MILLER TABAK + CO., LLC

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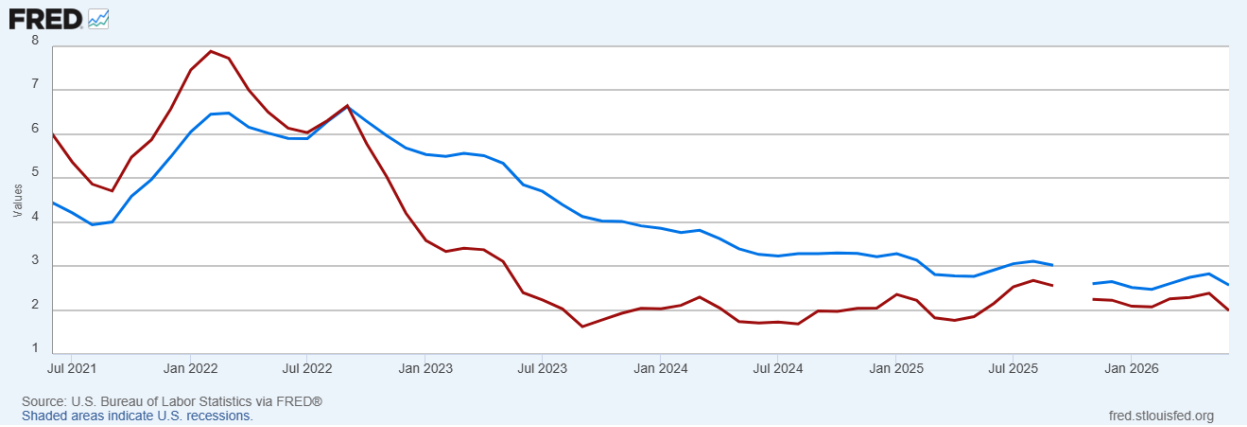
The Inflation that Never Was

Our strongest position remains that U.S. inflation concerns are badly overstated and that the ugly readings of recent months are just the temporary effects of higher energy prices. The June CPI report showing headline inflation at -5.1% and core at -0.2% (both m/m, annualized) makes us even more confident in our position. The Fed's next move should be a rate cut, but it will take until early 2027 before it finally enacts one.

Figure 1 illustrates why Chairman Warsh and much of the FOMC are wrong about inflation. We have long preferred to remove shelter, which is poorly measured, from measures of inflation. Doing so results in a core-CPI, ex-shelter, rate of -1.5% in June, bringing its y/y reading (red in Figure 1) to 2.0%, exactly the Fed's target. In 2022, as this metric neared 8%, the Fed managed to convince itself that minimal action was needed to bring inflation under control. As we warned at the time, it then took raising rates over 5% for over a year to bring inflation back down. Since then, we have been unconcerned with inflation. Warsh has misread the much smaller upticks in 2025 and 2026 as bigger threats than they really are. **These are explicable rises due to tariffs and crude oil prices that require no FOMC action.** The 2025 increase in inflation passed despite the Fed continuing to lower rates. The 2026 inflation spike will pass as well, even if the Fed were to continue with modest rate cuts.

Figure 1: Core-CPI (blue) and Core CPI, ex-Shelter. Year-Over-Year



In fairness to the Fed, measures of PCE inflation, which the Fed prefers, have run hotter than CPI over the past year. When June core-PCE comes out later this month, it could be a full 1% higher than core-CPI inflation. **This gap will close, however, over the next six months. The key is that with energy prices still below their peak (more on this below), there is no source for sustained inflation.** Monetary policy is restrictive. Yields are elevated. Aggregate demand and the labor market are tepid. Finally, while inflationary expectations are higher than at the start of 2026, they are not high enough to be a major concern.

Other Developments in Macroeconomics:

1. The lesson from the June CPI data is that markets should not overreact to energy price spikes. As we wrote at the time, the data show that, since the mid-1980s, energy price spikes have exhibited only minimal pass through to core-inflation. **Warsh's first major act as Fed Chairman was to fail to look through a temporary energy price spike and instead overstate inflation concerns.** This makes this week's re-escalation of conflict with Iran, which have pushed Brent crude oil prices back above $80/barrel a risk to FOMC policy. Even if crude oil once again goes above $100/barrel, it will produce some ugly inflation readings, but it would not affect our view on underlying inflation. We doubt, however, that Warsh has learned his lesson. He could respond to such an outcome by pushing for an ill conceived rate hike. In any case, we expect the data to push the Fed back towards rate cuts by 1Q2027.

2. The June FOMC minutes showed that members understood that shelter was propping up inflation readings and that this effect was likely to soon reverse. Strangely, however, this did not seem to affect the discussion about upcoming monetary policy. In June, CPI-shelter was 1.4% annualized to bring its y/y reading down to 3.3%. While shelter inflation is cooling, both figures are still boosting core-CPI. As always, most of shelter is owner's equivalent rent, a deeply flawed survey that just asks homeowners what they believe the rent would be on their home. **When we replace CPI-shelter with Zillow's housing price index, y/y core-CPI is just 1.4%, well below the Fed's target.**

3. Another consequence of the June CPI data is to raise the stakes for Thursday's June retail sales report. Our overall position remains that inflation is overrated, and that the most likely path for the U.S. economy over the next year is below average GDP growth with slowly rising unemployment. We still see a 35% chance of a U.S. recession starting within the next year. Our view of the June CPI report is benign, that it largely reflects a reversal of the inflationary pressures from higher crude oil prices. **A weak retail sales report would, however, raise concern that cool June inflation also reflects a further**

slowing of aggregate demand. It is notable that lower June inflation is very broadly based and encompasses both goods and services. While this suggests that the data are not an outlier, it also hints that consumers could be starting to broadly pull back.

-Paul Shea

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