

Will The FOMC Look Through Softer Core PCE Inflation?

United States, Personal Income / Consumption, % m/m, October:

Actual: 0.5 / 0.6

Consensus: 0.4 / 0.4

Scotia: 0.4 / 0.5

Prior: 0.2 / 0.2 (Revised from 0.2 / 0.4)

United States, PCE / core PCE deflators, y/y % change, October:

Actual: 2.0 / 1.8

Consensus: 2.1 / 1.9

Scotia: 2.1 / 1.9

Prior: 2.0 / 1.9 (Revised from 2.0 / 2.0)

- The USD and two year Treasury yield shook off the updates, but the broad takeaway is that core inflation is at least temporarily tracking lower while activity readings were generally in line with expectations for a slowing from unsustainable consumption growth over Q2/Q3 but generally remain solid. The FOMC minutes are a bigger focus for the markets. The key issue going forward is whether the FOMC looks through softer nearer term core PCE inflation readings as possibly a transitory spin-off from factors like USD strength and toward the effects of the US economy's move into excess aggregate demand and so far limited tariff effects.
- Q4 real consumption growth tracking 2.4% q/q SAAR based on the Q3 hand-off and October assuming flat Nov/Dec to focus upon what we know so far. That's a bit weaker than Bloomberg consensus at 2.8%. The broad takeaway is that consumer spending growth is slowing from the unsustainable Q2/Q3 pace as expected but is still respectable and still signalling actual GDP growth that is above potential and hence putting further upward pressure on the output gap that already stands at 1 ½% as of Q3 and well into excess aggregate demand territory.
- Core PCE inflation pulled back to 1.8% y/y and was revised a touch lower the prior month. Why? This certainly goes against an output gap in solid excess demand territory and minimal effect from tariffs so far. The lagging effects of broad dollar strength represent one culprit I've been warning about over the year but that could stabilize as an influence into 2019 as USD influences eventually pass through prices and stabilize. Recall Fed estimates that a 10% broad dollar appreciation knocks core PCE inflation down by about ½% within six months and with the effects beginning to dissipate to 0.3% within twelve months.
- But there is more to the softness in core PCE than that. The chart below breaks down the year-ago change in PCE inflation from September to October. For example, gasoline's year-ago pace of increase picked up sharply in October versus September. Note, however, the breadth of the softening across components in the bottom half of the chart. Some of them may be transitory (e.g. accommodations) while several others are concentrated in the food categories as commodity price softness trades off against tariff considerations.

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- Nominal income growth was very solid at 0.5% m/m in keeping with the 3.1% y/y nominal average hourly wage gains. In inflation-adjusted terms, real personal disposable income growth is tracking +2.0% in Q4 from 2.4% the prior quarter, 1.8% in Q2 and 4.4% in Q1. Income growth was boosted by the TCJA in Q1 before the first round of effects through a rise in the saving rate was then followed by spending the income gains in Q2 and Q3. This effect is shaking out of the data now.

US PCE Price Indices



Sources: Scotiabank Economics, Bureau of Economic Analysis.

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