A Good Summer for a Hike

Report for the week ending July 18, 2026

Dylan Smith

Key Takeaways

- MONOLOGUE: Inflation is a little cooler and the economy a little warmer, which is precisely the combination that clears the way for the Warsh Fed to hike.
- MACRO: US inflation cooled sharply in June on falling energy prices, but producer prices and margin behavior say the underlying pressure has not gone away, while the Beige Book and retail sales point to an economy that is quietly improving.
- MARKETS: AI-exposed equities took a hit on earnings skepticism while Energy surged on the Iran war, and European sovereign yields led a modest global back-up.
- MEMO: High-frequency data show a labor market that has emerged from its 2025 slowdown, with claims falling, stress indicators benign, and wage growth running hot in cyclical industries.

Monologue

After a rich week of US macroeconomic data and a volatile one in markets, now is a good time to zoom out a little and assess how the macro picture has evolved.

At the margin, our understanding of current inflation dynamics is that price growth is slightly cooler, while activity and the labor market look a little warmer. Both are steps in a positive direction.

Of course, the latest macro data end in June, and do not incorporate the recent rise in the oil price and the re-escalating conflict in the Strait of Hormuz. At the margin, then, the forward-looking picture is a little weaker than before, albeit from a stronger base.

For investors and dealmakers, the most important macro question right now is whether the Warsh Fed really is minded to raise interest rates. Our answer remains "yes," unchanged by this week's data. Inflation may be a little cooler, but it still has not returned to target, and there are upside risks. Meanwhile, the economy looks like it can withstand the 25-50 basis point increase in interest rates that would be necessary to get underlying inflation under control.

That last part is now the most salient part. From everything we've heard from the Fed recently, the mission is to "restore credibility" by prioritizing getting "underlying" inflation to the 2% target sustainably. If that's a given, then the key variable is whether or not higher rates would come at the cost of a material economic slowdown. If the answer is that a slowdown is unlikely, then rates will rise, possibly as early as the end of this month, though more likely in September. We've dedicated this week's Memo to studying the latest high-frequency labor market data to gain more insight.

We can deepen the empirical support for this line of reasoning by checking our arcMacro Factor Framework to assess the aggregate signals across all available macro data (see the appendix for charts).

Our Activity Factor indicates that growth is improving, but remains below trend — consistent with the widely cited commentary that we're in a "2% economy." Our Price Factor showed a strong inflation spike even when viewed relative to 2021/22, but this went into reverse in June (expect a re-acceleration in July). The Financial

Factor has eased further, supporting future growth and inflation.

Putting this all together, our model still assesses the current economic regime as a mild Stagflation episode. But the 12-month-ahead probabilities have shifted meaningfully. The most likely states of the economy in 12 months' time are a Rebound or Overheating regime (70% combined). Both involve above-average growth, the key difference being whether inflation is spiking or stable (currently, the model views stable as more likely).

Weak growth regimes collectively account for only 25% of the probability mass in the model, with the remaining 5% smeared across unlikely scenarios.

Bottom line: If the Fed wants to hike to restore credibility on inflation, now would be a good time to do it.

Dylan Smith

Founder and Chief Economist

Marginal Movers

Rising 👆

- **Insiders:** Trump teleprompter aide made $100,000 betting on what Trump would say, reports say — "The teleprompter operator for one of the world's most powerful people tapping away at his phone *during a Trump speech* to ensure he made more money for himself."
- **AI Bets:** AI Premium — "We show that firms whose returns covary more positively with the AI factor—high AI beta firms—earn higher subsequent returns."

Falling 👇

- **Miracles:** How Might Fiscal Policy Respond to the Rise of Artificial Intelligence? — "Given the uncertainty surrounding AI's economic effects, policies that are robust to different scenarios would be especially valuable."
- **The Fed:** How to shrink the Fed's $7trn balance-sheet — "The trouble is that just as the city was gradually moulded around abundant water, the banking system is now built around abundant reserves."

