



UNITED BANKERS' BANK

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## New Sheriff in Town: Can He Tame Inflation?

On June 17, Kevin Warsh concluded his first rate-setting meeting as Chair of the Federal Reserve, replacing Jerome Powell who remains a board member of the Fed. Folks who expected fireworks were disappointed. Although appointed by a President who loudly believes that interest rates should be cut immediately if not sooner, Warsh astutely read the room and recognized that any attempt to push through rate cuts would have been thoroughly outvoted by other voting members of the committee. That would have been the first time a Fed chairman is overruled by colleagues since 1938, when then-Chair Mariner Eccles was at the helm.

That said, Warsh's comments at the post-meeting press conference suggested that he is fully on board with the committee's judgment. The Fed has a dual mandate -- to achieve price stability and maximum employment. At the presser, Warsh repeatedly said that price stability is his main objective, barely uttering the words maximum employment. We doubt that the central bank is abandoning the plight of workers who can't find a job. It's just that unemployment is not the chief, or even a relevant, concern at the moment. The unemployment rate is currently 4.3 percent, which by historical yardsticks is pretty much consistent with a fully employed economy.

But the goal of price stability is far from being met. In May, the consumer price index ran 4.2 percent ahead of the same time last year, a three-year high and up for the third consecutive month. The Fed's definition of price stability is 2 percent, so inflation is running more than twice as high as policy makers feel comfortable with. To be sure, there are myriad other price measures that are tracking a lower inflation rate; they include the so-called core-consumer price index, which excludes volatile items like gas and food. But the core index is also running high -- at 2.9 percent in May -- and importantly, virtually all other broad inflation measures have been above the Fed's 2 percent target for five years. This is what economists and policy makers refer to as "sticky inflation", something that stubbornly resists efforts to bring it down. So, is the new sheriff entering a no-win situation, pursuing price stability at all costs even if it causes mass layoffs and higher unemployment? The good news is he probably won't have to deal with that Hobson's choice.

### Oil's Retreat

The latest CPI release briefly sent tremors through the financial markets, stoking fears that the Fed is falling behind the curve in stifling inflation and, just as bad, seeing workers being robbed of hard-won gains in purchasing power. Indeed, in both April and May the annual increase in consumer prices outpaced wage gains, resulting in lower real earnings for the first time in three years. Inflation also dilutes the

purchasing power of the fixed income that bond holders and many pensioners receive. Unsurprisingly, traders demanded greater returns to compensate for the faster inflation, sending bond yields higher.

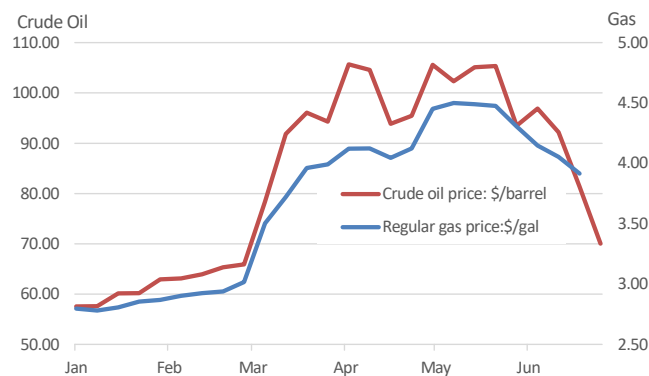
But the tremors faded, and the markets soon stabilized for several understandable reasons. For one, this inflation surge is not being fueled by organic forces that feed on themselves and generate lasting momentum. The main culprit stoking the inflation embers is the Mideast war that sent energy prices soaring from around \$60/barrel to over \$112 in April. Higher gasoline prices alone accounted for about two-thirds of the month-over-month increase in the May consumer price index. The closing of the Strait of Hormuz also drastically cut shipments of fertilizer and liquified natural gas (a key fertilizer feedstock), boosting costs of farming and, hence, grocery prices.

Historically, when external shocks -- which usually involve oil shortages -- fade, the inflation flareup loses steam. This time is no exception. The tentative ceasefire struck in late June based on a Memorandum of Understanding, may or may not endure. But oil-carrying ships started moving through the Strait of Hormuz again and oil prices are already tumbling. Retail gasoline prices fell below \$4 a gallon following the MOU from about \$4.50 at the May peak. Prices at the pump lag the global price of crude oil by several weeks, so barring a reescalation of hostilities motorists should see more price drops in coming weeks.

