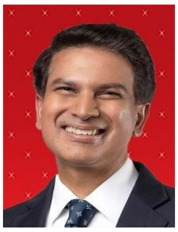
ALLIANCEDBS RESEARCH

Macro Insights Weekly

Inflation watch (only in the US)

Group Research

May 19, 2025



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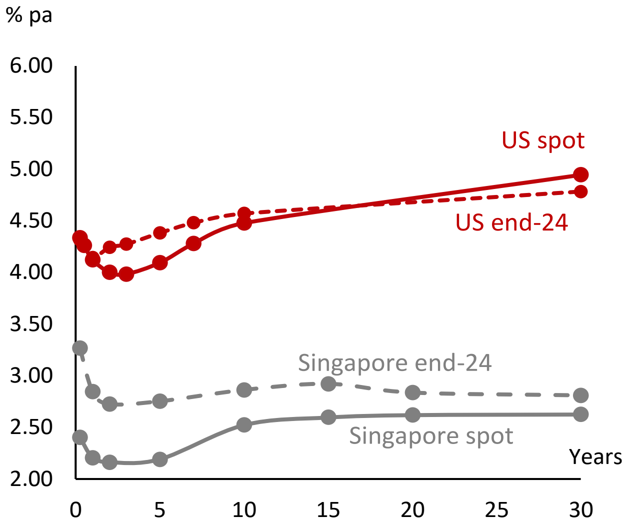
- *Globally, inflation risks are muted. One major exception to that narrative is the US, which is facing a striking policy-induced upward risk to the price level.*
- *Backward looking price data do not pose much concern for the US.*
- *But they are an inadequate reflection of underlying inflation risks.*
- *Surveys of consumer and businesses alike point to substantial upside risk to prices.*
- *A period of policy volatility may lead to higher inflation and interest rates.*
- *On price pressures, we will look at guidance from big retailers first and then small businesses.*

Chart of the Week: US debt rating and yield curve

Moody's joined its ratings peers on Friday to downgrade the US senior unsecured ratings to Aa1 from Aaa. It also changed the US fiscal outlook to stable from negative. Moody's rationalised its action on the basis of an already large debt (98% of GDP) and deficit (6.4% of GDP) situation, coupled with President Trump's plans to make the 2017 tax cuts permanent and provide additional tax cuts. Moody's sees trillions in added deficit and debt ahead, projecting debt/GDP to rise to nearly 135% by 2035. US seems destined for higher yields.

US and Singapore Treasury yield curves



Source: Bloomberg, DBS

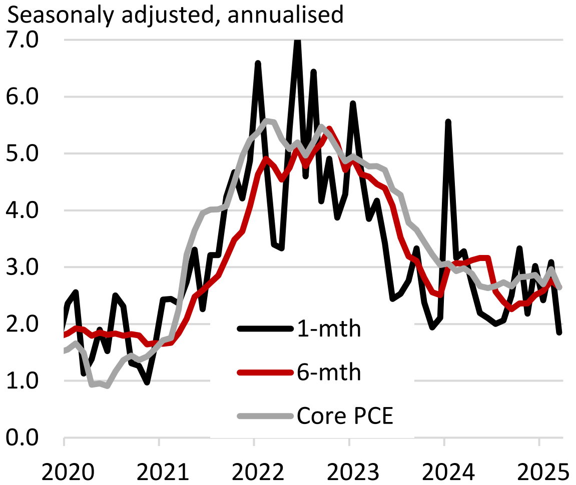
Commentary: Inflation watch (only in the US)

Globally, inflation risks are muted. Demand is soft and the investment environment is facing uncertainties around trade wars. Sustained currency appreciation against the USD and a marked decline in commodity prices have added to the fading of inflation concerns. One major exception to that narrative is the US, which is facing a striking **policy-induced upward risk to the price level**.

Backward looking data do not pose much concern. US headline CPI and PCE inflation rates are tracking sub-2.5%, while core readings are at below-3%. These are not very comfortable figures by historical standards, but they don't keep Fed policy makers up at night, we're sure.

