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Strong consumption and sticky prices

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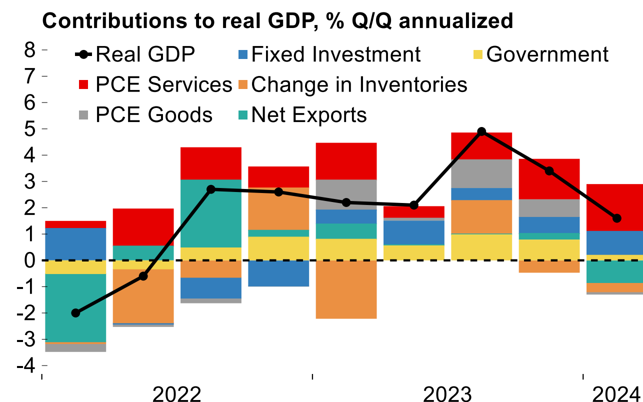
- The US economy had a relatively strong expansion in Q1 2024, supported by accelerated services consumption and fixed investment growth. Goods consumption fell, but much of it was driven by volatility in the automotive sector and weaker demand for gasoline and other energy goods. Export growth was minimal, and expectations for the rest of 2024 will be a balance between a stronger US dollar, driven by a divergence in Fed policy and that of other central banks, and recovering global demand.
- Inflation accelerated in Q1 2024, driven primarily by core services, and supported by elevated housing price growth. Traditional contributors to services inflation, such as wage growth, are likely not driving the recent trend. Rather, real price rigidity and delayed inflation of sticky-price items may be to blame.

Strong services spending and weak exports

Real GDP expanded at an annual rate of 1.6% in Q1 2024, down from 3.4% in Q4 2023. (Chart 1). Though growth was slower, the economy is still very much in an expansionary phase. Services consumption accelerated to 4% annualized growth, up from 3.4% in Q4 2023, and fixed investments accelerated to 5.3% annualized growth, driven by strong growth in residential investments amid the recovery in new home building.

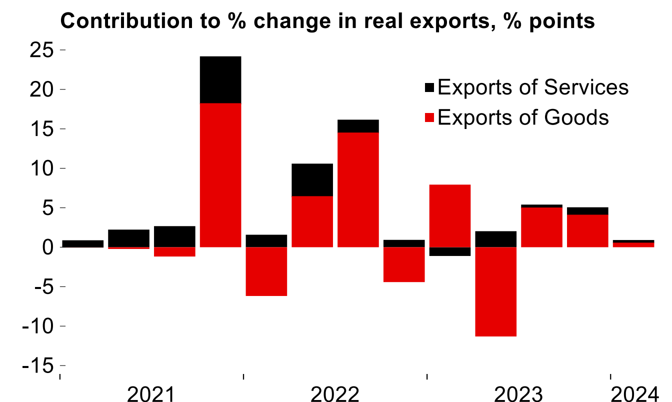
Slower government spending growth and negative contributions from goods consumption and net exports weighed on GDP growth in Q1, some of which may reverse in the coming quarters. For government spending, growth will likely remain positive and potentially accelerate in the second half of 2024, with defense spending as a likely major contributor. On the consumer end, durable goods consumption was brought down by a contraction in spending on motor vehicles and parts (-9.0% annualized growth) and in recreational goods and vehicles (-1.6% annualized).

Chart 1: Strong services consumption was partially offset by weaker goods consumption and net exports



Source: BEA, MUFG Bank Economic Research Office

Chart 2: Exports growth was weak in Q1, and headwinds from monetary policy signal continued weakness ahead



Source: BEA, MUFG Bank Economic Research Office

Motor vehicle consumption has been especially volatile in the post-pandemic era, and this negative contribution may not be indicative of broad weakness in demand for goods. For nondurable goods, consumption growth was essentially flat, but much of the weakness can be attributed to gasoline and other energy goods (-11% annualized growth). The overall contraction in goods consumption may be short-lived.

More likely to endure is weakness in exports. In Q1, net exports contributed -0.86% points to overall GDP (Chart 1). Growth was still positive (Chart 2) but imports heavily outweighed exports. Going forward, the US export market will face headwinds from the Fed's interest rate policy, but stronger global demand may offset some of the effect.

