US Consumption Soars, Core Inflation Decelerates

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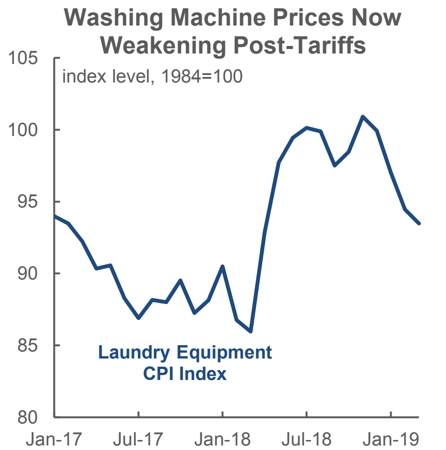
United States, Personal Income / Consumption, % m/m, March:
Actual: 0.1 / 0.9
Consensus: 0.4 / 0.7
Scotia: 0.4 / 0.8
Prior: 0.2 / 0.1

United States, PCE / core PCE deflators, y/y % change, March:
Actual: 1.5 / 1.6
Consensus: 1.6 / 1.7
Scotia: 1.6 / 1.7
Prior: 1.3 / 1.7

- The Fed policy risk involves how to read competing influences of strong consumption growth versus another slip in core PCE inflation. The best course of action to the Fed may well be to retain 'patience' as it awaits much greater evidence on how transitory both trends may or may not be. **There are several areas of uncertainty behind what is driving core PCE inflation softer,** with plausible effects being US dollar influences, methodological questions surrounding used vehicle prices that contributed 0.1 points to the deceleration in core PCE in year-ago terms, and the very early beginnings of tariff unwinding in categories with so far low (but about to rise) weights in the inflation basket like appliances. Controlling for such effects will take time during which income dynamics need to be evaluated as drivers of sustainable consumption growth. Personally I think decelerating core inflation faces several plausible explanations that may be transitory.
- **In inflation-adjusted terms, consumption growth tied with two other months (March 2017, August 2014) for the strongest monthly gain since 2009.** The 0.7% real gain indicated that most of the 0.9% m/m rise in the value of spending was due to higher volumes and not prices.
- Ending Q1 consumption on a solid note matters for Q2 expectations. **What's baked in for Q2 US consumption growth?** About 1.8% q/q SAAR based solely upon the way Q1 ended and the average quarterly math. This is before we get any actual Q2 spending numbers. So we're already tracking higher than the 1.2% actual consumption growth in Q1 but solely in terms of the hand-off math.
- **Core PCE inflation eased to 1.6% y/y (1.7% prior).** It has been declining since floating around 1.9-2.0% over March through December of last year. In month-ago terms, core PCE inflation was flat in March after rising by just 0.1% m/m in each of the prior two months. More on the drivers below.
- While core PCE inflation is softening, patience is a virtue here in that we're likely paying the price for last year's broad dollar strength that has since flat lined. As 2019 evolves, we're likely to get firmer core PCE inflation but may not yet be at the trough. The US moved aggressively into excess aggregate demand only over the past year and there are lagged effects in translating this to a core PCE forecast even with a flatter relationship than historically. Then it depends upon forecasting the broad USD—if it remains sideways as it has generally trended for months now, then the disinflationary effects of last year's strength get worked through by around mid-year.



Sources: Scotiabank Economics, Bureau of Labour Statistics.

- **Income growth was softer than expected (+0.1%, consensus 0.4) so the saving rate pulled back to 6.5% in order to finance the consumption gain.** The saving rate overshot into the end of 2018 and start of 2019 by soaring to 7.7% so there is a mixed message here. The saving rate is coming back down to earth as pent-up consumption gets unleashed but we need firmer income growth on a trend basis to take over as 2019 further unfolds. Bring on Friday's nonfarm payrolls and wages for the next incremental piece of evidence in this regard.
- **Drivers of the deceleration in core PCE inflation included softer used vehicle prices that remain an area of controversy** (-2.7% y/y, -0.3% prior). The Manheim used car price index continues to show prices up 4.0% y/y. The Manheim index, however, captures wholesale auction prices without adjustments for depreciation or quality changes versus inflation data that makes such adjustments to a different set of used car price data. For CPI, the BLS uses a sample of 480 vehicles from sales data collected by J.D. Power Company for vehicles aged between two and seven years which may be a limited sample. Further information on methodology is available here.
- Other categories that decelerated included furnishings and durable household equipment (1.4% y/y, 1.7% prior) that masked decelerating increases in appliance prices (8.6% y/y, 11.2% prior) as **the effects of tariff hikes** into early 2018 dissipate partly on year-ago base effects in terms of the inflation consequences but also as higher prices likely dent demand (see chart). There will be more of this as pass-through of higher steel/aluminum prices and tariffs on Chinese imports gets re-based. There were also falling clothing prices (-2.2% y/y, -1.0% prior), and a slight deceleration in service price inflation (2.3% y/y, 2.4% prior). Within services, accommodation prices climbed at a slower rate of 3.1% y/y (4.8% prior), financial services and insurance prices were up 2.1% y/y (2.5% prior).