AXA Investment Managers

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Investment Institute Macroeconomics

Where's inflation?

- The escalation in the Middle East adds another layer of uncertainty.
- US inflation is still tame. The pass-through from tariffs could be slower than in 2018-2019.
- Waller makes a good "dovish case" for the Fed – but that is not for immediate consumption: Fed should stick to a "wait and see" attitude for now.

The FOMC meets again this week with no less uncertainty, overall, than last month. True, the trade confrontation has given way to talks – even if their outcome remains unclear – but at the same time the exacerbation of tension in the Middle East puts in doubt what had been one of the very few tailwinds benefiting the world economy recently: the decline in oil prices. There are two parameters which we will closely monitor to assess the risk of a persistent oil shock: how Gulf states – and particularly Saudi Arabia – position themselves on oil supply, and the likelihood of a disruption in oil flows through the Strait of Hormuz. It is early days, but on balance the risk still seems containable.

Were it not for the exogenous shocks – tariffs and oil – it seems that the Fed has successfully concluded the post-pandemic policy cycle, to borrow from Christine Lagarde's expression about the ECB two weeks ago. The May print for the US CPI was particularly encouraging. It is getting surprising that no tangible sign that the tariffs are starting to bite has emerged, as even core manufactured goods prices were tame, apparently disproving the Fed's assessment of the first trade war of 2018-2019 of a rapid pass-through. However, a key difference between now and then is that the level of preparation of US stakeholders was much higher this time. Inventory building may delay the transmission.

While the re-affirmation of the Fed's "wait and see attitude" is highly likely this week, the FOMC dot plot for 2026 and 2027 could reflect some divergence across members, with hawkish and dovish clusters appearing, divided over the risks of inflation persistence in the US. We explore in detail the recent speech by Christopher Waller, which very neatly makes the dovish case. Some of his arguments are seductive, but the ongoing crackdown on immigration weakens his point on the normalisation of US labour supply. Besides, his views matter more for the terminal rate – whether the Fed could go all the way into accommodation – than for the next few months of US monetary policy.

Another shock

The equity market reaction last Friday (the S&P500 fell by 1.1% on the day) to Israel's strike on Iranian nuclear facilities contrasted with the stability seen after the previous Iran-Israel air confrontation (Iranian ballistic missiles launched on Israel on 1 October 2024, Israel striking back on 26 October). This was a rational response to the immediate spike in oil prices (+8.4% for Brent on Friday, to USD74.2 per barrel), which also contrasted with the October 2024 episode. The magnitude of the attack is of course different (focus was squarely on air defence last year), the strikes and counterstrikes are continuing and trust in sources of moderation – Joe Biden was still in charge then – has diminished. But **the reaction of other asset prices also illustrates how market dynamics have changed over the last few months under Trump 2.0 policies. Indeed, there was no safe-haven effect boosting the US Treasury market:** the US 10-year yield even rose by 5 basis points (bps) on the day to 4.41%. (there was a 7-bp decline on 1 October 2024). The dollar exchange rate did not benefit much from the shock: the euro lost only 0.3% on the day, correcting in the afternoon most of the knee-jerk decline of the early morning, to still stand above 1.150 (it had lost 0.8% on 1 October 2024). This is providing a natural experiment in the erosion of the status of dollar-denominated assets.

Given the long list of headwinds threatening the world economy, the recent decline in oil prices was a welcome source of relief. While oil at USD 60/bl meant no major investment in capacity could be expected in the US, as we discussed last week, at least the drop in energy prices could offset some of the deterioration in consumers' purchasing power triggered by the tariffs, and this effect is also a key ingredient in the European Central Bank (ECB)'s hope for the resilience of the European economy this year. The ramifications go well beyond energy though. Low oil prices would over time erode Russia's capacity to maintain its war effort in Ukraine, raising the probability of a cease-fire there. The new escalation in the Middle East puts this in question.

The military situation remains fluid as we write, but we will look at two parameters to assess the magnitude of the economic shock. One, how Organization of the Petroleum Exporting Countries (OPEC) members, and prominently the Gulf States, position themselves in this conflict. Second, what are the risks oil flows to the rest of the world gets disrupted.