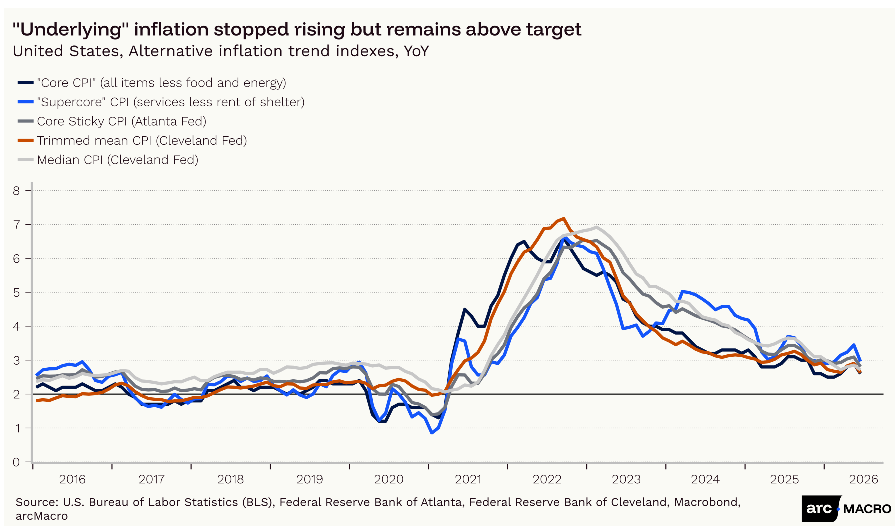
Macro Monitor

US inflation cools — for now

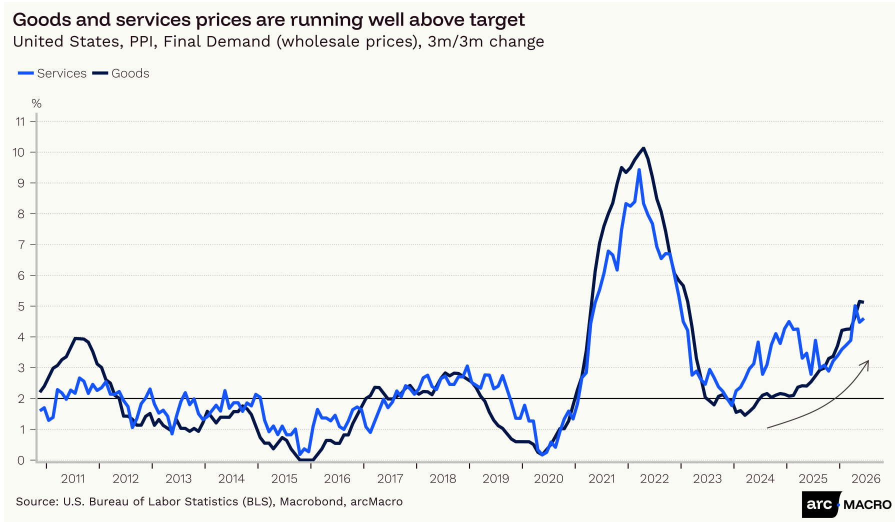
US Consumer Price Index (CPI) inflation slowed to 3.5% year-on-year in June, from 4.2% in May. On a month-on-month basis, prices fell by 0.4%. Lower oil prices were a major driver of this move, but core inflation (CPI excluding food and energy) followed the same pattern, mainly because transport prices fell alongside gas prices.

The recent updraft in "underlying" inflation was partially reversed, but with the main metrics all lying between 2.5% and 3.0%, there is still some distance to the 2% target.

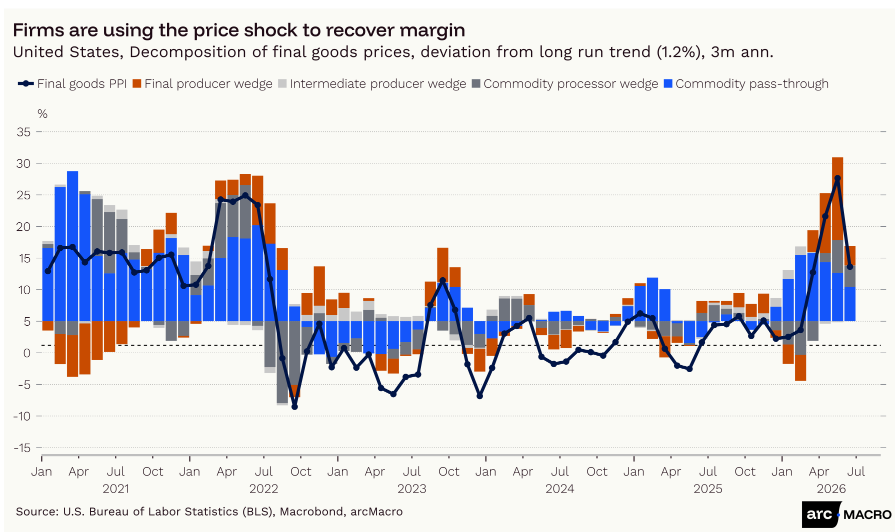
[Underlying chart]



Producer price inflation also cooled, but remains too warm for comfort. On a 3m/3m basis, final goods price inflation was running at 5.1%, and final services price inflation at 4.6% in June. This implies that part of the decline in June inflation was due to retailers accepting lower margins.



