FOCAL POINT

Inflation risks in the US keep lingering

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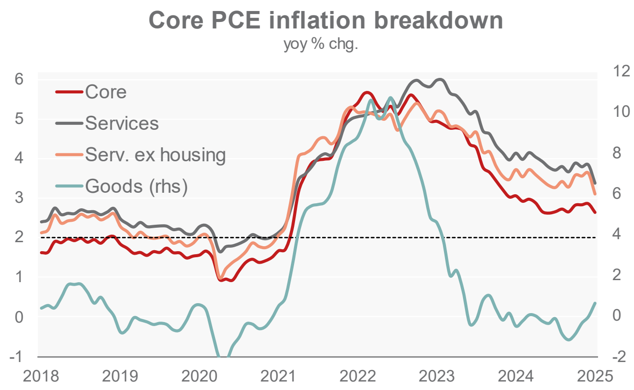
Our Focal Point series explores topical issues on macro, markets and investment

- **Market reaction to the announcement of the imposition of tariffs has focused on the recessionary impact. We argue that, even if a lower level of tariffs is applied, inflation risks remain.**
- **Our pre-tariff announcement scenario had core PCE inflation at or above 2.6% yoy until spring, with risks tilted to the upside given the slow labour market cooling and the rise in consumer expectations. The tariff induced spike in the price level could lift 2025 inflation by as much as 0.7pp.**
- **The Fed should look through the price level increase, without rushing into cuts to avoid that higher inflation expectation remain entrenched. Despite choppy data, the economy is not weak enough to justify cuts before the summer.**
- **We think that the recent decline in longer term market-based inflation expectations owes much to recession fears. Given the large price impact of tariffs we do not expect inflation expectations to fall further. On the contrary, if the recent tariff hikes escalate into a trade war, medium- and long-term US inflation expectations may rise again.**

The announcement of a sharp increase in US import tariffs to its closest trade partners (Mexico and Canada) and to China exacerbated fears of a US slowdown already raised by deteriorating indicators (slumping consumer confidence ISM manufacturing expectations), that brought down long-term interest rates. However, if the measures on Mexico, Canada and possibly Europe, are imposer before activity is impacted in full, the level of prices would rise, leading to a spike in inflation. This will prove temporary and the ensuing damage to activity will moderate inflation. While the full implementation of the tariffs threatened remains very uncertain, the underlying trend in price increases is very sticky and may be only partially weakened by the slowdown in activity tariffs would bring about. Moreover, and contrary to the current market expectation of a fast monetary easing, the almost instantaneous price increase may prevent the Fed from cutting rates quickly even though unemployment is set to rise. This means that bond yields may remain prone to bouts of volatility as the market reassess the growth and inflation implications of the new economic scenario.

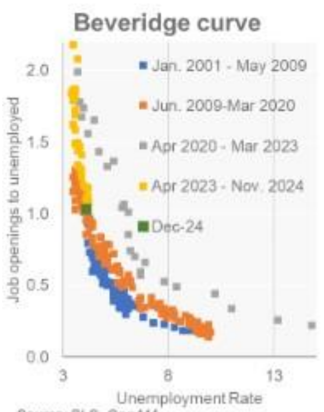
Even without tariffs core inflation is too high …

The January consumption data raised fears of a recession as purchases dropped significantly. The news on prices were mixed, with favourable base effect pushing down annual inflation, while monthly developments and the revision of the past year data showed a still high degree of stickiness. The bulk of inflation is in services, and the situation does not change much once rental costs are stripped out. Disinflation in goods stopped almost one year ago as supply gridlock eased, and the latest figures show that this category is adding back to price pressure. Moreover, expectations of tariffs have pushed back up the prices paid component of the both the manufacturing and services ISM indexes and drove up consumer inflation expectations. The recent news will lead to a further increase that will reverberate into retail prices over the coming months.



Source: BEA, GenAM

Ex housing services is labour intensive but inflation there has so far reacted rather softly to the normalisation of the labour market. The steep fall in job offers has brought them back in line with the unemployment rate and in the coming months labour market weakening will affect joblessness too. Further downward pressure on wage growth should come from continuing moderation in quits, as finding a new job is getting harder. Indeed, both indicators are now within the pre-pandemic range. The tariff induced slowdown in activity will lead to a worsening of the labour market. But according to our simulation the tariffs announced would increase the unemployment rate by no more than 0.4pp by year-end, exerting a rather small downward pressure on wages, likely to be offset by higher inflation expectations.

