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Inflation Casts Shadow on Markets

This week's readings on consumer and producer prices could fuel volatility

BY KAREN LANGLEY

Wall Street's worst fears about the trade war—that escalating tariffs could sink the global economy—have receded. But anxieties about inflation remain.

Price pressures subsided as a driver of markets when inflation cooled from the red-hot levels of recent years. But with traders and money managers racing to gauge how President Trump's trade war is affecting businesses and households, this week's readings on consumer and producer prices could spark a new round of market turbulence.

"We are trying to work out how tariffs will be split between price increases and perhaps job losses," said Irene Tunkel, chief U.S. equity strategist at BCA Research. "This will take months to play out."

The implications for markets are significant. Stocks have recovered from their dive after Trump's April 2 tariff announcement and are again trading at levels many investors consider expensive. Government-bond yields have climbed off their April lows. The S&P 500 weathered a steep decline in Tesla shares after the eruption of a feud between Trump and Chief Executive Elon Musk, notching a weekly gain of 1.5% after jobs data beat Wall Street's expectations.

Rising inflation could make the Federal Reserve reluctant to enact the interest-rate cuts that investors are counting on later this year. If companies refrain from boosting prices enough to cover tariff costs, they may compensate by shedding workers, a potential drag on the economy that would weigh on the side of the central bank lowering rates.

The S&P 500 has now gained 2% this year and is at its highest levels since February, before the tariff shock rattled markets. Yet Americans are feeling gloomy about the economy and inflation is a key worry.

The University of Michigan found consumers expect prices to surge 6.6% over the next year, up from April's reading of 6.5% and the highest since 1981.

Such expectations can become self-fulfilling: If workers expect brisk inflation, they may demand higher wages, in turn encouraging businesses to raise prices to preserve their profits.

Households foresee a jump in inflation even though recent data has been encouraging, with the reduction in price pressures helping stocks in May power to their best month since 2023. Year-over-year consumer inflation eased to a 2.3% increase in April, its lowest since February 2021, while a gauge preferred by the Fed also fell on an annual basis.

Many observers think the new U.S. trade policies will reverse the trend. The Organization for Economic Cooperation and Development, a Paris-based research group, said in recent days that the tariff regime threatens to slow U.S. economic growth while boosting inflation.

And Larry Fink, chief executive of investment giant BlackRock, warned of the inflationary impact of trade levies. "If the tariffs are instituted over the next five months, I think we're going to see very elevated inflation," he said.

That outlook is contributing

to some investors' anxieties about the path ahead. Timothy Chubb, chief investment officer at Girard, a wealth-advisory firm backed by Univest, said he expects tariffs to slow the economy, so he trimmed positions in bank stocks and added to holdings of big tech companies, which he views as a durable source of growth.

"Worries about inflation, what that might mean for the consumer's purchasing power ultimately, is something that we're pretty concerned about," he said. "I just don't think most consumers are going to be able to absorb those higher prices."

Traders are watching closely to see where tariffs begin to pinch profits.

PVH shares slumped 18% on Thursday after the owner of Calvin Klein and Tommy Hilfiger cited a hit from tariffs and reduced its annual profit outlook.

And while companies vary in their exposure to trade, many investors fear the broad stock market has grown too expensive to post robust gains in a time of heightened economic uncertainty.

The S&P 500 traded late last week at 21.4 times its member companies' projected earnings over the next 12 months, above a 10-year average of 18.7, according to Fact-Set.

"The chances of recession have inched up, but the valuations on U.S. large-caps are still quite high," said Tim Courtney, chief investment officer at Exencial Wealth Advisors. "They're still priced for good news."

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