RBC Economics & Thought Leadership

Daily Economic Update

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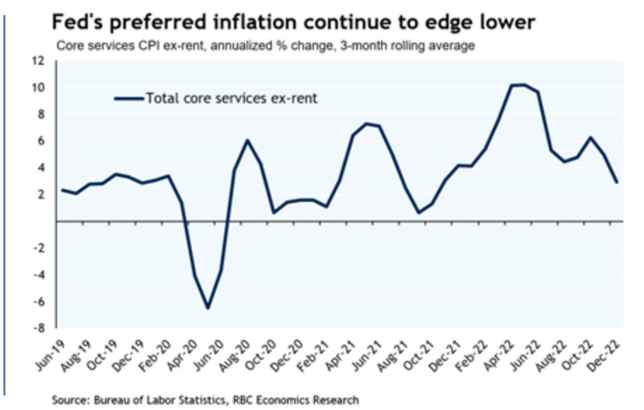
More easing in December's US inflation report won't stop the Fed (yet)

- Headline inflation in the U.S. dropped lower to 6.5% in December amid deflating energy prices
- Breadth of CPI growth narrowed and Fed's preferred gauge of underlying pressure (core services CPI ex-rent) continued to show signs of decelerating
- Slower inflation drawing the Fed close to the end of hiking cycle – we expect 50 bp increase in the Fed Funds target in Q1 2023 before a pause

RBC Inflation Watch: a tracker of key indicators on price trends in the US.

Read Report

The positive trend in U.S. inflation reports largely continued in December, with headline price growth dropping lower to 6.5% year-over-year amid decelerations in all major categories. Food and energy inflation are both still very high, but year-over-year rates dialed lower, to 10.4% and 7.3% respectively thanks to moderations in supply side constraints that helped push inflation higher earlier during the pandemic recovery. That includes improvements in global supply chain conditions and falling commodity prices that should extend into 2023, absent major disruptions. 'Core' CPI growth that excludes food and energy



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products also slowed to 5.7% year-over-year in December or 0.3% on a month over month seasonally adjusted basis. That month-over-month increase is slightly higher than the reading in November but was also much lower than the 0.6% average pace during the first half of 2022. And nearly all of that monthly increase in core CPI came from surging rent costs. Those rent prices should start to ease soon as lower observed rent prices since last summer start to feed through to lease renewals.

Overall the breadth of inflation pressure in the U.S. also continued to narrow in December. By our count, 50% of the CPI basket (ex-shelter) still saw annual inflation at above 3% over the past 3 months. But that is significantly lower than the peak of more than 90% in July. The 'core' services CPI ex-rent measure that has been dubbed as the best gauge of underlying price pressures by Chairman Powell has also continued to show signs of improvement, averaging around just under 3% (annualized) for the last quarter of 2022. Those green shoots won't prevent more interest rate hikes – Federal Reserve officials will still be wary about easing financial conditions on top of extremely heated labour markets conditions and elevated wage growth. We expect a 25 bp increase in the Fed Funds target in February to be followed by another one of the equal size in March, before the Fed pauses for a reassessment. Still, interest rates are high enough for us to expect slower growth and more easing in inflation pressures in the year ahead. Our forecast remains for the economy to enter a mild contraction in the first half of 2023.

U.S. CPI Growth

	Oct-22	Nov-22	Dec-22	Dec-22
	MoM % change (SA)			*YoY % change*
Headline	0.4	0.1	-0.1	6.5
Food	0.6	0.5	0.3	10.4
Energy	1.8	-1.6	-4.5	7.3
Core	0.3	0.2	0.3	5.7
Goods ex food and energy	-0.4	-0.5	-0.3	2.1
Services ex energy	0.5	0.4	0.5	7.0