Yardeni Research

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Morning Briefing

Inflation In Trump's World

Check out the accompanying chart collection.

Executive Summary: Yesterday, we changed our stock market and economic projections owing to Trump's "Reign of Tariffs"; today, we explain our thinking about the higher inflation we now expect. People's expectations about future inflation are critical to how high inflation actually climbs since the expectations of economic actors alter their decisions, which Fed Chair Powell often points out. So will the Fed raise the federal funds rate to keep inflation expectations well anchored? Or will it cut the rate to keep the crisis from Washington from crippling economic growth? Our conclusion: Neither. We're sticking with our "none-and-done" Fed forecast for this year.

Weekly Webcast. If you missed Monday's live webcast, you can view a replay *here*.

Economy: Expecting Unanchored Inflation Expectations? In yesterday's *Morning Briefing*, we raised our expected 2025 PCED inflation rate from 2.0%-3.0% to 3.0%-4.0%. While services disinflation should continue, goods prices are very likely to raise consumer prices in short order. After the Trump tariffs' "one-time price hikes" work through the economy, we think the PCED rate could return to 2.0%-3.0% next year. That's the Federal Open Market Committee's (FOMC) general expectation now as well, though it's more optimistic about the ultimate PCED rate than we are, based on the FOMC's latest *Summary of Economic Projections* (SEP) (*Fig. 1*).

Most mainstream monetary policy theory suggests that tariffs should be "looked through," meaning they shouldn't be a reason to raise interest rates in an attempt to counter tariff-induced higher prices; that would unduly tighten financial conditions. However, this Trump Tariff Turmoil 2.0 may poke holes in that theory should it alter Americans' perceptions about inflation.

Tariff announcements have been capricious, and legal barriers prevent the tariffs from being rolled out all at once. So businesses and consumers will likely be seeing rolling price increases for several quarters. Moreover, if tariffs are used as negotiating sticks later in the year with no preannouncements, that could further upset the typical price behavior.

Retaliation by other countries could easily raise prices as well. And of course, inflation remains elevated above the Fed's 2.0% target, and the pandemic price shock is still fresh in Americans' minds.

"Inflation expectations" is likely to be one of the Federal Reserve's phrases of the year. The basic thought is that businesses and consumers make investment and consumption decisions in part based on their inflation expectations rather than on current inflation. When they expect higher inflation in the future, consumers may prepare by asking for a raise at work, businesses may jack up selling prices in anticipation of higher input costs, and investors may shift allocation decisions to protect their assets against inflationary effects. So just expecting inflation can lead to actual inflation, which is why policymakers are so scared about expectations becoming "unanchored" or rising above levels consistent with around 2.0% y/y inflation.

On the flipside, when inflation expectations are well anchored and people trust that the Fed will keep inflation near 2.0%, behavior normalizes when the Fed provides stimulus during a downturn. Anchored expectations also helps avoid deflationary spirals, where falling expectations reduce consumer spending and limit stimulus efforts.

Indeed, Fed Chair Jerome Powell mentioned inflation expectations early in his March FOMC press conference. He was optimistic and regarded them to be well anchored across various measures. However, signs are mounting that businesses and consumers are losing faith in inflation's stability. The FOMC's 100bps of interest rate cuts in the second half of last year, ongoing fiscal stimulus, and now volatile trade policy may be undermining faith that the Fed can achieve its 2.0% target as we speak.

Let's discuss the latest inflation sentiment data as well as hard price data, and what it all may mean for the Fed:

(1) *Powell on inflation expectations*. The Fed's dual mandate demands that the central bank balance price stability and full employment as equal goals, calibrating monetary policy to maximize both. However the two goals are interrelated, mostly via inflation expectations, as Powell has said many times.

For example, at the Jackson Hole Economic Symposium in August 2020, when Powell was announcing the Fed's updated framework (updates occur every five years), he said the Fed would employ "average inflation targeting"—i.e., targeting 2.0% y/y inflation not continuously but as an average over multiple years. That concept is likely to be nixed in this year's update, as it may have led the Fed to let inflation get out of control before hiking rates in 2022 (*Fig. 2*). But back in 2020, CPI inflation was just 1.3%; getting the rate up to 2.0% was the challenge and deflation was the worry. He said, "Well anchored inflation expectations are critical for giving the Fed the latitude to support employment when necessary without destabilizing inflation." The risk was that, unanchored, inflation expectations would be too low.

Two years later, that same statement was true, but for the inverse situation—i.e., the risk was that inflation expectations would be too high for price stability. At the Jackson Hole Economic Symposium in August 2022, as consumer price inflation was above 8.0%, Powell cited the "public's expectations about future inflation" as being important for the path of actual inflation over time, and a key learning lesson from the Volcker-era Fed. And in November 2022, Powell said that "[p]rice stability is the responsibility of the Federal Reserve and serves as the bedrock of our economy … Without price stability, we will not achieve a sustained period of strong labor market conditions."

