

## TD Economics

### Data Release: US core CPI shows some sturdiness

- Total CPI was bang-on expectations at -0.1% m/m, resulting in a y/y growth rate of 1.1%. The closely watched core measure came in above expectations with a 0.2% m/m gain, holding the annual rate steady at 0.9%.
- The annual growth rate in total CPI dropped significantly from 2.0% in May, but this was due to base-year effects from large energy price increases this time last year.
- In recent months, a largest single downward influence on the core measure was owner's equivalent rent (OER), which edged up 0.1% m/m in June. After six months of continuous declines, this subcomponent has finally held its ground in the past two months. Nevertheless, OER still shaved half a percentage point from the annual growth rate of the core measure.
- Within other subcomponents, medical care, recreation and apparel all posting gains in the month. Interestingly, apparel had been one of the other subcomponents that was also offering a large drag on the core measure, but this hasn't been the case in the last two months.

### Key Implications

- The downtrend in the annual core growth rate has stabilized in the past three months, holding at 0.9%. However, with considerable slack remaining in the economy, downward pressures should persist through the year, with the core measure touching in the 0.5-0.6% range by the fourth quarter. As such, while this report offers good news that there is some sturdiness to underlying prices in the US economy, market concerns that the core measure could actually dip into deflation territory will likely be around for some time to come, perpetuating a low yield environment.
- To this end, a key subcomponent to watch is the OER, which represents one-third of the core CPI index. It has been shaving off 0.5 percentage points from the core annual rate throughout the year. However, the fact that it appears to have stabilized in the last two months could be an early indication that the drag coming from OER will soon dissipate.
- If the OER continues to reflect the modest gains seen in the May-June period, the subcomponent component would cease to offer a downward influence on the overall core measure by October.
- The other indicator to watch is market inflation expectations. Irrespective of what happens in the near-term inflation data, it is vital that long-run inflation expectations remain anchored; otherwise the belief of deflation can become a self-fulfilling prophecy, as people delay purchases in anticipation of lower future prices. 5-year expectations were anchored at around 2% over the spring, and have since slipped below 1.5%. Although this current level is not cause for concern, any significant ratcheting down in the coming months would become more worrisome.
- Today's report offers some comfort that the risks of the US trending towards a certifiable deflationary period are limited. CPI is a lagging indicator, and an ongoing recovery in the job market alongside some stabilization in the housing market will eventually put a floor under prices. Admittedly, the U.S. economy has a long way to go to claw away economic slack. But, by early 2011, we expect inflation will start to trend back up more convincingly, reaching 1.3% by the end of 2011.

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