

Benign US inflation allows the Fed to focus on jobs

The Federal Reserve's favoured price measure is on the correct glidepath to 2% annual inflation. This allows officials to focus more on the growth and jobs backdrop. With income growth looking tepid and households noticing a downshift in the jobs market, pricing for substantial Fed policy easing looks set to persist

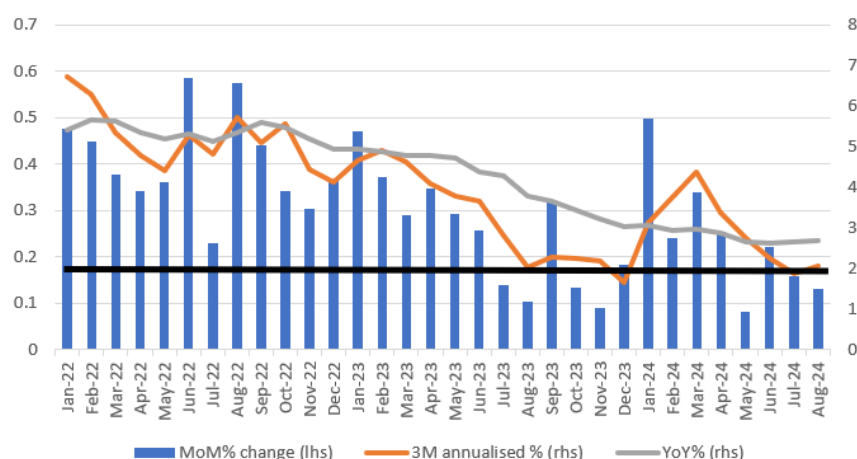


The August core PCE deflator of 0.1% indicates that inflation is headed toward the Fed's 2% target

Inflation is looking more benign

The main focus in the August personal income and spending report is the core PCE deflator, which the Federal Reserve tends to favour as the gauge to watch for underlying price pressures in the US economy. The 0.1% month-on-month outcome is better than the consensus forecast of 0.2% and when measured to 2 decimal places it is 0.13%, below the 0.17% MoM threshold (black line in the chart below) that if repeated over 12 months would generate the targeted 2% year-on-year inflation.

Core PCE deflator MoM%, 3M annualised, YoY%



Source: Macrobond, ING

The YoY rate ticked up to 2.7%, but it should drop back again next month before holding in the mid-2% area through to year-end given the tough comparisons with last year, when MoM readings averaged 0.14% over the final three months of the year. Nonetheless, it should plunge through first quarter 2025 as a series of 0.3% and 0.4% MoM prints drop out of the annual comparison. In any case the Fed is more interested in the monthly run rate, which looks benign, with the three-month annualised rate at around 2%. This gives them complete flexibility on interest rate policy. Instead it is going to be the jobs data that determines the speed and scale of rate cuts over coming months.

Income growth is under pressure

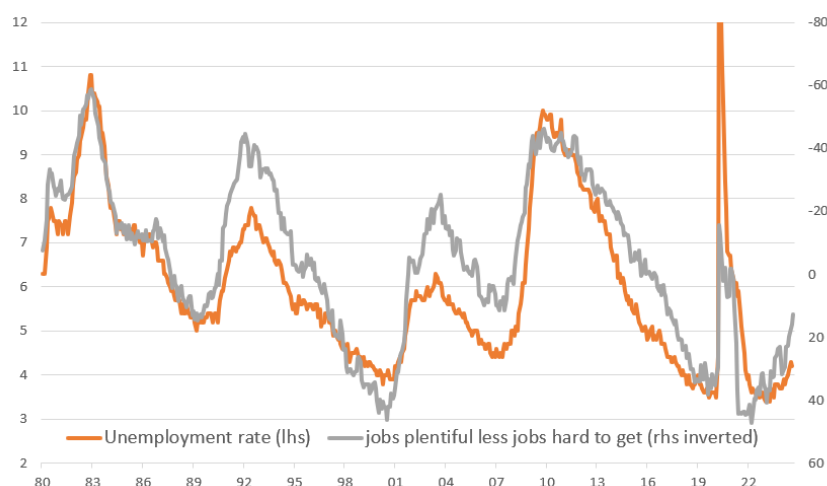
Meanwhile, the personal spending and income report incorporates all the revisions in yesterday's benchmarking exercise with income hugely revised up to magic away the significant discrepancy between the expenditure and the income measure of national output. This leaves the savings rate looking in a better place at 4.8% versus just below 3% before the revision. Nonetheless, real household disposable income rose just 0.1% MoM for the third straight month and is unlikely to pick up meaningfully given the apparent cooling in the jobs market over the summer. This points to weaker consumer spending growth ahead unless households increasingly run down savings and accumulate more debt.

With regard to consumer spending, we continue to highlight the bifurcation going on. According to the most recent data available, the top 20% of households by income accounted for around 41% of total consumer spending, more than the 38% accounted for the lowest 60% of households by income. The situation facing these two groups couldn't be more different.

The top 20% have been far less impacted by inflation, given their incomes are so high, and are far more likely to have stock market wealth and property wealth, which has soared in value. Moreover, high interest rates have likely benefitted many in this income category given they are more likely to either own their home outright or have locked in a long-term mortgage at perhaps rates as low as 3.5%. At the same time they can put their cash in money market funds at what were 5%+ rates. Looking as a whole, everything that could go right financially for this group has gone right and their spending has been very strong.

It is a very different story for the bottom 60% of households. They are more likely to be among the 40% or so of households that rent their home, with rent increases rapidly eating into spending power, while the Fed's tri-annual survey of consumer finances shows they have far less stock market exposure through either direct holdings or their 401k plans. They are also more likely to borrow to finance spending and those high borrowing costs have contributed to sharp increases in loan delinquencies over the past 18 months.

Households are noticing the cooling jobs market and this tends to lead an upswing in unemployment (%)



Source: Macrobond, ING

The jobs market holds the key to the pace of rate cuts

The Federal Reserve interest rate cut may provide a little bit of relief for borrowers, but it will hit the incomes of higher income households. However, the biggest risk comes from the cooling jobs market. The latest Conference Board consumer confidence report suggests households are becoming much more concerned about job security, which implies intensifying headwinds for consumer spending for all income groups. In an environment where inflation is looking much better behaved, the market pressure for ongoing substantial Fed interest rate cuts will persist. If we get the unemployment rate rising back to 4.3% next Friday and a sub 75,000 payrolls print expect the calls for a second 50bp rate cut to grow markedly.

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