Economic Update

PNC

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Core Inflation Picked Up in July, Making the Fed's Task Even More Difficult as Higher Tariffs Kick In

- **Overall prices rose 0.2% in July according to the CPI, with core inflation (excluding food and energy) of 0.3%.**
- **Energy prices fell on the month, with food prices flat.**
- **Core inflation moved higher in July on a year-ago basis, and remains above what the Fed would like.**
- **Tariffs will lead to higher inflation in the months ahead. Even so, a softening labor market will support fed funds rate cuts later this year and in early 2026.**

Overall prices rose 0.2% in July from June, according to the headline consumer price index from the Bureau of Labor Statistics. Overall inflation was 0.3% in June and 0.1% in May.

The core CPI, excluding food and energy and important for determining underlying trends in inflation, rose 0.3% in July, the biggest monthly increase since January.

On a year-ago basis overall inflation was 2.7% in July, the same pace as in June. Overall inflation peaked at 9% in mid-2022 after pandemic-related disruptions, and got as low as 2.3% in April, but is now creeping higher. Core inflation is also picking up on a year-ago basis. It was 3.1% in July, up from 2.9% in June and a cyclical low of 2.8% in March through May. Core CPI inflation peaked at close to 7% in the fall of 2022.

The Federal Reserve faces a dilemma. The central bank has a dual mandate of stable prices and maximum employment. The labor market has been in solid shape in recent months, but the weak July jobs report, with just 35,000 jobs added on average over the past three months, has heightened concerns about a slowdown. At the same time core inflation continues to run above the Fed’s 2% inflation mandate: it was 2.8% in June, using the Fed’s preferred inflation measure, the personal consumption expenditures price index, which tends to run slightly lower than the CPI. With the core CPI picking up in July, and higher prices coming as businesses pass along higher tariff costs to their customers, core PCE inflation is set to move even further above the Fed’s target in the months ahead. Weaker job growth would normally suggest federal funds rate cuts, but higher inflation would argue against rate cuts. Therefore, the Federal Open Market Committee must balance its competing objectives in setting monetary policy in the months ahead.

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PNC's forecast is for fed funds rate cuts of 25 basis points each over the next four FOMC meetings, three in the remaining months of this year, starting in mid-September, with a fourth rate cut in early 2026. This would take the fed funds rate to a range of 3.25% to 3.50% by late winter. The FOMC is likely to view any higher inflation coming from tariffs as temporary, focusing more on the softening labor market.

Falling energy prices slowed headline inflation in July. Energy prices were down 1.1% for the month, with an almost 10% drop for gasoline prices. Food inflation was zero in July from June, with a small drop in grocery store prices offsetting an increase in restaurant prices.

Core services prices rose 0.4% in July, the largest increase since January. There were large increases in shelter prices (homeownership, rent, and lodging) and airline fares over the month. Core goods prices rose 0.2%, led by a more than 2% jump for used car prices as buyers concerned about tariffs turned to less expensive used cars. New cars rose less than 0.1% in July, but that was the first increase since March. Other goods that have high import shares, such as audio/visual products and sporting goods, have seen stronger inflation over the past couple of months as tariffs start to bite.

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