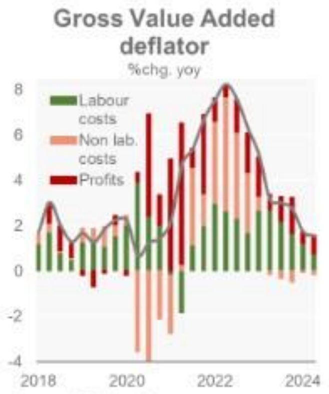


Source: BLS, GenAM

Source: BLS, GenAm

So far, the transmission of lower wage growth onto retail prices has been modest. Stronger demand has so far allowed retailers to pass a large extent of costs to consumers and keep margins high. Indeed, inflation in retail trade production prices (a common proxy for margins) has rebounded recently and profits still explain an historically large share in value added deflator growth. As tariffs dent economic activity consumption growth should start easing and pricing power with it, but we do not expect the process to be quick.

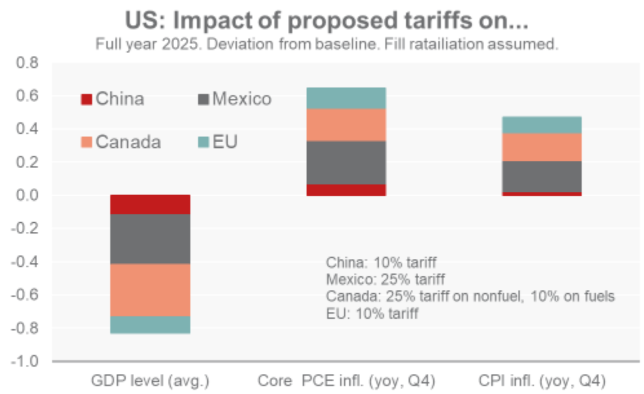
Source:BLS, Refinitiv, GenAM



Source: BEA, GenAM

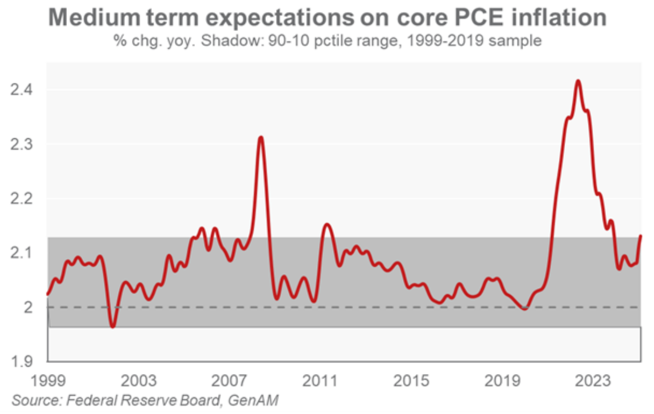
... and tariffs risks push expectations up

Whether at ball or to which degree the Trump administration will ultimately implement tariffs remains unclear, but some damage has already been done. Business surveys show anticipation of higher input prices. In a [previous Focal Point](), we tried to quantify the economic impact of some of the proposals floated by the administration. Our model simulations show that the 25% rate on Mexico and Canada and an additional 10% on China would lower growth this year to below 2% but, importantly, add around 0.6pp to annual inflation by year end, which would bring it towards 3% yoy.



Source: GenAM

One of the most concerning developments was the increase in expected inflation, signalled by surveys and, at least until mid-February, market prices. Fears of tariffs induced price increases are a clear cause, together with the price spike in some frequently purchased foodstuff (like eggs). There is not a single best measure of expectations, and political polarisation is also affecting the quality of surveys, for example inflation expectations from Republican leaning respondents shifted from way above the median before the election to way below afterwards, with those by Democrats flipping in the opposite direction. We try to make sense of the common signal form a divers set of indicators by constructing the monthly version of the Federal Reserve Board's index of Common Inflation Expectation (see Appendix for the details). Our estimate for the first two months of 2025 point to a sharp increase in expectations, which are at the uppermost end of the pre-COVID period range.