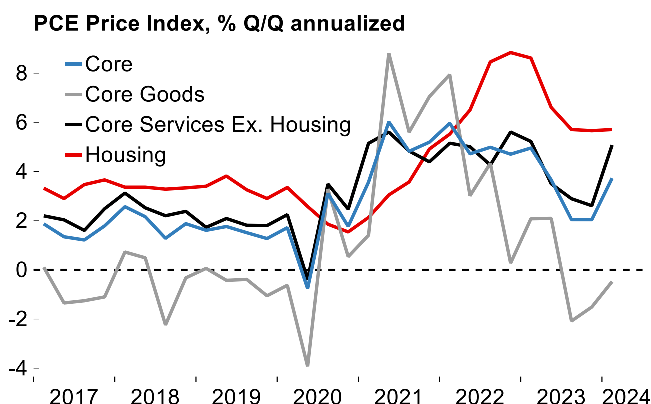
It is becoming increasingly likely that the first Fed rate cut will not occur until the second half of this year, at the earliest. This is at odds with other major central banks, including the European Central Bank and the Bank of England, and any diversion in policy will likely strengthen the US dollar. However, demand has been improving in major export economies, primarily in Europe, and this can offset some of the negative impact on exports that a strong dollar will have.

Sticky prices, not sticky inflation

The Fed's preferred inflation measure accelerated in Q1 2024, with core price growth growing at an annual rate of 3.7%, up from 2.0% in Q4 2023 (Chart 3). Growth was primarily driven by accelerating core services excluding housing prices (5.1% annualized) and elevated housing inflation (5.7% annualized).

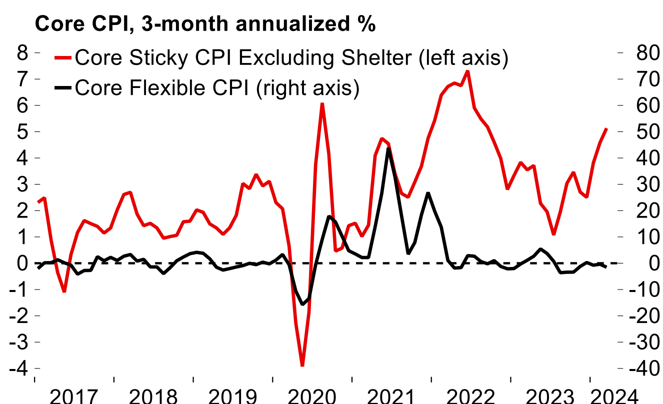
Year-over-year inflation presents a more plateaued view, with core PCE standing at 2.8% in both February and March of this year. This is perhaps the more appropriate interpretation of current inflation, rather than the waves presented when observing quarterly growth. Though prices are accelerating at a 3-month rate, the typical underlying drivers of inflation are not. As mentioned, services inflation is the primary driver of this recent re-acceleration, but wage growth (historical contributor to services inflation) is easing and leading indicators of wage growth (i.e., quits rate) signal further easing. So why are services prices accelerating? Price rigidity of certain spending categories may be to blame.

Chart 3: Core services excluding housing has been the major driver of re-accelerating inflation



Source: BEA, MUFG Bank Economic Research Office

Chart 4: Delayed inflation from sticky price spending categories may be to blame for the recent re-acceleration



Source: Atlanta Fed, MUFG Bank Economic Research Office

"Sticky" is often used to depict elevated inflation levels, but the term more appropriately describes the price level of certain spending categories rather than the price change. In other words, prices are sticky, not price growth. This is relevant because certain items change in price much less frequently than others, and the current re-acceleration in inflation may be delayed price growth of these spending categories.

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Shown in Chart 4, the 3-month percent change in core CPI is negative for flexible price items (those that change in price every 0.5 to 4 months) but is accelerating for sticky price items (those that change in price every 5 to 26 months), many of which are services. Though not definitive, price pressures that peaked in 2022 and 2023 may be materializing now in sticky price spending categories, potentially driving the re-acceleration in inflation on a quarterly basis.

It is important to note that although the CPI and PCE differ in inflation level, the underlying categories driving change are largely the same. Items that exhibit sticky price behavior are likely also driving growth in the PCE Price Index.

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