

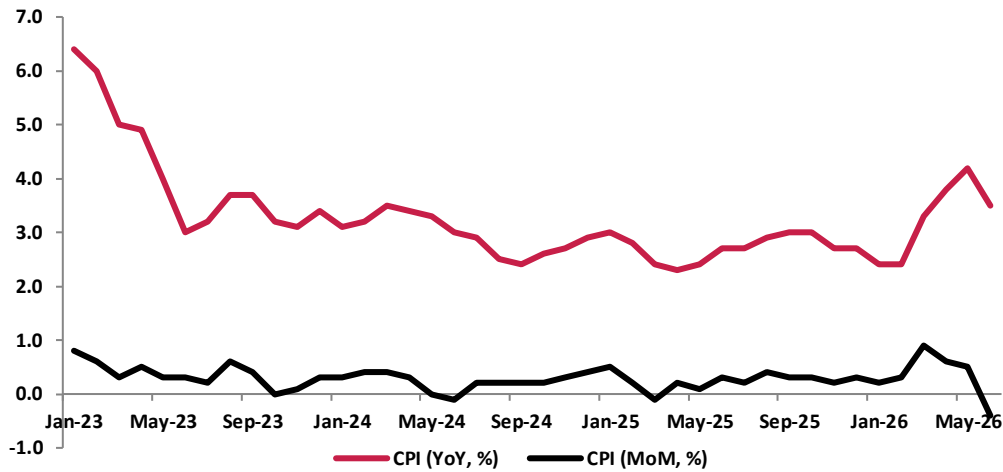
US CPI: June Inflation Delivers a Meaningful Downside Surprise, Easing Near-Term Fed Pressure

- U.S. inflation moderated more sharply than expected in June, delivering the first significant downside surprise in several months and challenging the market narrative that inflation risks were becoming increasingly entrenched. Both headline and core CPI readings undershot consensus expectations, reflecting not only a sharp reversal in energy prices but also encouraging moderation across several core inflation categories.
- The report provides evidence that underlying price pressures remain on a gradual disinflationary path despite heightened geopolitical tensions and renewed volatility in global energy markets. While the recent rebound in crude oil prices poses an upside risk to the inflation outlook, June's data suggest that inflationary pressures were considerably less broad-based than recent hawkish rhetoric had implied.
- As a result, markets have significantly reduced expectations of additional near-term Federal Reserve tightening, allowing policymakers greater flexibility to assess incoming data before determining the next policy move.

Headline Inflation Falls as Energy Reversal Drives Disinflation

- Headline CPI declined by 0.4% m-o-m in June, a substantial slowdown from the 0.5% increase recorded in May and the largest monthly decline since April 2020. On an annual basis, headline inflation eased to 3.5% y-o-y from 4.2% y-o-y previously.
- The primary driver was a sharp correction in energy prices. The energy index fell 5.7% m-o-m, reversing a sequence of strong gains recorded over the preceding three months. Gasoline prices led the decline, falling 9.7% m-o-m, producing the largest monthly drop in the energy component since the early stages of the pandemic.
- Importantly, the inflation improvement was not solely an energy story. While the decline in fuel costs accounted for most of the monthly weakness, several underlying inflation categories also exhibited signs of moderation, reinforcing the view that broader price pressures continue to ease.
- Food prices increased a modest 0.2% m-o-m, leaving annual food inflation at 3.0% y-o-y, suggesting that consumer price pressures in essential categories remain relatively contained despite ongoing supply-side uncertainties.

Chart 1: US Headline Inflation (%)

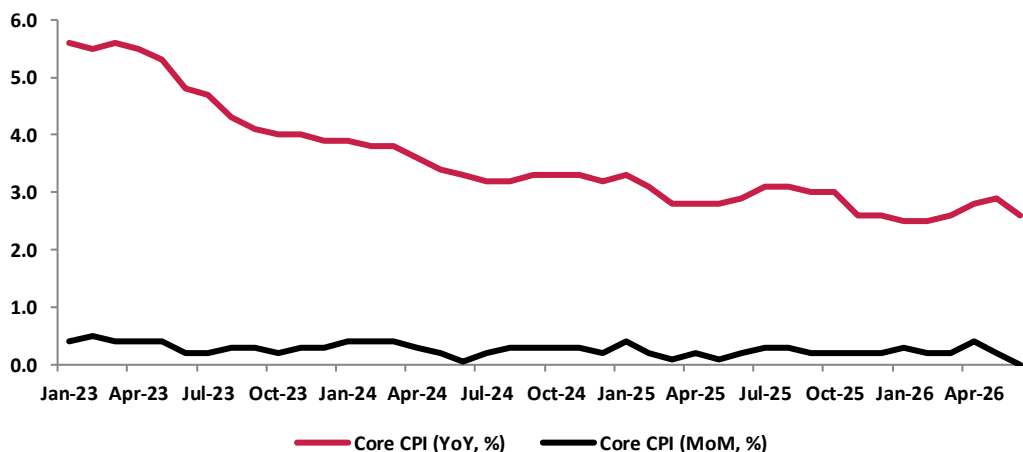


Source: US Bureau of Labor Statistics, Bank Islam

Core Inflation Shows Broadening Signs of Moderation

- The more encouraging aspect of the report was the performance of core inflation. Core CPI was unchanged in June, resulting in the annual core inflation rate slowing to 2.6% y-o-y from 2.9% y-o-y, marking the weakest pace since before the recent escalation in U.S.-Iran tensions.
- The flat monthly reading indicates that inflation pressures remain largely contained outside the volatile energy sector. Several categories that had previously contributed to sticky inflation either stabilized or declined during the month, suggesting that restrictive monetary policy continues to restrain underlying demand.
- For the Federal Reserve, this development is particularly significant. Policymakers have consistently emphasized core inflation as a more reliable gauge of medium-term price dynamics. June's outcome therefore provides stronger evidence that inflation is continuing to converge toward the Fed's longer-term objective, albeit gradually.