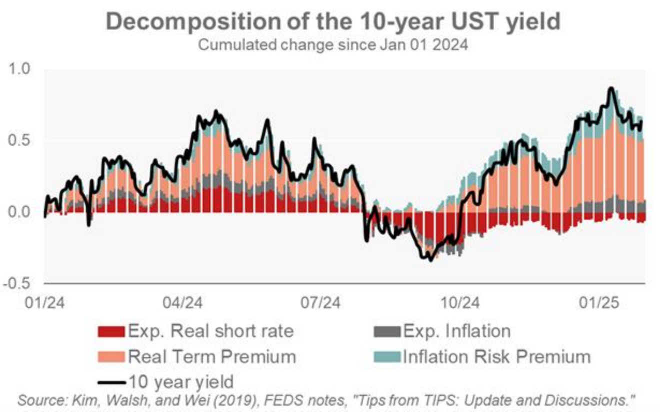
Rising expectations may affect wage demand, especially if the labour market continues to cool only marginally, and is likely to impact firms pricing behaviour, helped by still strong domestic demand. This probably constitutes one of the key upside risks to the economy.

The second is clearly politics: the new administration's proposal on tariffs, even if they are diverse and seemingly aiming at fulfilling also non-economic objectives, are pointing to an active use of trade measures in the future, with the risk of stoking and outright trade war. The spike in manufacturing input costs when the first Trump administration levied tariffs on Chinese goods and global steel and aluminium imports, is instructive in this sense. In the end, we stick to our view that the need not to upset consumers ahead of the likely tight midterm election and given the relatively low popularity president Trump seems to be enjoying in polls[1], may still prevent extreme measures on the trade side. But of course, news over the last week is testing this assumption. Yet, the often-contradicting statements are creating uncertainty which works to some extent already like an adverse shock, by depressing growth expectations and rising expected inflation.

Another, milder and longer horizon source of upside risk for inflation comes from the housing sector. Higher borrowing rates have depressed construction activity. Since the beginning of the rate hike cycle in 2022, multifamily housing starts for rent almost halved. This can create again supply bottlenecks as the vacancy rate for rental is low and that the preference for renting expressed in surveys is at an historical high. Therefore, the gradual disinflation in the rental component (which account for around 40% in core CPI and 15% in core PCE) might come to a halt within a few months.

Expectations of fast rate cuts likely underestimate inflation risks

Therefore, despite the mounting concerns of a substantial downshift in demand growth we still see substantial upside risks to our forecast of tariffs adding to an already sticky inflation. As observed by chair Powell recently, despite the first data release for the year are choppy, the underlying trend of the economy is solid and inflation way too high to justify a rush to cut rates. Moreover, the large uncertainty on trade gives the Fed a strong case for pausing unless the economy and the labour market deteriorate very quickly. Yet, the recent string of bad activity data has triggered a massive repricing of the next Fed moves. Markets now expect three cuts, with the first one already in June; we think that this underestimates the willingness of the Fed to be sure that inflation is headed steadily down. Moreover, nervousness is increasing at the long end of the curve. A popular model-based decomposition of the 10-year Treasury yield, developed by the Fed, shows that investors are getting more worried not just by the expected inflation level but also its variability as shown by the sizeable risk premium that has built up since the November election.

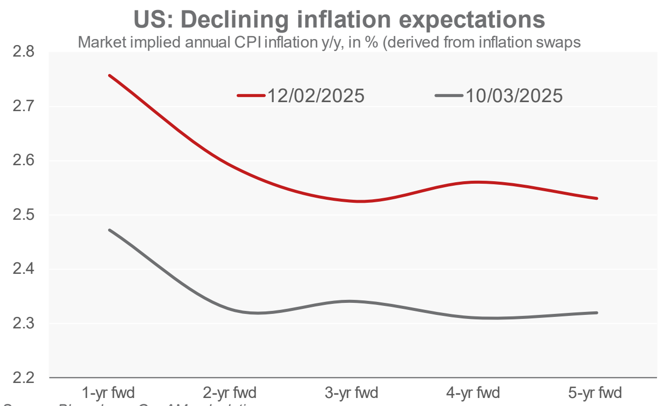


Little leeway for a decrease in inflation expectations

Despite the inflationary developments described above, market participants' inflation expectations have tended to decline in recent weeks. While long-term expectations are now back to the levels seen last autumn, even short-term inflation swaps have fallen from their mid-February peak (although e.g. 2-year inflation swaps, at 2.70%, are still 15

