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MACRO MORNING BRIEFING

July 1, 2024

US May Inflation: Summer Swallow?

- Promising PCE data as expected, but we need to see more
- Personal spending is slowing
- Bank of Canada receives an inflation setback

Progress on services inflation welcome

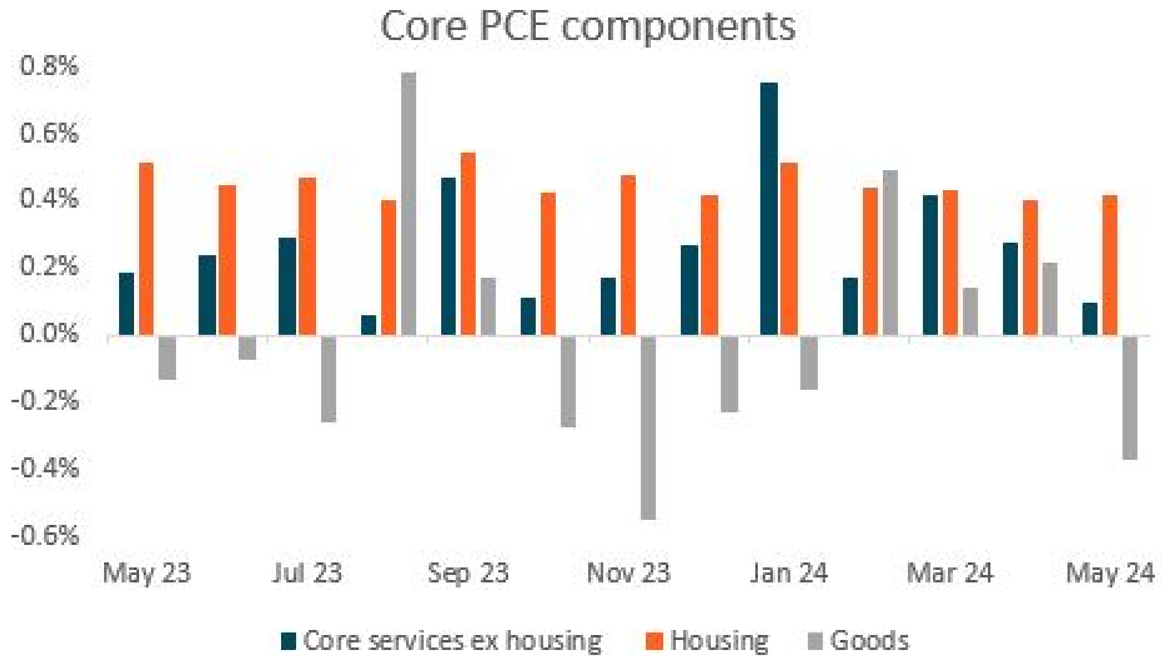
Good news on US inflation Friday was well-anticipated by the market. It nevertheless offered emphatic confirmation of the message first delivered by May CPI and PPI a few weeks ago. Adding in the PCE outcome, the pace of price increases slowed significantly in May. It's true, as Aesop was quoted to have said, that one swallow does not make a summer, and one month of good data doesn't make a trend. We don't think that the May price data alone will provide the Federal Open Market Committee with the "greater confidence" it needs to reduce rates. However, we do think these data, along with broadly – and gradually – slowing economic data could be the start of something that should lead a September rate cut. Market-implied probabilities for such a reduction in the policy rate are ~64% at this writing.

There was very little to quibble with in the PCE deflator data. Indeed, there were mostly laudable developments. As the top chart below shows, the monthly pace of increase in core PCE service ex housing (the famous "Powell supercore") has declined for three straight months since it blipped higher at the beginning of the year. It was up only 0.1% in May and is now running at an annual pace of 3.4%, the lowest yearly increase since March 2021. Services had been among the stickiest components of inflation in both the CPI and PCE data, so ongoing deceleration is welcome – both by us and the FOMC.

