Soft US Inflation: Temporarily Transient

by Andrew Grantham and Katherine Judge

Continued softness in US inflation is likely to give FOMC members the room to maneuver, and move rates lower, should trade tensions with China persist or escalate. Even though Chair Powell was correct in asserting that much of the slowdown in core PCE inflation has been due to financial management fees, that area of the basket shouldn't be relied upon to grow at near double-digit rates just to keep inflation at the 2% target.

And with equity market volatility returning again, inflation in those fees won't return to prior strength anyways. As such, a wider gap between core PCE and CPI (more akin to historical norms) will persist and the former will remain below 2% through the end of the year.

The Excuse

The excuse that the softness in core PCE inflation was largely due to financial management fees was a good one. At first. Only a month ago, such charges contributed to more than half of the slowdown in core PCE inflation versus its recent peak in March 2018 (Chart 1).

However, that became less of a factor in the most recent month of data, despite core PCE remaining 0.4%-pts below its prior peak. And based on prior correlations, there could be renewed softness on the way for portfolio fees by the time the June data roll in (Chart 2).

There are, of course, other factors impacting inflation readings at the moment. A change in methodology for collecting data, for example, is thought to have contributed to weak readings for apparel prices. That area has accounted for 0.1%-pts of the softening in core PCE recently. However, unlike portfolio management fees that aren't included in the more globally comparable CPI figures, clothing prices are. As such, that factor is weighing on both core PCE and core CPI.

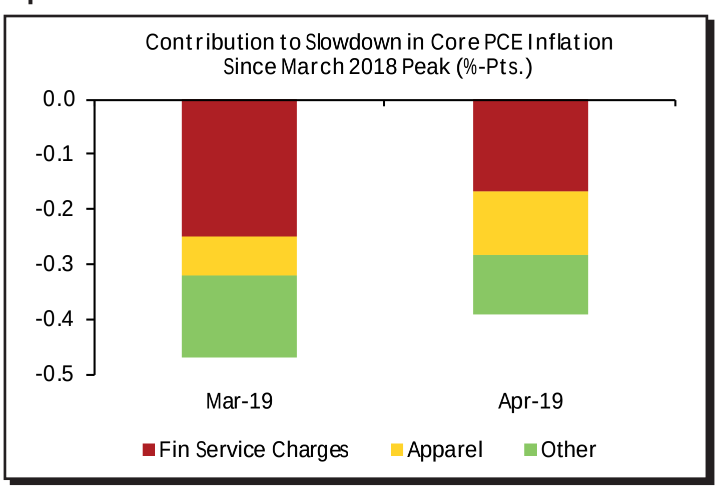
After surging portfolio management fees contributed to a historically small difference between core PCE and CPI last year, we're now back to something more akin to the average difference. The mere 0.1%-pts spread between the two last March, or something even more tilted toward PCE, has only been seen about 20% of the time since 1990 (Chart 3). And most of those instances came in the years following the financial crisis when housing (greater weight in CPI) remained weak but portfolio management fees (only included in PCE) were surging.

Underlying it All

The weakening in core PCE therefore simply reflects the return to a more normal gap, and the slowdown in core CPI as well. However, the underlying trend in inflation hasn't really weakened over the past year, at least according to different measures of underlying inflation

Chart 1

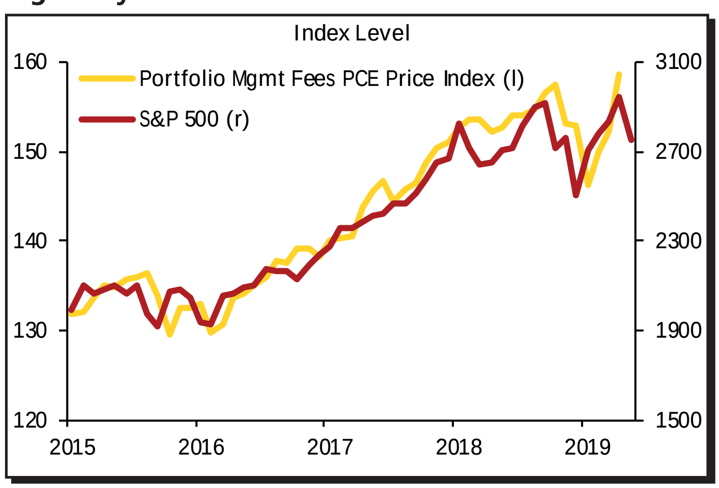
Financial Management Fees Less of An Issue in April vs March



Source: BEA, CIBC

Chart 2

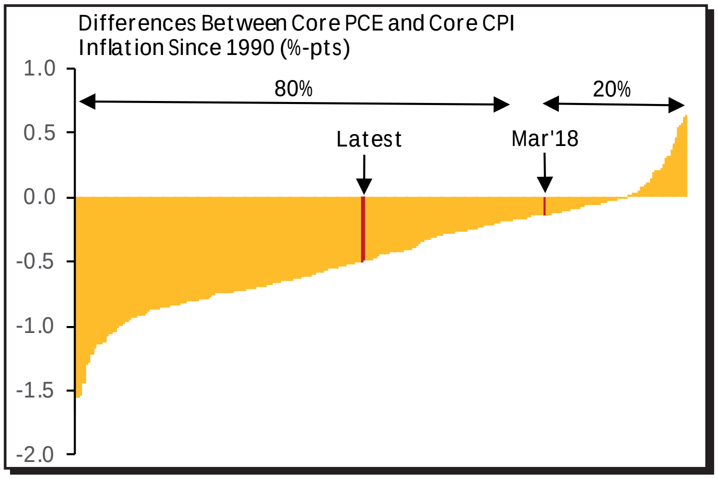
Portfolio Management Fees May Come Down Again by June Data



