

Flash Note

US PCE inflation – Still moderate

US core inflation on track to reach 2% soon, but not much more

Pictet Wealth Management - Asset Allocation & Macro Research | 29 March 2018

February core PCE inflation rose 0.23% m-o-m, in line with expectations. The y-o-y reading was up to 1.6% from 1.5% in January.

The improvement in US core inflation remains quite unspectacular when taking into account full employment and solid underlying growth (likely to reach 3% this year).

Core inflation should rise to 2% y-o-y in Q2-2018, but it is then likely to be broadly stagnant for several months.

Rising inflation is unlikely to steer the Fed off its current routine of one quarter-point rate hike per quarter. It would take core inflation to rise above 2.5% y-o-y (and GDP to rise above 3%) for the Fed to consider accelerating tightening, we think. That remains quite unlikely in the near future.

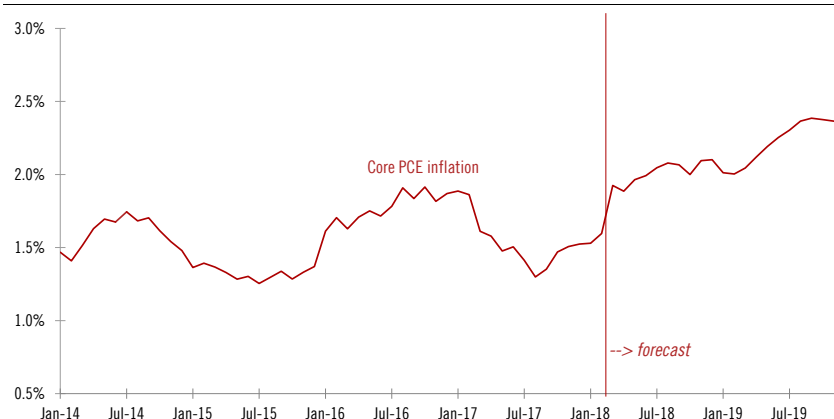
Core PCE inflation rose **0.23% m-o-m in February** (in line with market expectations of 0.2%), up from 0.29% in January and 0.16% in December. The **y-o-y reading rose to 1.6%** (also in line with market expectations), up from 1.5% in January.

Core inflation is on the rise, but seen from the perspective of full employment and solid underlying growth of near 3%, it **remains quite unspectacular – especially as much of the price increase is due to rents**, up 3.5% y-o-y in February.

Furthermore, core inflation was in fact more subdued than the February print suggested, as it was abnormally boosted by another strong gain in clothing (+1.5% m-o-m). It also looks like there were ‘one-off’ spikes in airplane tickets (+2.6% m-o-m) and healthcare services (dentist +1.3% m-o-m, hospital +0.8% m-o-m). These categories could give back their gains in the March inflation print.

While likely to improve further, we think US core inflation will remain unspectacular going forward. We maintain our annual core PCE inflation forecast of 1.9%, still a touch above current the Bloomberg consensus of 1.8%. We have factored in another 0.2% m-o-m gain in core PCE inflation in March, which should then push up the y-o-y print to 1.9% as a result of base effects (there was a sharp drop in telecommunications prices last year). After that, though, the y-o-y print should rise very gradually. **We forecast core PCE inflation at 2.0% y-o-y by June and 2.1% by year end** (see chart 1).

Chart 1: Core PCE inflation, % y-o-y (and our forecast)



Source: Pictet WM-AA&MR, Thomson Reuters.

AUTHOR

Thomas COSTERG
tcosterg@pictet.com
+41 58 323 3963

Pictet Wealth Management
Route des Acacias 60
CH - 1211 Geneva 73
www.group.pictet

Among the **upside risks** to our inflation scenario are a **sharp escalation in trade tensions**. For now, we do not think that the recent tariffs announced against a portion of Chinese imports (25% tariffs on 10% of all Chinese imports) will materially affect the US inflation outlook.

But they could if the protectionist net on Chinese goods were cast wider and if it affected all imports from China (in which case core inflation could rise by a percentage point in our view). In the meantime, imported clothing prices and household goods, including electronics, have been a structural drag on US inflation in recent years, and they are likely to remain so in the near future.