Another – and more frustrating – sticky element of the inflation picture is housing. The PCE data, which compute housing inflation differently from the CPI program, show only a very slow decline in monthly and annual inflation in this category. The second chart below suggests that if the housing PCE component follows rents (shown as the yearly rate of rental price

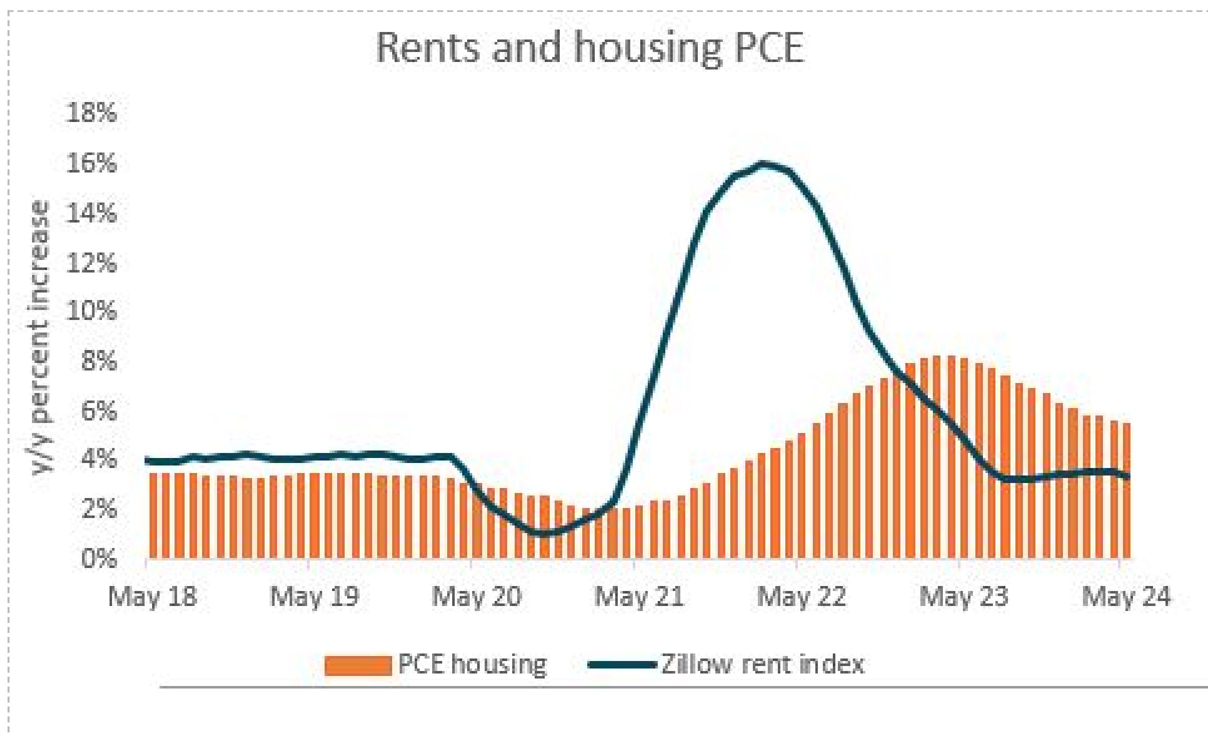
increases in Zillow's all homes index), we should see gradual relief continuing – but it will take a while. Housing tends to run hotter than overall PCE inflation in normal times, as we can see below, but it's still too high currently and a major contributor to stubborn inflation. Nevertheless, housing only represents 15% of the PCE (the Fed's preferred inflation measure and its official target), while it is over one-third of the CPI aggregate.

