US Macroeconomics

July 21, 2026

Joseph Lavorgna, Chief US Economist | 212.893.1619 | joseph.lavorgna@smbcnikko-si.com

Magical Thinking

Politicians and policymakers expect inflation to return to 2%, but we doubt this will happen on its own. Something must change the tide of current inflation dynamics. As with Newton's Law of Inertia, inflation will continue to move at a constant velocity (or potentially trend higher) unless acted upon by an external force, in this case interest rates.

The core personal consumption expenditures (PCE) deflator is the Fed's preferred inflation metric. This measure excludes food and energy prices because they distort the underlying trend in inflation. This is especially important now because the Iran war induced an energy and broader commodity price shock that has adversely plagued an already fraught U.S. inflation backdrop. The core inflation rate is well above target, and the situation may worsen without a successful Middle East resolution.

Last year, the core PCE deflator rose 2.9% from four quarters earlier, which is the fifth consecutive year that the inflation rate has exceeded the Fed's 2% target. The cumulative miss on core inflation during this time is over 8%. Troublingly, prices have accelerated further this year with the consensus of forecasters projecting a 3.3% year-over-year increase as of Q2 2026.

It is no wonder Fed Chair Warsh is harping on the need to restore price stability. If the inflation rate does not slow, policymakers will lose hard won credibility. Many of his colleagues agree. But words alone are insufficient. The Central Bank needs to slow demand by lifting the fed funds rate and the cost of money. There is no other historical roadmap.

In the last seven decades, there have only been six episodes when core inflation fell by 0.9% or more from one year to the next. It happened in 1972 and 1975, then successively from 1981 to 1983, and then again from 1989 to 1991, in 2008, and finally in 2023. In each instance, the slowdown occurred because the Fed was tightening. In only one instance, 2023, was the Fed able to avoid a recession. Will this time be different?

For the record, the Fed's Central Tendencies do not see core inflation moving down to 2% until 2028 at the earliest. But this does not change the fact that the Fed needs to raise rates because there has never been a time when inflation gradually moderated without impetus from the Fed. In other words, core inflation is not going to magically slow. Action needs to be backed up by words, and the time is now.

The longer the Fed waits, the higher the probability rates will have to rise further than need be. This is why so many previous tightening episodes ended in tears. Chair Warsh understands this. Investors should prepare. We hope that this time is different. Stay tuned.

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