MILLER TABAK + CO., LLC

September 16, 2026

A Rate Hike Without Upside

By raising rates, and predicting one more hike this year, the Fed has made a significant blunder, and one that is supported by neither the current inflation nor employment outlooks. The immediate impact will be to keep yields and mortgage rates artificially high for longer. Our biggest complaint is that this rate hike will do little to ease inflation concerns. It will not affect the timeline for when markets' inflation fears will ease; late fall if oil prices come back down, or early 2027 if they do not.

The biggest impact will be on two areas. First, it will further weaken the housing market, eliminating any chance that the positive growth of 2Q2026 is the start of a sustained recovery. Second, it will further strain the finances of low-middle income households, whose leverage ratios are relatively high. Neither, however, will be significantly disinflationary. Official measures of inflation (*e.g.* those using owners' equivalent rent) are not designed to capture any resulting decline in housing prices. Low-middle households are also never the main driver of consumer inflation. **Higher rates will hit the parts of the economy least at risk of overheating.**

Higher rates could be more disinflationary if they have a large effect on either business investment or the consumption of middle-high income households. Both impacts will, however, be small. The ongoing capital expenditures boom is insensitive to interest rates. Also, wealthier households' balance sheets remain better than normal, a factor that has helped make their consumption resilient to higher rates ever since the Fed started hiking in 2022.

This is a policy that will do real, but far from catastrophic damage, without any notable benefit. We do, however, see the political benefit for the Fed. Inflation will come down regardless of what the Fed does in the coming months, and Chairman Warsh will be especially well positioned to claim credit. **He will then be able to take interest rates back down to their neutral level which probably remains near 300 bps (more on this later).**

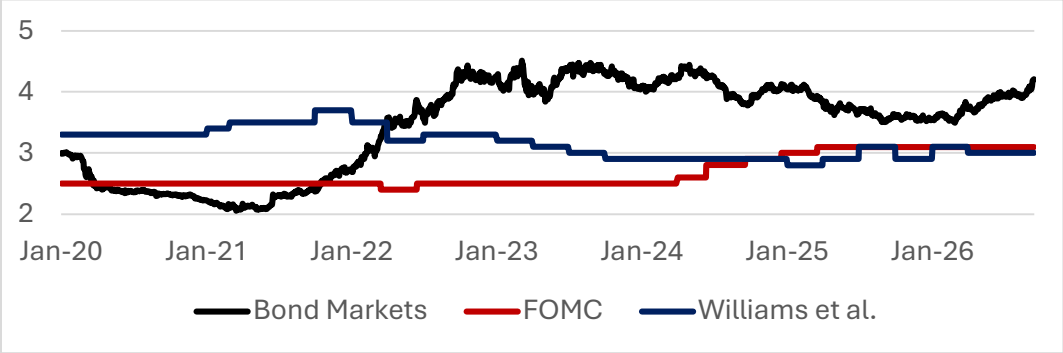
Other Developments in Macroeconomics:

1. With the ten-year Treasury yield hitting 5%, we reiterate that this is at odds with even the most hawkish interpretation of Warsh's plans. **Bond markets now imply a neutral rate**

(using expectations 5-10 years ahead) over 420 bps. CME Fed Funds future for October 2027, the latest available, put the Fed Funds rate at 450 bps. This cannot result from even the most pessimistic reading of the inflation data. Instead, it requires the Fed to keep rates at least 30 bps above their new, higher level (375-400 bps) indefinitely. In other words, bond market are acting as if current yields are still somewhat accommodative. Although there has been speculation that AI could push the neutral rate up, there is little evidence to support this claim. The FOMC's own estimate of neutral remains at 320 bps, just above that of New York Fed President John Williams and his coauthors. The latter remains the best quantitative estimate of neutral. **Kevin Warsh has convinced bond markets that his hawkishness translates to higher rates, forever.** This will not be the case.

Figure 1 shows how out of line bond markets' estimates of neutral (black) are from both those of the FOMC itself (red) and model of John Williams (blue).

Figure 1: Bond Markets' Implied Neutral Rate is Far Too High



2. The Fed's new Summary of Economic Projections is too pessimistic on inflation and too optimistic on the labor market. The new FOMC statement claims that "job gains have kept pace with the workforce," effectively blaming slow job growth since January 2025 entirely on lower population growth. This ignores the concerning drop in labor force participation, which has fallen from 62.6% in January 2025 to 61.6% today and creates a risk of higher unemployment in the coming months. **The Fed expects 4.1% unemployment through 2027; we expect a rise to 4.7%**. The Fed expects core-PCE to be 2.5% in 2027. **After today's actions, core-inflation will be below 2% next year**.

3. Both markets and the FOMC are still failing to see through energy price volatility that has taken crude oil prices back to the neighborhood of their May peak. The first question asked to Warsh cleverly noted that "a quarter point rate hike will not reopen the Straits of Hormuz." He provided no real answer. The August CPI data were not alarming. **Core-CPI was high at 3.5% (m/m, annualized), ending a streak of three tame readings.**

More importantly, core-CPI, ex-shelter, is just below 2% y/y. The uptick in August core-CPI is explicable as pass-through from energy prices, especially given that transportation services, which are sensitive to fuel costs, were up 5.4% annualized. September CPI, especially headline, will be worse**. It will, however, simply be a repeat of the spring when higher inflation reversed once energy prices came back down**. Even if crude oil remains above $100/barrel indefinitely, it will not be the start of sustained inflation. It will instead be a one-time shock to prices that cycles out of y/y inflation measures a year later.

-Paul Shea

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