Initially, Israel had spared Iranian oil-exporting capacity, focusing on *domestic* storage and distribution centres but this has seemingly changed in the latest wave. The Wall Street Journal reported on Sunday night that some Iranian oil exports from Kharg island, the country's main terminal, have been delayed. Iran supplies roughly 4% of total oil in the world. Saudi Arabia holds the key to the oil market given its unique capacity to modulate its production swiftly in a way which has an immediate impact on the overall market balance. Riyadh condemned the Israeli strike. **It is however unlikely Saudi Arabia would display any sign of active solidarity with Tehran**. True, over the last few years a détente between the two usually rival regional powers has occurred – materialised in the visit of the Saudi Defence Minister to Iran in April 2025 – but Riyadh's main objective in this détente is to foster stability in the region to advance its own economic development agenda, which continues to be based on its capacity to protect its market share in oil production. **We would thus *not* expect Saudi Arabia to reconsider its current positive stance on oil supply**, while working in favour of a de-escalation.

As usual with Middle Eastern crises involving Iran, the key issue is whether the Strait of Hormuz will remain open to oil flows. The temptation to act there may be higher than usual for Tehran not only because of the magnitude of the attack, which pushes for significant retaliation, if only to appease their internal hardliners, but also because Iran's capacity for indirect action against Israel is much degraded after its loss of influence in Syria and the military setbacks of Hezbollah in Lebanon. Yet, this is a last-resort option, since **closing the Strait would lead to economic asphyxiation for Iran itself and could trigger existential threats against the survival of the regime**.

Donald Trump's non-interventionist leanings would probably find their limits should the Gulf be in turmoil. The consensus from geopolitical experts who took to the wires since Friday is that the Israeli strike was not coordinated with the US, and that Donald Trump was genuinely looking for a deal with Iran. However, in case of military escalation from Tehran, it would be very difficult for him not to intervene directly (beyond the current US active involvement in the protection of the Israeli airspace). On top of the implications for the US vital interests – even if the US is now a net exporter of oil, a price spike would not be in its interest given the impact on US consumers – domestically the current crisis could hit the US President politically, as it could be easily portrayed by his opponents as a consequence of his decision, in his first mandate, to walk away from the nuclear agreement with Iran which had been negotiated under Obama. Despite his isolationist instincts, allowing the Strait to close would be disastrous for him. Tehran is probably well aware of this.

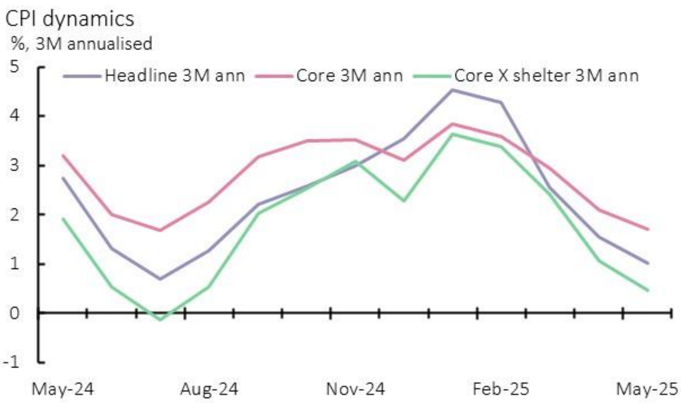
China is another key player here. The political and economic links between Beijing and Tehran – China labelled Iran as a "comprehensive strategic partner" in April – have intensified. China is Iran's largest trading partner. This is parameter which the US needs to take on board when designing an intervention, should this be needed. Yet, according to Comtrade data used by Center for Strategic & International Studies (CSIS) Research, in 2021 45% of Chinese oil imports transited via the Strait (although this proportion has probably fallen since then given the intensification of the trade relationship with Russia). **Given its sensitivity to sea traffic in the region, Beijing at this stage probably has a vested interest in supporting de-escalation.**

Again, **it is an extraordinarily fluid situation, but on balance there are still many elements which could "cap" the geopolitical consequences, and hence the macro-financial consequences of this new bout of tension in the Middle East**. If oil stabilises close to the levels seen as of Friday night – which would be consistent with such "cap" – then the boost to Russia's position in its conflict with Ukraine would be relatively small. The fate of that war probably still lies more squarely in the outcome of the current Russian offensive on the field, rather than in the Iranian airspace.

