ABN·AMRO

US Watch

Group Economics
Financial Markets Research

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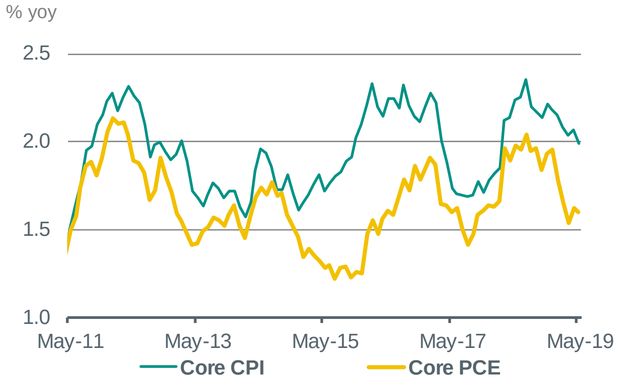
What's up with inflation?

Bill Diviney
Senior Economist
Tel: +31 20 343 5612
bill.diviney@nl.abnamro.com

- **Core inflation continues to disappoint to the downside, despite an apparently tight labour market**
- **While some transitory factors are at work, and base effects should push core PCE back near the Fed's 2% target by year-end…**
- **…low unit labour cost growth makes it unlikely we will see a significant acceleration over the next 18 months**
- **Prolonged subdued inflation is leading to inflation expectations becoming unanchored**
- **Concern over this is one of the main reasons we expect the Fed to cut rates, regardless of the outcome of trade negotiations**

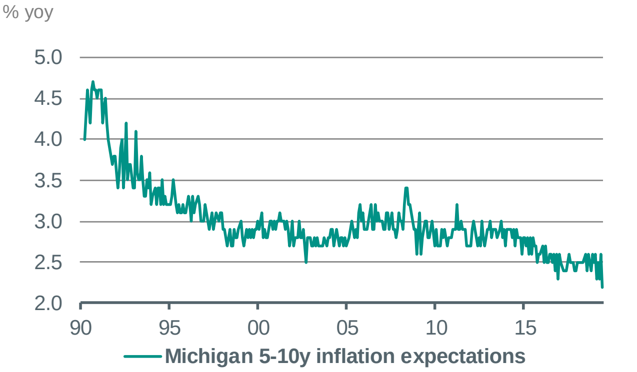
Inflation is, once again, becoming a key concern for investors and policymakers. Indeed, while increased uncertainty linked to trade policy is the primary driver of the Fed's dramatic dovish shift, 'muted inflation pressures' were explicitly cited in the June FOMC statement as a reason for the Committee to 'act as appropriate to sustain the expansion' (code for rate cuts). Since the beginning of the year, CPI inflation has repeatedly disappointed to the downside, and core PCE inflation is running below the Fed's 2% target at 1.6% (see Appendix on p6 for differences between CPI and PCE measures). Even more concerning for the Fed, there are signs that longer term inflation expectations are becoming unanchored, raising the urgency to act to prevent below-target inflation becoming entrenched. In this note we explore the drivers of the inflation undershoot, and the prospects for a recovery.

Core inflation has fallen back…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…while inflation expectations have hit an all-time low



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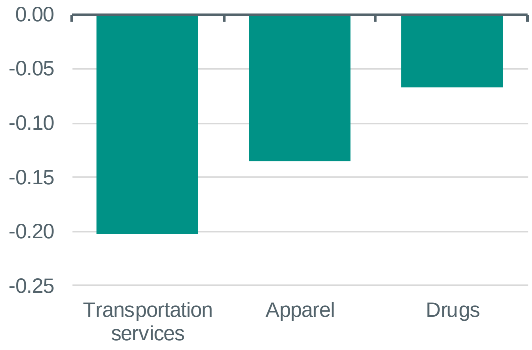
The return of 'temporary factors'

To an extent, the undershoot in inflation of the past half year is indeed driven by some transitory factors. First, and most often cited, is the change in data collection methodology for apparel. This involves the tapping of big data sources, with manual survey-based data replaced with a direct feed from a department store chain. Apparel has a 4% weight in the core CPI and has been 0.1pp drag on inflation since the start of the year, though it is unclear how much of this is due to the methodological change. Ultimately, the Bureau of Labor Statistics expects up to 32% of the index to be fed by big data in future, but it remains to be seen whether future changes will have moderating or amplifying effects on inflation.

