**AGRON NICAJ**
*US Economist*

Economic Research Office

T: +1 (646) 357 6180
E: anicaj@us.mufg.jp

**MUFG Bank, Ltd.**
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# The Fed is right to be cautious

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- Growth in the PCE deflator was notably, and somewhat expectedly, strong this month after both the CPI and PPI also showed accelerated growth. While the PCE and CPI differ on the level of price growth, the expenditure components driving the recent trend are largely the same. Some idiosyncratic factors at the industry level have contributed to the recent acceleration, but growth in cyclical components, especially housing, should not be dismissed. The lagged effects of re-accelerating home prices will likely weigh on the disinflation momentum in the first half of this year.

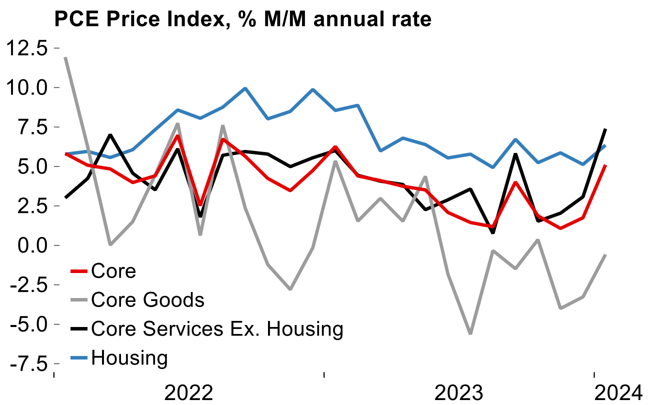

### Don't dismiss the data

Monthly growth in January's PCE deflator came in strong, which was partially expected given that both the CPI and PPI also accelerated this month. Despite the differing methodologies, it does signal potential trouble ahead for the Fed's preferred inflation measure.

Monthly growth in core PCE (excluding food and energy) expanded at an annual rate of 5.1%, the highest monthly growth rate since January of last year (Chart 1). Much of the growth was concentrated in core services excluding housing, where growth accelerated to an annualized 7.4%, the largest monthly growth since December 2021. Personal services contributed to this rise, growing at an annual rate of 14.9% in January. Housing inflation accelerated a bit in January, but the overall trend has been virtually flat since the summer of last year.

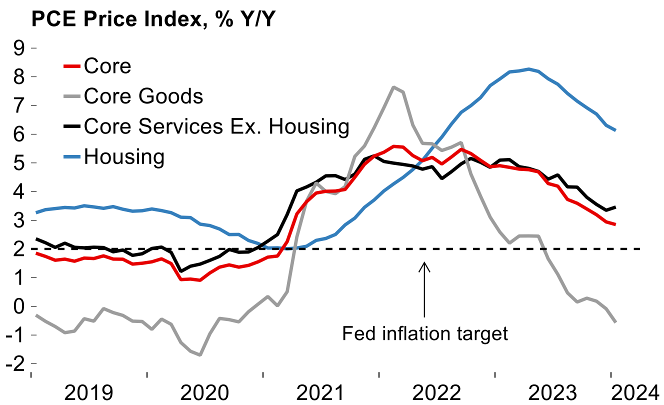
Hardliners insistent on declaring "victory over inflation" will (and have) assert that January's acceleration is an anomaly. Seasonality has been the go-to excuse when official data doesn't align with pre-dispositions, but there is little to no evidence that seasonal behavior, especially for price-setting, is markedly different now than in the past (seasonal factors are calculated using historical data). Seasonally adjusted inflation series' likely still smooth out most of the seasonal volatility.

**Chart 1:** Monthly core inflation accelerated in January, driven primarily by the services sector




Source: BEA, MUFG Bank Economic Research Office

**Chart 2:** Annual core goods deflation is helping to bring core inflation down, but housing poses a risk




Source: BEA, MUFG Bank Economic Research Office

With that said, the overall inflation picture can still be characterized as having disinflationary momentum. Core goods deflation is helping to bring down overall inflation, and the January uptick in core services excluding housing isn't likely to completely reverse the downward trend in core price growth (Chart 2). The risk going forward isn't necessarily that inflation will accelerate, but rather, that disinflation will slow or stagnate. Hardly what the Fed would consider a victory.

