AGRON NICAJ
US Economist

Economic Research Office

anicaj@us.mufg.jp

MUFG Bank, Ltd.
A member of MUFG, a global financial group

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.

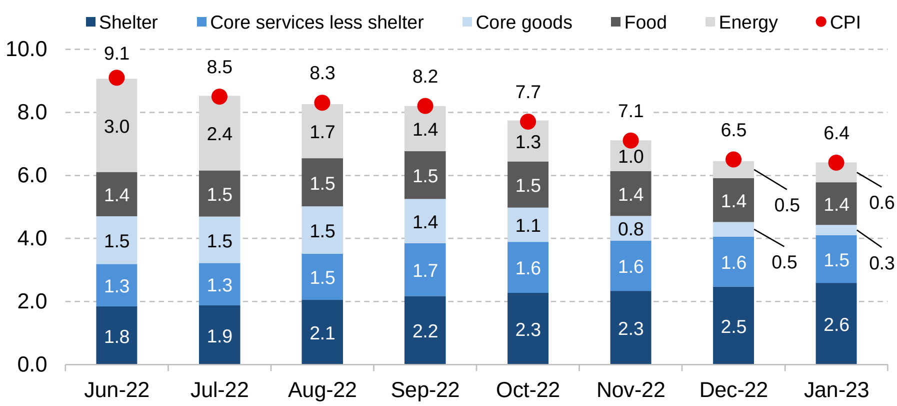
Disinflation may be slowing, but it is too soon to tell

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 annnual disinflation slowed in January

Contributions to annual growth in CPI, % points



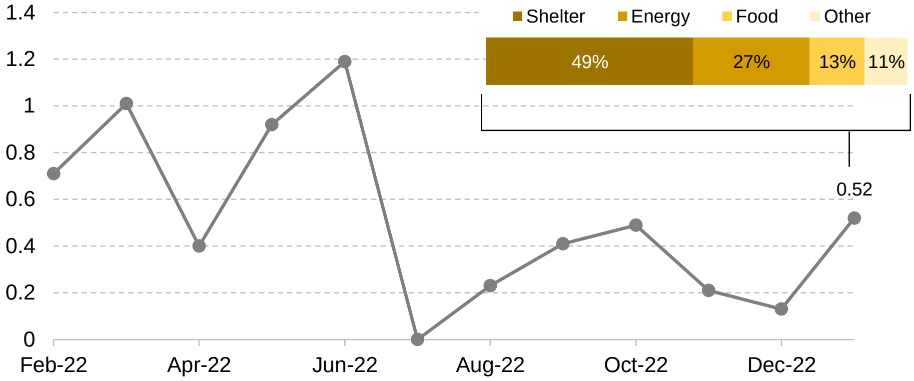
Source: BLS, MUFG Bank Economics Research

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

Monthly growth in headline CPI, %



Source: BLS, MUFG Bank Economic Research

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

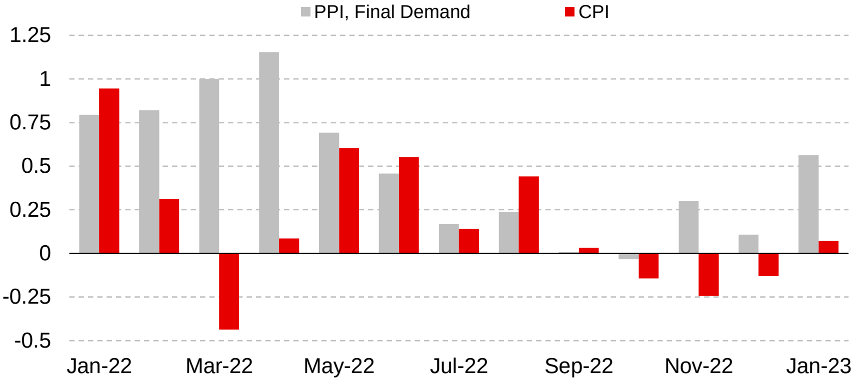
Consumer prices for core goods experienced a reversal in January, increasing by 0.07% monthly. And while this increase is small, it follows 3 straight months of declines. A similar case is happening with producer prices of core goods which increased by 0.56% in January. Core goods PPI increased by less 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



Source: BLS, MUFG Bank Economic Research

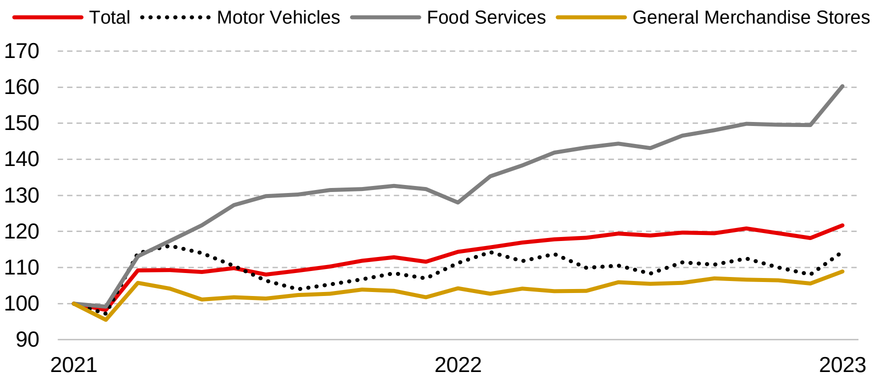
Increases in the PPI are akin to rising costs from the producer, but other factors influence how these costs translate into inflation in the short run. A key factor to watch in conjunction with the PPI and CPI is the strength of demand from the consumer perspective and the willingness to spend. Combined, 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.

Strong rebound in sales to start the year

Index of retail sales, Jan 2021=100, SA



Source: Census Bureau, MUFG Bank Economic Research

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

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 (MUAH), 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. MUAH 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.