Macro Comment US

Back with a vengeance - Inflation to haunt Trump too

Despite being proclaimed under control, the inflation surge, which overshadowed the Biden administration, propelled Donald Trump to a clear victory. We, however, believe that the taming of inflation has been declared prematurely. Not only is US inflation still too high and sensitive to new shocks, it is also, ironically, likely to be stoked by the president-elect's planned policies. The bond market is already on high alert as rising inflation and growth risk premiums fuel interest rates, yet Trump's treasury secretary candidate looks likely to become the latest in a string of MAGA politicians to turn a blind eye. Inflation is poised to return with a vengeance and haunt the next presidential term too. So, when will the Fed act? Plus, US data watch: Strength beyond the noisy jobs report.

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Victory in fight against inflation somewhat premature

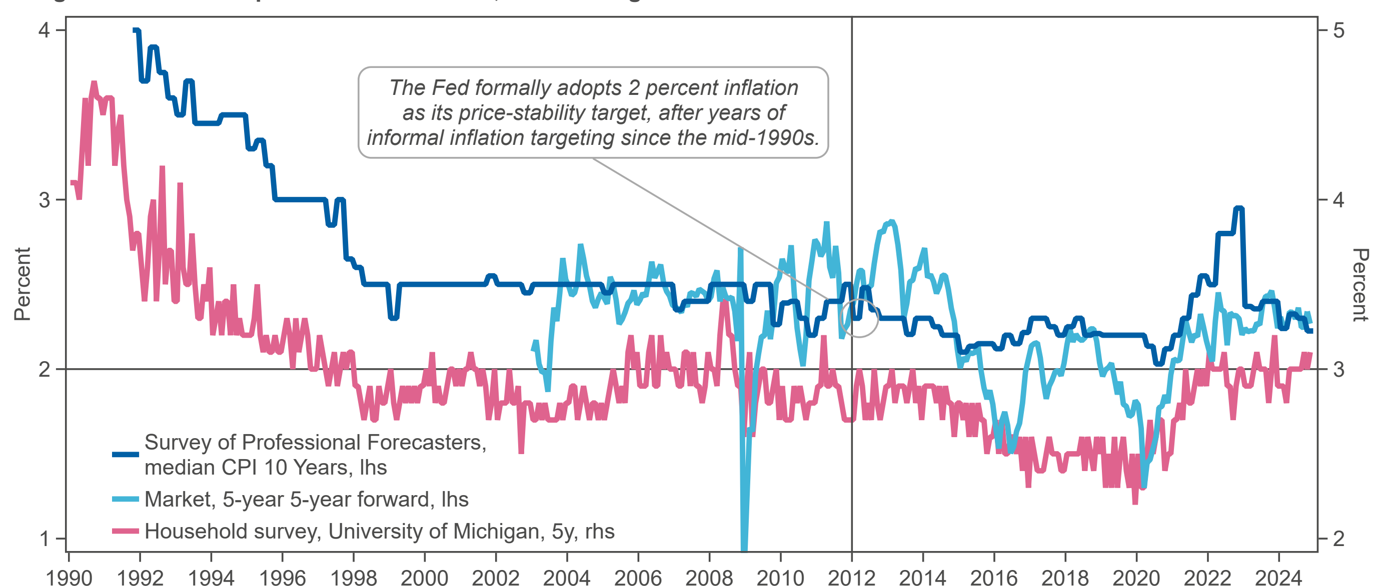
Recent years' high inflation key to Trump election win

We were right to say that the economy would tip the scales in the US presidential election while at the same time expressing uncertainty on whether positivity about the strong economy or negativity about the high cost of living would be the dominating factor. Experts' post-election analyses show that in the end it was the latter – the grief over the Biden-era inflation surge propelled Donald Trump to a clear election win. Households loathe purchasing-power losses, and inflation was their number one issue in this election, according to election day exit polls and other surveys.

Progress towards inflation target and well-behaved inflation expectations have lead to premature declarations of victory

The election outcome is one sign that declarations of victory in the fight to lower inflation have been made too soon. Furthermore, inflation outcomes are currently too high, with recent momentum prints not consistent with reaching the 2-percent target. The current setback may not be as big as the one experienced in early 2024, but that is a small comfort, as October could post a trend-breaking rise in the Fed's underlying inflation dashboard (see chart in data watch section). Long-term inflation expectations have risen during the inflation-crisis years, but at first glance they have remained anchored at levels consistent with the 2-percent target (see graph).

