US Macroeconomics

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Both Roads Lead to Lower Prices

Core inflation is trending lower for two reasons: First, supply-chain disruptions associated with the global pandemic have massively eased. And second, the economy is slowing, which will lead to fewer wage demands, thus putting downward pressure on input costs. Consequently, **concern that inflation will be sticky is misplaced**. Instead, policymakers should be more worried they have tightened rates too much.

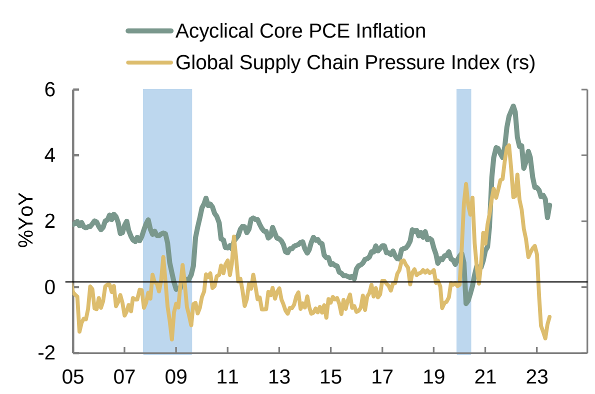
The Fed's preferred inflation metric is the core PCE deflator although Chair Powell has highlighted a variant, which is core PCE services less housing. Our analysis, which focuses on the former, does not change if we look at this narrower measure of inflation.

As we have highlighted on several occasions, the San Francisco Fed breaks the core PCE deflator into two parts: One component measures acyclical prices, which are those components whose price is independent of the economy's performance. These prices are not correlated with the unemployment rate. For example, this would include education and healthcare. The other component measures cyclical prices, which are those components whose price is dependent on the economy's performance. These prices are highly correlated with the unemployment rate. This would include recreational services, residential rents, and restaurant sales.

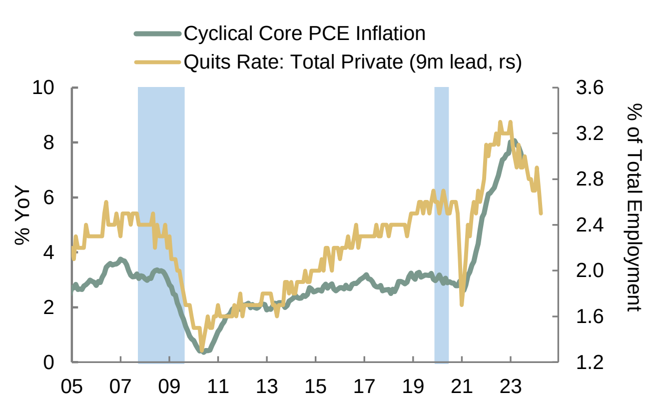
According to our calculations, **most of the runup in core PCE deflator was the result of soaring acyclical prices**—they accounted for 80% of the increase in the inflation rate and were the direct result of covid-related shutdowns which disrupted global supply chains. This is evident from the left-hand side chart below, which shows the New York Fed global supply chain pressure index. To note, the series soared during the pandemic and peaked in December 2021. But as the global economy has normalized, supply pressures have collapsed, and currently the series shows downward pressure as it is back to levels seen during the 2008-09 recession. Acyclical prices will continue to slow.

At the same time, cyclical prices are moderating too, the result of a cooling labor market. The quits rate, which leads both the unemployment rate and wage demands, continues to slow. Consequently, quits are back to their pre-covid levels. This suggests that cyclical prices (with a lag) will fall significantly further as illustrated in the right-hand side chart below.

Based on the trends in acyclical and cyclical prices, the core PCE deflator could be back to a 2% rate sometime next year. But if the economy goes into recession, inflation is likely to be even lower. This is a factor monetary policymakers should consider as they debate the need for another interest rate hike.



Sources: FRBSF, FRBNY, Haver, SMBC Nikko



Sources: FRBSF, BLS, Haver, SMBC Nikko

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