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May CPI: Tariffs Not Yet Enough to Upset the Inflation Cart

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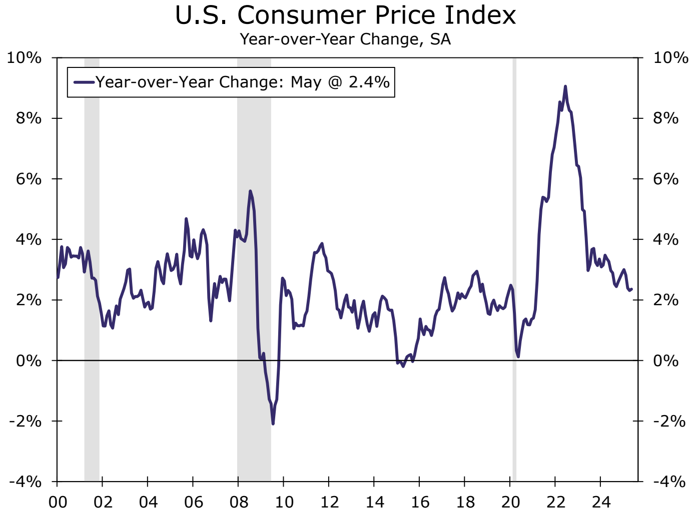
Summary

Today's CPI report is unambiguously good news for the FOMC. Headline CPI increased 0.1% in May and 2.4% over the past year, still comfortably below the 3.5%-4.0% nominal wage growth the average worker has seen over the past year. Core CPI also rose just 0.1% in May, below consensus expectations and led lower by softer-than-anticipated readings for both core goods and core services prices. The 1.7% annualized increase in the core CPI over the past three months matches the slowest pace of three-month core inflation that has occurred since price growth shot above 2% in early 2021.

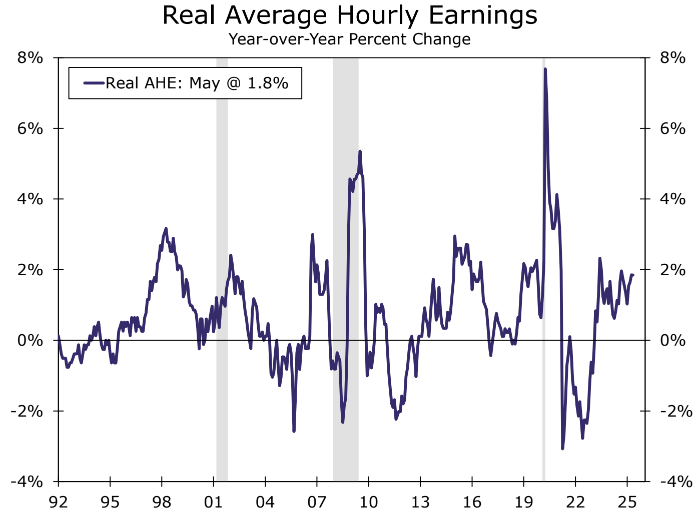
That said, we believe it is too early to declare victory and say that the significant increase in tariffs over the past few months will have no material impact on consumer price growth. Most of the tariff increases occurred over the March-May period, and we doubt enough time has elapsed for the full effects of these policy changes to be felt on output, hiring and pricing. We still look for the core CPI to rise to a little over 3% the next few quarters, largely due to higher tariffs. But for now, the FOMC will likely be content to stand pat at its meeting next week and await the next round of economic data before altering its monetary policy stance.

A Friendly Inflation Print

Consumer price growth came in cooler than expected in May, with monthly inflation registering a 0.1% increase. The year-over-year change in the CPI ticked higher from 2.3% to 2.4%, but the move was smaller than it appeared, as May's year-ago reading of 2.35% just barely rounded up. Prices at the pump declined 2.6% in the month and helped to keep headline inflation in check in May. Food inflation strengthened last month to a 0.3% gain compared to a 0.1% dip in April, but the underlying trend generally remains little changed, with food prices up 2.9% over the past 12 months. With nominal wage growth hovering in the 3.5%-4.0% range in recent months and consumer price inflation floating in the 2.25%-2.50% zone, real wage growth for the average worker continues to be a solid-if-unspectacular 1.5% or so.



