US Daily: Less of a Q1 Bump in Inflation (Walker)

- Last year, a combination of residual seasonality and noise contributed to a sharp acceleration in inflation at the start of the year, pushing monthly core PCE from an average increase of 0.13% in 2023Q4 to 0.50% in January and 0.36% on average in 2024Q1.
- This year, we expect a more limited monthly acceleration (and consequently a decline in the year-on-year rate) because the form of residual seasonality we call the "January effect" is a function of the level of inflation and should now be smaller, the seasonal factors will have learned from recent years to expect larger January increases, and we see no reason for last year's noise—particularly in owners' equivalent rent—to repeat.
- However, we still expect a sequential acceleration because the level of inflation is still above normal so the January effect should remain positive (GS forecast: a 0.06pp contribution to January 2025 core PCE inflation vs. 0.09pp in January 2024), a different kind of residual seasonality will boost the consumer electronics category (0.05pp vs. 0.04pp), and the rise in stock prices at the end of the year will boost the financial services component, albeit by much less than last year (0.04pp vs. 0.14pp).
- On net, we forecast core PCE inflation of 0.32% month over month in January, above the 0.18% average monthly increase in 2024Q4 but well below the average increase of 0.48% in the last two Januarys. We expect favorable base effects and more moderate sequential increases in the remainder of Q1 to lower the year-over-year rate for core PCE by 0.29pp to 2.50% in March.

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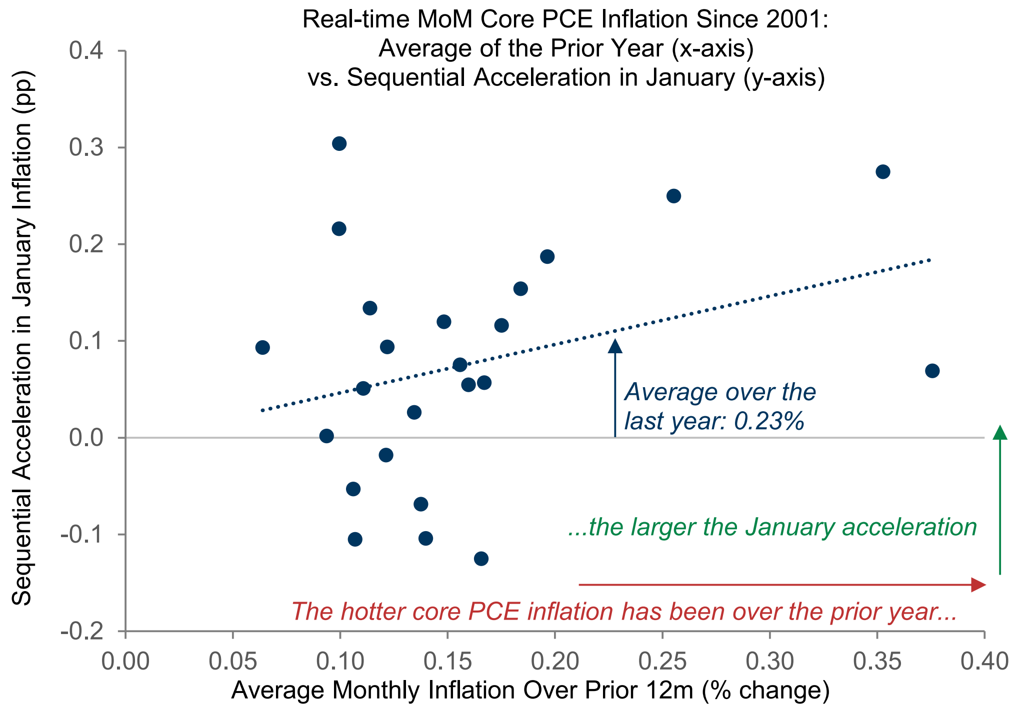
Less of a Q1 Bump in Inflation

Inflation accelerated sharply at the start of 2024. Core PCE inflation rose from an average monthly pace of 0.13% in 2023Q4 to 0.50% in January and 0.36% on average in 2024Q1, stoking concerns about reacceleration. Some investors are now concerned about a repeat of last year in this year's Q1 inflation data.