Within the supply chain, however, margins are still rising. According to our modeling, more than half of the rise in producer goods prices over the past three months is due to price increases unrelated to higher commodity input prices. Manufacturers are still using higher oil prices as a cover to recoup margin pressure created by higher tariffs.



Some positive growth signals

Ahead of the next interest rate decision on July 29, the Federal Reserve has published the latest Beige Book, its narrative account of the state of the economy based on interviews with its regional networks of business contacts.

For the first time this year, none of the Federal Reserve System's twelve districts were described as contracting, and only one was flat. The rest all improved. Manufacturers reported improving conditions, and the labor market commentary improved from neutral to positive, with the low-hire, low-fire "frozen" labor market environment clearly thawing.

One blot on the report was the consumer, where signs of stress remain. The June retail sales report was therefore encouraging, with the "control group" that feeds directly into GDP growing by 0.5% MoM even though prices fell on aggregate.

Boring Is Good in Canada

The Bank of Canada held its policy rate steady at 2.25%, citing an improving growth outlook and easing inflation pressure (primarily due to lower oil prices amid a backdrop of relatively subdued demand), with businesses reporting "they are finding ways to navigate through the uncertainty" created by annual reviews of the USMCA trade agreement.

Risks appear to have tilted slightly toward the next change being a hike rather than a cut, but there is little urgency either way.

See the appendix for arcMacro proprietary Factors and the Key Macroeconomic Indicators tracking chart.

Market Monitor

Public markets

The divergence between AI-driven stocks and the broader business cycle was on full display in equity markets this week. A bout of skepticism over the ability of AI-exposed names to hit their soaring earnings targets led to a 3.8% drop in the Information Technology sector and a 2.4% fall in Communication Services. There were pockets of strong performance among more economically sensitive sectors, notably Financials (+1.0%), Consumer Staples (+1.4%), and Real Estate (+2.3%), but the star performer was Energy, which rose by 5.0% as the Iran War continues to heat up.

In sovereign fixed income, European bonds were the biggest movers — yields on German bunds and UK gilts both ticked up by 6 basis points. Front-end US yields fell modestly (the two-year Treasury note yield down by 3 basis points) as softer-than-expected inflation data were partially offset by healthy growth signals and the $11.1 per barrel (15.5%) increase in the WTI crude benchmark oil price. Agricultural commodities were up by 1.2%.

See the appendix for the market monitor table

Memo

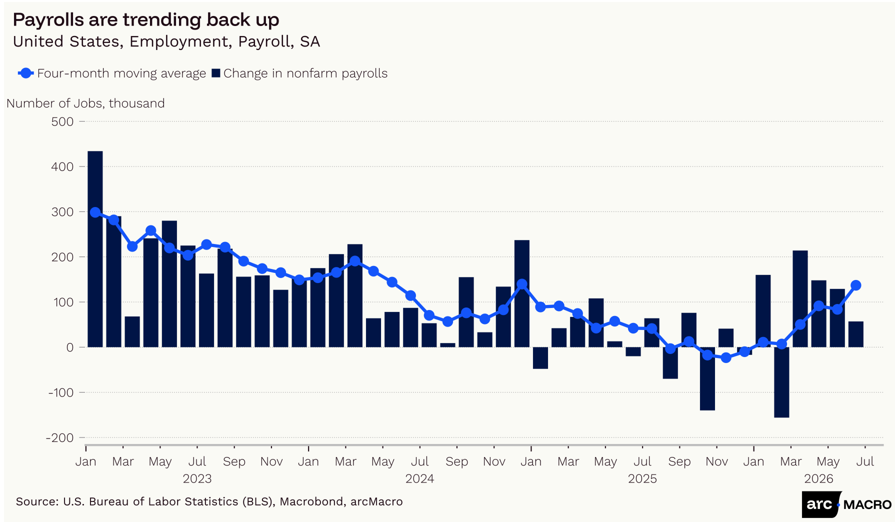
The Routes of Our Labor

Bottom line: *After a long detour, the labor market is back on track, with high-frequency indicators pointing to improving employment and wage growth signaling tightness in cyclically sensitive industries.*

What it means for investors: *The labor market is not an obstacle to interest rate hikes in the near future.*

The June employment report had something for everyone. Those who tend to view semi-loaded glasses as half full could point to a fourth consecutive month of positive job growth, the first such streak since 2024. Those who focus on the aerated half-empty component of the glass have pointed out that employment appears to have lost some momentum and that healthcare and social assistance are driving a significant portion of the gains.