Long-term inflation expectations have risen, but at first glance well anchored



Sources: Macrobond, University of Michigan, Federal Reserve and Handelsbanken

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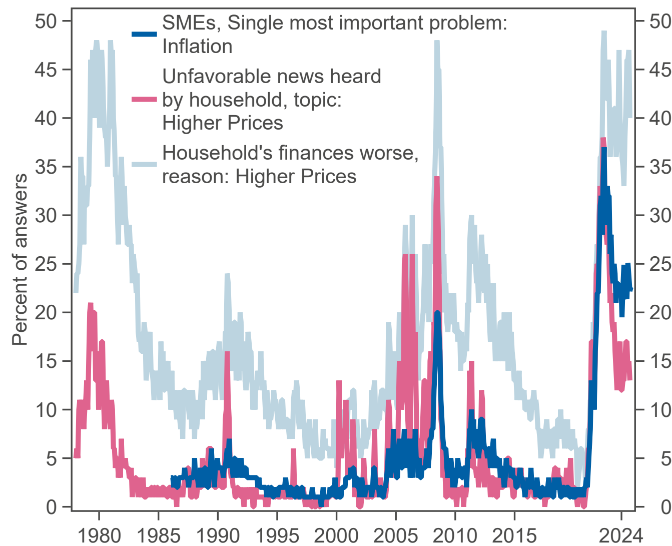
Inflation still has the attention of households and firms



Sources: Macrobond, NFIB, University of Michigan and Handelsbanken

Inflation risk and expectations uncertainty both elevated

Sources: Macrobond, FRBs of Minneapolis and NY, and Handelsbanken

The observation of "anchored" inflation expectations has made central bankers and economists state that the worst of the crisis is likely behind us. In our view, this conclusion does not rest on strong foundations, and we believe that there is a risk that the economy is not equipped to fend off the next inflation shock. To document this fragility, we delve into a broader data set beyond simplistic point estimate inflation expectations:

Three reasons the economy remains susceptible to a new inflation shock

• Firstly, much like the election result signalled, macro data also indicates that inflation continues to have the full attention of households and businesses (see above-left chart), implying that the "rational inattention" state of the previous three decades has not been re-established and hence the economy is still susceptible to new inflation shocks.

Attention, rather than "rational inattention"

• Secondly, the still-strong economy also risks propagating any new inflations shocks by more than average. Note for example that while the labour market has "moved into better balance", using the Fed's current phrasing, it remains tight with a vacancy-to-unemployed ratio above 1 – a level marking the inflection point for when the non-linear Phillips curve tends to steepen markedly, according to some academic research.

Strong economy close to steeper part of Phillips curve

• Thirdly, the balance of inflation risks is tilted upwards, with a still-higher-than-pre-pandemic likelihood of a large inflation increase priced into derivatives markets (see above-right chart). In addition, inflation uncertainty remains unusually high even today, as evidenced by household survey expectations exhibiting a much broader uncertainty band.

