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# Inflation down and incomes up

**September 27, 2024**

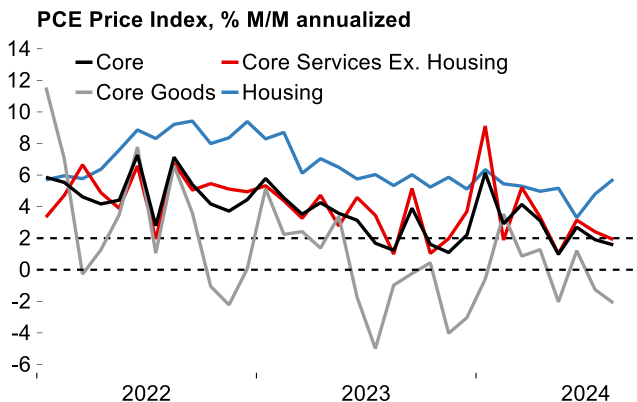
- August PCE inflation supports the Fed's strong confidence that price growth is moving in the right direction. Month-to-month, core goods prices fell further into deflation territory and core services excluding housing inflation fell below 2% annualized growth. Like in the CPI, housing inflation remains troublesome, having risen for two consecutive months from growth in Owners' Equivalent Rent (OER).
- Personal incomes have been revised upward by a large margin, with the personal savings rate now standing at 4.8%, compared to 2.9% pre-revision. The implications of this are significant and it calls into question how justified the Fed was in their aggressive rate cut decision earlier this month. Higher incomes than previously thought have allowed consumption to grow, despite depleted excess savings. Combined with continued growth in household net worth, real GDP is set to expand at a healthy rate in Q3.

### Income revision supports continued spending

The latest PCE inflation data should maintain the Fed's confidence that price growth is progressing toward their 2% target. On an annualized monthly basis, core goods prices fell further into deflation, falling to -2.1% growth in August compared to -1.3% in July. Core services price growth excluding housing eased to 1.9%, down from 2.4% in July, and overall core PCE inflation eased to 1.6% in August (Chart 1).

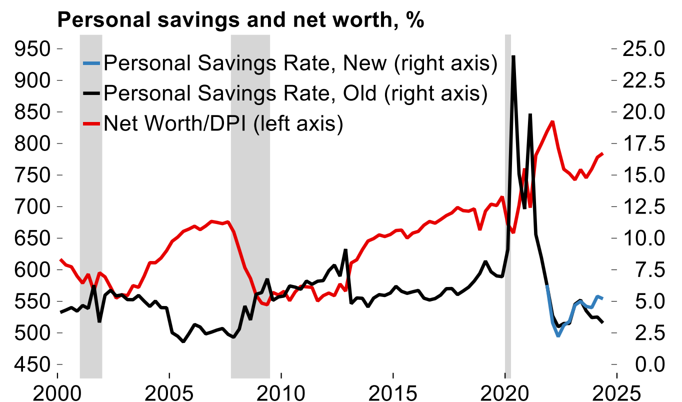
Housing inflation continues to be problematic, accelerating for the second consecutive month to an annualized 5.7% growth in August, the largest monthly increase since January of this year. The imputed portion that represents owner occupied dwellings, otherwise known as Owners' Equivalent Rent (OER), was the cause of the increase. The methodology of OER will likely be called into question, but growth more broadly follows housing prices with a somewhat sizable lag of 12-16 months.

**Chart 1:** Core inflation continues to trend along the Fed's 2% target on a monthly annualized basis




Source: BEA, MUFG Bank Economic Research Office

**Chart 2:** Revised income data brings the personal savings rate up to a more sustainable level




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



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This makes the outlook on inflation more problematic. The Fed rate cutting cycle has begun, and mortgage rates have followed. There is some uncertainty as to how much mortgage rates will fall given the larger than average spread with the 10-year treasury yield, but the logic stands that housing demand will rise, likely faster than supply. This spells trouble for housing prices and subsequent inflation moving forward.

This isn't to say that the Fed was wrong to begin the rate cutting cycle. Aggregate demand appears to be normalizing, and overall inflation is trending toward 2%. What may turn out to be wrong is the Fed's assessment of the labor market, and more specifically, their interpretation of the CES benchmark revision. Every year, March payroll employment numbers from the CES establishment survey are benchmarked to the more comprehensive, though less timely, QCEW dataset. The preliminary benchmark revision showed that payroll employment is to be revised down by a historically large 818,000 jobs for the 12 months ending in March 2024.