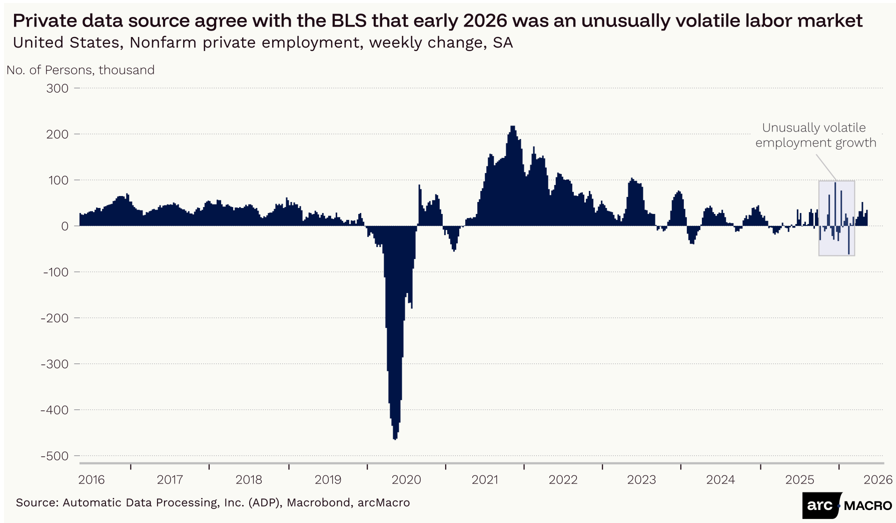
Which perspective you take is important, because the state of the labor market determines how well the real economy can tolerate the higher interest rates that would be needed to tame still-elevated core ("underlying") inflation, and, in turn, the outlook for all major asset classes.



Focusing too much on June might be a mistake. The interesting part of the nonfarm payrolls chart above is the period between May 2025 and March 2026, when monthly employment figures fluctuated wildly between growth and contraction. Gauging the underlying trend became very difficult. The question now is whether we've emerged from this fuzzy slowdown phase into a more stable or even improving labor market.

And in case you're wondering, this is not a statistical quirk in the official data from an underfunded and understaffed federal agency. Weekly data from ADP shows that this period of volatility was there at a weekly frequency, too. Looking back at their data history, these swings in job growth are a historical anomaly.

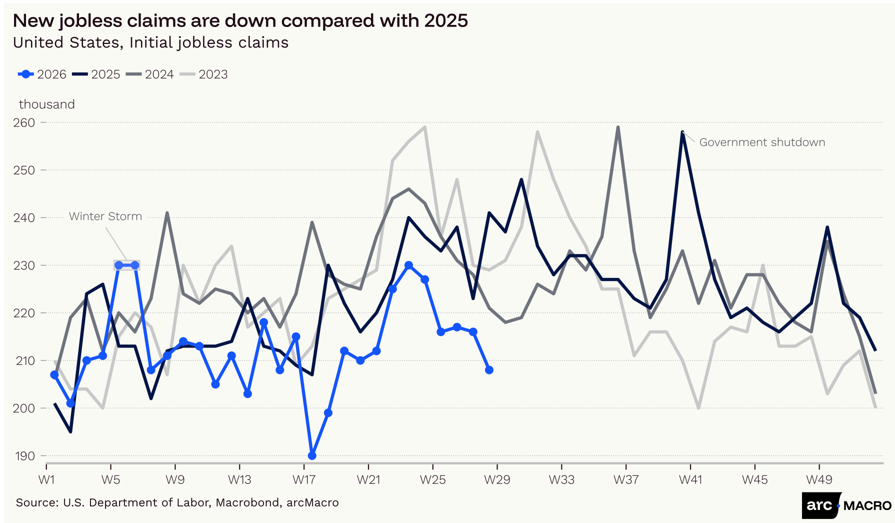
It's clear we've been in an unusual economy, and we would not discount the role of AI-based churn, especially in new business formation, as one reason for the volatility. That said, we can take some comfort from the fact that we appear to have established a more normal pattern as of June.