Upward inflation risk tilt, and unusually large uncertainty

Planned policies to stoke inflation but Trump camp turning a blind eye

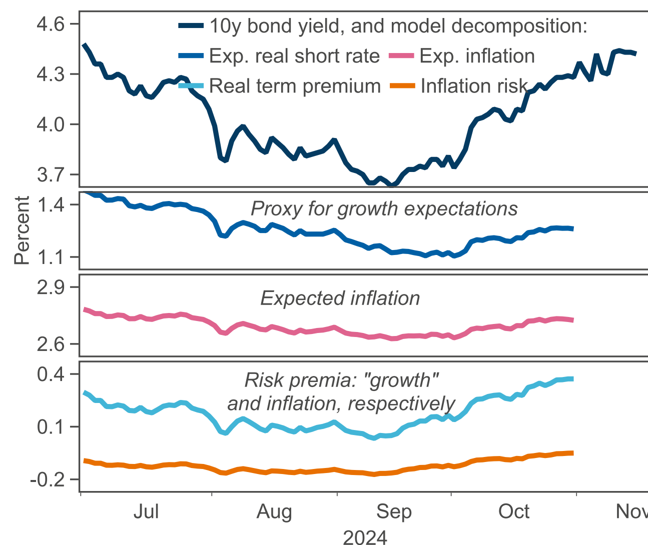
The economy's inflation fragility could be exposed by a shock sooner rather than later. Ironically, inflation is poised to be stoked by the president-elect's planned policies, and depending on the combination of policies actually enacted, the inflation effect could be large, as we laid out in our September Global Macro Forecast report. The bond market is already on high alert – surging interest rates from mid-September to today have been fuelled primarily by a rising term premium, according to the New York Fed's bond yield decomposition model. Under the hood, we find that the inflation risk and real term premiums are key drivers (where the latter is a proxy for growth risk, i.e. economic and fiscal uncertainty), according to another Fed bond yield model (see below-left chart). According to this decomposition, inflation expectations have also picked up and so has the expected real short rate, which got a big boost when the unexpectedly strong jobs report in early October helped avert lingering recession fears. All told, the premia rise happened hand-in-hand with the rise in expectations of a Trump win and a "red sweep" election outcome and looks to have continued after election day.

Trump's policy plan is inflationary, according to the economist consensus and the bond market...

However, Trump's treasury secretary candidate looks likely to join the ranks of MAGA politicians to (so far) turn a blind eye to the serious inflation risks. At least judging by Scott Bessent's analysis in a WSJ opinion piece, which naturally argues the benefits of the president-elect's policy agenda, but then goes on to claim that "financial markets have clearly spoken" and that they are "unambiguously embracing the Trump 2.0 economic vision". The analysis is flawed both because it fails to explain how the sharp tariff increases would help the economy (it does not mention tariffs at all), and because its "markets hail Trump's economics" conclusion leaves out the forward-looking bond market repricing of the past two months, and other market inflation worries described above. Bessent has, until recently, been in pole position to become treasury secretary, but news flow now suggests that he risks losing out, due to a supposed lack of support for Trump's tariff increase plans, and the field of candidates is widening, according to the FT – an indication of larger-than-expected tariffs ahead?

...but the Trump camp is turning a blind eye

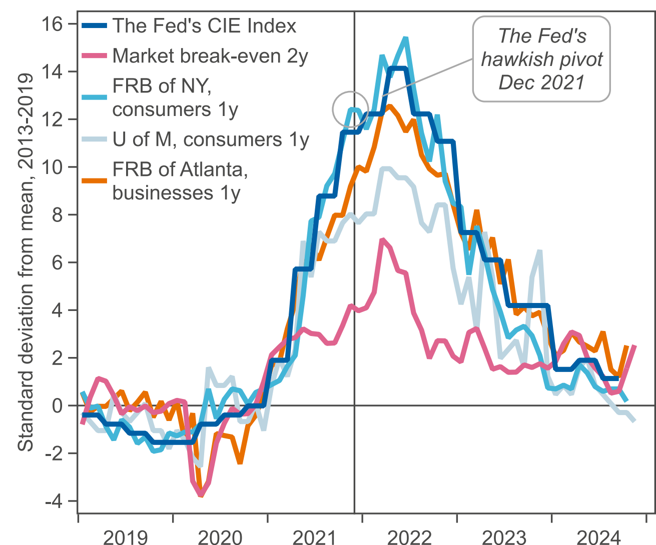
Fed model: Risk premia main driver of bond yield surge



Sources: Macrobond, Federal Reserve and Handelsbanken

Note: Nominal yield decomposed with the DKW-model of the Board of Governors of the Federal Reserve System. Estimated with data until October 2024.

Short-term inflation expectations could be early warning



Sources: Macrobond, Federal Reserve, University of Michigan, Fed Banks of Atlanta and NY, and Handelsbanken

If inflation returns with a vengeance, when will the Fed react?

