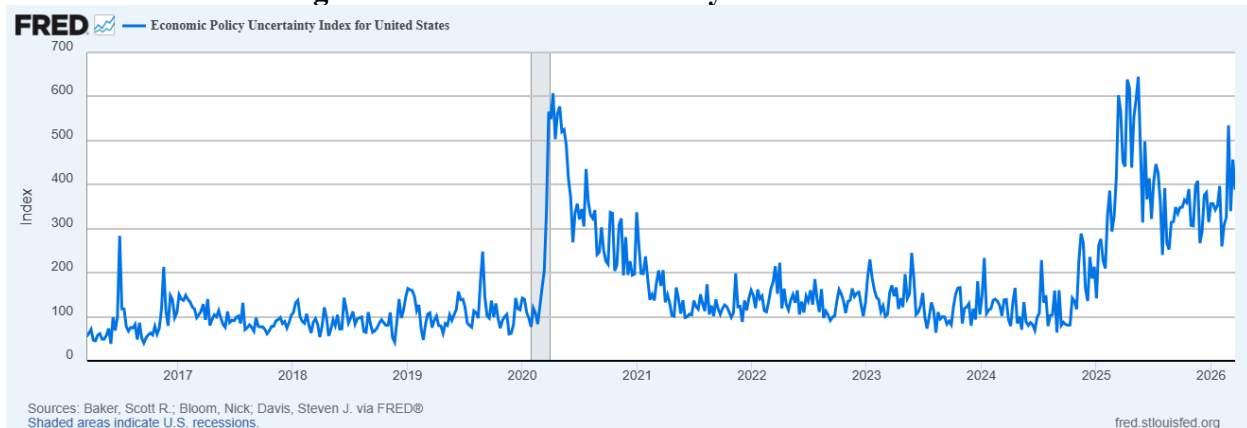


March 18, 2026

## The War in Iran will Eventually be Disinflationary

Financial markets continue to pay far too much attention to crude oil prices as the biggest economic impact of the war in Iran. We reiterate that while high crude oil prices will obviously lead to a sharp increase in headline inflation, there will be very little impact on core-inflation. Furthermore, the drag on GDP growth is likely to be small, albeit significant, at around 0.2%. The focus should instead be on another variable that has reached dangerous levels. The U.S. economic uncertainty index is at its third highest level since the mid-1980s, behind only covid and the announcement of tariffs in April. The latter spike dissipated quickly. Our concern is that with no clear off-ramp in Iran uncertainty will remain elevated for much longer.

Figure 1: Economic Uncertainty Index for the U.S.



The big mistake that markets are making is thinking that elevated uncertainty is not inflationary. **Instead, this type of uncertainty acts to reduce demand by inducing households and firms to delay spending and is thus disinflationary.** Were these elevated levels to last through the summer, some evidence suggests that **uncertainty could take as much as 2% off inflation over the next year and add 1% to unemployment.**<sup>1</sup> Although we see this as the worst case scenario, the fragile state of the U.S. labor market makes it poorly positioned to handle any additional reductions to demand.

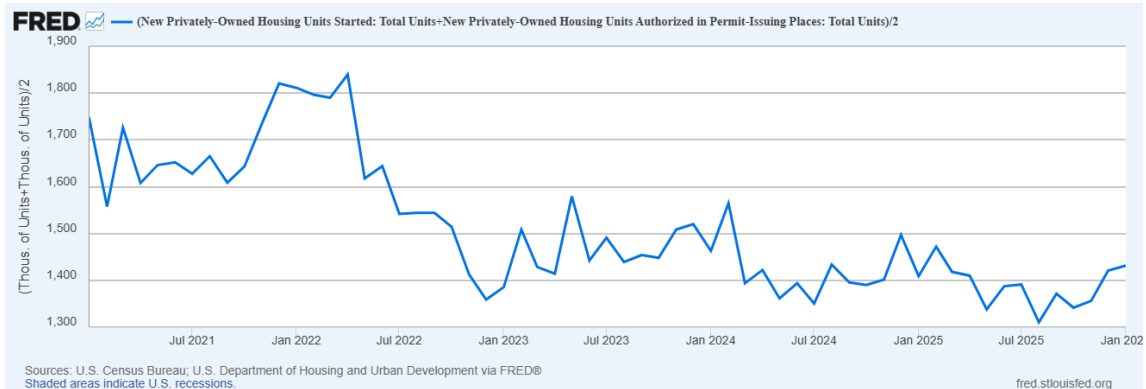
<sup>1</sup> Leduc, Sylvain, and Zheng Liu. "[Uncertainty shocks are aggregate demand shocks.](#)" *Journal of Monetary Economics* 82 (2016): 20-35.

While we are unconcerned about the inflation impacts from the war with Iran, we must acknowledge the poor February PPI inflation reading. PPI tends to be much noisier than CPI, but the latest release marks two straight poor reports with core-PPI inflation rising 0.9% over the past two months. We remain confident that inflation will return to its 2% target, even if the Fed resumes cut. It may take longer, however, than we previously believed. **We are delaying our forecast for the next FOMC rate cut from June to September and delaying our prediction of a 250-275 bps range for the Fed Funds rate from 1Q2027 to 2Q2027.** We continue to expect the 10-year Treasury yield to fall to 375 bps by the end of 2026 and reach 340 bps later in 2027.

### **Other Developments in Macroeconomics:**

1. The March FOMC meeting was surprisingly uneventful and as overall neutral in tone. Although the new Summary of Economic Projections had only small changes, it was slightly hawkish. Governor Chris Waller switched from voting to cut rates to voting to hold steady. Also, the number of FOMC members anticipating at least 50 bps of rate cuts this year fell from eight to four. Chairman Powell's comments, however, were slightly dovish, especially when noting that "longstanding thinking is that you do look through energy shocks," suggesting that the FOMC will not overreact to crude oil prices. The most surprising aspect of the meeting is that, despite the awful February employment report, the FOMC stood by its forecast that the unemployment rate will end 2026 at 4.4%, its current level. This is wishful thinking. **We expect unemployment to trend upwards throughout 2026, exceeding 5%, and forcing the FOMC to resume rate cuts.** Once again, the Fed will do the right thing, albeit 6-9 months too late. **We expect the Fed to cut by 25 bps in both 3Q and 4Q.**
2. Our two biggest concerns about the U.S. economy remain the ongoing contraction of employment outside of education and the weak housing market. The past week has brought small pieces of good news on both fronts. First, job openings jumped from 6.6 million to 6.9 million with the increase being widely distributed across sectors. **The same report did, however, show no increase in hiring, which makes it likely that the February data are just noise around a downward trend.** Likewise, housing is showing some very tentative signs of recovery with housing starts surprisingly jumping from 1.39 million to 1.49 million, helping to boost the Atlanta Fed's 1Q2026 GDP growth forecast from 2.1% to 2.7%. Permits, however, disappointed by falling from 1.46 million to 1.39 million. Still, as shown in figure 2, while the average of permits and starts remains low, the last two months of data are at least showing an upward trend.

**Figure 2: Average of Housing Starts Plus New Permits**



3. The downward revision of 4Q2025 GDP growth from 1.4% to 0.7%, as well as overall 2025 growth to 2.1% may be old news, but it is still important. An ongoing puzzle remains the gap between decent GDP growth and the stagnant labor market, and whether this is sustainable. **We are increasingly confident that the answer is no and that the labor market remains the better indicator of where the economy is headed.** This revision indicates that some of this gap was not real. Slowing 4Q growth is consistent with previous discrepancies where GDP eventually growth slowed to match a weaker labor market.

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