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CPI Preview: More Disinflation Evidence

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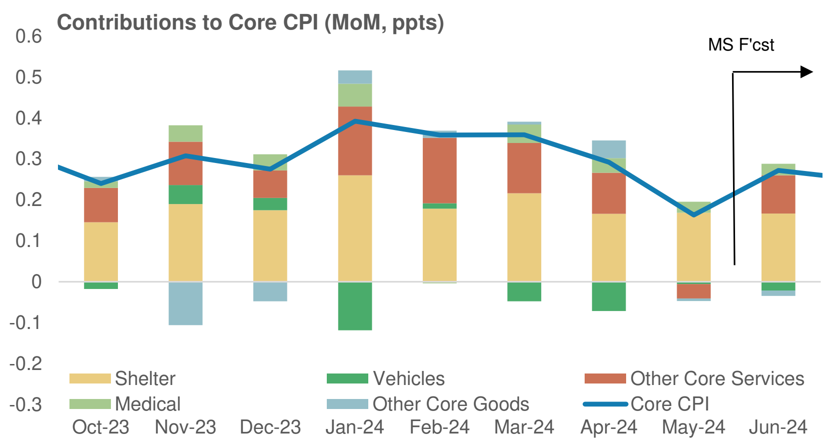
We see core CPI inflation at 0.27%M in June (0.2%M cons, 3.5%Y). Data in line with our expectation points to June core PCE at 0.23%M up from 0.08%M in May, but still the second lowest print of the year. We expect headline CPI at 0.13%M due to negative energy inflation (3.2%Y, NSA Index: 314.823).

Exhibit 1: Core inflation at 0.27%M in June



Source: Bureau of Labor Statistics, Morgan Stanley Research forecasts

June CPI - More Disinflation Evidence

We expect Core CPI inflation at 0.27% (0.2%M consensus, 3.5%Y), higher than May's weak print but still the second lowest read this year. We think a repetition of May's weak prints in auto insurance and airfares is unlikely and, therefore, we forecast stronger core services ex-housing. In turn, we see more core goods deflation and gradual progress in rents inflation. Lower gasoline prices weighs on headline CPI, pushing it below core – we expect headline CPI at 0.13%M (headline CPI NSA index: 314.823).

Our CPI forecast **implies an increase of 0.23%M for core PCE vs 0.08%M in May. The PPI data will be released one day later than CPI, on Friday July 12th, which will help hone our expectation for core PCE inflation.** Core PCE estimates for airfares, medical and financial services are taken from PPI, and other inputs such as import prices feed into other categories (import prices will be released on July 16th).

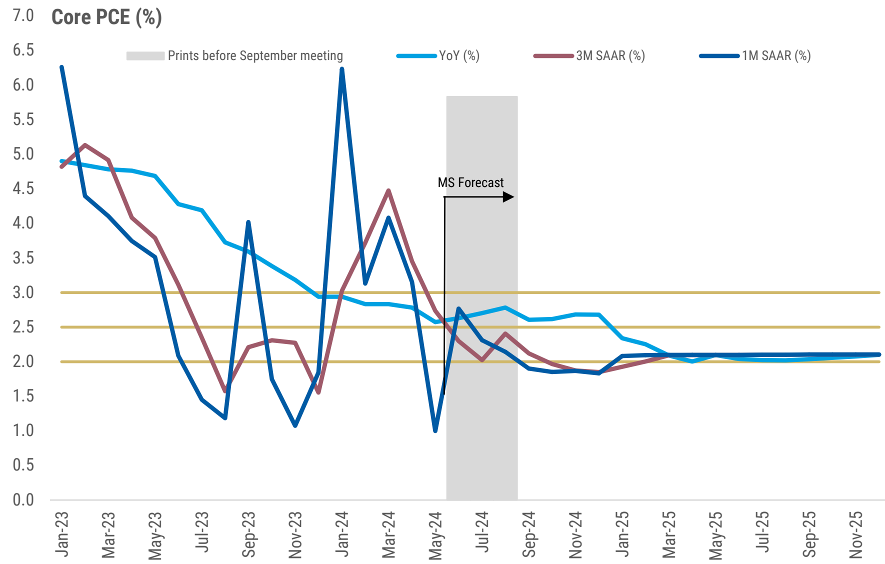
We see the annualized 3-month pace for core PCE at 2.3% in June (2.7% in May) and the 6-month pace at 3.4% (3.2% in May). Exhibit 2 shows our core PCE forecast at the 1-month, 3-month, and 12-month annualized pace through 2025, with shading for additional data the FOMC will have in hand for its September meeting when we expect it to first cut rates. We expect core PCE inflation gradually moving closer to target, with the 3-month pace of core PCE inflation below 2.5% before the September FOMC meeting.

