21/ Core CPI will decline soon, as credit creation slows and the housing market starts to peak

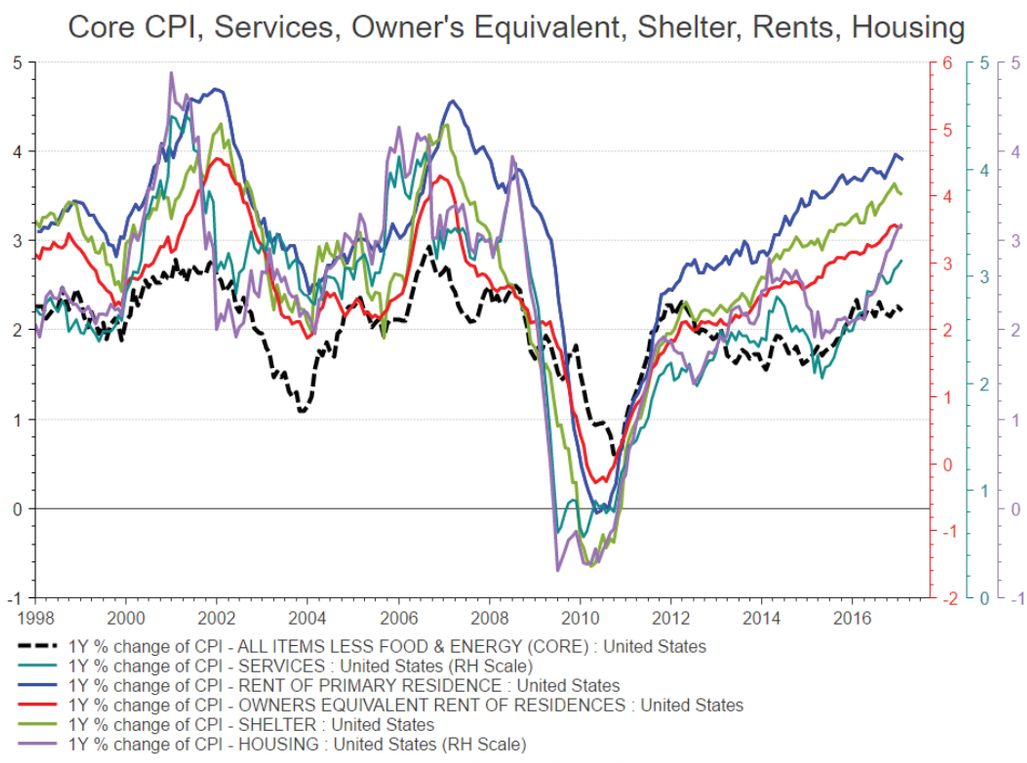
This month's CPI held some drama, not only because of last month's surprising spike, but also because the inflation data is coming during the same day (but earlier) that the FOMC will release their decision on policy rates. But it was clear that the data, whatever the outcome, was unlikely to change the decisions made by the FOMC committee, or even the tenor of the statement or post-meeting press conference.

The data set, after all, was less threatening than the January report, and so in that sense, was a much less-significant than last month's release. February Core CPI was at 0.21%, higher than consensus expectations of 0.15% , but significantly lower than last month´s 0.31% m/m, which was far far above consensus. As for the headline CPI, it increased 2.74% in February 2017 over February 2016. That was the highest inflation rate registered in this format since February 2012.

As has been the case for the past three months, the acceleration of headline inflation can be attributed almost exclusively to the sharp increase in oil prices as compared to the lowest levels last year (base effects). Underlining that, the energy price index was up 15.6% year-over-year, relative to an 11.1% increase in January.

The gamma of energy (simplistically, the rate of change of the monthly change) and therefore the CPI is already falling, after oil prices were stuck at 54-52$ during January and February. If the WTI price meanders around 48$, the inflation data provided by the current month (March) will be the last to incorporate any significant acceleration from oil. This is one indication that the inflation ogre is receding. The other stems from the behavior of Core CPI -- it was up 2.1% in February, the fifteenth straight month where the core increase was either 2.2%, 2.1.% or 2.3%. The last time the core rate (stripped of energy) accelerated even slightly was during the second half of 2015. The issue stemming from rising Core CPI originates from rising rent prices. The rent component of Core CPI rose 4.2% in February. Over the past eighteen months, this component has risen sixteen times above 4.0%, and the remaining two months were just less than 4.0%.
This compares to the period leading to the peak of the housing bubble, when the rent component of Core CPI increased at a better than 4.0% for nineteen months going to early 2008. In the early 2000s, there were twenty-five 4.0% or better increases in this component.

Summary: despite the worrying uptrend in rental prices, the situation is nowhere near what we saw in this component going into the peak of the housing bubble -- a painful reminder of the current underlying weakness in the real economy. As the housing market starts to peak, as mortgage rates continue to rise, the rent component of Core CPI will start to fade. But situation is exacerbated by the fact that recent price increases have been entirely in goods that consumers cannot go without -- gasoline and rent. Slow economic growth combined with the «bad» kind of inflation is not a recipe for a happier consumer.



