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A more accurate inflation measure still flags red

ECO

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This past week we obtained another important data point on inflation and unfortunately it reinforces something consumers already know: that prices remain stubbornly high.

Note

The personal consumption expenditure, or PCE, price index is the Federal Reserve's preferred measure for inflation because it accounts for what economists call the substitution effect. This effect describes how consumers might switch what they buy in order to avoid escalating price levels. For example, if beef becomes more expensive and consumers switch to chicken, the PCE price index takes account of that changing behavior and weighs chicken prices more heavily because consumers are now buying more of it. By contrast, headline CPI inflation doesn't account for how consumers shift their buying patterns to avert higher prices. The PCE price index also more heavily weighs items like health care, which we all know is a big chunk of household budgets.

(As a quick aside, a few of my kids have commented on how mom's delicious pot roast which they fondly remember from their youth is now out of reach pricewise. I bought chuck roast all the time when the kiddos were young for easy, cheap protein. Throw in some canned tomatoes, carrots, potatoes and rosemary and voila! How sad that feed-a-hockey-team staple is now considered unattainable for many young workers.)

In July, the year-over-year PCE price index was 3.7%, almost double what the Fed wants it to be (2.0%). That is the same rate as June, meaning price levels are staying high and are not changing. The core rate, which removes volatile food and energy prices, stood at 3.3% year-over-year.

This report also gives us consumer spending information. In July, Americans spent 0.2% more compared to June, but after adjusting for inflation, real consumer spending increased less than 0.1%. The report from the U.S. Bureau of Economic Analysis did give some encouraging news that even adjusting for inflation, personal income rose a healthier 0.4%. But I caution that while this metric includes income from wages, it also includes increases in government benefits like Medicare and, more importantly, increases in interest and stock dividend income that typically accrues to wealthier households. The overall savings rate also increased slightly to 3.0%, so some of the additional income is going toward savings, although that rate is still less than half of what it has been historically.

All in, the persistently high PCE price index at 3.7% keeps the pressure on the Federal Reserve to hike interest rates at its September meeting. If they do, that policy decision has pros and cons. I think a lot about how it impacts first-time homebuyers, people who need to buy a new car and those with credit card debt. Unfortunately, the dampening effect of higher interest rates disproportionately hurts younger and lower-income households. So much for pot roast.

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