Focus on the signal and not the noise

17 February 2023

- January’s CPI showed slowing annual disinflation, driven by accelerating monthly growth in shelter and energy prices. We can expect more growth in Owners’ Equivalent Rent (OER), a key shelter component of the CPI, until the measure peaks (likely in Q2) and the trend matches that of declining new rent prices.

- Energy prices will likely stay elevated throughout the first half of 2023 but may accelerate in the second half as demand is expected to outpace supply. OPEC increased their forecast for global oil demand growth by 100,000 barrels a day and Russia announced that it will cut production by 500,000 barrels a day starting in March. The strength of China’s economic rebound will be key for energy markets.

- The January PPI came in well above consensus forecasts, but in isolation, does not provide strong signals. The PPI has not been shown to affect the CPI in the short run, but the combination of accelerating producer prices and strong demand from retail sales growth can apply upward inflation pressures.

- Retail sales rebounded strongly, driven by motor vehicles and food services. Together, the two accounted for nearly 70% of January’s growth. Warmer than usual weather in January can potentially explain some of the increase, but it doesn’t dismiss the consumer’s capacity to spend.

Disinflation may be slowing, but it is too soon to tell

Every month, there is new “evidence” that points to either rapidly decelerating inflation or persistently elevated price growth. The January CPI report points to the latter, with price growth slowing only slightly to 6.4%, down from 6.5% last month. This drop of 0.1% points is much smaller than that of the previous 6 months, where annual price growth fell by an average of 0.4% points.

There is some indication of an emerging trend, but it is too soon to tell for sure. The rapid deceleration of core goods prices may be coming to an end, core services inflation (excluding shelter) is proving to be stubbornly high, and there is little evidence to suggest that energy prices will fall. The signal on shelter, though, is more predictable.

The rate of annual disinflation slowed in January

<table>
<thead>
<tr>
<th>Contributions to annual growth in CPI, % points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shelter</td>
</tr>
<tr>
<td>---------</td>
</tr>
<tr>
<td>Jun-22</td>
</tr>
<tr>
<td>Jul-22</td>
</tr>
<tr>
<td>Aug-22</td>
</tr>
<tr>
<td>Sep-22</td>
</tr>
<tr>
<td>Oct-22</td>
</tr>
<tr>
<td>Nov-22</td>
</tr>
<tr>
<td>Dec-22</td>
</tr>
<tr>
<td>Jan-23</td>
</tr>
</tbody>
</table>

Source: BLS, MUFG Bank Economics Research
Rent inflation is not worrisome

For the shelter component of the CPI, signs point to accelerating price growth over the next few months, but rapid deceleration thereafter. January’s CPI certainly showed more growth with nearly 50% of the monthly gain coming from shelter. Owners’ Equivalent Rent (OER) grew by 7.8% annually, propelling the overall shelter component to contribute 2.6% points to annual CPI growth. Shelter continues to be a growing contributor, and it possesses a significant weight in the overall CPI (33%).

Prices accelerated in January, driven by shelter and energy

The good news is, shelter price growth will likely start to slow sometime in the next few months. Annual rent growth from CoreLogic’s Single-Family Rent Index (SFRI) has historically led CPI shelter by about 12 months. And as of November 2022, CoreLogic’s index has fallen at a rapid rate for 7 straight months. This, along with other private sector measures, provides the strong signal of an upcoming deceleration in shelter, probably sometime in Q2 of this year.

Energy prices will likely stay elevated

Energy costs contributed to 27% of the monthly CPI growth in January, much of which came from motor fuel (15%) and gas services (11%). Prices for motor fuel have fallen for several months but they may be reversing, as the price of gas is directly tied to oil prices.

Crude oil production from OPEC fell by 49,000 barrels per day overall in January, with top producer Saudi Arabia cutting output by 156,000 barrels per day. Additionally, Russia announced it will cut oil production by 500,000 barrels per day starting in March in retaliation against the EU capping Russian seaborne oil prices at $60 per barrel. OPEC has not changed production targets despite this announcement. Global energy supply will certainly be impacted as a result, but the extent of which is unclear.