Since the election, we have been assuming that the incoming Trump government will impose sharp tariff increases on China, but also some increases aimed at a broader group of trading partners, and we have revised up our interest rate forecast. However, the tariff increases may be more sweeping and ignite a serious trade conflict, not just some tentative tit-for-tat retaliation. If the Trump camp keeps turning a blind eye to inflation risks – risks that are already becoming engrained in the bond market – then the overall policy agenda looks set to make inflation return with a vengeance and haunt the Trump presidential term too. The lesson ahead of the 2026 midterm elections is that even if the government boosts growth, it will be punished if inflation also surges. A more pressing question is how the Fed will react to fiscal and other government policies likely becoming more inflationary? At its November meeting, Fed Chair, Jerome Powell, made it clear that the FOMC would not speculate about or assume future policy. We do not think this implies that it will wait for policy to be enacted, because a Fed diligently acting on data will likely find inflation risk proof earlier, e.g. because government signals also affect markets and the economy.

The Fed to not "buy the rumour" in policy calls, but wait for inflation proof first...

One thing that would cause the Fed to slow or pause rate cuts is resurgent inflation and inflation expectations. Short-term expectations are still mostly above their pre-pandemic averages (see above-right chart), and any increase could raise worries about the long-term inflation expectations being next in line. If the timing and mix of Trump's policy communication initially causes a negative supply shock (e.g. tariff increases and migration cuts), then expectations, commodity prices and perhaps some survey data (including the Fed's Beige Book) could be places where we can track the impact. Another scenario is that Trump's policies initially create a positive demand shock in the

...in whatever shape or form this comes, subject to Trump's policy timeline, the mix of demand and supply shocks, and more

economy (e.g. a sentiment boost from deregulation and promised fiscal stimulus), and then the Fed may adapt its policy to better-than-expected economic activity data before the effects on inflation are significant. Remember that the Fed is already in a position where it is considering pausing its rate cuts. The most likely outcome is perhaps some combination of net-negative supply and net-positive demand shocks in 2025 – an inflationary environment.

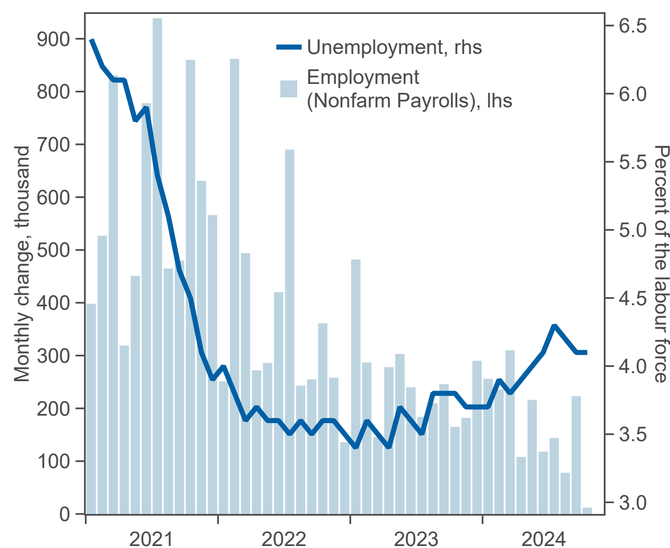
Our next Global Macro Forecast report is on 22 January 2025, with full updates on the US outlook and its impact on the world, including China and Handelsbanken's main markets. Until then, we will keep monitoring economic and inflation risks in the data – stay tuned.

US data watch: Strength beyond noisy jobs report

All told, sustained strong data outcomes keep the soft-landing scenario in view, but we expect fewer Fed rate cuts ahead