Some temporary factors have been at play…

Decline in core CPI and biggest negative contributions over past 12 months



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…such as sharply lower car insurance inflation…

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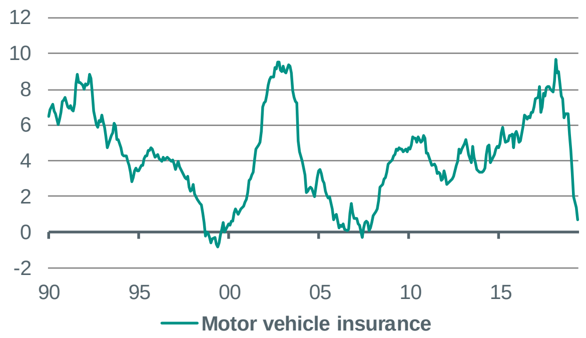

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

An even bigger drag has come from transportation services, and within that category, car insurance premiums. This category was a significant boost to inflation in 2018, following dramatic hikes to premiums after the devastating damage from hurricanes Harvey and Irma in 2017. As these effects unwound, the decline in transportation services inflation has meant a 0.2pp drag on annual core inflation.The final notable drag on inflation has come from drugs prices. The Trump administration has been on a drive to accelerate the approval of generics and this has weighed heavily on prices. Indeed, annual drug price inflation turned negative on a sustained basis for the first time in over 45 years last December, and has remained mostly negative since then. This has subtracted approximately 0.05pp from core inflation over the past year.

…a change in apparel data collection methodology…

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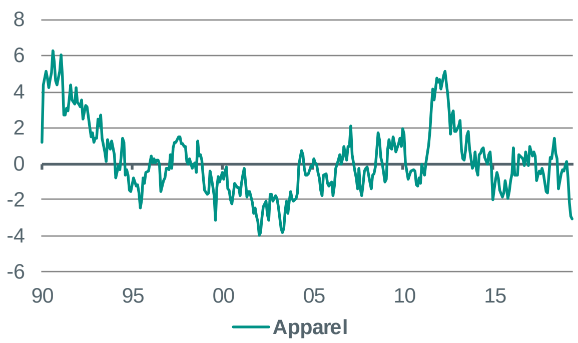

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…and generics approvals weighing on drugs prices

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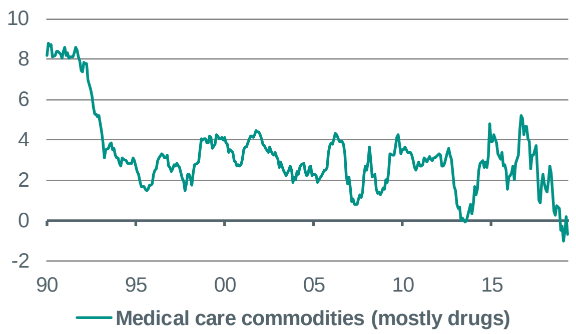


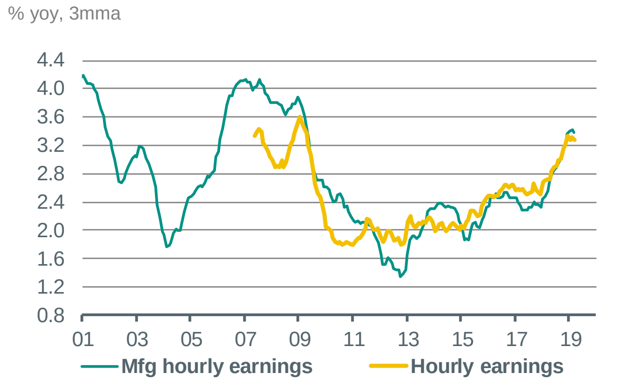
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Temporary factors will fade, but underlying inflation is muted

At the very least, the impact of the fall in car insurance premiums, and some of the drag from apparel linked to the methodology changes should gradually fade. The impact of generic drugs approvals could persist as more come to market, though this drag should remain modest given the small weighting (just 2% of core CPI).

However, looking beyond these components, core services inflation remains remarkably muted given the tightness in the labour market and the corresponding pickup in wage growth. Indeed, wage growth has accelerated a full percentage point over the past 2 years, from c.2% to c.3%, yet core services inflation has actually fallen back recently. Why is this?

