Economic Analysis

Headline CPI Rises in February and Pass-Through to Core Remains Limited

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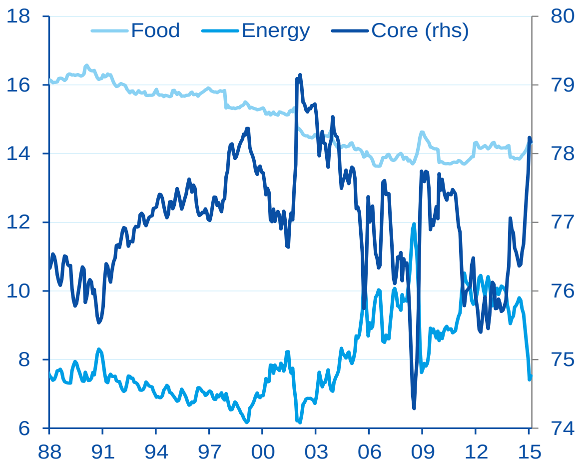
- **CPI increased 0.2% for the first time since October, though YoY inflation held in negative territory at -0.1%**
- **At 1.7% YoY, the pass-through to core remains limited as services remains the most relevant component**
- **Although core inflation will remain below the Fed's target, we continue to expect the first rate hike in September**

Downward pressures on inflation are proving to be transitory, with the headline consumer price index up 0.2% in February following three consecutive months of declines. As expected, the rise in crude oil prices lifted the energy index 0.95% for the month, the first increase since June. However, annual inflation remains extremely low, at -0.1% compared to 12 months ago. This marks the second consecutive month for negative YoY inflation and points to a prolonged period of slow price growth in the year ahead, even if headline CPI continues to increase on a monthly basis. That may even prove to be a difficult feat given that crude oil prices already declined again throughout the early part of March and have only recovered partially towards February's highs.

When it comes to core inflation, February's report notes another 0.2% monthly gain and an increase to 1.7% YoY inflation. Although this rate remains lower than the Fed's 2.0% target, it reflects an important lack of pass-through from headline to core. From an economic perspective (and, more importantly, in the Fed's eyes), this is good news because it implies that consumer demand remains relatively strong. Much of this core inflation stems from the usual suspects of shelter and medical care commodities, up 0.2% and 0.7%, respectively, in February. There has also been a shift in the relative importance of various components in the CPI that may be artificially limiting the pass-through to core inflation. Commodities have become less relevant, making way for services (less energy) to grow to nearly 60% of the index. Shelter prices make up about one-third of the CPI, so the ongoing strength in this component tends to overshadow other less relevant drivers. For example, YoY inflation remains negative for apparel and used cars and trucks, yet the relative importance of both of these components has trended downward throughout the recovery period. The downward trend in core commodities such as apparel over the longer term more likely reflects the cheaper cost of labor and input materials rather than a pure decline in consumer demand. In the shorter term, this could also be reflecting the impact of the stronger USD and weaker growth abroad.

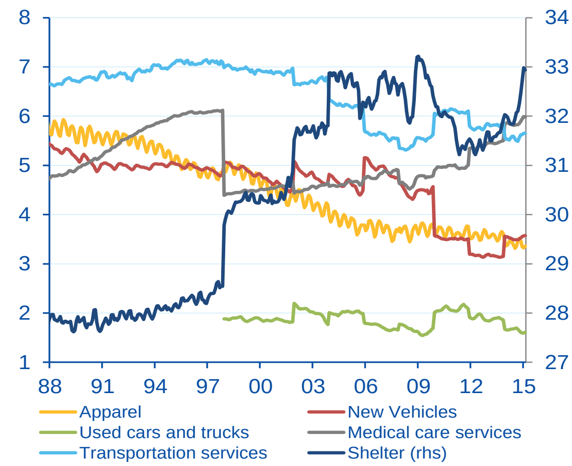
Overall, we expect that core inflation will remain below the 2.0% target throughout 2015 and well into 2016. This prolonged period of low inflation has fallen in line with our projections set out at the beginning of last year (Should Low Inflation be a Concern?), even before oil prices started to decline in June. As long as core inflation holds at its steady pace, we continue to expect the first rate hike in September 2015, regardless of whether or not energy prices drag down headline inflation for another month.

Chart 1
CPI Relative Importance: Headline and Core (%)



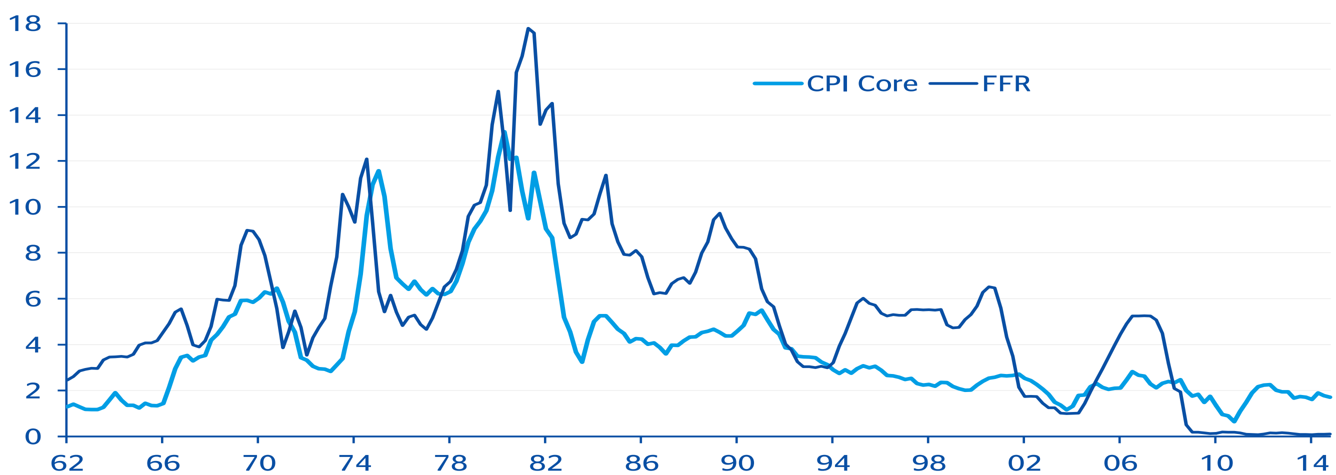
Source: Bureau of Labor Statistics & BBVA Research

Chart 2
CPI Relative Importance: Core Components (%)



Source: Bureau of Labor Statistics & BBVA Research

Chart 3
Core CPI Inflation and Federal Funds Rate (% and YoY % Change)



Source: Bureau of Labor Statistics, FRB, & BBVA Research

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