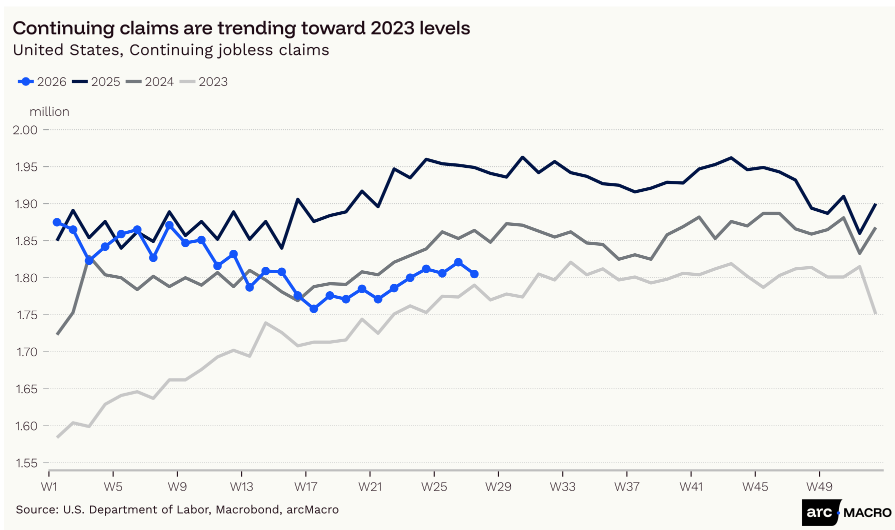


To gain insight into whether we've emerged from this period of uncertainty, we can turn to high-frequency (weekly) employment data.

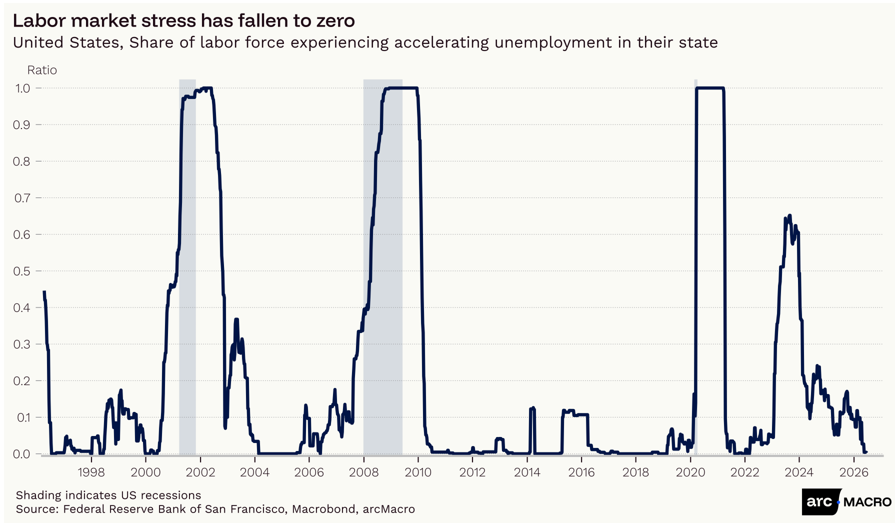
These higher-frequency indicators are generally positive — the ADP numbers above suggest we're at a pace of weekly job growth similar to that of 2024. No data are more positive than unemployment insurance claims. Initial claims (those filing for the first time after becoming unemployed) are running well below the rate in 2025 or 2024, and are approaching 2023 levels. The same goes for the stock of unemployed people drawing benefits each week.

Detractors say that this, in part, reflects a shift to gig jobs instead of government support for people between jobs. But those gig jobs existed in 2025 and 2024. Even if it's a different form of employment, and likely a temporary one, driving an Uber is a job, and one that is more socially productive than drawing a check from Uncle Sam. In any case, the scope of the improvement in the claims data makes it hard to argue the jobs market is about to collapse.





The Federal Reserve Bank of San Francisco takes the claims analysis one step further, using state-level data to construct a "stress indicator." The labor market is stress-free on both the state and national levels.

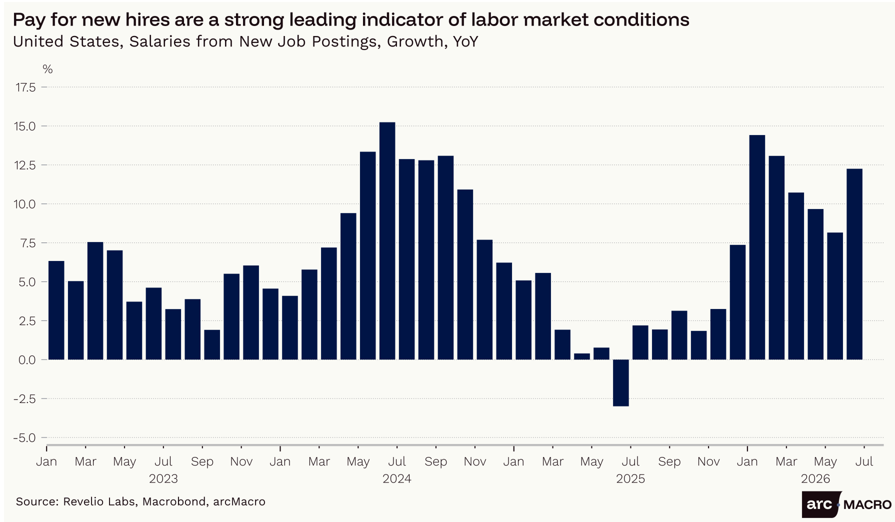


The labor market is about more than employment levels. Wages are the link between employment and inflation, which together drive policy rates. At the headline level, wages have indeed been soft; on a three-month annualized basis, wages for nonsupervisory employees (more cyclically informative) have risen by only 3.3%. That's paltry enough to have eroded real income during the peak of the oil price spikes.

