

# US Macroeconomics

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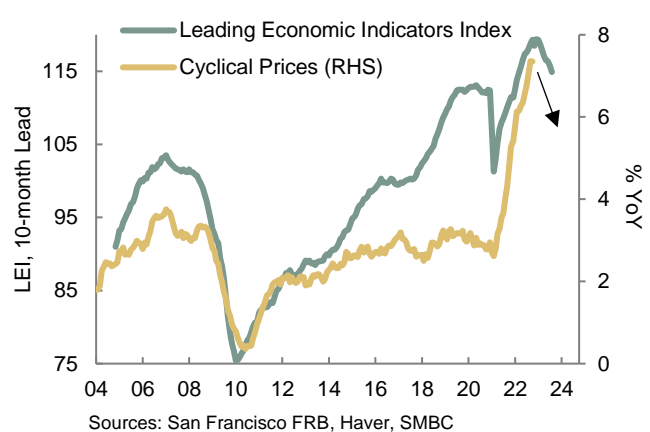
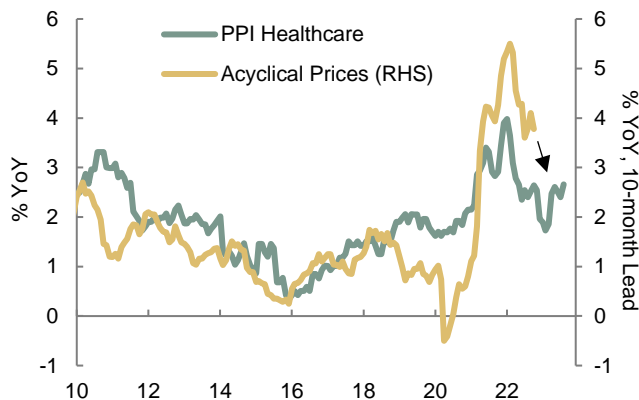
## Core Inflation Has Peaked

The San Francisco Fed created an inflation metric that breaks the core PCE deflator into two components. One is **acyclical**, meaning that its trend is not correlated with the business cycle. The other is **cyclical**, meaning its movements are highly correlated with changes in real GDP growth. Acyclical prices account for 58% of the core PCE deflator with healthcare services the dominant subcomponent at 35%. Cyclical prices account for the remaining 42% and capture such spending categories as housing, recreational services, and restaurants. There are good reasons for the growth rates in both sets to meaningfully slow over the next year.

Trends in the core PCE are dominated by healthcare, which is the largest component of acyclical prices. PCE healthcare is derived from the producer price index (PPI). As we can see in the lefthand-side chart below, **the growth in PPI healthcare prices peaked and is trending downward**. This means that the growth in acyclical prices, which has already begun its decent, will be moderating further going forward. PPI healthcare has a 10-month lead on acyclical inflation. Meanwhile, cyclical prices have not yet peaked but are about to.

The righthand-side chart shows the Index of Leading Economic Indicators versus cyclical prices. The former is a leading indicator of GDP and shows that economy activity is poised to trend downward. This series also leads by 10 months and tells that **the year-over-year rate in cyclical prices should make a top in a month or two**. There is no doubt as to the direction of the inflation rate. What is in doubt is at what rate does inflation bottom.

The Fed's latest economic projections from September—new ones are released on December 14—show the median central tendency on the core PCE finishing next year at 3.2% and 2.35% in 2024. This compares to a current run rate of 5.0%. However, monetary policymakers are not anticipating a recession. So, **if we enter a downturn next year, we estimate that core inflation will be under 3% in 2023 and possibly below 2% in 2024** because cyclical prices will plunge just as they have in the past. In fact, when a recession inevitably arrives someday, we would not be surprised if financial markets were to worry anew about deflation.



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