MILLER TABAK + CO., LLC

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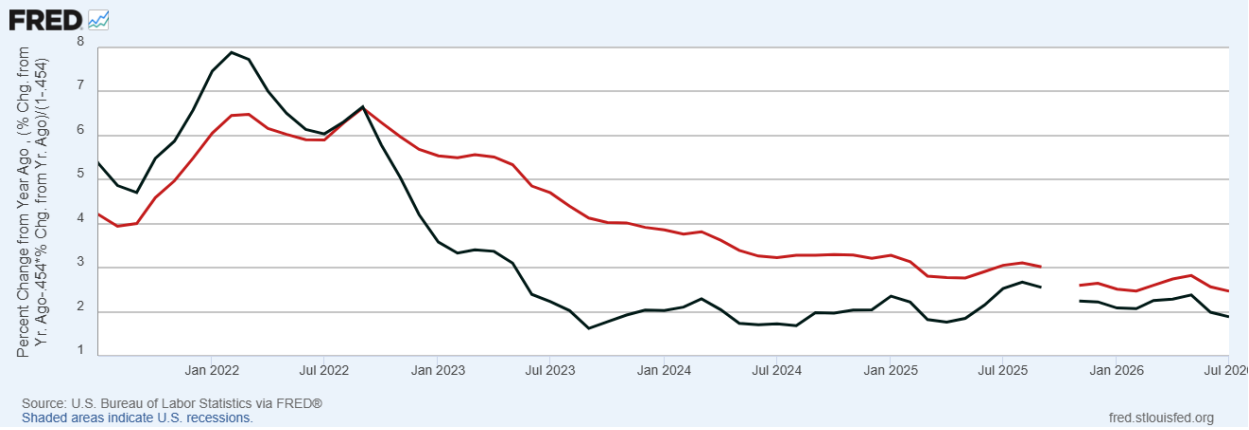
A September Rate Hike Would be Madness

Last month, following the cool June CPI report, we wrote that inflation fears were a misguided reaction to higher energy prices and that underlying inflation is not a problem. Although mostly in line with expectations, the July CPI report confirms our view. **A deeper look shows that it is past time to stop worrying about a return of sustained inflation and instead start worrying that high yields are creating a concerning fall in demand.**

There has never been a better time to ignore headline readings and instead focus on core. Cool headline inflation in July at 0.9% (m/m, annualized) was mostly due to an unusually long lag between higher crude oil prices, which rose 13.0% in July, and consumer energy prices. **Headline readings will pick back up in August, but that will not be cause for concern.**

Core-CPI inflation was 2.6% annualized in July, bringing its three month average to 1.6% and its y/y reading to 2.5%. This latter figure is set to fall as high readings from July and August 2025 soon cycle out of the 12 month window. We always prefer to remove shelter from core-inflation measures. At first glance, core-CPI, ex-shelter, was hot in July at 3.3%. For reasons, we discuss later, however, this is not concerning. Most importantly, its year-over-year change is 1.9%, just below the Fed's target. With yields remaining high, inflation will continue to drop and we expect the Fed and markets to come around to our view later this year.

Figure 1: Core-CPI Inflation, with (red) and without (black) Shelter, y/y



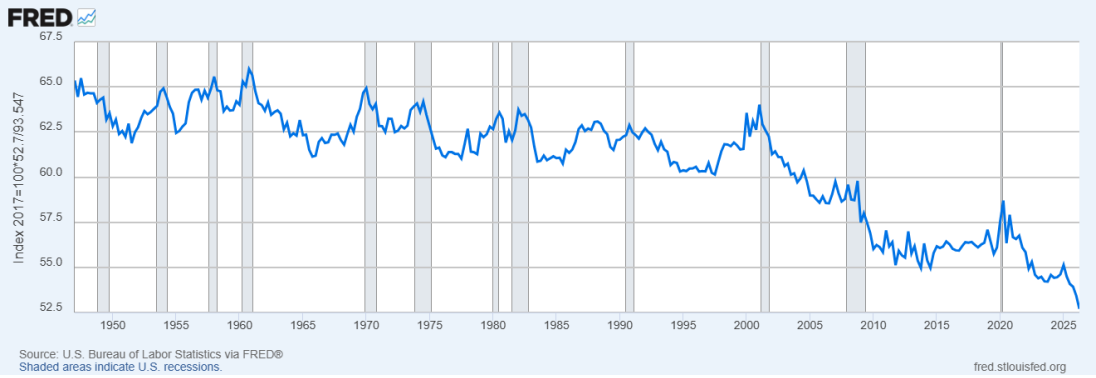
Last month, three FOMC members voted to raise rates. Based on the labor market and inflation data that have come out since, there is no rational basis for any additional FOMC members to do so. **Barring major surprises in either the August jobs or CPI data, a September rate hike is indefensible**, and we are surprised that CME futures put the odds at 38%.

Other Developments in Macroeconomics:

1. Removing shelter pushes July core-inflation up to 3.3%, annualized. The story is, however, more complicated. We write often about problems with owner equivalent rents, which account for 73% of the CPI's shelter component and 33% of core-CPI. It is simply a survey that asks homeowners how much they would expect to rent their home for and tends to reflect lagged housing prices. **Owner equivalent rents were up 3.1% in July, again pushing core-CPI up**. Shelter itself was lower because hotel rates, which are 4.8% of shelter, plummeted by an annualized 35.5%. In other words, the BLS's measurement problems with shelter ae still making inflation readings seem worse than they really are.

2. One of the most consequential long-term developments for the U.S. economy is the collapse of labor's share of national income. This is simply the share of income paid to workers as wages, benefits, etc., as opposed to income from capital. Labor's share has trended down since 2000, and the BLS is reporting a sharper decline from 55.1% in 1Q2025 to 52.9% today, a record low. The timing of this drop is unprecedented. The only other time it has fallen so rapidly is after recessions when capital typically recovers faster than labor.

Figure 2: Labor's Share of Income



The decline in labor's share is primarily technological. The U.S. is increasingly focused on goods and services that are more capital intensive, and this trend will almost surely continue. AI is clearly a factor in the latest drop. This could provide an additional

rationale for those advocating higher taxes on capital. Political constraints, however, assure that this will not happen until at least 2029. Poor consumer sentiment is often blamed on inflation but labor's falling share is probably a bigger factor. **If so, consumer sentiment will not fully recover even as inflation fears recede.**

3. The New York Fed's 2Q2026 report on household credit explains why GDP growth has continued to outperform the labor market. The combination of low interest rates and high inflation post-covid created a massive transfer of wealth to homeowners. The report shows that despite years of much higher mortgage rates, this effect has still not dissipated. Mortgage debt quality remains high with low delinquency rates at just 1.0%. This financial strength has allowed household consumption to hold up despite the headwinds of high interest rates, low consumer sentiment, etc. At the same time, the report shows considerable distress among non-homeowners. Both credit card and auto loan delinquencies, which are 12.9% and 5.5% respectively, and which more closely track low-middle income households, are near their 2010 peaks. There is a lesson for the Fed. **Higher interest rates are doing little to slow down the spending of homeowners. They are, however, placing considerable strain on non-homeowners who skew younger and poorer.**

-Paul Shea

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