DALLASFED Economic Update U.S.

Inflation Ticks Higher Amid Moderate Growth in Early 2017

March 17, 2017

Economic indicators released in February and March have been mostly positive, with the 2017 consensus outlook for output and inflation improving slightly since January's Federal Open Market Committee (FOMC) meeting.

The second revision for real (inflation-adjusted) gross domestic product (GDP) growth in fourth quarter 2016 was unchanged at 1.9 percent, with a shift from investment to consumption. Other indicators such as the Institute for Supply Management (ISM) Manufacturing Index suggest improving business investment in 2017. Core inflation measures are converging toward the Federal Reserve's target rate of 2 percent, while unemployment and broader measures of utilization are converging toward their natural rates. Growth and inflation forecasts for 2017 and 2018 have improved slightly.

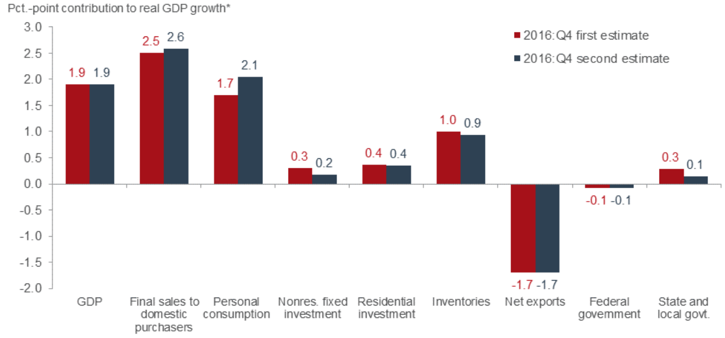
Key Indicators Remain Mostly Positive

Real GDP remained unchanged at 1.9 percent for fourth quarter 2016 *(Chart 1)*. Between the first and second estimates for fourth-quarter GDP, personal consumption expenditures' percentage contribution to growth expanded, from 1.7 percent to 2.1 percent, while nonresidential fixed investment contracted slightly, from 0.3 percent to 0.2 percent. Net exports remain a drag on the economy, and government spending, which has slowed since 2015, contributed almost no growth in the fourth quarter.

Business fixed-investment remains uneven, mainly due to low oil prices and an appreciating dollar. New factory orders rose 1.2 percent in January, and core capital goods orders fell 0.1 percent, with neither sustaining December's slightly higher gains. However, surveys point to greater optimism. The ISM manufacturing index reached 57.7 in February, and the ISM non-manufacturing index came in at 57.6. These numbers are the highest for both indicators since early 2015. A reading above 50 indicates a generally expanding economy.

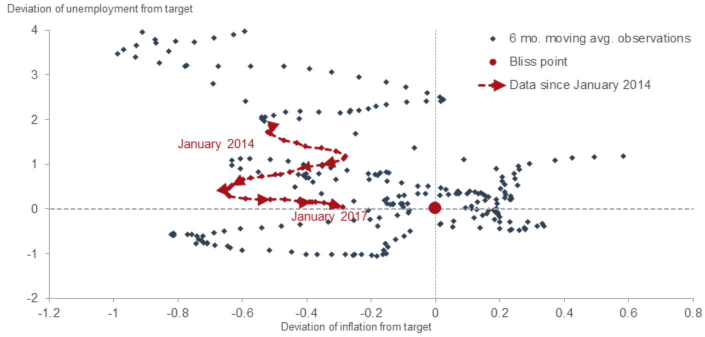
Consumer sentiment is high despite uncertainty regarding future fiscal policy. The University of Michigan's index of consumer sentiment reached 96.3 in February, slightly down from January's reading of 98.5 but a 5 percentage-point increase from February 2016. The previous three months' readings combined were the highest since 2004.

Chart 1
Consumption Leads Contributions to Fourth-Quarter Growth



*Seasonally adjusted, annualized rate.
SOURCE: Bureau of Economic Analysis.

Chart 2
Core PCE Inflation and Unemployment Move Toward Fed Targets



NOTES: Inflation rate used is core personal consumption expenditures (PCE) inflation. The Federal Reserve's target inflation rate is 2.0 percent. The target unemployment rate is the short-term natural rate of unemployment. Data start in 1994. The "bliss point" occurs when the deviation is zero.
SOURCES: Bureau of Economic Analysis; Congressional Budget Office; author's calculations.

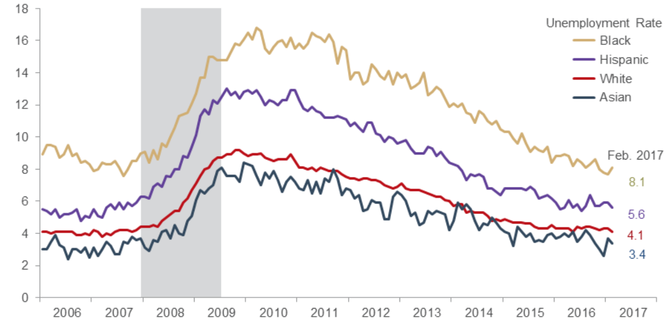
Inflation Inches Closer to Fed Target

Core personal consumption expenditures (PCE) inflation—PCE inflation excluding food and energy—reached 1.7 percent in January on a year-ago basis. Both the headline PCE inflation rate and the Federal Reserve Bank of Dallas' Trimmed Mean PCE inflation measure stood at 1.9 percent, approaching the FOMC's 2 percent target rate. Core Consumer Price Index (CPI) inflation reached 2.2 percent on a year-ago basis in February, also confirming movement toward the target.