On the demand side, OPEC raised their forecast for global economic growth to 2.6%, driven largely by the reopening of China’s economy and government stimulus measures. They project global oil demand to grow this year by 100,000 barrels per day, which if proven to be true, will further exacerbate the supply/demand imbalance.

Eyes are back on goods prices

Consumer prices for core goods experienced a reversal in January, increasing by 0.07% monthly. And while this increase is small, it follows 3 straight months of declines. A similar case is happening with producer prices of core goods which increased by 0.56% in January. Core goods PPI increased by less than 0.5% for 7 straight months and grew less than 0.25% for 6 of the 7 months. For reference, annual growth in the January PPI came in at 7.6% and overall core PPI rose by 4.5 percent, only a modest slowdown from December. Monthly, overall core PPI rose 0.6%, well above consensus expectations of 0.2% growth.
Disinflation in goods has been the driving force behind the overall slowdown in inflation, but it is losing some steam. Now on their own, a single month of increases isn’t evidence of a new trend where waves of inflation in goods emerges. Nor does the magnitude of the core goods PPI growth mean that core goods CPI will soon follow with larger monthly increases.

Historically, the PPI and CPI are cointegrated where the series’ move together over the long run. This relationship is not significant when looking at monthly changes though. Some divergence in the PPI and CPI can be attributed to just noise in the dataset, especially when looking at relatively high frequency monthly changes. But intuitively, the relationship stands to reason.

**Turnaround in growth of goods prices in both CPI and PPI**

*Monthly change in core goods prices, %, SA*

![Graph showing turnaround in growth of goods prices in both CPI and PPI](source: BLS, MUFG Bank Economic Research)

Increases in the PPI are akin to rising costs from the producer, but other factors influence how these costs translate into inflation in the short run. A key factor to watch in conjunction with the PPI and CPI is the strength of demand from the consumer perspective and the willingness to spend. Combined, these may indicate increased inflationary pressures from both supply and demand. And in January, consumers did spend more (nominally) in all major categories.

**The Fed will likely interpret that demand is still prevalent in the economy**

The latest January retail sales data came in well above expectations, increasing by 3%. The latest rise in sales was driven by motor vehicles and food services, which combined, contributed to 70% of the overall 3% monthly increase. Sales at general merchandise stores was also strong in January, contributing 11%. Sales at food services and drinking places has outpaced the rest of retail sales, having grown by 60% since the start of 2021, compared to 9% at general merchandise stores and 20% for all retail sales.
January’s retail sales reversal can be interpreted as a “correction” following 2 straight months of declines or as an indication of stronger than expected demand. The truth is likely a bit of both, plus some noise. Seasonality can potentially explain some of the higher-than-expected growth in spending, especially in food services, but we run the risk of attributing our hindsight biases to what just might be noise in the data.

Warmer than normal January weather may have played a part, but that doesn’t increase consumers overall capacity to spend. The ability to spend reflects strong consumer finances and the willingness to spend, regardless of weather, is a reflection of demand. The Fed will likely interpret the latest retail sales, PPI, and CPI data as an indication that demand is still present in the economy and further increases in interest rates should be expected.
Analyst Certification

The views expressed in this report solely reflect the personal views of Agron Nicaj, the primary analyst responsible for this report, about the subject securities or issuers referred to herein, and such views may not necessarily reflect the thoughts and opinions of MUFG Bank, Ltd. and its affiliates or management team. No part of such analyst's compensation was, is, or will be directly or indirectly related to the specific recommendations or views expressed herein.