Among the downside risks to inflation are a potential **slowdown in rents**. There are signs that apartment vacancy rates are gradually moving up, while the housing market continues to normalise (especially for first-time buyers). A surprise for our inflation outlook would be a sharp moderation in rents. Since housing is contributing 1.3 point to core inflation at the moment, a slowdown in rents could have a material impact on the inflation outlook.

Federal Reserve still set to hike rates again in June

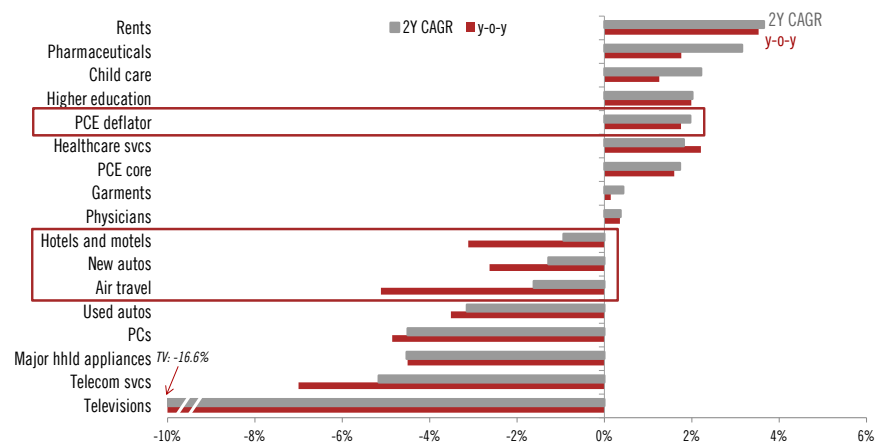
While core inflation should rise to the Fed's target in the near term, we think the Fed is going to **remain cool headed about the inflation picture even if core PCE inflation is set to soon reach the psychologically important level of 2%**. Chairman Jerome Powell emphasised at the March meeting that he saw no sign of a sudden pickup in inflation, a stance he is unlikely to change.

Two further points are worth noting. First, the Fed has increasingly emphasised the "symmetric" nature of the 2% inflation target, which means that it could let core inflation rise a bit above 2% temporarily, given that core inflation has undershot the target for so many years.

Second, other inflation signals remain tame and do not suggest overheating is imminent. In particular, both market-based and consumer-based inflation expectations remain subdued. In other words, there is no sign of a sudden spiralling out of control of inflation expectations, which could then reverberate on inflation itself.

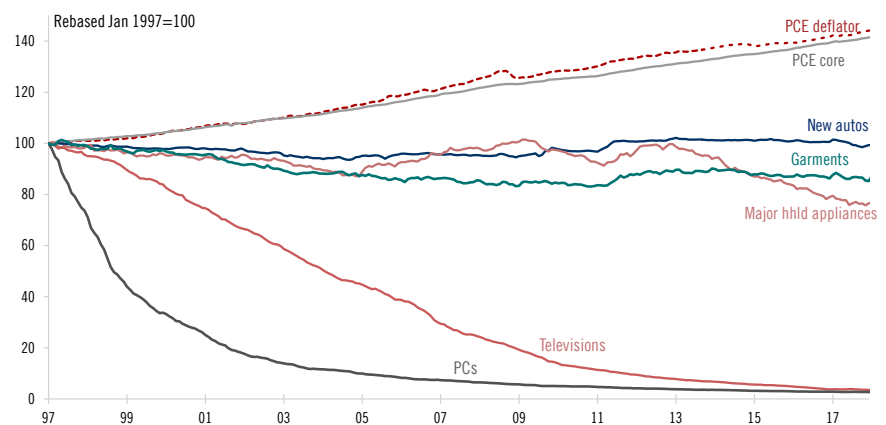
We continue to think the Fed will keep its **current routine of a quarter-point rate increase each quarter until at least mid-2019**. We think it would take core inflation to move higher than 2.5% for the Fed to start considering accelerating the pace of tightening. But even then, the Fed would also consider whether growth was still looking strong and whether inflation expectations were moving further up. We see these conditions as quite unlikely in the next 24 months, even though we see core inflation rising to the upper end of the 2.0-2.5% range in 2019 due to the **lagged impact of growth that is likely to be strong for the rest of 2018**.

