AVALON
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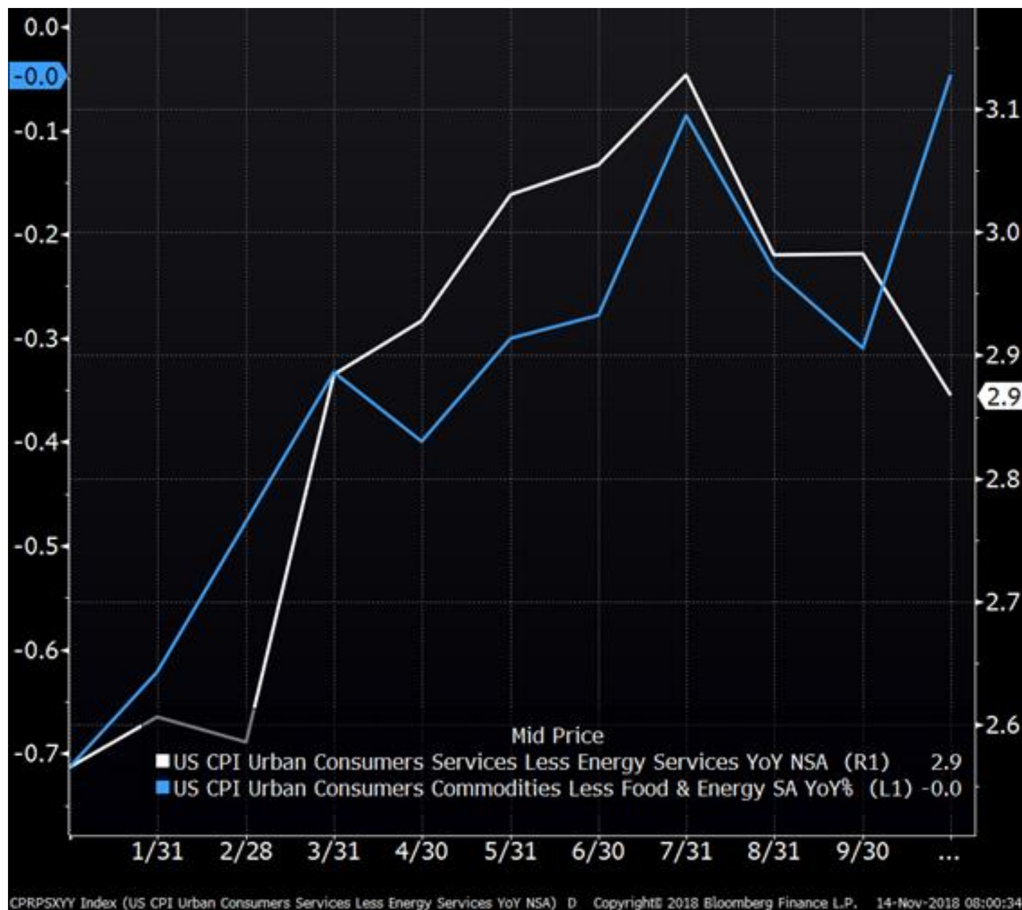
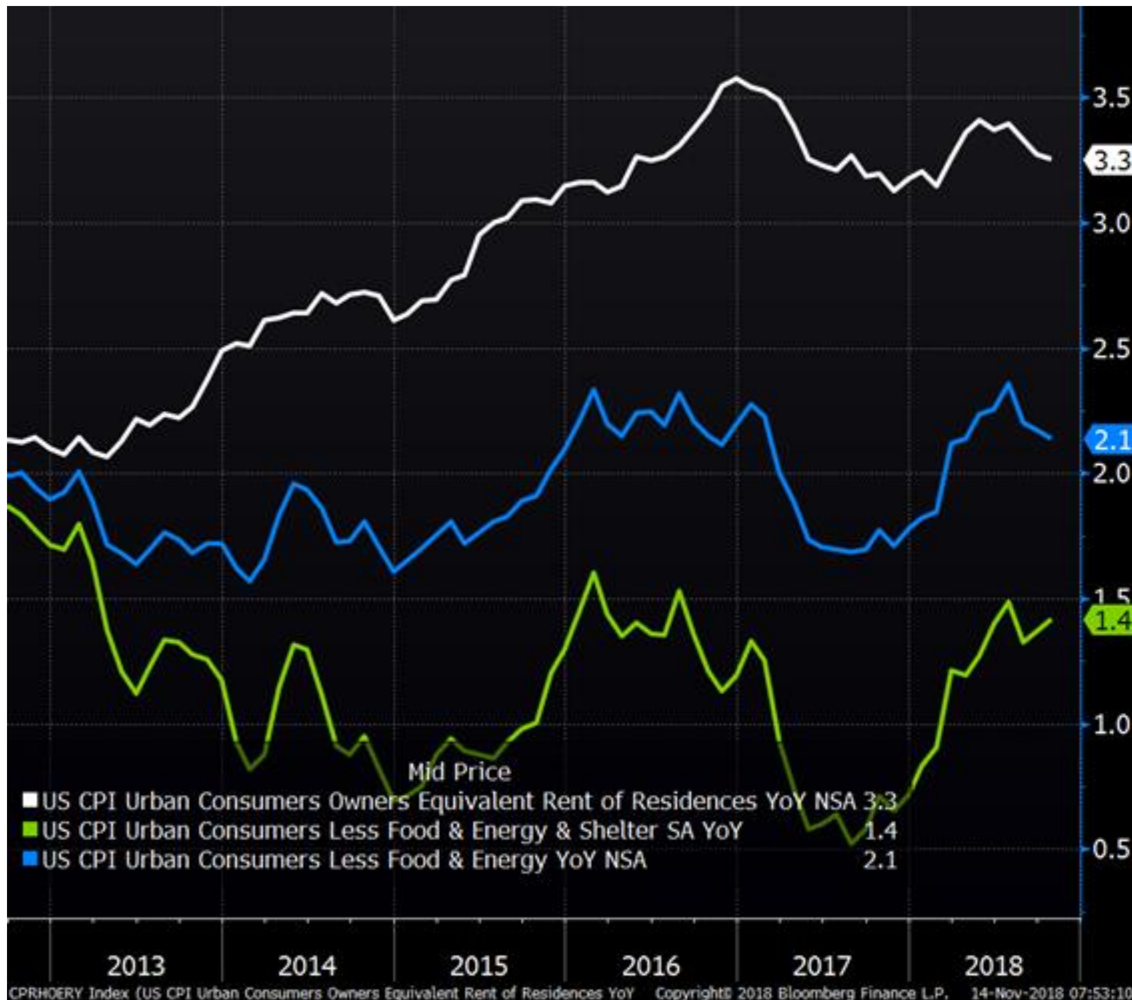
Macro Note: Inflation Implications

