National Retail Federation

MONTHLY Economic Review

March 2024

Jack Kleinhenz, Ph.D., CBE
Chief Economist
National Retail Federation

The data for this report is released on a rolling schedule. The presented numbers are current as of publication and are subject to revision.

SYNOPSIS | The Path of Monetary Policy Runs Through the Inflation Outlook

With the U.S. economy's strength resting heavily on household spending, all eyes are on the consumer – and how consumers will respond the next few months to the Federal Reserve's ongoing efforts to tame inflation. While inflation is down from its peak, it has slowed less than expected and is still an important problem that remains to be solved.

Year-over-year inflation as measured by the Consumer Price Index stood at 3.1% in January, which was down from 3.4% and about a third of the 9.1% high point seen in June 2022, but still a considerable distance from the Fed's target of 2%. Core CPI, which excludes food and energy, was up 3.9% from a year earlier.

While the CPI, which is released by the Labor Department's Bureau of Labor Statistics, gets more press, the Personal Consumption Expenditures Price Index from the Commerce Department's Bureau of Economic Analysis is the Fed's favored gauge of inflation. The PCE index was up only 2.4% as of January, and 2.8% with food and energy prices excluded.

It is important to recognize the differences between the CPI and the PCE. The CPI represents a set basket of goods and services a consumer would buy without making substitutions when prices change. The PCE encompasses a broader range of goods and services from a broader range of buyers, and tries to track what is actually purchased, representing how consumers change their buying patterns when prices change. In addition, the CPI only covers out-of-pocket household expenditures while the PCE includes expenditures such as those covered by Medicare and Medicaid. Because of these differences in emphasis, the weights in the baskets differ. The CPI also famously places more emphasis on the cost of housing.

By any measure, inflation progress has been remarkable compared with a year ago, but inflation remains above the Fed's target.

A key issue in inflation is the difference between prices for services, which the CPI showed were up 4.9% year over year in January, and commodity-based prices (including retail goods), which were up only 0.1% over the same period. Why such a difference and which measure is the Fed paying more attention to? Stuck at home during the initial months of the pandemic, Americans responded with a dramatic shift in spending from services to goods, buying furniture, exercise equipment and the like. The surge in demand coupled with pandemic-related production shortages and supply chain issues contributed to price pressures, although production, warehousing and distribution networks have largely returned to normal since then. With consumers able to go out again after a long suspension from purchasing services ranging from entertainment to travel, households are moving back toward pre-pandemic patterns although there's still some distance to go. As of the fourth quarter 2023, 65% of consumer spending was allocated to services, which was short of 68% in the fourth quarter of 2019 but up from a pandemic low of 63% in April 2021.

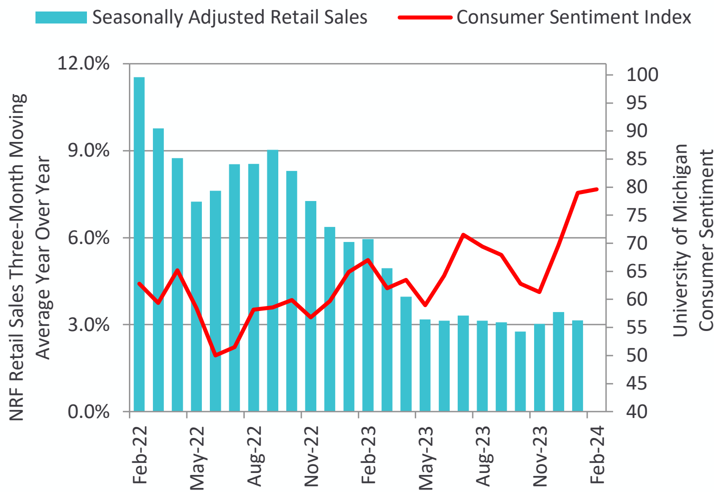
With the vast service sector including businesses as varied as restaurants, dentists, apartment rentals, auto repair, travel and hotels, high services prices make it harder to tame inflation. In addition, 86% of the labor force is employed in the service sector compared with 14% in the goods-producing sector.

