

Inflation, jobs and the Fed: softer data helps to scale back rate hike expectations

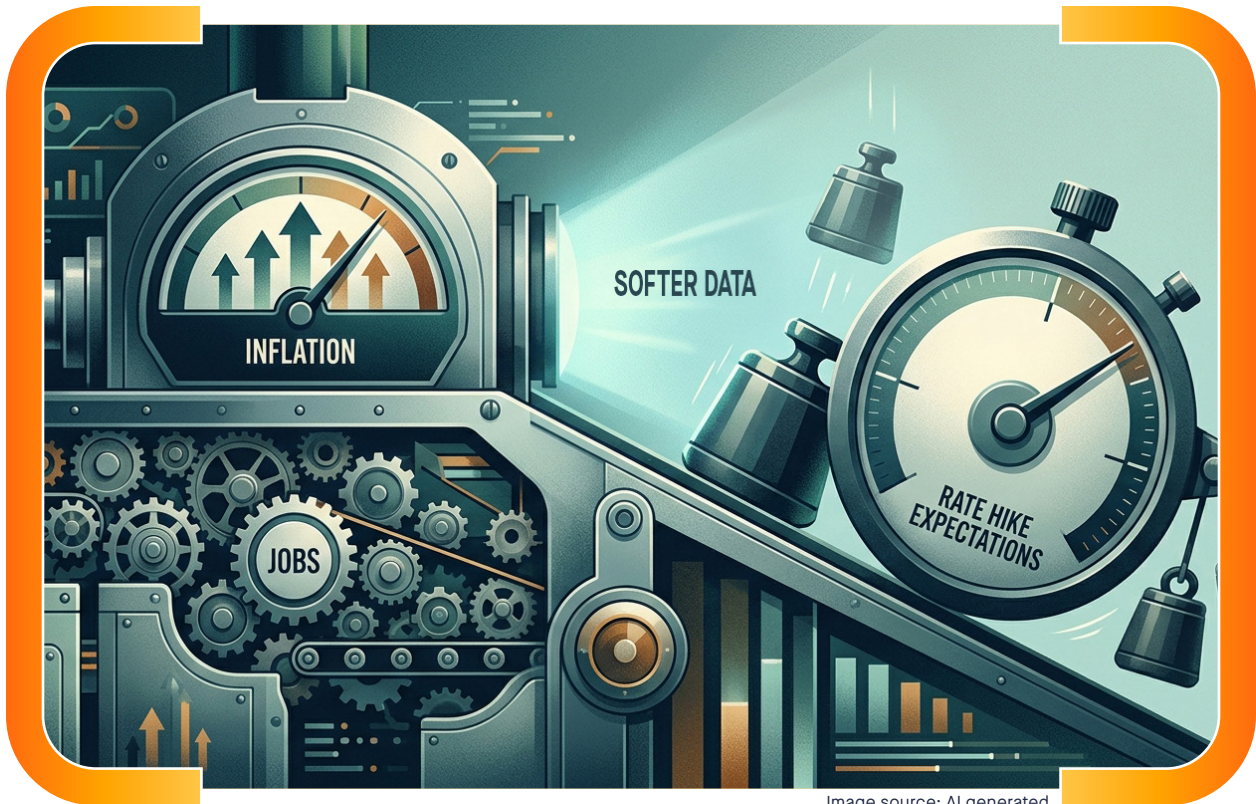


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- ▶ PCE inflation was softer than expected, and downward revisions explained much of the lower annual rates. Recent core momentum has moderated, while elevated energy prices and persistent underlying price pressures still prevent a clear all-round easing in price pressures.
- ▶ Disposable income rose by 0.3%, but real disposable income was unchanged, while nominal and real consumer spending increased by 0.9% and 0.6%, respectively. Consequently, the saving rate fell to 4.1%, indicating that spending outpaced income growth, pointing to our view that consumption likely will moderate in the quarters to come.
- ▶ September payroll growth slowed to 29,000 and previous months were revised lower. Unemployment edged up to 4.2%, partly reflecting higher participation, while wage growth moderated also pointing to less leeway for household consumption. The report softened, but did not fundamentally alter, the labour-market picture.
- ▶ Fed speakers favour patience in October, but inflation risks remain. Taking the latest data into account, we still expect one key rate increase this year, most likely in December, followed by another in the first half of 2027, but do not foresee a more aggressive tightening cycle with 4 or more hikes in the next 12 months.