The last CPI/PCE prints were well aligned with our bullish view that the Fed will cut three times this year, starting in September, followed by two more cuts in November and December. April and May were the first two data points of a descending inflation path, which we think will provide the Fed the confidence it needs that inflation is on a track toward target. Four additional cuts through mid-2025 bring the range of the federal funds rate target to 3.625%.

On a 4Q/4Q basis, we forecast core PCE inflation slows from 3.2% last year to 2.7% this year and 2.1% in 2025. Our 2024 inflation forecast is lower than the Fed's SEP median forecast. Note, however, that the Fed's SEP inflation projections might be old, as most FOMC participants have not included the last CPI print in their published forecasts.

12-month changes (or YoY%) in 2H24 will remain quite high as we roll into very easy comps to last year's surprising pace of deceleration. This makes the sequential month-over-month path of core PCE inflation more important to follow than year-over-year comparisons when gauging the Fed's reaction function to incoming data. **Chair Powell has also underscored the need to focus on month-over-month sequential prints.**

Exhibit 2: Bumpy inflation in 1Q confirmed. Disinflation started in April and becomes more pronounced in 2H24



Note: Shaded area highlights data in hand for the FOMC September meeting. Source: BEA, Morgan Stanley forecasts

The Details

Exhibit 3 provides a detailed look at recent monthly CPI inflation and our June expectation.

Core goods deflation continues. We see weaker core goods inflation (-0.13%M vs -0.04% the month prior). Used cars, a volatile category, turns negative again. Actually, the three leading indicators we follow (Manheim, Blackbook, and Car Guru) point to lower used car prices. We also see new cars and other core goods accelerating a touch but remaining in negative territory. We forecast another negative apparel inflation print, reflecting more payback from strong prints we saw earlier this year.

Exhibit 3: Higher services inflation compared to May increases core CPI to 0.27%M

CPI %MoM	Mar-24	Apr-24	May-24	Jun-24 F'cst
Headline	0.38	0.31	0.01	0.13
Core	0.36	0.29	0.16	0.27
Energy	1.13	1.12	-2.03	-1.53
Food	0.10	0.02	0.14	0.14
Core Goods	-0.15	-0.11	-0.04	-0.13
New Vehicles	-0.17	-0.45	-0.49	-0.12
Used Vehicles	-1.11	-1.38	0.60	-0.43
Apparel	0.65	1.20	-0.34	-0.20
Other goods (ex. alcohol, drugs, tobacco)	-0.28	-0.15	-0.27	-0.12
Core Services	0.52	0.41	0.22	0.39
OER	0.44	0.42	0.43	0.41
Rent of Primary Residence	0.41	0.35	0.39	0.37
Hotels	0.08	-0.16	-0.10	0.08
Medical Services	0.56	0.45	0.34	0.35
Airfare	-0.37	-0.81	-3.56	0.90
Motor Vehicle Insurance	2.58	1.76	-0.12	1.30
Core services ex-housing	0.65	0.42	-0.04	0.39
Headline CPI NSA Index	312.332	313.548	314.069	314.823

Source: Morgan Stanley Research forecasts

Gradual deceleration in rent inflation. We foresee some progress in OER, coming in at 0.41%M, down from 0.43% the month prior. Rent of primary residence also comes down to 0.37% (vs. 0.39% prior). Weak data on new leases point to further deceleration in rent inflation, with a more notable step down in 2H24.

