US CONSUMPTION STARTS Q3 ON SOLID NOTE; INFLATION AT FED’S 2% TARGET

*The July U.S. Personal Income and Spending report suggests that momentum carried over into the consumer sector in Q3. Current-dollar consumption increased by 0.4% m/m in July, the fifth consecutive monthly gain of at least 0.4%. Real consumption (adjusted for inflation) rose by 0.2% m/m and 2.8% yr/yr, its best increase since last November (Chart 1).

*Personal incomes rose by 0.3% m/m in July, supported by solid wage and job growth. Disposable incomes rose by 0.3% m/m, and the saving rate inched down to 6.7% from 6.8% but remains elevated. Real disposable incomes increased by 0.2% m/m in July, pushing its yr/yr change down by 0.1pp to 2.9% - still robust enough to support healthy consumption gains (Chart 2).

*The Fed’s preferred price measures were in line with expectations in July. The headline PCE price index increased by 0.1% m/m, lifting its yr/yr change to 2.3% from 2.2%, and the core PCE price index rose by 0.2% m/m, lifting its yr/yr change to 2% from 1.9% (Chart 3). For the third time since March, both headline and core PCE inflation are at/above the Fed’s 2% target pointing to further policy rate hikes but at a gradual pace as the Fed is comfortable with inflation modestly above 2%

Personal Consumption

Real consumption of nondurable goods (+0.6% m/m) and services (+0.2% m/m) both increased in July, but durable goods consumption fell by 0.5% m/m. Solid consumption gains in the following discretionary goods and services reflect elevated consumer optimism: restaurants (+1.1% m/m), recreational goods and vehicles (+0.3%), clothing and footwear (+1.5%).

The trend that probably best reflects the improved financial positions of households and their willingness to spend on discretionary services is the sharp run-up in sales at restaurants (Chart 4). After slumping for two years, consumption at restaurants (adjusted-for-inflation) was up by a strong 5.7% yr/yr in July.

We expect a 3% annualized increase in Q3 consumption - a moderation from the bumper 3.8% Q2 gain - that should support -3% real GDP growth. Consumer fundamentals are solid. Consumer confidence jumped to a near 18-year high in August, reflecting the strong labor market and the equity market rally. The high saving rate suggests that consumers have a sizable cushion for “rainy days” and room to dig more into their savings and boost current spending.

Strong consumer demand has pushed the inventories-to-sales ratio in the retail sector to cycle-lows. Given expectations for another solid holiday shopping season we expect retailers to replenish inventories this fall boosting imports, and production demand (“US Q2 inventory liquidation points to healthy production growth in H2”, August 8, 2018).

PCE Price Index

The underlying inflation trend is stabilizing around 2% after the initial jump earlier this year, with the three-month annualized change in the core PCE price index at 1.9% in July (down from 2.3% in March) and the six-month annualized change at 2% (down from 2.2% in May). See Chart 5.
Note that core services prices (excludes energy) has driven broader inflation for the last 5.5 years, with core goods prices declining consistently (Chart 6). Core services prices rose by 2.8% yr/yr in July - boosted by stronger domestic demand and labor markets - while core goods prices declined by 0.6%.

Fed Chair Powell, in his speech at the annual Monetary Policy Symposium at Jackson Hole last week, emphasized the importance of anchored inflation expectations in achieving monetary policy goals (Fed Chair Powell stresses gradualism due to uncertainty with estimates of key longer-run variables”, August 24, 2017). Inflation expectations are currently well-anchored although they are below where the Fed would like them to be (Chart 7). Anchored inflation expectations and the symmetry of the Fed’s 2% inflation target suggest that the Fed will continue to normalize its policy at a gradual pace even if inflation modestly exceeds its target for some time.

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

![Chart 1](image)

Source: Bureau of Economic Analysis/Haver Analytics

Chart 2: Real Disposable Personal Income (year-over-year, %)

![Chart 2](image)

Source: Bureau of Economic Analysis/Haver Analytics
Chart 3: PCE Price Index: 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: Real Personal Consumption Expenditures: Food Services

Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics
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Chart 5: 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

Chart 6: Core Services and Core Goods Prices (year-over-year, %)

Source: Bureau of Economic Analysis/Haver Analytics

Source: Monthly data. Source: Bureau of Economic Analysis and Haver Analytics
Chart 7: University of Michigan: Consumers’ Inflation Expectations, 5 Years Ahead

Source: University of Michigan/Haver Analytics

Source: Monthly data. Source: University of Michigan and Haver Analytics
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