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Federal Reserve Monitor | North America

Upward revisions to core PCE inflation means the Fed has less margin for error

Upward revisions to prior inflation mean we are now forecasting 4Q/4Q core PCE of 3.2%, near the 3.3% that the Fed forecasted in June when half the committee said this would warrant rate hikes. We maintain our outlook for no hikes this year, but it is a closer call.

Key Takeaways

- While July PCE inflation pointed to disinflation, 2Q core PCE inflation was revised higher. Base effects put our 4Q/4Q core PCE inflation at 3.2%
- The median FOMC participant in June forecasted 4Q/4Q core PCE inflation of 3.3% when half of the committee saw higher policy rates as appropriate.
- We think underlying trends matter: 3- and 6- month annualized rates of PCE inflation point to disinflation, as do market-based PCE and Dallas Fed trimmed mean.
- That said, the Fed has less margin for error. We retain our view of a Fed on hold, but the call is closer than before; disinflation must continue.

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Upward revisions to core PCE inflation means the Fed has less margin for error

First, the good news: July inflation points to disinflation

July PCE inflation data came broadly in line with expectations, with headline and core PCE inflation rising by a fairly muted 0.2% m/m, for annual increases of 3.7% at the headline and 3.3% at the core.

Core goods rose in July on account of AI-related inflation for computers, peripherals, and smart home assistants, likely reflecting Apple price increases implemented in late June. That said, our models continue to suggest that we are at, or very close to, the finish line for tariff pass-through. We estimate that tariffs have added roughly 60bp to PCE prices so far, and the recently announced Section 338 tariffs on Canadian exports do not materially alter our outlook (they raise the overall effective U.S. tariff rate by only 0.2pp). Hence, significant tariff pass through remains in the pipeline.

On net, we read the July PCE inflation data as consistent with our outlook for slowing inflation.

Now the bad news: Upward revisions to core inflation

Core inflation in 2Q was revised higher

The bad news came in the area of core PCE inflation, where the quarterly annualized pace was revised higher by two-tenths to 3.6%. The upward revisions were largely explained by non-profit institutions serving households. Our 4Q/4Q forecast for core PCE inflation is now 3.2% for 2026.

At the time of the June FOMC meeting, our forecast for core PCE inflation was 3.0% and the disinflation we expected was the main input into our view that the Fed would stay on hold into year-end. We expect payback from prior increases in oil prices, an end to tariff pass-through, further diminution in shelter inflation, and payback from residual seasonality. Our monthly forecasted rates of inflation heading into year-end have not changed, but a higher June PCE price index level means we have a higher annual reading at year end due to base effects.

Our new 4Q/4Q forecast for core PCE inflation is only a tenth below the median FOMC participant's forecast for core PCE inflation at the June meeting, when the committee was evenly split on whether the policy rate should stay at the target range of 3.5-3.75% or move higher (the chair did not submit a dot in June).

The probability of an "oil risk premium" scenario also remains elevated

We also cannot rule out further increases in energy prices on account of the inability of the administration to bring about a de-escalation in the Middle East conflict and a restoration of oil through the Strait of Hormuz. Gasoline prices have retreated to about

$4/gallon across much of the US, but diesel prices have returned to April-May highs.

Reflecting the slower road to full recovery in oil supply and refinery capacity, our commodity team raised its price target for Brent this week. Previously the team forecasted $75/bbl for Brent through year-end, and that now stands at $90/bbl for 3Q and $100/bbl in 4Q (see Slower Road to Full Recovery; Raising Brent Forecasts). Our "oil risk premium" alternative scenario for the US economy that we highlighted in our mid-year economic update doesn't want to go away just yet.

The longer oil prices remain elevated, the greater the risk of elevated headline inflation and second round pass-through into core.

We retain our outlook for no hikes this year, but it is a closer call now

Although our forecast for inflation has worsened, we maintain our outlook for the Fed to stay on hold this year on account of near-term inflation trends.

The July inflation data and revisions imply core PCE inflation running at a 3-month annualized pace of 3.05% (3.11% in June), a 6-month pace of 3.46% (3.87% in June), and a 12-month rate of 3.34% in July (vs. 3.34% in June). Hence, even with upward revisions to prior data, trends still point to lower inflation ahead.

In addition, market-based core PCE came in at 0.15% m/m in July, with a 3-month annualized pace of 2.3%. The Dallas trimmed mean PCE on a 1-, 6-, and 12-month annualized basis is 2.2%, 2.4%, and 2.3%, respectively. Signals from these measures of underlying inflation remain favorable.

Finally, our forecast for PCE inflation does not incorporate the annual national accounts revisions scheduled for September 30, which could lower core PCE inflation by roughly 20bp on account of new methodologies that quality adjust software prices in consumer price inflation. If we explicitly included this element into our forecast, it would largely offset the upward revisions we just received.

Overall, we still see inflation moving in the right direction and we maintain our view that the Fed stays on hold into year-end, but whether it's upward revisions to core inflation or persistently elevated energy prices, the Fed has less margin for error than before.

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