Source: Bloomberg, BLS, CIBC

Chart 3

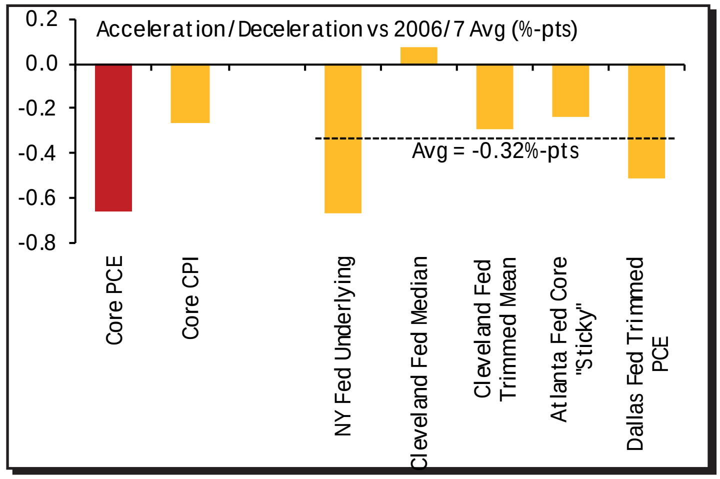
Gap Between Core PCE and CPI Closer to Middle of Range Now



Source: BEA, BLS, CIBC

Chart 5

… But remain Below Last Cycle's Average



Source: BEA, BLS, Regional Fed Boards, CIBC

from various regional Fed economists. Indeed, on average those measures have shown that inflation is a little higher than a year ago (Chart 4).

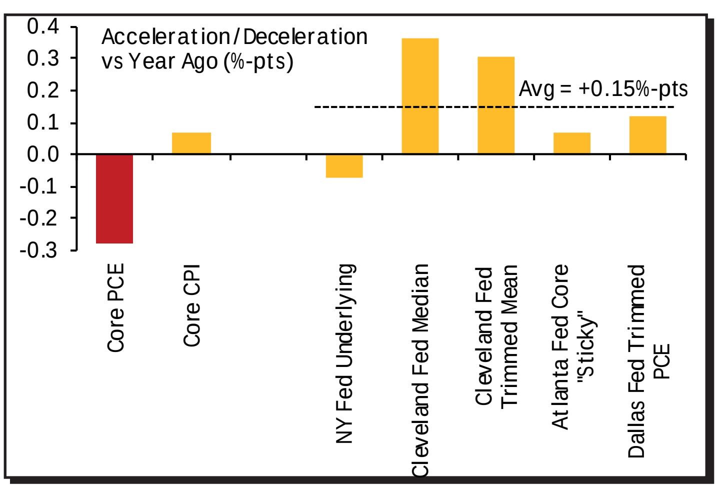
However, that modest underlying acceleration doesn't mean that inflation isn't still a little on the cool side. Looking at those measures of underlying inflation compared to where they stood on average before the Great Recession, most are still lower with the average gap over 0.3%-pts (Chart 5).

And the continuation of lower inflation readings relative to prior cycles is having an impact on inflation expectations. While new and threatened tariffs have seen short-term inflation expectations move higher recently, the University of Michigan's series of consumer expectations for longer-term price pressures remains stubbornly below its prior average (Chart 6). As such, there could be a case for reducing interest rates slightly to boost those inflation expectations.

Given the average gap between core CPI and core PCE, combined with the fact that underlying inflation measures are still not back to their prior-cycle averages, it's unlikely that core PCE will return to 2% in the near-future. And while readings around or just over 1.5% don't scream for immediate interest rate cuts, they do provide FOMC members with the luxury of being able to cut rates a couple of times as growth slows and trade tensions persist.

Chart 4

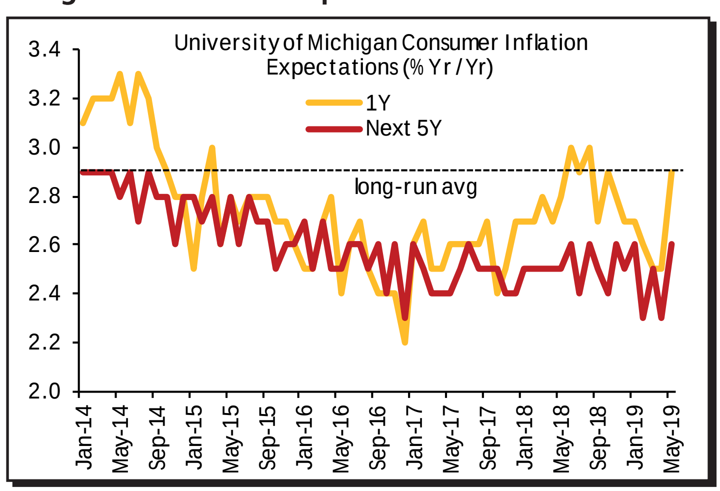
Measures of Underlying Inflation Have Accelerated a Little Over Past Year…



Source: BEA, BLS, Regional Fed Boards, CIBC

Chart 6

Long-Term Inflation Expectations Remain Low



Source: UoM, Bloomberg, CIBC