A Swift Price-Level Adjustment, Not an Inflation Spike: April U.S. CPI

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The U.S. core consumer price index (CPI) significantly outpaced expectations in April, driven by a massive jump in prices for used cars and COVID-19-sensitive travel services. Other consumer goods prices, which saw soaring demand in the March retail sales report, also saw firm price increases. This was enough to help year-over-year (y/y) core CPI jump to 3.0%, the strongest print since the mid-1990s.

April CPI data meaningfully surprised on the upside, but we continue to view this as a price-level adjustment. Price increases were largely concentrated in sectors supported by fiscal stimulus-driven demand and semiconductor shortages, which hindered auto production and created supply bottlenecks. As a result, April CPI data suggests that price increases were more front-loaded than anticipated, and we continue to expect inflation to normalize through the second half of this year. Elsewhere, underlying price trends remained moderate in April, with measures of rental inflation little changed relative to the recent pace.

The CPI report will also make the U.S. Fed's job more challenging, as some market participants question their view that price pressures will ultimately prove transitory. Since we share the Fed's view that the inflationary pressures seen in April will ultimately prove temporary, the report does not change our expectations that rate hikes are still likely a question for 2023.

Under the hood of April CPI: Used cars, COVID-sensitive travel services, and retail goods
Three factors came together in a perfect storm that led April CPI inflation to meaningfully beat expectations – surging used car prices due to semiconductor shortages that disrupted supply, normalizing travel service prices as the economy continued to reopen, and firming core goods prices due to stimulus-boosted demand.

Over past year demand for cars has been very strong thanks to fiscal stimulus, low rates, and disruptions to public transportation. More recently, this strong demand has been met with semiconductor shortages that disrupted production, limited supply and raised prices. This helped new car prices rise 0.5% month-over-month (m/m) in April. Price pressures from low inventories are also spilling over to used car prices. Used cars surged 10% in April, which was enough to contribute 30 basis points to the m/m increase in CPI. In the second half of this year, as bottlenecks clear and consumers moderate some of their durable goods purchases, auto inflation should also eventually normalize.

COVID-19-sensitive travel service sectors also saw swift price-level adjustments in April: Airfare (10.2% m/m) and hotel (8.8% m/m) prices both jumped more than expected. We expect some additional price normalization ahead as the economy continues to reopen. But keep in mind that travel services such as airfare and hotels account for less than 2% of the CPI basket. So while a strong recovery for these sectors will continue to support prices, they are not a significant enough part of the basket to drive the overall trajectory for U.S. inflation.

Other core goods prices were also firm, as retail goods spending surged in March. Tax rebates boosted consumer demand for retail goods and gave retailers more pricing power. However, the tax rebates are not expected to repeat, and as a result April likely represented the peak in monthly sequential inflation.

Outside of these three factors, underlying trends in inflation were more moderate. Changes in prices for shelter – which makes up the largest part of the CPI basket – remained more muted, in line with our expectations. Rent and owners' equivalent rent were both little changed again in April.

Implications for monetary policy

In our view, the U.S. is undergoing a multi-month price-level adjustment, where higher inflation prints will prove to be temporary. As a result, the Fed will remain patient (for further insights, read our recent *Viewpoint,* "The Great U.S. Inflation Head Fake"). The key question the Fed will be monitoring is whether this temporary jump is meaningful enough to raise inflation expectations on a sustained basis and therefore result in more persistent inflation (read our recent blog post on how the Fed can realign inflation expectations). For now, we don’t expect Fed officials would overreact to one month of volatile employment and inflation data. Instead, we believe they will be monitoring inflation expectations closely.

Visit our dedicated webpage on inflation for more insights into the inflation outlook and investor takeaways.

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