**Housing inflation will persist**

Idiosyncratic factors at the industry level likely do play a role in January's increase. This is especially true for expenditure categories that are acyclical, where price changes are less responsive to economic conditions and movements are more independent of the broader macroeconomy (i.e., healthcare). Shown in Chart 3, the inflation contribution of acyclical spending categories reversed course in January, adding 2.4% points to core PCE's monthly annualized growth rate. The contribution was especially strong for non-healthcare categories, where contributions to growth were negative in 5 of the previous 7 months.

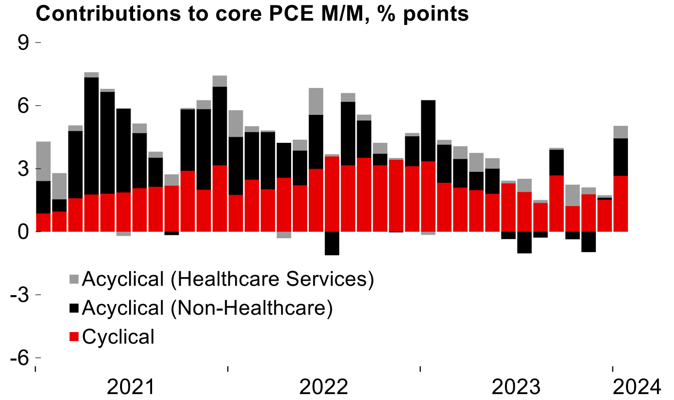
For these spending categories, in particular, there is reason to dismiss some of the growth as being an anomaly (though not all of it). Independent industry factors that contributed to the growth may not be systemic, contrary to supply shortages from the early years of the pandemic.

What should not be dismissed, is price growth in cyclical spending categories that are responsive to economic conditions and monetary policy. Shown in Chart 3, cyclical components contributed 2.7% points to core PCE's monthly annualized growth rate in January, up from 1.5% points in December. Housing comprises the largest share of cyclical spending categories, and as shown in Chart 1, inflation accelerated in January.

Housing inflation from official inflation sources (PCE and CPI) have been contested since prices first started taking off in 2021. Though the PCE and CPI differ in how much weight is given to housing inflation, the general trend and concept of measurement are similar. They both attempt to capture the consumption component of housing for new and existing tenants.

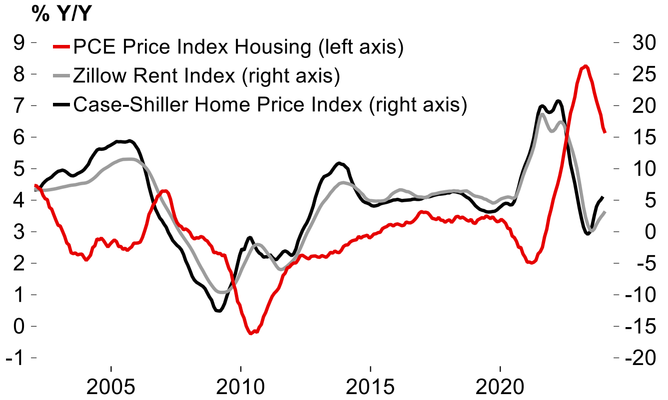
What has been true so far for PCE housing inflation is the predictable lag of private sector measures of new rents and housing prices, given the strong correlation between the series. Severe housing shortages, low vacancy rates, and stabilizing mortgage rates have ensured that demand and construction of single-family homes would rebound. Show in Chart 4, PCE housing lags the Zillow Rent Index and the S&P/Case-Shiller Home Price Index by about 16 months. This relationship suggests that housing inflation will become more consequential for the Fed in 2024.

**Chart 3**: Acyclical spending categories helped push inflation up in January, but the cyclical components are most worrisome




Source: San Francisco Fed, MUFG Bank Economic Research Office

**Chart 4**: Annual growth in PCE housing inflation lags home prices and new rents, signalling future price growth




Source: BEA, Zillow, S&P, MUFG Bank Economic Research Office

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