PCE Inflation - Slowing On Most Fronts



Source: BNY Mellon Markets, Bureau of Economic Analysis

Housing Inflation Needs To Follow Rents



Source: BNY, Bureau of Economic Analysis, Zillow

Moderation in services consumption, as well

Personal spending and income data are included in the same data dump as the PCE deflator, and they make for interesting reading – especially the former. Incomes have continued to run at just below 5% y/y, just below their pre-pandemic average. Transfer payments and other government support from the pandemic era are no longer affecting the data, so what we're observing now is a general – and steady – rise in incomes from compensation. Moreover, the San Francisco Fed has been monitoring developments in personal savings and reckons that, by now, so-called "excess savings" from those lumpy government support programs during COVID have run out. See the chart below and here for the SF Fed's work on the topic.

Excess Savings Are Exhausted

Source: BNY Mellon Markets, Federal Reserve Bank of San Francisco

Even more noteworthy have been recent developments in personal spending. The two charts below track those by breaking out personal spending into its three main components: services, nondurable goods, and durables. The first chart indexes all three measures, starting in December 2015. Before the pandemic, they all rose in lockstep. Post pandemic, the three indices begin to diverge. Initially, we see a big increase in goods consumption, as most personal services were unavailable during the lockdowns, and consumption was curtailed. It took over a year for services spending to recover to pre-pandemic levels.

In addition, the trajectory – the slope of the post-pandemic time series for all three

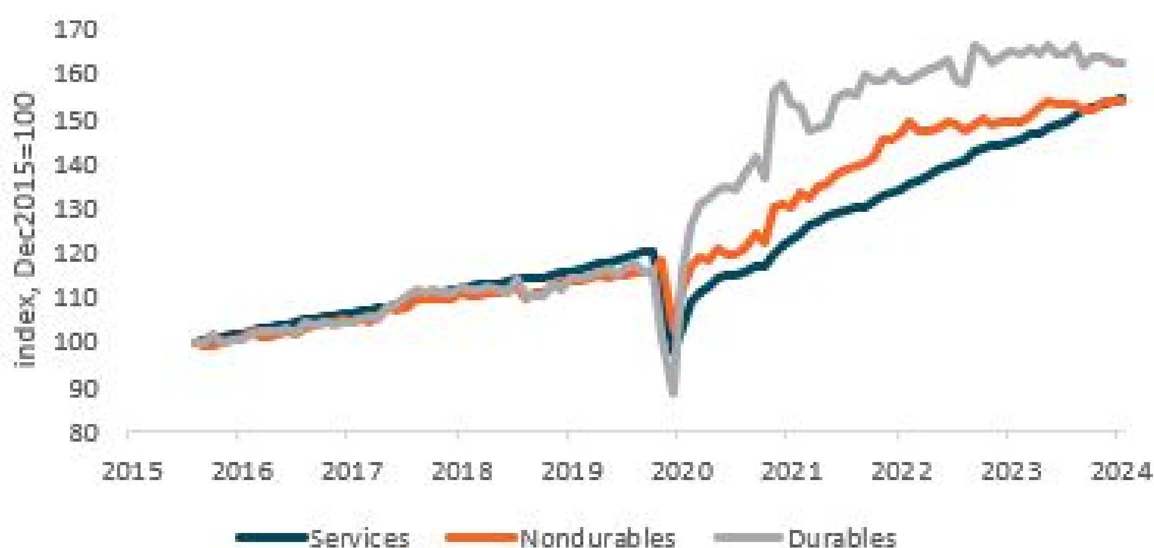
components – of consumption moved significantly higher. Consumption increased quickly after re-opening. Indeed, household consumption has risen by over 12% in real terms from its December 2020 levels; overall GDP is up a little over 9% in the same period.

Finally, we note that consumption of goods – both durable and non-durable – has slowed, almost becoming flat from around the beginning of 2023, while services have inexorably risen the whole time.

Nevertheless, as the second chart below shows, recently the pace of spending on services has more than moderated. We show monthly increases, again for each of the three major series, over the past twelve months. After peaking in January this year at monthly rate of increase of over 0.8%, services spending has been slowing and was up just 0.3% in May. Nondurables consumption has been lackluster for much of the past 12 months, and even durable goods purchases are showing signs of easing.