The Federal Reserve in recent years has made considerable progress in achieving its dual mandate: to promote full employment and price stability. Chart 2 shows the path of monthly core PCE inflation and unemployment, indicating that the economy is approaching the "bliss point," where the difference between unemployment and the natural rate of unemployment is zero and where the difference between the core PCE inflation rate and the target inflation rate is also zero.

Chart 3
Unemployment Gradually Falling to Prerecession Levels

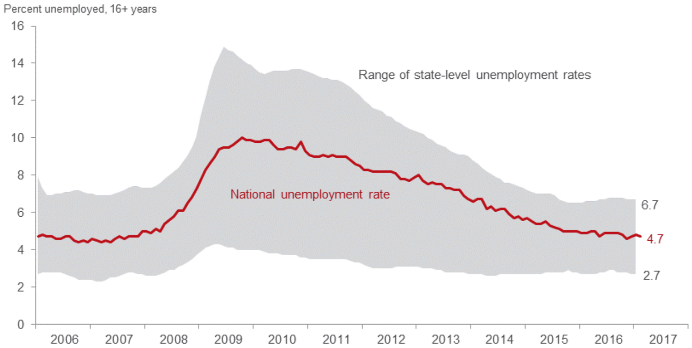
Percent, 16+ years, seasonally adjusted



NOTE: Shaded area indicates recession.
SOURCE: Bureau of Labor Statistics.

Chart 4
Dispersion of State-Level Unemployment Slowly Narrowing

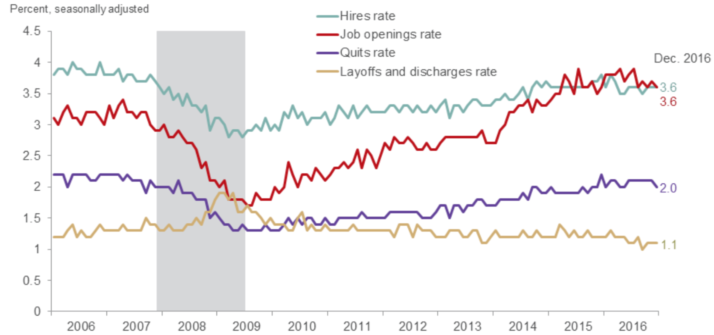
Percent unemployed, 16+ years



SOURCE: Bureau of Labor Statistics; author's calculations.

Chart 5
JOLTS Components Show Labor Market Improvement

Percent, seasonally adjusted



NOTE: Shaded area indicates recession.
SOURCE: Bureau of Labor Statistics.

Labor Market Returning to Pre-Great-Recession Levels

Unexpected payroll growth of 235,000 jobs in February helped drop the unemployment rate to 4.7 percent from 4.8 percent in January and boosted the labor force participation rate to 63 percent from 62.9 percent in January. Chart 3 shows the national unemployment rate by race, with a gradual return to 2006 unemployment rates for all groups. However, a large unemployment gap between groups persists, an occurrence that predates the Great Recession.

Chart 4 depicts the national unemployment rate relative to the range of rates in all 50 states. The dispersion of state-level unemployment rates is narrowing and is also comparable to the range before the Great Recession. Together, Charts 3 and 4 show that the labor market is improving, regardless of racial or regional divides.

The most recent Job Openings and Labor Turnover Survey (JOLTS) release, in December 2016, indicates that headline JOLTS indicators are also returning to pre-Great-Recession levels *(Chart 5)*. The quits rate (the number of job quits during a month as a percent of total employment) rose, indicating that workers are more optimistic about labor conditions and finding new employment. Job opening and hire rates have stabilized and are close to 2006–07 levels.

Expectations for Future Inflation, Growth Remain Positive

Long-term inflation expectations have changed little, though they have marginally moved toward the target inflation rate *(Chart 6)*. The Survey of Professional Forecasters' 5- and 10-year-ahead CPI inflation expectations are both at 2.3 percent, while the University of Michigan's survey expectations for 1- and 5-year-ahead CPI inflation are both at 2.6 percent.

The most recent Survey of Professional Forecasters report, released Feb. 10, indicates a slightly improved outlook for growth and inflation since the last release in November. The survey projects year-over-year real GDP growth of 2.3 percent for 2017 and 2.4 percent for 2018, an increase of 0.1 percent and 0.3 percent, respectively, from November's projections.

—Daniel Chapman

About the Author

Chapman is a research assistant in the Research Department at the Federal Reserve Bank of Dallas.