Delayed inflation

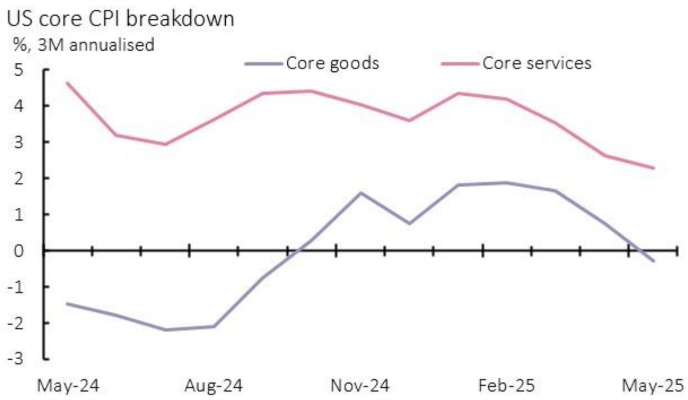
Of course, should the oil price spike prove persistent, the inflation trajectory in the West would change. Yet, as of now, what is striking in the US is more the continuing moderation in price pressure. Indeed, while the trade war is still taking up a lot of the market's collective brain time, for now hard evidence of any impact of the tariffs on prices remains scant.

Exhibit 1 – Inflation down



Source: Bureau of Labor Statistics and AXA IM Research, June 2025

Exhibit 2 – No sign of tariff impact for now



Source: Bureau of Labor Statistics and AXA IM Research, June 2025

The US headline Consumer Price Index (CPI) print for May came out in line with expectations, at 2.4%yoy, barely accelerating from April's 2.3%, but **core inflation was below consensus**, stabilising at 2.8%yoy while the market was projecting a slight rise (2.9%). As usual, we want to vary the vantage point by focusing on the latest developments, looking at the 3-month annualised change. The picture then gets positively rosy. Headline fell to 1.0%, continuing the brisk descending trend which had started last winter, while core CPI fell below 2.0% for the first time since last summer. Excluding shelter, following the Federal Reserve (Fed)'s favourite gauge of price pressure these days, core was particularly weak, at 0.5% (see Exhibit 1). In the current circumstances, when tariffs are the most obvious source of tension, the first concerning signs of pass-through should emerge in core goods prices (that is the internationally tradable component of the consumer basket). This is not yet happening: on a three-month annualised basis, the price of goods excluding food and energy fell again in negative territory in May, while core services posted an innocuous, and decelerating, 2.3% gain (see Exhibit 2). There does not seem to be anything of concern up in the pipeline: producer prices were also tame in May (3.0%yoy, down from 3.2%yoy in April).

Were it not for the looming tariff shock, we would be tempted to borrow from Christine Lagarde's statements at the June press conference, to characterise the US as well: this monetary policy cycle is closing. The post-Covid inflation shock is absorbed, and central banks have reason to congratulate themselves on their deft management of the last, momentous 5 years. They delivered disinflation gradually but ultimately within a reasonable time frame, without triggering a recession, after having saved the global economy's bacon in 2020 with massive, pre-emptive support. With the benefit of insight, grumblings on whether they changed course and opted for restriction quickly enough are largely inconsequential in our opinion.

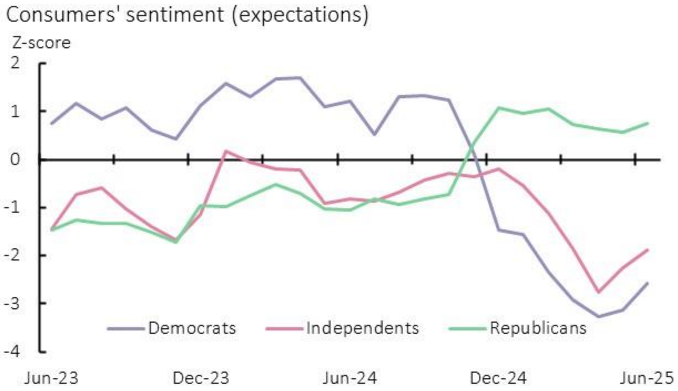
Still, of course, central bankers can never fully rest, and success on yesterday's mission does not preclude an equally deft dealing with the trade war. Tariffs will hurt. Import prices shocks are usually unpredictable – rising energy and commodity prices in response to geopolitical disturbances are perfect examples. But as the trade war had been telegraphed for months, **businesses could prepare and adjust their inventory behaviour**. Massive imports fuelling equally massive inventory building in Q1 to beat the tariffs currently help wholesalers and retailers to delay the transmission of the shock to their final consumers. As inventories gradually deplete, the pass-through should show its ugly head.

