

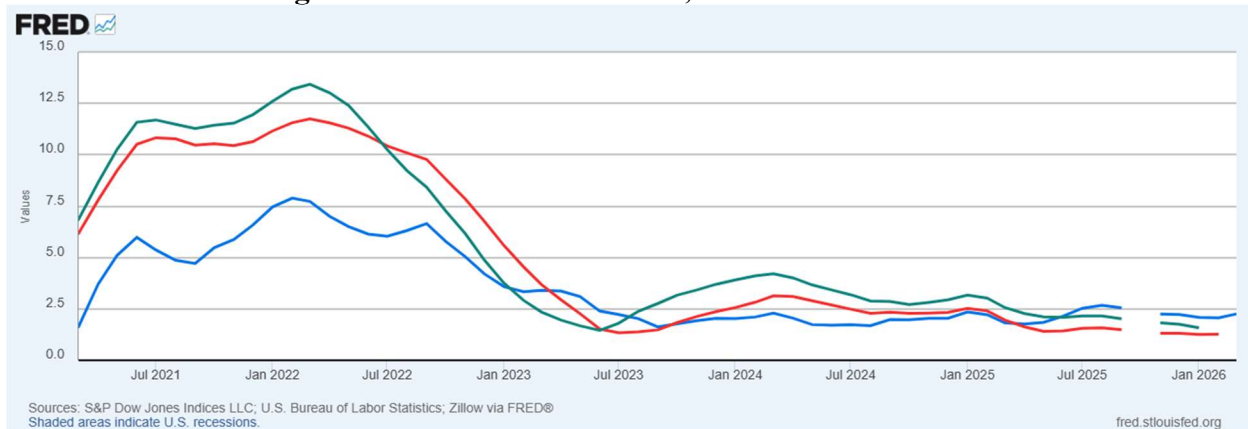
April 15, 2026

Higher Inflation Readings will Be Sort-Lived

President Trump’s claim that the Straits of Hormuz are permanently open does not affect our outlook and markets are wise to mostly ignore it. Nevertheless, we are surprised at how optimistic markets have become about the conflict in Iran soon winding down. The International Energy Agency, for example, has only delayed their prediction for when oil traffic will return to normal until mid-June. This is closer to the best-case scenario, and it is more likely that disruptions will continue late into 2026, even if there is a cease fire in the coming weeks. The good news, however, is that we are increasingly confident that markets are severely overestimating the risk from inflation.

The headline readings for both March CPI and PPI were much higher as they absorbed the direct impact of higher energy prices. This will continue for a few months, barring a dramatic reversal in crude oil prices. **It will also delay the Fed’s next rate cut, we expect until September, given that the Fed is unwilling to look past higher headline inflation.** Longer-term, however, it is not cause for concern. The underlying inflation situation is encouraging, Figure 1 (blue) shows the y/y change in core-CPI inflation, ex-shelter. We prefer removing shelter because shelter is mostly owner equivalent rents, a flawed survey that simply asks homeowners what they expect their home would rent for. It usually tracks housing prices with a long lag. Core-CPI, ex-shelter, has been steady between 2.1% and 2.3% for months. Figure 1 also displays two other inflation measures, one that replaced CPI-shelter with Zillow’s housing price index (red) and another that uses Case-Shiller. These are at just 1.3% and 1.8%, respectively. **In other words, pre-Iran, the only driver of excess U.S. inflation was the mismeasurement of shelter inflation.**

Figure 1: Without CPI-Shelter, Core-Inflation is Low



Although March core-CPI (2.3% m/m, annualized) and core-PPI (2.2%) were close to target, there are some signs of pass through from higher energy prices to core-measures. Inflation in transportation services, an energy-sensitive sector, jumped to 7.3% in March. **More is to come and we do expect core-readings to come in closer to 3% through May.** After that, however, this jump will be mostly offset by a broad disinflation as tighter household budgets reduce demand in other areas. Furthermore, the weak labor market and slow moving FOMC will continue to push inflation down. By the fall, monthly inflation readings will again be at or below target.

Other Developments in Macroeconomics:

1. The Atlanta Fed's public 1Q2026 GDP forecast continues to wane and is now at just 1.3%. Most of the decline is due to a weaker consumption outlook, with consumption also expected to grow at a soft 1.3%. The unusual feature of the data is business equipment, which includes AI, and is forecast to grow at a torrid 13.8% annual rate, adding 0.7% to GDP. This is good news for productivity growth down the road, but in the near-term, AI driven growth will do nothing to boost hiring. Apart from equipment, the rest of the GDP forecast now looks as lukewarm as recent labor market data. **We do not expect hiring to recover until the Fed resumes lowering rates.** Although we expect the Fed to cut to 250-275 bps by 3Q2027, which will take the ten-year Treasury yield to 340 bps, we also expect the current pause to last until September.
2. The main impact of President Trump's actions against the Fed has been to keep term premiums higher for longer. His latest threat to fire Chairman Powell if he serves past May 15 will have no additional impact. **We agree with betting markets that Kevin Warsh is almost certain (94%) to be confirmed, and we expect it to happen no later than mid-June.** Also, the FOMC will remain in its current holding pattern during this period preventing any impact on rates. We expect Warsh to advocate for lower rates for the next year or two, which will help ensure that the Fed resumes rate cuts in the fall. Longer-term, however, we worry about Warsh's resistance to the Fed's aggressive responses to the 2008 and 2020 crises, including his opposition to non-conventional measures such as QE. If the U.S. faces a major recession during his tenure, Warsh's Fed will probably be too slow to respond.
3. The April Fed Beige book had some interesting responses that largely support our outlook. Most importantly, "the conflict in the Middle East was cited as a major source of uncertainty that complicated decision-making around hiring, pricing, and capital investment, with many firms adopting a wait-and-see posture." **This fits our view that uncertainty, rather than energy prices, will eventually be the biggest impact of the Iran war.** This matters because, unlike oil prices, uncertainty tends to be disinflationary. The rest of the Beige Book suggested a continuation of the status quo, including slow growth, a low hire-low fire labor market, and increased financial strain concentrated

among low-middle income households. Overall, the U.S. economic performance remains decent, but fragile.

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