The persistent strength in services spending and inflation in the service sector strongly suggest that the Fed will likely be cautious about rate cuts. Likely adhering to research that indicates services prices may carry signals for future overall inflation, Chairman Jerome Powell specifically said at a recent press conference that non-housing services (health care, financial services and insurance, restaurants and transportation) are important to watch and a guide to inflationary trends. Two reasons were cited: 55% of the core PCE index is made up of non-housing services. In addition, non-housing services are closely related to the labor market and labor is the sector's biggest cost. That's a challenge for services because the labor market is "very strong" with little softening amid "very high" wages and job growth, he said. Powell said job vacancies are "quite elevated" and that "there's an imbalance in the labor market between supply and demand."

At its most recent meeting at the end of January, the Fed's Federal Open Markets Committee left interest rates unchanged for the fourth straight time over about seven months. The committee said its employment and inflation goals "are moving into better balance" but also that it would not be appropriate to reduce rates until it has gained greater confidence that inflation is moving sustainably toward 2%. My assumption is that the FOMC will likely hold rates steady at its March meeting but then cut rates by a quarter of a percentage point either at its following meeting at the end of April or at its June meeting. If inflation indicators remain stronger than preferred, the mid-year scenario is more likely. Subsequent cuts in September and December could bring the total reduction in rates to between three-quarters of a percentage point and a full point.

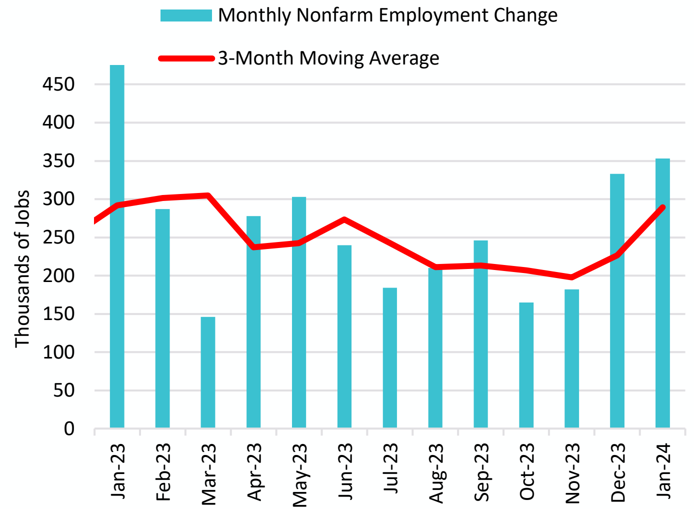
SALES AND SENTIMENT

While January retail sales declined from December, year-over-year spending on a three-month moving average was positive.



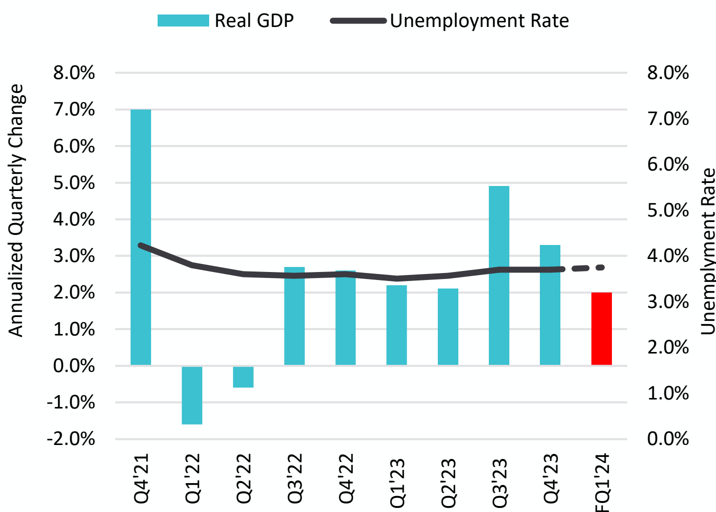
JOB GROWTH

Revisions to prior months and a strong January gain left job growth up 289,000 on a three-month average. That compares with a gain of 165,000 in December prior to revisions.



