MARKET SIGHT LINES

Supply and Demand Are Both Keeping Inflation in Focus

By **Michael O'Keeffe, CFA**
Stifel's Chief Investment Officer

June 5, 2026

Looking back to the economic reopening from the pandemic, the U.S. inflation surge was quite troubling, rising to levels not seen in decades. While inflation eventually receded, it has remained stubbornly above the Federal Reserve's 2% target, further aggravated by tariffs and the conflict in the Middle East. These events have triggered supply-side inflation, which comes from higher costs or limited availability of inputs, such as energy, tariffs, and supply chain shifts. But inflation is also being pressured by the demand side, triggered by the spending, investment, and income growth strong enough to support higher prices. So, geopolitics, energy, tariffs, and reshoring are adding to costs, while artificial intelligence investment, strong markets, and the related wealth effect are supporting demand in parts of the economy. In this Sight|Lines, we discuss why supply and demand are both keeping inflation in focus, why that makes the Fed's job harder, and what it means for investors.

THE TAKEAWAY: SUPPLY AND DEMAND ARE BOTH KEEPING INFLATION IN FOCUS

Inflation is being influenced by both supply-side cost pressures and demand-side strength, making the path for inflation and interest rates less certain looking forward. In summary:

- The Fed's favored measure, core personal consumption expenditures (PCE), is running hotter recently, compared to the core consumer price index (CPI).
- Supply-side inflation comes from higher costs or reduced supply, with reshoring adding pressure.
- Demand-side inflation reflects strong spending and investment, with AI-related capital spending and the wealth effect supporting parts of the economy.
- A still-resilient labor market and solid wage growth are reinforcing demand and keeping services inflation sticky. The drivers of inflation are hard to identify in real time, leaving the inflation signals more ambiguous.
- With inflation still well above target, the Fed's next move may be a hike rather than a cut.
- While AI investment may be driving inflation today, its influence could shift to disinflationary if productivity rises and the cost of producing goods and services falls.

IN-DEPTH: SUPPLY PRESSURES AND RESILIENT DEMAND ARE MAKING INFLATION HARDER TO READ

Specific geopolitical events are difficult to forecast, but investors can monitor how geopolitical risk moves through the economy and markets. Going deeper:

- Different inflation gauges are diverging, which is an important signal in itself:
  - Core CPI has looked less concerning than core PCE, the Fed's preferred inflation measure.
  - The three-month annualized pace of core PCE increased from 2.4% in November 2025 to 3.7% in April 2026.
- Supply-side inflation reflects higher costs and reduced supply, with energy, tariffs, and reshoring adding some pressure:
  - Higher energy prices tied to the Iran conflict, along with tariffs, are key contributors to recent price pressure.
  - San Francisco Fed research attributes about 20 basis points of the recent core PCE acceleration to supply.
- Demand-side inflation reflects strong spending and investment, with AI-related capital spending and the wealth effect supporting parts of the economy:
  - Strong demand for semiconductors, memory, power, data centers, and other AI-related inputs is adding pressure in parts of the economy.
  - AI investment has added meaningfully to U.S. GDP growth, with some estimates of the broader AI buildout exceeding $5 trillion through 2030.
- A resilient labor market and solid wage growth are reinforcing demand-side pressure:
  - The unemployment rate remains historically low at 4.3% in April 2026, with payrolls continuing to grow.
  - Wage growth, near 3.4%-3.6%, is roughly at the pace consistent with 2% inflation.
- The dominant drivers of inflation are hard to identify in real time, leaving inflation signals more ambiguous:
  - By one estimate, the PCE-to-CPI gap has shifted from roughly negative 30-40 basis points to positive 60 basis points, one of the largest reversals since 1985.
  - San Francisco Fed research signals the recent acceleration may be both supply-driven and clearly demand-driven.
- With inflation still above target, investors should not assume the Fed's next move is necessarily a cut:
  - April meeting minutes suggest officials would consider hikes if inflation does not moderate.
  - Inflation expectations remain contained, though still elevated, with the five-year breakeven at 2.5% – raising the bar for rate cuts.
- Over time, AI could shift from inflationary to disinflationary if productivity rises and production costs fall:
  - Near term, AI-related demand is adding pressure in areas like semiconductors, power, and construction.
  - Longer term, productivity gains from AI could lower costs, improve efficiency, and help reduce inflation pressure.

WHAT WE THINK

Inflation remains challenging, with supply-side and demand-side pressures in play. Supply-side effects include higher costs or disruptions, such as energy prices, tariffs, and supply chain shifts. Demand-side effects include spending, investment, and income growth strong enough to support higher prices. The Fed's tools to fight inflation focus mostly on demand-side forces, making its job harder in today's environment. The net result? Investors are now expecting a tighter Fed policy for longer after anticipating more Fed cuts later this year. That means the Fed may keep rates steady, or even consider rate hikes, if elevated inflation persists.

Michael P. O'Keeffe, CFA
Chief Investment Officer
michael.okeeffe@stifel.com
StifelInsights.com

Stifel, Nicolaus & Company, Incorporated | Member SIPC & NYSE | Stifel.com

0626.8960295.1