However, this aggregate view distorts critical cyclical dynamics. The drag is coming from the pseudo-public Education and Healthcare industries, where three-month annualized wage growth is just 0.8%. Retail trade (1.6%) and non-durable goods manufacturing (like food processing, 0.7%) also have subdued wage growth.

Meanwhile, in industries in which employment and income dynamics are cyclical, we're seeing scorching hot wage growth: 11.4% in the information industry, 7.1% in utilities, and 5.8% in durable goods manufacturing.

An even stronger signal on the health of the labor market comes from the growth in salaries that firms are posting in job ads to entice new hires. This accelerated in June, growing at a rate of 12.5% YoY. The improvement in this metric mirrors the labor market stabilization we've seen in the past two quarters.



In all, our real-time read on the labor market is that it has emerged from a tariff-induced slowdown in late 2025, and is now improving on aggregate and approaching a state of tightness in key cyclical pockets with high exposure to AI investment.

That's a healthy enough state for the Fed to raise rates without worrying about causing a recession.

Appendix

Proprietary Factor and Regime Model and Key Indicators

The Week in Markets

	Latest*	Change since last week (units)	Change since last week (%)	3-month change (units)	3-month change (%)	Year-to-date change (units)	Year-to-date change (%)
US Equities							
S&P 500	7458	-118	-1.6	416	5.9	612	8.9
Information Technology			-3.8		11.5		15.0
Financials			1.0		8.1		2.7
Consumer Discretionary			-1.3		-1.7		-2.0
Communication Services			-2.4		-3.0		2.1
Health Care			0.1		9.9		4.0
Industrials			-1.4		5.3		15.7
Consumer Staples			1.4		2.7		9.1
Energy			5.0		1.5		28.2
Utilities			-0.5		-2.6		5.7
Real Estate			2.3		3.7		13.4
Materials			-1.4		-3.3		9.7
Nasdaq Composite			-2.9		5.9		9.8
Dow Jones Industrial Average			-0.9		7.3		8.5
Russell 2000			-0.5		8.9		19.4
Global Equities							
DM: MSCI World index			-1.6		4.7		10.4
EM: MSCI EM Index			-4.1		1.9		16.9
CAN: TSX Composite			-0.1		3.6		11.2
EUR: STOXX 600			0.1		4.0		8.3
HK: Hang Seng			1.6		-6.9		-4.2
JPN: TOPIX			-2.9		2.7		15.0
UK: FTSE 100			1.0		0.1		6.7
Sovereign Fixed Income							
US: 2-year Treasury	4.18	-0.03		0.4		0.71	
US: 5-year Treasury	4.28	-0.02		0.37		0.55	
US: 10-year Treasury	4.55	-0.01		0.23		0.37	
CAN: 2-year GoC	2.83	0.010		0.040		0.25	
CAN: 10-year GoC	3.53	0.02		0.060		0.11	
UK: 10-year Gilt	5.02	0.060		0.14		0.48	
GER: 10-year Bund	3.13	0.06		0.1		0.28	
CHN: 10-year CGB	1.74	0.00		-0.0408		-0.107	
JPN: 10-year JGB	2.71	-0.15		0.31		0.65	
Corporate Bond Spreads							
US: A-rated	68.2	1.0		-3.8		-1.6	
US: BBB-rated	98.9	-0.2		-7.5		-5.6	
Foreign Exchange Rates							
DXY US Dollar Index	101		-0.2		2.6		2.5
EUR/USD	1.15		0.3		-2.7		-2.4
USD/CAD	1.4		-0.7		2.2		2.5
USD/CNY	6.77		-0.2		-0.7		-3.2
USD/JPY	162		0.0		2.1		3.7
GBP/USD	1.35		0.5		-0.3		0.4
USD/CHF	0.807		0.1		3.4		1.8
Commodities							
WTI Crude	82.5	11.1	15.5	-12.2	-12.9	25.1	43.7
Gold	3995	-104	-2.5	-798	-16.7	-372	-8.5
S&P GSCI Commodities			6.1		-5.2		22.9
S&P GSCI Industrial Metals			0.2		-4.6		6.5
S&P GSCI Agriculture			1.2		3.8		5.5

