MILLER TABAK + CO., LLC

July 29, 2026

The Fed is Rapidly Drifting Off Course

We are surprised that three FOMC members switched from voting to hold rates steady in June to voting to raise rates by 25 bps today. The biggest macroeconomic changes since the June FOMC meeting are the June CPI inflation reading and the latest rise in real and nominal yields, both which push against rate hikes. The June CPI report showed June inflation falling well below the consensus forecast. **The lesson that the FOMC should have taken is that the high March-May inflation readings were just another energy price swing**. Like all such spikes since the mid-1980s, this one produced some ugly inflation readings, but with only small pass through to core-inflation. The Fed should have looked through it. A significant fraction of the Fed, however, has failed to do so. Chairman Warsh, despite not voting to raise rates, dismissed the June reading as "a single month of modest price decreases."

Our concern is straightforward. After the latest re-escalation in Iran, Brent crude oil prices are now up 28% so far in July. Barring a rapid decline in the coming weeks, this will lead to more ugly headline inflation readings in July and August, along with a much more modest boost to core inflation readings. **As before, these readings will reverse soon after crude oil prices come back down (or at least will stabilize at or below 2% if crude oil prices plateau at an elevated level) without FOMC action.** We now doubt, however, that the Fed, and Warsh in particular, will be able to resist hiking rates in the face of bad inflation data. This would be a mistake. Absent a change in rates, we expect somewhat slow GDP growth with a 35% chance of recession within the next year. **If the FOMC instead hikes, even once, recession risk could jump back up to 50%.**

As for our inflation outlook, the re-escalation of conflict in Iran does not change our outlook. We simply reiterate what we wrote after June's soft inflation readings. Markets should look through energy prices and keep in mind that underlying inflation is only a mild concern. **Core-CPI, ex-shelter was just 2.0% y/y through June. When we use Zillow's housing price index instead of the BLS's flawed measure, core-CPI is just 1.4%.** We do note that core-PCE, ex-shelter, will be somewhat above 2% when it comes out this week. The gap between the two should close, however, within the next six months. We also note that the Atlanta Fed's survey of businesses saw year-ahead inflationary expectations fall from 2.32% to 2.15% in July.

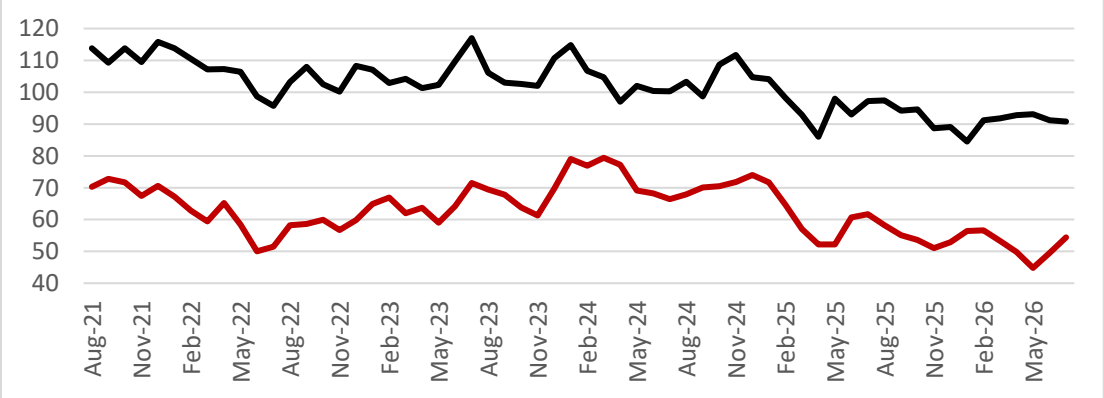
We much prefer this survey to any other survey of expected inflation (businesses set prices), and this decline supports our optimism around inflation.

Three dissents reveal something about Warsh's managerial style. For decades, the Fed has tried to avoid dissent with the Chair often working to achieve a lopsided, usually unanimous, vote. We suspect that Warsh is less concerned with consensus, he welcomed "a good family fight," and that Hammock, Kashkari, and Logan's dissents are more a reflection of this change than a revision of their policy positions. We await the written statements from the dissenters.

Other Developments in Macroeconomics:

1. Despite our confidence that inflation is trending down, without the Fed's help, we have every expectation that the war with Iran will continue on and off for some time. As a result, there is no end in site to the current volatility of inflation, especially for headline readings. The Fed can do nothing to address this volatility. Because the Fed seems ill prepared to look through energy prices, another concern is that it will take longer for the data to dissuade the Fed's inflation concerns. We still hope that this will happen by the Fall, but this hope is, unfortunately, sensitive to geopolitical events in the Middle East. **We had expected the Fed to shift back to a dovish stance by 1Q2027, likely after having claimed credit for lower inflation. We now think that 2Q2027 is the earliest for the Fed to reverse course.** We had expected the 10-year yield, to reach its long-run level of 350 bps by December 2027. **With the Fed moving slower, we are also moving this date back to 2Q2028.** We stand by the 350 bps target.

Figure 1: Consumer Confidence (black) and Sentiment (red)



2. We remain more concerned about weak growth than persistent inflation. The Conference Board's consumer confidence rating fell again from 92.2 to 90.8 in July. Declines in consumer confidence are not usually cause for concern because they are usually just

responses to what we see in other data (*e.g.* inflation, asset prices, and unemployment). The Conference Board measure is known to track the labor market and does not fully match other July employment data, including jobless claims, making it somewhat concerning. **It may signal a July jobs report that is weaker than expected**. All of its decline comes from worse perceptions of current conditions rather than weaker expectations of the future. Consumer confidence is still much stronger than the University of Michigan's consumer sentiment measure, which more closely tracks inflation and households' balance sheets. Despite some bounce back from the historically low reading of May, consumer sentiment remains very poor. Collectively, these readings indicate significant downside risk for upcoming growth.

3. Although the Atlanta Fed projects just 1.5% GDP growth for 2Q2026, their forecast is still very optimistic. Our focus is not on the overall growth figure, or even the final demand reading which attempts to strip out volatile components such as exports and inventories. Our main focus is instead on consumption growth, which is coming off a very weak 1Q2026 at just 0.5%, but which the Atlanta Fed expects to hit a strong 2.5% in 2Q. **It will be very good news for the U.S. economic outlook if consumption growth nears 2.5%.** We are also curious to see if housing can scratch out its first positive quarter since 4Q2024, although with mortgage rates still elevated, we doubt it would mark the start of a sustained recovery.

-Paul Shea

Strategic Economist, Miller Tabak