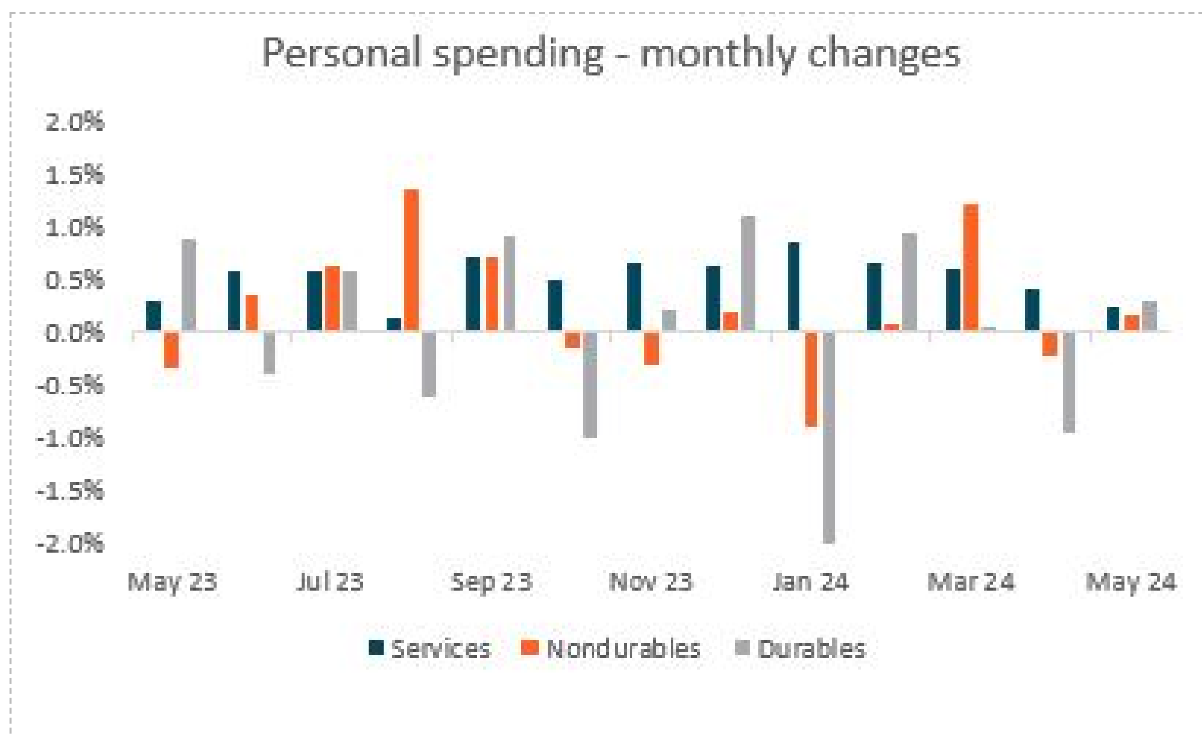
These recent developments corroborate that goods inflation (as seen in the charts) is basically zero – or even negative on a monthly basis, and the previously discussed gradual slowing of core services prices, as well. The economy is slowing and spending is moderating – a recipe for continued disinflation and what we continue to believe will be an initial Fed rate cut in September.

Developments In Personal Spending



Source: BNY Mellon Markets, Bureau of Economic Analysis

Monthly Data Show A Slowdown Across the Board



Source: BNY Mellon Markets, Bureau of Economic Analysis

Bank of Canada: July cut fading?

Speaking of rate cuts, we're not so sure there will be one coming in July in Canada. Last week's May CPI provided a negative, with both the headline and core measures above expectations. This development represents a reversal of progress on inflation. The recent line from the BoC has been (quoting from the June Summary of Governing Council Deliberations) "if inflation continued to ease and remained on a sustainable track to the 2% target, it was reasonable to expect further cuts to the policy interest rate". A reversal of this easing would make it unreasonable to cut rates in July, in our view.