The first trade war with China of 2018-2019 was different: until quite late into the dispute, US stakeholders failed to adjust their behaviour despite clear warnings from the US administration, the consensus of the time being that a last-minute deal would emerge. The US Trade Representative issued on 3 April 2018 the first list of Chinese products hit by 25% tariffs (applicable to USD50bn worth of imports), enforced only on 6 July. While press reports at the time pointed to US businesses speeding up their orders, seasonally adjusted Census Bureau data show that US imports from China *fell* in April 2018 (-3.9%mom) and May (-1.4%). It is only the second wave of US tariffs (announced in the late summer) which triggered some measurable reaction (imports from China rose by 4.9%mom in September 2018). A Fed staff study from May 2025 (see the link here), drawing on the 2018-2020 experience, concluded that the tariffs were passed to consumers "*within 2 months*". Given the better level of preparation this time, the pass-through may take a bit longer.

Exhibit 3 – Still high, but not as high, expected inflation

Source: University of Michigan and AXA IM Research, June 2025

Exhibit 4 – Americans feel a bit better



Source: University of Michigan and AXA IM Research, June 2025

This is essentially why we take the improvement in consumer confidence reflected in the Michigan University survey released last week with a pinch of salt. Clearly, the concessions offered on trade by the White House after the shock of "Liberation Day", and the observation of tame actual consumer prices, triggered a swift downward revision in US households' inflation expectations for next year, from nearly 7% to slightly above 5% (see Exhibit 3). This has lifted their overall macro-outlook. We have been increasingly prudent in our analysis of consumer confidence given accumulating evidence that political preferences are playing a major role in economic perceptions, but interestingly, the rebound in consumer confidence was particularly acute among Democrats and Independents (see Exhibit 4). We are still bracing for another downturn in the consumers' outlook once the price shock materialises in earnest. Besides, long-term inflation expectations remain very elevated, which suggests that consumers have not lowered their guard: the post-pandemic price shock has reminded everyone that, after decades of "great moderation", inflationary shocks can still happen, and sensitivity to even relatively small price movements has probably increased.

Still, for now, consumers are – a bit – reassured. If the pass-through does not materialise soon, a natural conclusion will be that much of the tariff shock is being absorbed in foreign exporters' and domestic margins. The first effect will be made less likely by the dollar depreciation (exporters would have to shoulder both the currency move and the tariffs). The second effect would be key to the monetary policy response. Indeed, **depressed margins would skew the shock towards the demand-side, with less space for investment, hiring and pay, and a smaller inflation spike**. Such outcome could speed up the resumption of rate cuts by the Fed. The market may be moving slightly towards this scenario: at a recent trough 6 June, forward contracts were consistent with only 41bps of Fed cuts by December. As of Thursday evening, last week – i.e. before the news of the Israeli air strikes on Iran – this had moved to 55bps (which we find reasonable). In these circumstances, Governor Christopher Waller's recent dovish case for the Fed trajectory, laid out in his speech on 1 June, is well worth an exploration.

Following the Waller Walk

There is little suspense on this week's Federal Open Market Committee (FOMC) meeting's outcome – there has been ample communication from the FOMC to cement the "wait and see attitude" clearly articulated last month. **The market focus will be squarely on the new forecasts**. The FOMC members views from March were collected before "Liberation Day", and even with the concessions that followed, their baseline for tariffs is probably higher than it was then. The March projections were consistent with two cuts by the end of 2025, by a small margin (8 members had less cuts). We would thus not be surprised if there was only cut telegraphed in the new dot plot. However, **we think the dot plot will be more interesting for the following years**. Assuming the median projection does not change from March, three cuts (to 3.37%) would be pencilled in 2026. Yet, **the dispersion around the median could be more interesting than the median itself.** Indeed, we could see a cluster of "doves" pushing for swifter cuts, with a quicker convergence back to neutral. Christopher Waller could be the leader of this group.

As usual with him, his speech on 1 June offers a remarkably cogent and persuasive narrative, even if ultimately, we disagree with the characterisation of balance of inflation risks which is at the heart of his story.

In his baseline, tariffs would rise by 15% – which is also pour central scenario – but this is only an average of a "low case" (10%) and "high" one (at 25%). In the "low" scenario, he would expect much of the shock to be absorbed in margins, which would push consumer prices to a 3% pace temporarily. In the "high" one, the pass-through would be more significant, and Personal Consumption Expenditures (PCE) could accelerate to 5%. But even in this case, **he would not expect the deviation from target to last very long. His main point if that this new supply-side shock would occur in a vastly different context as the one triggered by the pandemic.** Indeed, labour supply contracted significantly under Covid and did not normalise quickly as the economy was reopening. At the same time, global supply lines were profoundly disrupted at the time. These two factors are absent today. Inflation should be less persistent.