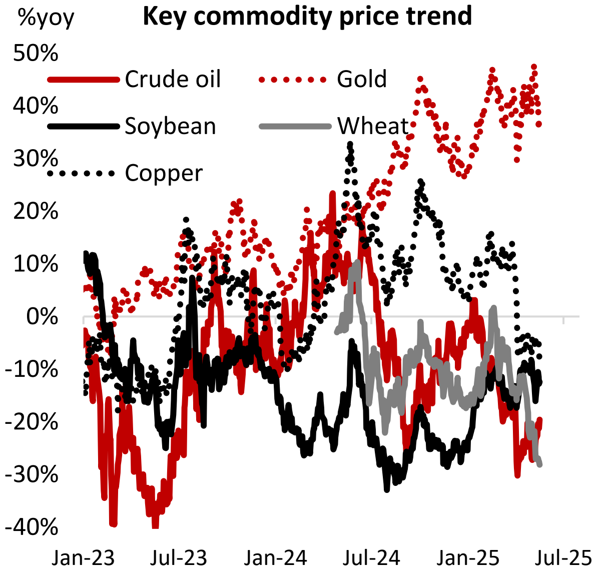
An economy that has grown robustly in recent years and has so far been blessed with a tight labour market can absorb 2-3% inflation with little friction. The easing of commodity prices, spanning the spectrum from fuel to food, so far this year, also helps the inflation narrative, especially at the headline level. Even at the core level, Dallas Fed's trimmed mean measures show encouraging developments.

US PCE inflation rate trimmed mean and core



Source: Dallas Fed, CEIC, DBS

Key commodity price trend

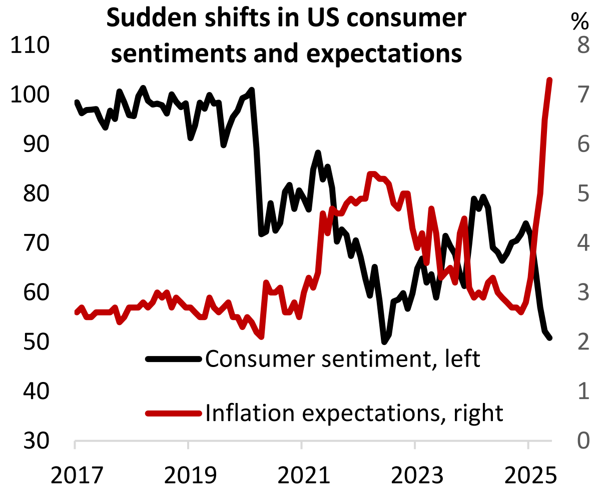


Source: Bloomberg, DBS

"We may be entering a period of more frequent, and potentially more persistent, supply shocks—a difficult challenge for the economy and for central banks."—Fed Chair Jerome Powell, [Second Thomas Laubach Research Conference], May 15.

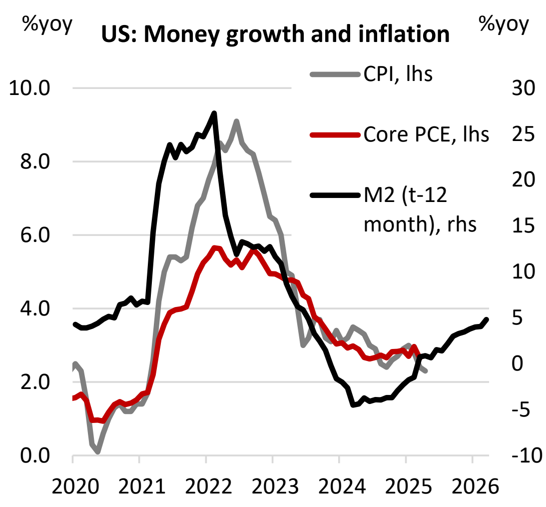
Backward data, however, are an inadequate reflection of underlying inflation risks in the US. As noted by Fed Chair Powell at a speech last week, policies undertaken by the Trump administration have led to a fundamental shift in price expectations. Recent favourable developments on China-US trade talks mask the fact that this year's trade policy measures have taken US import tariffs to levels not seen since the 1940s. These tariffs, even if they settle with 30% on China and 10% on most of the world, along with assorted rates on selected sectoral imports, will contribute to margin compression for firms and/or price passthrough at the retail level. Thanks to on-again, off-again tariffs and other trade restrictions, there have already been episodes of sudden stop and resumption of orders and shipments. These are bound to affect sentiments and prices.

University of Michigan survey's latest readings are dramatic. The recent jump in inflation expectation and correction in consumer sentiment coming out of the survey responses reflect crisis-type magnitudes. The fact that these shifts have yet to materialise in higher inflation or lower purchases should not be cause for complacency; it may well be just a matter of time.