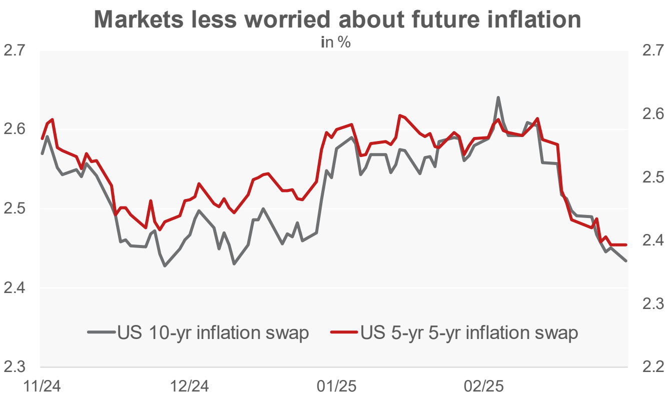
[1] According to the Gallup poll published in mid-February, only 44% of surveyed citizens have a positive view the president. It is the lowest level for a president in the first month of inauguration since the poll exists (late 1950s). The level drops to 42% when the handling of the economy is considered.

bps above their level at the beginning of the year). The 10-year breakeven inflation rate has fallen by more than 20 bps since mid-February close to 2.45%, and the 5-year-5-year forward inflation swap rate has also fallen by 20 bps over the same period to around 2.40%.



Source: Bloomberg, GenAM calculations

In our view, the main reason for this development is the increasing risk of recession due to rising uncertainty. With the risk-off sentiment on US financial markets of recent weeks, real yields have fallen significantly, along with inflation expectations. We forecast a further significant decline in US nominal yields (i.e., 10-year Treasury yields below 3.70%) if either US growth weakens noticeably or the new US administration succeeds in noticeably reducing the budget deficit. This is what US Treasury Secretary Scott Bessent has in mind when he argues that a significant reduction in the budget deficit will lower long-term bond yields, irrespective of the Fed's monetary policy.



Source: Bloomberg, GenAM

Some market participants have pointed out that hopes of a dampening effect on inflation induced by AI might have led to a decline in inflation expectations, but we think this is more relevant in the longer term. Moreover, the recent risk-off sentiment in the US financial market also suggests that a positive AI-induced productivity shock is not the cause.

Policy uncertainty and fears of a slowdown in economic growth, instead of a more benign outlook for inflation are therefore the main reasons for the decline in expectations priced into the US market. However, our scenario of still around 2% growth in the coming years and sluggish disinflation does not leave much room for lower inflation expectations. If, on the other hand, the US administration opts for a complete implementation of its tariff (such as the recently imposed tariffs on goods from China, Canada and Mexico) and migration policies, accompanied by fiscal easing to cushion the negative economic impulses, then even a rebound in the expected inflation component of yields is likely. Hence, we regard the risk/reward ratio as attractive and see value in medium- and long-dated inflation-linked bonds and recommend that investors overweight them.

Conclusions

The uncertainty generated by the string of policy announcement by the US administration has started to hit sentiment, raising fears of a marked growth slowdown. This has been the key driver of lower US yields in the past weeks. However, we argue that elevated inflation remains a high, and somehow underappreciated risk to the outlook. The common assumption of a downward path for rates is therefore subject to several risk, stemming from both the possible persistence of inflation at levels above the target and the high bars for the Fed to cut rates swiftly in response to the shock the possible imposition of tariffs would create. Investors should then stand ready to bouts of volatility.

APPENDIX: A MONTHLY INDEX OF MEDIUM-TERM INFLATION EXPECTATIONS

Recent years have seen a growth in data on inflation expectations from various surveys and financial instruments. These data vary by economic agent, expectation horizon, data source (survey vs. market-based), and inflation concept, making it hard to identify common trends. To address this issue the Federal Reserve develops a methodology to filter the common trend by means of a statistical model (a Dynamic factor model , similar to principal component analysis but that takes also into account the lag structure within and between series) to build a general measure of medium term inflation expectations, the Index of Common Inflation Expectations. The model uses 21 indicators of inflation expectations, with different frequencies (from daily to annual), but sampled quarterly. The updated series is published around twenty days after the end of the quarter. To get a timelier gauge, we applied the same algorithm but with monthly series and extended to 33 the number of series employed. The resulting series tracks very closely the Fed quarterly series and can be updated in real time.

Imprint

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