US Daily: Why Core PCE Inflation Rose in Q1 and Will Fall in the Rest of the Year: A Category-Level Perspective (Rindels)

- After falling to a 1.9% average monthly annualized pace in 2023H2, core PCE inflation re-accelerated to a 4.0% average monthly annualized pace in 2024Q1, based on our estimate of the March print. We look at the categories that drove this re-acceleration and assess the outlook for core inflation through the rest of the year.
- In Q1, consumer electronics prices increased at a 21.9% average monthly annualized rate (boosting the core by 6.8bp per month, not annualized, relative to 2023H2), the largest quarterly increase since the data began in 1959, likely due to the reversal of larger-than-usual end-of-year promotions that drove down prices in 2023Q4. The financial services component also accelerated to a 10.1% average monthly annualized pace (worth + 4.5bp vs. 2023H2), reflecting the mechanical boost from rising equity prices to financial services prices. Healthcare services inflation ran hot in Q1 (worth +2.4bp vs. 2023H2) because price catch-up to the pandemic cost surge occurs disproportionately at the start of the year. Foreign travel also picked up (worth +2.9bp vs. 2023H2) as wholesale jet fuel prices increased while the dollar remained slightly weaker.
- Looking ahead, we expect the sequential pace of monthly core PCE to slow from +0.33% on average in Q1 to 0.18% on average over the rest of the year, mostly reflecting softer consumer electronics, financial services, and healthcare services inflation. Recent dollar strength should weigh on foreign travel prices going forward, and we expect housing to be an ongoing source of disinflationary pressure this year and next. Our forecast implies that the average monthly annualized pace of core PCE inflation will return to 2.2% over the next three quarters, leaving the year-on-year rate at 2.6% in December 2024.

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Why Core PCE Inflation Rose in Q1 and Will Fall in the Rest of the Year: A Category-Level Perspective

After falling to a 1.9% average monthly annualized pace in 2023H2, core PCE inflation re-accelerated to a 4.0% average monthly annualized pace in 2024Q1, based on our estimate of the March print. In this *Daily,* we look at the components driving this re-acceleration and assess the outlook for core inflation through the rest of the year.

What Changed from 2023H2 to 2024Q1?

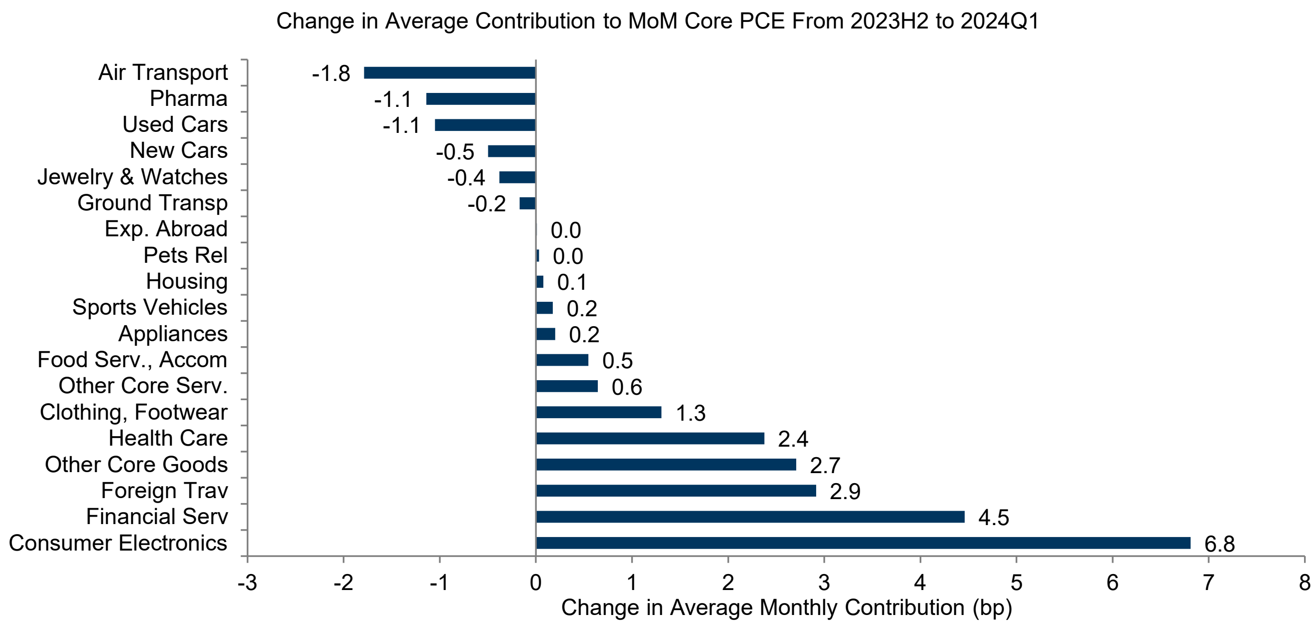
Based on our estimate of the March print, consumer electronics and software prices increased at a 21.9% average monthly annualized pace in Q1 (boosting the core by 6.8bp per month, not annualized, relative to 2023H2), the largest quarterly increase since the data began in 1959, swinging from a -2.6bp contribution to core PCE on average in 2023H2 to +4.2bp in 2024Q1 (Exhibit 1). We attribute the outsized first quarter strength to the reversal of larger-than-usual end-of-year promotions, as 2023Q4 marked the second largest quarterly *decrease* in prices (-17.4% average monthly annualized rate) since the data began.

