April 18, 2024

In this week's "Three on Thursday," we explore the Personal Consumption Expenditures (PCE) Price Index, which became the Federal Reserve's preferred inflation gauge starting in 2000. This shift occurred after Federal Reserve Chairman Alan Greenspan highlighted its advantages in The *Monetary Policy Report* to Congress. The Fed favors the PCE Price Index over the Consumer Price Index (CPI) for several reasons. Firstly, the PCE Price Index uses a formula that adapts to changes in spending habits, reducing the upward bias inherent in the CPI's fixed-weight approach. It also employs weights based on a broader expenditure measure. Additionally, the PCE Price Index's historical data can be revised to incorporate new information and improvements in measurement techniques, which include refinements to the source data used in the CPI, leading to a more consistent time series. While the Federal Open Market Committee (FOMC) has adopted the PCE as its preferred measure, it continues to use a range of price metrics and other cost information to assess inflation trends. For further clarity, we've included a table and two detailed charts in this edition.

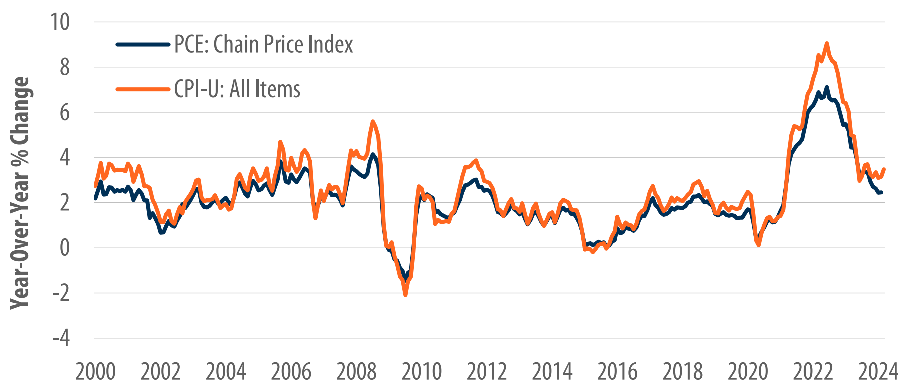
PCE Price Index Breakdown

	Weighting		Weighting
Goods	**33.07%**	**Services**	**66.93%**
Durable goods	**11.64%**	**Household consumption expenditures (for services)**	**63.97%**
Motor vehicles and parts	4.01%	Housing and utilities	17.74%
Furnishings and durable household equipment	2.52%	Health care	16.32%
Recreational goods and vehicles	3.67%	Transportation services	3.27%
Other durable goods	1.45%	Recreation services	3.86%
Nondurable goods	**21.43%**	Food services and accommodations	7.46%
Food and beverages purchased for off-premises consumption	7.70%	Financial services and insurance	7.07%
Clothing and footwear	2.75%	Other services	8.24%
Gasoline and other energy goods	2.53%	**Nonprofit institutions serving households**	**2.96%**
Other nondurable goods	8.45%		

Source: Bureau of Economic Analysis, First Trust Advisors. Data as of Q4 2023.

The PCE Price Index can be divided into two main categories: Goods and Services. Goods represent 33.1% of the index, with Durable Goods (items intended to last three years or more such as appliances and furniture), and Nondurable Goods (items with a shorter lifespan, like food and clothing) contributing 11.6% and 21.4% to the overall index, respectively (off 0.1% due to rounding). Services account for 66.9% of the index, dominated by Household Consumption Expenditures, which hold a substantial 64.0% weighting. Nonprofits contribute a smaller portion at 2.9%. Within Household Consumption Expenditures, Housing and Utilities form the largest group, influencing the overall index with a 17.7% weighting, followed closely by Health Care at 16.3%.

Inflation Measures: PCE vs CPI



Source: Bureau of Economic Analysis, Bureau of Labor Statistics, First Trust Advisors. Monthly data 1/2000 - 3/2024. PCE data only available through 2/2024.

Since 2000, the annualized gain in the PCE Price Index has typically been about 0.4 percentage points lower than the CPI due to several key differences. First, the CPI uses a fixed basket of goods and services with quantities based on past consumption, rarely updating. In contrast, the PCE Price Index adapts more dynamically, reflecting changes in consumer behavior and substitutions in response to price changes by frequently adjusting item weights based on current spending data. Second, consumption categories in the CPI and PCE are weighted differently; for instance, housing accounts for about 45% of the CPI but only 15.4% of the PCE. Third, the CPI measures direct out-of-pocket expenses by consumers, while the PCE includes all goods and services consumed by households, even those paid by employers and the government, like medical premium payments made by employers, providing a broader view of consumption. Lastly, variations in seasonal adjustments and price calculations for identical products also contribute to discrepancies. For example, the PCE's airline fare index is based on passenger revenue and miles traveled, whereas the CPI measures ticket prices for specific routes, leading to different pricing insights.

"Supercore" Inflation

Source: Bureau of Economic Analysis, First Trust Advisors. Monthly data 1/2010-2/2024.

For decades, economists have excluded food and energy prices from inflation measures – commonly referred to as "core prices" – because they can be both seasonal and volatile. Starting in November 2022, the Federal Reserve said it will focus on a narrower measure known as "Supercore" inflation, which refines this perspective even further. Fed economists categorize core inflation into three segments: core goods, housing services, and core services minus housing. The latter category, often referred to as Supercore, gained traction after the COVID lockdowns. This focus stems from the Fed's belief that service sector prices, unlike goods prices, are predominantly influenced by labor costs—a factor the Fed thinks it can influence. Raising interest rates typically cools economic activity, and jobs growth, which should limit wage hikes. In contrast, they believe goods prices are more susceptible to global dynamics like supply chain variations. Interestingly, in spite of major interest rates hikes, Supercore has remained stubbornly elevated, up 3.3% from a year ago. This is likely a significant argument for fewer rate cuts this year than the market has been expecting.