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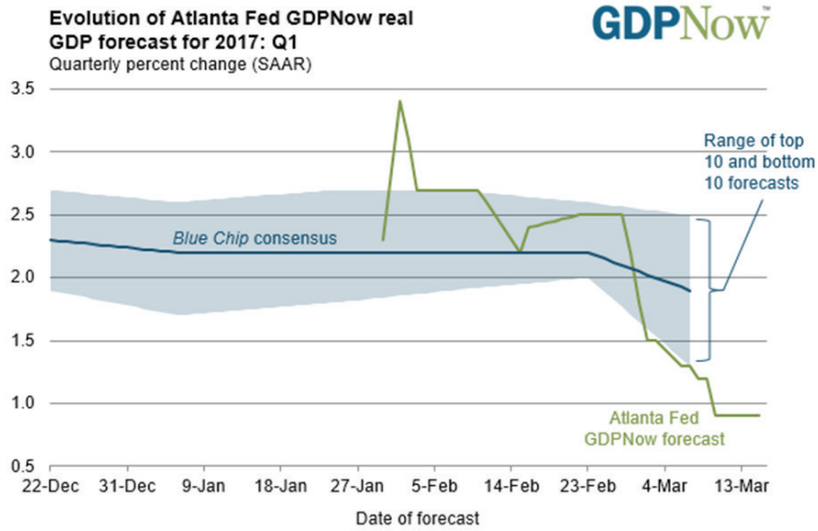
The tame outlook in inflation, at least in the near-term, poses some questions as to the alacrity of the Fed in raising rates this week. Going by their dual mandate, growth is not so hot, if we can believe the Atlanta Fed s Nowcast of 0.9% GDP growth for Q1 2017 (see first chart on the right). And with inflation not an imminent threat, the reasons for the Fed tightening policy in March has to originate from other sources than the remit given to them by Congress.

The mechanisms for inflation to continue rising are being undercut. Although money growth is still brisk, the outlook of lower bond yields post-FOMC meeting can only mean money velocity will fall. Changes in inflation responds to the changes in Money Velocity and GDP growth after a very long lag. Using this measure, Core CPI should start to roll over very soon, although inflationary pressures could push Core back higher into Q4 2017. But by and large, Core CPI should be lower in 2017 and into Q2 2018 (see the second chart on this page).

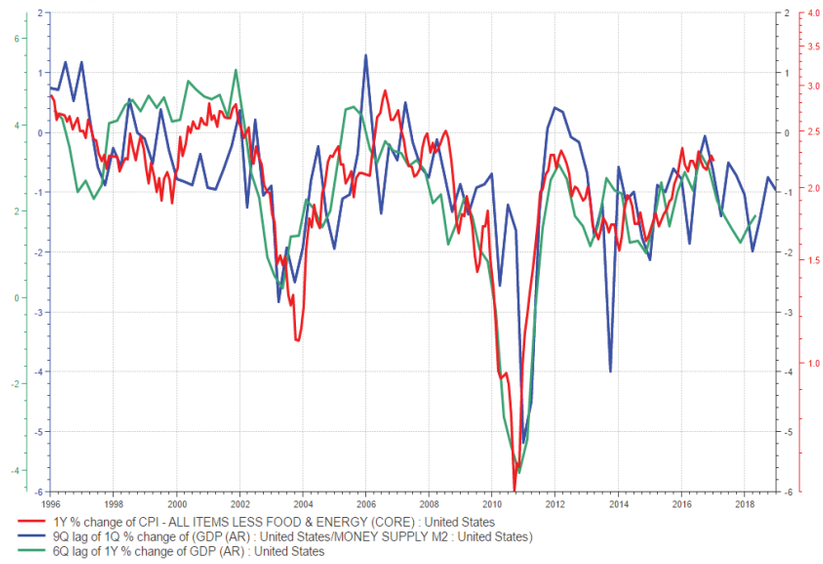
Moreover, with bank loans being curtailed at a fast clip, credit and money creation process will fall significantly over the near-term at least. That will seriously dent the uptrend of Core CPI in the near-term (see the third chart on this page).



Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

Falling Money Velocity, soft GDP growth keeps Core CPI subdued in 2017



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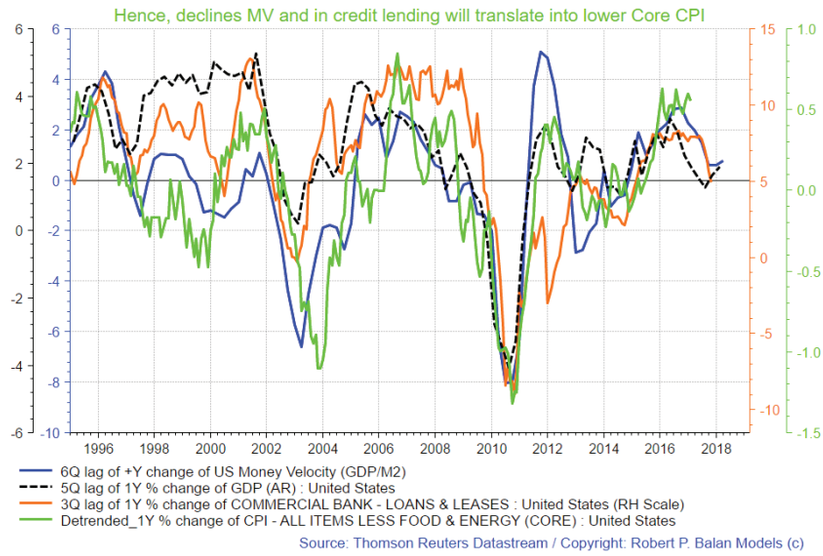
Velocity of Money vs Bank Loans and Liabilities vs GDP vs Core CPI

The Rate of Change of Money Velocity is equivalent to the ROC of Bank Lending

Hence, declines MV and in credit lending will translate into lower Core CPI



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