

Mixed CPI Supports Widely Expected Fed Pause

The May consumer price index (CPI) report was generally in line with forecasts. With Fed officials in the midst of policy discussions today and tomorrow, a single meeting pause is still the most likely outcome.

The slight +0.1% rise in May headline CPI was primarily the result of a -3.6% decline in energy prices. Energy has been particularly volatile in recent months and has been the main driver of overall CPI. A +0.6% energy increase in April had pushed monthly CPI up +0.4%, while a -3.5% energy drop back in March was responsible for a +0.1% monthly gain. This period-to-period volatility illustrates why Fed officials prefer to look at core inflation, which excludes food and energy prices.

Food prices rose +0.2% in May after *unchanged* readings in the previous two months. On a year-over-year basis, food costs are now rising at a +6.7% pace. Still much too hot, but likely to cool further as the year progresses.

Core CPI rose +0.4% in May, the sixth straight month at or above +0.4%. On an annual basis, core CPI came in at +5.3%. Although this was down from +5.5% in April, it was above the +5.2% median forecast and the 18th consecutive month above 5.0%.

The year-over-year headline was a bright spot, decreasing from +4.9% to +4.0%, just below the +4.1% forecast. Because energy prices, and by extension overall inflation was so high a year ago, the annual change appears much cooler by comparison. *This will be even more pronounced in the June report, but will reverse itself in July and August.*

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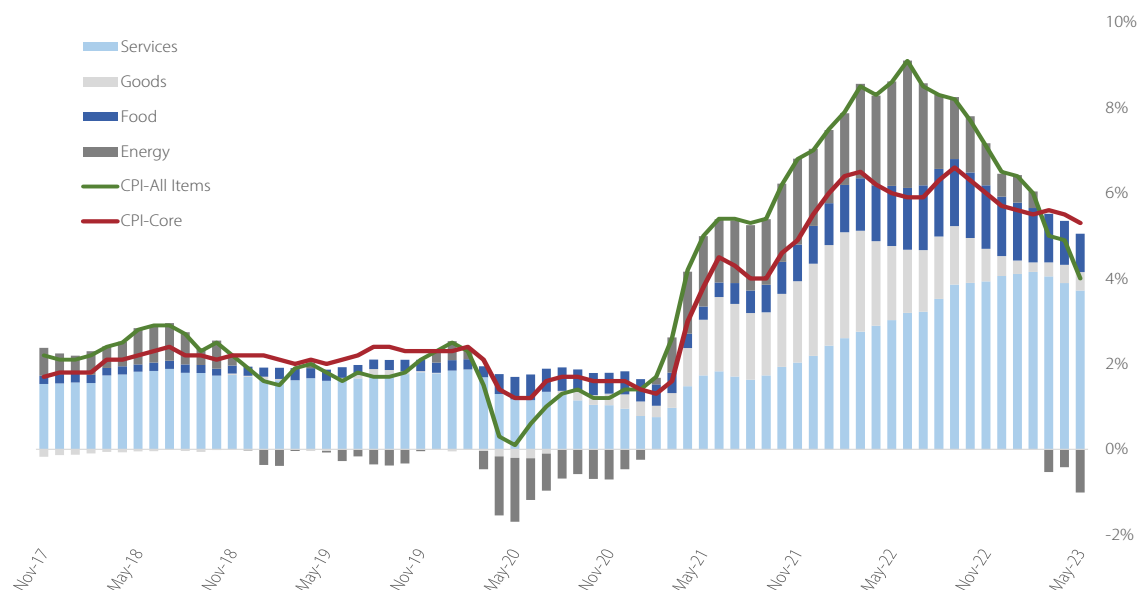
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Consumer Price Index (Year-Over-Year Percent Change)



Source: Bureau of Labor Statistics

There were a few head-scratching sub-categories, in particular used car prices which were up +4.4% for the second straight month. By contrast, new car prices were down -0.1%. Perhaps with the average purchase price for a new vehicle climbing above \$48k this spring, consumers are reluctantly returning to a more affordable option.

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Service prices still made the largest contribution to overall inflation, with shelter costs adding the majority. Shelter costs were up +0.6% in May, reversing a steadily declining trend. Rents are notoriously sticky as leases are typically renegotiated annually. The May increase was unexpected, but there's significant evidence that rents have peaked and will likely fall further later this year.

Airline prices dropped for the second straight month in May and are down -13.4% on an annual basis, but summer travel demand promises a resurgence.

The CPI version of "supercore" inflation, according to Bloomberg, rose +0.24% in May, more than double the April increase. Supercore inflation, a recent focus point for Fed officials, represents service inflation less shelter costs. Although FOMC members are expected to maintain the overnight rate target range at 5.0% to 5.25% tomorrow, the sticky core will keep discussions lively and a July hike in play.

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Equities rallied big in early trading, but have since retreated from highs. Bonds also rallied, driving yields briefly lower, before selling off.

Market Indications as of 9:32 A.M. Central Time

DOW	Up 102 to 34,168 (HIGH: 36,800)
NASDAQ	Up 26 to 13,488 (HIGH: 16,057)
S&P 500	Up 11 to 4,350 (HIGH: 4,797)
1-Yr T-bill	current yield 5.18%; opening yield 5.16%
2-Yr T-note	current yield 4.58%; opening yield 4.57%
3-Yr T-note	current yield 4.19%; opening yield 4.17%
5-Yr T-note	current yield 3.91%; opening yield 3.89%
10-Yr T-note	current yield 3.77%; opening yield 3.74%
30-Yr T-bond	current yield 3.92%; opening yield 3.88%

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