

The Fed Will Probably Remain Frustrated By Its Inflation Goals Into 2020

- Core CPI remains stuck at 2.3%...
- ...which suggests core PCE remains at 1.6%...
- ...and materially below the Fed's 2% target...
- ...with no chance at overshooting in order to support symmetry
- Three approaches to inflation suggest 2020 will keep the Fed dovish...
- ...and the door open to additional easing

US CPI, headline/core, m/m % change, SA, November:

Actual: 0.3 / 0.2

Scotia: 0.2 / 0.2

Consensus: 0.2 / 0.2

Prior: 0.4 / 0.2

US CPI, headline/core, y/y % change, November:

Actual: 2.1 / 2.3

Scotia: 1.9 / 2.3

Consensus: 2.0 / 2.3

Prior: 1.8 / 2.3

US core CPI inflation held steady at 2.3% y/y which implies fair odds that core PCE inflation will remain at 1.6% y/y when the November reading is released on December 20th given the connection between the two readings (chart 1). That's based upon the recent gap between the measures and little evidence of hotter inflation in categories that PCE places a higher weight upon. Ahead of this afternoon's Fed meeting, the CPI figures suggest that the Fed's 2% inflation goal will continue to be frustrated especially in terms of the very low odds that core inflation overshoots the goal as per the Fed's 'symmetry' wishes.

Where is inflation going in future? I'll offer three suggested approaches. By one approach, it's probable that core CPI remains in the 2.2–2.3% y/y range through 2020H1 before slipping a little over 2020H2. This would be the outcome derived from shifting year-ago base effects and month-ago seasonally unadjusted changes that are in keeping with recent historical averages. By corollary, this approach would suggest that core PCE inflation fails to crack higher than the 1.6% y/y mark and might even slip somewhat over the course of 2020.

Another approach would take a fundamentals-driven to ongoing disinflationary offsets from USD strength, a flatter US Phillips curve than in the past, and neutral real wage pressures. Recall from [this](#) speech by former Fed vice chair Stanley Fischer in late 2015 that cited former Chair Yellen's guidance on the Fed's estimate of dollar pass-through effects that suggest that every 10% broad dollar appreciation knocks ½% off core PCE inflation within six months and just over ¼% a year afterward as the effects diminish somewhat. The broad dollar index has only appreciated by about 3% since the temporary softness in January and is about 12% stronger than it was in early 2018. At the margin, the peak

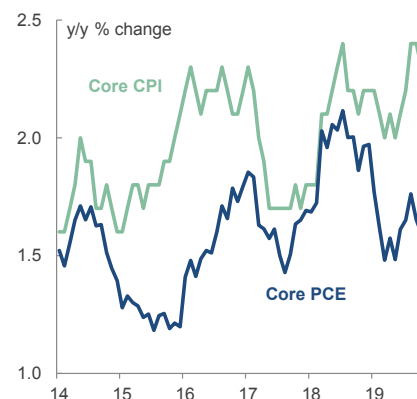
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Core PCE Inflation Remains Low



Sources: Scotiabank Economics, BLS, BEA.