Wage growth has picked up…



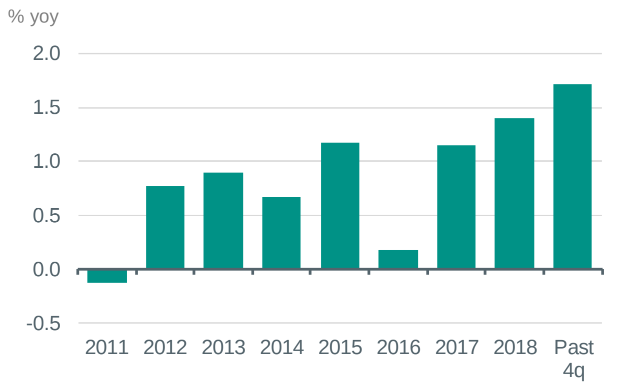
Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…but core services inflation is still muted

Source: Thomson Reuters Datastream, ABN AMRO Group Economics

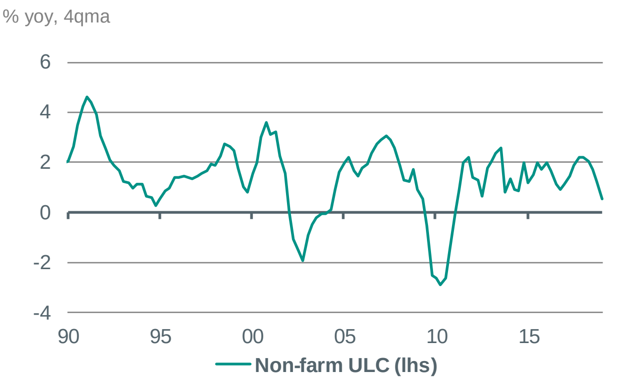
The answer lies with productivity growth. After many years of subdued rates of growth, productivity has picked up markedly over the past few quarters, from around 1% on average for much of the post-crisis period, to 2.1% on average over the past two quarters. This has in effect paid for the acceleration in wage growth, as unit labour cost growth actually fallen. While the drivers of productivity growth are complex, we think this largely reflects higher rates of investment over 2017-18 of 6.1% on average, up from 1.1% over 2015-16. Indeed, the tight labour market seems to be encouraging employers to raise productivity as an alternative to hiring new staff (there have been anecdotal reports of this in the ISM surveys).

Higher productivity growth…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

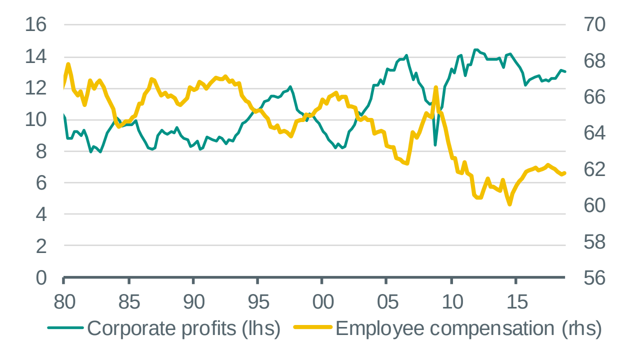
…is dampening unit labour cost growth



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

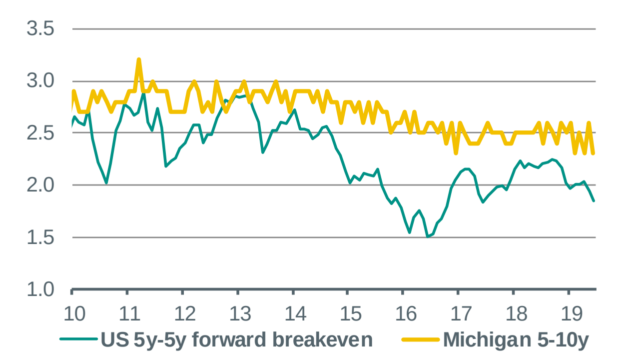
As such, while base effects should push core PCE inflation back up near the 2% target by year-end, broadly speaking we expect inflationary pressure to remain subdued for the foreseeable future – at least on our forecast horizon to end-2020. Even if productivity growth falters and unit labour cost growth starts accelerating again, the lack of pricing power in a globalised market, and still-elevated profit margins, means that businesses are likely to (initially at least) take the hit to margins before passing on costs to consumers. This should keep core inflationary pressure contained.