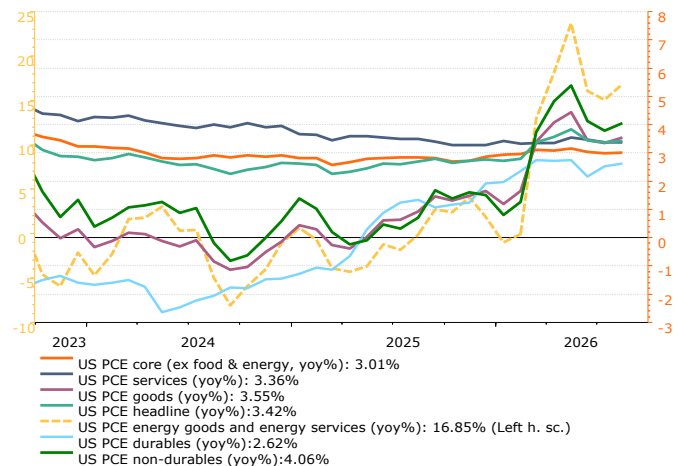
Downward revisions lowered annual inflation while monthly comparison shows no acceleration

The August PCE price report delivered a softer inflation reading than expected, although its interpretation is complicated by the annual update to the national accounts. The headline PCE price index rose by 0.3% month on month and 3.4% year on year. Excluding food and energy, core PCE increased by 0.2% on the published one-decimal basis, or 0.25% on an unrounded basis, while its annual rate stood at 3.0%.

Much of the apparent downside surprise in the annual rates reflected revisions rather than a sudden improvement in August. As part of its annual update to the national accounts, the BEA incorporated revised source data and methodological changes, with the largest downward effects on core PCE coming from portfolio management services and computer software and accessories. These revisions lowered the previously reported inflation path, including July's headline and core rates by more than 0.3 percentage points. The lower year-on-year readings therefore largely represent a reassessment of earlier price increases rather than a significant easing in August. Compared with these revised levels, annual inflation was broadly stable in August.

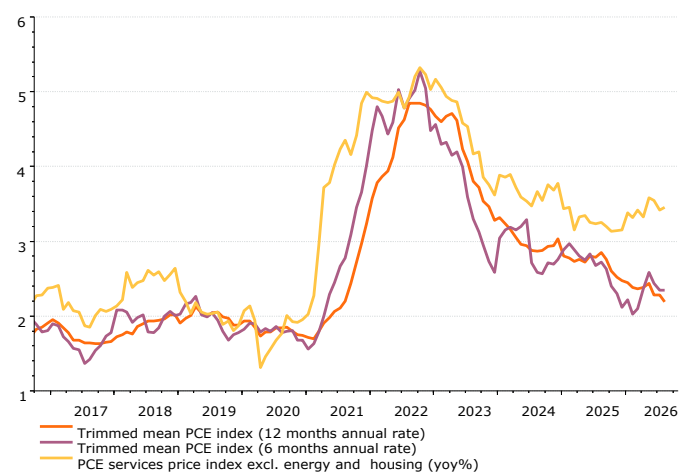
The more encouraging signal came from recent momentum: core PCE increased at an annualised rate of 2.0% over three months and 2.7% over six months, both below the 3.0% year-on-year rate. The composition remained mixed. Energy made a sizeable contribution to headline inflation, while housing inflation eased to 3.0% and core goods inflation stood at 1.9%. Price pressure within services excluding housing remained firmer, particularly in communication and transportation-related categories. Overall, the release points to contained near-term core momentum, but not to a broad decline in underlying price pressures.

Chart 1: Energy goods drove August inflation, while core inflation remained stubborn despite undershooting expectations



Source: LSEG Datastream, Syz Group

Chart 2: Mixed underlying inflation signals offer little evidence of a clear easing price trend so far



Source: LSEG Datastream, Syz Group

US consumption is steadily growing but income is not keeping up with the pace

August's Personal Income and Outlays report showed household spending rising faster than income. Personal income increased by \$66.6bn, or 0.2% over the month, while disposable personal income, which excludes personal current taxes, rose by \$68.6bn, or 0.3%. Disposable income was 4.8% higher than a year earlier. After adjusting for prices, however, real disposable personal income was unchanged in August.

Personal consumption expenditures increased by \$190.8bn, or 0.9%, following a much smaller revised rise in July. In real terms, spending advanced by 0.6%. The increase was broad across goods and services. Within goods, recreational items and vehicles, food and beverages, and energy goods contributed to the rise. Within services, the main additions came from financial services and insurance, healthcare, and food services and accommodation.

Total personal outlays, which cover consumption, personal interest payments and current transfer payments, rose by \$190.7bn. Because expenditure outpaced disposable income, personal saving fell to \$990.2bn, and the saving rate declined to 4.1% from 4.6% in July. The report therefore depicts robust household outlays in August but also shows that their strength relied partly on a lower share of income being saved.

