US ECONOMICS ANALYST

# July FOMC Preview: Better Inflation Data, Worse Geopolitical News

**David Mericle**
+1(212)357-2619 |
david.mericle@gs.com
Goldman Sachs & Co. LLC

- The inflation data have improved but the geopolitical news has worsened in recent weeks. We expect the -2bp core CPI print for June to translate to 18bp on core PCE and mark the start of a softer trend. We also expect the BEA's recently announced methodological changes designed in part to fix the mismeasurement of AI effects to shave 0.2pp off of year-over-year inflation. But the re-escalation of the war with Iran and attacks on Russian oil refineries have pushed energy prices higher and revived fears that the already lengthy series of supply shocks could continue.
- We expect the FOMC to leave the fed funds rate unchanged at its July meeting next week. The statement might acknowledge the upside risks to inflation posed by renewed geopolitical conflict, and there will likely be at least one dissent in favor of a hike.
- Market pricing implies that investors see the outcome of the July meeting as unusually uncertain, likely because the FOMC has been split recently, Chairman Warsh's own position remains unclear, and some of the re-escalation with Iran occurred during the blackout period. But most voters appear unlikely to push for a hike next week after the softer June inflation data, the Fed has historically avoided delivering surprise rate hikes, and we suspect that voters might be especially reluctant to do so at a meeting without a Summary of Economic Projections.
- Despite the rebound in oil prices, we continue to think that the combined impact of tariffs, the war, and AI effects on monthly inflation should diminish in the months ahead, leaving core inflation soft enough for the FOMC to stay on hold through the end of the year.
- But comments from FOMC participants indicate that many could support hiking if the inflation news is worse than we expect. As a result, as we noted when the re-escalation with Iran began, we see little margin for error on inflation and suspect that continued conflict could influence the rate hike debate more than the oil passthrough math alone implies by adding to concerns that supply shocks could continue and can come back unpredictably even after they appear over.
- We are skeptical that modest rate hikes would provide much of a disinflationary offset to the impact of supply shocks. We suspect Fed officials would agree, but if the inflation news does not continue to improve as we expect, some might still

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see it as important for the Fed to respond to avoid the public misperception that it accepts high inflation. Many FOMC participants have also expressed concern that prolonged high inflation could unanchor inflation expectations, and while we do not think this has happened yet, some might feel that it can be difficult to know in real time and that it is better to err on the side of acting early.

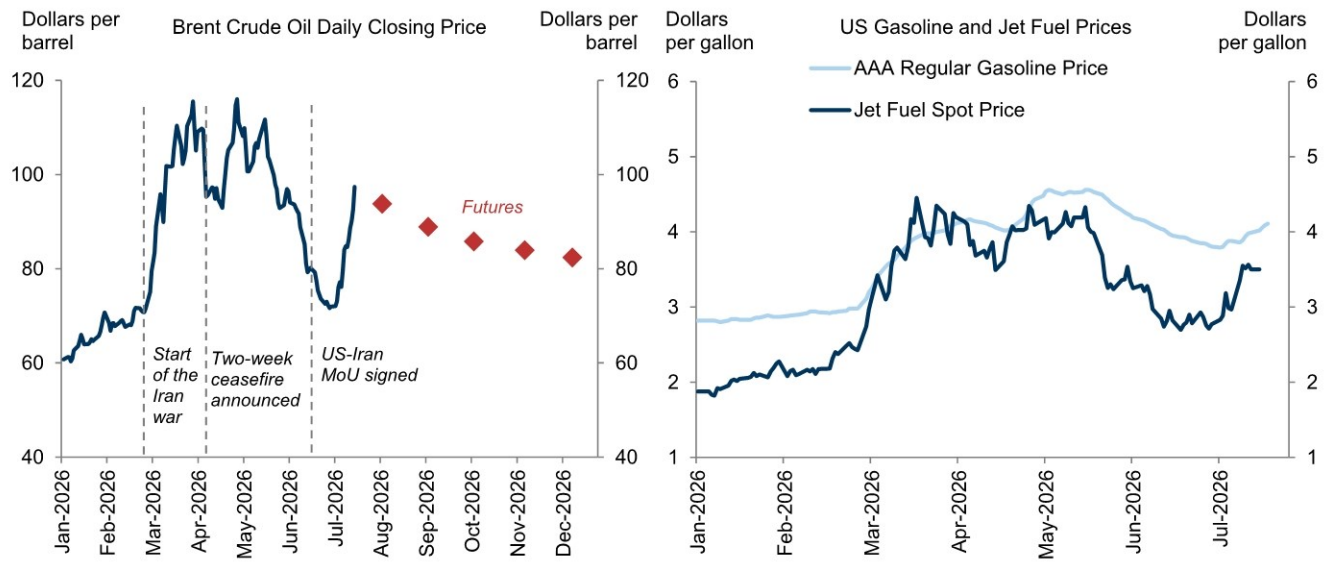
- For these reasons, while our baseline forecast remains that the Fed will remain on hold through year-end, we have raised our probability of eventual rate hikes from 25% to 35%. Even after the change, our probability-weighted Fed forecast remains dovish relative to market pricing.

