ECONOMIC UPDATE

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August Personal Income/Spending: Ah, Sweet Mystery Of Inflation

- Personal income rose by 0.2 percent in August, personal spending rose by 0.1 percent, and the saving rate was unchanged at 3.6 percent.
- The PCE deflator rose by 0.2 percent and the core PCE deflator rose by 0.1 percent in August. Year-on-year, the PCE deflator was up by 1.4 percent and the core deflator was up by 1.3 percent.

Total personal income rose by 0.2 percent in August while total personal spending was up 0.1 percent, both matching our forecasts. The previously reported 0.4 percent increase in personal income in July was revised down to a 0.3 percent increase. The personal saving rate held at 3.6 percent in August, as nominal disposable personal income was up by 0.1 percent. Perhaps the bigger story in the August data is that inflation came in lighter than expected (okay, stop us if you've heard that one before), with the total PCE deflator up by 0.2 percent and the core PCE deflator up by 0.1 percent – our forecast anticipated increases of 0.3 percent and 0.2 percent, respectively. This leaves total PCE inflation at 1.4 percent and core PCE inflation at 1.3 percent.

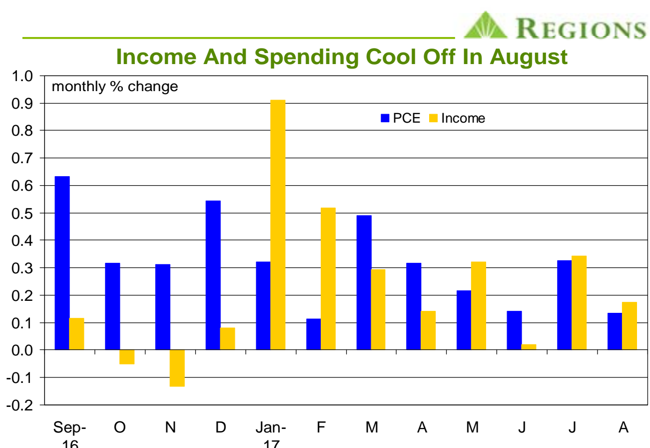
Our low expectations for August personal income stemmed directly from the underwhelming August employment report. On top of a below-trend increase in private sector employment, August also saw a decline in the average length of the workweek and a tepid 0.1 percent increase in average hourly earnings. That's a bad combination for growth in aggregate labor earnings, as the August personal income data bear out; aggregate private sector wage and salary earnings were flat in August, and government sector earnings were up just 0.1 percent. If there is a glimmer of hope here, it is that over the past several years the initial estimates of job growth in August tend to be revised significantly higher in subsequent months, which can also filter through to the first estimates of hours worked and hourly earnings. As such, we won't be surprised to see these initial estimates of August labor earnings revised higher over coming months. Elsewhere, dividend income was up 0.2 percent, rental income was up 0.7 percent, and interest income was up 0.2 percent for a second straight month. As it now stands, total personal income was up 2.8 percent year-on-year in August. Real disposable personal income was down 0.1 percent in August.

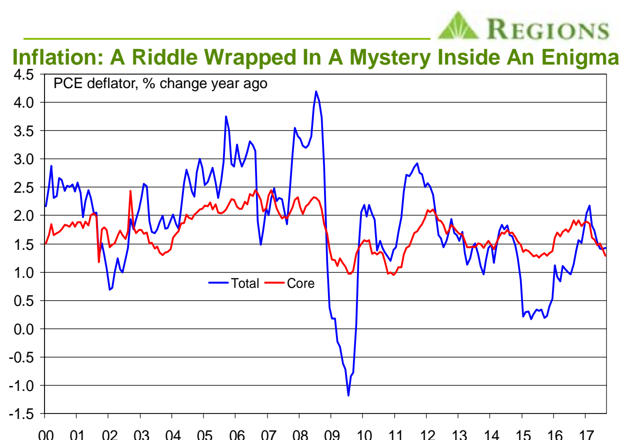
As anticipated, spending on consumer durable goods was down sharply in August, weighing on growth in total consumer spending. The sharp decline in unit motor vehicle sales was the primary culprit behind the decline in spending on consumer durables. Spending on household services rose 0.3 percent, but sharply lower utilities outlays acted as a drag on growth in services spending, which accounts for roughly two-thirds of all consumer spending. Real consumer spending was down 0.1 percent in August, and over the first two months of Q3 annualized growth in real consumer spending is tracking well below Q2 growth.

As to the inflation data, while many greeted the August CPI data, showing headline inflation up 0.4 percent and core inflation up 0.2 percent (and but a rounding error from being up 0.3 percent), as a sign that inflation was firming, which helped push up the market implied probability of a December Fed funds rate hike. Our thought at the time was that too much was being made of that August CPI report, as outsized gains in only a few categories (primarily gasoline and rents) drove the headline numbers higher. It remains to be seen whether the August data for the PCE deflator will make market participants, and perhaps the FOMC, reconsider their views on inflation, particularly with core PCE inflation now at its lowest rate since November 2015.

As to the FOMC, we think the question has changed from whether or not inflation will perk up by the December FOMC meeting and provide cover for a Fed funds rate hike to does it matter. After all, while the behavior of inflation over recent months may be a mystery to the FOMC, they seem, at least collectively, confident of its future path. Sure, at some point transitory can turn into structural, but the FOMC does not seem close to that point. Time will tell, but in the interim we'll exploit the whole "mystery" thing as cover to throw out all kinds of references you may or may not get – that we've gone so deep in our arsenal of references (Jeanette MacDonald/Nelson Eddy, Winston Churchill) so soon shows we think "transitory" will last a while.

The income and spending data in the near term will be distorted by the recent hurricanes but the underlying trends remain fairly solid. The bigger story in the near term will be the inflation data, particularly the core inflation data. Without a reversal of the recent trend, a December funds rate hike could be a tougher sell for the FOMC.





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