Chart 2 : Selected core PCE inflation sub-indices, % y-o-y (and 2Y CAGR)



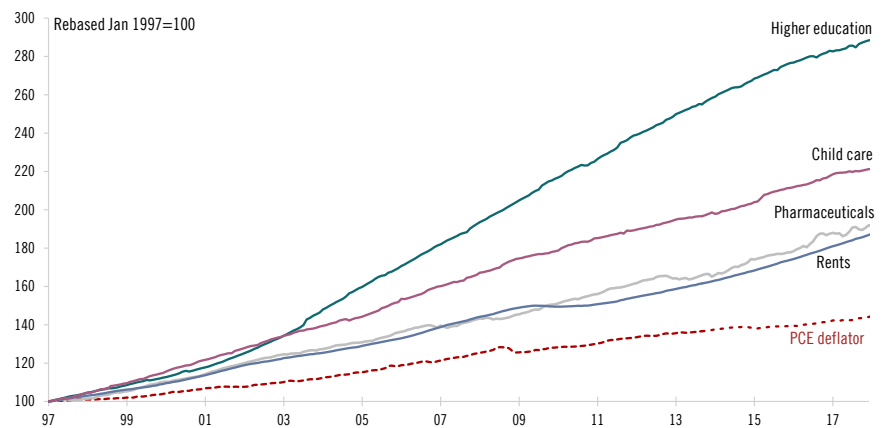
Source: Pictet WM-AA&MR, Thomson Reuters.

Chart 3 : Key 'drags' on US core inflation include autos, clothing and electronics



Source: Pictet WM-AA&MR, Thomson Reuters.

Chart 4 : Meanwhile, the big inflation gainers are education, childcare and rents



Source: Pictet WM-AA&MR, Thomson Reuters.

DISCLAIMERS

Distributors: Banque Pictet & Cie SA, Route des Acacias 60, 1211 Geneva 73, Switzerland and Pictet & Cie (Europe) SA, 15A, avenue J. F. Kennedy, L-1855 Luxembourg/B.P. 687 L-2016 Luxembourg.

Banque Pictet & Cie SA is established in Switzerland, exclusively licensed under Swiss Law and therefore subject to the supervision of the Swiss Financial Market Supervisory Authority (FINMA).

Pictet & Cie (Europe) SA is established in Luxembourg, authorized and regulated by the Luxembourg Financial Authority, Commission de Surveillance du Secteur Financier.

This marketing communication is not intended for persons who are citizens of, domiciled or resident in, or entities registered in a country or a jurisdiction in which its distribution, publication, provision or use would violate current laws and regulations.

The information, data and analysis furnished in this document are disclosed for information purposes only. They do not amount to any type of recommendation, either general or tailored to the personal circumstances of any person. Unless specifically stated otherwise, all price information is indicative only. No entity of the Pictet Group may be held liable for them, nor do they constitute an offer or an invitation to buy, sell or subscribe to securities or other financial instruments. The information contained herein is the result neither of financial analysis within the meaning of the Swiss Bankers Association's Directives on the Independence of Financial Research, nor of investment research for the purposes of the relevant EU MiFID provisions. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness.

Except for any obligations that any entity of the Pictet Group might have towards the addressee, the addressee should consider the suitability of the transaction to individual objectives and independently assess, with a professional advisor, the specific financial risks as well as legal, regulatory, credit, tax and accounting consequences.

Furthermore, the information, opinions and estimates in this document reflect an evaluation as of the date of initial publication and may be changed without notice. The Pictet Group is not under any obligation to update or keep current the information contained herein. In case this document refers to the value and income of one or more securities or financial instruments, it is based on rates from the customary sources of financial information that may fluctuate. The market value of financial instruments may vary on the basis of economic, financial or political changes, currency fluctuations, the remaining term, market conditions, the volatility and solvency of the issuer or the benchmark issuer. Some investments may not be readily realizable since the market in the securities can be illiquid. Moreover, exchange rates may have a positive or negative effect on the value, the price or the income of the securities or the related investments mentioned in this document. When investing in emerging countries, please note that the political and economic situation in those countries is significantly less stable than in industrialized countries. They are much more exposed to the risks of rapid political change and economic setbacks.