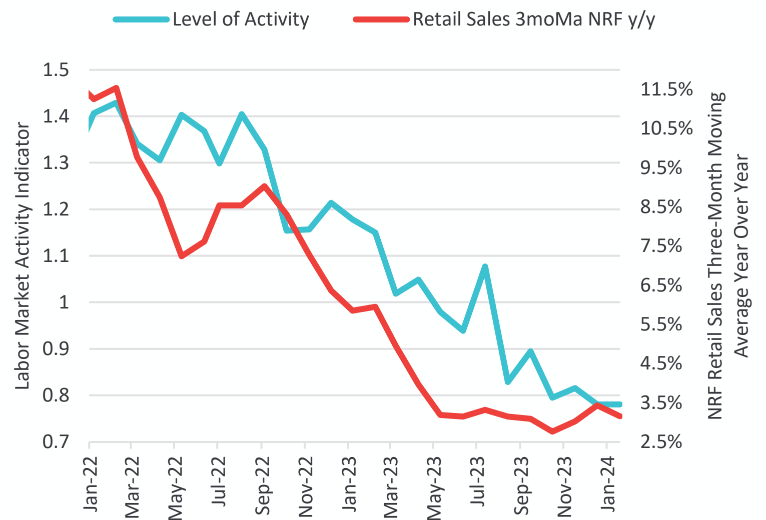
GDP & UNEMPLOYMENT

2023 ended with stronger-than-expected GDP growth. We are tracking first-quarter GDP at 2% and the unemployment rate at 3.8%.



LABOR MARKET CONDITIONS

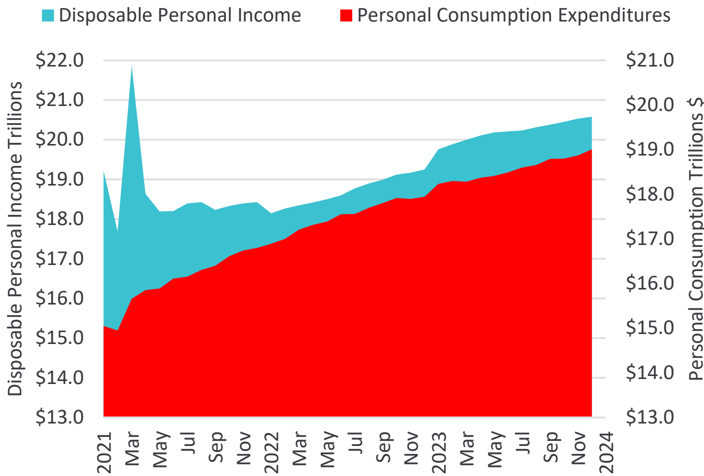
The Kansas City Fed's Labor Market Conditions Indicator suggests that activity declined slightly in January, confirming the slower pace of January retail sales.



NRF National Retail Federation

INCOME & EXPENDITURES

Consumer spending growth remains steady and an important factor in keeping the economy out of recession. Wage gains in the midst of decelerating inflation have provided purchasing power.

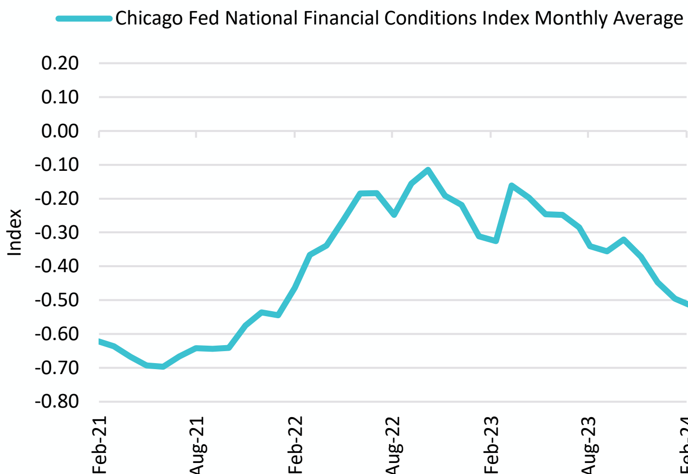


INFLATION

The path of inflation is making headway. The Personal Consumption Expenditure Price index was up 2.6% year-over-year in December, the smallest increase since March 2021.

FINANCIAL CONDITIONS INDEX

Negative values for the Chicago Fed's National Financial Conditions Index, which measures risk and the availability of funding, suggest financial conditions have eased to levels comparable with March 2022, when the Fed first began increasing rates to slow inflation.



JOB OPENINGS

Retail job openings and hires have moderated in fits and starts. Yet both recorded gains in December, reflecting a healthy labor market that is not under stress.

NRF National Retail Federation