MILLER TABAK + CO., LLC

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The Fed's Next Mistake Will have to Wait until December

Although expected, the Fed's decision to hold rates steady comes as a relief. With Brent crude at $115 per barrel, the next couple of months will bring ugly headline inflation readings with some temporary pass-through to core. A rate hike, however, would not have done anything to prevent this and would have only slightly affected the timeline for when inflation fears will dissipate. We still put this in 2Q2027 with a clear FOMC pivot by mid-2027. **A rate hike would have, however, pushed yields back well above 5%, threatening a labor market that is more vulnerable than the Fed believes.**

Chairman Warsh's comments themselves were clearly discouraging. The most concerning was his attention to the latest rise in energy prices and fears that they may "broaden out across the rest of the economy," suggesting that the FOMC may continue to struggle to look through crude oil price shocks. Other comments suggested impatience. Under Powell, the Fed's language about policy having "long and variable lags" became cliched. It is, however, true. **We are yet to see how the labor market will weather the much higher yields of recent months.** Monetary policy takes at least a year to have its full effect. Warsh did, however, note that the Fed has "started to see changes in business and current conditions" that are disinflationary. This is true, although it would have happened regardless of FOMC policy.

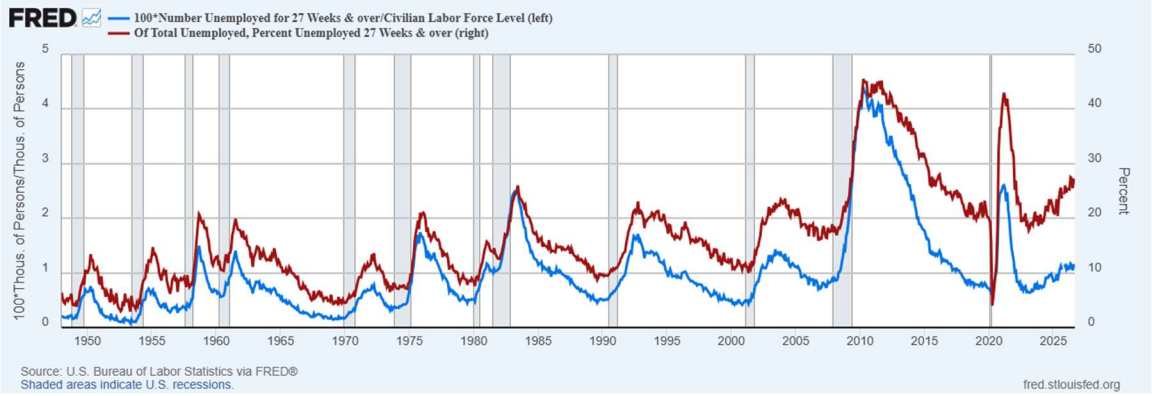
The recent decline in yields is largely disconnected from today's Fed decision. First, Warsh said nothing to indicate a change in the Fed's thinking. Unfortunately, this is just a pause, and the Fed is extremely likely to hike by 25 bps in December. Second, lower yields are entirely due to lower term premiums as lenders have fled to safer credit. There has been little change in the neutral rate implied by bond markets, which remains at 425 bps. The good news is that this is well over 100 bps too high. Once markets realize that neutral is about where it was pre-pandemic, this entire gap will be reflected in lower yields. **We still expect a 350 bps 10-year yield by mid-2028.**

Other Developments in Macroeconomics:

1. An underrated aspect of the ongoing low-hire, low-fire labor market is rising long-term unemployment, defined as 27 weeks or more. Because this typically implies the exhaustion of unemployment insurance, long-term unemployment is especially predictive

of rising household credit delinquencies. Figure 1 shows two measures: the share of unemployed who are long-term unemployed, which equals 27.1% (red in Figure 1), and the overall share of the labor force that is long-term unemployed (blue), which is up to 1.1%. **The unusual, and concerning, feature of these data is that this is the first time these measures have trended up during an economic expansion since 1972.** It is not because of AI. Instead, it reflects the complete lack of job growth outside of private education and healthcare. When workers outside these sectors lose their jobs, the lack of job growth makes it very hard for them to find another. This is another source of weakness in the labor market that is masked by the benign 4.2% overall unemployment rate. We reiterate that the labor market is far more fragile than markets, or the Fed, believe. We are especially interested if anecdotal reports of job cuts (*e.g.* Microsoft) show up in next week's JOLTS release.

Figure 1: Long-Term Unemployment is Steadily Rising



2. There is one encouraging piece of news around the labor market. The Conference Board's consumer confidence measure unexpectedly rose in October from 84.2 to 91.7. This measure tends to track the labor market. The share of households describing jobs as "plentiful," for example rose from 24.3% to 26.7%. One good month may turn out to be noise, but it is welcome given that the University of Michigan's consumer sentiment measure, which more closely tracks households' financial situations, recorded its second worst month since 1978 in September.

3. One of the reasons why we are so optimistic about inflation falling to 2% or lower in 2027 is that we cannot identify any source for sustained inflation. This includes inflationary expectations, which as Warsh noted remain "anchored" near 2% while crediting the Fed's new policy stance for keeping them that way. The past week has brought mixed news on this front. 5-year breakeven inflation jumped to 2.48% last week, its highest level since June. This partly reflects higher crude oil prices, but it also captures bond markets' struggles with interpreting recent inflation data. **More importantly, the Atlanta Fed's survey of businesses found that one-year ahead expected inflation fell**

from 2.4% to 2.3% in October. We put more stock in this figure because it measures the views of actual price-setting firms.

-Paul Shea

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