in time.

"There's more of a lag time, cycle time as it relates to the impact as it pulls through the supply chain," he said, expressing surprise about October's 2ppt increase in the price index. "When you see prices go up on the manufacturing side, they won't go up as fast on the services side because sometimes it gets absorbed in the supply chain and it's not passed on directly or immediately."

The headline composite for the ISM services survey declined from 56.7 in September to 54.4 in October, disappointing expectations of 55.0. The survey has softened significantly since late last year and the October headline print was the lowest reported since the early stages of the pandemic in May 2020.

But even so, the recent ISM services data do not look as downbeat as seen in some other recent business surveys, such as the S&P Global US Services PMI that registered a sharper contraction.

HARDER SIGNALS

Nieves expects the services sector to see moderate growth through the end of the year but said it is now harder to get clear economic signals from the data, with some survey respondents showing greater concern about the economic outlook. The new orders index fell 4.1ppts to 56.5 in October and demand appears to be normalizing right now, he said.

Still, the services sector is holding up despite the Federal Reserve's historically fast tightening cycle this year, he said. Nieves pointed to the ISM manufacturing survey as a leading indicator but downplayed concerns that a contraction in manufacturing would signal the same for services.

"All indications are that we'll finish up the year still growing just not at as fast a pace as we have seen in the past, due to the pent up demand," he said. "We'll start seeing some leveling off after the first of the year but right now things are still positive but there is a lot of uncertainty surrounding some of the conditions out there."

The ISM services chair said the employment picture is now more mixed than earlier this year as some companies still struggle to retain headcount and others are refraining from additional hiring. The employment index fell 3.9ppts to 49.1, below 50 for the first time in 3 months.

"Some companies are saying right now that they are not going to hire and they are taking a wait and see approach to see what's going on with the economic picture," he said.