MILLER TABAK + CO., LLC

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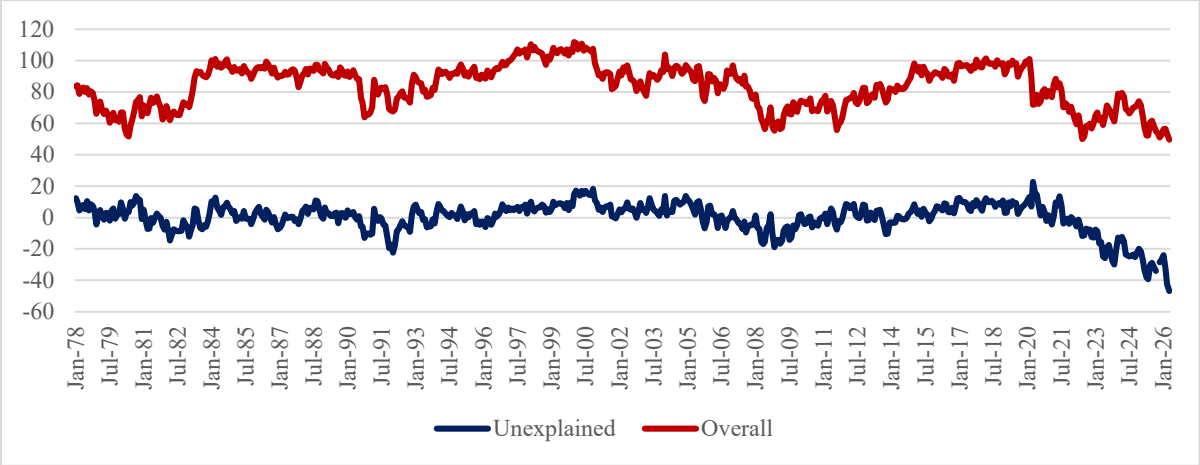
Iran and Gasoline do not Explain Terrible Consumer Sentiment

The University of Michigan's consumer sentiment measure (red in Figure 1) fell from 49.2 in April to 44.8 in May. This is the worst reading since the survey began in 1978, even lower than other low points such as 1980, 2008, and 2012. The obvious reason for the latest decline is the ongoing war in Iran and its impact on energy prices and uncertainty. Were this the only reason for poor sentiment, we would pay it little mind because it would not add anything beyond what we already know from other data.

It would, however, be a major mistake to dismiss low sentiment as just a side effect of Iran and other policy uncertainty. The decline in sentiment began in 2023, predating both the Iran war and trade tensions. Furthermore, although headline inflation is again elevated it does not compare to the energy price spike of 1979-80. Nor are economic conditions remotely as weak as during the Global Financial Crisis, or covid-19 pandemic, when sentiment was better than it is today.

To quantify this, we estimated the historic relationship between consumer sentiment and economic conditions including asset (equities and housing) prices, unemployment, CPI-inflation, and interest rates. What remains is "unexplained consumer sentiment." **As shown in Figure 1 (blue), unexplained sentiment is now far lower than it has ever been.** It makes no difference whether we use the part of the survey asking about current conditions or future expectations. Consumers are historically downtrodden for reasons that are not clear from other data and not just due to Iran and inflation. We suspect that a big part of the drop is instead due to distributional factors making the economic situation worse for low-middle income households than the overall data suggests.

Figure 1: Overall and Unexplained Consumer Sentiment



There is a strong relationship between poor unexplained sentiment and weaker demand over the next year. **Historically, the current reading suggests a 1.8% increase in unemployment and a 1.4% decline in CPI-inflation over the next year.** We do offer a pair of caveats. First, given that we have never seen such poor readings, quantifying their impact is noisy. Second, as we discuss below, the Conference Board's related consumer confidence metric is also weak, but not as concerning as Michigan's measure. Nevertheless, this extraordinary pessimism is a red flag for the economic outlook.

Other Developments in Macroeconomics:

1. The Conference Board' consumer confidence survey is fell from 93.8 in April to 93.1 in May. This is weak, but not historically so, it remains well above 2008 levels. Like consumer sentiment, consumer confidence's weakness is not explained by other data. Michigan's consumer sentiment survey asks mostly about prices and households' balance sheets. The Conference Board's measure, in contrast, is more focused on the labor market, which helps explain its better reading. Both are equally predictive about upcoming inflation and employment. We ran the same model as earlier using unexplained consumer confidence. **It predicts that unemployment will rise 0.8% while inflation will fall by 0.7% over the next twelve months.**

2. We reiterate that bond markets are misinterpreting the high inflation readings of past months. Although these will continue for a few more months, we expect inflation to cool by the autumn. **The bond market's implied neutral rate is now all the way up to 387 bps, almost 100 points above what is suggested by the best empirical evidence.** In other words, the market expects the FOMC to respond to higher energy prices by keeping

rates much higher for at least the next 5-10 years. That will not happen. Barring a return of crude oil prices to their February levels, it will, however, take until October or November for the FOMC to again cut. Down the road (mid-2027), we still expect the 10-year Treasury yield to fall to 340 bps.

3. Our concerns over consumer sentiment are partly offset by better news from the housing sector. Housing starts were 1.47 million (annualized) in April while permits were 1.44 million, the best joint figures since February 2024. With mortgage rates so high, it is surely not the start of a robust recovery. Still, housing may grow this quarter for the first time since 4Q2024. Also, housing price growth remains poor with March's Case-Shiller index falling by 2.7% annualized and Zillow' April housing price index growing at just 0.3%. Why are flat housing prices good news? Recall that the hot April CPI reading was mostly driven by shelter inflation at 7.3%. Weak housing price data confirms that reading was not real and was likely just noise caused by problems measuring owner equivalent rents. **Overall, we still put the chances of a U.S. recession within a year at 50%.**

-Paul Shea

Strategic Economist, Miller Tabak