(2) *Inflation expectations and monetary policy*. We can infer that Powell believes that when the labor market is hot, if inflation expectations become unanchored then the Fed will have to tighten policy so much that full employment cannot be sustained. Given that the unemployment rate is currently a low 4.1%, we think the Fed will be much more concerned about losing the public's faith on inflation than about stemming a downturn in the economy (*Fig. 3*).

We've noted in our *Credit Crisis Cycle* theory that the Fed tends to cut interest rates in reaction to financial crises. Since 2008, this mostly has been done to prevent crises from morphing into credit crunches, which lead to economic downturns (*Fig. 4*). Successfully, the Fed averted long-lasting recessions in 2019, 2020, and 2023 (though perhaps at the cost of overstimulating the economy and accelerating inflation). However, today's threat is macroeconomic policy uncertainty from Washington rather than any financial contagion, which the Fed would have the most firepower to fight. We therefore think that, absent a black swan event or unemployment surging toward 5.0%, it's far more likely that the Fed will remain on hold with respect to rate changes this year—i.e., we continue to project "none and done."

Because of the expected impact of tariffs on consumer prices, Goldman Sachs economists raised their year-end core PCE inflation forecast by 0.5ppt to 3.5% y/y. But they also upped their federal funds rate cut expectations this year from two to three, all in the second half of the year, based on expected weaker economic growth. During Q4-2024, they lowered their

2025 real GDP growth forecast by 0.5ppt to 1.0% y/y and raised their unemployment forecast from 4.2% to 4.5%. To us, these preconditions are not enough to spark an additional 75bps of rate cuts for a total of 175bps this cycle. In fact, we suspect the FOMC members may be regretting how much they cut rates last year amid a possible inflation redux.

(3) *Measures of inflation expectations surging*. Survey-based measures of inflation expectations are rising—rapidly. The University of Michigan consumer sentiment survey shows year-ahead expected inflation at 5.0%, nearly as high as the pandemic peak and 4.1% over the next five years, the highest on record (*Fig. 5*).

Inflation expectations in the New York Fed's consumer survey are at or above 3.0% y/y for all future periods (*Fig. 6*). Even rent expectations are starting to increase, suggesting a broader shift in the public's perception of inflation than just on tariff-related goods (*Fig. 7*).

(4) *Actual inflation probably rising soon, too*. If the 25% tariff on all autos is sustained, headline inflation may increase quickly.

Used car inflation surged during the pandemic as supply chains furled, which bled into new car prices (*Fig. 8*). While the rate of price increases has plateaued, the costs of auto maintenance, repairs, and insurance surged in 2023 and 2024 to keep up with the earlier price rises, which they tend to lag.

So just when auto industry inflation was poised to finally settle down this year, the coming tariffs will boost new car prices directly and likely will boost used car prices indirectly as demand shifts toward them, which threatens to keep insurance and maintenance costs on a continual climb. This "rolling inflation" could boost inflation expectations.

(5) *PCED inflation*. The Fed's preferred inflation gauge has been accelerating since November. One- and three-month annualized core PCED inflation rates were 4.4% and 3.5%, respectively, in February (*Fig. 9*). Both are not just well above the 2.0% target but also higher than the 6- and 12-month annualized rates of 3.1% and 2.8%, respectively. Further monthly increases in the 0.2%-0.3% range would keep the core PCED above 3.0% by year-end, whereas anything north of 0.35% m/m would likely raise questions about whether the Fed needs to hike interest rates again.

(6) *Commodities already rising*. The price of copper has shot up recently, likely due to a combination of Chinese and European stimulus as well as tariff frontrunning. Given its role

as a key input in industrial processes, copper is tightly correlated with "breakeven inflation" (the difference between nominal and inflation-adjusted Treasury yields) (*Fig. 10*). That suggests that inflation expectations—and bond yields—are likely to rise in the coming weeks.

While supercore (core services ex-housing) inflation is generally trending in the right direction, tariffs and increased demand for goods are likely to boost goods prices (*Fig. 11* and *Fig. 12*). We expect durable goods inflation to turn positive during Q2, while nondurable goods inflation will likely climb above 1.5% y/y. The end of goods deflation combined with sticky and too-high services inflation risk sending inflation expectations—and therefore actual inflation—climbing out of control.

Calendars

US: Tues: ISM M-PMI & Price Index 50.3 & 65.0; JOLTS Job Openings 7.68m; Construction Spending 0.2%. **Wed:** ADP Employment Change 105k; Factory Orders 0.5%; Total Vehicle Sales 15.9mu; MBA Mortgage Applications; Kugler. (FXStreet estimates)

Global: Tues: Eurozone Headline & Core CPI 2.2% & 2.5%y/y; Eurozone, Germany & France M-PMIs 48.7, 48.7 & 48.9; UK M-PMI 48.7; Italy Unemployment Rate 6.3%; UK M-PMI 44.6; China Caixin M-PMI 51.1; Australia Retail Sales 0.3%; RBA Interest Rate Decision 4.1%; Cipollone; Greene. **Wed:** Japan NM-PMI 49.5; China Caixin NM-PMI 51.6; Schnabel; Lane. (FXStreet estimates)

