

Fed rate cuts unlikely despite US inflation miss

The latest downside surprise on US inflation won't help resolve market pessimism towards the Fed policy outlook. But with wage pressures continuing to build, we think a rate cut is much less likely than markets currently think



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US inflation back to target, but it won't help market pessimism

US headline CPI has nudged back up to the 2% target for the first time since November, helped along by the 30% rise in gasoline prices since the low at the start of the year. But the fact that this data came in below expectations will do little to assuage ongoing market concerns about inflation. That said, there are a few key reasons why we think market pessimism on the Fed rate outlook is misplaced.

Firstly, as Chair Jerome Powell noted in his recent press conference, there are a few CPI components that are temporarily keeping a lid on overall inflation. For instance, apparel alone is knocking almost 0.1ppt off the headline rate, which is partly down to some recent methodology changes. Financial services costs have also been a bit of a drag. While the collective of all of this isn't massive, it's enough to keep both core and headline inflation around 0.2-0.3ppts lower than

they might otherwise have been.

A rate cut is less likely than markets are pricing

More broadly, we expect the strength in wage growth to gradually exert upward pressure on core inflation over coming months. Tightness in the jobs market is causing firms to lift pay more rapidly to retain/attract staff, and according to the Fed's Beige Book, corporates are increasingly looking at other non-wage benefits too (extra vacation, pension/health benefits, sign-on bonuses etc).

To us, all of this suggests that the market may be a little too relaxed when it comes to inflation. Investors are currently pricing at least one rate cut over the next 12 months, but despite the latest increase in trade uncertainty, we think this is unlikely to materialise as things stand. Given the robust activity story, inflation backdrop and recent improvement in financial conditions, we think it is more likely that the Fed remains on hold for the foreseeable future.

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