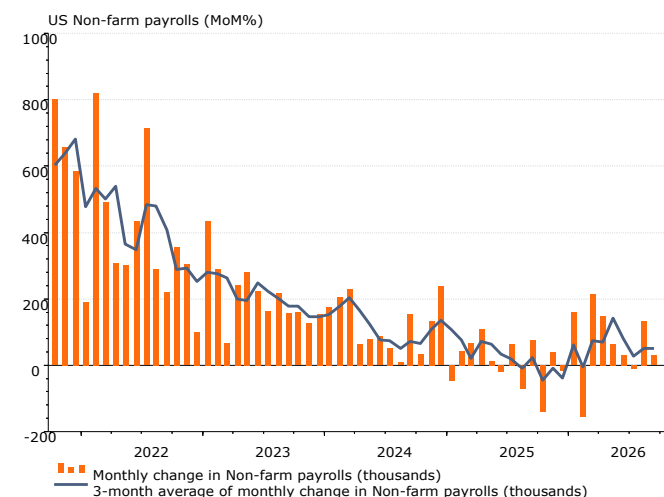
The other mandate of the Fed: US jobs market and the latest situation report

The September employment report showed a tangible slowdown in job creation. Nonfarm payrolls increased by 29,000, significantly below the expected gain of 90,000 and down from a revised 133,000 in August. Earlier estimates were also weaker: July was revised down by 31,000, while August was reduced by 29,000 from the initially reported 162,000. Together, the two preceding months recorded 60,000 fewer jobs than previously reported. Education and healthcare continued to account for most of the jobs added, while construction also contributed positively. The government sector exerted the strongest drag on employment growth in September.

The unemployment rate edged up to 4.2% from 4.1% in August, while the number of unemployed people rose modestly to 7.1 million. At the same time, labour supply strengthened. The labour force participation rate increased by 0.2 percentage points to 61.8%, and the employment-to-population ratio edged up by 0.1 percentage point to 59.2%. The rise in unemployment can therefore be viewed somewhat positively, as it partly reflected more people returning to the labour market and looking for work. Wage growth moderated further. Average hourly earnings for private-sector employees increased by five cents, or 0.1% month on month, after rising by a revised 0.3% in August. The annual increase

slowed to 3.0% from 3.1%. Overall, September combined subdued payroll growth and downward revisions with slightly higher labour-force participation, modestly higher unemployment and softer wage momentum. The report did not substantially change the picture of the US labour market, but it tempered claims that the labour market was running hotter than previously thought.

Chart 3: US non-farm payroll growth disappointed but remains positive, helping keep the labour market in balance



Source: LSEG Datastream, Syz Group

Fed speakers point to patience, while hawks continue to flag upward inflation risks

Even before the latest PCE inflation reading and the jobs report was released, New York Fed president Williams said there was “no need for urgency” following September’s move. While he still considered a further increase potentially appropriate later this year, his remarks argued against treating an October move as a foregone conclusion.

Interestingly, in a speech about a month ago, Williams had also said that a monthly core inflation pace of 0.2% (MoM) would reassure that underlying price pressures were easing. This is precisely what we have seen over the past four months. The day after the PCE release, Fed Vice Chair Philip Jefferson delivered a similar message, stating that “my colleagues and I will need to come to our own judgment, which may take more time”. He also noted that higher bond yields suggest investors are reassessing the macroeconomic landscape. Michelle Bowman likewise said she did not currently see an urgent need for further action and wanted to assess how September’s increase works its way through the economy.

The remarks tempered markets expectations for further rate hikes, with the probability of an October increase falling from above 70% to below 30%. However, inflation remains above target, and Fed officials continue to stress the need for vigilance.

We still expect one Fed key rate hike this year and another one in the first half of 2027

Softer-than-expected inflation and labour-market data, together with calls for a fuller assessment of incoming information, have reduced the immediate case for back-to-back increases. The latest communication from Fed speakers favours patience in October, while clearly keeping the option of further moves open. The latest business surveys point to stronger economic activity in

the US, but also to elevated price pressures and solid labour demand. Moreover, there has so far been no tangible easing of tensions in the Middle East, keeping energy prices elevated. Taking all of this into account, we still expect one Fed key rate increase this year, most likely in December, and another in the first half of 2027, possibly even two. However, we do not foresee an aggressive cycle involving four or more increases by the end of next year. As Fed Chair Warsh has noted, the Fed is removing the accommodative stance of monetary policy, but we think it is not moving beyond that at this stage.

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