Benign US inflation remains vulnerable to tariff-induced price hikes

US inflation was much softer than expected in May with little evidence of tariff-induced price hikes so far. This is unlikely to last though with inflation still likely to get to around 4% later in the year, which is likely to keep the Federal Reserve in a wait-and-see mode

US inflation for May was lower than expected at 0.1% month-on-month for headline and core CPI

0.1% MoM

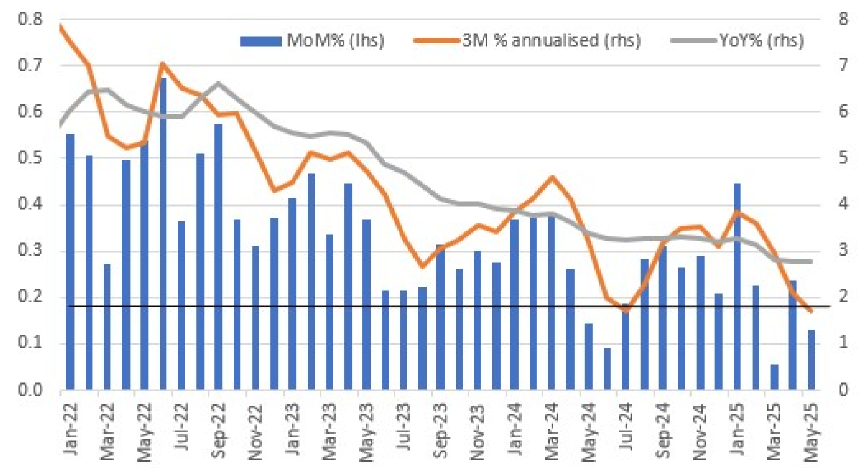
Lower than expected

Increase in both core and headline prices

Subdued inflation shows no signs of pre-emptive price hikes

We've had a very comforting set of US inflation numbers for May with both headline and core CPI rising 0.1% month-on-month versus market expectations of 0.2% for headline and 0.3% for core. It is also softer than the 0.2% MoM outcome for the core measure we had been looking for on the rationale of some softness in services and that tariff impacts are more likely to be felt in July - around three months after the imposition of tariffs. This was the approximate timeline that we saw when washing machines were hit by a 20% tariff in 2018 as inventory already in the country is not subject to the tax.

Core CPI metrics



Source: Macrobond, ING

The chart above shows that the US is now tracking around the 0.17% MoM run rate that would bring annual inflation down to the 2% year-on-year target. Interestingly, 0.4% falls in apparel and a 0.3% drop in new car prices helped hold down inflation as these are areas which are at high risk of price rises due to tariffs, so no indication of pre-emptive moves yet. Airline fares fell for a fourth consecutive month while housing rent costs were a relatively benign 0.3% MoM.

But tariff fears linger

Markets obviously like this, but we need to be careful of saying that tariff fears are overdone. Remember the Fed's Beige Book commentary from last week that ***"There were widespread reports of contacts expecting costs and prices to rise at a faster rate going forward. A few Districts described these expected cost increases as strong, significant, or substantial. All District reports indicated that higher tariff rates were putting upward pressure on costs and prices. Contacts that plan to pass along tariff-related costs expect to do so within three months."*** July and August are likely to see much stronger inflation prints and we still expect headline CPI to head towards 4% YoY in the third quarter.

Nonetheless, tariffs are a one-off price hike that will drop out of the annual comparison in late summer 2026. Meanwhile the Cleveland Fed's new tenant rents data suggests the housing components of CPI, which account for 40% of the core inflation by weight, can act as a major disinflationary force over the next 12 months. Moreover, we need to remember that the US economy is primarily a service sector economy and the biggest cost input is the cost of workers. A cooling jobs market implies that this too will help to mitigate the tariff impact. We still see an excellent chance of inflation getting down to 2% in late 2026 and that keeps the door open to Fed rate cuts late in 2025.

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