The Daily Dish

Fed Reality Check

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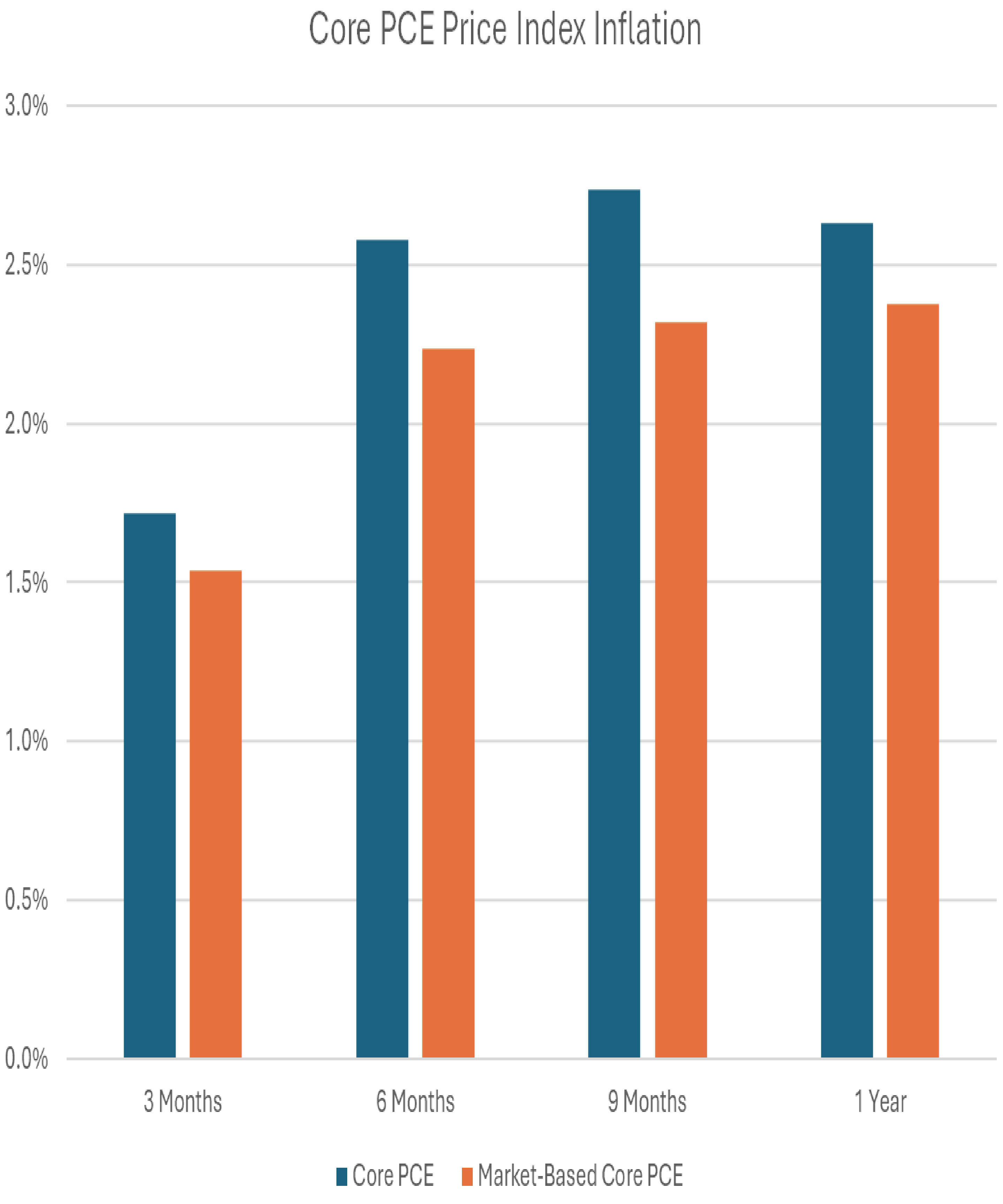
Tomorrow morning at 8:30 the Bureau of Economic Analysis (BEA) will release the August data on the personal consumption expenditures (PCE) price index – the Fed's preferred measure of inflation. Although these data represent inflation measured prior to the Fed's recent decision to drop the target range for the federal funds rate by 50 basis points, the report will doubtless be greeted as either ratifying or confounding the Fed's decision.

The framework repeatedly enunciated by Fed Chairman Jerome Powell has been that the Fed would ease when it was confident that inflation would return to, and remain stable at, the 2-percent target. Inflation is not yet at 2 percent, but the chart below sheds some light on the issue. The chart shows the measure of core inflation; that is, the inflation measure excluding food and energy. Core inflation is of interest not because it is a better measure of the cost of living – it is not because it deliberately excludes important purchases. It is of interest because core inflation is the best predictor of future total inflation.

The chart shows core PCE inflation and market-based core PCE inflation measure over three-month, six-month, nine-month, and one-year horizons. (Market-based PCE is calculated using only those goods and services for which there are actual data of a market transaction. No imputed prices are used.)

As one can see, market-based measures run consistently below the overall core because one of the most significant imputations is the rent a homeowner would hypothetically charge herself to occupy the house for the month. Both series have run in the vicinity of 2.5 percent over the past six to 12 months, but inflation in the most recent three months is noticeably more subdued. The Fed is evidently confident that this pattern will continue, and that inflation will decrease toward the 2 percent target.



Of course, a hot core PCE reading that raised noticeably the pace of inflation over the past three months would represent a real spanner in the works. The consensus among forecasters, however, is that while year-over-year core inflation will rise to 2.7 percent from 2.6 percent, the last three months (June, July, and August) will show annual inflation on average at a 1.6-percent annual rate (down from 1.7 percent in July).

Looking forward to Inflation Friday!