# July FOMC Preview: Better Inflation Data, Worse Geopolitical News

The inflation data have improved but the geopolitical news has worsened since the FOMC last met in June. We expect the -2bp core CPI print for June to translate to 18bp on core PCE and mark the start of a softer trend for core inflation. We also expect the BEA's recently announced methodological changes designed in part to fix the mismeasurement of AI effects to shave 0.2pp off of year-over-year inflation in the August report released in late September.

But the re-escalation of the war with Iran and attacks on Russian oil refineries have pushed energy prices higher (Exhibit 1) and revived fears that the already lengthy series of supply shocks could continue. The White House also announced new tariffs on Friday, though they will have little impact on the average tariff rate.

**Exhibit 1: Re-escalation of the War with Iran Has Pushed Oil and Refined Product Prices Higher Again**




Source: Goldman Sachs Global Investment Research, Department of Energy, EIA

We expect the FOMC to leave the fed funds rate unchanged at its July meeting next week. President Logan has expressed support for "modestly higher" interest rates and might dissent in favor of a hike, and one or two other voters might as well. The post-meeting statement might acknowledge the upside risks to inflation posed by renewed geopolitical conflict as a nod toward the possibility that the FOMC could hike if the situation worsens.

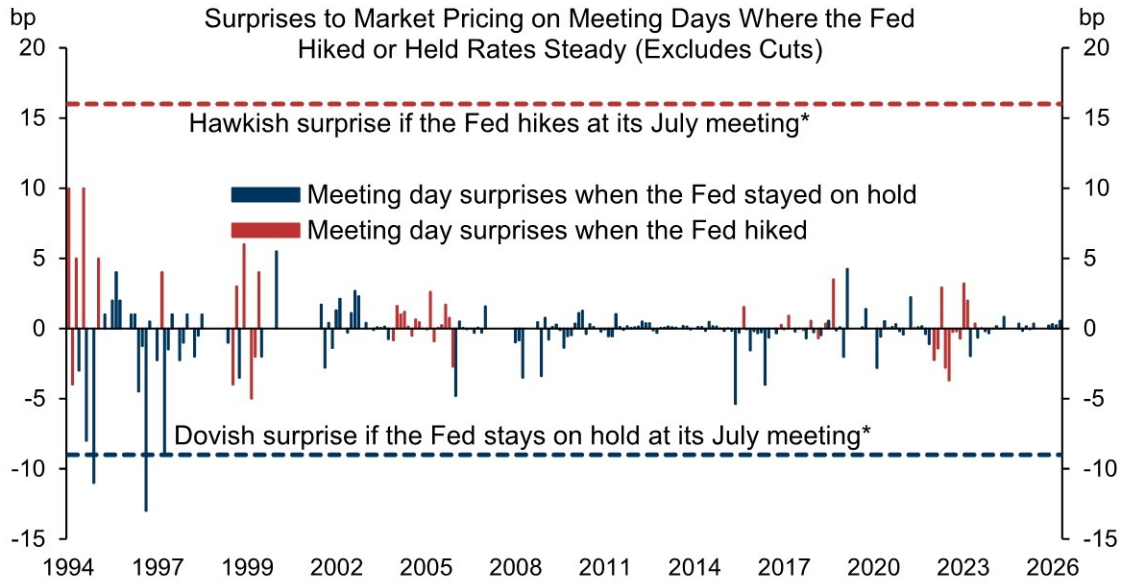
We do not expect Warsh to offer many hints about the policy outlook in his press conference, though he might also acknowledge the upside risks to inflation posed by the latest rise in oil prices. He recently announced the leaders of the five Chairman's Task Forces for Advancing Monetary Policy and might provide an update on the timeline for their work.

