Macro Signposts | If Inflation Is the Problem, Why Aren't Wages?

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Kevin Warsh's Jackson Hole speech struck a decidedly hawkish tone and was arguably the clearest signal yet that the Federal Reserve is actively considering additional tightening. Markets responded by raising the probability of a September hike to roughly 60% and pricing approximately 60 basis points of cumulative tightening through the middle of next year.

The speech did three things simultaneously.

Re-established 2% Personal Consumption Expenditures (PCE) as the operative inflation target and observed that across a range of underlying inflation measures, inflation is running above 2%.

Rejected the notion that two softer inflation prints represent meaningful progress.

Explicitly stated that policy must tighten if the Federal Open Market Committee (FOMC) lacks confidence that inflation is moving toward target "clearly and at sufficient speed."

According to Fed Chair Warsh the question is not only if inflation is improving, but if it's improving fast enough – a higher bar than what was set by public comments from other FOMC officials. Still, Warsh wasn’t completely clear on how much progress and over what time frame. Since the June meeting, various FOMC members have communicated a willingness to wait for more data before making further policy adjustments, especially since economic and inflation data received since June have been consistent with forecasts for inflation to moderate.

Many have also indicated that anchored inflation expectations shouldn't be taken for granted, and a prolonged period of elevated inflation (even if it were caused by a series of supply shocks and price level adjustments) may warrant additional tightening.

In the end, whether the committee ultimately hikes in September (or not) may not be due to substantial changes in the outlook for growth and inflation since June. Both our and consensus forecasts for PCE inflation for the end of 2027 have been in the range of 2.4%-2.5% since June – a substantial improvement from the current 3.3% pace but not a full return to target. We doubt the August Consumer Price Index print – the last consumer inflation data that will be released before the September FOMC meeting – will materially change the outlook.

If the committee hikes, it will be because they want to lean against the risk that inflation expectations will drift higher as progress on reducing inflation has been slow.

That risk hinges on a specific mechanism: Inflation expectations increase labor costs, which in turn feed through to prices. We think the risk is relatively low. While elevated demand for scarce workers may be impacting certain small segments of the economy, we think structural factors are putting downward pressure on wages (see Macro Signpost, “Counterintuitive Labor Market Shifts Constrain Measured U.S. Wage Gains”). Nevertheless, the policy decision will come down to a collective judgement call.

Right now, the gap between ULC growth and core PCE is unusually wide. ULC growth is running at roughly a 1% year-over-year pace, near the slowest pace since the pandemic, while core PCE is running at 3.3%. That gap is arithmetically explained by the decline in labor's share or the rise in capital owners' share, which is the inverse of labor's share – and indeed, labor's share of income has fallen to the lowest level in the series since 1947. The mirror image shows up in profits: After-tax corporate profit margins as a percentage of gross value added were at their highest level in over 80 years of data, according to the national income and product accounts, while S&P 500 Index net margins hit a record in the second quarter, according to FactSet data (see Figure 2). In short, today's above-target inflation is arithmetically a profit-share story, not a labor-cost story.

Source: https://www.pimco.com/us/en/insights/if-inflation-is-the-problem-why-arent-wages