

## US FEBRUARY CONSUMPTION SOFT, BUT REBOUND LIKELY, INFLATION FIRING

*\*Consumption advanced 0.2% m/m in February and was unchanged in inflation-adjusted terms, a continued modest retracing of the robust holiday season (real consumption fell 0.2% in January), but fundamentals point to a March rebound (Chart 1)*

*\*Personal incomes rose by a solid 0.4% for the third consecutive month and disposable incomes rose 0.4% following its robust 1.0% rise in January. The rate of personal saving has been bouncing around and we expect it to recede in coming months as spending picks up (Chart 2)*

*\*The headline and core PCE price inflation rose 0.2% m/m (+1.8% yr/yr) and 0.2% m/m (+1.6% yr/yr), respectively, suggesting moderate inflation. Note that the PCE deflator yr/yr increase is expected to jump in the March reading as the one-time decline of March 2017 rolls off. Nevertheless, the core PCE deflator measure of **inflation is expected to remain below the Fed's 2% target in coming months, but we expect it will rise to the Fed's target later this year and modestly above 2% in 2019** (Chart 3)*

### Consumption

Real consumption is on track to increase only 0.6% annualized in Q1, but this is on top of the robust 4% annualized rise in Q4. We expect consumer spending to pick up decidedly beginning in March in response to rising employment and personal income and higher take home pay as a consequence of the Tax Cuts and Jobs Act, as well as elevated confidence. Households are particularly confident about the state of labor markets (Chart 4). Even though surveys show that consumers are less bullish about stock prices in 2018, they have higher expectations about future incomes.

Foreign trade data indicate that retailers remain bullish on the consumer outlook, with real consumer goods imports surging 6.5% yr/yr in January, the best gain since last May and an all-time high. Retailers are restocking after the bumper holiday shopping season that pushed inventory-sales ratio very low (Chart 5).

Real consumption on durable goods rose 0.6% m/m after a sharp 1.6% fall in January, but nondurable goods consumption fell for the second consecutive month and services consumption increased only slightly in part due to a warmer-than-usual February that required less heating demand – expect a smaller drag from this category in March. Better spending on recreational goods and vehicles and services in February reflect consumers' **continued willingness to spend on non-essential goods** (Chart 6).

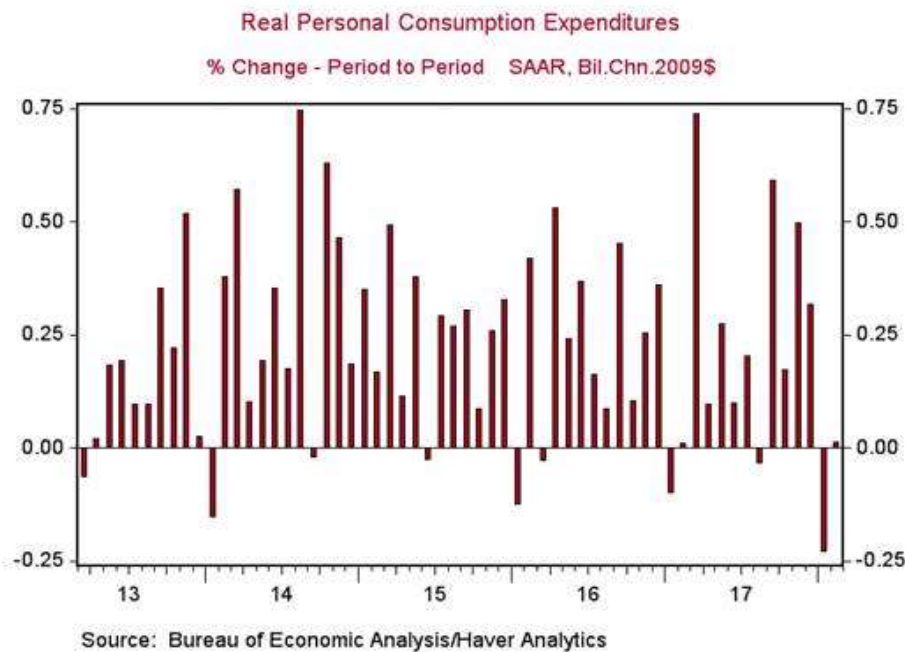
### PCE Price Index

Core inflation has firmed significantly in recent months, increasing by 2.8% and 2.3% on a three-month and six-month annualized basis, respectively. The 2.8% three-month annualized increase is the highest in this recovery by far (Chart 7). This trend is likely to keep the Fed's gradual normalization of interest rates on track. Idiosyncratic factors, such as the steep decline in cellphone service prices, that suppressed inflation in early 2017, will roll off the yr/yr measure in March and could add 0.1pp to yr/yr core PCE inflation. We expect core PCE inflation to reach 2% later this year.

