

US stagflation fears rise ahead of tariff hit

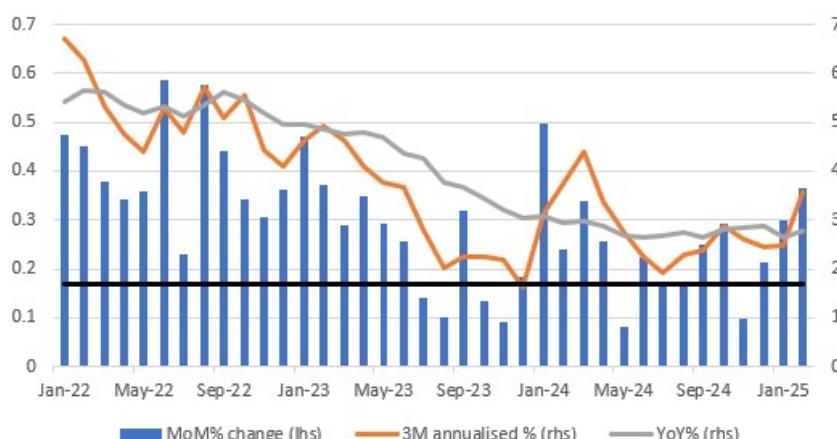
Hot inflation and cooling consumer spending are trends that are likely to be intensified by President Trump's aggressive moves on tariffs and government spending cuts. Stagflation fears are rising and will constrain the Fed's ability to cut rates further



Well today's US data is only inflaming stagflation fears. The Federal Reserve's favoured inflation measure, the core PCE deflator, has come in hotter than predicted at 0.4% month-on-month while real personal spending comes in softer at just +0.1% MoM and January's contraction is worse than previously thought – revised down to -0.6% MoM from -0.5%.

The inflation print is ugly, but we did suspect that if there was a risk to the 0.3% MoM consensus number it was going to be the upside given the composition of the CPI and PPI inputs that feed through. Remember that we need to average 0.17% MoM (the blue bars need to average where the black line is in the chart below) over time to bring us down to the 2% year-on-year target. We are moving in the wrong direction and the concern is that tariffs threaten higher prices, which mean the inflation prints are going to remain hot. This will constrain the Fed's ability to deliver further interest rate cuts.

US core PCE inflation metrics look increasingly ugly



Source: Macrobond, ING

From a growth perspective those potential rate cuts can't come quickly enough. Tariff-related fears about squeezed spending power and job worries tied to the Department for Government Efficiency's actions have seen sentiment plunge and this appears to be translating into much cooler spending. Fed Chair Powell was fairly dismissive of this narrative earlier this month so it will be interesting to see if he changes his tune next week.

We expect to see another round of downward revisions to first quarter GDP growth forecasts coming through over the weekend from a lot of banks. For example, if March real consumer spending is flat that will mean first quarter annualised consumer spending would be -0.1%, which would be the first negative print since second quarter 2020 when we were in the depths of the pandemic. Given the drag from awful trade numbers this really does run the risk of a negative first quarter GDP growth rate. As we head towards 'Liberation Day' on Wednesday and then the jobs report on Friday followed by Powell's speech on the economic outlook, this sets us up for a volatile week ahead for markets.

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