Economic Update

February 28, 2025

Consumer Spending Fell in January as Auto Sales Plunged, But Income Growth Was Good; Moderate Inflation, But Still Too High for the Fed

- **Consumer spending fell for the first time in almost two years in January, with a big drop in auto sales.**
- **Even as spending fell income growth was the strongest in a year. There was a big increase in Social Security benefits, but labor market income growth was also solid.**
- **Overall and core PCE monthly inflation were both 0.3% in January, near their recent paces.**
- **On a year-ago basis core PCE inflation slowed, but it has been stuck close to 3% for a year, higher than the Federal Reserve would like.**
- **The fundamentals for consumer spending growth in 2025 are generally solid, but tariffs could be a drag.**
- **Risks to the inflation outlook are to the upside.**

Consumer spending, not adjusted for inflation, fell 0.2% in January, the first drop since March 2023. Good spending fell 1.2%, including a 3.0% drop for durable goods. Motor vehicle and parts spending fell more than 40% over the month. Services spending rose 0.3% in January.

Even as consumer spending fell, personal income growth was solid in January, up 0.9%, the biggest increase since January 2024. Much of the income growth came from the annual cost-of-living adjustment for Social Security benefits; transfer payments increased 1.8% over the month. But wages and salaries were up a solid 0.4% in January due to job growth and wage increases. After-tax personal income also rose 0.9% in January.

With income up and spending down the personal saving rate jumped to 4.6% in January from 3.5% in December. This is the highest the saving rate has been since June 2024.

The personal consumption expenditures price index rose 0.3% in January; inflation has been at that pace in three of the past four months. The core PCE price index—the Federal Reserve's preferred inflation measure, which excludes volatile food and energy prices—rose 0.3% in January, an acceleration from core inflation of 0.1% in November and 0.2% in December.

On a year-ago basis overall PCE inflation was 2.5% in January, down from 2.6% in December. Core PCE inflation was 2.6% in January (2.647% before rounding), down from 2.9% in December. But there has been little progress on slowing core inflation in recent months; it has been between 2.6% and 3.0% for a year, still

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stuck above the Federal Reserve's 2% objective. Still, this is a big improvement from core inflation of close to 6% in 2022.

After adjusting for inflation, consumer spending fell 0.5% in January, the biggest drop since February 2021, when coronavirus cases surged. Real (inflation-adjusted) after-tax personal income was up 0.6%.

The personal income and outlays report for January was a mixed bag. Income growth was strong. Some of this was due to high inflation in 2024 that boosted Social Security benefits at the start of this year, but labor market income growth was solid. But even as income grew at the fastest pace in a year, consumer spending fell sharply, led lower by autos and other durable goods. Some of this is likely consumer uneasiness over Trump administration policies; consumer confidence has fallen sharply at the beginning of the year. But the fundamentals for consumer spending are still positive, particularly the strong labor market, including good job growth and wages that are increasing more quickly than prices. Other positives for consumer spending this year are rising household wealth, thanks to increasing home values and the strong stock market, a drop in short-term interest rates since the Federal Reserve started to ease monetary policy last fall, and low consumer debt burdens relative to incomes. Although spending fell in January, one positive that came out of that was the jump in the saving rate. The saving rate has been running below its pre-pandemic level since 2022 as spending growth has outpaced income growth; with the increase in the saving rate in January, consumer incomes and spending should be able to increase roughly in tandem going forward.

But there are some negatives for consumer spending in early 2025. Although the Fed has been easing, interest rates are still much higher than they were a few years ago, and longer-term interest rates have increased in recent months. There are also downside risks to consumer spending this year, including tariffs that would raise prices on consumer goods and federal job cuts.

The data on PCE inflation were not as bad as in the consumer price index release earlier this month. Both overall and core PCE inflation were 0.3% in January, around where they have been in recent months. On a year-ago basis core PCE inflation slowed, although it still above the central bank's 2% objective, with little progress in recent months. Risks to the inflation outlook are to the upside in 2025. Tariffs would boost consumer goods prices. And restrictions on immigration could lead to stronger wage growth, which would flow through to consumer inflation. After cutting the federal funds rate, their key short-term policy interest rate, by a cumulative one percentage point in the second half of 2024, the Federal Open Market Committee is unlikely to cut the rate again until core PCE inflation has moved noticeably lower. PNC expects the next fed funds rate cut to come in May. But this rate cut could be pushed out later into 2025, or even into 2026, if tariffs and stronger wage growth lead to higher near-term inflation.

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