

Are Rate Hikes on the Way?

The job market was surprisingly strong in May with non-farm payrolls growing 172,000, beating even the strongest forecasts for the month. As a result, the futures market is now pricing in a quarter-point rate hike later this year and more likely than not another quarter point rate hike sometime in 2027.

But we think rate hike would be ill-advised and unlikely. First, this is a good employment report, but not a “barnburner.” Barnburner job growth is 300,000 to 400,000 per month. Even Keynesians who think strong job growth causes inflation, are over-reacting.

Second, yes, the CPI is up 3.8% versus a year ago and the Fed’s preferred inflation measure, the PCE Deflator hasn’t been at or below 2.0% for more than five years. But we think without the Iran War temporarily boosting prices, the Fed had already set the stage for a return to 2.0% inflation. The M2 measure of the money supply is up 4.7% from a year ago and has been up at a 3.2% annual rate in the past three years. By contrast, in the ten years prior to COVID, when inflation was consistently below the Fed’s 2.0% target, the money supply was up at a 6.2% rate.

In other words, the money supply has been growing slowly enough for inflation to be brought under control. However, the war has caused oil prices to soar, lifting official measures of inflation. Over time, higher oil prices will mean less money for consumers to spend on other products, which will push other prices down.

But in the short run, consumers have reacted to higher oil prices by running down their saving rate. In January consumers saved 4.3% of their income. Yes, that’s low historically, but nothing compared to the 2.6% saving rate in April. That may not seem like much, but if the new lower saving rate keeps up for a year, consumer saving would be down by \$400 billion versus where it was in January. That reduction in the saving rate temporarily gives ample room to pay for higher oil prices without putting downward pressure on the prices of other goods and services.

Don’t mistake this argument for the one used several years ago when former Fed Chairman said the increase in inflation was “transitory.” Back then inflation measured by the PCE Deflator

peaked at more than 7.0% – the highest in forty years – and the M2 measure of the money supply had skyrocketed about 40%.

On the other side of the conflict with Iran (whenever that is) are lower prices for energy, consistent with modest growth in the money supply and a re-assertion by consumers of a higher pace of saving. It is possible that this conflict drags on. Iran is not negotiating in good faith and flew missiles into Israel last night. But even if this war continues, and inflation stays elevated, it would be wrong to raise rates. Why hit consumers, whose spending is already growing faster than their incomes, with a rate hike on top of everything else? Higher oil prices are a drag on growth...why compound it?

Other indicators are consistent with lower inflation. For example, in spite of robust job growth, average hourly earnings are up only 3.4% from a year ago, matching the slowest pace in five years. This is consistent with 2.0% inflation plus the long-term trend of 1.5% productivity growth. If productivity growth is faster than that right now – and we will be writing about this issue in the weeks ahead – then 3.4% wage growth is an even better signal that monetary policy is already tight enough to bring inflation back down to 2.0% (after the Iran War).

As we said earlier, job growth doesn’t cause inflation, but neither do rising wages. The Fed operates on a Keynesian model that thinks strong growth causes inflation. It’s wrong, but still does it. So, what will it focus on temporarily higher inflation, or moderate wage growth? Raising rates is a mistake.

Other measures of inflation have been lower. For example, the Dallas Fed’s measure of “trimmed mean” inflation, which ignores the most volatile categories of prices, is up only 2.4% from a year ago, down from 2.6% in April 2025.

At present, we don’t think newly-minted Chairman Kevin Warsh has the votes to cut short-term interest rates, even if he wanted to. But given modest wage growth and moderate trimmed-mean inflation, we think Warsh does have a political clout at the Fed to keep rate hikes at bay.

The market sell-off on Friday was more than about a better-than-expected jobs number. The market is overvalued. We don’t expect a crash, but the idea that the market will only move one way (higher) has always been wrong.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
6-9 / 7:30 am	Int’l Trade Balance – Apr	-\$56.5 Bil	-\$54.8 Bil		-\$60.3 Bil
9:00 am	Existing Home Sales – May	4.060 Mil	4.130 Mil		4.020 Mil
6-10 / 7:30 am	CPI – May	+0.5%	+0.5%		+0.6%
7:30 am	“Core” CPI – May	+0.3%	+0.2%		+0.4%
6-11 / 7:30 am	Initial Claims – Jun 6	219K	220K		225K
7:30 am	PPI – May	+0.7%	+0.7%		+1.4%
7:30 am	“Core” PPI – May	+0.5%	+0.6%		+1.0%