Corporate profit margins remain relatively high



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Are inflation expectations de-anchoring?



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

Inflation expectations becoming unanchored

Against the backdrop of low inflation and elevated risks to the growth outlook, market-based inflation expectations (5y5y forward breakeven) have declined considerably, from 2.1% as recently as April, to 1.8% in recent weeks. A bigger concern is the decline in more stable survey-based measures, and in particular the Michigan consumer survey. In June, 5-10y expectations fell to 2.2% - the lowest in the survey's 40 year history. While such a number might not seem like much to worry about given the Fed's target is 2%, as a survey-based measure this is likely to be inconsistent with 2% realised inflation. To illustrate, the last time core PCE inflation was at the Fed's 2% target on a sustained basis was in 2008, when the Michigan survey-based measure averaged 3.1%. As such, a 2.2% reading from the Michigan survey likely corresponds with a core PCE rate below 2%.

It appears, then, that the prolonged period of subdued inflation is leading to expectations becoming unanchored. At a time when the Fed is actively examining policy framework changes that would *raise* inflation expectations[1], this development should be particularly worrisome to FOMC members. Expectations are hard to shift once they become entrenched, as they often feed into wage expectations, creating a self-fulfilling dynamic. Indeed, Fed Chair Powell voiced concern over the possible de-anchoring of expectations at the June FOMC press conference, while more dovish members of the Committee such as James Bullard and Neel Kashkari have explicitly cited the fall in inflation expectations as a reason to cut rates.

[1] The Fed is currently conducting a review of its monetary policy framework, the outcome of which could mean the Fed adopting an average inflation target, or price-level targeting. These would likely raise inflation expectations. See: https://www.federalreserve.gov/monetarypolicy/review-of-monetary-policy-strategy-tools-and-communications.htm

Lowering our inflation forecasts

As a result both of the transitory factors weighing on inflation, but also the weakening in pipeline pressure from lower unit labour cost growth and the decline in inflation expectations, we are lowering our core inflation forecasts. The bulk of this is visible in our forecast for core PCE, which we have lowered by 0.2pp in both 2019 (to 1.7%) and 2020 (to 1.9%), as the higher weight of shelter in the CPI to some extent blunts the weakness in inflation elsewhere (see Appendix). Should these forecasts be realised, PCE inflation will have undershot the Fed's 2% target for eight out of the ten years to 2020, while core PCE will have undershot for all ten of those years. While the size of the undershoot is not as severe as has been observed in other developed markets such as the eurozone and Japan, the asymmetry in the target miss, combined with the fall in inflation expectations is a cause for concern.

Inflation forecasts (annual averages, old forecasts in parentheses)

	CPI	Core CPI	PCE	Core PCE
2018	**2.4**	**2.1**	**2.0**	**1.9**
2019F	**1.8** *(1.6)*	**2.0**	**1.6**	**1.7** *(1.9)*
2020F	**2.0**	**2.0** *(2.1)*	**1.9** *(2.1)*	**1.9** *(2.1)*

Note: The forecast for headline CPI for 2019 was raised on account of higher oil prices earlier this year.

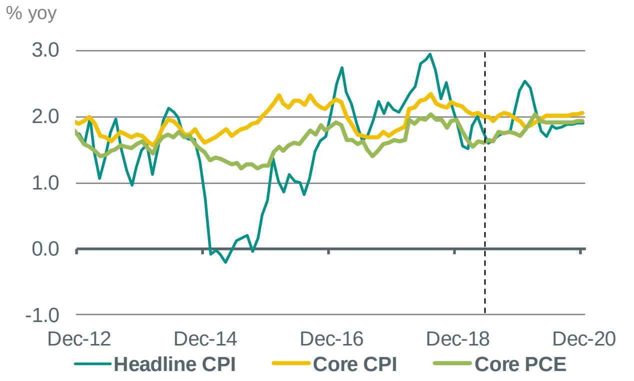
Source: ABN AMRO Group Economics

Muted inflation bolsters the case for rate cuts

We expect the Fed to cut rates a cumulative 75bp by Q1 2020, starting at the July FOMC meeting with a 25bp cut. The principal driver for this is the trade war re-escalation, which – even with the recent truce – has significantly raised uncertainty for business. This is weighing heavily on investment, leading us to downgrade our growth forecast for this year and next to 2.2% (previous: 2.3%) and 1.5% (1.9%) respectively.

