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## Eyes are back on goods inflation and manufacturing

3 March 2023

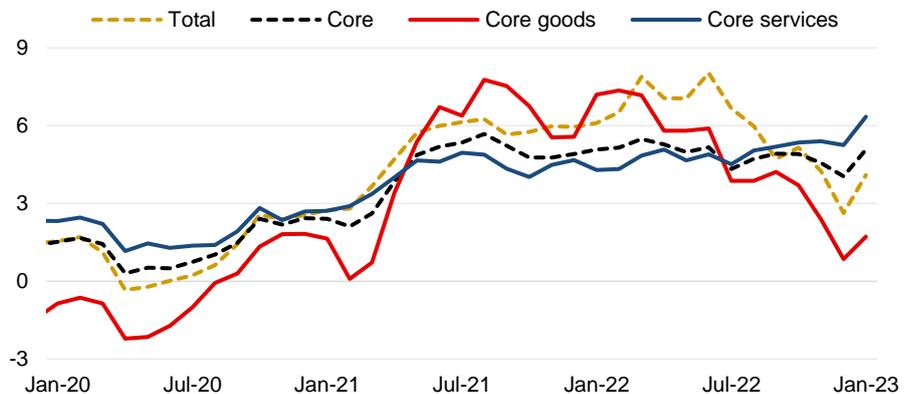
- Core inflation is proving to be stubborn after January's PCE Price Index showed accelerating price growth for core goods and core services. The Fed's preferred measure of inflation is signalling a continued imbalance of supply and demand, which will likely result in a higher terminal rate than previously thought and at least two more rate hikes this year.
- The story hasn't changed for services inflation as it continues to grow, but goods price growth is showing signs of re-emerging after a disinflationary spell. The trend in real consumption of durable goods has been essentially flat since the start of 2022, but the level is still too high to support current production capacity. Average lead times for production materials from the ISM Manufacturing PMI are increasing again, and price growth in core goods is expected to follow.
- New orders for durable goods have been less volatile in recent months, potentially in response to increased recessionary fears. However, construction spending in manufacturing continues to increase rapidly. Manufacturers appear to be betting on long-run demand while remaining conservative in the short-run.
- Month's supply of new and existing homes declined again in January after steep rises in 2022. The trend of new housing supply is closely following that of mortgage rates, but the supply of existing homes is much slower to respond. While housing prices are set to decline, less new construction will prevent any significant improvements in the stock of available houses and will keep prices from crashing.

### The Fed's war on inflation is far from over

Stubborn services inflation has been dominating headlines ever since overall inflation peaked in the summer of 2022. And as of January 2023, services inflation remains high. Low substitution in services means high prices do not deter consumption and sticky prices has lagged effects on certain spending categories. Combined with the lagged effect of housing prices on the PCE Price Index, core services prices accelerated in January 2023 to 6.3% on a 6-month moving average annualized rate, up from 5.3% in December 2022.

#### January inflation accelerated for core good and core services

PCE Price Index, 6-month moving average, % annualized



Source: BEA, MUFG Bank Economic Research

To add fuel to the fire, goods inflation is beginning to rear its ugly head once again. Core goods prices have been driving disinflation, leading some to prematurely declare victory over inflation. January's CPI showed continued disinflation in goods, but at a slower rate. The PCE Price Index, however, showed accelerating goods prices at a 6-month moving average annualized rate. Core goods rose 1.7% in January 2023, up from 0.9% in December 2022.

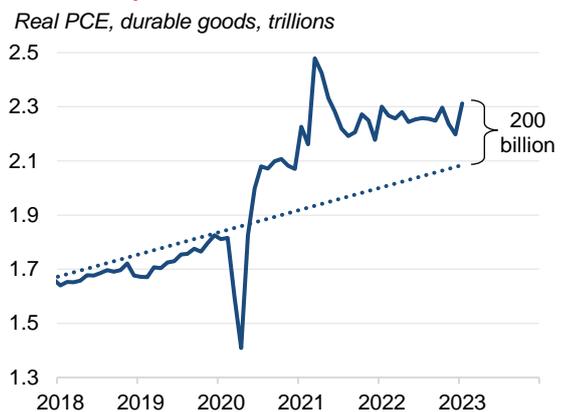
The PCE Price Index is the preferred measure of inflation by the Fed, in part because of how spending categories are weighted compared to the CPI. The Fed's 2% target is generally based off of the 12-month growth rate, but such a long time span can cloud emerging trends and the month-to-month growth rate can be noisy. Observing the annualized growth rate using a 6-month moving average smooths out much of the noise while still preserving the signal.

**Goods disinflation may have come to a halt**

Up to now, the strongest case for the victory over inflation has been on the disinflation of goods, especially durable goods. The imbalance of supply and demand in goods industries has certainly eased relative to when supply chain issues peaked during the pandemic, but that's not to say that current production capacity (supply) can meet current consumption (demand). Inflationary pressures from these imbalances are still present.