Higher car insurance after exaggerated weakness in May. Motor vehicle insurance came in very weak in May (-0.12%M), but we think it would be a mistake to make a trend from the last print. Even though we expect disinflation ahead as insurance companies normalize profits, we haven't seen a meaningful slowdown in companies' rate filings. Companies are still asking regulators to increase premiums meaningfully. That said, we expect filings to start coming down in 2H24 decelerating car insurance inflation.

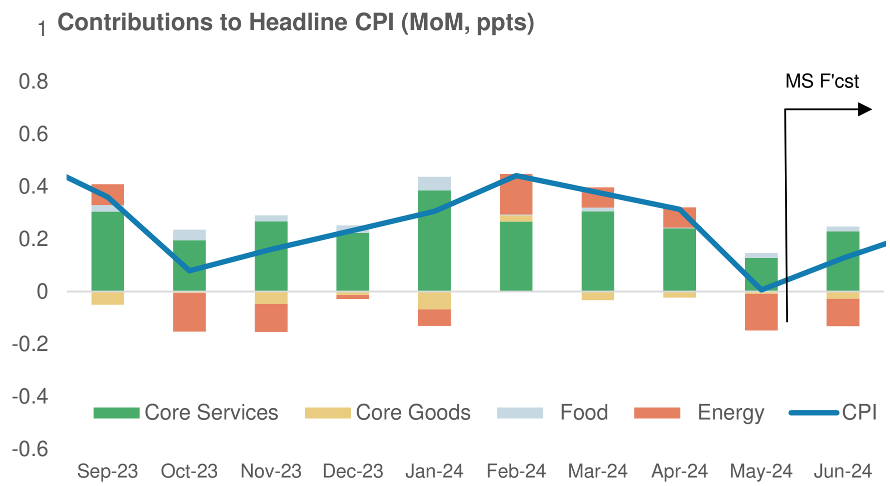
Airfares up. Slowdown in discretionary spending and oil prices moving sideways suggest that airfares inflation should remain subdued ahead. Nevertheless, we expect a slightly stronger print in June compared to the underlying trend (0.9% in June vs -0.5% on average in the last 12 months), due to tougher seasonal factors.

CPI core services ex-housing aggregate is expected to have increased 0.39%M (vs -0.04%M the month prior). However, note that the Fed is mostly concerned with the PCE price index, which gets airfares, medical and financial services from PPI, and also uses other inputs such as import prices for services related to foreign travel by US residents. **We currently track June core services ex-housing PCE inflation at 0.33%M (vs 0.10%M the month prior).** The PPI data will be released one day later than CPI, on Friday July 12th, which will help further hone our expectation for core PCE inflation. Import prices will be released on July 16th.

We expect low headline monthly CPI inflation at 0.13%M (vs 0.01%M the month prior). A drop in gas prices is the main factor explaining the weak print.

Contributions to the change in CPI are depicted in Exhibit 4 .

Exhibit 4: Headline inflation remains low on negative energy inflation



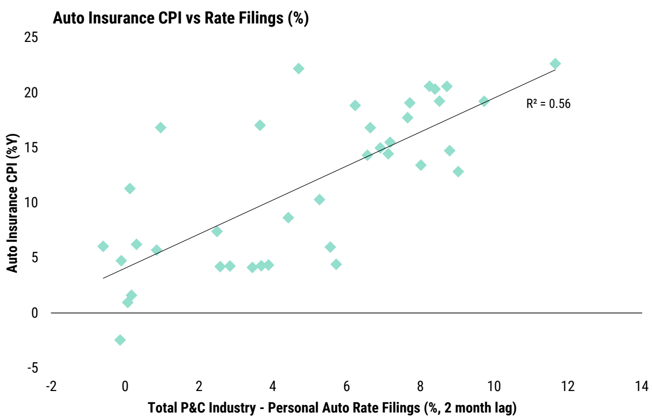
Source: BLS, Morgan Stanley Research forecasts.

