US Macroeconomics

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Why We Don't Believe the Sticky Inflation Narrative

If the consensus of forecasters is correct and the December core PCE deflator prints 0.2%, it will provide more evidence that the inflation rate is at target. Consequently, this opens the door for a 25 basis point March 20 rate cut. The implied probability of such action is currently a smidgeon above 50%.

Assuming no revisions, a 0.2% December core PCE increase lowers the three-month annualized rate of change to 1.6%, from 2.2% and 2.3% in November and October. The six-month annualized change will also be under 2%, and for a second month in a row at 1.9%. The year-over-year rate would fall two-tenths to 3.0% which will likely lead some analysts to worry about "sticky" inflation. But they should focus on the shorter run trend, which points to significant downward momentum as illustrated in the chart below.

At this point there is little reason to think inflation stops slowing at least in the intermediate term. Goods prices are flat over the last year and are poised to slow further given that the US is importing goods deflation from China.

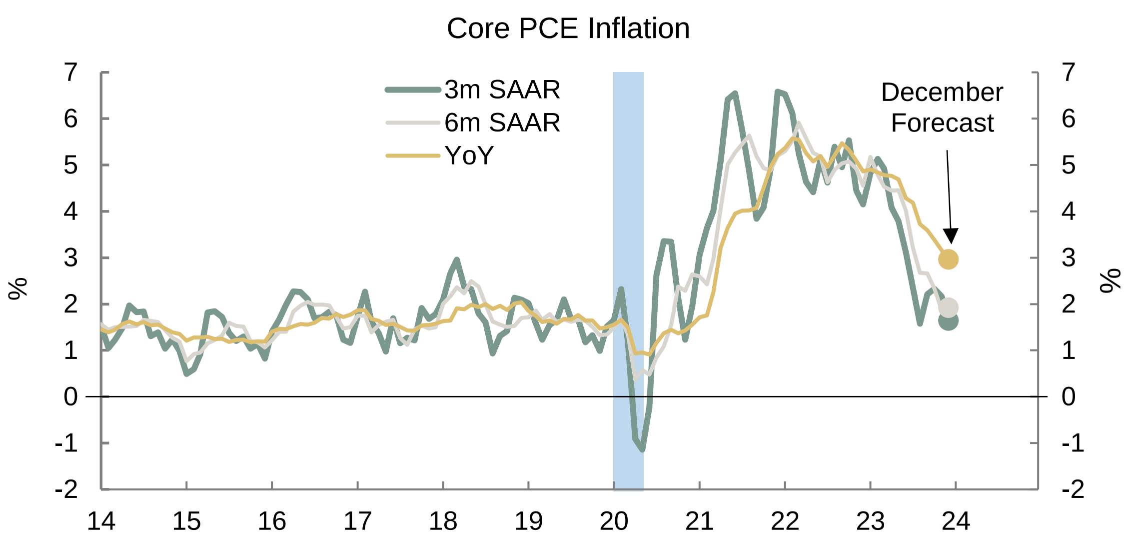
In addition, Germany recently entered recession which further increases global manufacturing slack. US capacity utilization has been trending lower and this will continue for the foreseeable future.

It is also worth noting that a broad basket of commodity prices is down sharply from last summer, and the trade-weighted dollar remains steady at a high level. A resurgence in goods inflation is highly unlikely. Rather, goods prices are likely to deflate over the rest of 2024.

Over the last 12 months, PCE services inflation is up 4.1% while core PCE services excluding housing is up 3.5%. Significant further slowing should be expected for two reasons: One, there is a lot of additional housing supply poised to hit the market. **Last year saw the highest number of multi-family housing completions since 1987**. This supply deluge will occur against the backdrop of slowing rents (as measured by new tenant leases).

Two, the labor quits rate is now at its lowest non-pandemic reading since March 2018. Since quits are a leading indicator of wages, **the employment cost index is on track to slow to just above 3% annual growth** within the next few quarters, down over one point from its current reading.

Consequently, there is no reason at this point to think the progress on inflation is going to stop. For that to happen either the economy needs to suddenly gain steam or suffer the ill-effects of an aggregate supply shock, something akin to Covid or the 1970s oil embargo.



Source: BEA, Haver, SMBC Nikko

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