The financial services component accelerated to a 10.1% average monthly annualized pace (worth +4.5bp per month, not annualized, vs. 2023H2) in 2024Q1, reflecting the mechanical boost from rising equity prices to financial services prices through higher portfolio management fees. The S&P 500 increased by 3.1% per month on average in 2024Q1, compared to 1.3% on average in 2023H2.

Healthcare services inflation also ran hot in Q1 (worth +2.4bp per month, not annualized, vs. 2023H2). Healthcare prices lagged the cost environment throughout 2023, and the sudden acceleration in Q1 likely reflected the price catch-up to the pandemic cost surge occurring disproportionately at the start of the year. We expect healthcare inflation to remain elevated this year as this catch-up continues to materialize.

Foreign travel prices picked up to an average monthly annualized rate of 14.0% in Q1, which added 2.9bp per month (not annualized) to the core. Wholesale jet fuel prices increased while the dollar remained slightly weaker on average in Q1 than in the second half of 2023, both of which likely boosted foreign travel prices.

Exhibit 1: Consumer Electronics and Financial Services Contributed Much More to Monthly Core PCE Inflation This Quarter Than in the Second Half of 2023

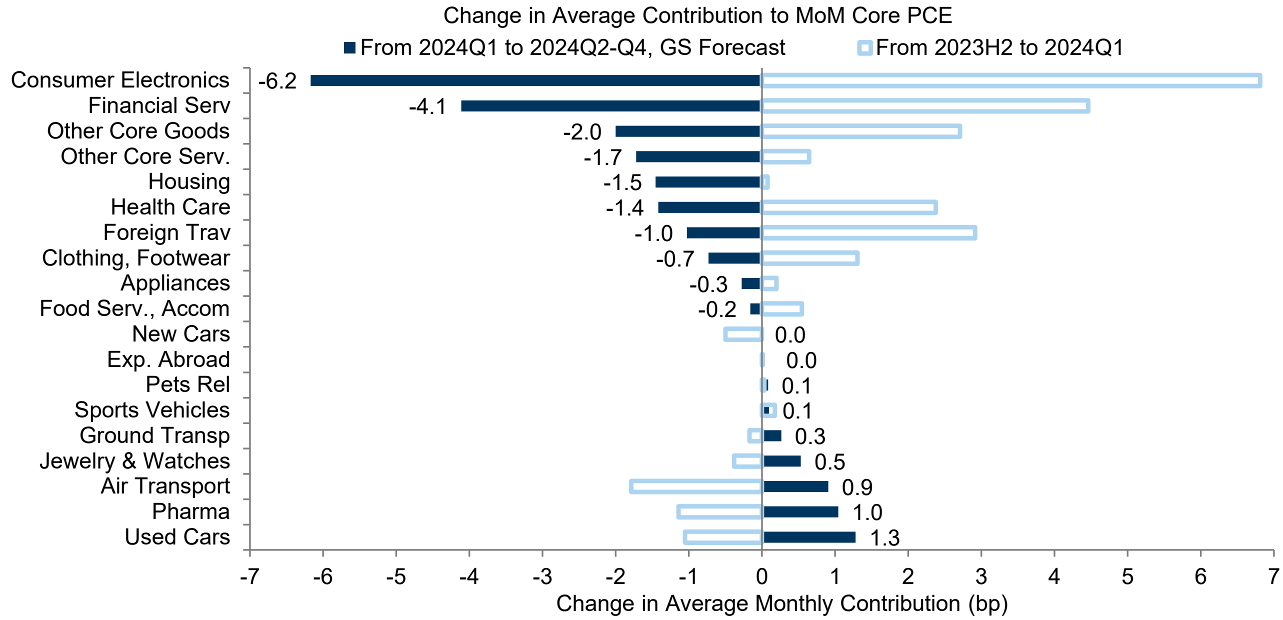


Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

What Will Change from Q1 to Q2-Q4?

We expect the monthly pace of core PCE inflation to slow from +0.33% on average in Q1 to +0.18% on average over the rest of the year, mostly reflecting softer consumer electronics, financial services, housing, and healthcare services inflation (Exhibit 2).

Exhibit 2: We Expect the First Quarter's Highest-Above-Trend Contributors to Account for Almost Two Thirds of the Deceleration in the Sequential Pace of PCE Over the Rest of the Year



Source: Bureau of Economic Analysis, Goldman Sachs Global Investment Research

The end-of-year promotions for consumer electronics and software appear to have mostly reversed, and we expect prices to decline on average over the next nine months. We expect the contribution to monthly core PCE inflation to swing from +4.2bp (not annualized) in Q1 to -2.0bp, a turnaround of -6.2bp per month, through year-end.