Past performance must not be considered an indicator or guarantee of future performance, and the addressees of this document are fully responsible for any investments they make. No express or implied warranty is given as to future performance. Moreover, forecasts are not a reliable indicator of future performance. The content of this document can only be read and/or used by its addressee. The Pictet Group is not liable for the use, transmission or exploitation of the content of this document. Therefore, any form of reproduction, copying, disclosure, modification and/or publication of the content is under the sole liability of the addressee of this document, and no liability whatsoever will be incurred by the Pictet Group. The addressee of this document agrees to comply with the applicable laws and regulations in the jurisdictions where they use the information reproduced in this document.

This document is issued by Banque Pictet & Cie SA. This publication and its content may be cited provided that the source is indicated. All rights reserved. Copyright 2018.

Distributors: Bank Pictet & Cie (Asia) Ltd ("BPCAL") in Singapore, 10 Marina Blvd #22-01 Tower 2, Marina Bay Financial Centre, Singapore 018983 and Pictet & Cie (Europe) S.A., Hong Kong branch ("Pictet HK branch") in Hong Kong. The registered address of Pictet HK branch is 9/F, Chater House, 8 Connaught Road Central, Hong Kong.

The information, tools and material presented in this document are provided for information purposes only and are not to be used or considered as an offer, an invitation to offer or solicitation to buy, sell or subscribe for any securities, commodities, derivatives, (in respect of Singapore only) futures, or other financial instruments (collectively referred to as "Investments") or to enter into any legal relations, nor as advice or recommendation with respect to any Investments. This document is intended for general circulation and it is not directed at any particular person. This document does not have regard to the specific investment objectives, financial situation and/or the particular needs of any recipient of this document. Investors should seek independent financial advice regarding the appropriateness of investing in any Investments or adopting any strategies discussed in this document, taking into account the specific investment objectives, financial situation or particular needs of the investor, before making a commitment to invest.

BPCAL/Pictet HK branch has not taken any steps to ensure that the Investments referred to in this document are suitable for any particular investor, and accepts no fiduciary duties to any investor in this regard. Furthermore, BPCAL/Pictet HK branch makes no representations and gives no advice concerning the appropriate accounting treatment or possible tax consequences of any Investment. Any investor interested in buying or making any Investment should conduct its own investigation and analysis of the Investment and consult with its own professional adviser(s) as to any Investment including the risks involved with transactions on such Investment.

This document is not to be relied upon in substitution for the exercise of independent judgment. The value and income of any Investment mentioned in this document may fall as well rise. The market value may be affected by, amongst other things, changes in economic, financial, political factors, time to maturity, market conditions and volatility, and the credit quality of any issuer or reference issuer. Furthermore, foreign currency rates of exchange may have a positive or adverse effect on the value, price or income of any Investment mentioned in this document. Accordingly, investors must be willing and able to, and effectively assume all risks and may receive back less than originally invested.

Past performance should not be taken as an indication or guarantee of future performance and no representation or warranty, expressed or implied, is made by BPCAL/Pictet HK branch regarding future performance.

This document does not constitute the investment policy of BPCAL/Pictet HK branch, or an investment recommendation, and merely contains the different assumptions, views and analytical methods of the analysts who prepared them. Furthermore, the information, opinions and estimates expressed herein reflect a judgment at its original date of publication and are subject to change without notice and without any obligation on BPCAL/Pictet HK branch to update any of them.

BPCAL/Pictet HK branch may have issued or distributed other reports or documents that are inconsistent with, and reach different conclusions from, the information presented in this document.

While the information and opinions presented herein are believed to be from sources believed to be reliable, BPCAL/Pictet HK branch is not able to, and do not make any representation or warranty as to its accuracy or completeness. Accordingly, BPCAL/Pictet HK branch accepts no liability for loss arising from the use of or reliance on this document presented for information purposes only. BPCAL/Pictet HK branch reserves the right to act upon or use any of the information in this document at any time, including before its publication herein.

