First Trust DATAWATCH

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December CPI

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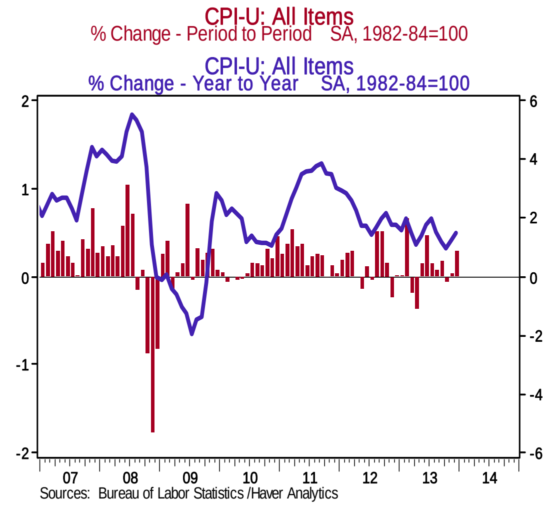
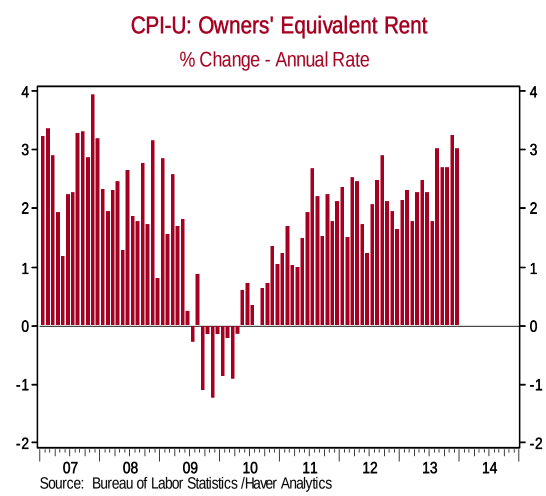
- The Consumer Price Index (CPI) rose 0.3% in December, matching consensus expectations. The CPI is up 1.5% versus a year ago.
- "Cash" inflation (which excludes the government's estimate of what homeowners would charge themselves for rent) rose 0.3% in December and is up 1.2% in the past year.
- More than half of the increase in the overall CPI in December was due to energy, which rose 2.1%. Food prices rose 0.1%. The "core" CPI, which excludes food and energy, was up 0.1% in December, matching consensus estimates. Core prices are up 1.7% versus a year ago.
- Real average hourly earnings – the cash earnings of all employees, adjusted for inflation – declined 0.3% in December, but are up 0.2% in the past year. Real *weekly* earnings are unchanged in the past year.





Implications: The Consumer Price Index increased 0.3% in December, the largest increase in six months. Once again, energy was the key mover, rising 2.1% and leading gains in most major categories. For the year, overall consumer prices were up 1.5%. "Core" prices, which exclude food and energy, rose 0.1% in December and are up 1.7% in the past year. So, for the time being, neither overall inflation nor core inflation is setting off alarm bells. Instead, they suggest the Fed's preferred measure of inflation, the PCE deflator (which usually runs a ¼ point below the overall CPI) will remain well below the Fed's target of 2%. Given loose monetary policy, we don't expect this to last; inflation should reach the 2% target by late 2014. Notice that despite generally quiet inflation in 2013, there is a rising trend in housing inflation. Owners equivalent rent (the government's estimate of what homeowners would charge themselves for rent), which makes up about ¼ of the CPI, has increased at a 3% annual rate in the past three months versus a 2.5% gain in the past year. However, for the Fed, the key measure of inflation is its own forecast of future inflation. So, even if inflation moves higher, as long as the Fed projects the rise to be temporary it will not react by raising short-term interest rates. What's more likely to get the Fed to raise short-term rates is the continued decline in unemployment. The Fed has said 6.5% is the threshold it needs to see before discussing rate hikes. It also has published a research paper suggesting rate hikes should start at around 5.5% unemployment. With the jobless rate now at 6.7%, and, we think, headed to 6% at year end, it looks like rate hikes will (finally!) start in 2015. In other news this morning, new claims for unemployment insurance declined 2,000 last week to 326,000. Continuing claims for regular state benefits rose 174,000 to 3.03 million. On the manufacturing front, the Philly Fed index, a measure of factory sentiment in that region, rose to +9.4 in January from +6.4 in December. The index has remained positive for eight consecutive months, signaling continued expansion in the manufacturing sector. In housing news, the NAHB index, which measures confidence among home builders, came in at 56 in January, down 1 point from December, but remaining near its highest levels in eight years.

CPI - U *All Data Seasonally Adjusted*	**Dec-13**	**Nov-13**	**Oct-13**	**3-mo % Ch. annualized**	**6-mo % Ch. annualized**	**Yr to Yr % Change**
Consumer Price Index	**0.3%**	0.0%	-0.1%	1.1%	1.4%	1.5%
Ex Food & Energy	**0.1%**	0.2%	0.1%	1.6%	1.6%	1.7%
Ex Energy	**0.1%**	0.1%	0.1%	1.5%	1.5%	1.6%
Energy	**2.1%**	-1.0%	-1.7%	-2.4%	0.4%	0.5%
Food and Beverages	**0.1%**	0.1%	0.1%	1.2%	1.2%	1.1%
Housing	**0.2%**	0.2%	0.1%	2.2%	1.9%	2.2%
Owners Equivalent Rent	**0.2%**	0.3%	0.2%	3.0%	2.8%	2.5%
New Vehicles	**0.0%**	-0.1%	-0.1%	-1.0%	0.0%	0.4%
Medical Care	**0.0%**	0.0%	0.0%	0.1%	2.2%	2.0%
Services (Excluding Energy Services)	**0.1%**	0.3%	0.2%	2.4%	2.4%	2.3%
Real Average Hourly Earnings	**-0.3%**	0.2%	0.1%	0.0%	0.0%	0.2%

Source: U.S. Department of Labor