We agree that labour supply today has normalised – with a big caveat for the near future which we will discuss later – but **we would not be as dismissive as Waller of the "supply line disruption effect"**. While indeed it is unlikely to be as pervasive as the Covid shock, slapping tariffs, especially if they are differentiated across countries and products, could prove quite difficult to navigate for US businesses: industrial processes cannot always be amended quickly to changes in the input mixes. Finding substitutes for heavily hit foreign suppliers takes time.

Waller then moves on to **the other traditional ingredient in any lasting inflation drift: the de-anchoring of inflation expectations**. He highlights the gap between the benign projections by professional forecasters (i.e. economists) and investors (forward contracts) on the one hand, and consumers' clear concerns over future inflation reflected in surveys on the other hand. He states his preference for the former. His point is that market players and professional forecasters have "skin in the game", in the sense that they compete against each other to produce the best possible forecast and benefit from their trading ideas, while consumers don't. This is another reason, in his narrative, to be relatively relaxed on the long-term impact of the tariffs.

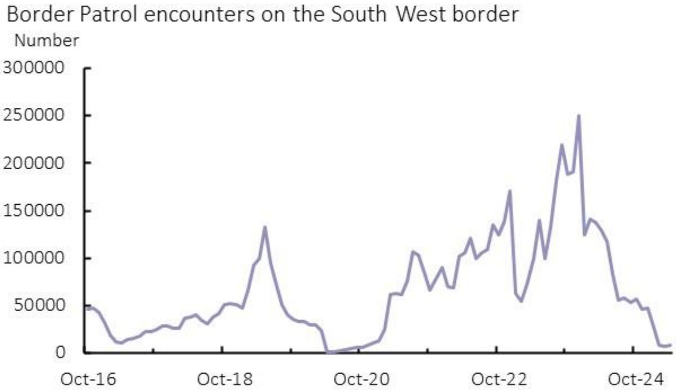
It is a seductive argument, but in our opinion, **there is another fundamental difference between the two sets of expectations: to form their inflation projections, investors and professional forecasters take on board their expectations for monetary policy.** A key ingredient there is the widespread belief in the credibility of the Fed: those price expectations routinely return towards 2% because investors and private sector economists believe the Fed will always end up doing the right thing and bring inflation back to target. Consumers are usually less convinced. **A massive gap between consumers and market-based expectations could thus signal the need for some "credibility reinforcement" by the central bank**, which would play in favour of delaying the resumption of rate cuts.

Now, Waller goes one step further and explores the possibility that high consumers' inflation expectations drive them to demand stronger pay rises, which indeed would fuel inflation, in a self-fulfilling prophecy. His argument there is that such demands will fail, since the labour market is much less tight than during the Covid shock. Again, we think this a very strong point, but only if one takes a static view to labour supply. Indeed, he highlights the decline in the Quits rate (resignations as a share of employment, see Exhibit 5) to suggest that households are already much less confident on their job prospects and value security over potential wage increases. However, **the argument on the labour market tightness should take on board the effect of the ongoing immigration crackdown.** According to the latest employment report, job creation in the US is currently standing at about 1% annualised. Over the last few years, immigration was lifting working age population by about 1%. Extrapolating from the recent Border Patrol data, immigration flows to the US have come to an almost complete halt (see Exhibit 6). This could re-create some tension on the labour market, allowing more response from wages to the tariff shock.

Exhibit 5 – Normalised quits rate

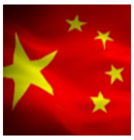
Source: Bureau of Labor Statistics and AXA IM Research, June 2025

Exhibit 6 – No-one is crossing



Source: Department of Homeland Security and AXA IM Research, June 2025

A key point for us is that Waller does not argue that tariffs won't have an inflationary impact. He simply states his belief in the possibility it could be relatively quick to dissipate. But **for his case to be validated, the actual response of wages and margins will need to be scrutinized. In other words, the Fed would not be in position to rally to his view before the shock effectively materialises, and this will take some time – until well into 2H 2025, in our view**. In the meantime, the wait and see attitude will continue to prevail.

