Economic Indicator — January 31, 2025

Strong December Spending Amid Only Modest Inflation

Summary

Despite stronger-than-expected consumer spending in December, the Fed's preferred gauge of underlying inflation rose only slightly putting the year-over-year rate at 2.8%. We explore the challenge of sustaining robust activity while still finishing the job of bringing down inflation.

U.S. Personal Income & Spending: December 2024

	Jan-24	Feb-24	Mar-24	Apr-24	May-24	Jun-24	Jul-24	Aug-24	Sep-24	Oct-24	Nov-24	Dec-24
Personal Income (MoM)	1.4	0.4	0.6	0.1	0.3	0.2	0.3	0.2	0.4	0.7	0.3	0.4
Personal Income (YoY)	6.0	5.9	5.9	5.7	5.5	5.4	5.4	5.2	5.1	5.5	5.3	5.3
Personal Income, Ex. Transfers (MoM)	1.0	0.3	0.6	0.1	0.3	0.1	0.3	0.2	0.2	0.6	0.3	0.4
Wages & Salaries Income (MoM)	1.0	1.1	0.8	-0.3	0.2	0.0	0.4	0.5	0.4	0.5	0.5	0.4
Personal Spending (MoM)	0.1	0.5	0.7	0.3	0.5	0.3	0.6	0.2	0.7	0.5	0.6	0.7
Personal Spending (YoY)	4.5	4.8	5.6	5.2	5.5	5.4	5.4	5.3	5.4	5.6	5.8	5.7
Durable Goods Spending (MoM)	-2.0	0.7	0.5	-0.5	1.1	-0.3	1.2	-1.0	1.7	0.2	2.7	0.6
Nondurable Goods Spending (MoM)	-1.1	0.1	1.3	0.0	0.3	-0.1	0.8	-0.4	0.8	-0.2	0.3	1.0
Services Spending (MoM)	0.8	0.7	0.6	0.5	0.5	0.4	0.4	0.6	0.5	0.7	0.4	0.6
Real Disposable Personal Income (MoM)	0.9	0.1	0.3	-0.1	0.3	0.0	0.1	0.0	0.2	0.4	0.1	0.1
Real Disposable Personal Income (YoY)	3.7	3.3	3.1	2.8	2.8	2.7	2.7	2.6	2.7	2.9	2.6	2.4
Real Personal Spending (MoM)	-0.3	0.2	0.4	0.0	0.5	0.1	0.4	0.1	0.5	0.2	0.5	0.4
Real Personal Spending (YoY)	1.9	2.1	2.7	2.4	2.8	2.9	2.9	2.9	3.2	3.2	3.2	3.1
PCE Deflator (YoY)	2.6	2.6	2.8	2.7	2.6	2.4	2.5	2.3	2.1	2.3	2.4	2.6
Core PCE Deflator (YoY)	3.1	2.9	3.0	2.9	2.7	2.6	2.7	2.7	2.7	2.8	2.8	2.8
Personal Saving Rate (%)	5.5	5.4	5.2	5.1	4.9	4.8	4.4	4.4	4.1	4.3	4.1	3.8

Notes: MoM = Month-over-Month Percent Change
YoY = Year-over-Year Percent Change

Source: U.S Department of Commerce and Wells Fargo Economics

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Consumer Confidence: January 2025

Retail Sales: December 2024

Consumer Sentiment: December 2024

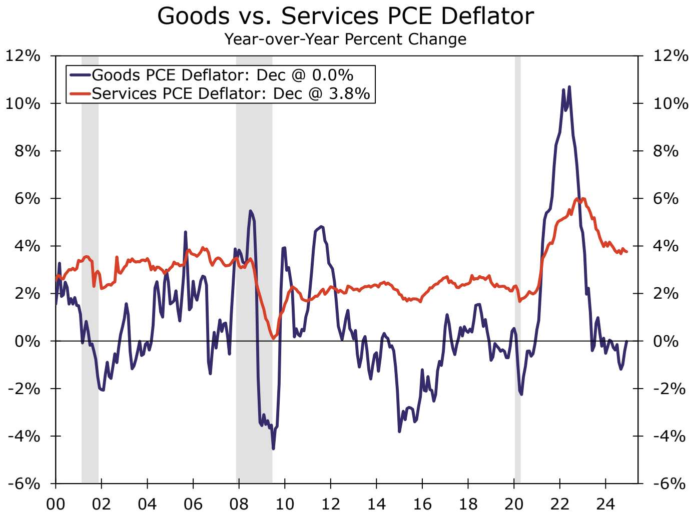
Nobody Said it Was Easy

Policymakers at the Federal Reserve this week signaled a willingness to sit tight for now after having cut the fed funds rate 100 basis points since September. A key challenge in setting short-term interest rates is whether inflation remains on a glide path toward the 2.0% target. Among the various ways inflation could creep back up, two that stand out are tariffs and sustained demand in the service sector.