Key Components to Watch

1. Car Insurance

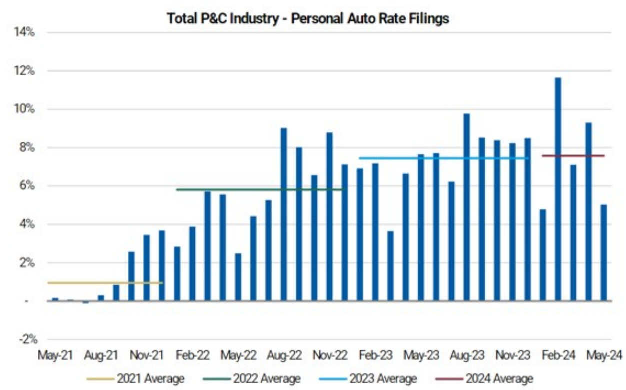
May CPI auto insurance print was unequivocally weak, coming in at -0.1% MoM, but we think it is a mistake to make a trend from it. Last reading was likely exaggerated, with payback from March and April's upward surprises. What will convince us that a turning point in auto insurance has started? A necessary condition would be to see a meaningful drop in companies' rate filings to regulators. Rate filings data tell us the percentage increase in premiums insurance companies are asking to regulators on average. CPI auto insurance inflation and rate filings are correlated with a 2-month lag (see Exhibit 5). But, as Exhibit 6 shows, the average rate filing since the start of 2024 is not materially different from 2023. We do expect filings to come down the rest of the year feeding into lower auto insurance inflation, but we are not at that point yet. For a more detailed description of our views, forecasting methods, and industry facts see: US Economics & Insurance - Property & Casualty: Auto Insurance: The Turning Point (27 Jun 2024)

Exhibit 5: Rate filings predict auto insurance CPI..



Source: BLS, SNL, Morgan Stanley Research.

Exhibit 6: ... they are still at 2023 level, but we expect deceleration ahead

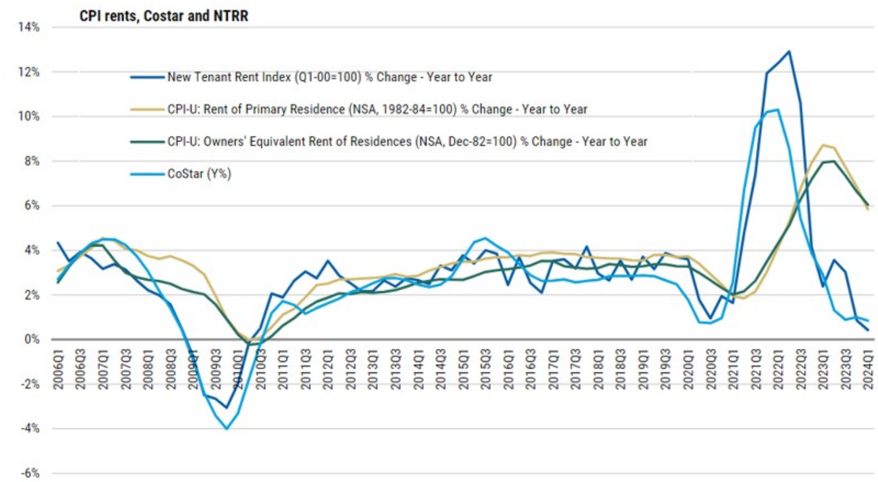


Source: SNL, Morgan Stanley Research.

2. Rents

The next few months will be important for rents inflation as some market participants are expecting a meaningful step down similar to what occurred in Mar-23. Given that typical predictors of rent inflation are relatively smooth, almost by construction our models predict a smooth disinflationary path ahead. Of course our models could be wrong and another sharp step down might happen this year. Discontinuities are hard to predict, but leading indicators suggest that a faster drop in rent inflation is more likely to happen in 2H24 (Exhibit 7).