Market pricing implies that investors see the outcome of the July meeting as unusually uncertain. If current pricing implying a roughly 40% chance of a hike persists going into the meeting, either outcome would be the largest surprise in a few decades at a meeting where the Fed hiked or held (Exhibit 2), because the Fed has historically avoided

delivering surprise rate hikes at its meetings.

The market uncertainty likely reflects that Chairman Warsh's approach is sufficiently different to raise doubts about whether historical patterns still apply, that his own position on hiking remains unclear, that the FOMC has been split recently, that some of the re-escalation with Iran occurred during the blackout period, and that further escalation is possible before Wednesday. While we agree that the uncertainty is greater than usual, most voters appear unlikely to push for a hike next week after the softer June inflation data, and some might be especially reluctant to deliver a surprise hike at a meeting without a Summary of Economic Projections out of fear that the market might infer more than they intended.

**Exhibit 2: In Recent Decades, the Fed Has Shown a Strong Aversion to Delivering Surprise Rate Hikes**



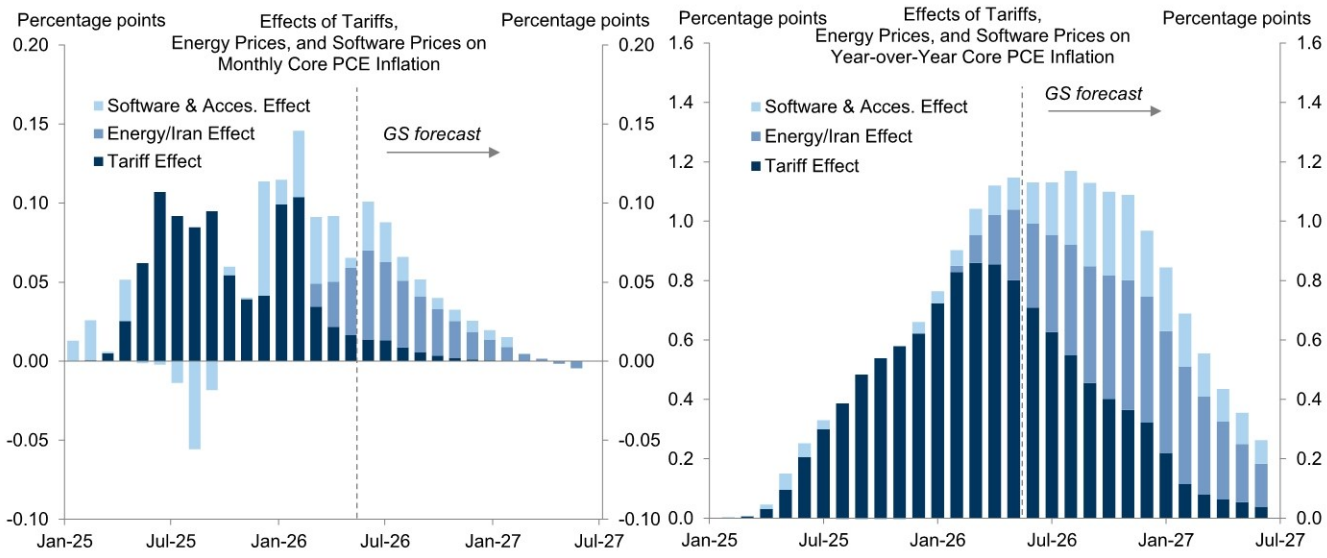

* Assuming that current market pricing remains unchanged before the meeting.

Source: Goldman Sachs Global Investment Research

Despite the rebound in oil prices, we continue to expect the combined impact of tariffs, the war, and AI mismeasurement on monthly inflation to diminish in the months ahead (Exhibit 3). That said, both the effects of the war and the month-to-month impact of the software & accessories category are uncertain. FOMC participants have appeared to take the effects of AI demand on the inflation statistics at face value—in contrast to our view, which is shared by some Fed staff economists and the BEA—and the FOMC's June minutes suggested that any source of further firmness in inflation, including these three factors that a central bank might normally look through, could count as an argument for rate hikes.

