Don't get complacent about US inflation

The market is rightly focused on worrying trade and global growth signals, but inflation should not be completely ignored. If trade tensions do ease there is significant scope for a market re-pricing of Federal Reserve rate cuts

Shoppers at a technology store in Houston

0.3%

US inflation rise (MoM)

The second consecutive 0.3%MoM increase in core inflation

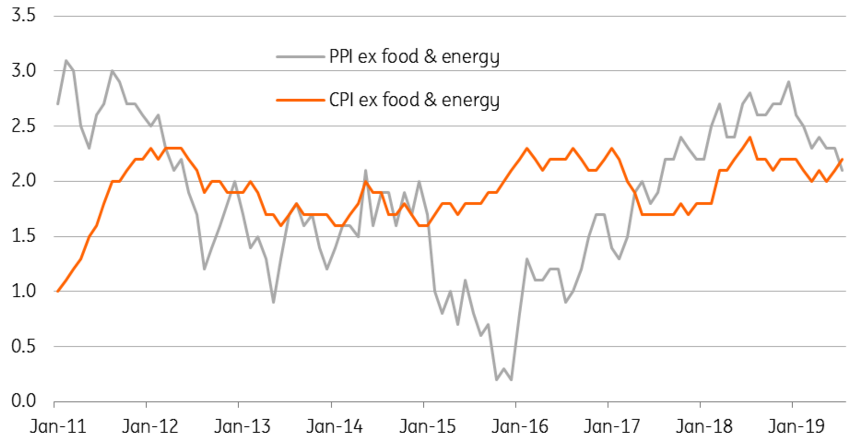
Broad increases in prices cause a surprise

US headline and core consumer price inflation both rose 0.3%MoM in July, which was enough to push the annual rates of inflation up to 1.8% and 2.2% respectively. The headline increase was as expected, but the core increase was a surprise. This is the second 0.3% monthly increase in a row, something that hasn't happened since 2001. It perhaps provides some food for thought given that everyone is expecting the Federal Reserve to cut interest rates further in the next few months.

In terms of the main components, energy rose 1.3% thanks to a seasonally adjusted increase in gasoline prices while apparel continued its recent rebound with a 0.4%MoM increase after a 1.1%

jump in June. Housing once again rose 0.3% while tobacco prices gained 1% and transport increased by 0.8%. There were no key categories seeing price falls in July.

Core inflation series (YoY%)



Source: Bloomberg

The market is vulnerable to a positive development on trade

Even though core inflation is moving higher, it is the outlook for economic activity that is driving sentiment right now. The market is assuming a US downturn is coming due to intensifying trade tensions, weaker global activity and dollar strength. The view is that this will dampen price pressures over the medium term and give the Federal Reserve significant room to cut interest rates – the market expects four 25bp cuts over the next 18 months.

> *It's the outlook for economic activity that's driving sentiment right now*

However, there is the possibility of a more positive economic scenario. A strong jobs market and rising real wage growth keep consumer spending strong – watch out for another decent retail sales report on Thursday. This can help to offset weakness elsewhere before a more durable US-China trade truce is potentially struck later in the year.

This may look rather optimistic at the current juncture, but President Trump wants to be re-elected in 2020 and he recognises that a robust economy with rising asset prices is critical for that to happen. As such, we anticipate a “deal” even if not all of President Trump’s demands are met.

With inflation close to target and equity markets likely to rally hard on a positive trade outcome we could end up seeing a significant re-evaluation of the outlook for monetary policy later this year that also results in a sharp correction higher in Treasury yields. Our house view remains two 25bp rate cuts in the second half of 2019.

Author

James Knightley
Chief International Economist
james.knightley@ing.com

Disclaimer