Disclaimers

The information and views contained herein are not intended for distribution to, or use by, any person or entity in any jurisdiction or country where such distribution or use would be contrary to law or regulation or which would subject MUFG Bank, Ltd. (collectively with its various offices and affiliates, "MUFG Bank") to any registration requirement within such jurisdiction or country. The information and views contained herein are provided for general informational purposes only, are subject to change, and are not intended to be, nor should be used, or considered, as an offer, or the solicitation of an offer, to sell or to buy or to subscribe to or for securities or any other financial instruments, and do not constitute specific investment, legal, tax or other advice or recommendations. The information contained herein reflects the thoughts and opinions of the noted authors only, and such information does not necessarily reflect the thoughts and opinions of MUFG or its management team. Neither this nor any other communication prepared by MUFG Bank should be construed as investment advice, a recommendation to enter into a particular transaction or pursue a particular strategy, or any statement as to the likelihood that a particular transaction or strategy will be effective and it does not take into account the specific investment objectives, financial situation, or the particular needs of any specific person who may receive this information. Any information relating to performance contained herein is illustrative and no assurance is given that any indicative returns, performance or results, whether historical or hypothetical, will be achieved. Before entering into any particular transaction, you should consult an independent financial, legal, accounting, tax, or other advisor as may be appropriate under the circumstances. In any event, any decision to enter into a transaction will be yours alone, not based on information prepared or provided by MUFG Bank. MUFG Bank hereby disclaims any responsibility to you concerning the characterization or identification of terms, conditions, and legal or accounting, or other issues or risks that may arise in connection with any particular transaction or business strategy. While MUFG Bank believes that any relevant factual statements contained herein, and any assumptions on which such statements are based, are in each case accurate, neither the authors nor MUFG have independently verified its accuracy, and such information may be incomplete or condensed. The information is provided "AS IS". The authors and MUFG do not warrant the accuracy of the materials provided herein, either expressly or implied, for any particular purpose and expressly disclaims any warranties of merchantability or fitness for a particular purpose. The authors and MUFG cannot and do not guarantee the accuracy, validity, timeliness or completeness of any information or data made available to you for any particular purpose. MUFG Bank may have issued, and may in the future issue, other reports that are inconsistent with or that reach conclusions different from the information and views contained herein. Such other reports, if any, reflect the different assumptions, views and/or analytical methods of the analysts who prepared them, and MUFG Bank is under no obligation to ensure that such other reports are brought to your attention.

© 2023, MUFG Bank, Ltd. All Rights Reserved.

About Mitsubishi UFJ Financial Group, Inc.’s U.S. Operations including MUFG Americas Holdings Corporation

The U.S. operations of Mitsubishi UFJ Financial Group, Inc. (MUFG), one of the world’s leading financial groups, has total assets of $332.4 billion at March 31, 2022. As part of that total, MUFG Americas Holdings Corporation (MUAM), a financial holding company, bank holding company, and intermediate holding company, has total assets of $159.2 billion at March 31, 2022. MUFG Securities Americas Inc. is a registered securities broker-dealer which engages in capital markets origination transactions, domestic and foreign debt and equities securities transactions, private placements, collateralized financings, and securities borrowing and lending transactions. MUAM is owned by MUFG Bank, Ltd. and Mitsubishi UFJ Financial Group, Inc. MUFG Bank, Ltd., a wholly owned subsidiary of Mitsubishi UFJ Financial Group, Inc., has offices in Argentina, Brazil, Chile, Colombia, Peru, Mexico, and Canada. Visit www.mufgamericas.com for more information.

About MUFG and MUFG Americas

Mitsubishi UFJ Financial Group, Inc. (MUFG) is one of the world’s leading financial groups. Headquartered in Tokyo and with over 360 years of history, MUFG has a global network with approximately 2,100 locations in more than 50 countries. MUFG has nearly 160,000 employees and offers services including commercial banking, trust banking, securities, credit cards, consumer finance, asset management, and leasing. The Group aims to “be the world’s most trusted financial group” through close collaboration among our operating companies and flexibly respond to all the financial needs of our customers, serving society, and fostering shared and sustainable growth for a better world. MUFG’s shares trade on the Tokyo, Nagoya, and New York stock exchanges.

MUFG’s Americas operations, including its offices in the U.S., Latin America, and Canada, are primarily organized under MUFG Bank, Ltd. and subsidiaries, and are focused on Global Corporate and Investment Banking, Japanese Corporate Banking, and Global Markets. MUFG is one of the largest foreign banking organizations in the Americas. For locations, banking capabilities and services, career opportunities, and more, visit www.mufgamericas.com.