Real durable goods consumption has been relatively flat since the start of 2022, but the level is well above the pre-pandemic trend. Historically, recessions produce a downward shift in consumption followed by a stable upward trend. In the case of 2008, it took about four years for real durable goods consumption to return to pre-recession levels. For the COVID recession, it took only two months for the consumption level to return and a year for it to peak. The growth has since slowed, but the massive level shift cannot be ignored. The difference in real personal consumption is about 200 billion above what the trend from 2010-2019 would suggest.

**Durable goods consumption is well above the pre-COVID trend**



Note: Dashed line represents the 2010-2019 trend  
Source: BEA, MUFG Bank Economic Research

This elevated consumption, combined with ongoing labor shortages in manufacturing and supply side issues, has current production capacity still struggling to meet demand. The ratio of unfilled orders to shipments of durable goods, an indicator of pressure on manufacturing capacity, has eased in 2022 but remains historically high at 1.5 as of January 2023. The ratio is down from highs in early 2022 but is above the previous historical high of 1.4 in 2012.

**Pressure on manufacturing capacity has not eased by much**



Source: Census Bureau, MUFG Bank Economic Research

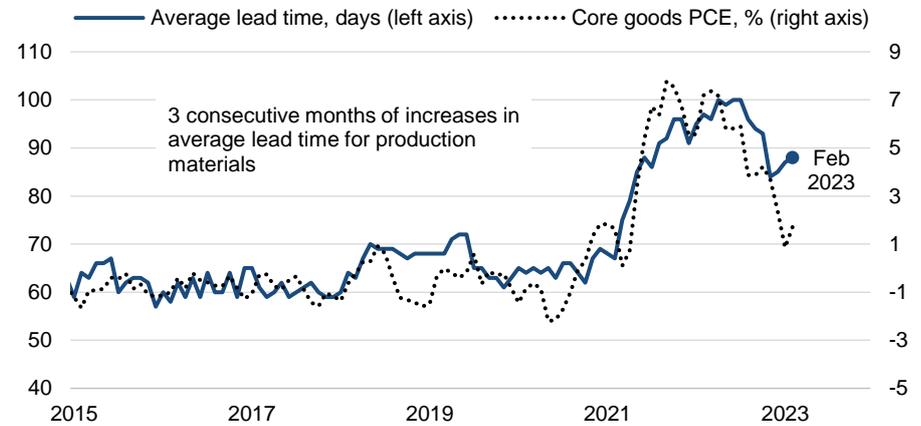
The ratio is down from highs in early 2022 but is above the previous historical high of 1.4 in 2012. Yes, conditions have improved from the peak of the pandemic, but they are still strong enough to keep goods price growth in positive territory.

The direct relationship between these manufacturing pressures and goods prices can be seen when observing lead times. The average lead time between placement and receipt of orders for production materials from the ISM Manufacturing PMI rose for the third consecutive month in February. Goods PCE inflation closely follows lead times, indicating that we may experience further acceleration in core goods prices in the coming months.

### Rising lead times are adding pressure to core goods prices

Average lead time, production materials, days

PCE Price Index, core goods, 6-month moving average, % annualized



Source: ISM, MUFG Bank Economic Research

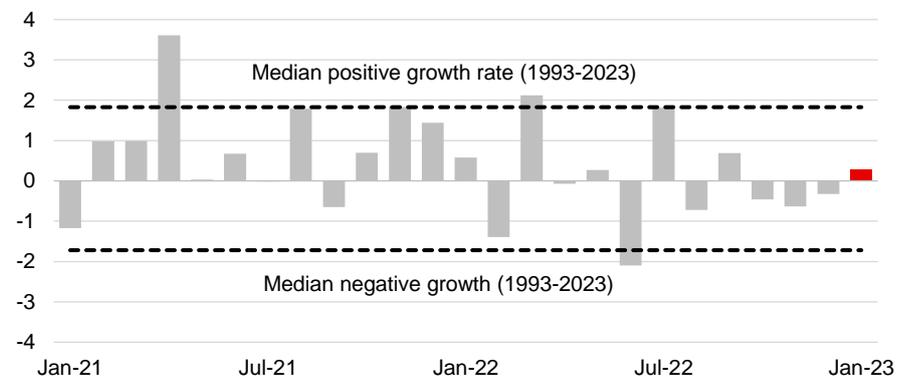
These latest signals showing an upcoming acceleration in goods prices and the earlier mentioned stubbornness of services inflation point to price growth staying above 2% in 2023. The Fed will be keen to not let inflation expectations de-anchor, and a long stretch of greater than normal price increases risks just that. Monetary policy certainly operates with a long lag, but the window for a “wait and see” plan is shrinking. The Fed is more willing to risk overtightening and pushing the economy into a recession than it is allowing sustained price instability. At least two more rate hikes are likely this year as a result.

