US Inflation, Spending Support Fed's Narrative—For Better, Or More Likely For Worse

- Core inflation increased only off of downward revisions for a net miss
- Consumer spending slightly beat consensus expectations on revisions
- The saving rate suggests post-election hording behaviour
- Consumer confidence strongly rebounded
- 70% of the US economy says the Fed shouldn't be easing
- Fed easing would do nothing for inflation…
- ...while emboldening Trump's protectionism and raising moral hazard risks

United States, Personal Income / Consumption, % m/m, June:
Actual: 0.4 / 0.3
Consensus: 0.4 / 0.3
Scotia: 0.3 / 0.3
Prior: 0.4 / 0.5 (revised from 0.5 / 0.4)

United States, PCE / core PCE deflators, y/y % change, June:
Actual: 1.4 / 1.6
Consensus: 1.5 / 1.7
Scotia: 1.4/ 1.7
Prior: 1.4 / 1.5 (revised from 1.5 / 1.6)

It's pretty obvious that the Fed views easing as a function of inflation and trade policy risks that magnify uncertainty while it sticks to the narrative that the US economy's underlying performance remains solid. This morning's inflation prints and both hard and soft readings on the performance of the US consumer sector generally reinforce an easing bias informed by such a risk narrative. That doesn't mean the Fed *should* ease, as I'll return to in a moment.

Core PCE inflation not only fell a little shy of an expected up-tick, it was revised lower. At 1.6% y/y in June (1.7% consensus), core PCE inflation was also revised down to 1.5% in May (from 1.6%). Core PCE inflation has been running at 1.5–1.6% over the past four months. Even though it increased in June, it did so by less than expected off of downward prior revisions making for a net miss to expectations. The best one can say is that core inflation has carved out a bottom and stopped falling after peaking at 2.1% in July of last year before dropping to 1.5% in March, but there isn't much progress being made toward lifting transitory factors. See chart 1.

Should the Fed be blamed for over-tightening policy last year because of this drop in inflation? I doubt that argument. Why core inflation fell probably has a fair amount to do with some transitory factors but also the influence of US administration policies on dollar strength. Adding stimulus in early 2018 and driving protectionist concerns that are overhanging the global economy played a substantial role in motivating dollar strength through temporarily boosting US growth relative to its trading partners and by fanning safe haven demand. The Fed's estimates (here) suggest that each 10% broad dollar appreciation drives core inflation lower by up to ½% within six months and 0.3% within a year as the

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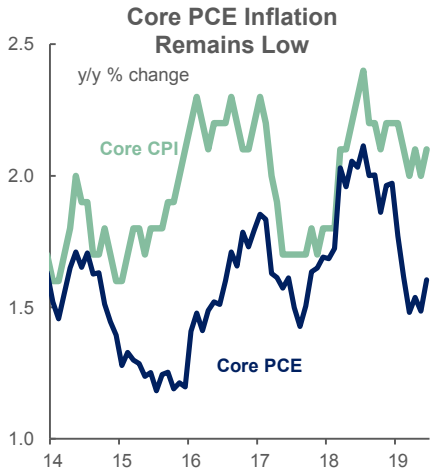
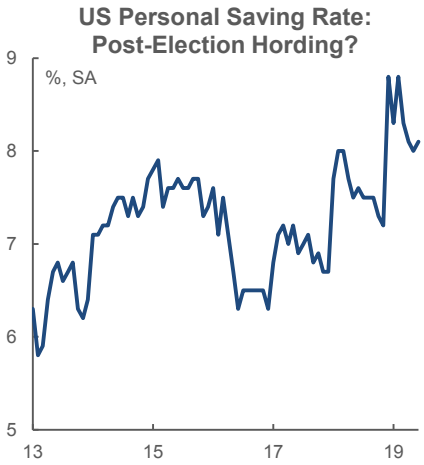
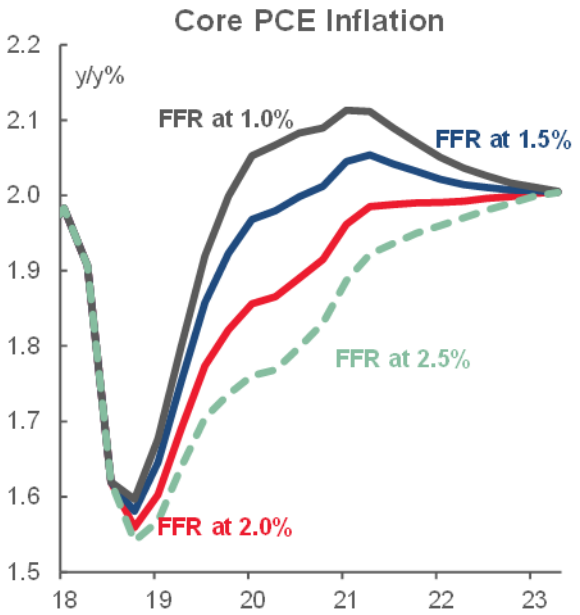


Sources: Scotiabank Economics, Bloomberg.



