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February 16, 2024

Our Thoughts

Mixed Data Messages

We were hoping for a clearer message from this week's major economic indicators, one that would swing the economic outlook even further toward the soft-landing camp. Instead, we received, at best, a **muddled message**: stronger January CPI and PPI inflation—both core and headline—than anyone had bargained for; combined with sharp declines in retail sales and manufacturing production, well short of expectations for a modest slowdown in growth. But before we go too far down that rabbit hole, **it is important to not draw too sharp a conclusion from one month of data**.

There were a few one-off factors that may help ease the pain from the January data. Inclement weather (freezing temperatures followed by heavy rainfall) along with falling gasoline prices likely added to the weakness in total retail and motor vehicle sales. Spending is likely to rebound in February and March as (mostly) Spring-like weather erupts and the underlying fundamentals that support real consumer spending growth return. Consumer confidence remains buoyant; U.S. equity markets, already at record levels, continue to rise; and the decline in initial jobless claims over the past two weeks shows labor demand remains solid. As long as people have jobs, and real incomes continue to climb, **we are not too concerned about a one-month stumble in spending**. Even so, the worse-than-expected retail sales data also came with downward revisions for gains in November and December, suggesting less momentum coming into this year. As a result, we have lowered our real consumer spending growth forecast for Q1 to a still-healthy 2.4% a.r. from 3.2% previously.

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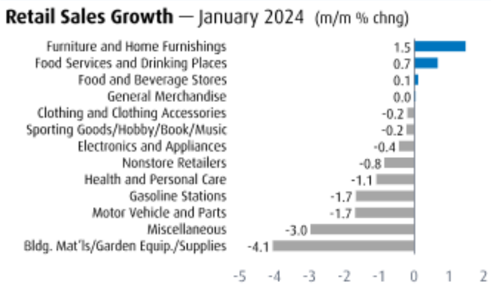
Sources: BMO Economics, Haver Analytics, BLS

Chart 2
Building Material and Motor Vehicle Sales Particularly Weak: Was It Due to Bad Weather?



Sources: BMO Economics, U.S. Census

Chart 3
A Bad Start for Inflation Has Been a Trend for The Past Three Years

Sources: BMO Economics, Haver Analytics, BLS

January manufacturing production (down 0.5%). Still, our call for real GDP growth remains at 2.0% a.r. in Q1 given offsetting upward revisions to residential investment and business inventory growth (due to solid readings in the NAHB Housing Market Index and in business inventories). In short, **despite the tweaks in the near-term forecast, the soft-landing narrative remains intact**. Unfortunately, the mixed messages coming from the January data will keep economic and inflation uncertainty high and the Fed on hold as it awaits more data to gain *"greater confidence"* that inflation is moving sustainably toward 2%.

On the inflation front, **the 'hot' January data might not be quite as bad as it seems at first blush**. Over the past three years, CPI inflation has consistently started the year very high even after adjusting for seasonal factors, suggesting there may be residual seasonality that is not yet being fully accounted for. For example, more companies may now decide to raise selling prices altogether at the start of the year before expected year-ahead cost increases. Better to push through somewhat bigger price increases all at once rather than more gradual price increases multiple times a year that could draw unwanted attention. If that is indeed the case, we should see smaller price increases in the months ahead, as we have in recent years—especially if demand continues to cool. As we have long said, the path from 3% to 2% inflation would not be a straight line and could be rocky. The unwelcome January data pushed up our CPI inflation forecast for Q1 to 3.2% a.r. with core CPI now at an elevated 4.0%. However, the likely moderation over the rest of the year only leads to a slight increase to 2.9% in our CPI inflation forecast for all of 2024.

In reality, the CPI acceleration had a bigger impact on the fixed income markets, which have long been

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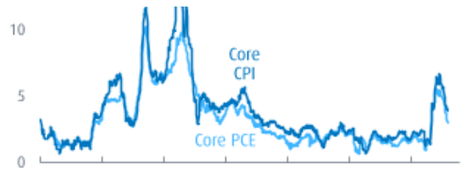
expectations. The Fed funds futures probability of a March rate cut is at less than 10% with the probability of a May cut under 30%. The market has scaled back from pricing in six quarter-point rate cuts in 2024 at the start of the year to just over three quarter-point cuts today. **Our refreshed U.S. economic and inflation outlook is still much more consistent with an initial cut around July at the earliest.**

Mind the (Inflation) Gap: CPI vs. PCE

labor-intensive industries still struggling with worker shortages. Meantime, the Cleveland Fed's trimmed-mean and weighted-median CPI measures both rose 0.5% last month, suggesting the leap in core prices wasn't related to a few anomalies that are poised to retrace next month. An unwelcome jump in core producer prices only piled onto the bad news. True, one month doesn't make a trend; and, as Scott explains, some of January's spike could be reversed in coming months. But the fact of the matter is that, even if core goods continue to deflate, the Fed's price stability goal could prove elusive unless service costs cool down much further.

But wait, you say, the Fed doesn't target the CPI but the more comprehensive PCE deflator, which has decelerated rapidly. In fact, core PCE prices rose an annualized 1.9% in the second half of 2023, or a tick *below* the target. On a yearly basis, the **core PCE deflator moderated to 2.9% in December, a full percentage point below the core CPI rate**. Even if prices rise 0.3%-to-0.4% in January, the yearly rate could edge down a tenth or two due to an easy comparison last year. The gap between the two core inflation measures could widen to 1.2 ppts—the largest in over 22 years and three times the long-run median (of 0.42 ppts going back to 1960).

The PCE deflator tends to run slower than the CPI largely because of substitution effects, as shoppers often swap faster-rising items for slower-moving ones. Note in *Chart 1* that the gap tends to widen in high-inflation periods. This gap reflects a mix of different weights on spending categories, different items within categories, and diverse methods of measuring price changes. To help explain the source of the 1.0-ppt spread between the two core measures in December (more than twice the norm), it's best to focus on the two categories—**rent and health care**—that have the biggest weight difference (by far) and often the biggest variation in price movements.



Sources: BMO Economics, Haver Analytics, BLS, BEA

following year added a hefty 2.7 ppts to core CPI inflation in December 2023. By comparison, rent accounts for a smaller (though still large) 17% share of the core PCE deflator, and a mild 1% rise last year added just 0.2 ppts to core PCE inflation. **The net 2.5-ppt contribution of rent to the core rate gap was partially offset by a negative 1.0-ppt contribution from health care.** This reflected the larger weight of health care in the core PCE deflator (22.1% versus 10.1%), combined with a faster increase (about 6%) in medical costs compared with a much milder 0.5% rise in the CPI. Together, **rent and health care accounted for a net 1.5 ppts of the gap in the two core rates; i.e., more than all of it**. Without these two heavyweights, core PCE inflation likely would be above the core CPI rate in December. Then again, excluding shelter, core CPI inflation would also be much lower than it currently is; in fact, just 2.2% in December *and January*, according to the BLS.

Bottom Line: As rent growth moderates this year, inflation should ease further. But sticky services costs, even beyond shelter, suggest the decline—regardless of the survey—will be gradual. This means the Fed might not attain "*greater confidence that inflation is moving sustainably toward 2 percent*" until the summer, thereby delaying rate cuts until the 2024 Olympics are underway.

Disclosures

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Well, we are finally here: time to close the books on 2023 and open a new chapter in 2024.