Inflation Slowed in June, But That May Not Be Enough for the Fed

Headlines

- **The PCE price index was down 0.1% in June, with the core index up a soft 0.1%. PCE inflation slowed on a year-over-year basis but remains well above the Fed's 2% target.**
- **Real after-tax personal income rose 0.3% in June, with real consumer spending up 0.4%. Income growth has slowed over the past few years while spending growth has held up better.**
- **For the last two years, spending has been growing faster than income and the personal savings rate continues to decline. Weaker income growth will constrain consumer spending growth in the near term.**
- **Unless inflation slows over the next few months, the FOMC is likely to increase the fed funds rate in mid-September.**

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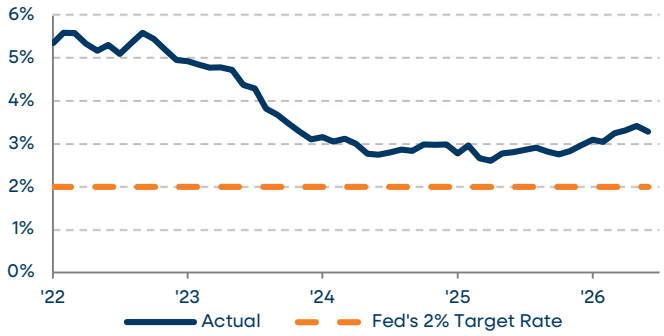
Details

According to the Bureau of Economic Analysis, prices fell somewhat in June from May, with the personal consumption expenditures price index down 0.1% for the month, pulled down by a 6% monthly drop in energy prices as hostilities eased between the U.S. and Iran. **Core PCE inflation, excluding food and energy, was 0.1% over the month.** The drop in prices was welcome after average monthly inflation of 0.5% in the first five months of the year and was the first drop in the PCE price index since mid-2022. It was also the lowest monthly reading on core inflation since March 2025.

On a year-ago basis, overall PCE inflation was 3.7% in June, down from 4.1% in May. Core inflation was 3.3% in June, down from 3.4% in May. **Although inflation slowed for both measures in June, it remains well above the Federal Reserve's 2% objective.** And inflation has been picking up: both overall and core inflation were well below 3% year-over-year in the spring of 2025. Inflation has moved higher due to tariffs; the big jump in energy prices; supply chain disruptions from the closure of the Strait of Hormuz; and a pickup in services inflation, especially non-housing services.

Personal income rose 0.2% before adjustment for inflation in June from May, with after-tax personal income also up 0.2%. Wages and salaries, which are most important for consumer spending, also rose 0.2% over the month. Income growth was 0.7% in May, boosted by one-time farm payments. With the slight decline in prices, **real (inflation-adjusted) disposable income rose 0.3% in June.**

Figure 1: Core PCE inflation (% chg., y/y)



Sources: BEA, PNC

Nominal consumer spending increased 0.3% in June, but with the decline in prices real spending was up 0.4% for the month, matching the pace in May. Real spending on goods rose 0.7% in June, including a 1.5% increase for durable goods. Real services spending rose 0.3% over the month, matching the pace in April and May.

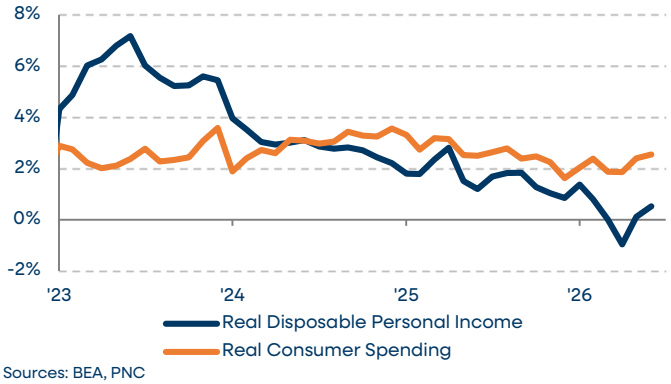
With spending up more than after-tax income, the personal saving rate continued to decline, down to 2.7% in June from 2.8% in May and above 5% in early 2025. Outside of the economic recovery from the pandemic, the saving rate has not been below 3% since the runup to the Great Recession.

Real after-tax income growth has been below 1% year-over-year in six of the past seven months; this is down from around 6% in 2023, 3% in 2024, and 2% in 2025. But even as income growth has slowed substantially with weaker job growth and slowing wage gains, real consumer spending growth has been running between 2% and 3%. **The very strong stock market and rising household wealth have been propping up consumer spending, but spending growth cannot continue to run indefinitely above income growth.** Other drags on consumer spending in mid-2026 are high inflation and elevated interest rates. Consumer spending growth is expected to slow in the second half of this year and in 2027 to a pace more consistent with income growth.

Although the drop in PCE prices in June, and the slowing in core inflation, were welcome news for the Federal Open Market Committee, there was just one month of data. (The PCE price index is the Fed's preferred inflation measure.) Energy prices have picked back up in July with renewed hostilities between the U.S. and Iran, and some of that will flow through to core inflation. There will be some limited near-term slowing in inflation as the impact of tariffs fades. But with the Trump administration announcing new tariffs this month to replace expiring ones, goods inflation will simply return to its pre-tariff pace, and goods prices will remain elevated compared to where they were before the administration raised tariffs in the spring of 2025. Inflation should gradually ease through the rest of 2026 and in 2027 but will remain above the FOMC's 2% target.

The next few months of inflation data will be crucial for monetary policy. The FOMC meets next on September 15 and 16, and the committee will be weighing the employment and CPI releases for July and August and the PCE release for July. If core inflation is moving decidedly lower, the FOMC can keep the fed funds rate in its current range of 3.50% to 3.75% in September. But if core inflation is running at an annualized pace above 2%, and year-over-year inflation numbers are not slowing, a 25-bps rate hike is likely. Right now the fed funds futures market is pricing in a 59% probability of a 25 bps increase in the fed funds rate on September 16.

Figure 2: Real disposable personal income and consumer spending (% chg., y/y)



Sources: BEA, PNC

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