MILLER TABAK + CO., LLC

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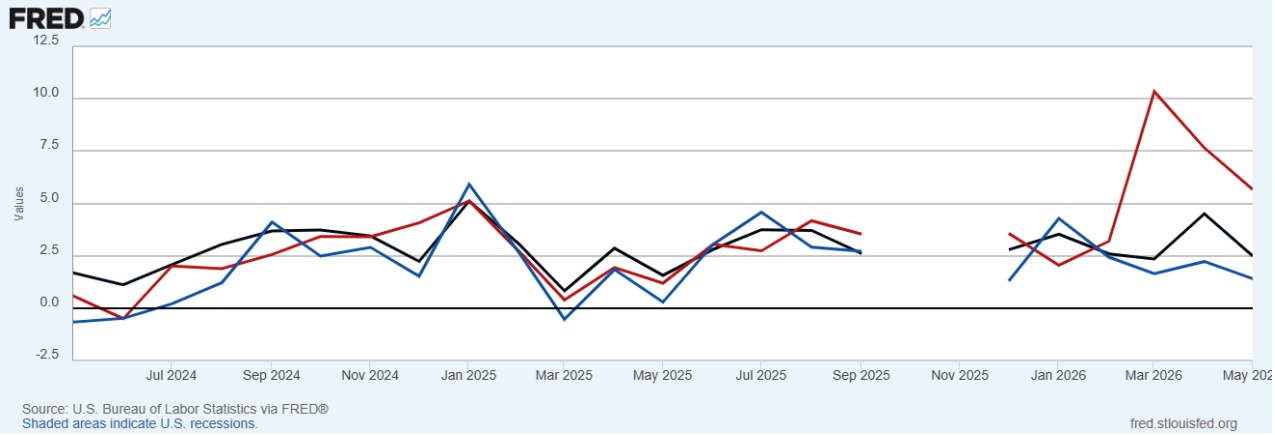
Warsh's First Move is a Blunder

Kevin Warsh's first meeting as FOMC Chairman delivered several significant surprises. The first is mostly stylistic, scrapping most of the Fed's boilerplate language in favor of a parsimonious style. This is welcome. **The second is to deliver a stunningly hawkish shift that contrasts sharply with his comments prior to becoming Chairman**. Half of the FOMC now forecasts rate hike this year with only one predicting a rate cut. In March, seven predicted a hike while five predicted a rate cut. Warsh's press conference leaves no doubt that he, more than recent data, was the catalyst for this shift.

Figure 1: Headline, Core, and Core, ex-shelter, CPI Inflation



Like financial markets, Warsh's Fed is badly overstating inflation concerns. We are skeptical that the deal with Iran will last in the long-term. Nevertheless, it will lead to a decline in energy prices that will partly undo the elevated headline inflation readings of recent months. Figure 1 shows that higher inflation is mostly isolated to headline CPI (red, all figures m/m, annualized), which will soon turn negative as energy prices fall. We have expected core-CPI (black) to also be elevated through the summer before returning to 2% in the Fall. This, however, has not happened. Even the hot April core-inflation reading was just the result of an anomalous spike in shelter-inflation, which makes up 45% of core-CPI. **Removing shelter (blue) shows that core-CPI, ex-shelter, has averaged just 1.8% since March**. The improvement in the labor market has allowed the Fed to be overly hawkish. Still, needlessly high rates are holding the economy back. Warsh himself confirmed that high rates are hurting the housing market.

The Fed's new Summary of Economic Projections predicts that core-PCE inflation, which has run hotter than CPI lately, will come in at 3.3% y/y through December. Given the data through April, this implies a 3.0% rate between May and December. Furthermore, the FOMC does not expect inflation to return to target until 2028. We reiterate that this is far too pessimistic.

Other Developments in Macroeconomics:

1. If the SEP was hawkish, Warsh's first press conference was even more so. His answers were full of thinly disguised criticism for the FOMC's recent performance, especially when he questioned their recent "commitment" to price stability. His go to language that the FOMC is "unambiguously and unanimously" committed to price stability makes clear that it will take a lot of data to get Warsh to support rate cuts. Warsh also displayed hostility to the Fed's existing methodology, including forward guidance, frequent communications, and its holding of ample reserves, implying hostility to the use of quantitative easing. This is concerning. **We were harshly critical of the Fed in 2022 for keeping rates far too low for far too long.** Excluding the Fed's misguided adventure with average inflation targeting, however, the problem was not the process. The problem was that the Fed misread the data, leading to needlessly high inflation. **Warsh is now repeating this mistake, but by overstating inflation.** In fairness, we do appreciate Warsh's desire to cultivate more real time data. It is absurd that the Fed's preferred inflation measure, PCE inflation, was only available through April for its mid-June meeting.

2. Just as the FOMC is too pessimistic about inflation, its 4.3% year-end unemployment rate is too optimistic, especially given the Fed's new guidance. **We put the chances of the Fed holding steady through 2026 at 60% with a 30% chance of a rate hike, which would be an error, and a 10% chance of a rate cut,** which would require a faster deterioration of the labor market than we expect. When might rate cuts resume? It will take a full year of data with inflation coming in below 2%. **With today's guidance, we expect that to happen by May 2027, paving the way for renewed and cautious rate cuts.**

3. This week's data is mixed with one horrible and one excellent new report. The bad news is housing starts falling from 1.39 million in April to a shockingly low 1.17 million units in May, the lowest since the pandemic. **This clearly reflects higher mortgage rates and marks of the end of housing's fragile recovery.** One silver lining is that permits were steady at 1.41 million, suggesting that the housing starts figure is at least partly an outlier. In contrast, May retail sales were great at 0.8% m/m, ex-auto, versus 0.6% expected. The

retail sales figure is very good even after controlling for the impact of gasoline sales. Overall, we put more stock in the housing report given that housing is a much better leading indicator than retail sales, which is more of a signal of current growth.

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