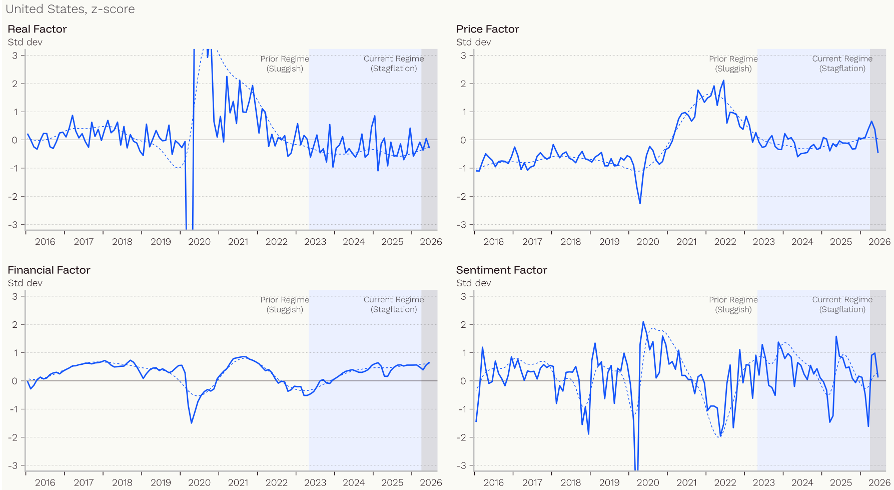
* Weekly closing value. Color indicates positive (green) or negative (red) change since prior week.

Source: S&P Global, Russell Investment Group, Nasdaq, U.S. Department of Treasury, Macrobond Financial AB, Central Bank of Germany (Deutsche Bundesbank), Bank of Canada, Intercontinental Exchange (ICE), International Monetary Fund (IMF), CME Group, LBMA (London Bullion Market Association), Robert Shiller, Chicago Board Options Exchange (CBOE), U.S. Department of Labor, U.S. Bureau of Labor Statistics (BLS), Federal Reserve Bank of Atlanta, Citi, Federal Reserve Bank of St. Louis, Energy Information Administration (EIA), MSCI, STOXX, Tokyo Stock Exchange, Toronto Stock Exchange, FTSE Russell, Hang Seng Indexes Company, Pitchbook | LCD, arcMacro

