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May CPI

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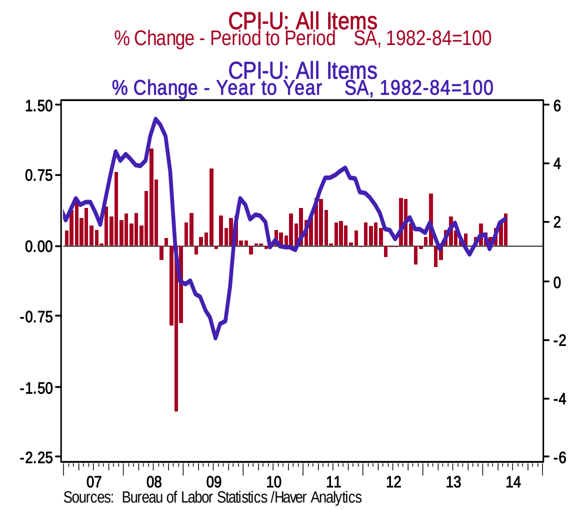
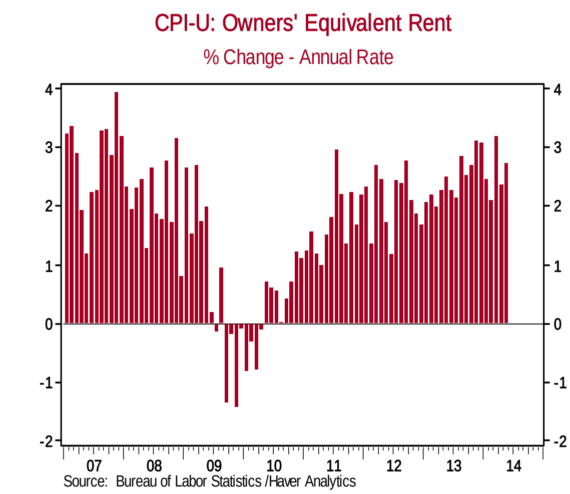
- The Consumer Price Index (CPI) increased 0.4% in May versus consensus expectations of a 0.2% rise. The CPI is up 2.1% versus a year ago.
- "Cash" inflation (which excludes the government's estimate of what homeowners would charge themselves for rent) rose 0.4% in May and is up 2.0% in the past year.
- Food prices increased 0.5% in May, while energy rose 0.9%. The "core" CPI, which excludes food and energy, increased 0.3%, above consensus expectations of 0.2%. The gain in core prices was led by shelter and core prices are up 2.0% versus a year ago.
- Real average hourly earnings – the cash earnings of all employees, adjusted for inflation – declined 0.2% in May, and are down 0.1% in the past year. Real *weekly* earnings are also down 0.1% in the past year.

Implications: The long-awaited acceleration in inflation is finally here and is sure to be a hot topic of conversation at the Federal Reserve meeting both today and tomorrow. Consumer prices increased 0.4% in May, the most in fifteen months. Energy and food led the way higher, but were not the whole story. The "core" CPI, which excludes food and energy, was up 0.3% in May, the largest gain since 2009. The trend in inflation is starting to show the influence of prolonged loose monetary policy. Although consumer prices are up a moderate 2.1% from a year ago, they're up at a 3.3% annual rate in the past three months. Core prices are up 2% from a year ago, but up at a 2.8% annual rate in the past three months. In addition, owners' equivalent rent (the government's estimate of what homeowners would charge themselves for rent), which makes up about ¼ of the overall CPI, is up 2.6% from a year ago but up at a 2.8% annual rate in the past three months. This measure will be a key source of the acceleration in inflation in the year ahead, in large part fueled by the shift toward renting rather than owning. Plugging today's CPI data into our models suggests the Fed's preferred measure of inflation, the PCE deflator, probably increased 0.3% in May. If so, it would be up 1.8% from a year ago, barely below the Fed's target of 2%. We expect to hit and cross the 2% target later this year, consistent with our view that the Fed starts raising short-term interest rates in the first half of 2015. Expect tomorrow's Fed announcement to include a continued taper of quantitative easing, keeping the Fed on pace to finish expanding its balance sheet this Fall. Also pay close attention to how Fed Chair Janet Yellen talks about inflation in her press conference. A lack of concern would bolster the case that, despite a public target of 2% inflation, the Fed intends to let inflation move and stay higher. If so, that's a bad sign for bonds and, at least in the near term, a good one for equities.





CPI - U *All Data Seasonally Adjusted*	May-14	Apr-14	Mar-14	3-mo % Ch. annualized	6-mo % Ch. annualized	Yr to Yr % Change
Consumer Price Index	**0.4%**	0.3%	0.2%	3.3%	2.6%	2.1%
Ex Food & Energy	**0.3%**	0.2%	0.2%	2.8%	2.1%	2.0%
Ex Energy	**0.3%**	0.3%	0.2%	3.2%	2.3%	2.0%
Energy	**0.9%**	0.3%	-0.1%	4.4%	5.7%	3.3%
Food and Beverages	**0.4%**	0.4%	0.4%	4.9%	3.4%	2.4%
Housing	**0.3%**	0.0%	0.4%	2.9%	3.3%	2.6%
Owners Equivalent Rent	**0.2%**	0.2%	0.3%	2.8%	2.7%	2.6%
New Vehicles	**0.2%**	0.3%	0.0%	1.9%	0.5%	0.5%
Medical Care	**0.3%**	0.3%	0.2%	3.2%	2.8%	2.8%
Services (Excluding Energy Services)	**0.3%**	0.3%	0.3%	3.6%	2.9%	2.7%
Real Average Hourly Earnings	**-0.2%**	-0.2%	-0.1%	-1.9%	-0.8%	-0.1%

Source: U.S. Department of Labor