Sources: Scotiabank Economics, Bureau of Economic Analysis.

effects begin to dissipate. The Fed tightened as it saw core PCE inflation run around 2% and hence hit its goals throughout most of 2018, no longer requiring a negative real policy rate and if anything a slightly positive one. The policies of the US administration pulled the rug out from beneath the Fed's dual mandate by pushing the dollar higher, sapping confidence and weakening pricing power.

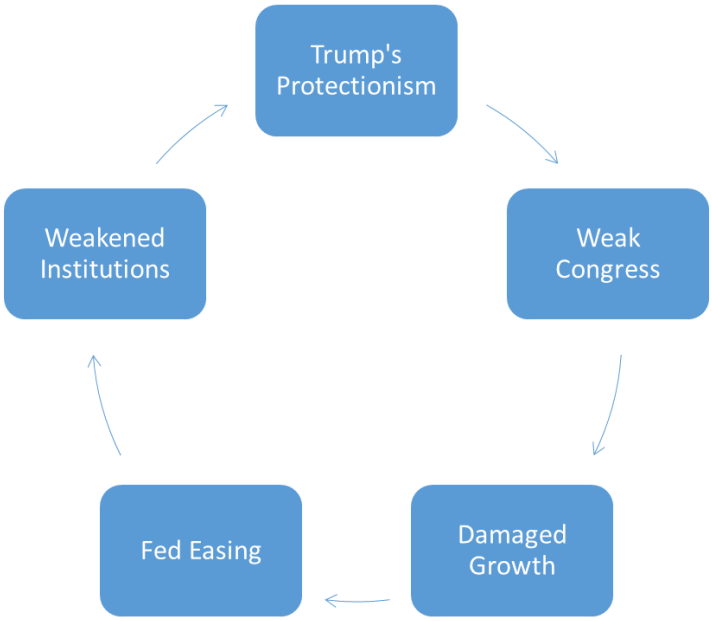


Sources: Scotiabank Economics.

Spending was up by 0.3% m/m, matching consensus but revised up a tick the prior month to 0.5%. **Overall, consumer spending beat expectations.** We already knew that consumption was up by 4.3% q/q in Q2 through last Friday's GDP accounts as pent-up demand from a weak Q1 was unleashed. Consumer spending is therefore on solid foundations.

The saving rate sits at 8.1%. It has trended upward from 6.5% back in November 2016 at the time of the election (chart 2). What have US consumers done with modest stimulus for some, plus income growth that has been driven by solid job markets and wealth gains? They've horded a good portion of it. Why? There are multiple drivers of saving rates but among them are likely increased precautionary motives perhaps partly driven by concerns over the economic outlook and the role that protectionism is playing. Temporarily higher real interest rates also likely drove some of this. So did cash infusions in early 2019 and share buybacks following the Tax Cuts and Jobs Act.

US consumer confidence also soared. At 137.5 (consensus 125), the Conference Board's July reading lies just beneath the recent peak set in October which was the highest reading since the dot com era. Both present and future expectations drove the rise from the dip in June that had been caused by Trump's Mexican stand-off and the deterioration in US-China trade negotiations. Overall, the roughly 70% of the US economy that is driven by consumer spending isn't screaming for monetary policy stimulus. Confidence is high, spending growth is strong, the saving rate points to plenty in the tank and the Fed's measure of the share of incomes going toward debt payments continues to trend around record lows.



The overall takeaway is that the FOMC is still on track to ease with combined inflation and trade policy concerns in the driver's seat. There's nothing wrong with the US economy. Excess demand conditions and solid growth don't merit easing.

The Fed, however, seems to wish to prove symmetry to the inflation target of 2%. Being stuck at 1.5–1.6% inflation is a long shot away from an overshoot toward the 2–2.5% range. Therefore to get to an average inflation target of 2%, they want to ease but our modelling using an augmented Phillips curve approach to improve its tracking ability suggests they will fail (chart 3). Even an immediate massive rate cut of 1–1.5 percentage points that is far bigger than anything markets expect only gets core PCE up to 2.0–2.1% over 2020–2021. Cutting once, twice, or three times won't matter one iota to inflation.

The result could well just fan financial stability concerns, give away precious bullets, and embolden Trump to turn even more protectionist as the cycle depicted in chart 4 gets reinforced. Trump is rather transparent as it's pretty obvious his sharp escalation of trade rhetoric since Friday coincides with the start of the two-day FOMC meeting today. We'll know soon enough if bullying the Fed into easing works as much as Trump's electoral chances may desire. Thus, Fed easing could boil down to vain attempts to boost inflation and address trade policy risks in such fashion as to potentially backfire with heavy moral hazard risk superimposed upon the outcomes that could drive worsened circumstances over time. Unless, of course, we hear differently from Chair Powell tomorrow by way of reticence toward going as far as bond markets and Trump would like him to.