arc MACRO

arcMacro Real Time Factors

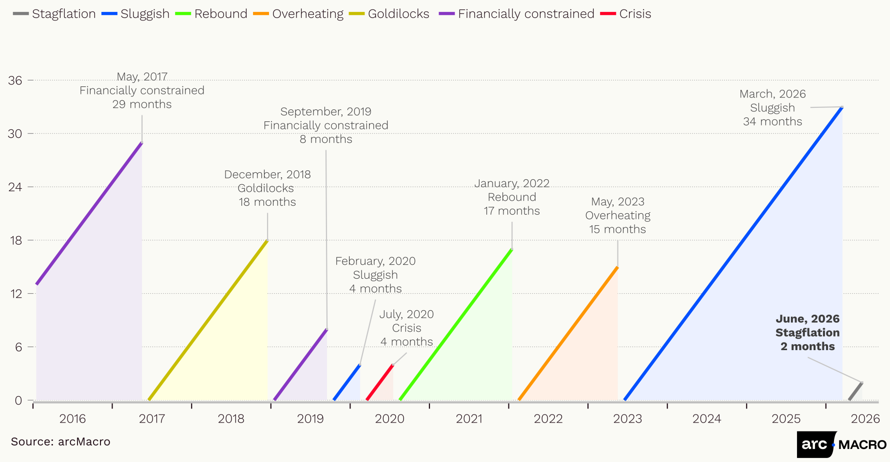
United States, z-score



Source: arcMacro

arcMacro Regime Summary

United States, Cumulative Months in Regime

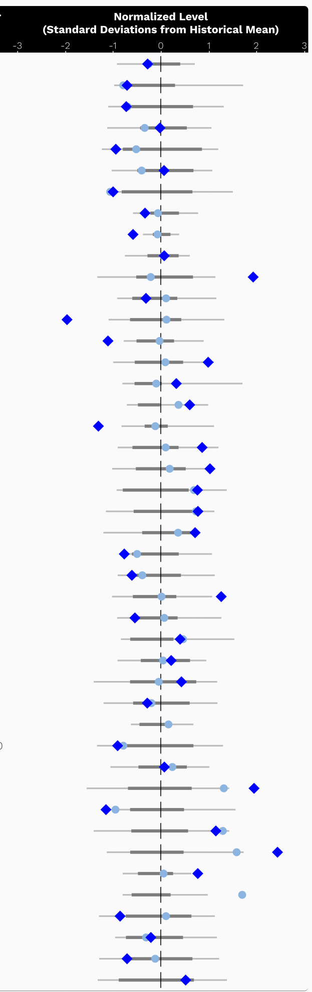


Source: arcMacro

arcMacro Factor Input Monitor

Top 10 inputs by factor loading

Indicator	Unit	Latest*	Three months prior	One year prior
arcMacro Real Factor	**Standard deviations**	**-0.3**	**-0.1**	**-0.1**
Underemployment (U-6)	%	7.9	8.0	7.7
Capacity Utilization	%	78	75.5	76.2
Industrial Production (IP)	%, YoY	1.6	0.8	0.1
Employment-to-Population Ratio	%	59.0	59.2	59.7
Dallas Fed Services Index	%, YoY	2.9	-13.3	-6.3
Unemployment Rate	%	4.2	4.3	4.1
Transportation Services Index	%, YoY	-0.2	1.3	0.0
Employment	Thousands, MoM	-507.0	-64.0	83.0
Construction Employment	Thousands, MoM	11.0	15.0	-2.0
Philadelphia Fed Manufacturing Index	%, YoY	41.4	26.7	11.4
arcMacro Price Factor	**Standard deviations**	**-0.3**	**0.7**	**0.2**
Trimmed CPI	%, MoM, SA	0.0	0.2	0.3
"Sticky" CPI	%, MoM, SA	0.1	0.2	0.3
PCE	%, MoM, SA	0.4	0.4	0.2
Inflation Expecations (NY Fed)	%, Annual	3.7	3.4	3.0
Inflation Expecations (U-Mich)	%, Annual	4.2	4.7	4.5
Core CPI	%, MoM, SA	0.0	0.2	0.2
Services PCE	%, MoM, SA	0.5	0.2	0.2
Market-based PCE	%, MoM, SA	0.4	0.4	0.1
Richmond Fed Services Price Index	%, Annual	5.6	4.8	5.2
5 Year Break-Even Inflation Rate	%, Annual	2.4	2.6	2.3
arcMacro Financial Factor	**Standard deviations**	**0.7**	**0.5**	**0.4**
Financial Stress Index (KC Fed)	Index (>0: higher stress)	-0.8	-0.6	-0.6
Financial Stress Index (OFR)	Index (>0: higher stress)	-2.5	-0.8	-1.5
Gold Volatility Index	%	27.4	35.9	19.1
Bank Lending Standards	% (>0: net tightening)	-6.3	-8.5	-3.7
Anxious Index (SPF)	% (Probablity of recession)	25.1	20.9	36.1
Dividend growth	%, YoY	7.9	8.4	6.2
Bank Loan Demand	% (>0: net increase)	6.3	12.0	-2.5
Household Debt-to-Income Ratio	Ratio	8.6	8.6	8.9
IPO Underwriting Activity	US$ Billions	98.1	3.1	4.3
Household Debt Growth	%, QoQ, Annualized	2595966.0	3092884.0	2060881.0
arcMacro Sentiment Factor	**Standard deviations**	**0.1**	**-1.7**	**0.9**
Cyclically-Adjusted PE Ratio (S&P 500)	Ratio	41.4	38.1	37.5
Dividend Yield (S&P 500)	Ratio	1.2	1.2	1.2
12-month Forward PE Ratio (S&P 500)	Ratio	20.1	19.9	21.9
Price/Book Ratio (S&P 500)	Ratio	5.3	5.0	4.9
Crude Oil Volatility Index	%	55.5	99.8	50.4
Economic Policy Uncertainty Index	Index	332.8	391.1	379.4
MOVE Index	Index	70.6	89.4	92.8
VIX	%	17.9	25.6	18.4
Bull-Bear Spread (AAII)	% (>0: net bullish)	-4.6	-14.8	-1.4
Equity Risk Premium (NYU Stern)	%	1.1	1.1	1.2



10th-90th Percentile · 25th to 75th Percentile · Mean of past 5 years · Latest Value

Source: arcMacro, BLS, Fed, Dallas Fed, DOT, Philadelphia Fed, Cleveland Fed, Atlanta Fed, BEA, New York Fed, University of Michigan, Richmond Fed, Macrobond, Kansas City Fed, The Office of Financial Research (OFR), CBOE, S&P Global, SIFMA, Robert Shiller, Economic Policy Uncertainty, ICE BofAML, LJKmfa, AAII
*Most recent published data point. Time period and frequency do not necesarily align.

Disclosures

AI Declaration

All written content, analysis, and opinions are original and ascribed to the author. AI tools were used for proofreading and summarization purposes only. AI tools may also have been used in the development (codebase) of the analytical models reported in this document.

Disclaimer

This publication is for informational and educational purposes only and does not constitute financial or investment advice. Nothing in this report should be construed as a recommendation to buy, sell, or hold any security or financial instrument. Always consult a qualified financial advisor before making investment decisions.