Exhibit 7: Housing disinflation ahead, with a faster decrease in 2H24



Source: BLS, Morgan Stanley Research

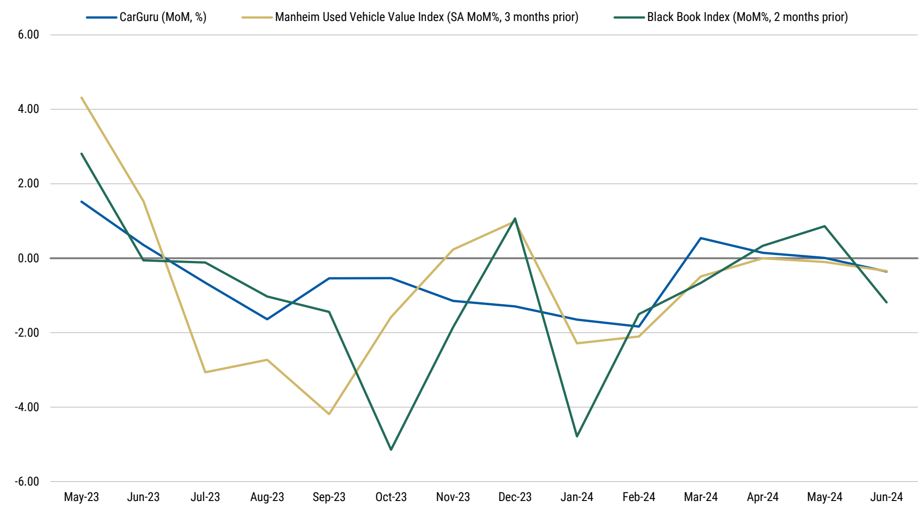
3. Used and New Car Prices:

Used car prices are expected to return to deflationary territory. In fact all leading indicators are pointing to a negative print in June. Also, the lagged effect of better supply chains and falling used car prices should bring down new car prices as well.

US car dealerships have been affected for almost two weeks by a cyber incident that blocked a system used to register sales, repairs, and provide financing. While the impact on retail sales could be meaningful, we think the effect on used and new car prices should be minor. The disruption lasted less than two weeks and it looks like the software provider reacted fast providing some alterative resources to dealerships and clarifying that the outage was temporary. Hence, our base case is a delay in sales without a meaningful effect on prices.

If there is a boost in June prices, it will likely be followed by weaker prices in July. One one hand, the disruption can be interpreted as a negative supply shock that could have boosted prices June. But, on the other, the shock did not affect production levels and, therefore, the drop in sales likely means higher inventories for July suggesting lower prices that month.

Exhibit 8: Used car leading indicators returned to negative territory



Source: CarGuru, Haver, BlackBook, Morgan Stanley Research/

Inflation Forecast Table

Exhibit 9 details our monthly forecasts across CPI and PCE inflation through December 2025.

