US Daily: A Wider CPI-PCE Gap and a Hotter Inflation Dashboard in 2022 (Mericle/Hill)

- We recently bumped up our 2022 PCE inflation forecasts on an expectation that it will take longer to overcome supply chain challenges and in particular to boost auto production enough to replenish depleted inventories and exert downward pressure on prices. We now expect core PCE inflation to stand at 4.3% at end-2021, 3% in June 2022, and 2.15% at end-2022.
- We also expect CPI inflation to exceed PCE by more than usual over the next year, for three main reasons. First, durable goods such as cars have a higher weight in the CPI, and it now appears that it will take longer for their very elevated inflation rates to come down. Second, shelter inflation also has a much larger weight in the CPI and is likely to rise sharply. Third, the source data used to calculate the health insurance component that is unique to the CPI point to a spike over the next year. We expect these factors to push year-on-year core CPI inflation to the mid-5's in 2022Q1, 4% in June 2022, and 3.1% at end-2022, a roughly 100bp gap with PCE. The first and third issues should reverse in 2023, which would then compress the CPI-PCE gap.
- While the PCE index is the Fed's preferred inflation measure, Fed officials look at many measures, and it increasingly appears that the full set of inflation data will look quite hot on a year-on-year basis around the middle of next year when tapering ends. As we noted recently, this increases the risk of an earlier hike in 2022.

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A Wider CPI-PCE Gap and a Hotter Inflation Dashboard in 2022

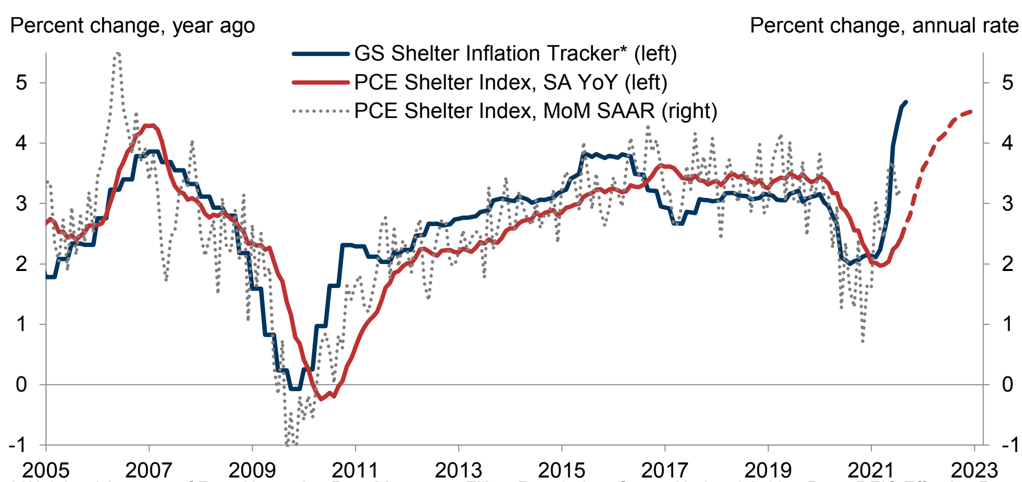
We recently bumped up our 2022 PCE inflation forecasts on an expectation that it will take longer to overcome supply chain challenges and in particular to boost auto production enough to replenish depleted inventories and exert downward pressure on prices. We now expect core PCE inflation to stand at 4.3% at end-2021, 3% in June 2022, and 2.15% at end-2022.

We also expect the gap between core CPI and core PCE inflation—usually about 25bp—to be wider than usual over the next year, leaving the core CPI measure quite high all year. There are three main reasons.

First, durable goods such as cars have a higher weight in the CPI than in the PCE index, and these categories have experienced large price increases that are likely to continue in coming months. We still expect a moderate degree of price level reversion toward pre-pandemic trends in these categories eventually, but this now looks likely to take longer because of longer-lasting supply chain challenges and persistent shipping congestion. As a result, the inflationary boost—especially to the CPI—is likely to last longer, and the eventual deflationary drag is likely to arrive later in 2022 and extend into 2023.

Second, shelter inflation also has a much larger weight in the CPI and is likely to rise sharply. We have argued since May that the US housing market is likely to remain historically tight for a while and that prices and rents are likely to rise much further. We expect spillover effects to the rental market to help push shelter inflation to about 4.5% by end-2022, disproportionately boosting the CPI measure. The dramatic recent acceleration in our shelter inflation tracker (Exhibit 1) suggests that the risks around even our aggressive forecast are two-sided.

Exhibit 1: We Expect a Sharp Acceleration in Shelter Inflation, Which Would Boost CPI More Than PCE