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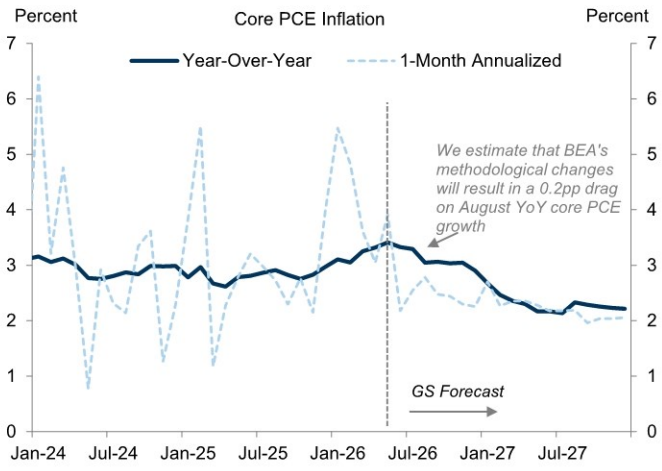
**Exhibit 3: Despite the Rebound in Oil Prices, We Still Think That the Combined Impact of Tariffs, the War, and AI Mismeasurement on Monthly Inflation Should Diminish in the Coming Months**




Source: Goldman Sachs Global Investment Research

Our core PCE inflation forecasts for the rest of the year, starting with 18bp in June, 21bp in July, and 23bp in August (Exhibit 4), should be soft enough for the FOMC to stay on hold through year-end.

**Exhibit 4: We Expect Upcoming Core Inflation Numbers to Be Soft Enough to Keep the Fed on Hold, but the Re-escalation with Iran and the Rebound in Oil Prices Have Further Reduced the Margin for Error**




| Upcoming FOMC Meetings and GS Inflation Forecasts | | | | |
|---|---|---|---|---|
| FOMC Meeting | July | September | October | December |
| Latest Data | June CPI and implied PCE | August CPI and implied PCE | September CPI and implied PCE | October CPI and PCE |
| MoM Core CPI | -0.02% | 0.20% | 0.17% | 0.21% |
| YoY Core CPI | 2.57% | 2.34% | 2.29% | 2.41% |
| MoM Headline CPI | -0.42% | 0.49% | 0.09% | 0.10% |
| YoY Headline CPI | 3.46% | 3.50% | 3.29% | 3.26% |
| MoM Core PCE | 0.18% | 0.23% | 0.20% | 0.20% |
| YoY Core PCE | 3.33% | 3.05% | 3.06% | 3.04% |

Source: Goldman Sachs Global Investment Research

But comments from FOMC participants indicate that many could support hiking if the inflation news is worse than we expect (Exhibit 5). As a result, as we noted two weeks ago when the re-escalation with Iran began, we see little margin for error on inflation and suspect that continued conflict could influence the rate hike debate more than the oil passthrough math alone implies by adding to concerns that supply shocks could continue and can come back unpredictably even after they appear over.

**Exhibit 5: Recent Comments from FOMC Participants Suggest That Many Could Support Hiking If the Inflation News Is Worse Than We Expect**