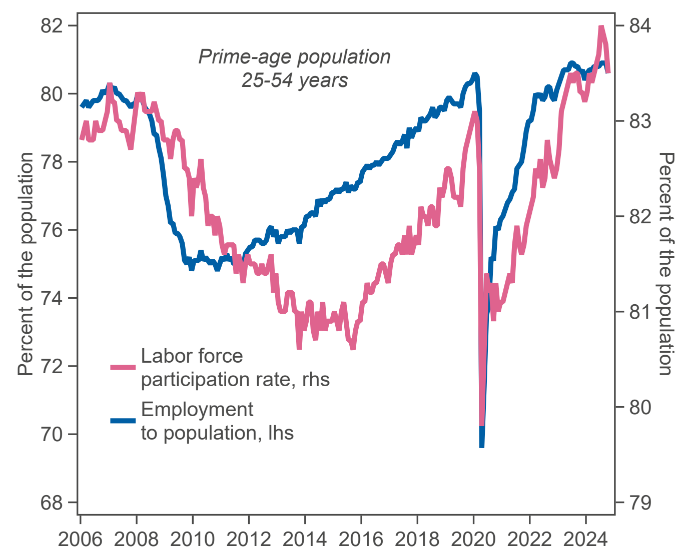
• GDP growth is primed to beat our forecast again in Q4, with the Atlanta Fed's GDPNow model showing an early estimate of growth at 2.5%, q-o-q annualised. Leading indicators remain mixed but have on average picked up to normal levels – all eyes are now on the moves ahead, as election uncertainty fades and households and businesses take onboard Trump's policy agenda. All told, sentiment is set to rise initially, but will it last when contentious policy is likely launched?
• Unemployment remains lower than we have forecast. The downbeat October jobs report was distorted by the recent hurricanes and large strikes and thus analysing the expected rebound in November will be key.
• Inflation has continued to surprised on the upside, and we have lifted our Fed policy rate forecast somewhat, also factoring in tentative effects from an initial government policy assumption change following the republican "red sweep" election win, see main article above. Our year-end 2025 Fed rate range of 3.5–3.75% is more hawkish than the consensus, but just below the market.

Headline labour market statistics



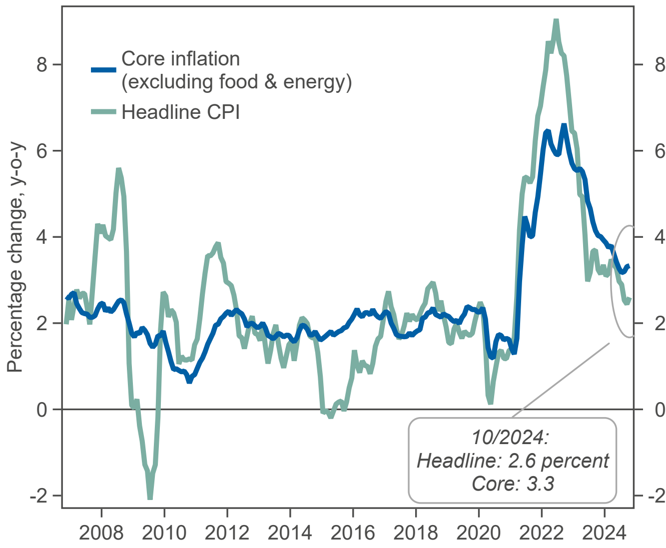
Sources: Macrobond, BLS and Handelsbanken

Core employment rate and labour force participation



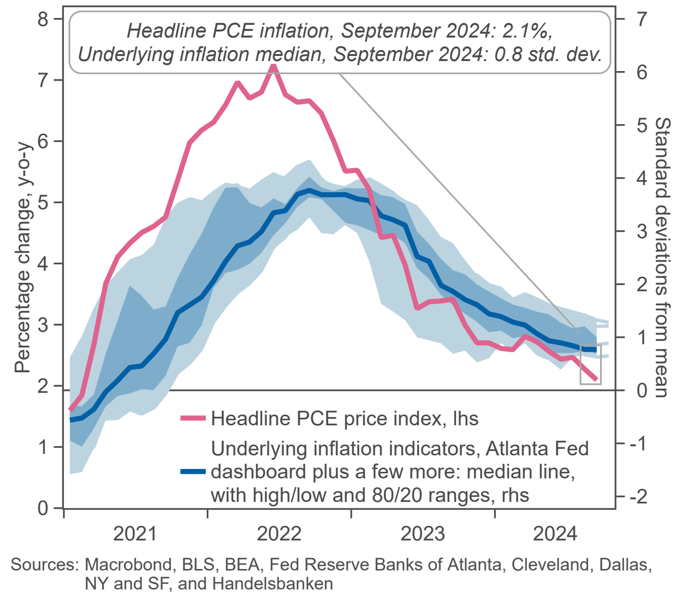
Sources: Macrobond, BLS and Handelsbanken

Headline inflation statistics



Sources: Macrobond, BLS and Handelsbanken

Underlying inflation indicators vs. headline inflation



Sources: Macrobond, BLS, BEA, Fed Reserve Banks of Atlanta, Cleveland, Dallas, NY and SF, and Handelsbanken

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