Economics

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Kevin Warsh's sticky problem

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The new Fed chair Kevin Warsh could have a sticky problem on his hands if he tries to steer the Fed towards a dovish view on inflation in the months ahead. This will be true even if a reopening of the Straits on Friday has oil prices falling further. That is because the challenge will be to make progress on the core measures of inflation that the Fed targets, and elements in that basket where price trends seem likely to be stuck in an elevated upswing.

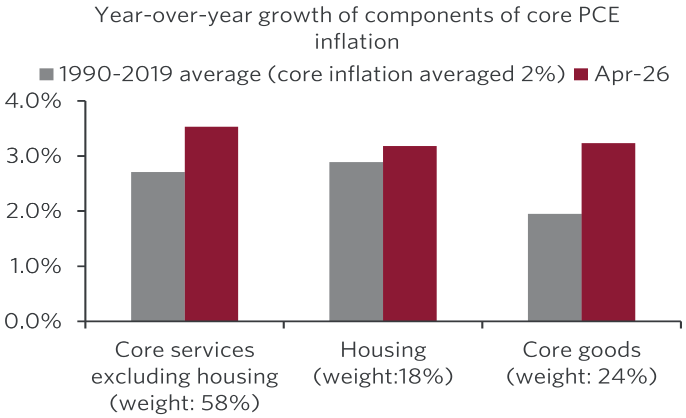
"Supercore" holding up core inflation

Even before the Iran war began, core inflation in the US was at 3% on an annual basis in February, above the Fed's 2% target. In fact, core inflation has been sticky around 3% ever since 2024. Much of this has to do with core services excluding housing, often referred to as "supercore" inflation. It accounts for just over half of core PCE in the US and is currently growing at 3.5% year-over-year (Chart 1). That means that its contribution to year-over-year growth of core inflation is around 2 p.p. and has been stubbornly stable around 2 p.p. since 2021. This leaves little room for contributions from core goods — which have also been adding to core inflation as a result of tariffs — and housing, if the Fed hopes to reach its 2% inflation target.

So why has "supercore" service inflation been so sticky? Two components sticks out recently: (1) health care contribution has been constant as hospital and physician prices are often set through multi-year contracts; (2) financial services contribution has increased since 2023 partly tied to the equity market rally. These two components more than offset the declines in contributions from other services components and food services and accommodation (Chart 2).

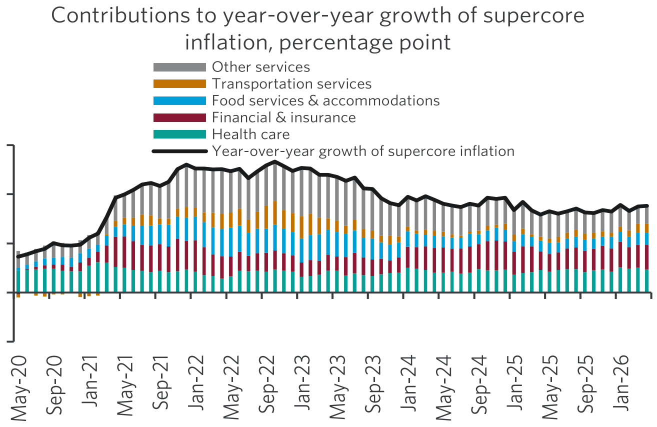
Even without the Iran war, it is hard to imagine that contributions from these two components (health care and financial services) would come down any time soon. Wage growth, which affects many services components is still above 3% on an annual basis albeit easing at a slow pace. And while some components in transportation services such as airfares could come down when the Iran conflict resolves and oil prices decline, their weights are relatively small.