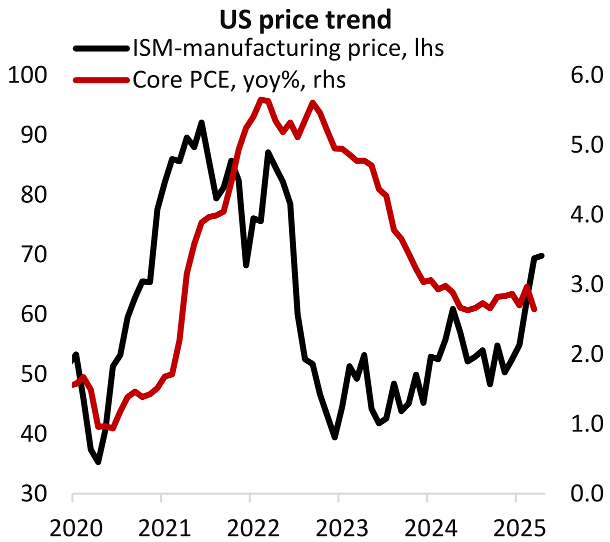
Source: University of Michigan, DBS. Sentiment index set to 100 for 1966 reading. 12-month ahead inflation expectations is survey median reading.

A combination of tight labour market and rising money growth would have caused some upside risk to inflation in any case. Combine this with trade war matters, and firms have a few excuses to raise prices in the near term.

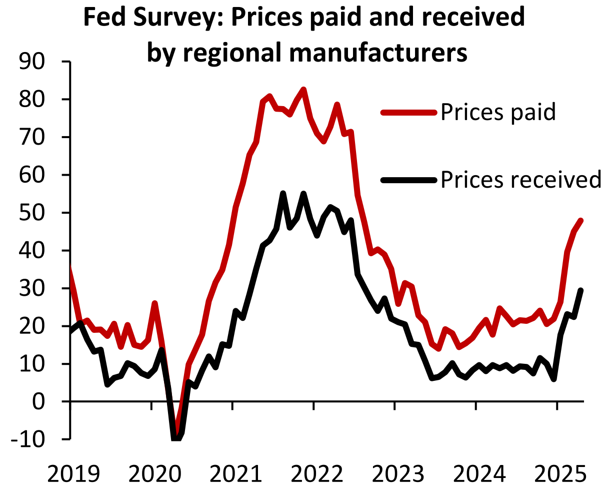


Source: Bloomberg, DBS

The fact that weakness in commodity prices has not managed to dent inflation expectations or consumer sentiment is troublesome. Equally concerning is the fact businesses are already reporting a sharp rise in input prices. The survey readings reflect pressures akin to 2022, which was a time of much higher inflation. Regional manufacturers' surveys warrant particular attention, as they are likely to be at the frontline of the tariff mayhem.



Source: CEIC, DBS.

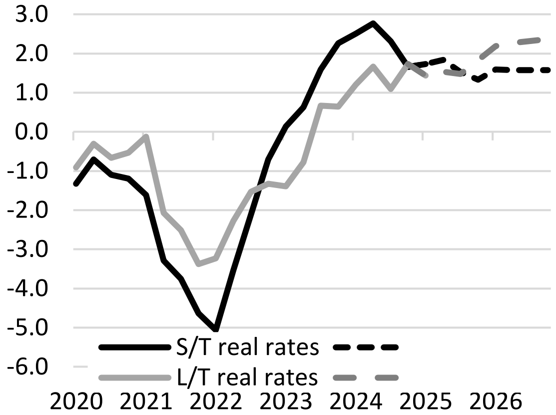


Soure: CEIC, DBS. Note: Average of prices paid and received in surveys conducted by New York, Kansas City and Philadelphia Fed district banks.

"Higher real rates may also reflect the possibility that inflation could be more volatile going forward than in the inter-crisis period of the 2010s."—Fed Chair Jerome Powell, Second Thomas Laubach Research Conference, May 15.

Chair Powell's observation last week that higher real interest rates than what was seen in the 2010s is likely going forward drew our attention. Long-term interest rates in the mid- to high 4% range may well be the outcome of higher inflation expectations, induced by policy volatility. But they would lead to steep yield curves and dampen equity and real estate prices, and hurt the consumption and investment outlook. If the Fed is serious about arresting a rise in inflation expectations, it would have to communicate a more hawkish stance, risking substantial pushback from President Trump and considerable near-term downside to asset prices.