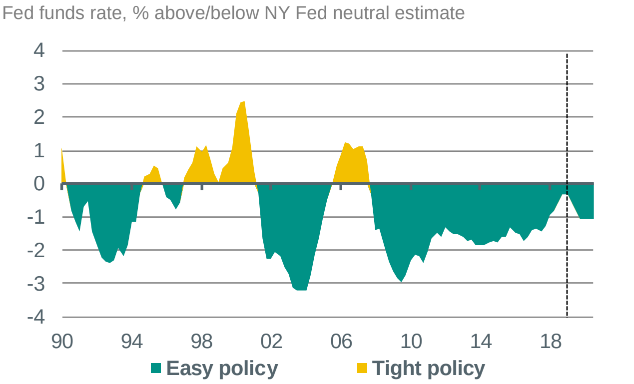
However, the weakness in inflation and the decline in inflation expectations bolsters the case for easing even further, and is one of the reasons why we expect rate cuts regardless of the truce in the US-China trade war.

Core PCE to continue to mildly undershoot 2%…



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

…bolstering the case for the Fed to ease



Source: Thomson Reuters Datastream, ABN AMRO Group Economics

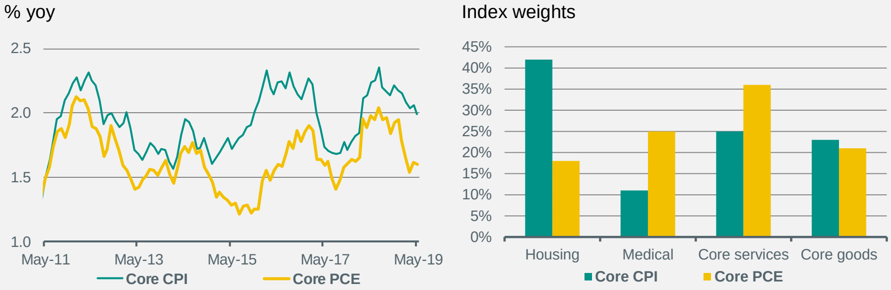
Appendix: You say CPI, I say PCE… what exactly are the differences?

The US has two main inflation measures – the consumer price index (CPI), published by the Bureau of Labor Statistics, and the personal consumption expenditure index (PCE), published by the Bureau of Economic Analysis. The CPI is a more timely measure, typically released 10-14 days after the end of the reference month. The PCE measure is released with a longer lag – around 1 month after the reference month – and has a differing scope, weights, and calculation method. The Fed's preferred measure, and the one that it formally targets as its 2% inflation objective, is the PCE index. The market however tends to be more responsive to the CPI release, as it is much more timely, and it is possible with reasonable accuracy to forecast PCE outturns based on the CPI release.

Since 2010, both headline and core CPI inflation have been on average c.20bp higher than PCE inflation. What explains this difference? The most important and easily recognisable difference is the weighting of housing (or shelter, as it is referred to in the CPI). Shelter has a weight of 33% in the CPI (42% in core CPI), but the equivalent housing component makes up only c.16% of PCE (18% of core PCE).[2] It is this that explains much of the undershoot of PCE inflation vis-à-vis the CPI, as shelter inflation has been consistently firm in the post-crisis period, outperforming overall inflation.

Other important differences include the fact that PCE inflation covers goods and services purchased on behalf of consumers by non-profit organisations (for instance, healthcare providers), whereas the CPI only includes expenditure borne directly by consumers. For this reason medical inflation (goods and services) has a higher weighting in the PCE at 22% (25% core), but only a 9% weighting in the CPI (11% core).[3]

Weight differences explain much of the core CPI-PCE divergence



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[2] PCE weights are our own estimates based on volume expenditures, as the Bureau of Economic Analysis does not formally publish PCE weights.

[3] For a more detailed technical comparison of the CPI and PCE index, see the following article from the Bureau of Economic Analysis: https://www.bea.gov/scb/pdf/2007/11%20November/1107_cpipce.pdf