### The Peak Has Passed

If the ceasefire holds, the May inflation rate of 4.2 percent is probably the peak of the current cycle. Even if gasoline prices hold at current levels, it will reverse a big chunk of the boost they

Lower Gas Prices Coming



imparted to the May CPI in June. That alone will take a meaningful fraction out of the inflation rate for the month. True, it will take longer for the knock-on effects of the oil surge – on food and air fares, for example – to play out. But the pressure from those and other prices linked to the war will ease and gradually reinforce the inflation retreat.

Keep in mind that many prices avoided the war's impact and were already on a disinflationary trend before the conflict started. Chief among them is housing, which accounts for fully one-third of the weight in the consumer price index. This component has been a key influence keeping the inflation rate above the Fed's 2 percent target for the past five years, thanks to the housing shortage and soaring rents. But over the first five months of this year, annual rent increases have averaged 2.8 percent, down sharply from the 9.1 percent peak in 2022. And the official government data overstates rent increases because they include older as well as current leases. According to industry sources, like Zillow, CoStar, Apartment List and Realtor.com, year-over-year rent changes on new leases are ranging between -1.7% and +1.8%.

Finally with regards to external influences on inflation, the rolling series of tariffs since Liberation Day has significantly boosted prices on imported goods, much of which were passed on to consumers. But the passthroughs are mostly in the rearview mirror; while some businesses will still try to pass on the cost, the incremental boost to prices will be less than it was last year and early this year. Indeed, the Supreme Court ruled that the tariffs imposed under the National Emergencies Act are illegal and must be returned to businesses. It's doubtful that the refunds will be returned to consumers in the form of lower prices. But at least it removes pressure on businesses to raise prices on sales of the goods that were imported earlier with the tariffs attached.

### ***Warsh Dips Into Greenspan's Playbook***

As noted, the new Fed chairman agreed with his central bank colleagues not to cut rates at the latest policy meeting. The financial markets went even further, pricing in a 100 percent probability that rates will be hiked at least once this year. Those odds are based on incoming data and projections made by Fed officials at the meeting. Not only is inflation running well above the 2 percent target, but the economy continues to chug along at a sturdy pace, underpinned by a resilient consumer and the muscular thrust from AI spending. Those pillars of strength are expected to persist, prompting Fed officials to revise up their inflation forecast from their projections made three months ago.

While Warsh agreed that a rate cut at this time would be inappropriate, he declined to speculate on what the future holds. This was deliberate, as he has long believed that the less forward guidance the Fed provides, the better. Warsh has long argued that forward guidance locks the Fed into positions based on stale data and unduly influences the financial markets, distorting the very market signals that could be valuable to policymakers. This change in communication echoes the recently departed Fed Chairman, Alan Greenspan, who was a master of obfuscation and is famous for saying to Congress "If I seem unduly clear to you, you must have misunderstood what I said."

Warsh also shares a belief held by Greenspan in the late 1990s when the economy was running at full tilt and unemployment was falling, prompting many to urge the Fed chairman to clamp on the

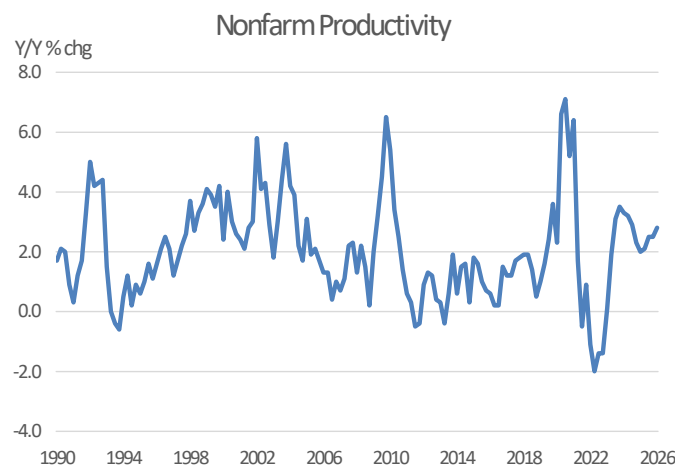
monetary brakes to prevent an inflation outbreak. Greenspan argued against that view, believing that the rapid adoption of personal computers and the Internet would increase productivity and allow the economy to grow faster without stoking inflation. He was right for several years until he was wrong as the fascination with the new technology led to overzealous spending that strained the economy's limits, lifted inflation and spurred the dot.com boom/bust cycle that ended in a recession.