We expect the recent decline in equity prices to slow financial services inflation from an average monthly annualized pace of 10.1% in 2024Q1 to 3.8% over the rest of the year, which would lower its contribution to core PCE from 6.7bp (not annualized) to 2.6bp, a turnaround of -4.1bp per month.

Start-of-year price increases for healthcare services should be out of the way, but there is still substantial room for prices to catch up to costs in the remainder of 2024 and beyond. Accordingly, we expect the sequential pace of healthcare inflation to slow from an average monthly annualized rate of 4.1% in Q1 to 3.2% over the rest of the year, remaining about 0.6pp higher than the average monthly annualized rate of 2.6% in the second half of 2023. This will lower its contribution to core PCE from 6.3bp (not annualized) in Q1 to 4.9bp through year end, a -1.4bp per month turnaround.

Recent dollar strength should weigh on foreign travel prices going forward, and we expect the contribution to core PCE to decline from +1.4bp (not annualized) in Q1 to +0.4bp over the rest of the year, a -1.0bp per month turnaround.

Finally, we expect housing to be an ongoing source of disinflationary pressure this year and next. The gap between new- and continuing-tenant rents has already closed and a benign outlook for new-tenant rent growth suggests that rent is on course to return to its pre-pandemic pace later this year. At the same time, continued scope for catch-up in

OER suggests that OER will slow but remain elevated. Taken together, we expect the contribution to core PCE to decline from +8.1bp (not annualized) in Q1 to +6.6bp through year end, a -1.5bp per month turnaround.

After increasing to 4.0% in Q1, our forecast implies that the average monthly annualized pace of core PCE inflation will return to 2.2% over the next three quarters, leaving the year-on-year rate at 2.6% in December 2024.

Jessica Rindels

Disclosure Appendix

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