US Core CPI Could Face Downside Risk



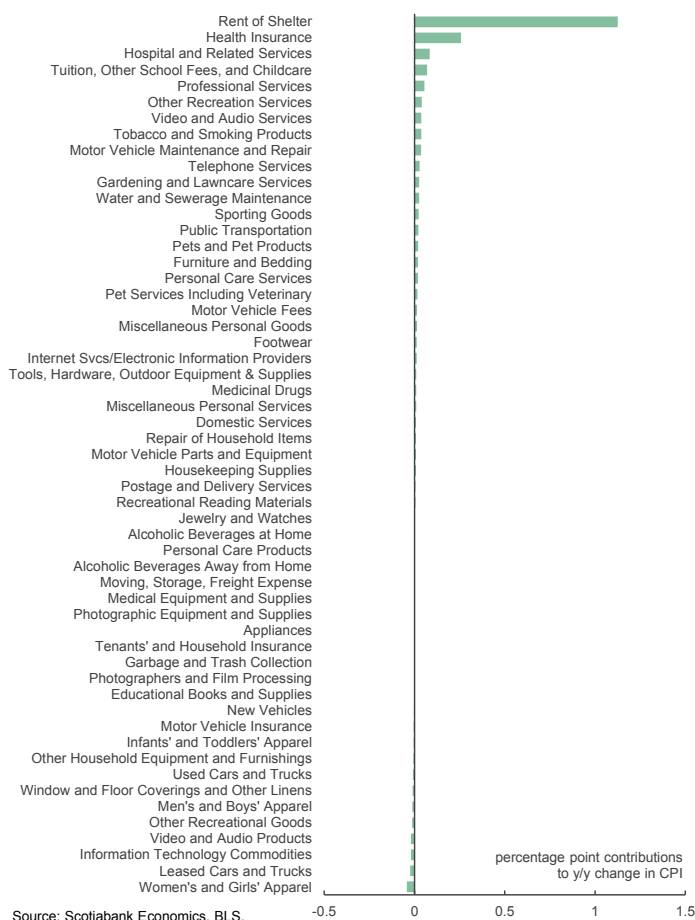
Sources: Scotiabank Economics, BLS, Bloomberg.

disinflationary effect of the dollar may be dissipating, but a turn toward an inflationary dollar effect would require a material 10%+ depreciation in the dollar to occur over 2020 with lagging effects on inflation thereafter. Personally, I'll believe dollar weakness when I see it and it will only matter to the inflation. Also note that real wage gains are generally in keeping with trend productivity growth which isn't inflationary.

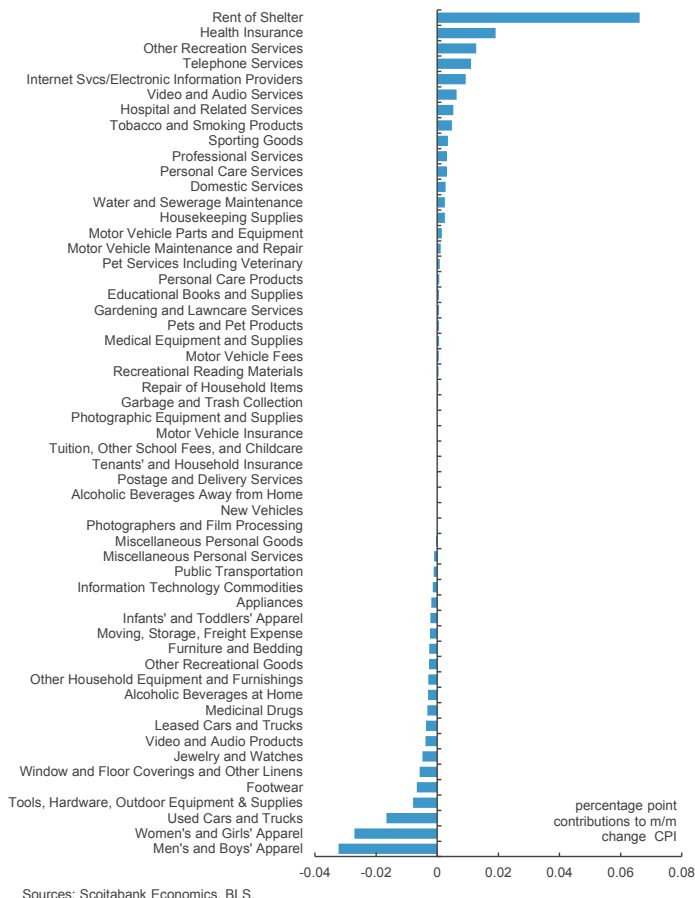
Third, there might even be mild downside risk to core inflation. Owners' equivalent rent carries a 24% weight in total CPI. It is generally correlated over time with US house prices using the Case-Shiller repeat sales metric (chart 2). As CS-20 house price inflation has subsided, the up to two year lag effect on OER could well be disinflationary.

Charts 3 and 4 provide the usual break down of the CPI basket in year-ago and seasonally unadjusted month-ago terms. The sources of upward pressure on CPI are pretty thin in year-ago terms and especially housing related.

November Weighted Contributions to Headline CPI



November Weighted Contributions to Headline CPI



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