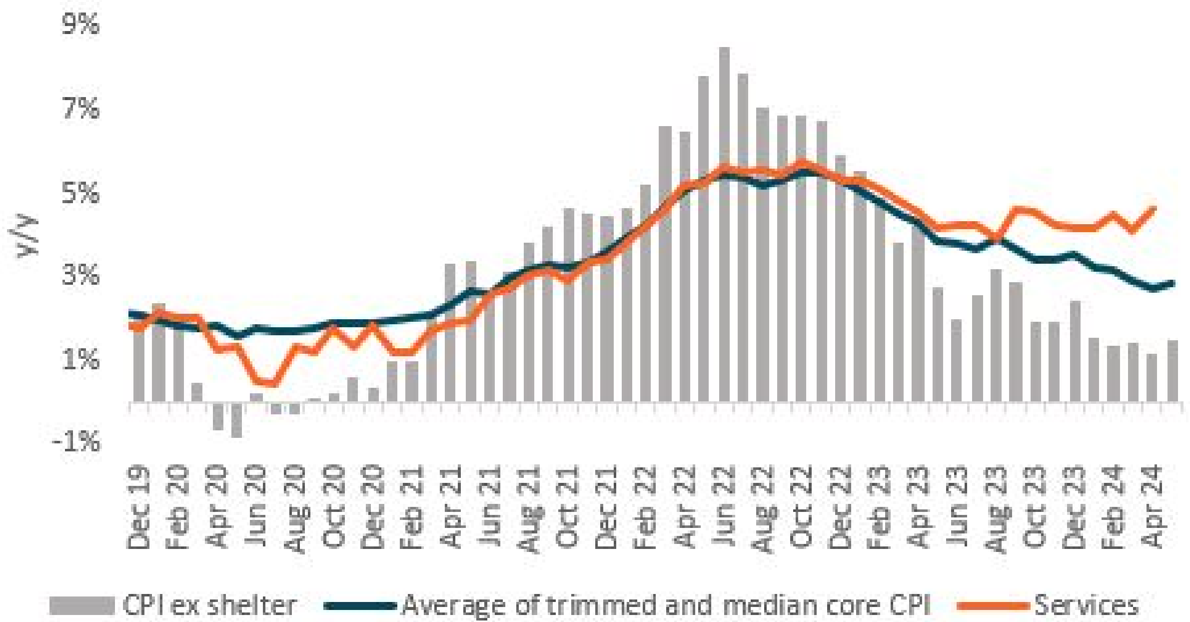
There is still plenty of time for the BoC to receive more inflation data, as the June CPI will be published a week before the next rate-setting meeting. A reversal of the May data could be in the cards and restore confidence of the general and steady downward trend we had been observing since last December. Services inflation remains sticky, as in the US, and the May report was disappointing on this front, as well.

Also, the economy, which the BoC asserts is exhibiting excess supply, is growing more slowly. Last week's SEPH data – essentially Canada's equivalent of the US's establishment survey – reported a decline of over 20k employees in May, the third negative print this year. The job market is slowing – this coming Friday's report will be essential reading.

Current market probabilities for a rate cut in July are down to 45%, compared to 71% on June 5. On the day of the CPI report these expectations were as low as 15.5%. If we had to choose, we would say that the current setup argues for a pause in the recently initiated cutting cycle in Ottawa. But there are still some important data points to come, and a hike

could be put back on the table. Like for all central banks, but especially its neighbor to the south, data dependency is the watchword for the BoC, and volatile reactions to data beats or misses will likely be a feature of summer markets.

Canadian Inflation Reverses In May



Source: BNY Mellon Markets, Statistics Canada

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Please direct questions or comments to: iFlow@BNYMellon.com

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