ECONOMIC UPDATE

REGIONS

August 30, 2018

July Personal Income/Spending: Growth In Labor Earnings Remains Solid

- Personal income rose by 0.3 percent in July, personal spending rose by 0.4 percent, and the saving rate fell to 6.7 percent.
- The PCE deflator rose by 0.1 percent and the core PCE deflator rose by 0.2 percent in July. Year-on-year, the PCE deflator was up by 2.3 percent and the core deflator was up by 2.0 percent.

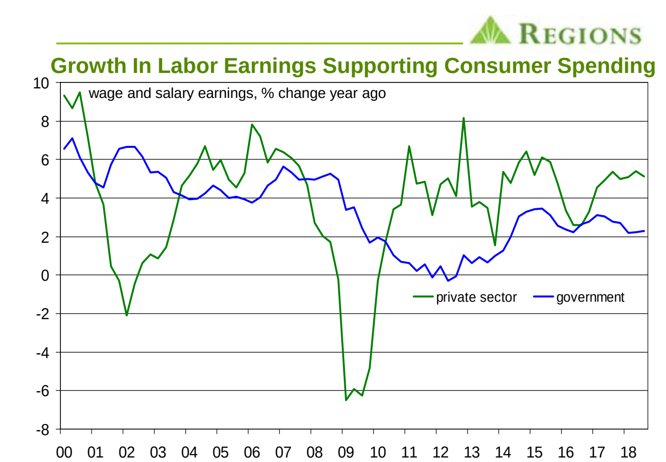
Total personal income rose 0.3 percent in July, short of the 0.4 percent increase we and the consensus expected, while total personal spending rose by 0.4 percent, above our forecast of a 0.3 percent increase. As income growth fell short of spending growth, the personal saving rate dipped to 6.7 percent in July. The PCE deflator, the FOMC's preferred gauge of inflation, rose by 0.1 percent in July, with the core PCE deflator up by 0.2 percent, each matching our forecast. On a year-on-year basis, the PCE deflator is up 2.3 percent – the fastest rate of PCE inflation since March 2012 – with the core PCE deflator up 2.0 percent. We do not expect the July inflation data to cause the FOMC much, if any, concern. Keep in mind that the FOMC has gone out of their way over recent months to stress that their inflation target is symmetric, i.e., after a prolonged period of inflation falling short of their 2.0 percent target rate, the FOMC is willing to tolerate a period of inflation running ahead of that target rate. The great unknown here of course is how far and how long, i.e., how far above their target will the FOMC be willing to let inflation run and how long will they be willing to do so. We do not think that tolerance will be put to the test any time soon, however, as we think July will mark the peak for headline PCE inflation in 2018.

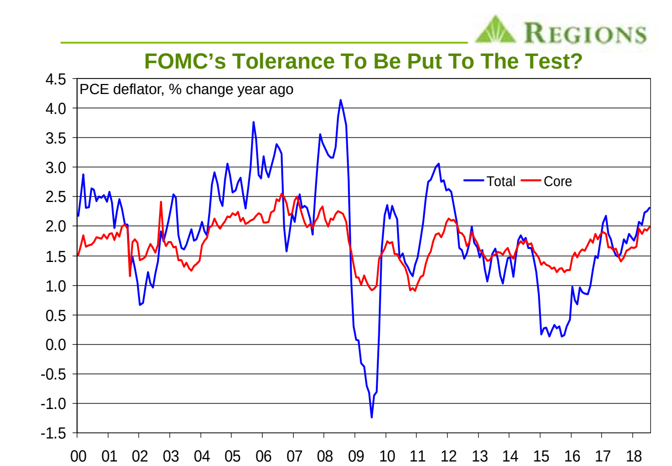
While growth in total personal income fell short of our expectations, the 0.4 percent increase in private sector wage and salary earnings surprised us to the upside. Recall that in July job growth slowed sharply which, along with a decline in average weekly hours, pointed to only a muted increase in aggregate wage and salary earnings. Either way, the more relevant point is that aggregate private sector wage and salary earnings are growing at a better than 5.0 percent clip over the past six quarters. Why this matters is that wage and salary earnings are far and away the largest single component of personal income and, despite all the attention heaped on average hourly earnings as "the" indicator of labor earnings, the reality is that hourly earnings are but one component of the broader measure of aggregate wage and salary earnings, and it is the aggregate measure that matters in terms of growth in personal income and, in turn, growth in consumer spending. And, even with inflation having "heated up" in July, growth in aggregate labor earnings is still easily outpacing inflation and, if we are correct in our inflation outlook, this disparity will get even wider in the months ahead. Anyone focusing only on average hourly earnings is missing the bigger picture.

Growth in total personal spending topped our forecast due to stronger spending on personal services than our forecast anticipated. Spending on goods rose by 0.2 percent, with spending on consumer durable goods down by 0.2 percent and spending on nondurable goods rising by 0.4 percent, each matching our forecast. The 0.4 percent increase in spending on services topped our forecast, as utilities outlays were higher than our forecast anticipated. On an inflation adjusted basis total personal spending was up by 0.2 percent in July, and though in terms of the data we're only one month into Q3, the data are in line with our expectation that Q3 growth in real consumer spending will fall between the middling pace logged in Q1 and the blistering pace seen in Q2.

Core goods prices were flat in July but were down 0.6 percent year-on-year, making July the 69th consecutive month in which core goods prices were down year-on-year. The path of core goods prices over coming months will to a large extent be determined by the behavior of the U.S. dollar and whether, or to what extent, U.S. tariffs will be imposed directly on consumer goods – thus far they have been largely confined to raw and intermediated goods. The path of core goods prices will in turn be a key determinant of the path of core inflation. Core services inflation has been fairly steady over recent months, running at a 2.7 percent pace. But, with last year's noise from cell phone service plan prices fading from the data, the over-the-year comparisons for inflation, headline and core, will get harder, which is one reason we look for inflation to back off of July's pace over coming months.

The FOMC is more than justified in taking policy to neutral from the current accommodative stance. With growth in labor earnings putting a firm floor beneath them, consumers will withstand the shift in the stance of monetary policy.





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