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Economics Group

Sam Bullard, Senior Economist
sam.bullard@wellsfargo.com • (704) 410-3280
Sarah House, Economist
sarah.house@wellsfargo.com • (704) 410-3282

CPI Falls in December, but Weakness Moderating

The CPI fell 0.1 percent in December as a decline in food and energy more than offset further gains in core inflation. Although energy will continue to weigh on the index in the near term, the drag is diminishing.

Soft December, but Trend Is Edging Up

Consumer price inflation edged lower in December, with the CPI down 0.1 percent. As expected, energy dragged down the headline, but elsewhere prices rose more slowly over the month. Still, the trend in both headline and core CPI has picked up. The year-over-year change in the CPI rose to 0.7 percent, while the core index increased to 2.1 percent.

After rising 0.2 percent in each of the past three months, core CPI increased a more modest 0.1 percent in December. Prices for core goods ticked down 0.1 over the month as the cost of apparel, new vehicles and medical goods fell. Services, however, which account for about 75 percent of the core index, continued to rise. Shelter costs rose 0.2 percent as a decline in lodging was not enough to offset the steady gains in primary housing. Prices for medical care services also advanced more slowly in December, but after strong gains in the previous three months, are up 2.9 percent over the past year.

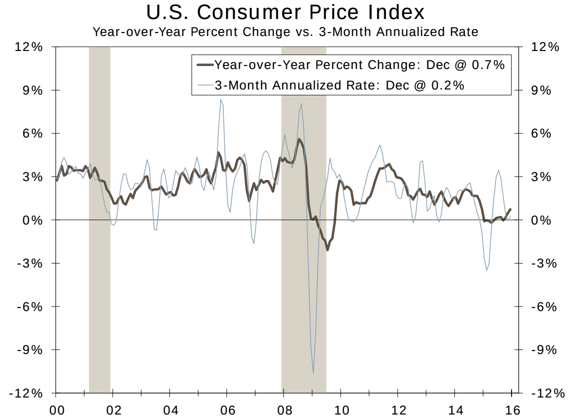
Prices for food fell for a second straight month as five out of the six major grocery store categories posted declines. Prices for food away from home continued to rise and are up 2.6 percent from a year ago.

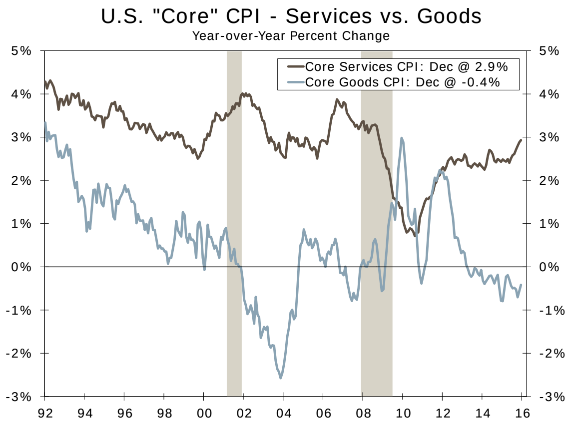
We knew heading into today's report that the fresh cycle lows in oil prices hit in December would push the gasoline index lower, and indeed gas prices fell 3.9 percent last month. Over the past year, gasoline prices are down 19.7 percent, but the pace of declines has moderated since last January when prices were down 35 percent. Although energy will continue to be a drag on inflation at least through January, the moderation in price declines is a reminder that oil can continue to reach new multi-year lows while at the same time being less of a headwind of inflation—the transitory nature to which Fed officials have been adamant about.

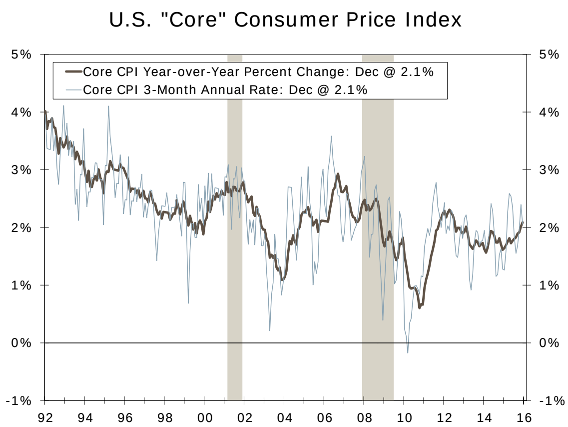
The continued drop in oil, however, means that a significant rebound in inflation will now be delayed further. As the weakness in commodity prices drags on, the risk to inflation expectations grows and could challenge the eventual return to the Fed's target.

Firmer readings in the core CPI should continue to support the Fed's confidence that inflation will eventually rebound towards target. Although the Fed's preferred measure of core inflation, the PCE deflator, has been stuck around 1.3 percent over the past year, the uptrend in core CPI suggests underlying inflation is not as unequivocally weak.

We expect base effects will push the year-over-year rate of headline inflation up more noticeably in the coming months, but for headline CPI to remain below 2 percent through the remainder of the year. Core inflation, however, should continue to move along around a 2 percent pace amid a tightening housing market and rebound in medical care prices.







Source: U.S. Department of Labor and Wells Fargo Securities, LLC

Wells Fargo Securities, LLC Economics Group

Diane Schumaker-Krieg	Global Head of Research, Economics & Strategy	(704) 410-1801 (212) 214-5070	diane.schumaker@wellsfargo.com
John E. Silvia, Ph.D.	Chief Economist	(704) 410-3275	john.silvia@wellsfargo.com
Mark Vitner	Senior Economist	(704) 410-3277	mark.vitner@wellsfargo.com
Jay H. Bryson, Ph.D.	Global Economist	(704) 410-3274	jay.bryson@wellsfargo.com
Sam Bullard	Senior Economist	(704) 410-3280	sam.bullard@wellsfargo.com
Nick Bennenbroek	Currency Strategist	(212) 214-5636	nicholas.bennenbroek@wellsfargo.com
Eugenio J. Alemán, Ph.D.	Senior Economist	(704) 410-3273	eugenio.j.aleman@wellsfargo.com
Anika R. Khan	Senior Economist	(704) 410-3271	anika.khan@wellsfargo.com
Azhar Iqbal	Econometrician	(704) 410-3270	azhar.iqbal@wellsfargo.com
Tim Quinlan	Economist	(704) 410-3283	tim.quinlan@wellsfargo.com
Eric Viloria, CFA	Currency Strategist	(212) 214-5637	eric.viloria@wellsfargo.com
Sarah House	Economist	(704) 410-3282	sarah.house@wellsfargo.com
Michael A. Brown	Economist	(704) 410-3278	michael.a.brown@wellsfargo.com
Erik Nelson	Economic Analyst	(704) 410-3267	erik.f.nelson@wellsfargo.com
Alex Moehring	Economic Analyst	(704) 410-3247	alex.v.moehring@wellsfargo.com
Misa Batcheller	Economic Analyst	(704) 410-3060	misa.n.batcheller@wellsfargo.com
Michael Pugliese	Economic Analyst	(704) 410-3156	michael.d.pugliese@wellsfargo.com
Donna LaFleur	Executive Assistant	(704) 410-3279	donna.lafleur@wellsfargo.com

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