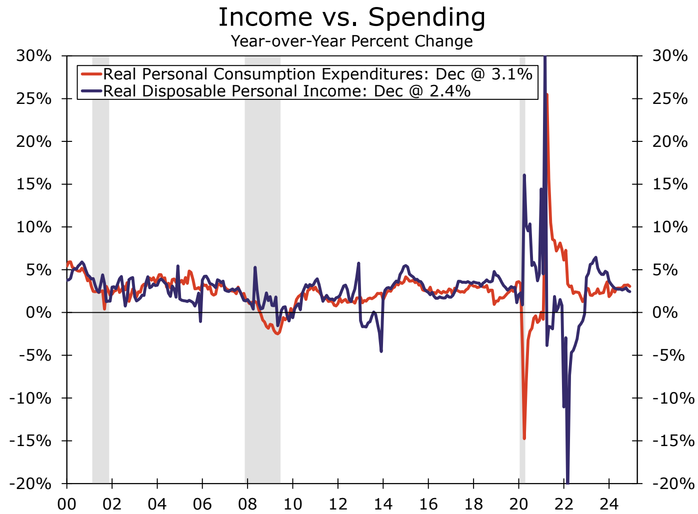
The Fed might look-through the tariff impact if it is seen as a temporary driver, but it is less apt to ignore services inflation. Consumers themselves tend to be less discerning about the drivers yet acutely aware that inflation has not gone away. When asked about where they expect inflation to run over the longer term in a recent survey from the University of Michigan, consumers' expectations rose to 3.2%, the highest since the financial crisis in 2008.

Hard inflation data today suggest that price pressures persist in both goods and services. The headline PCE deflator rose 0.3%, while the core metric—excluding food and energy prices—was up a more modest 0.2%. That gain keeps the annual rate of core inflation at a sticky 2.8% annual rate for the third-straight month and the underlying drivers of inflation suggest goods *disinflation* is quieting still-strong services inflation (chart), where prices rose 0.3% in December.

Separately released data this morning showed the employment cost index—a comprehensive measure of labor costs—is running at a rate *consistent* with the Fed's 2% inflation target, and suggests the labor market is no longer exerting significant pressure on inflation. It is sustained services sector spending that is more of a challenge for prices today. Even as consumers have grown more price sensitive they are still spending, and firms are unlikely to cease price increases until they see demand falter.



Source: U.S. Department of Commerce and Wells Fargo Economics



Source: U.S. Department of Commerce and Wells Fargo Economics

Real disposable personal income advanced another 0.1% in December, and is up 2.4% over the past year, still running very much at a rate that is supportive of continued consumption (chart). That helps shore up broad economic activity in the U.S., but makes stomping out the final mile of inflation all the more challenging for the Fed. This is particularly true when more interest-rate sensitive categories may be seeing a near-term boost in spending amid fears of tariffs. President Trump has most recently cited imposing a 25% tariff on Canada and Mexico this coming weekend. To the extent tariffs come to pass, they will likely more directly re-light the flame in goods inflation. Yet even just the prospect of tariffs is already influencing behavior. It's fanning cost plans for businesses and pushing consumers into a buy now, or pay *more* later mindset.

Pulling the Puzzles Apart

While spending was strong across categories, real spending on durables was particularly robust, up 1.1% in December along with upward revisions revealing a 2.6% pop in November spending. Spending on autos accounted for most of November's surge. The 5.6% pop in November spending on motor vehicles was the biggest since January 2023, this category saw a more modest gain of 0.3% in December. The strength in December durable goods spending is less about autos and more about broad-based gains in other categories. Furnishings, recreation and other goods each posted monthly increases of 1.3% or larger on an inflation-adjusted basis in December.

Rather than a reawakening in demand for durable goods we suspect some of this is a pull-forward in demand for big-ticket items and is tariff-related as consumers make key outlays now before prices go up. That said, the tariff rationale is trickier to apply to non-durable goods categories such as spending on groceries and gas, both of which posted real increases in December.

The thing to keep in mind when breaking out the categories of spending is that goods outlays are choppy, services outlays are not. Case in point: real goods spending was up in seven months and down in five throughout all of 2024. Real services spending rose in all twelve months with an average monthly gain of 0.24%. December's real services gain was 0.26%. Slower services activity may be the key to finishing the job on inflation, but that likely requires a more significant slowing in economic activity.

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