MILLER TABAK + CO., LLC

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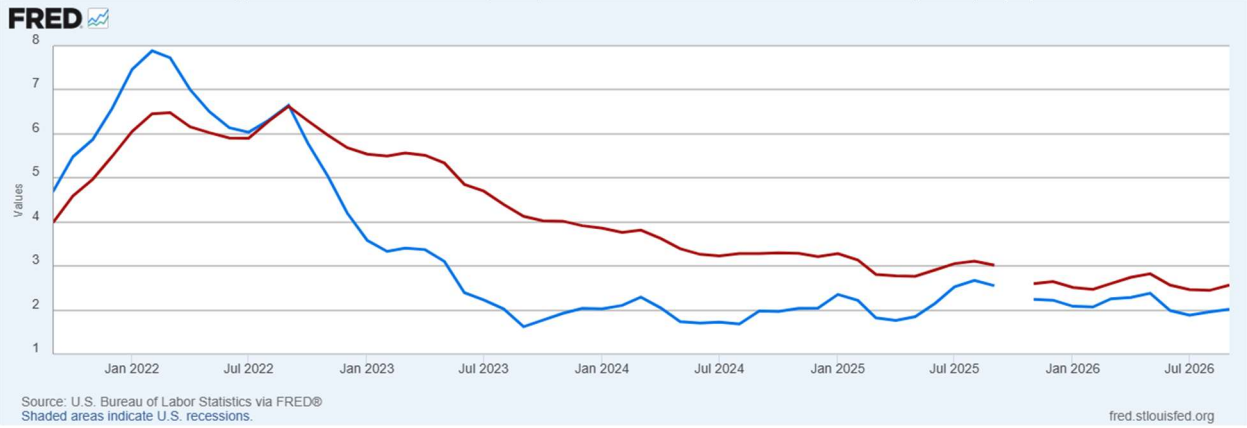
Housing Data is Creating an Inflation Mirage

The bad news from the October CPI report is not the data themselves. The report shows underlying inflation right around 2%. Rather, the problem is that the report provides plenty of fodder for those, like Chairman Warsh, looking for a reason to raise rates or to write headlines about accelerating inflation. Beyond the ugly headline readings (0.7% m/m, as expected), core-CPI was higher than expected (0.3% m/m vs. 0.2% expected) to take its y/y reading to 2.6% and its three-month average rate to 3.4%. The latter will be especially useful for FOMC members pushing for a rate hike later this month.

Figure 1: Core-CPI (red) and Core-CPI, ex-shelter (blue), y/y



The three-month CPI rate of 3.4% does reflect some passthrough from headline to core inflation. Transportation services, a sector highly sensitive to energy prices, rose at a 5.4% annualized rate over that same period. **This, however, is just a repeat of March-May, when rising energy prices led to a spike in core inflation that subsided as soon as energy prices came back down.** It does not indicate the start of sustained inflation. Also, the past three months are far too early to feel the impact of much higher yields. At almost 100 bps above neutral, monetary policy remains highly restrictive, and inflation will continue its longer-term (*e.g.* since 2024) downward trend. **By 2Q2027, it will be clear that the Federal Funds rate has been too high.**

More importantly, the only reason that y/y core-CPI is above 2% is due to shelter. Removing it (blue in Figure 1) leaves a score-CPI rate, ex-shelter, of exactly 2.0%. **To argue**

that the CPI data justify another rate cut is akin to arguing that we need to raise rates to cool off the U.S. housing market. This is, of course, absurd. We know that shelter, especially the owners' equivalent rents component, is very badly measured. Better sources such as Zillow and Case-Shiller show housing price growth over the past year of 1.2% and 1.9% respectively, in sharp contrast to the CPI's 3.2% figure. Using either of these former figures instead of CPI-shelter yields a core-CPI rate significantly below 2%. With mortgage rates at a staggering 7.4%, there is no chance of a near-term housing rebound.

There is one piece of bad new inflation news. The Atlanta Fed's survey of businesses saw one-year ahead inflation expectations tick up from 2.2% to 2.4% in August. Still, we remain very optimistic that inflation concerns are severely overstated. With both aggregate demand and the labor market far from overheated, there is no source for persistently high inflation. Inflation hawks are not fighting the last war as much as they are fighting one from the 1970s. Then, energy prices did trigger sustained inflation. The economy is very different now and it is a mistake to overreact to energy price swings. The pressing concern should instead be the labor market which, while still in adequate shape, continues to exhibit fragility.

Other Developments in Macroeconomics:

1. Chairman Warsh has mentioned that his inflation concerns come not just from overall readings but also the distribution of price changes. This is perplexing. Trimmed-mean measures exist to address Warsh's concerns. Trimmed-mean CPI, which cuts out the 8% largest and smallest price changes is not concerning. It is at 2.7% y/y, just above core-CPI. **Furthermore, if we correct for shelter, it would also right very close to 2.0**%. It is 1.8% if we replace owners' equivalent rents with Zillow's index.

2. The University of Michigan's consumer sentiment reading was awful with readings just above their April 2026 levels, when they were the lowest in the survey's history. The decline so far in 2026 has been driven by poorer households. This makes sense given that their balance sheets are weaker than usual and they are more affected by higher yields. Unlike the Conference Borad's consumer confidence survey, which tracks the labor market, consumer sentiment is more sensitive to household balance sheets. Consumption has obviously held up well despite weak sentiment over the past year. **The risk is that if another major shock hits the U.S. economy, then consumption could weaken very rapidly.** One candidate would be an end to the cap-ex boom, a risk not unlike the bursting of the tech bubble in 2000.

3. Much of the Fed's October Beige Book showed few major macroeconomic changes in October. The labor market for example, showed 'little or no net change in overall employment levels," suggesting the low-hire, low-fire job market continues. We were a little bothered by the comment that "expectations tend to be for slight [GDP] growth,

weighted toward manufacturing and burdened by persistent uncertainties." Since June, manufacturing data have been strong. **Manufacturing is, however, sensitive to high yields and its strong recent growth is unlikely to last.** A manufacturing decline would not only dent GDP growth expectations but would also probably turn overall job growth negative.

-Paul Shea

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