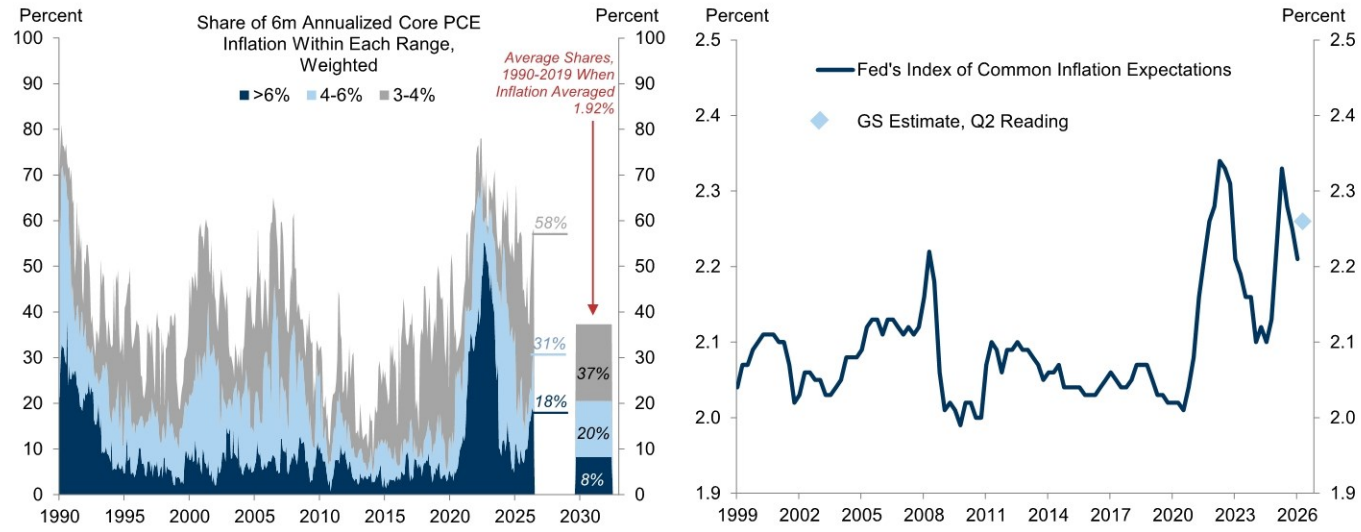
| Date | Speaker | Quote |
|---|---|---|
| July 16 | Jefferson | [The current] policy stance should ... [allow] inflation to resume its decline toward our 2 percent target as the effects of past tariffs and energy prices pass through completely. ... In a scenario where actual inflation does not start to cool down soon, I believe that it could be appropriate to reconsider our current policy stance to ensure we fulfill our commitment to deliver price stability. ... The quick succession of shocks raises the risk that inflation becomes entrenched and inflation expectations become unanchored. |
| July 16 | Logan | Modestly higher interest rates would better balance the outlook and risks for the FOMC's dual mandate goals. |
| July 16 | Schmid | Though this week's inflation data showed an encouraging deceleration, it would be premature to put too much weight on a single data point relative to recent trends. ... With the price of oil once again rising, it is uncertain how persistent any relief on energy will be. |
| July 15 | Cook | If we do not see signs of disinflation soon, I am prepared to act. |
| July 15 | Williams | With inflation running high, it is imperative that we restore it to the Federal Reserve's 2 percent longer-run goal on a sustained basis. The current stance of monetary policy is well positioned to do that. |
| July 14 | Warsh | The FOMC's job is to make sure that any short-term changes in particular prices don't broaden out, don't change to a generalized change in the price level. |
| July 14 | Goolsbee | We need to start having the conversation about whether inflation is going to be more persistent than we want it to be. |
| July 13 | Waller | I will need to see several months of lower readings to feel that inflation is moving in the right direction … I think that is still a reasonable outcome, and I would then continue to hold the policy rate at its current target range. |
| July 8 | June FOMC Minutes | Most participants, however, also pointed to scenarios in which, in the context of stable labor market conditions, inflation would remain elevated due to strong AI-related demand, the conflict in the Middle East, or the effects of tariffs. In such scenarios, almost all of these participants indicated that some policy firming would likely be warranted to return inflation to 2 percent. |
| June 30 | Hammack | Right now, I see no tension in our mandates—inflation is too high and if that continues, it may mean that we need higher interest rates to bring inflation back down to target. |

Source: Goldman Sachs Global Investment Research

We noted last week that evidence from economic research suggests that modest rate hikes would not provide much of a disinflationary offset to the much larger inflationary impact of supply shocks.

We suspect Fed officials would agree, but if the inflation news does not improve as we expect, some might still see it as important for the Fed to respond to avoid the potential public misperception that it accepts high inflation. Many FOMC participants have also expressed concern that prolonged high inflation could eventually broaden out or unanchor inflation expectations. While we do not think either has happened in a dangerous way yet (Exhibit 6), some participants might feel that it can be difficult to know in real time and that it is better to err on the side of acting early.

