Horrible PCE Inflation Report - Fed Needs To Hike In March

Feb. 29, 2024 2:32 PM ET | **S&P 500 Index (SP500), SPX, DJI, NDX** | QQQ, UUP, TLT... |
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Summary

- January core PCE inflation reported at 0.4%, the highest since February 2023, indicating possible acceleration of inflation.
- Services inflation increased by 0.6% in January, the highest increase in the last 12 months.
- The Fed may need to induce a recession to ensure inflation falls to the 2% target.

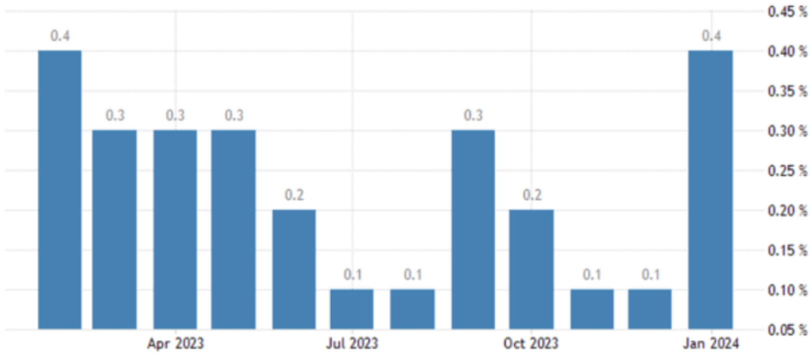
Spencer Platt

January PCE Inflation Report

The Bureau of Economic Analysis reported the much-awaited PCE inflation report for January. This was an important report because: 1) it's the Fed's preferred inflation measure; and 2) it follows up a "hot" January CPI report.

Specifically, the Fed's inflation target is 2% core PCE inflation, which excludes food and energy. Thus, the monthly core PCE should be consistently between 0.1% and 0.2% to get an annual sustained 2% inflation - that's called price stability, and it's the Fed's mandate.

The January core PCE inflation was reported at 0.4%, which is the highest inflation number since February 2023. Obviously, this is a very "hot" inflation figure, and it's consistent with around 4.8% annual inflation.



Monthly Core PCE (Trading Economics)

More importantly, the core PCE inflation at 0.4% in January matches the core CPI for January at 0.4% and confirms that the disinflationary process is stalling and inflation is possibly accelerating.

On an annual basis, the core PCE is still falling due to the base effects, currently down to 2.849%, which is still well above the 2% target. However, if the monthly core PCE data continues to come at 0.3% over the next three months, even the annual core PCE will stall and then start rising during the summer.

Annual core PCE (Trading Economics)

The beginning of a new inflationary spike?

Thus, it is important to understand what was driving inflation higher during the month of January, and determine whether this is the beginning of a new inflationary spike or just a transitory temporary boost to inflation.

The January PCE inflation report shows the following:

- Total PCE increased by 0.3% in January, and the total PCE is split into goods inflation and services inflation. Since the end of the pandemic, goods prices have been falling, while services prices have been sticky. Thus, the Fed is primarily concerned about services inflation. However, the fear is that goods deflation will end and that goods prices will start rising before services inflation falls.

- The goods inflation continues to fall, with a negative 0.2% in January. However, the goods inflation is split between durable and non-durable goods, and durable goods deflation was more pronounced as the post-pandemic supply chain bottlenecks eased.

- However, durable goods deflation ended in January and increased by 0.2% - that's bad news.

- But most importantly, service inflation increased by 0.6% in January, which was the highest increase in service inflation over the last 12 months.

- Thus, when combined, services inflation is accelerating, while durable goods deflation has ended. That's the worst-case scenario, and it signals that inflation is on the rise.

