

US Macroeconomics

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Some Optimism Around the Super Core

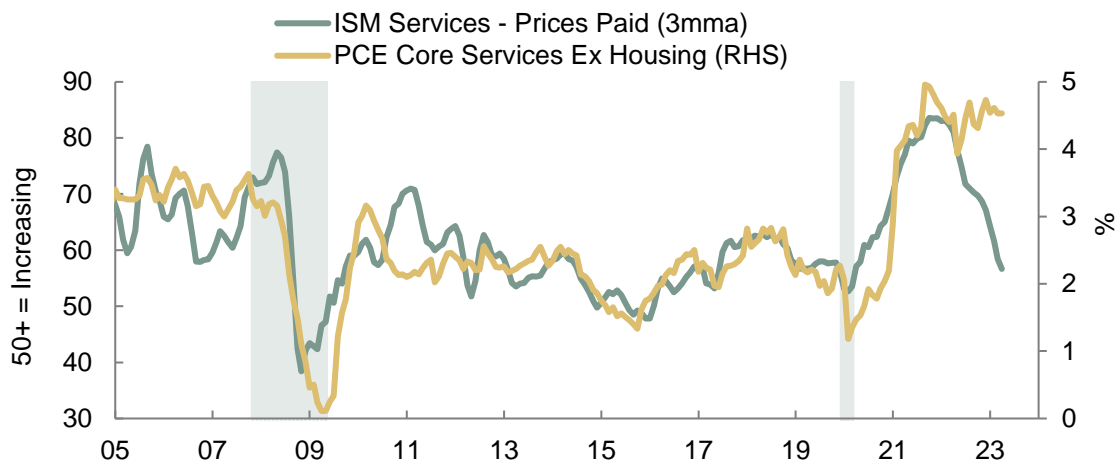
Late last year Chair Powell introduced a variation on the core personal consumption expenditures (PCE) deflator that policymakers were newly focused on. It was core PCE services excluding housing. While this series captured only about 55% of the overall core PCE, this Fed “super core” series was thought to be highly dependent upon labor costs since they are the dominant input into the pricing of services.

If an excessively tight labor market leads workers to demand higher wages, companies will pass along these higher costs onto consumers. Therefore, the Fed wants the unemployment rate to rise as it will dampen worker wage demands or so the theory goes. Leaving aside whether this is true in practice—our work found the opposite, that super core prices tend to lead wages and not the other way around—there is some evidence pointing to a sharp drop in inflation in the months immediately ahead. If so, current monetary policy is much too restrictive because there is more inflation progress being made than what is assumed.

In the chart below, we graph the three-month moving average of the prices paid series in the ISM services survey versus the year-over-year change in core PCE services excluding housing. The two series are plotted contemporaneously and have a high 0.80 correlation coefficient. Historically, they tend to move closely together or at least until recently when a yawning gap has opened between the two. The key question for the Fed and investors is how this divergence is resolved.

Will the super core soon follow prices paid in the ISM service survey lower? Conversely, will they rebound higher to match the elevated growth rate in the super core? Or will both series meet in the somewhere in the middle of the gap, with super core falling some and the ISM prices rising some?

Our best guess is core PCE services excluding housing weakens substantially in the months ahead because this would be consistent with other series which are already showing noticeable deceleration in the rate of inflation such as the consumer price index for services less shelter and producer prices for final demand services. Data on the former is released tomorrow while data on the latter is released Thursday so we eagerly await the results.



Sources: ISM, BEA, Haver, SMBC Nikko

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