QNB Economics
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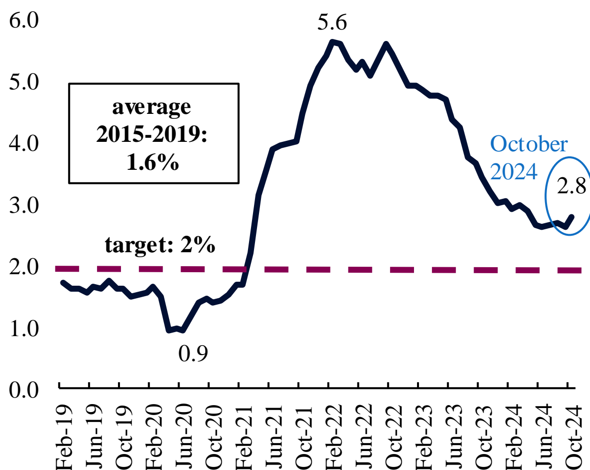
Is US inflation in check?

After peaking at 5.6% per year more than 30 months ago, in June 2022, US inflation has gradually returned to close to the 2% target in recent months. This was a major achievement for the US Federal Reserve (Fed) and has justified the beginning of the easing cycle in September this year, when policy rate cuts were enacted for the first time since the beginning of the pandemic in 2020.

Despite the success and progress in taming inflation, US consumer price concerns still loom large on investor's agenda. In recent weeks, higher than expected inflation prints and a "Republican sweep" with a Trump presidential victory and majority over both the Senate and the House highlighted the risks to the inflation outlook. Importantly, the main gauge for the Fed, the core Personal Consumption Expenditure (PCE) inflation, which excludes volatile energy and food prices from the index, continues to be above target. There are concerns that the "last mile" of inflation may not be as easy as previously expected and that "America First 2.0" may be inflationary, due to fiscal expansion and higher tariffs on imported goods.

Core PCE inflation
(%, y/y growth, 2019-2024)



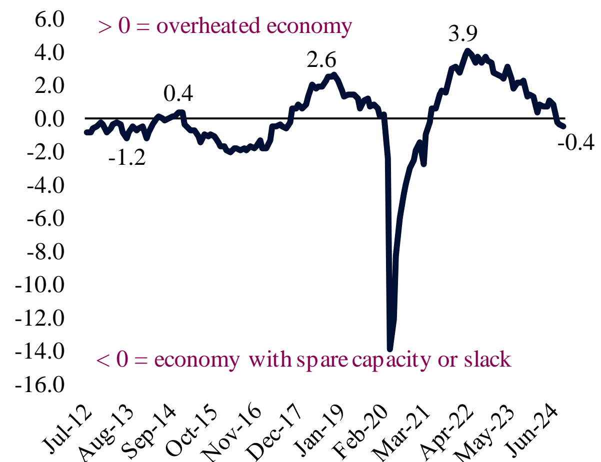
Sources: Haver, QNB analysis

In fact, the potential for higher inflation has already created a significant re-pricing of expectations about the magnitude and pace of monetary easing from the Fed for 2025. In a matter of a few weeks, fixed income investors reduced their expectation for policy cuts from 150 bps to only 50 bps, suggesting that the Fed Funds Rate should close next year at 4% instead of 3%.

In our view, however, irrespectively of all the concerns and potential shocks that US prices are vulnerable to, we believe that the US inflation outlook is constructive, i.e., is set to gradually return to target (2%) in the absence of any major geopolitical event or US policy rupture. Three main factors sustain our view.

First, the US economy has already undertaken a significant adjustment in recent quarters, which contributed to ease the supply demand tightness that was pressuring prices. US capacity utilization, measured in terms of the state of the labour market as well as industrial slack, suggests that the US economy is no longer overheated. In other words, there is a healthy supply of labour for job openings available, whereas industrial activity is running below its long-term trend. The labour market, which reached maximum tightness in early 2023 with the unemployment rate much below equilibrium at 3.4%, fully adjusted and is now at a normalized level with the unemployment rate at 4.1% in October 2024. These conditions support a gradual easing of price pressures.

US estimated capacity utilization
(% deviation from estimated capacity, 2012-2024)



Sources: Haver, QNB analysis

Second, decreasing inflation in the housing component of prices will become a key contributor to falling total inflation in the coming quarters. Housing represents approximately 15% of the PCE index, and includes either rent or, if the housing unit is owner-occupied, what it would cost to rent an equivalent unit in the current housing market. Inflation in housing reached a peak of 8.2% in April 2023, much later than the peak in overall inflation, which reflects the "stickiness" of prices, given that contracts are based on an annual lease. Therefore, prices react more slowly and with a lag effect to changing macroeconomic conditions. Housing inflation has fallen at a steady pace since mid-2023 and is currently below 5%. Market indices of newly contracted rents, which anticipate the trends in the traditional statistic, show that rent inflation is below pre-pandemic levels. This signals that the housing component of prices will continue to decelerate in 2025, helping to bring overall inflation down.

Third, concerns about the inflationary nature of "America First 2.0" are often exaggerated. The new Trump administration would start in a much different national and international environment than the previous one in 2016, with the scope for large fiscal stimulus being more limited. The US fiscal deficit has already widened significantly from 3% of GDP in 2016 to 6% in 2024, with the debt-to-GDP ratio having increased in the same period from less than 100% to nearly 125%. The upcoming Treasury Secretary, Scott Bessent, considered a fiscal "hawk," had already expressed his intent to "normalize" the deficit back to 3% by the end of the administration. In other words, fiscal conditions should tighten rather than ease, which would contribute to slow price pressures, notwithstanding any impacts from tariffs and immigration from policies that are not fully formalized yet.

All in all, we expect to see US inflation moderate further over the coming year, driven by normalized capacity utilization, housing cost adjustments and the potential for fiscal consolidation under Trump 2.0 with Bessent as the Treasury Secretary.

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