- If the Fed is looking for excuses to tighten monetary policy further, this is not the CPI report it wanted to see.
- Core CPI came in below expectations by a touch (2.1% vs 2.2%), but the internals point toward further deceleration in both the headline and core.
- The fundamental story is rather simple: core commodities were less deflationary, and core services less inflationary.
- That is not the dynamic the Fed wants to see at this point. Services prices are sticky, less volatile, and less cyclical.
- The data points toward inflation weakening through the end of 2018 and into 2019.



With the Fed set to continue hiking rates, inflation - or a lack thereof - is one of the few metrics that matters. And this morning's inflation report did not affirm the Fed's aspirations. Granted, the headline reading for October was 2.5%, an acceleration from the 2.3% seen in September. Nearly all of the acceleration was due to energy, however. In the few weeks since the data for this report was collected, the energy surge has more than fully reversed. The headline CPI reading is completely useless for understanding the dynamics going forward.

One of the potential signals it did send, however, was a heightened chance of a "Fed error". The Fed error being the Fed raising too quickly and causing a recession. Quite simply, the report showed little in the way of underlying inflation pressure with the stickiest inflation measures showing nascent weakness.



There were a few jumps in prices on a month over month basis that should raise a few questions. Used autos were positive +2.6% in October from September (after a 3% decline the prior month). That accounts for the majority of the pick-up in the core goods prices. For core services, a continued subtle deceleration in shelter pushed the index lower. Used autos are volatile and unlikely to be a fundamental driver of core goods inflation over time. But shelter is a primary driver of inflation and should continue to decelerate.

The underlying inflation dynamics do not point to further strength. It is worth noting that any acceleration in core goods inflation is easily overwhelmed by a deterioration in core services. Core

goods represent only roughly 25% of the core inflation weight. Core services prices are sticky, less volatile, and less cyclical - better for making policy decisions.

There are a few reasons this inflation report will matter for markets and the Fed. It will be difficult for the Fed to back-off its hiking plans in December. But it should cause the Fed to rethink its 2019 plans. The composition of the Fed's FOMC voters changes yearly, and it already appears to be slightly more dovish in 2019. With inflation pressures tepid and likely waning, the Fed will be hard-pressed to justify tightening significantly further. The Fed will be loath to back away from its current posture. But the data is the data, and it can be inconvenient at times.

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