SUMMARY

- Consumer prices rose 0.6 percent in June from May, with core prices up 0.2 percent. These were the first gains in both measures since February.

- Overall inflation accelerated in June on a year-ago basis, and core inflation stabilized.

- Near-term deflation concerns are fading as demand picks up following the Viral Recession.

- Inflation remains far below the Federal Reserve’s 2 percent objective. Monetary policy is likely to remain highly expansionary in the medium term.

Inflation returned to the U.S. in June, with the consumer price index up 0.6 percent over the month, and core prices (excluding volatile food and energy prices) up 0.2 percent. Both of these measures fell in March, April, and May, meaning overall prices were declining in the U.S. as the Viral Recession weighed on consumer demand.

Overall inflation accelerated on a year-over-year basis to 0.7 percent in June, from 0.2 percent in May, the low point during the current cycle. Inflation was as high as 2.5 percent year-over-year in January 2020. Core inflation was stable on a year-over-basis at 1.2 percent in both May and June. Core inflation reached 2.4 percent year-over-year in February 2020 (see Chart).

With both major CPI measures up in June from May, and at least stable on a year-over-year basis, the immediate threat of deflation is over. Deflation, when prices are falling broadly, can be disastrous for an economy; it can cause consumers and businesses to put off purchases in the hopes of buying at a lower price later on, exacerbating economic downturns. Deflation can also make it more difficult for real (inflation-adjusted) wages to adjust during periods of high unemployment, prolonging job market softness, and can also reduce the effectiveness of Federal Reserve monetary policy.

Energy prices rose 5.1 percent in June, including a 12.3 percent increase in gasoline prices. This was the first increase in energy prices since December 2019. Even with the large increase in energy prices in June, they were still down 13 percent year-over-year, with gasoline prices down 23 percent from one year earlier. Gas prices are rising as consumers drive more. Food prices rose for a fourteenth straight month in June, up 0.6 percent from May. On a year-ago basis food inflation was 4.5 percent in June.

Some segments of the economy where prices had been falling because of weak demand saw higher prices in June, including apparel, tobacco, air fares, and car insurance. Rising prices for these goods and services is another indication that consumer spending is picking up after sharp drops in demand in the spring as the pandemic spread and states implemented restrictions on economic activity.

The Federal Open Market Committee can be relieved that the immediate threat of deflation has passed, but it can hardly rest easy. Even during the previous expansion inflation was persistently below the FOMC’s 2 percent objective (using the personal consumption expenditures price index, an alternative inflation measure that tends to run a bit lower than the CPI). And now, with the Viral Recession and a huge drop in consumer spending, inflation has moved even further away from 2 percent; thus the FOMC would like to see stronger inflation. When the committee updates its monetary policy guidelines later this year, it is likely to call for average inflation of 2 percent over the long run, implying that the central bank would like for price growth to move temporarily above 2 percent as the economy recovers.
This suggests that monetary policy will remain highly aggressive for at least the next few years. PNC expects the FOMC to keep the fed funds rate in its current near-zero range into 2023. The FOMC will also continue quantitative easing, designed to keep long-term interest rates low, by electronically placing money on the Fed's balance sheet to purchase long-term securities, such as Treasury bonds and mortgage-backed securities.

The FOMC could also adopt yield curve control later this year, when the central bank sets a target yield for an intermediate-term interest rate. By committing to keep an intermediate-term rate below a certain level, the Fed would be promising to keep interest rates low for an extended period of time, putting downward pressure on rates throughout the yield curve, supporting economic growth, a solid recovery in the labor market, and eventually higher inflation.

PNC expects inflation to gradually accelerate over the next few years as an improving economy gives firms more pricing power and a falling unemployment rate leads to wage gains. Overall inflation will accelerate more quickly than core inflation as energy prices rebound due to stronger economic growth and reduced supply.

Consumer prices rise in June, first gain in four months; deflation threat fading

Threat of deflation appears to have passed, but inflation still very low

Chart source: Bureau of Labor Statistics

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