Table 5. Price Indexes for Personal Consumption Expenditures: Level and Percent Change from Preceding Period (Months)

Line		2023							2024	Line
		June	July	Aug.	Sept.	Oct. [r]	Nov. [r]	Dec. [r]	Jan. [p]	
	Chain-type price indexes (2017=100), seasonally adjusted									
1	**Personal consumption expenditures (PCE)**	**120.221**	**120.373**	**120.803**	**121.267**	**121.319**	**121.307**	**121.451**	**121.870**	1
2	**Goods**	**114.794**	**114.492**	**115.390**	**115.588**	**115.267**	**114.630**	**114.363**	**114.169**	2
3	Durable goods	108.390	107.616	107.261	107.154	106.890	106.385	105.898	106.122	3
4	Nondurable goods	118.369	118.354	120.012	120.395	120.040	119.325	119.193	118.745	4
5	**Services**	**122.797**	**123.192**	**123.370**	**123.976**	**124.228**	**124.551**	**124.917**	**125.662**	5
	Addenda:									
6	PCE excluding food and energy	119.189	119.332	119.449	119.842	120.027	120.134	120.308	120.808	6
7	Food [1]	124.790	125.082	125.395	125.770	126.020	125.855	125.912	126.500	7
8	Energy goods and services [2]	134.192	134.319	142.555	144.958	141.367	138.758	138.364	136.436	8
9	Market-based PCE [3]	118.814	118.990	119.437	119.911	120.011	120.000	120.096	120.407	9
10	Market-based PCE excluding food and energy [3]	117.400	117.569	117.658	118.051	118.311	118.438	118.560	118.948	10
	Percent change from preceding period in price indexes, seasonally adjusted at monthly rates									
11	**Personal consumption expenditures (PCE)**	**0.2**	**0.1**	**0.4**	**0.4**	**0.0**	**0.0**	**0.1**	**0.3**	11
12	**Goods**	**-0.1**	**-0.3**	**0.8**	**0.2**	**-0.3**	**-0.6**	**-0.2**	**-0.2**	12
13	Durable goods	-0.4	-0.7	-0.3	-0.1	-0.2	-0.5	-0.5	0.2	13
14	Nondurable goods	0.1	0.0	1.4	0.3	-0.3	-0.6	-0.1	-0.4	14
15	**Services**	**0.3**	**0.3**	**0.1**	**0.5**	**0.2**	**0.3**	**0.3**	**0.6**	15
	Addenda:									
16	PCE excluding food and energy	0.2	0.1	0.1	0.3	0.2	0.1	0.1	0.4	16
17	Food [1]	-0.1	0.2	0.3	0.3	0.2	-0.1	0.0	0.5	17
18	Energy goods and services [2]	0.6	0.1	6.1	1.7	-2.5	-1.8	-0.3	-1.4	18
19	Market-based PCE [3]	0.1	0.1	0.4	0.4	0.1	0.0	0.1	0.3	19
20	Market-based PCE excluding food and energy [3]	0.1	0.1	0.1	0.3	0.2	0.1	0.1	0.3	20

p Preliminary
r Revised

BEA

On an annual basis, goods inflation is still negative at 0.5%, led by negative 2.4% inflation for durable goods. This is likely to change based on the monthly inflation data, and durable goods are likely to start to contribute to the overall inflation.

Service inflation is still very high at 3.9%, and based on the monthly data, it's likely to accelerate.

Table 7. Price Indexes for Personal Consumption Expenditures: Percent Change from Month One Year Ago