### ***Will Productivity Do The Same?***

Warsh is also a believer of how productivity can spur growth even as it keeps inflation in check. Like the 1990s, he has convincing evidence that stronger productivity is well underway as it has increased by an average annual rate of 2.7 percent a year during the last three years compared to 1.3 percent from 2010 to 2020. With the rapidly spreading adoption of AI technology, the trend in productivity is poised to continue if not accelerate. That's a critical input to the economy's potential growth rate, as an ageing population and restrictive immigration policies are crimping the increase in the labor force.

Similarly, productivity growth sped up during the 1990s, from 1.7 percent to 2.8 percent between the first and second half of the decade. But the Greenspan Fed of the 1990s had help in taming inflation from other sources besides faster productivity. Globalization and the entrance of China into the World Trade Organization contributed importantly to lower prices of many goods in the U.S. The period also saw a bulge in immigration, which restrained labor costs. Both of those inflation-taming influences are trending in the opposite direction now. Hence, the productivity boom may not have the same inflation-fighting impact it had in the 1990s.

That said, the stage is set for inflation to retreat over the coming year, thanks to lower oil prices, a weaker tariff impact, sustained productivity strength and, importantly, less support for demand from Washington, as the enlarged tax refunds in recent months are running out and personal savings are already at the second lowest rate in twenty years. The new sheriff should have more compliant deputies around the turn of the year, as the second half of the dual mandate, maximum employment, will regain an equal if not greater importance alongside inflation. With the risk of unemployment growing and inflation receding, the new Fed Chair will by then have more of a case to pull the rate-cutting trigger.



# KEY ECONOMIC AND FINANCIAL INDICATORS

## Financial Indicators \*

|                                             |            |              |              |                 |                |                 |                 | 12-Month Range |            |
|---------------------------------------------|------------|--------------|--------------|-----------------|----------------|-----------------|-----------------|----------------|------------|
|                                             | <u>May</u> | <u>April</u> | <u>March</u> | <u>February</u> | <u>January</u> | <u>December</u> | <u>November</u> | <u>High</u>    | <u>Low</u> |
| Prime Rate                                  | 6.75       | 6.75         | 6.75         | 6.75            | 6.75           | 6.83            | 7.00            | 7.50           | 6.75       |
| 3-Month Treasury Bill Rate                  | 3.60       | 3.61         | 3.61         | 3.57            | 3.57           | 3.59            | 3.78            | 4.25           | 3.57       |
| 5-Year Treasury Note Rate                   | 4.15       | 3.94         | 3.85         | 3.78            | 3.78           | 3.70            | 3.67            | 4.15           | 3.65       |
| 10-Year Treasury Note Rate                  | 4.48       | 4.32         | 4.25         | 4.21            | 4.21           | 4.14            | 4.09            | 4.48           | 4.06       |
| 30-Year Treasury Bond Rate                  | 5.03       | 4.91         | 4.85         | 4.84            | 4.84           | 4.80            | 4.70            | 5.03           | 4.64       |
| Tax-Exempt Bond Yield                       | 4.78       | 4.74         | 4.84         | 4.77            | 4.79           | 4.80            | 4.77            | 5.27           | 4.74       |
| Corporate Bond Yield (AAA)                  | 5.56       | 5.42         | 5.48         | 5.34            | 5.34           | 5.31            | 5.26            | 5.56           | 5.13       |
| Conventional 30-Year Mortgage Rate          | 6.44       | 6.33         | 6.18         | 6.10            | 6.10           | 6.19            | 6.24            | 6.82           | 6.10       |
| Dow Jones Industrial average                | 49917      | 48430        | 46860        | 49138           | 49138          | 48119           | 47016           | 49917          | 42753      |
| S&P 500 Index                               | 7413       | 6957         | 6654         | 6929            | 6929           | 6853            | 6741            | 7413           | 6080       |
| Dividend Yield (S&P)                        | 1.09       | 1.16         | 1.21         | 1.16            | 1.15           | 1.15            | 1.16            | 1.28           | 1.09       |
| P/E Ratio (S&P)                             | 27.9       | 28.2         | 25.6         | 26.9            | 27.7           | 27.3            | 27.2            | 28.4           | 25.6       |
| Dollar Exchange Rate (vs. Major Currencies) | 118.8      | 119.0        | 119.9        | 119.2           | 119.2          | 120.6           | 121.8           | 121.8          | 118.8      |

