Economy and Inflation: Consumption, Income, Consumption Deflator (PCE) and "Core"

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Overall—Economy Weak, Inflation Way High; Upward Revised January Keeps Q1 Real GDP Tracking Near 3%

February Consumption and Consumer Inflation split *weak* on spending (real consumption -0.4%; DE, unch.; 0.1% Cons.) and quite *high* on inflation (0.6%; DE, 0.9%, Cons. 0.6%) 7.2% annualized, 6.5% YoY, and 5.4% Ex-Food and Energy—*weaker economic growth but much higher inflation* (overall and Ex-Food and Energy).

This is an unpleasant "Stagflation" data read, although just one month, remember—but a much weaker and slower-growing economy beset by accelerating inflation and not just from Food and Energy.

Fed Tightening Underscored—A New Instrument

The inflation data reinforce the expectation of a significant coming Fed tightening with the new peak YoY in the Consumption Price Deflator (PCE), 6.5%, but the ultimate peak not yet in sight.

Inflation is Public Enemy Number One for Chair Powell and many other Fed Members, made clear in recent testimonies, speeches, and Q. and A.

Chair Powell and the Fed will follow the data. The data say too much inflation, too high, too long, and inflation expectations in danger of becoming unanchored.

A 50 b.p. increase in the federal funds rate at the May 2-3 FOMC Meeting is the DE forecast and then many more increases thereafter. A 50 b.p. increase at the June Meeting is a toss-up, 50-50.

Quantitative Tightening (QT) will be spelled out at the next Fed Meeting. The DE working assumption is reductions of $100 billion per month open-ended (tied to the Dual Objective, particularly price stability), or $1.2 Trillion per year for the next few years, cumulatively $3.5 Trillion.

The total 175 basis point increase in the federal funds rate over this year and the working assumption on QT constitute a huge turn by the Federal Reserve away from Accommodation, long in-place because of the Pandemic, to Tightening, until and unless price inflation heads lower and clearly defines movement toward whatever ends up as the Price Stability target of the central bank.

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The QT is mainly a long duration interest rate factor, with about 40 basis points rise in the 10-year U.S. Treasury yield estimated by yearend in DE model simulations—*the Q4 average for the 10-year yield expected to be 3-1/8% compared with 2-3/4% before this assumed Fed Tightening.*

Data Details in Q1—Split on Economy Weak and Inflation High

Real consumption fell a large 0.4% as Nominal Consumption rose only 0.2% with the PCE Deflator up a high 0.6%. Real Disposable Income (-0.2%) also was depressed by the high inflation.

Inflation-adjusted Consumption was weakest in Durables and Nondurables, -2.5% and -1.9%, respectively, big-ticket and other items in Nondurables because of inflation highest mainly in Energy and Food prices.

But, Inflation Ex-Food and Energy was still up a lot, though moderating somewhat at 0.4% for the month, 5.4% YoY, not really offering other than a glimmer of hope that the peak of rising inflation may be near.

So inflation—no peak seen yet!

With these results, PCE inflation in Q1 YoY was 6.5%, a new high for a year-long period of accelerating inflation. Ex-Food and Energy, the figure was 5.4%, also a high.

With the Russia/Ukraine War External Shock price inflation effects still moving through the economy in March and April, the peak of the accelerating inflation can not yet be seen, the earliest perhaps some time in Q2.

The DE forecast is that the peak of inflation will occur in Q2 or early Q3 and then price inflation gradually decline, on average, but still remain at a "Red-Hot" level of 5.2% Q4-over-Q4.

On slowing real economic growth, an easing labor supply, and surprisingly strong growth in productivity, price inflation is expected to decelerate in 2023 and 2024, but even then to land nowhere near the 2% average price stability target of the Federal Reserve.

This issue will have to be confronted by the Federal Reserve in Meetings this year.

Financial Markets

The readings on consumption inflation read pretty much neutral for various markets.

These are marginally negative for Fixed Income and the equity market because of the weaker growth and Stagflation-like appearance of the data.

For the equity market, still within a Correction range but increasingly looking to be out of the Correction, the short-run effect of the data would be neutral to slightly negative.

For interest rates, the too high and accelerating inflation is a negative, though likely already priced-in.

For the U.S. Dollar, the data read neutral to marginally positive.