Strategy Indicators

S&P 500/400/600 Forward Earnings (*link*): During the March 28 week, forward earnings rose for two of these three indexes for a sixth straight week, after falling for all three simultaneously for two straight weeks for the first time in 14 months. The script flipped somewhat this week as SmallCap's was higher w/w instead of LargeCap's. LargeCap's was down less than 0.1% from its record high a week earlier and MidCap's forward earnings hit another record high after doing so a week earlier for the first time in 33 months. SmallCap's rose for the first time in nine weeks, bouncing 1.6% higher w/w from a 40-month low due to index changes. However, it remains 12.7% below its June 2022 record. LargeCap's forward earnings has soared 23.4% from its 54-week low during the week of February 1, 2023;

MidCap's is 9.1% above its 55-week low during the week of March 10, 2023; and SmallCap's is only 1.0% above its 72-week low during the March 17, 2023 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (9.7%, 10.9%, 14.3%), MidCap (0.4, 9.3, 16.0), and SmallCap (-10.3, 8.0, 19.6).

S&P 500/400/600 Valuation (*link*): Valuations were mixed for these three indexes during the March 27 week, but remain above their multi-week lows during the March 13 week. LargeCap's forward P/E of 20.4 is up 0.1pt w/w and 0.2pt from its 28-week low of 20.2. It's now 1.9pts below its 43-month high of 22.3 during the December 6 week. It's up 3.4pts from a seven-month low of 17.0 during the October 27, 2023 week and 5.5pts from its 30-month low of 15.1 at the end of September 2022, which compares to an 11-year low of 11.1 during March 2020. MidCap's forward P/E was steady w/w at a 15-month low of 14.8, and is now 2.3pts below its 40-month high of 17.1 during the November 29 week. It's up 2.5pts from a 12-month low of 12.3 at the end of October last year and compares to a record high of 22.9 in June 2020 and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E was down 0.2pt w/w to 14.5, which is just 0.3pts above its recent 27-week low of 14.5 and 2.6pts below its 41-month high of 17.1 during the November 29 week. It's up 3.9pts from its 14-year low of 10.6 in September 2022 and compares to a record low of 10.2 in November 2009 during the Great Financial Crisis. That also compares to its record high of 26.7 in early June 2020 when forward earnings was depressed. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E is at a 27% discount to LargeCap's P/E, up from a seven-month low 28% several weeks earlier and above its 25-year-low 29% discount during the July 5, 2024 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is at a 24-week-low 29% discount to LargeCap's P/E, which compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 5ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E fell to a nine-week-low 2% discount to MidCap's, but that remains among the smallest since July 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

US Economic Indicators

Regional M-PMIs (*link*): The five regional Fed banks that report on manufacturing activity have all reported their results for March. The *New York* region weakened significantly, with its general business conditions measure dropping 25.7 points to -20.0—with both new orders (-14.9 from 11.4) and shipments (-8.5 from 11.4) measures swinging from expansion to contraction, while employment (-4.1 from -3.6) continued to decline, though at a slow pace. *Richmond* saw its region move from expansion to contraction, with its composite (-4 from 6) falling back into negative territory, led by a notable decline in shipments (-7 from 12), while new orders (-4 from zero) and employment (-1 from 9) dipped back into negative territory. *Kansas City's* composite index (-2 from -5) continued to decline, though was nearing positive territory as shipments (-4 from -11) and employment (-4 from -14) both neared the breakeven point of zero. However, new orders (-12 from -7) continued to deteriorate. Meanwhile, the *Philadelphia Fed* reported a slowdown in growth during March, with the current general activity index (to 12.5 from 18.1), new orders (8.7 from 21.9), and shipments (2.0 from 26.3) components showing a slowing in activity during the month. Factory activity in the *Dallas* region rose in March, as the production index—a key measure of state manufacturing conditions—rose 15 points to 6.0. Other measures were mixed: New orders increased 3 points to zero, while the shipments measure was positive and little changed at 6.1 last month. Meanwhile, the employment measure slipped further into negative territory to -4.6, while hours worked moved higher, though remained slightly negative at -2.9. *Turning to pricing*, in the *New York* region both price indexes climbed for a third successive month, with the prices-paid index the highest more than two years, and prices-received the highest since May 2023. Meanwhile, *Philadelphia's* price-paid measure posted its highest reading since July 2022, while prices received showed a slight easing in March. *Kansas City* showed a pickup in prices paid (42 from 38), while prices received for finished product (15 from 17) showed a slight deceleration. *Dallas'* input cost pressures edged higher, with the raw materials index ticking up 3 point 37.7—a multi-year high—while the finished goods prices index was largely unchanged at 6.3. *Richmond* price measures, which are measured as percentage changes over the last 12 months, show both the prices-paid (to 3.75% from 2.23%) and prices-received (2.34 from 1.62) measures accelerated during the month.

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