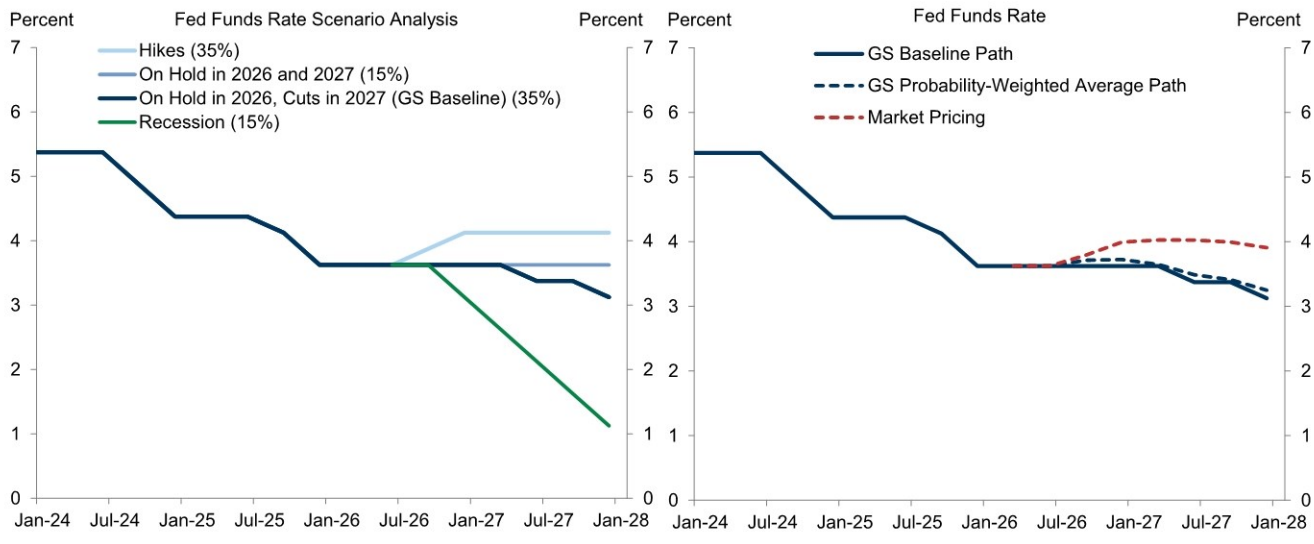
**Exhibit 6: We Do Not Think That High Inflation Has Broadened Out Dangerously or Inflation Expectations Have Become Unanchored, but Fed Officials Will Worry More the Longer the Supply Shocks Last**




Source: Goldman Sachs Global Investment Research

For these reasons, while our baseline forecast remains that the Fed will remain on hold through year-end, we have raised our probability of rate hikes from 25% to 35%. Even after the change, our probability-weighted Fed forecast remains dovish relative to market pricing.

**Exhibit 7: We Have Raised Our Probability of Rate Hikes to 35%, but Both Our Baseline and Probability-Weighted Fed Forecasts Remain More Dovish Than Market Pricing**




Source: Goldman Sachs Global Investment Research

**David Mericle**

# The US Economic and Financial Outlook

(% change on previous period, annualized, except where noted)