This year, we expect a more limited acceleration in Q1 inflation, for three reasons. First, there is less scope for an outsized boost from start of the year price increases (i.e., what we have dubbed the "January effect") because price pressures have moderated over the last year. This form of residual seasonality is caused by the interaction of start-of-year price hikes being larger when inflation is high and seasonal factors only being calibrated to average January increases. As a result, the January effect is a function of the level of inflation: Exhibit 1 shows that when core PCE inflation over the prior year has been hotter, January inflation tends to accelerate. This effect appears in categories that have a high share of annual price changes occurring in January, such as auto fees, food services and accommodations, and health care services. Second, the seasonal factors will have learned from recent years to expect larger January increases. For example, the seasonal hurdle for January core CPI has increased from 0.07pp in 2017 in real-time to 0.16pp in 2024 and could move higher as this week's CPI seasonal factor revisions incorporate the price moves of 2024. Third, a portion of last year's jump reflected noise, specifically a spurious spike in OER. We see no reason for that noise to repeat.

Exhibit 1: Today's Lower Level of Inflation Argues for a Smaller, But Still Positive, Sequential Acceleration in January Inflation



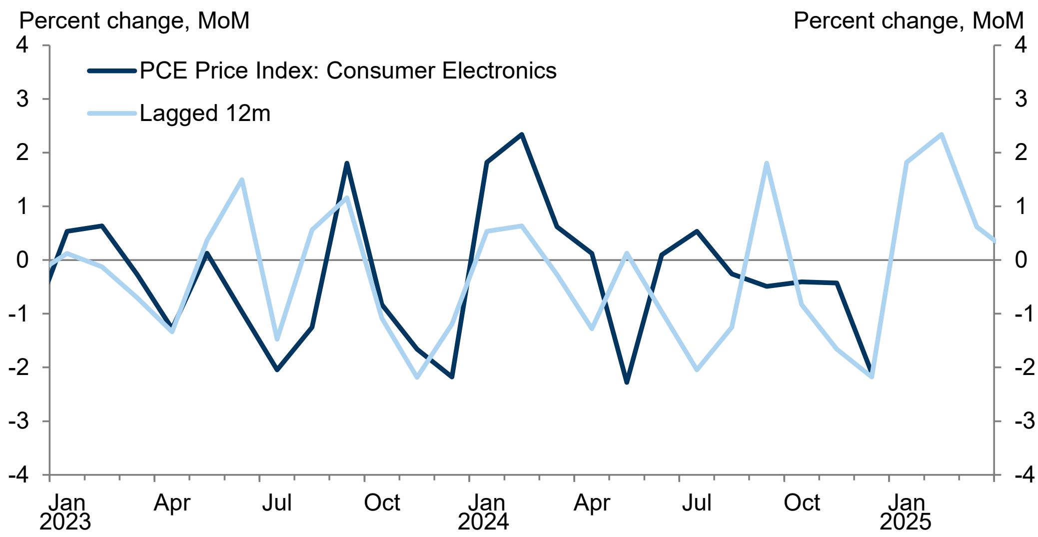
Source: Department of Commerce, Goldman Sachs Global Investment Research

However, we still expect a sequential acceleration this month, for three reasons. First, price pressures did not fully normalize in 2024 and will still contribute to a January effect. We expect the categories with the highest share of price setting done at the start of the year to contribute 0.13pp to monthly core PCE inflation in January 2025, down from 0.16pp in January 2024 but above the 0.07pp average contribution of those categories in January 2017-2019.

Second, a different kind of residual seasonality will likely boost the consumer electronics category (0.05pp vs. 0.04pp). Specifically, the pandemic disrupted some seasonal patterns and introduced new ones, causing some categories, such as the consumer electronics category, that were once adjusted to begin failing seasonality tests. Exhibit 2 shows that seasonal patterns have reemerged in the consumer electronics category, which has fallen sharply in Q4 and rebounded in Q1 in each of the last two years. As discussed in our January CPI Preview, the BLS will retest the components of CPI for seasonality as a part of the annual seasonal factor revisions and could resume seasonally adjusting problematic series if they test positive, which would temper the impact from this channel.

