US inflation fears cool on tariff climbdown and softer services

US inflation undershot expectations in April. With the price hike threat from tariffs receding thanks to recent agreements and with leading housing indicators pointing to a cooling in shelter costs, there will continue to be scope for Federal Reserve interest rate cuts later in the year

US CPI for April came in softer than expected on cooling shelter costs

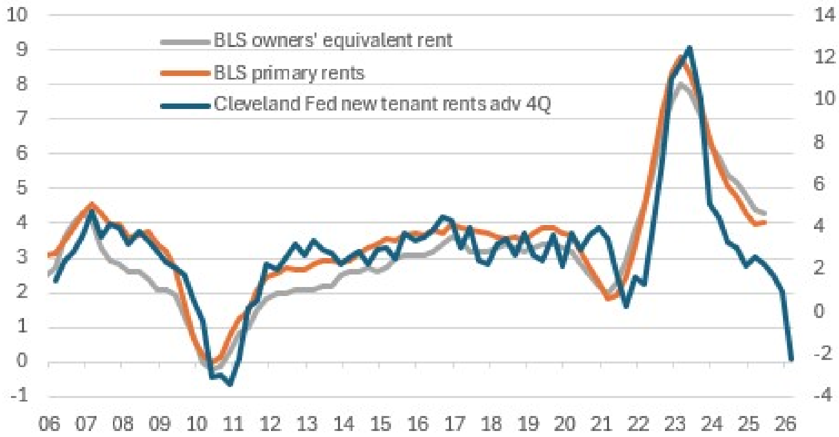
US inflation undershoots with shelter set to become a more important influence

US CPI rose 0.2% month-on-month for both headline and core in April, below the 0.3% readings expected. This means headline inflation is down to 2.3% year-on-year from 2.4%, which is the lowest reading since February 2021, while core - ex food and energy - remains at 2.8% YoY.

The details show a third consecutive drop in airline fares (-2.8%MoM/-7.9%YoY) while used car prices fell 0.5% and apparel fell 0.2% and food prices fell 0.1% MoM. This offset strength in medical care services (+0.5%MoM) and medical care commodities (+0.4%) plus large increases in motor vehicle maintenance (+0.7%) and vehicle insurance (+0.6%).

The shelter components, which make up 35.4% of the inflation basket by weight also continue to run at elevated rates of 0.3%MoM/4.0%YoY, but the good news is that lead indicators, such as the Cleveland Fed's new tenant rent series, are falling in YoY terms and suggests, based on the historical relationship, that housing costs will slow sharply late this year/early next.

US housing lead indicator points to moderating shelter inflation



Source: Macrobond

Receding tariff threat should calm Fed concerns

Moreover, it is important to remember that the US inflation basket is dominated by services. Commodities ex food and energy, which is what is going to be most impacted by tariffs, make up only 19.4% of the basket of products and services used to calculate inflation. Therefore the housing and services story can help to mitigate the inflation threat from tariffs, which itself is less of a concern in the wake of the recent cooling of tensions with China.

This softer services inflation narrative also appeared to be the message from today's NFIB survey of small businesses, which showed a pull back in the proportion of firms currently raising their prices to 25% versus 31% in February and those expecting to raise their prices over the next three months to 28% from 30% two months ago.

So while the de-escalation of trade tensions is helpful for growth, it also makes it more likely that inflation will be less of an issue for the Federal Reserve and the scope for Fed rate cuts remains. We had been looking for the Fed to wait until September before cutting and that still holds, but rather than start with a 50bp cut, it appears more likely to be a 25bp move.

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