

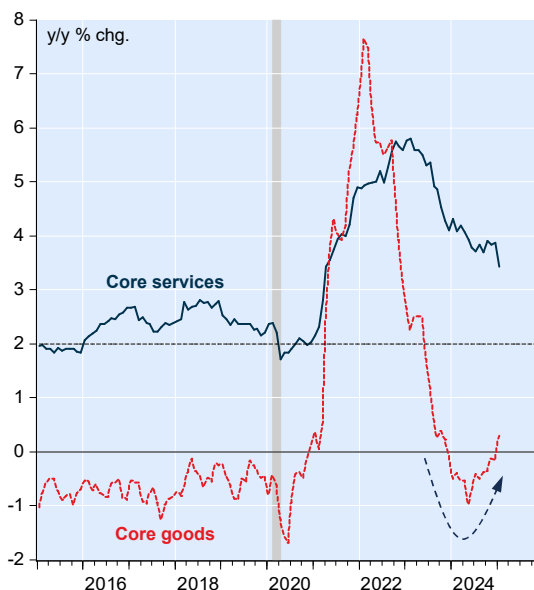
U.S. Watch

By Jocelyn Paquet

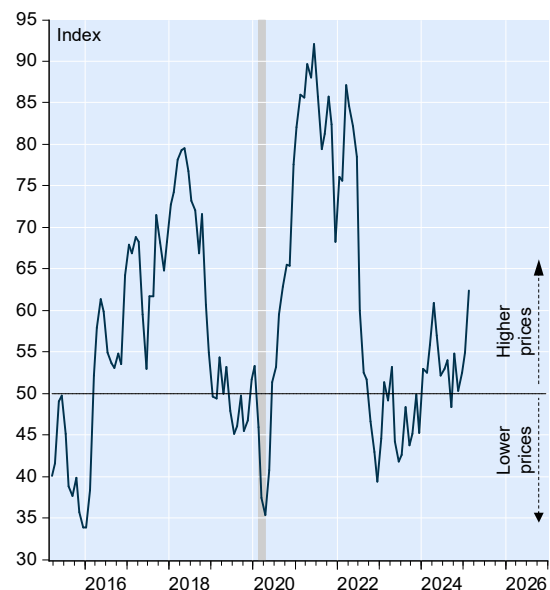
Last Friday's PCE deflator data was quite encouraging. Not only did the headline and core indices rise in line with economists' expectations, but inflation in the core services sector fell to its lowest level in almost four years (3.4%). As these data are unlikely to cause the Fed undue concern, they gave the market more hope that the central bank will cut rates further this year. And even if further rate cuts remain our baseline scenario, we have to admit that our confidence that inflation will return to the central bank's target in a sustainable manner has diminished somewhat of late. This is because many of the new administration's policies seem likely to push up prices. One example is the mass deportation of migrants (or reduced immigration), which risks decreasing the supply of low-wage workers. Another is fiscal policy, which, according to last week's budget blueprint, promises to put more pressure on an economy that is already operating above its potential. But it is the trade backdrop that worries us most. The United States has already raised tariffs on China and is now threatening to do the same to Canada and Mexico this week. This has the potential to accelerate a rebound in goods inflation that is already underway. And given how dependent the United States has been on disinflation in this sector to keep inflation within sight of the Fed's target, any deviation there could have serious consequences. One problem is that the threat of tariffs alone seems to be enough to generate inflation in the manufacturing sector. In order to avoid tariffs in the future, many companies are indeed trying to bring forward their shipments to the United States, as demonstrated by an unprecedented deterioration in the goods trade balance. This race against time is putting pressure on supply chains and is already leading to price increases, as evidenced by the prices paid sub-index of the ISM manufacturing report released today which, as today's Hot Chart shows, rose to a 32-month high in February. Comments collected in the survey only reinforced the sense that price pressure are mounting, with some respondents mentioning that "[s]weeping price increases are incoming from suppliers" and others noting that "customers are still very hesitant to commit to long term volumes due to the market uncertainty caused by the proposed tariffs". While it's too early for the Fed to call an end to its easing cycle, these data should nonetheless encourage it to exercise caution. Now is not the time for the central bank to let its guard down, especially considering the recent rise in consumers' long-term inflation expectations.

U.S.: Growing risks to the inflation outlook?

Personal Consumption Expenditures Deflator



ISM manufacturing, prices paid sub-index



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