| | 2023 | 2024 | 2025 | 2026 | 2027 | 2025 Q4 | 2026 Q1 | 2026 Q2 | 2026 Q3 | 2026 Q4 | 2027 Q1 | 2027 Q2 | 2027 Q3 | 2027 Q4 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **OUTPUT AND SPENDING** | | | | | | | | | | | | | | |
| Real GDP | **2.9** | **2.8** | **2.1** | *2.3* | *2.1* | **0.5** | **2.1** | *2.6* | *2.0* | *2.0* | *2.0* | *2.1* | *2.2* | *2.3* |
| *Real GDP (annual=Q4/Q4, quarterly=yoy)* | **3.4** | **2.4** | **2.0** | *2.2* | *2.1* | **2.0** | **2.7** | *2.4* | *1.8* | *2.2* | *2.2* | *2.0* | *2.1* | *2.1* |
| Consumer Expenditures | **2.6** | **2.9** | **2.6** | *1.8* | *1.9* | **1.9** | **0.5** | *2.3* | *1.5* | *1.5* | *1.9* | *2.0* | *2.1* | *2.2* |
| Residential Fixed Investment | **-7.8** | **3.2** | **-2.2** | *-4.1* | *1.2* | **-1.7** | **-7.8** | *-2.5* | *-1.5* | *1.5* | *2.0* | *2.0* | *2.0* | *2.3* |
| Business Fixed Investment | **7.3** | **2.9** | **4.1** | *6.9* | *5.8* | **2.4** | **10.6** | *8.8* | *7.5* | *6.9* | *4.9* | *4.9* | *4.9* | *4.9* |
| Structures | **16.7** | **1.1** | **-5.3** | *-3.6* | *2.1* | **-6.6** | **-4.7** | *0.7* | *-1.0* | *-0.2* | *3.5* | *3.5* | *3.5* | *3.5* |
| Equipment | **2.9** | **3.5** | **8.3** | *11.0* | *7.2* | **4.3** | **15.8** | *17.1* | *11.0* | *9.5* | *5.0* | *5.0* | *5.0* | *5.0* |
| Intellectual Property Products | **6.2** | **3.5** | **5.6** | *8.5* | *6.2* | **5.4** | **13.8** | *5.0* | *8.2* | *7.8* | *5.5* | *5.5* | *5.5* | *5.5* |
| Federal Government | **3.3** | **3.8** | **-1.2** | *-1.4* | *0.8* | **-16.7** | **9.4** | *-2.0* | *1.0* | *1.0* | *1.0* | *1.0* | *1.0* | *1.0* |
| State & Local Government | **3.6** | **3.8** | **2.5** | *1.4* | *0.9* | **1.5** | **1.6** | *0.8* | *0.5* | *1.0* | *1.0* | *1.0* | *1.0* | *1.0* |
| Net Exports ($bn, '17) | **-925** | **-1,033** | **-1,091** | *-1,081* | *-1,170* | **-969** | **-1,002** | *-1,082* | *-1,109* | *-1,131* | *-1,146* | *-1,162* | *-1,178* | *-1,194* |
| Inventory Investment ($bn, '17) | **47** | **44** | **29** | *39* | *65* | **-16** | **-17** | *46* | *60* | *65* | *65* | *65* | *65* | *65* |
| Nominal GDP | **6.7** | **5.3** | **5.0** | *6.0* | *4.6* | **4.2** | **5.8** | *8.9* | *3.7* | *4.1* | *4.7* | *4.7* | *4.5* | *4.3* |
| Industrial Production, Mfg. | **-1.0** | **-1.0** | **0.8** | *3.3* | *4.0* | **-3.5** | **4.4** | *8.5* | *5.1* | *4.1* | *3.3* | *3.2* | *3.2* | *3.3* |
| **HOUSING MARKET** | | | | | | | | | | | | | | |
| Housing Starts (units, thous) | **1,421** | **1,370** | **1,356** | *1,347* | *1,372* | **1,323** | **1,418** | ***1,299*** | *1,323* | *1,348* | *1,362* | *1,365* | *1,375* | *1,385* |
| New Home Sales (units, thous) | **666** | **684** | **679** | *631* | *649* | **711** | **623** | ***590*** | *649* | *661* | *636* | *642* | *649* | *670* |
| Existing Home Sales (units, thous) | **4,103** | **4,067** | **4,076** | *4,168* | *4,255* | **4,157** | **4,053** | ***4,160*** | *4,226* | *4,234* | *4,243* | *4,251* | *4,260* | *4,268* |
| Case-Shiller Home Prices (%yoy)* | **5.3** | **3.8** | **1.3** | *1.1* | *2.4* | **1.3** | **0.8** | *1.1* | *1.6* | *1.1* | *1.1* | *2.0* | *2.2* | *2.4* |
| **INFLATION (% ch, yr/yr)** | | | | | | | | | | | | | | |
| Consumer Price Index (CPI)** | **3.3** | **2.9** | **2.7** | *3.2* | *2.2* | **2.7** | **2.7** | ***3.8*** | *3.4* | *3.3* | *3.0* | *2.1* | *2.2* | *2.2* |
| Core CPI ** | **3.9** | **3.2** | **2.6** | *2.5* | *2.2* | **2.7** | **2.5** | **2.7** | *2.4* | *2.5* | *2.3* | *2.1* | *2.2* | *2.2* |
| Core PCE** † | **3.1** | **3.0** | **3.0** | *2.9* | *2.2* | **2.9** | **3.1** | *3.4* | *3.1* | *3.0* | *2.5* | *2.2* | *2.3* | *2.2* |
| **LABOR MARKET** | | | | | | | | | | | | | | |
| Unemployment Rate (%)^ | **3.8** | **4.1** | **4.4** | *4.4* | *4.3* | **4.4** | **4.3** | **4.2** | *4.3* | *4.4* | *4.4* | *4.3* | *4.3* | *4.3* |
| U6 Underemployment Rate (%)^ | **7.2** | **7.6** | **8.4** | *8.3* | *8.2* | **8.4** | **8.0** | **7.9** | *8.2* | *8.3* | *8.2* | *8.2* | *8.2* | *8.2* |
| Payrolls (thous, monthly rate) | **210** | **122** | **10** | *67* | *50* | **-39** | **73** | **111** | *40* | *45* | *50* | *50* | *50* | *50* |
| Employment-Population Ratio (%)^ | **60.1** | **59.9** | **59.7** | *59.0* | *59.0* | **59.7** | **59.2** | **59.0** | *59.1* | *59.0* | *59.0* | *59.0* | *59.0* | *59.0* |
| Labor Force Participation Rate (%)^ | **62.5** | **62.5** | **62.4** | *61.7* | *61.6* | **62.4** | **61.9** | **61.5** | *61.8* | *61.7* | *61.7* | *61.7* | *61.7* | *61.6* |
| Average Hourly Earnings (%yoy) | **4.4** | **3.9** | **4.0** | *3.9* | *3.8* | **4.0** | **4.0** | **4.0** | *3.9* | *3.8* | *3.8* | *3.8* | *3.8* | *3.8* |
| **GOVERNMENT FINANCE** | | | | | | | | | | | | | | |
| Federal Budget (FY, $bn) | **-1,694** | **-1,833** | **-1,775** | *-2,100* | *-2,100* | -- | -- | -- | -- | -- | -- | -- | -- | -- |
| **FINANCIAL INDICATORS** | | | | | | | | | | | | | | |
| FF Target Range (Bottom-Top, %)^ | **5.25-5.5** | **4.25-4.5** | **3.5-3.75** | *3.5-3.75* | *3-3.25* | **3.5-3.75** | **3.5-3.75** | **3.5-3.75** | *3.5-3.75* | *3.5-3.75* | *3.5-3.75* | *3.25-3.5* | *3.25-3.5* | *3-3.25* |
| 10-Year Treasury Note^ | **3.88** | **4.58** | **4.18** | *4.40* | *4.25* | **4.18** | **4.30** | **4.44** | *4.45* | *4.40* | *4.35* | *4.30* | *4.25* | *4.25* |
| Euro (€/$)^ | **1.11** | **1.04** | **1.17** | *1.12* | *1.14* | **1.17** | **1.15** | **1.14** | *1.14* | *1.12* | *1.12* | *1.12* | *1.13* | *1.14* |
| Yen ($/¥)^ | **141** | **157** | **157** | *164* | *145* | **157** | **159** | **163** | *162* | *164* | *164* | *165* | *157* | *145* |