Third, the rise in stock prices at the end of last year will boost the financial services component, albeit by much less than the rise in stock prices at the end of 2023 boosted the component last January (0.04pp vs. 0.14pp).

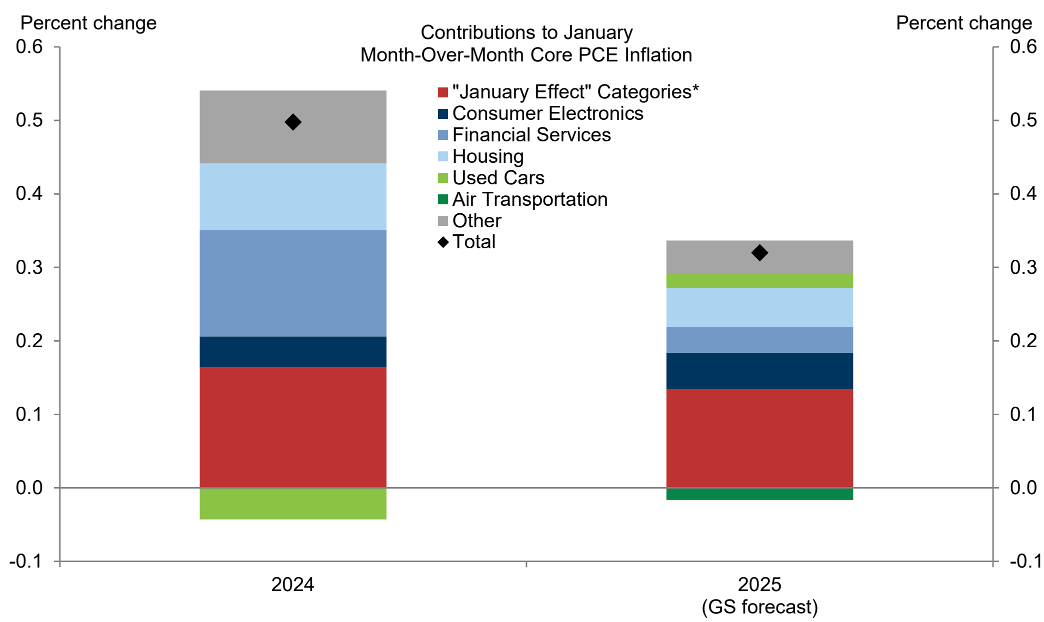
Exhibit 2: Resuming Seasonal Adjustment of Several Components That the BLS Stopped Adjusting Because of Pandemic Volatility, Including Consumer Electronics, Would Reduce the Scope for a January Bump in Inflation



Source: Department of Commerce, Goldman Sachs Global Investment Research

On net, we forecast core PCE inflation of 0.32% month over month in January, above the average monthly increase of 0.18% in 2024Q4 but well below the average increase of 0.48% in the last two Januarys (Exhibit 3). We expect inflation to moderate in February (+0.25%) and March (+0.22%), though we expect continued increases in consumer electronics prices to keep it above the Q4 pace.

Exhibit 3: We Expect Monthly Core PCE Inflation of 0.32% in January 2025, Well Below the 0.50% Pace of Last January; Smaller Contributions From Financial Services and "January Effect" Categories Contribute 0.13pp to the Slowdown



* Categories where a high share of annual price growth occurs in January (based on NSA CPI data). Includes health care services, food services and accommodations, transportation services ex. public, apparel, and other goods.

Source: Department of Commerce, Goldman Sachs Global Investment Research

How would the FOMC interpret the Q1 acceleration in our forecast? On several occasions, including at the November meeting, Chair Powell has noted that January inflation data “certainly looks like an example of residual seasonality” and suggested looking at the year-over-year rate to gauge how much progress has been made on inflation. By March, we expect favorable base effects to lower the year-over-year rate of core PCE by 0.29pp to 2.50%, which would mark meaningful progress towards the inflation target.

Ronnie Walker

Disclosure Appendix

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