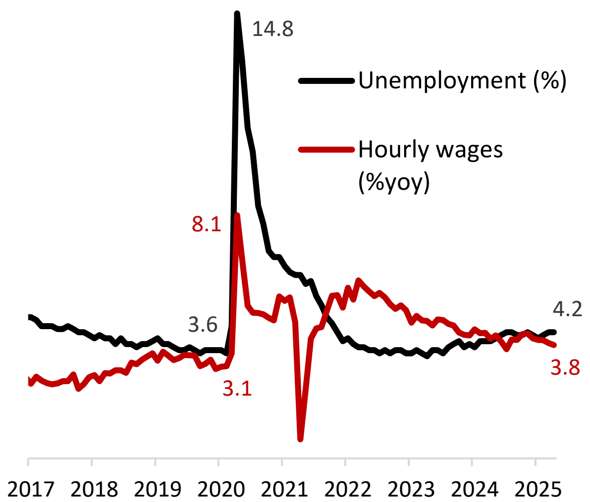
US real rates



Source: CEIC, DBS. Short-term real rates calculated by taking the difference between end-quarter Fed funds rate and the average core PCE inflation for that quarter. L/T uses end-Q 10-yr bond yield.

Financial markets, particularly equities, have recovered a large chunk of their losses since the early-April mayhem, cheered by some recent progress in trade talks. We are not at all convinced by this rally though, as we see the risks to inflation and interest rates highlighted by the Fed Chair not being captured in the pricing. We expect the summer reprieve to risk sentiments, helped by the 90-day pause in China-US trade war, to fade once the survey readings begin to get reflected in actual data.

Labour market



Source: CEIC, DBS. Data through April 2025

As risk markers, we will look at guidance from large retailers first, as they have the widest views on supply chain related matters. But for the US economy, perhaps equally critical is the situation with small businesses. As Chair Powell pointed out in his speech last week, potential disruptions to supply chains and distribution networks tend to be acute for small businesses, as their operations are less diversified, less able to access credit, and hence more vulnerable to adverse shocks.

Taimur Baig

FX: AUD is a better proposition than the USD

On May 20, a hawkish rate cut by the Reserve Bank of Australia could boost AUD/USD, which held above 0.64 for the third week. The RBA should lower the cash rate target a second time by 25 bps to 3.85% and signal a pause at the next meeting on July 8, mirroring the February 18 meeting. The data-dependent RBA will likely be more cautious than in previous meetings.

First, Australia's GDP growth improved to 1.3% YoY sa in 4Q24 following four quarters of slowdown. However, RBA Governor Michele Bullock will likely emphasize a cautious approach to how Trump's erratic trade policy impacts global growth and inflation, leaning towards the Fed's wait-and-see stance. The US-China tariff reset on May 12 brought much-needed relief to investors and businesses, until the 90-day pause ends in August.

Second, the Melbourne Institute's inflation gauge may be front-running CPI inflation, coming in surprisingly firmer at 3.3% YoY in April vs. 2.8% in March, above the RBA's target of 2-3%. The wage price index increased to 3.4% YoY in 1Q25 from 3.2% in 4Q24, but mainly in the public sector instead of the private sector.

Third, Australia's labour market remained tight, with the unemployment rate around 3.9-4.1% over the past year. Notably, the relative resilience of the Australian economy drove migration from New Zealanders seeking stable jobs and higher wages, away from NZ's recession with a four-year high jobless rate.

After reviewing the developments following Trump's "Liberation Day" tariffs on April 2, **AUD/USD is unlikely to repeat the 10% sell-off in 2018-2019.** In Trump 2.0, the administration is seeking to expedite the process towards trade deals with the "priority countries" such as Australia through its "escalate to de-escalate" tariff policy and tariff pauses. This helps to explain the AUD's quick rebound on the tariff pauses after its initial capitulation to 0.59 on Liberation Day.

Unlike his predecessor – Scott Morrison during Trump 1.0 – Prime Minister Anthony **Albanese did not align strongly with the Trump administration against China**. Albanese has been working to mend the strained ties with Beijing since taking office in 2022. Following the Labour Party's decisive re-election on May 3 and Albanese's disappointment over Trump's unjustified tariffs on US allies, the government has committed to defending national interests while seeking to diversify trade relations by elevating economic partnerships with the EU, India, and Southeast Asia. Unlike Trump 1.0**, China did not devalue the CNY when US tariffs increased to 145% before the truce.** The tariff reset underscored China's strengthened position in tackling trade tensions against the US.

Following Moody's decision to axe the US's final AAA debt rating on May 16, **AUD** – which retained all three AAA debt ratings with stable outlooks – **is looking like a sounder proposition than the greenback**. In the two elections that elected their leaders for a second term, Australian voters endorsed the Labour Party's centrist policies and stable leadership amid global uncertainties, contrasting with Trump's disruptive and erratic trade and "America First" agenda.

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations)

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