BPCAL/Pictet HK branch and its affiliates (or employees thereof) may or may not have long or short positions in, and buy or sell, or otherwise have interest in, any of the Investments mentioned herein, and may or may not have relationships with the issuers of or entities connected with Investments mentioned in this document. BPCAL/Pictet HK branch and their affiliates (or employees thereof) may act inconsistently with the information and/or opinions presented in this document. The information used to prepare this document and/or any part of such information, may have been provided or circulated to employees and/or one or more clients of BPCAL/Pictet HK branch before this document was received by you and such information may have been acted upon by such recipients or by BPCAL/Pictet HK branch.

This document is provided solely for the information of the intended recipient only and should not be reproduced, published, circulated or disclosed in whole or in part to any other person without the prior written consent of BPCAL/Pictet HK branch.

Singapore

This document is not directed to, or intended for distribution, publication to or use by, persons who are not accredited investors, expert investors or institutional investors as defined in section 4A of the Securities and Futures Act (Cap. 289 of Singapore) ("SFA") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject BPCAL and any of its affiliates or related corporations to any prospectus or registration requirements.

BPCAL has obtained an exemption from the Monetary Authority of Singapore ("MAS") under section 100(2) of the Financial Advisers Act ("FAA") for the provision of financial advisory services to High Net Worth Individuals (as defined in the MAS Guidelines on Exemption for Specialised Units Serving High Net Worth Individuals FAA-G07) (the "Exemption") and is exempted from the requirements of sections 25, 27, 28 and 36 of the FAA, the MAS Notice on Recommendations on Investment Products (FAA-N16), MAS Notice on Appointment and Use of Introducers by Financial Advisers (FAA-N02), MAS Notice on Information to Clients and Product Information Disclosure (FAA-N03) and MAS Notice on Minimum Entry and Examination Requirements for Representatives of Licensed Financial Advisers and Exempt Financial Advisers (FAA-N13).

Please contact BPCAL in Singapore in respect of any matters arising from, or in connection with this document.

Hong Kong

This document is not directed to, or intended for distribution, publication to or use by, persons who are not "professional investors" within the meaning of the Securities and Futures Ordinance (Chapter 571 of the Laws of Hong Kong) and any rules made thereunder (the "SFO") or any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet HK branch and any of its affiliates or related corporations to any prospectus or registration requirements.

Pictet & Cie (Europe) S.A. is incorporated in Luxembourg with limited liability. It is an authorized institution within the meaning of the Banking Ordinance and a registered institution (CE No.: AQ515) under the SFO carrying on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

Warning: The contents of this document have not been reviewed by any regulatory authority in Hong Kong. You are advised to exercise caution in relation to the offer. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice. Please contact Pictet HK branch in Hong Kong in respect of any matters arising from, or in connection with this document.

Distributor: Pictet Bank & Trust Limited, where registered office is located at Building 1, Bayside Executive Park, West Bay Street & Blake Road, Nassau, New Providence, The Bahamas.

The document is not directed to, or intended for distribution or publication to or use by persons who are not Accredited Investors (as defined in the Securities Industry Regulations, 2012) and subject to the conditions set forth in the Securities Industry Regulations, 2012 or to any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or would subject Pictet Bank & Trust Limited to any prospectus or registration requirements. Pictet Bank & Trust Limited is incorporated in The Bahamas with limited liability. It is a bank and trust company that is licensed in accordance with the Banks and Trust Companies' Regulation Act and is regulated by the Central Bank of The Bahamas. Additionally, Pictet Bank & Trust Limited is registered with the Securities Commission of The Bahamas as a Broker Dealer II and is approved to (i) Deal in Securities 1.(a) & (c); (ii) Arrange Deals in securities; (iii) Manage Securities; (iv) Advise on Securities.

Warning: The content of this document has not been reviewed by any regulatory authority in The Bahamas. You are, therefore, advised to exercise caution when processing the information contained herein. If you are in any doubt about any of the content of this document, you should obtain independent professional advice.