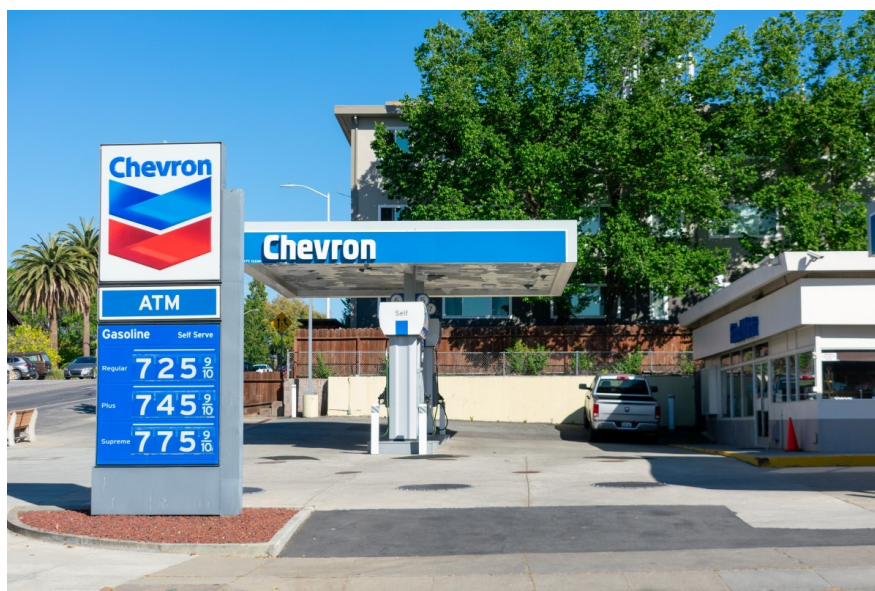


## US inflation surprise heaps pressure on the Fed to do more

US headline inflation accelerated in May while the core rate failed to drop back below 6%. Demand continues to outpace the supply capacity of the US economy and with supply factors showing little sign of near-term improvement, the onus is on the Fed to dampen the demand side of the equation with ongoing rate hikes



High gasoline prices are keeping inflation elevated

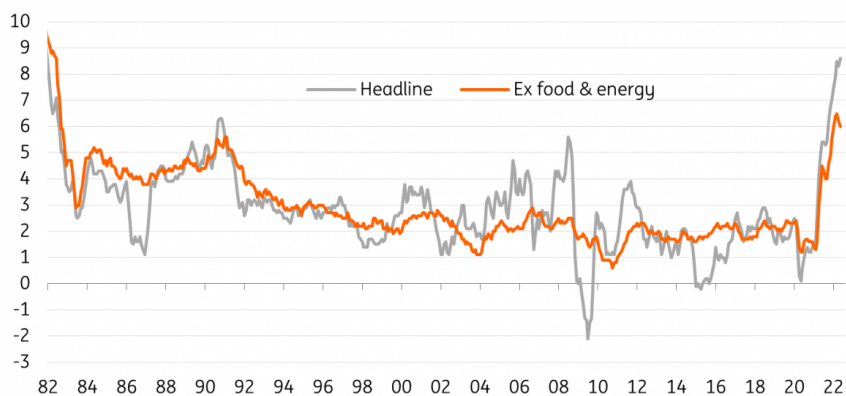
**8.6%** Highest US inflation rate since December 1981

### Inflation hits new cycle high

As we feared, the risk that inflation may not fall as much as hoped materialised. Headline has actually accelerated, rising 1% month-on-month which takes the year-on-year rate to 8.6% rather than the 8.3% consensus forecast. Food rose 1.2% and gasoline rose 4.1%, but even excluding food and energy the core rate came in above expectations, rising 0.6%MoM/6%YoY, rather than the

5.9% outcome expected.

## US annual inflation rates (YoY%)



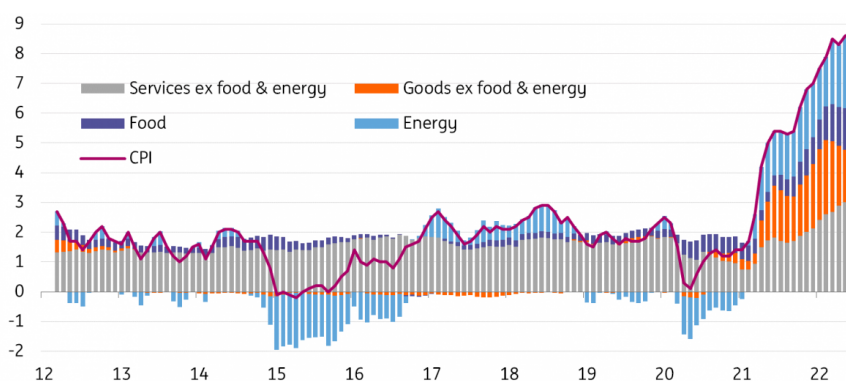
Source: Macrobond, ING

## Core goods are becoming a less important inflation driver, but service price pressures are rising

Here, there was another solid reading for shelter of 0.6% with the housing components (primary and owners' equivalent rent) lagging the surge in house prices by around 14 months. Airline fares were up another 12.6% – the third double digit rate increase in a row – as business travel returns and people movement continues to increase in a sector that has experienced significant supply constraints due to the legacy of the pandemic. Meanwhile, new and used cars rose more than 1% despite signs of improved auto production capabilities.

The chart below shows that the service sector is the key area generating inflation right now. People are seemingly wanting “experiences” that they missed during the pandemic and are clearly prepared to pay to do it, almost whatever the cost!

## Composition of contributions to inflation (YoY%)



Source: Macrobond, ING

## Demand is still exceeding the supply capacity of the economy

Nonetheless, we are hopeful that this marks the peak for headline inflation, but it is a low conviction call. The breadth of inflation pressures in the economy should alarm the Fed and will

certainly keep the hawks in the ascendancy and weaken the case for those arguing for a potential pause in the Fed hiking path in September.

To get inflation meaningfully lower quickly we need demand to move into better balance with the supply capacity of the economy. On the supply side we would ideally like to see three things. Firstly, reduced geopolitical risk to get energy prices lower. Secondly, supply chains easing to improve flows of inputs and lessen pricing power and thirdly, more labour supply to fill the vacancies in the US and again take a bit more steam out of the employment cost story.

## The onus is on the Fed to dampen demand with ongoing rate hikes

Unfortunately, none of these are likely to improve soon. Russia shows no sign of back tracking in its assault on Ukraine, China lockdowns have eased, but could come back any day given its zero-Covid strategy and US labour participation remains stubbornly low by historical standards despite a sharp pick-up in wage growth.

Consequently, to get demand into better balance with the supply the onus is on the Federal Reserve to do the heavy lifting. Hence 50bp rate hikes in June and July with more rate hikes to come to damp down the demand side of the equation.

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