Markets Shake Off US Data Conundrum

United States, Personal Income / Consumption, % m/m, May:
Actual: 0.4 / 0.2
Consensus: 0.4 / 0.4
Scotia: 0.4 / 0.3
Prior: 0.2 / 0.5 (revised from 0.3 / 0.6)

United States, PCE / core PCE deflators, y/y % change, May:
Actual: 2.3 / 2.0
Consensus: 2.2 / 1.9
Scotia: 2.2 / 1.9
Prior: unrevised from 2.0 / 1.8

- The conundrum raised by this morning's updates is that inflation climbed by more than anticipated while growth signals disappointed. On balance, US markets largely shook off the release likely because of this mixed set of readings whereas if anything it should raise conviction that the Fed is on track with the inflation half of its dual mandate goals.
- Core inflation climbed to 2% y/y which matched only four out of 36 estimates to the high side of consensus. Headline inflation also exceed consensus expectations. At the margin, this puts inflation in line with the Fed's policy goals.
- On the price deflators, however, the rise may be driven by somewhat transitory considerations. One is gasoline prices with energy up 12.8% y/y. Two is that there are the transitory upsides of some one-off components that were exerting transitory downsides last year, such as mobile phone service pricing. Telecommunication service prices were down 6 ½% y/y at the worst point in March 2017 but they are now down by only ½% y/y. Three is probably the temporary lagging effect of prior dollar movements. Recall that the Fed's estimate of the dollar's effects on core PCE is that for every 10% appreciation/depreciation in the broad dollar, core PCE falls/rises by ½% within two quarters and 0.3% over the course of a year as the effects gradually wane. As the dollar appreciated into early 2017, it played a role in taking down inflation over 2017. As that dollar move reversed ever since, it is playing a role in driving core PCE inflation higher. The broad dollar has been stronger over the past couple of months which—if sustained—may point to flattening or downside pressure on inflation into late year or early next. Also consider that there is no real wage growth in the US (ie: after inflation). So there is a decent case for the Fed not to get too carried about with being at its inflation target given several of the drivers are transitory and the Fed should look through currency effects. To tighten policy more aggressively than communicated through fed fund target rate hikes and balance sheet unwinding risks not being cautious enough in the face of drivers of inflation that may not repeat with similar upsides in future.
- **The caveat is that growth tracking in the US will be revised down a touch.** Real consumer spending in the US was revised down a tick to 0.3% in April and came in flat in May. US consumption growth is now tracking 2.3% q/q SAAR in Q2 which will be a significant downward revision to nowcasting GDP. This follows consumption growth of 0.9% q/q SAAR in Q1 so there is

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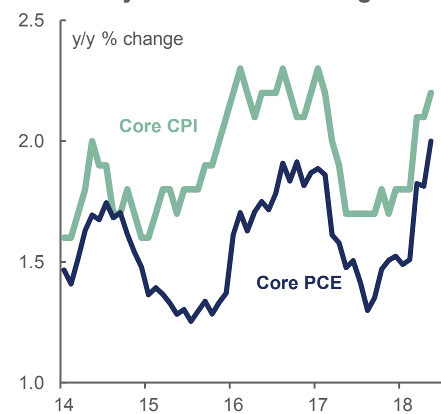

Sources: Scotiabank Economics, Bloomberg.

not that much release of pent-up demand occurring after all. So far, that pours cold water on the theory that consumption would get a tax boost and leans more toward favouring former Fed Chair Yellen's recent assertion that such expectations were being exaggerated. If consumers are temporarily hording income gains by raising the saving rate then there could still be a transitory boost to consumption forthcoming but almost half a year into the Tax Cuts and Jobs Act hasn't brought the consumer out in droves and, given the regressive nature of the tax changes, is unlikely to do so. My bias remains in favour of a more cautious Fed ultimately over time than expectations for accelerated hikes signalled in the dot plot.

- **The narrowly defined saving rate off of disposable income climbed by two-tenths to 3.2%.** That's off the 2.4% bottom in December as households horde some of the income gain in Q1 but it understates saving the way most households look at it by excluding most sources of gains in net wealth. Household net worth has been climbing sharply over the past couple of years relative to disposable income.

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