Line		2023							2024	Line
		June	July	Aug.	Sept.	Oct. r	Nov. r	Dec. r	Jan. p	
1	**Personal consumption expenditures (PCE)**	**3.2**	**3.3**	**3.3**	**3.4**	**3.0**	**2.7**	**2.6**	**2.4**	1
2	**Goods**	**-0.4**	**-0.2**	**0.7**	**0.9**	**0.2**	**-0.1**	**0.2**	**-0.5**	2
3	Durable goods	-0.5	-1.0	-1.9	-2.3	-2.2	-2.1	-2.3	-2.4	3
4	Nondurable goods	-0.3	0.2	2.1	2.7	1.6	1.0	1.6	0.5	4
5	**Services**	**5.1**	**5.1**	**4.7**	**4.6**	**4.3**	**4.2**	**3.9**	**3.9**	5
	Addenda:									
6	PCE excluding food and energy	4.3	4.2	3.7	3.6	3.4	3.2	2.9	2.8	6
7	Food [1]	4.7	3.7	3.1	2.7	2.4	1.7	1.4	1.4	7
8	Energy goods and services [2]	-17.5	-13.0	-3.5	0.1	-4.6	-5.0	-1.7	-4.9	8
9	Market-based PCE [3]	2.9	3.0	3.1	3.2	2.8	2.7	2.6	2.3	9
10	Market-based PCE excluding food and energy [3]	4.1	4.0	3.6	3.5	3.3	3.2	3.0	2.8	10

p Preliminary
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Implications

The Fed has been very optimistic about the disinflationary process, frequently referring to the "good" inflation data over the "last six months". The Fed was referring to the significant drop in monthly core PCE inflation data in June and July 2023 to 0.1% - this was consistent with the annual 2% target. The revised data also shows that November and December core PCE data was also at 0.1%.

These "low" core PCE readings caused the Fed to prematurely declare victory on inflation in December and signal an interest rate normalization policy. The financial markets significantly loosened since, with interest rates falling, the US dollar (UUP) falling, and the stock market soaring, which led to accelerating economic growth - and rising inflation.

The Fed tried to walk back the optimism in January and signaled a delayed normalization, specifically referring to the need to get "greater confidence" that inflation is falling sustainably towards the 2% target.

The January PCE report, which confirms the January CPI report, clearly shows that the disinflationary process is stalling at the level close to 3%, and that inflation is potentially accelerating, which will become evident after the base effects expire in early summer.

Obviously, with the labor shortage and the unemployment rate at 3.7%, inflation can only go higher from here, and this is shown in the accelerating service inflation, and the rising durable goods inflation.

Thus, the Fed may have to induce a recession to ensure that inflation sustainably falls to the 2% target - the unemployment rate has to increase.

The Fed is currently projecting 3 cuts in 2024 based on the December Summary of Economic Projections. However, the Fed is likely to revise the SEP at the March meeting to show less than 3 cuts, possibly signaling no cuts in 2024.

However, even this is likely not sufficient, the markets don't take the Fed seriously. During the entire hiking campaign, the markets have questioned the Fed's resolve to tighten the financial markets and continuously priced the interest rate cuts.

Given the January labor report, and January inflation data, the Fed should hike interest rates in March. Obviously, the policy rate is not sufficiently restrictive, and the neutral rate is likely much higher than currently projected.

However, the Fed is unlikely to hike in March, but the FOMC is likely to be more hawkish - signaling a return to higher-for-longer and delaying the normalization indefinitely.

Market reaction

The initial market response to the January PCE report is consistent with the media reports - positive.

The media focused on the annual PCE data, which still shows disinflation due to the base effects: "Fed's preferred inflation gauge logs lowest annual rise since March 2021."

The bond market reaction is also surprisingly positive, with interest rates initially falling (TLT, SHY) and December Federal Funds futures are still pricing 3 cuts in 2024 (the price level in the chart below of 95.4 is consistent with 4.6%)

December 2024 FF futures (Barchart)

The stock market initially increased, led by NVIDIA Corporation (NVDA), and Nasdaq 100-Index large-tech stocks (QQQ).

The point is, the market is still not taking the Fed seriously because the Fed is not taking inflation seriously. Thus, the GenAI bubble continues to inflate, and it's all leading to a painful end to investors ignoring the macro data.

Given that the GenAI bubble is still on the upswing, my recommendation for the S&P 500 Index (SP500) is still a Hold. But I am aware that the stock market "takes the escalator higher and elevator lower." Once, the bubble bursts, the correction could be deep and swift, and I am starting to position accordingly.