### Manufacturers are betting on the long run

New orders for durable goods, excluding volatile transportation and government, rose slightly in January by 0.3% following three straight months of small declines. New orders are a forward-looking indicator of the manufacturing sector, but the monthly movements are historically volatile. Lately though, that volatility has been subdued. Historically, the median positive growth rate is 1.8% and the median negative growth rate is -1.7%. In the past six months, the monthly growth rate never exceeded +/- 0.7%.

### New orders volatility has been historically low since mid-2022

Change in new orders, durable goods excluding transportation and government, %



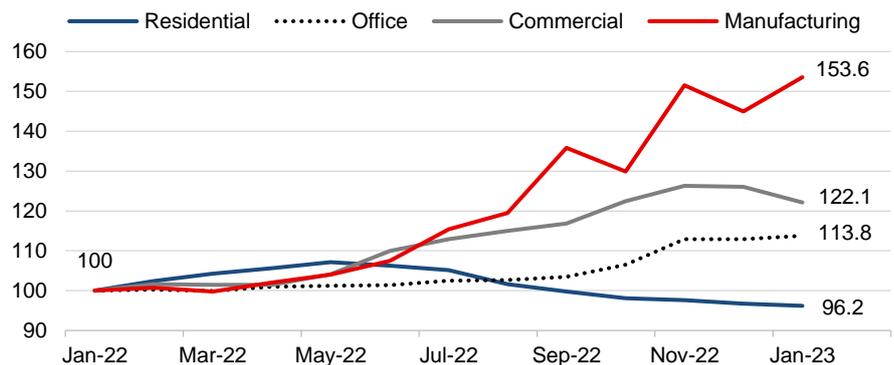
Source: Census Bureau, MUFG Bank Economic Research

Uncertainty about an upcoming recession can potentially explain the low volatility. Manufacturers may be operating more conservatively than they would otherwise. Large swings, either positively or negatively, are unlikely as long as manufacturers continue facing an uncertain near-term outlook.

On the long-term, manufacturers appear to be betting on strong growth. Construction spending on buildings and structures at manufacturing sites has grown significantly since 2020 and continues to accelerate even relative to the start of 2022. Residential construction comprises the majority of spending (about 50%) but the manufacturing sector is not inconsequential (about 8% of spending). Investments in clean energy technology (both for automotive and others) along with other advanced technology (i.e., semiconductors) are sure to support further construction spending in manufacturing.

### Construction spending in manufacturing continues to grow

Construction spending, indexed, Jan 2022=100



Source: Census Bureau, MUFG Bank Economic Research

### Don't expect a crash in housing prices

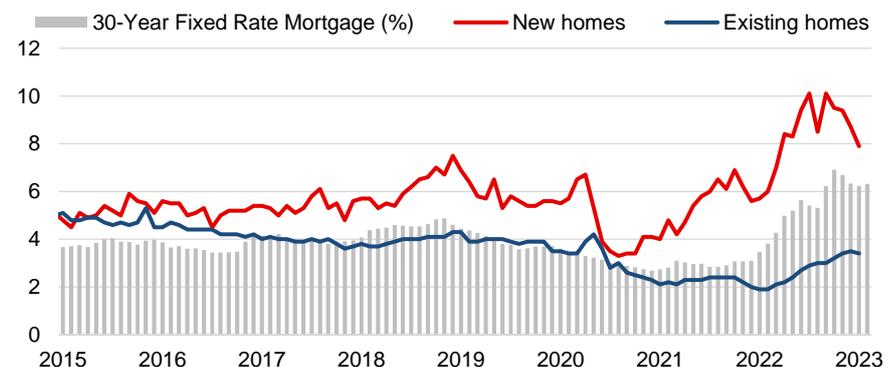
Housing prices continues to trend downward, after peaking in June 2022. The median sales price of existing homes from the National Association of Realtors (NAR) now stands at \$359,000 in January. Given the significant housing shortage, this downward trend is unlikely to be followed by a crash. Existing homes comprise most homes and month's supply has only slightly increased since mortgage rates started to rise in 2022. Supply of new homes has been much more responsive to rising mortgage rates since rising lending rates not only impact potential buyers, but also builders.

The average 30-year fixed rate mortgage has come down in recent months but will rise again if the Fed continues to hike rates in the next few FOMC meetings. We may begin to see housing supply gradually level off, but at a historically low level. Housing prices are set to continue to decline, but historically low supply will likely prevent a crash.

### Housing supply has largely been following mortgage rates

Month's supply of new and existing homes

Average 30-year fixed rate mortgage, %



Source: NAR, Census Bureau, MUFG Bank Economic Research

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