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A balance of risks

June 28, 2024

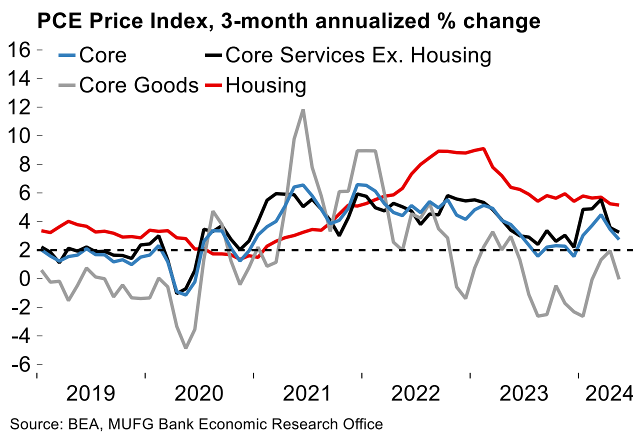
- Core PCE inflation eased in May and is re-approaching levels experienced in the second half of 2023 on a monthly and quarterly growth basis. Little progress is being made with the housing component, but core services excluding housing inflation is trending downward again and core goods are back in deflation territory. For annual inflation, price growth is expected to remain above 2% for the remainder of 2024, largely due to base effects.
- The Fed will have to balance the risk of re-accelerating inflation if they cut rates too soon with the risk of an economic downturn or a recession if they keep rates high for too long. Though a slowdown is expected in the second half of this year, a recession still seems to be the more unlikely scenario. The latest growth in real disposable personal income and household net worth will support positive growth in consumer spending, and combined with very low unemployment, the Fed's primary focus should be on avoiding a resurgence in inflation.

Risk of resurging inflation vs a recession

Monthly price growth eased considerably in May, with the core PCE Price Index growing by 0.08% M/M, compared to 0.26% in April. The slower pace of growth was supported by a drop in core goods prices (-0.18%), and disinflation in core services excluding housing. Energy price growth also returned to negative territory in May (-2.1% M/M) after three straight months of relatively strong increases.

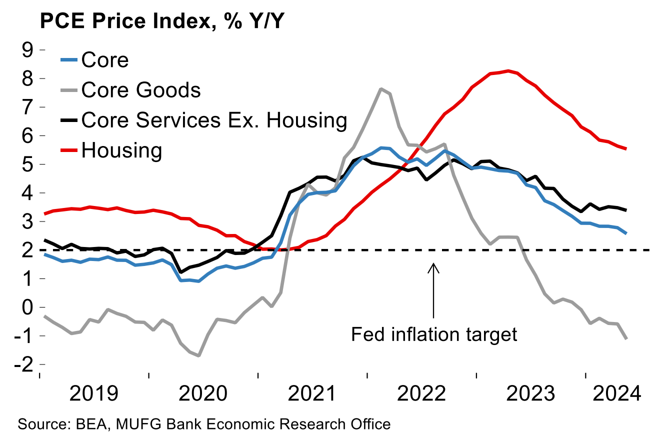
Overall, May's PCE report is positive news for the Fed, but any calls for a July rate cut are pre-mature. When observing growth on a 3-month annualized basis, core inflation is still above 2% (Chart 1) and meeting the threshold for being "sustainable" will almost certainly not be met by the July FOMC meeting, and perhaps not even by September.

Chart 1: Core goods and core services excluding housing inflation eased in May



Source: BEA, MUFG Bank Economic Research Office

Chart 2: Annual inflation will likely remain elevated above 2.5% for much of 2024



Source: BEA, MUFG Bank Economic Research Office

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A steady rate of disinflation, or consistently low growth on a monthly, 3-month, or even 6-month basis is likely what the Fed will aim for. Annual core price growth is overly influenced by base effects that incorporate “old data,” and even with a steady rate of disinflation from month-to-month, the 12-month growth rate is expected flatten this year and not fall much below the current 2.6% growth rate (Chart 2). The risk of keeping rates restrictive for too long is greater if annual growth were the target.

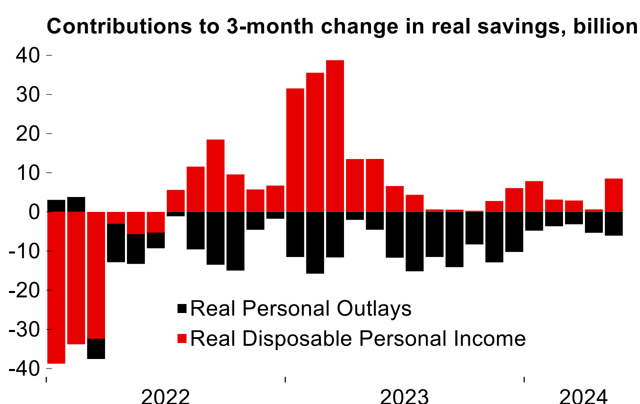
With that said, the current environment should be viewed as a balance of risk between re-accelerating inflation and a potential economic downturn. If the Fed prematurely cuts rates, that could risk a resurgence in domestic demand that, in turn, could lead to accelerating inflation. Now, the exact fundamentals that drives price increases are much more complex than what a single 25 bps cut could seemingly trigger, but the logic stands (unless you are in the minority that believe post-COVID inflation was purely a supply-side issue).

As recent history shows, predicting inflation is difficult. Going back to Chart 1, core inflation consistently exhibited 2% growth on a 3-month annualized basis in the second half of 2023, which led markets to price in a March 2024 Fed cut, and it then accelerated in Q1 2024 even though rates were held steady. A first rate cut in July, or perhaps even in September, would only increase the risk of another re-acceleration.

On the other side of the risk coin is the probability of an economic downturn or a recession by keeping rates too high for too long. Interest rates, and more specifically changes in interest rates, operate with a considerable lag. There is expected to be more deterioration in fixed investment growth, consumer spending, and in the labor market as we progress through 2024. The longer rates are held high, the more economic growth will be affected.

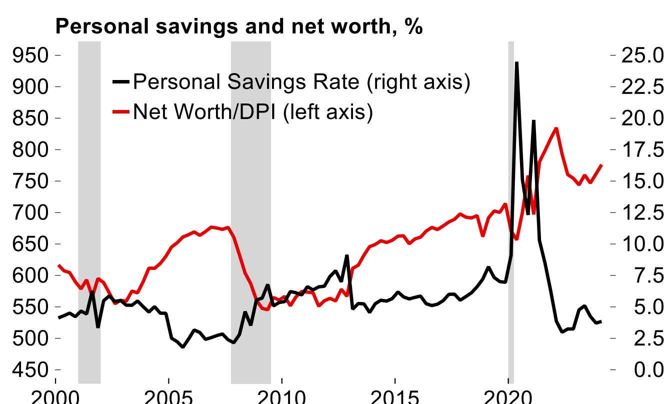
This risk, however sizable, is likely smaller than the potential for re-accelerating prices. Greater than expected growth in real disposable personal income in May (Chart 3), and Q1 growth in household net worth (Chart 4) will likely keep consumer spending growth in positive territory in 2024. Combined with a strong labor market, the idea that the Fed should proactively cut rates to prevent an economic downturn are indeed pre-mature, especially when the unemployment rate has yet to exceed 4%.

Chart 3: Real disposable personal income grew more than expected in May



Source: BEA, MUFG Bank Economic Research Office

Chart 4: Continued growth in household net worth will support consumer spending growth and keep savings rates low



Source: BEA, Federal Reserve, MUFG Bank Economic Research Office

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