\* Monthly Averages

## Economic Indicators

|                                              |            |              |              |                 |                |                 |                 | 12-Month Range |            |
|----------------------------------------------|------------|--------------|--------------|-----------------|----------------|-----------------|-----------------|----------------|------------|
|                                              | <u>May</u> | <u>April</u> | <u>March</u> | <u>February</u> | <u>January</u> | <u>December</u> | <u>November</u> | <u>High</u>    | <u>Low</u> |
| Housing Starts (Thousands of Units)          | 1177       | 1392         | 1522         | 1346            | 1385           | 1378            | 1319            | 1522           | 1177       |
| New Home Sales (Thousands of Units)          | 580        | 656          | 664          | 630             | 576            | 723             | 757             | 757            | 576        |
| New Home Prices (Thousands of Dollars)       | 425        | 417          | 393          | 412             | 416            | 429             | 403             | 429            | 393        |
| Retail Sales (%Change Year Ago)              | 6.9        | 4.8          | 4.2          | 4.2             | 3.3            | 2.4             | 3.2             | 6.9            | 2.4        |
| Industrial Production (%Change Year Ago)     | 1.7        | 1.4          | 0.6          | 0.8             | 1.1            | 1.2             | 1.8             | 1.9            | 0.6        |
| Operating Rate (%of Capacity)                | 76.2       | 76.1         | 75.6         | 76.0            | 75.6           | 75.7            | 75.4            | 76.4           | 75.4       |
| Inventory Sales Ratio (Months)               |            | 1.31         | 1.32         | 1.33            | 1.35           | 1.36            | 1.37            | 1.39           | 1.31       |
| Real Gross Domestic Product (Annual %Change) |            |              | 2.0          |                 |                | 0.5             |                 | 3.8            | -0.6       |
| Unemployment Rate (Percent)                  | 4.3        | 4.3          | 4.3          | 4.4             | 4.3            | 4.4             | 4.5             | 4.5            | 4.1        |
| Payroll Employment (Change in Thousands)     | 172        | 179          | 214          | -156            | -41            | -17             | 41              | 214            | -156       |
| Hourly Earnings (%Change Year Ago)           | 3.4        | 3.6          | 3.8          | 3.8             | 3.8            | 3.7             | 3.9             | 4.0            | 3.4        |
| Personal Income (%Change Year Ago)           | 3.8        | 2.6          | 3.3          | 3.5             | 4.0            | 4.2             | 4.4             | 5.1            | 2.6        |
| Savings Rate (Percent of Disposable Income)  | 3.0        | 3.0          | 3.5          | 3.8             | 4.4            | 3.6             | 3.8             | 4.9            | 3.0        |
| Consumer Credit (Change in Blns. Of Dollars) |            | 20.7         | 22.2         | 6.7             | 4.0            | 15.1            | 3.4             | 22.2           | -4.3       |
| Consumer Prices (%Change Year Ago)           | 4.2        | 3.8          | 3.3          | 2.4             | 2.4            | 2.7             | 2.7             | 4.2            | 2.4        |
| CPI Less Food & Energy (%Change Year Ago)    | 2.9        | 2.8          | 2.6          | 2.5             | 2.5            | 2.6             | 2.6             | 3.1            | 2.5        |
| Wholesale Prices (%Change Year Ago)          | 6.4        | 5.7          | 4.3          | 3.4             | 3.0            | 3.1             | 3.1             | 6.4            | 2.4        |

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