Chart 1: Growth of core PCE inflation components above their historical averages



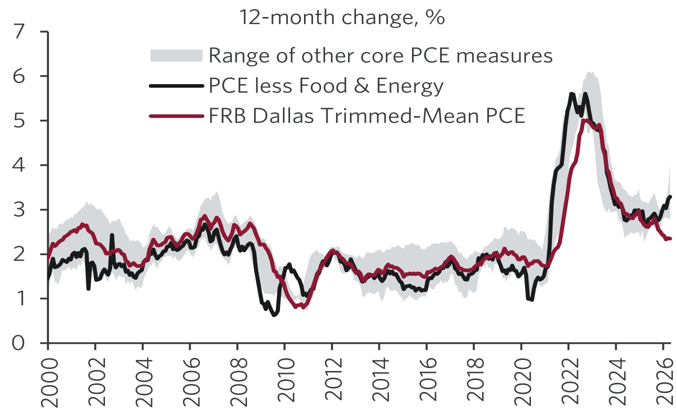
Source: BEA, CIBC

Chart 2: Health care and financial services are the largest contributors to supercore inflation



Source: BEA, FRBSF staff calculations, CIBC

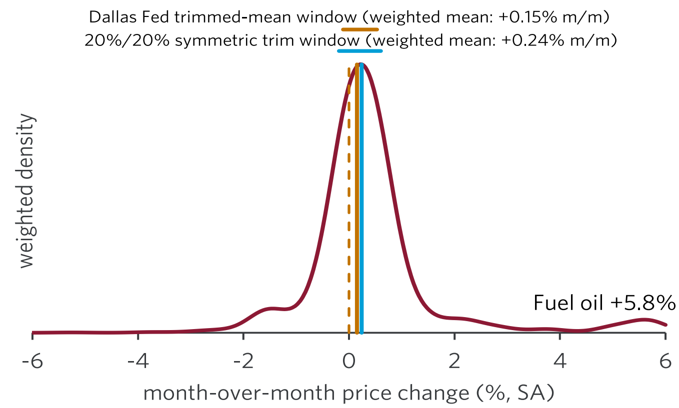
Chart 3: Trimmed-Mean PCE is currently running below other core measures



Note: The other core measures includeded in the range are the multivariate core trend inflation, FRB Cleveland Median PCE inflation and the Market-based PCE excluding food & energy.

Source: BEA, Federal Reserve Bank of Dallas, Federal Reserve Bank of New York via Haver Analytics

Chart 4: Positive skewness in April PCE price distribution



Note: Based on 177 PCE categories from BEA . The monthly weighted mean is the re-weighted average monthly growth of the included components.

Source: BEA, Federal Reserve Bank of Dallas, CIBC calculations

Caution on trimmed-mean PCE due to skewness in price distribution

There has been some discussion of the Trimmed-Mean measure of PCE inflation, something the new Fed Chair has pointed to as an alternative inflation measure at his Senate confirmation hearing. That has been decelerating on an annual basis to 2.35% in April while other core PCE measures have been picking up and range more between 3% to 4% in April (Chart 3). However, the tails of the distribution in Trimmed Mean PCE are not trimmed symmetrically as it drops components more from the upper end of the price distribution (31%) than it does from the lower end (24%). When the measure was first introduced in 2005, fewer categories experienced large price increases than the number with large price drops, so an asymmetric trim was decided to correct for this negative bias in the distribution. However, more recently, with the introduction of tariffs and the energy price shock, the distribution of PCE prices has skewed slightly towards the top. This means the measure is currently underestimating the underlying trend in inflation. For illustrative purposes, if we use the Bank of Canada's trim methodology with a symmetric trim of 20% from top and bottom, the April month-over-month weighted mean would be 0.24% instead of 0.15%, and in line with the monthly reading of the PCE ex food and energy measure (Chart 4).

Could other components balance out the sticky supercore?

Sticky supercore inflation is unlikely to go away soon even when the Iran war gets resolved. Historically, the US was able to achieve a long-run average core inflation of 2% due to zero core goods inflation, about 0.5 p.p. contribution from housing and 1.5 p.p. contribution from supercore services inflation. Currently, just core goods and supercore contributions alone would push core inflation close to 3%. However, the continued easing of shelter prices and the eventual dropping out of the tariff impact on core goods should help to mitigate sticky supercore inflation somewhat.

Getting to 2% core inflation looks unlikely. But a Fed that was looking for an excuse to ease in 2027 could plow ahead with some modest cuts if, as is likely if the Iran war ends, headline inflation is running well below core on a negative annual rate for gasoline. We would need to see some upward drift in the jobless rate as well, a deceleration in the growth rate in AI capital spending, and elevated long rates that keep housing activity muted, could provide that trigger. Until those signs of slowing emerge, sticky supercore inflation will be a sticky problem for the Fed's doves.

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