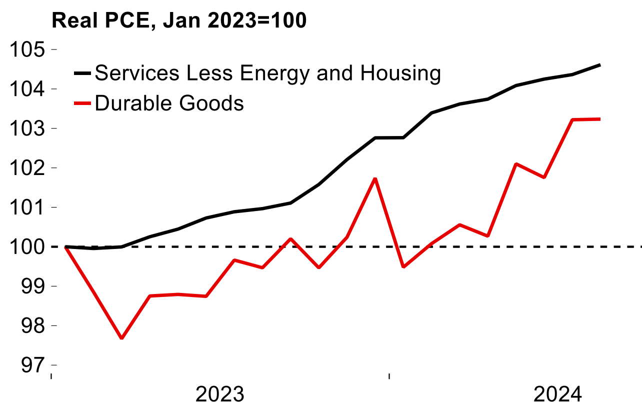
This may be where the Fed made a mistake in interpreting the data. If they implicitly assumed an equally distributed downward revision across all 12 months, then yes, the labor market for 2024 is weaker than previously thought. But comparing monthly growth rates of current payrolls (not yet benchmarked) to QCEW monthly growth rates, you see that the weaker growth is concentrated in the second half of 2023. Employment growth was still strong in Q1 2024. This is even more evident now with the upward revision to Q1 Gross Domestic Income (GDI).

Measures of domestic income from wages and salaries also depend on data from the QCEW program, and the latest revisions show that income from employment is higher than previously thought in 2024. Over the past six months, the puzzle has been understanding how households have been able to sustain strong spending growth and historically low savings rates despite depleted excess savings. This upward revision to domestic incomes unravels much of that mystery.

Shown in Chart 2, the revised "new" personal savings rate, that incorporates employment income data from QCEW, is substantially higher than the previous "old" measure (5.2% compared to 3.3% in Q2). Disposable personal incomes are higher than previously thought, making the gap between income and outlays larger and more sustainable than previously thought. Combined with the wealth effect, where there exists a negative relationship between household net worth and savings rates, consumers have more capacity to spend than previously thought.

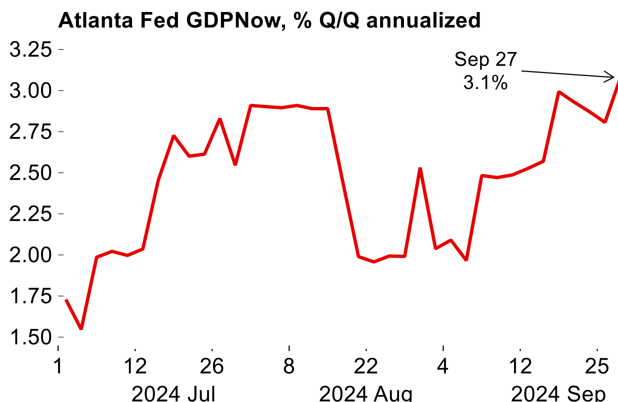
Now yes, the revised income data was not available to the FOMC before the meeting, but comparing non-benchmarked CES payrolls to QCEW employment should have led to the similar conclusion that an aggressive Fed action is not needed. Despite the Fed vocalizing that the economy is strong, the 50bps cut sent a different message.

**Chart 3:** Spending growth has been strong in 2024 for both durable goods and services




Source: BEA, MUFG Bank Economic Research Office

**Chart 4:** Nowcasts of real GDP project a strong economic expansion in Q3




Source: Atlanta Fed, MUFG Bank Economic Research Office



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The latest spending data further supports that the economy is indeed in a strong position. Shown in Chart 3, real personal consumption expenditures (adjusted for inflation) accelerated in August for services excluding energy and housing, and growth remained elevated for durable goods. The trajectory of consumption shows continued spending through Q3, and the Atlanta Fed's GDPNow measure now estimates that Q3 real GDP will expand by a strong 3.1%.

There is an expectation that the Fed will cut rates by an additional 50bps this year, though the Summary of Economic Projections shows that a number of FOMC participants only anticipate another 25bps worth of cuts. Unless layoffs begin to rise across a broad set of industries, it would be hard to justify slashing interest rates by more than an additional 50bps this year.

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