Country/Region	What we focused on last week	What we will focus on in next weeks
	• NFIB biz opti index up to 98.8 in May, from 95.8 • Headline CPI and core CPI inflation softened in May to 0.1%mom from 0.2%, weaker airfare price • PPI inflation rose to 0.1% in May. Together with CPI inflation, PCE inflation to edge up to 2.6% • Fed's Quarterly financial accounts in Q1 show a notable deceleration in Federal govt debt, rose by 1.95% saar in Q1, as the Treasury drew down cash balances, while state and local govt debt rose by 4.3% in Q1 after -1.3% in Q4 2024	• FOMC rate to hold in June, then cut successively from Sept onwards to 3.75% by year-end • Headline retail sales in May to stay stable, while ex-autos may inch up • Industrial production in May to tick up from stagnation • Housing starts in May to maintain at 1.36mn • Philadelphia Fed mfg business outlook (Jun), watch for potential boost from development on tariffs
	• April trade balance and industrial production pulled back significantly showing a likely reversal of frontloading behaviour • ECB speakers struck a dovish tone	• Final May HICPs • Preliminary consumer confidence index for June
	• Labour market (Apr/May) PAYE data fell by chunky 109K. AWE ex. bonus fell to 5.2%, from 5.5% • BRC Retail Sales (May) fell to 0.6%, from 6.8% as Easter impact reversed • Monthly GDP (Apr) dropped by 0.3%, 20bp below expectations • RICS House Price (May) fell to -8, from -3	• CPI inflation (May) we see a drop potentially to around 3.2% in May • BOE rate decision: look for hold at 4.25% with an 8:1 split • GfK cons. confidence (Jun) look for small rebound • Retail sales (May) look for a drop after 1.2% monthly increase in April
	• Final GDP (Q1) revised up to -0.2%qoq ann. from first estimate of -0.7% • ECO Watchers Survey (May) outlook improved to 44.8, from 42.7 • PPI (May) down 0.2%mom. Yoy fell to 3.2%	• BoJ rate decision: look set for hold. Accompanying statement likely to be on dovish side • Exports (May) look for further drop • CPI inflation (May) headline likely to remain unch. Core set to tick up
	• CPI (May) unch at -0.1%yoy, core CPI rose to 0.6% from 0.5% in April; PPI fell to -3.3% from -2.7% • Exports (May) slowed to 4.8%yoy from 8.1%. Impact of reduced US tariff has not yet shown. Imports (May) declined further to -3.4%, partly due to lower commodity prices • Total outstanding credit unch at 8.7%yoy in May, supported by front loaded govn't bond issuance, which continued the pace of 20.9% in April	• Monthly output (fixed asset investment, retail sales and industrial production) in May likely to be a touch lower, while waiting for impact of reduced tariffs to show • House prices (May): watch for sign of softening
	• CB: Peru (unch at 4.5%) • CPI (May): Romania (5.5%), Brazil (5.3%), Colombia (5.1%), Hungary (4.4%), Mexico (4.4%), Poland (4.0%), India (2.8%) • Industrial production (Apr): Turkey (3.3%), Malaysia (2.7%), Mexico (-4.0%)	• CB: Philippines (25bp cut to 5.5%), Indonesia (25bp cut to 5.5%), Chile (unch at 5%), Taiwan (unch at 2%), Turkey (unch at 46%), Brazil (25bp increase to 15%)

Upcoming events		
	US:	Mon: Empire State mfg survey (Jun); Tue: Retail sales (May), IP (May), Business inventories (Apr), NAHB housing market index (Jun); Wed: Housing starts (May), Initial jobless claims (w/e 14 Jun), FOMC announcement, long term investment flows (Apr); Fri: Philadelphia Fed Index (Jun)
	Euro Area:	Mon: It HICP (May); Tue: Ge ZEW surveys (Jun); Wed: Ez HICP (May); Fri: Ge PPI (May), Fr Insee mfg confidence (Jun), Ez Consumer confidence (Jun, p)
	UK:	Wed: CPI (May), CPIH (May), RPI (May); Thu: MPC announcement; Fri: GfK consumer confidence (Jun), PSNB (May), Retail sales (May)
	Japan:	Tue: BoJ announcement; Wed: Private 'core' machinery orders (Apr); Fri: CPI (May)
	China:	Mon: IP (May), Retail sales (May), Fixed asset investment (May); Fri: PBoC announcement: Loan Prime Rate

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** As at the end of December 2023.

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