US service sector softness offsets goods inflation for now

Another benign inflation print will do little to ease concerns that tariffs will lift inflation and limit the Fed's ability to respond to any economic weakness

Shoppers in a mall in New York

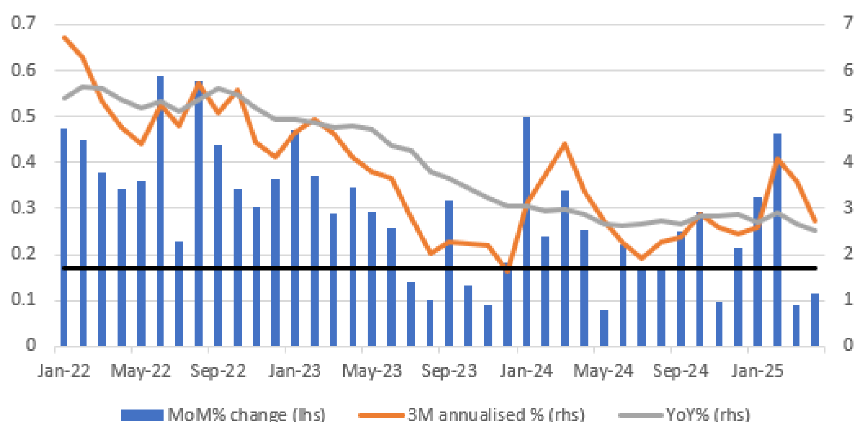
Inflation cools in the lead up to tariffs

The April personal income and spending report showed firmer income and ever so slightly better spending numbers than predicted, but the key inflation metric was largely as expected. The Fed's favoured inflation measure, the core personal consumer expenditure deflator, rose 0.1% MoM,/2.5%YoY. This is the slowest rate of annual inflation since March 2021.

The black line in the chart below is 0.17% MoM which, if averaged over time, will deliver 2% YoY inflation as targeted by the Fed. The blue bars show we have had two consecutive readings that were well below that. The so-called "super core" measure that excludes housing even posted a negative MoM print for the first time since April 2020.

Core PCE deflator metrics

MoM%, 3M annualised & YoY%



Source: Macrobond, ING

However, both the Federal Reserve and the market are worried that President Trump's tariffs will lift goods prices quite markedly in the coming months. This will limit the central bank's ability to support the economy if weak consumer survey evidence translates into much softer "hard" spending data.

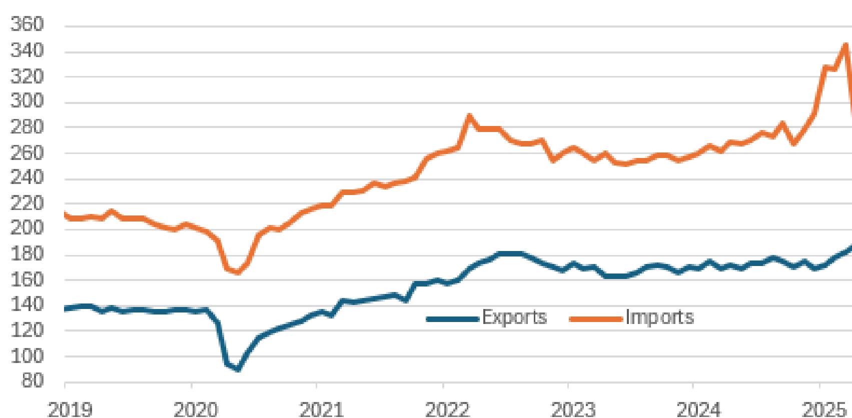
We are a little more relaxed about inflation over the medium to longer term. Tariffs are a one-off step change to prices, whose effect will drop out of the annual price comparison in 12 months' time. Moreover, the US is overwhelmingly a service sector, and the cost of employing workers is the biggest input, and that has slowed rapidly over the past year.

In addition, housing costs dominate and lead indicators for rents (such as the Cleveland Fed's new tenant series) suggest that more modest price changes here can mitigate the impact of tariffs on the broad inflation print. The Fed has made it clear that it is in no hurry to move policy and wants time to assess the underlying trends in the economy, so nothing should be expected before September, but I don't disagree with the market that is anticipating 50bp of cuts before year-end.

Plunging imports boost 2Q GDP growth outlook

Today's data reports also show that the "advanced" goods trade balance narrowed very sharply in April to $87.6bn from $162.3bn in March. This was much better than the $143bn consensus expectation. Clearly, there have been very violent swings in trade with companies trying to bring in so much product ahead of the imposition of tariffs, and then the shock of the scale of Liberation Day, seeing foreign orders grind to a halt. We expect to see a rewidening again in May, but today's outcome improves the prospect of a decent 2.5%-3% annualised 2Q GDP print.

US goods trade ($bn)



Source: Macrobond, ING

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