Exhibit 9: Inflation Forecast Table

	% Change - Year-over-Year					% Change - Month-over-Month				Headline CPI
	Headline PCE	Core PCE	Headline CPI	Core CPI		Headline PCE	Core PCE	Headline CPI	Core CPI	NSA Index
Jan-23	5.5	4.9	6.4	5.6	Jan-23	0.56	0.51	0.52	0.43	299.170
Feb-23	5.2	4.8	6.0	5.5	Feb-23	0.32	0.36	0.38	0.47	300.840
Mar-23	4.4	4.8	5.0	5.6	Mar-23	0.12	0.34	0.08	0.32	301.836
Apr-23	4.4	4.8	4.9	5.5	Apr-23	0.30	0.31	0.43	0.47	303.363
May-23	4.0	4.7	4.0	5.3	May-23	0.11	0.29	0.11	0.36	304.127
Jun-23	3.2	4.3	3.0	4.8	Jun-23	0.17	0.17	0.21	0.19	305.109
Jul-23	3.3	4.2	3.2	4.7	Jul-23	0.13	0.12	0.21	0.23	305.691
Aug-23	3.3	3.7	3.7	4.3	Aug-23	0.36	0.10	0.51	0.23	307.026
Sep-23	3.4	3.6	3.7	4.1	Sep-23	0.38	0.33	0.36	0.32	307.789
Oct-23	2.9	3.4	3.2	4.0	Oct-23	0.03	0.14	0.08	0.24	307.671
Nov-23	2.7	3.2	3.1	4.0	Nov-23	-0.01	0.09	0.16	0.31	307.051
Dec-23	2.6	2.9	3.4	3.9	Dec-23	0.13	0.15	0.23	0.28	306.746
Jan-24	2.2	2.9	3.1	3.9	Jan-24	0.43	0.51	0.31	0.39	308.417
Feb-24	2.5	2.8	3.2	3.8	Feb-24	0.33	0.26	0.44	0.36	310.326
Mar-24	2.7	2.8	3.5	3.8	Mar-24	0.34	0.33	0.38	0.36	312.332
Apr-24	2.7	2.8	3.4	3.6	Apr-24	0.26	0.26	0.31	0.29	313.548
May-24	2.6	2.6	3.3	3.4	May-24	-0.01	0.08	0.01	0.16	314.069
Jun-24	**2.5**	**2.6**	**3.2**	**3.5**	**Jun-24**	**0.13**	**0.23**	**0.13**	**0.27**	**314.823**
Jul-24	**2.6**	**2.7**	**3.2**	**3.5**	**Jul-24**	**0.19**	**0.19**	**0.23**	**0.25**	**315.510**
Aug-24	**2.4**	**2.8**	**2.9**	**3.5**	**Aug-24**	**0.15**	**0.18**	**0.19**	**0.24**	**315.862**
Sep-24	**2.1**	**2.6**	**2.7**	**3.4**	**Sep-24**	**0.15**	**0.16**	**0.18**	**0.20**	**316.092**
Oct-24	**2.2**	**2.6**	**2.7**	**3.4**	**Oct-24**	**0.11**	**0.15**	**0.12**	**0.20**	**316.110**
Nov-24	**2.3**	**2.7**	**2.7**	**3.2**	**Nov-24**	**0.11**	**0.15**	**0.11**	**0.19**	**315.313**
Dec-24	**2.3**	**2.7**	**2.6**	**3.1**	**Dec-24**	**0.13**	**0.15**	**0.15**	**0.18**	**314.747**
Jan-25	**2.1**	**2.3**	**2.5**	**2.9**	**Jan-25**	**0.16**	**0.17**	**0.18**	**0.20**	**316.068**
Feb-25	**1.9**	**2.3**	**2.2**	**2.8**	**Feb-25**	**0.16**	**0.17**	**0.18**	**0.20**	**317.200**
Mar-25	**1.7**	**2.1**	**2.0**	**2.6**	**Mar-25**	**0.16**	**0.17**	**0.18**	**0.20**	**318.626**
Apr-25	**1.6**	**2.0**	**1.9**	**2.5**	**Apr-25**	**0.16**	**0.17**	**0.18**	**0.20**	**319.449**
May-25	**1.8**	**2.1**	**2.0**	**2.6**	**May-25**	**0.16**	**0.17**	**0.18**	**0.20**	**320.543**
Jun-25	**1.8**	**2.0**	**2.1**	**2.5**	**Jun-25**	**0.16**	**0.17**	**0.18**	**0.20**	**321.487**
Jul-25	**1.8**	**2.0**	**2.0**	**2.4**	**Jul-25**	**0.16**	**0.17**	**0.18**	**0.20**	**322.024**
Aug-25	**1.8**	**2.0**	**2.0**	**2.4**	**Aug-25**	**0.16**	**0.17**	**0.18**	**0.20**	**322.369**
Sep-25	**1.8**	**2.0**	**2.0**	**2.4**	**Sep-25**	**0.16**	**0.17**	**0.18**	**0.20**	**322.599**
Oct-25	**1.9**	**2.1**	**2.1**	**2.4**	**Oct-25**	**0.16**	**0.17**	**0.18**	**0.20**	**322.808**
Nov-25	**1.9**	**2.1**	**2.2**	**2.4**	**Nov-25**	**0.16**	**0.17**	**0.18**	**0.20**	**322.227**
Dec-25	**1.9**	**2.1**	**2.2**	**2.5**	**Dec-25**	**0.16**	**0.17**	**0.18**	**0.20**	**321.744**

Source: BLS, BEA, Morgan Stanley Research forecasts

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