* Weighted average of metro-level HPIs for 381 metro cities where the weights are dollar values of housing stock reported in the American Community Survey. Annual numbers are Q4/Q4.
** Annual inflation numbers are December year-on-year values. Quarterly values are Q4/Q4.
† PCE = Personal consumption expenditures. ^ Denotes end of period.
Note: Published figures in bold.

Source: Goldman Sachs Global Investment Research

## The US Economics Team

**Jan Hatzius**
+1(212)902-0394
jan.hatzius@gs.com
Goldman Sachs & Co. LLC

**David Mericle**
+1(212)357-2619
david.mericle@gs.com
Goldman Sachs & Co. LLC

**Alec Phillips**
+1(202)637-3746
alec.phillips@gs.com
Goldman Sachs & Co. LLC

**Ronnie Walker**
+1(917)343-4543
ronnie.walker@gs.com
Goldman Sachs & Co. LLC

**Elsie Peng**
+1(212)357-3137
elsie.peng@gs.com
Goldman Sachs & Co. LLC

**Pierfrancesco Mei**
+1(212)902-8809
pierfrancesco.mei@gs.com
Goldman Sachs & Co. LLC

**Jessica Rindels**
+1(972)368-1516
jessica.rindels@gs.com
Goldman Sachs & Co. LLC

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Unless otherwise stated, the individuals listed on the cover page of this report are analysts in Goldman Sachs' Global Investment Research division.

**Contributing Authors:** David Mericle Goldman Sachs & Co. LLC.

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