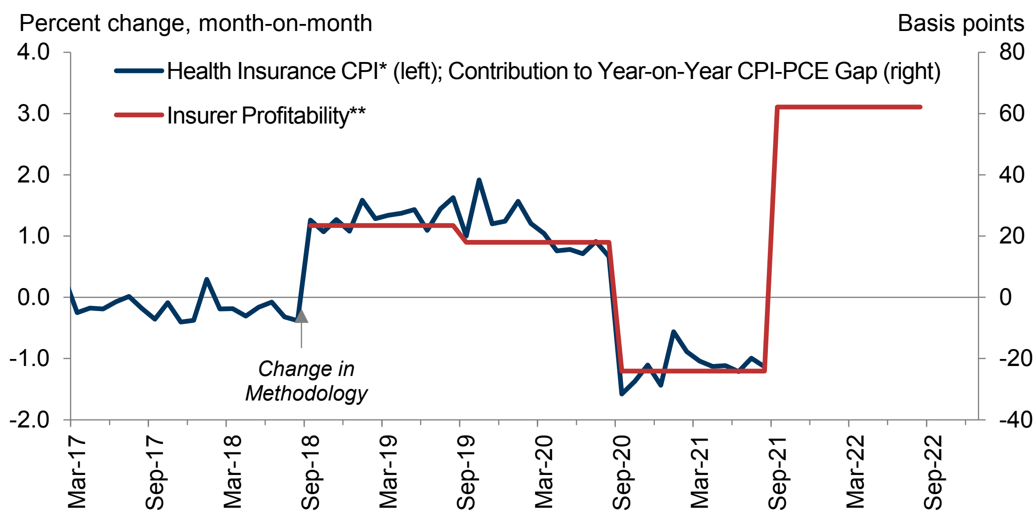
* Weighted Average of Four Alternative Rent Measures: Zillow Rent Index; Costar National Asking Rent; REIS Effective Rent per Apartment; Census Vacant Multifamily Median Rent.
Note: Dashed lines denote GS forecast.

Source: Department of Commerce, Goldman Sachs Global Investment Research

Third, the source data used to calculate the health insurance component that is unique to the CPI point to a spike over the next year. The multi-quarter trend in CPI health insurance inflation has closely tracked prior-year changes in insurer profitability since the current methodology was adopted in September 2018 (Exhibit 2). Rising insurance company profit margins are interpreted in the CPI as a larger markup over the cost of providing healthcare and therefore higher consumer prices.

The source data on insurer profitability are collected annually and incorporated in the CPI the following fall. The still-incomplete data for 2020 show that insurer profitability rose sharply (Exhibit 2) because doctor's visits and non-essential procedures fell during the pandemic, but insurance premiums did not fall proportionately. As a result, the trend in health insurance inflation should inflect sharply higher in the October report and remain strong through next summer, swinging from -1.25% monthly over the last year to 1.5-3% monthly starting in October. Sustained for a year, the contribution to core CPI from this small component would swing from -0.2pp to 0.3-0.6pp in August 2022. Because health care consumption has since recovered, this category will also eventually turn from a large boost to a drag.

Exhibit 2: Source Data Point to a One-Time Surge in the CPI's Health Insurance Component

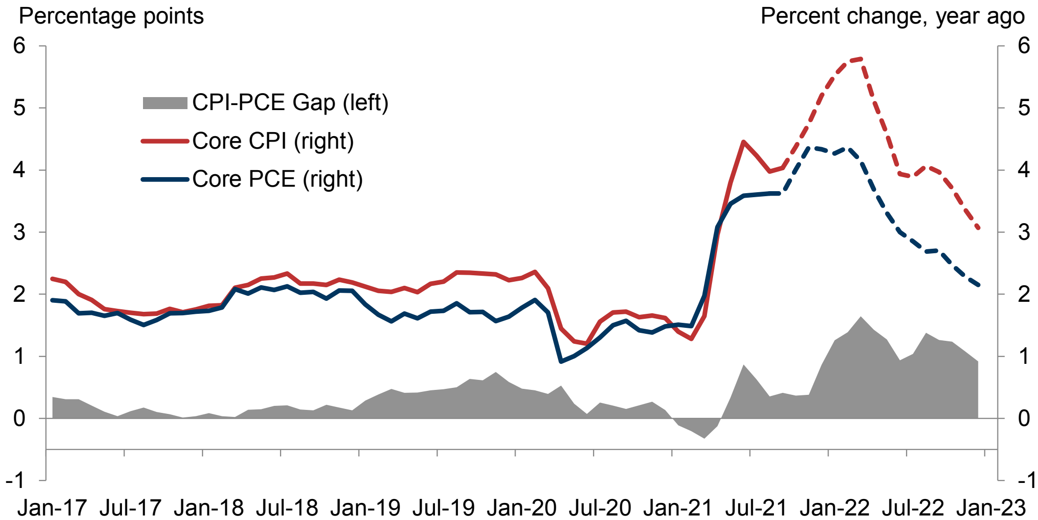


*Adjusted to exclude the trend in hospital services and physician services prices.
**Annual data on retention-benefit ratios, lagged 9 months. The latest data are incomplete.

Source: Department of Labor, National Association of Insurance Commissioners, Company data, Goldman Sachs Global Investment Research

We expect these factors to push year-on-year core CPI inflation to the mid-5's in Q1, 4% in June 2022, and 3.1% at end-2022, a roughly 100bp gap with PCE (Exhibit 3). Beyond that point, we expect eventual turnarounds in durable goods and health insurance prices to compress the CPI-PCE gap.

Exhibit 3: We Expect a Wider Than Usual Gap Between Core CPI and Core PCE in 2022



Source: Department of Labor, Department of Commerce, Goldman Sachs Global Investment Research

While the PCE index is the Fed's preferred inflation measure, Fed officials look at many measures. In addition to the core CPI, trimmed inflation measures that throw out outliers are also likely to rise as shelter accelerates. As a result, it increasingly appears that the full set of inflation data will look quite hot on a year-on-year basis around the middle of next year when tapering ends. As we noted recently, this increases the risk of an earlier hike in 2022.

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