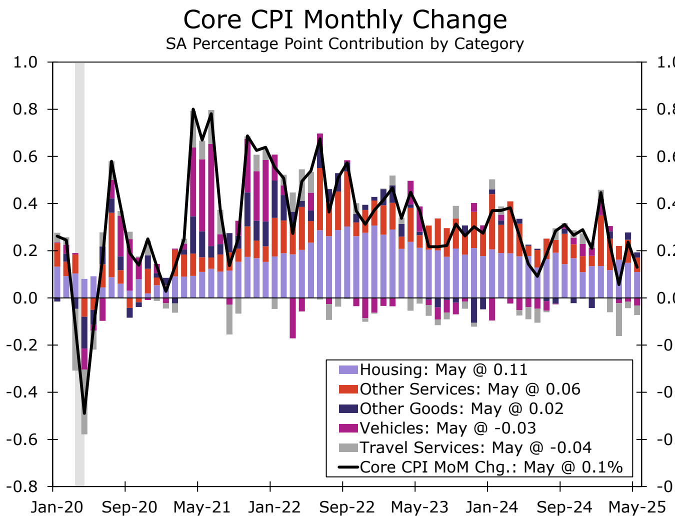
Source: U.S. Department of Labor and Wells Fargo Economics



Source: U.S. Department of Labor and Wells Fargo Economics

The softer-than-expected rise in headline inflation was driven by core inflation. Excluding food and energy, the core CPI edged up just 0.13% in May, leaving the year-over-year change steady at 2.8% for the third consecutive month. Core goods prices, where higher tariff rates are expected to be felt most directly, surprisingly *fell* 0.04% over the month. Declines in new (-0.3%) and used (-0.5%) vehicles largely explain the weakness. Tariff pressures were more apparent in motor vehicle parts & equipment, recreational goods and educational & communication goods, where price growth continued to outpace its trend from the past year. Excluding vehicles, other core goods prices advanced 0.2% over the month, matching April's increase and pushing the year-over-year change for all core goods up two-tenths to 0.3%.

Meantime, services inflation continued to moderate. Core services prices rose 0.2% in May, a touch softer than its six and 12-month averages. Primary shelter moderated to a 0.3% gain amid a softening in rents and owners' equivalent rents. Airline fares fell for the fourth straight month (-2.7% in May), which, taken together with a third consecutive decline in prices for lodging away from home, points to a pull-back in consumer demand for travel. Recreational service prices also declined for the second month. The ebb in discretionary services inflation suggests firms' pricing power has weakened, which is likely to keep overall services inflation subsiding in the coming months.



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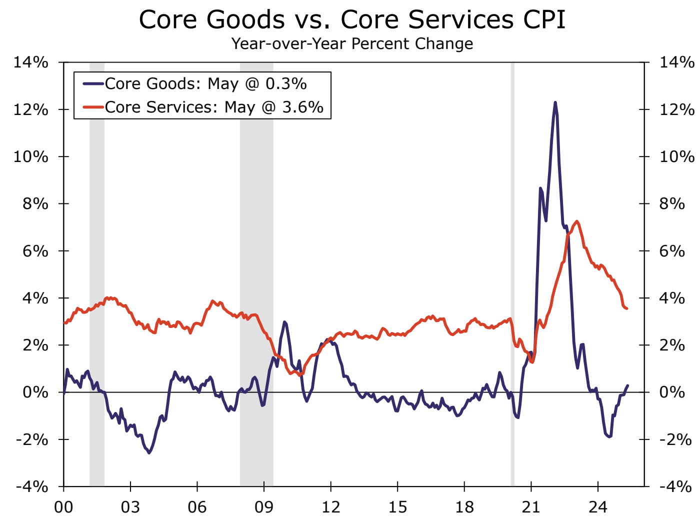

Source: U.S. Department of Labor and Wells Fargo Economics

The May report shows that the initial effects of higher tariffs remain muted when it comes to the overall inflation picture. While recent strength in some goods categories highlight tentative signs of inflationary pressure from tariffs, widescale pass-through remains limited. More importantly, the firming in goods prices has not been enough to push the underlying trend in inflation higher due to ongoing disinflation in the services sector.

The May data do not signal an all clear, however. Pre-tariff inventory building and anticipation that tariffs may eventually be dialed back are likely leading to some of the effects being delayed, and we see a particular risk of vehicle and apparel prices bouncing back in the near term. The pace of declines in travel-services prices in recent months (down at a 21% annualized pace the past three months) is also unlikely to be maintained and suggests services will not be able to provide quite as much of an offset to firmer goods prices. But for now, the unchanged picture of inflation is welcome news. With the labor market remaining in decent shape, we expect the Fed to keep the fed funds rate unchanged at its meeting next week and to await further data before changing its policy stance.

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