Chart 2: US Core Inflation (%)



Source: US Bureau of Labor Statistics, Bank Islam

- A notable feature of the report was the continued moderation in housing-related inflation. Shelter prices increased only 0.1% m-o-m, the smallest monthly gain since January 2021. Given shelter's large weight within the CPI basket and its persistent contribution to inflation over the past two years, the latest reading is particularly encouraging.
- The housing component has been one of the primary reasons inflation proved more resilient than expected throughout much of the tightening cycle. The recent slowdown suggests that softer rental market conditions and easing housing demand are finally feeding through into official price measures.
- If sustained over coming months, slower shelter inflation could become one of the most important drivers of the disinflation process and significantly reduce the risk of renewed inflation persistence.

Services Inflation Continues to Ease; Goods Prices Remain Well Anchored

- Core services inflation was effectively flat on a monthly basis while slowing to 3.2% y-o-y.
- Several key service categories contributed to the moderation:
 - Vehicle insurance: -2.0% m-o-m
 - Communication services: -1.5% m-o-m
 - Medical care services: -0.1% m-o-m
- The easing in services inflation carries particular significance because it has historically been linked more closely to domestic wage pressures and labor market conditions than goods inflation. The broad-based softness across multiple service categories suggests that underlying inflation dynamics are becoming more balanced and less dependent on temporary energy-related factors.
- Core goods prices declined 0.1% m-o-m for a second consecutive month, reinforcing the view that goods inflation remains largely under control.
- Notable declines included:
 - Apparel: -0.6% m-o-m
 - Medical goods: -0.2% m-o-m
 - Used vehicles: -0.2% m-o-m
- On a year-on-year basis, core goods inflation slowed to just 0.8%, the weakest pace since June 2025. Continued normalization of supply chains, easing input costs, and softer discretionary consumer demand are helping to suppress price pressures across the goods sector.
- As a result, inflation increasingly appears concentrated in a limited number of services categories rather than reflecting a generalized economy-wide pricing problem.

Geopolitical Risks Remain the Principal Upside Threat

- The inflation report arrives against a backdrop of escalating geopolitical tensions in the Middle East.
- Brent crude prices have rebounded sharply, rising above USD87 per barrel following renewed military exchanges involving the U.S. and Iran and increasing uncertainty surrounding the security of shipping routes through the Strait of Hormuz.
- The contrast between June inflation data and current energy market developments highlights an important distinction: the CPI report largely reflects the earlier decline in energy prices rather than the recent oil rebound. Consequently, while June inflation data are clearly supportive, they may understate inflation risks that could emerge in subsequent months if elevated oil prices persist.
- At present, however, there is limited evidence that higher energy costs have spilled over into broader inflation categories. The Fed will therefore be reluctant to react to energy-driven price movements unless they begin to affect inflation expectations or generate second-round effects across wages and services.

Federal Reserve Implications

- From a policy perspective, June's inflation report provides the Federal Reserve with greater flexibility.
- The combination of softer headline inflation, a flat core reading, slowing shelter inflation, and easing services prices challenges the case for additional near-term policy tightening. Market pricing responded accordingly, with expectations of an imminent rate increase falling sharply following the release.
- The next FOMC meeting is in a couple of weeks, and the June inflation data should help to quiet some of the more hawkish voices. According to CME FedWatch tools, markets are now paring the odds from +/- 40% to just 14% currently while still assuming at least one move at a later meeting this year.
- Federal Reserve Chair Kevin Warsh's congressional testimony reinforced this interpretation. While maintaining a firm commitment to restoring price stability and reiterating the Fed's intolerance for persistently elevated inflation, he offered no indication that policymakers are preparing for an immediate policy response to recent geopolitical developments.
- The absence of explicit hawkish guidance suggests the Federal Reserve remains focused on the underlying disinflation trend rather than reacting prematurely to energy-related volatility.

Outlook: Disinflation Intact, but Energy Risks Warrant Caution

- June's CPI report represents a constructive development for the inflation outlook and supports the view that underlying price pressures continue to moderate. The data indicate that inflation remains on a gradual path toward the Federal Reserve's target, with easing shelter costs, softer services inflation, and subdued goods prices all contributing to the improvement.
- Nevertheless, caution remains warranted. A significant portion of June's disinflation was driven by energy prices, and much of that decline has already been reversed by recent increases in crude oil prices. Consequently, some reacceleration in headline inflation is possible in the coming months.
- Our assessment is that the Federal Reserve is likely to view the June report as confirmation that inflation is moving in the right direction, reducing the urgency for additional tightening. While geopolitical developments and energy prices remain key upside risks, policymakers can afford to remain patient and evaluate whether higher oil prices evolve into a broader inflation problem.
- Overall, the June CPI report strengthens the case that the U.S. disinflation process remains intact. Inflation is no longer exhibiting the broad-based acceleration feared by markets earlier in the quarter, and barring a sustained energy shock, the Federal Reserve appears increasingly positioned to keep policy on hold while awaiting further evidence on the inflation trajectory.

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