29 March 2018

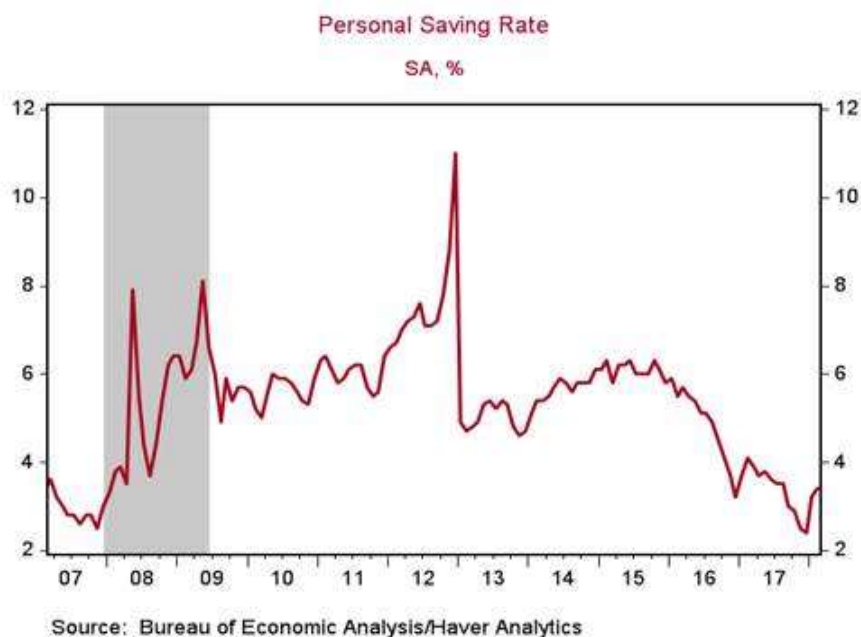
The Fed also forecasts core PCE inflation to rise modestly above 2% in 2019 and 2020. This explicit forecast of above-2% inflation suggests that the Fed is taking the symmetry of its inflation target seriously after a handful of years during which inflation fell short of 2%. The Fed is comfortable with the current strength in the economy, but when inflation rises above 2%, the question is will the Fed actually remain tolerant of the economy running hot.

Chart 1: Real Personal Consumption Expenditures (month-over-month, %)



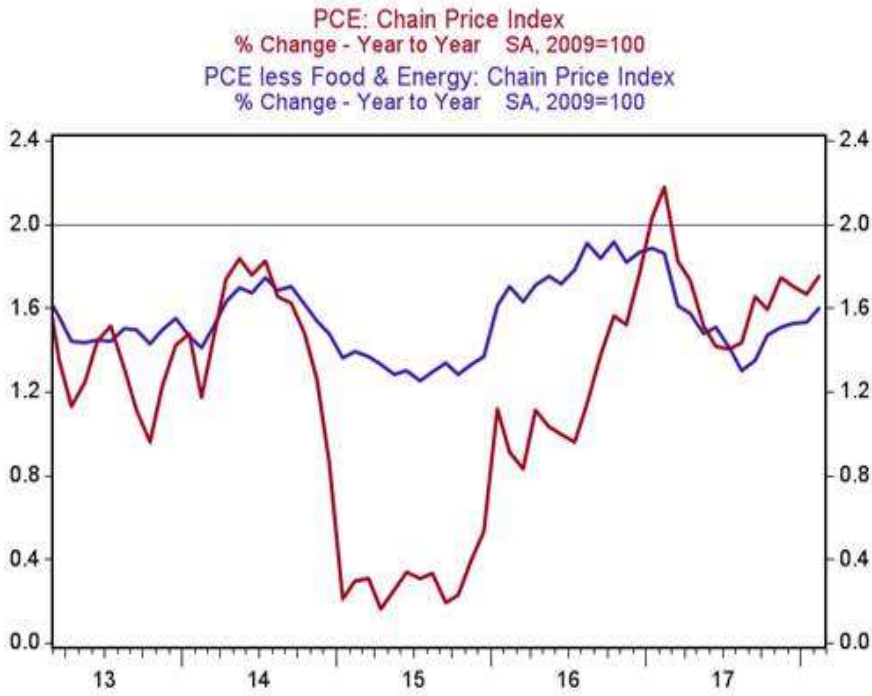
Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 2: Personal Saving Rate (%)



Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 3: PCE Deflator: Headline and Core (year-over-year, %)



Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 4: Share of Consumers Viewing Jobs as Hard to Get vs. Plentiful



Source: The Conference Board/Haver Analytics

Source: Monthly data. Source: The Conference Board and Haver Analytics

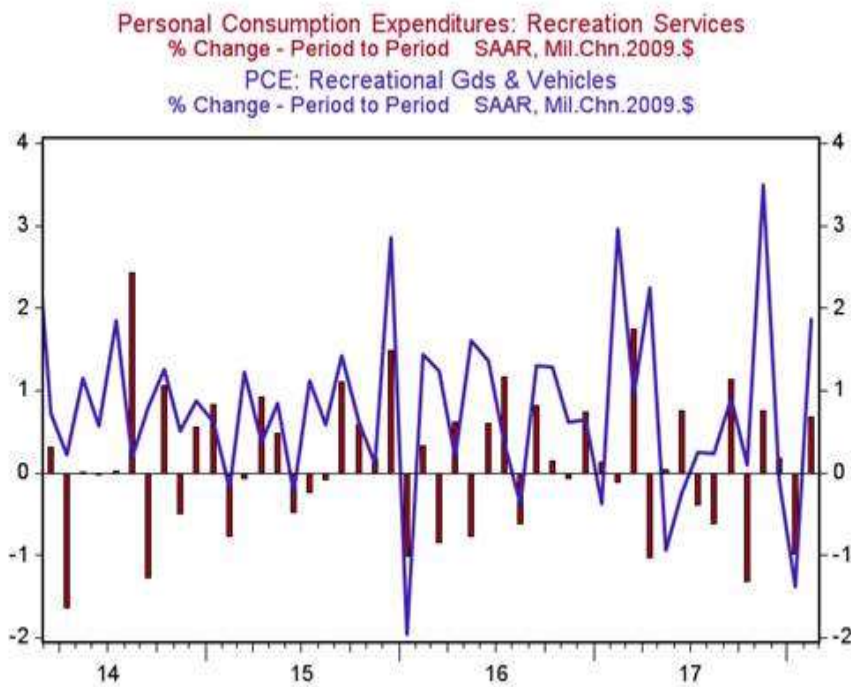
Chart 5: Inventory-Sales Ratio for Retail Trade (inflation-adjusted)



Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

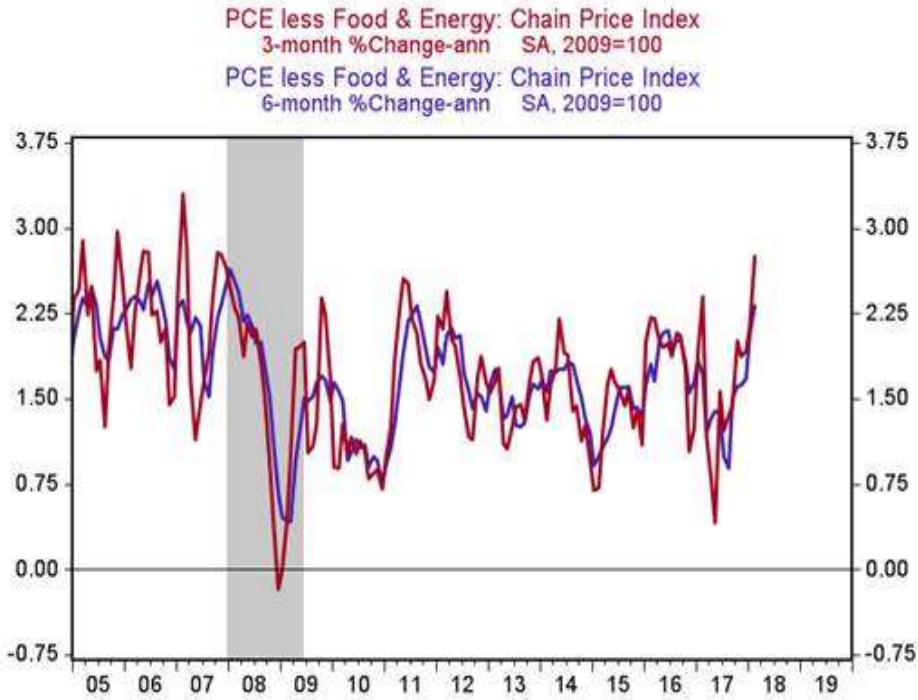
Chart 6: Real Private Consumption on Recreational Services and Goods and Vehicles



Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

Chart 7: Core PCE Inflation: 3-mth and 6-mth Annualized Percent Change



Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics

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