MILLER TABAK + CO., LLC

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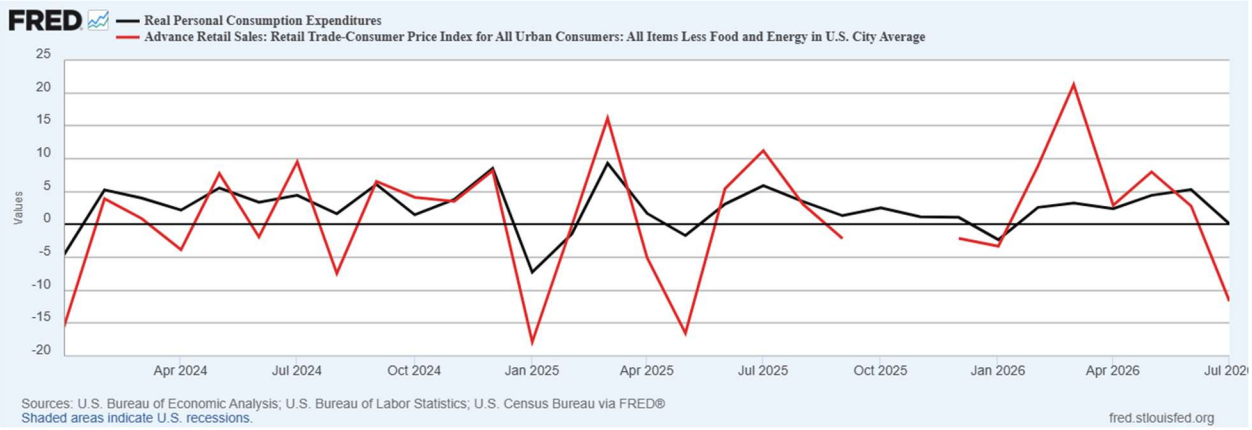
Consumers May Finally be Cracking

The big story from the PCE report is not inflation, which was about as expected and consistent with what we already know from the earlier July CPI release. **Much more concerning is that real consumption growth (black in Figure 1) in July was essentially zero**, bringing an abrupt halt to a period of strong growth that caused 2Q2026 GDP to be unexpectedly strong.

Figure 1: July Retail Sales and PCE Fall Sharply

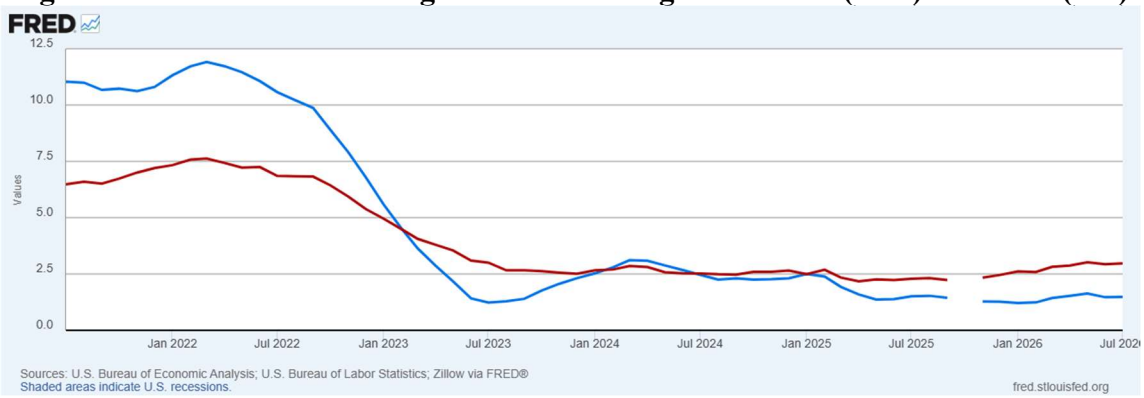


There are a few reasons why this should not be written off as a single bad month. First, the earlier July retail sales data (red in Figure 1) was alarmingly bad**. Retail sales are quite volatile, so the PCE report, which is more reliable, confirms that consumers really did pull back in July**. Second, this pullback is explicable in the face of high yields and terrible consumer sentiment. The University of Michigan's consumer sentiment measure more closely tracks household finances than the Conference Board's consumer confidence measure, which came out earlier this week and more closely tracks the labor market. Consumer sentiment will be updated for July next week. Finally, a breakdown of the data shows some concerning patterns. Real consumption was held up by non-discretionary sectors including housing, utilities, healthcare, etc**. Discretionary spending in sectors such as recreation, durable goods, etc., fell noticeably**. Following a strong second quarter, we now expect consumption growth to slow through the end of 2026 to better match the recent mediocre labor market data.

Other Developments in Macroeconomics:

1. The most surprising part of higher yields is that bond markets have come to expect the Fed to keep the Federal Funds rate near 4% for several years, higher than its current 350-375 bps range. This is now matched by CME Fed Funds futures, which predict a 400 bps rate as late as October 2027 (the latest date available). Markets and the Fed are making two major mistakes. First, they are exaggerating inflation concerns by overreacting to ugly headline measures that mostly reflect higher energy prices. **Second, assuming for the sake of argument that inflation fears are justified, the required FOMC response will not be to keep rates near 4% for years, but rather for an extra quarter or two.** For now, the Fed is ignoring the past two months of encouraging inflation data. By this fall, however, the data will make it clear that soft demand, not inflation, is the Fed's bigger concern. **We continue to expect the Fed to resume rate cuts in Q22027 with the Fed Funds rate returning to 300-325 bps in mid-2028, alongside a 350 bps 10-year Treasury yield.**

Figure 2: Core- Inflation Using Zillow's Housing Index: CPI (blue) and PCE (red)



2. Besides energy, another major factor causing inflation readings to exceed 2% is shelter, especially the poorly measured owner equivalent rents component. Instead of just removing shelter, another approach is to replace it with a housing price index. Zillow's July index showed 0.4% annualized growth while Case-Shiller's June index reported a 0.6% annualized decline. **Using Zillow's measure in place of shelter in CPI (blue in Figure 2) and PCE (red) produces y/y core-inflation figures of 1.5% and 2.9%, respectively.** Underlying inflation is somewhere between these two readings, not far from the Fed's 2% target. Although the PCE measure is significantly above 2%, correcting for shelter means that **core-PCE no longer exhibits the significant upward trend that has alarmed the FOMC**. With mortgage rates very high, there is little chance that housing price growth will soon pick back up. Critically, there remains no source of persistent inflation. Interest rates are restrictive, inflationary expectations are anchored, demand is far from overheated, and it has been decades since energy prices passed through to major increases in core-inflation.

3. **We do not share concerns that the brewing trade war between the U.S. and Canada is a significant risk to the U.S. economy**.[1] First, we expect President Trump to back down within a few weeks, especially given that higher tariffs could harm the Republicans' chances in the upcoming midterm elections. Second, although tariffs did contribute to inflation in 2025, the impact was less than most economists expected. These new tariffs, including Canada's retaliatory tariffs, are too narrow to have a noticeable effect on upcoming inflation readings. Likewise, although these new tariffs will slow consumption, the impact will also be minor.

-Paul Shea

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[1] Bartash, J. 8/25/26. "U.S.-Canada Trade War Threatens to Worsen Inflation for Both Countries. Neither Can Afford it." *Marketwatch*.