ECONOMIC RESEARCH · AUGUST 2026

The Case for Lower Interest Rates

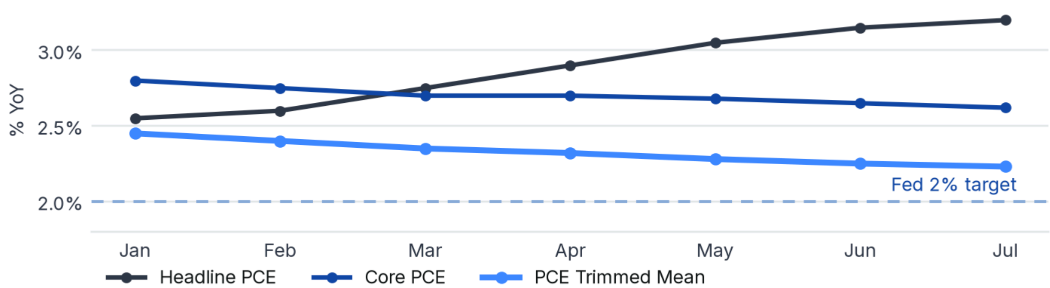
The balance of risks is shifting from inflation toward growth and employment, while monetary policy remains restrictive.

Executive summary The Federal Reserve should begin a **gradual, data-dependent rate reduction cycle**. Inflation remains above 2%, but a meaningful share of the recent increase is supply-driven, particularly energy. Trimmed-mean and real-time measures put underlying inflation much closer to target. Meanwhile the labor market is cooling through weaker hiring, consumer buffers are eroding, and policy is clearly restrictive in the sectors most exposed to rates. A measured cut would be a **recalibration of restraint, not a shift to stimulus**.

01 Inflation: Above target, but direction of travel matters

Headline PCE has re-accelerated on Middle-East–driven crude and gasoline prices with a **$10 rise in crude adding ~15–20bps to headline CPI**. Core PCE is drifting lower, and the **PCE trimmed mean is ~2.23%**, close to the Fed's 2% target. Truflation's real-time index shows underlying inflation moderating faster than official prints. Holding the nominal rate constant as inflation falls mechanically raises the *real* policy rate. This restraint tightens monetary policy without a hike.

Trimmed-mean inflation is already near the Fed's 2% target



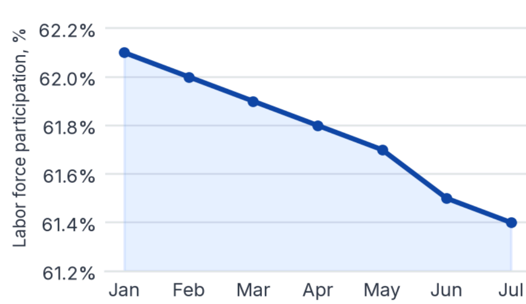
Source: Truflation analysis, BEA (illustrative 2026 path)

02 Labor Market: Cooling through weaker hiring

The labor market is best described as **"low-hire, low-fire"**. Payrolls fell 23k in July after a revised 57k in June; job openings are down from ~12m to ~7.4m, hires from ~7m to ~5.3m. Unemployment at 4.1% flatters the picture whereas participation has dropped 0.7pp YTD (~1.4m out of the workforce). Adjusted for January participation, the rate would be **~4.8% today**. Waiting for layoffs to accelerate risks moving too late.

Payroll growth stalled

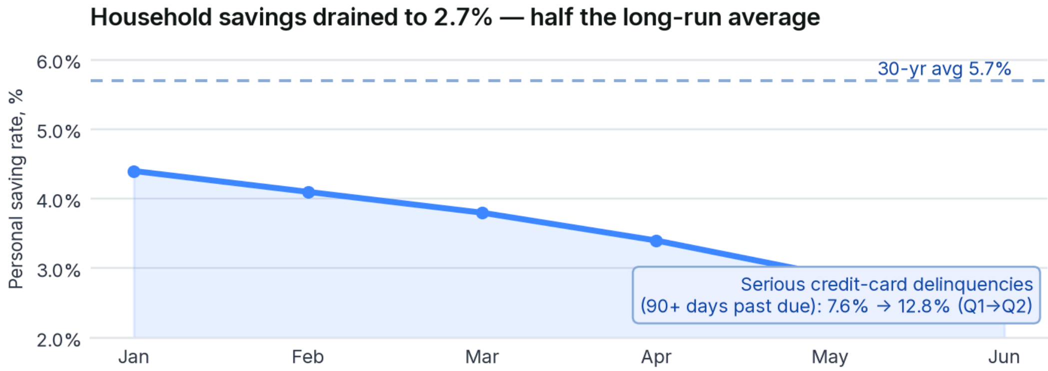
Participation fell 0.7pp YTD



Source: BLS; Truflation Nonfarm Employment

03 Domestic Demand: Resilient, but fraying

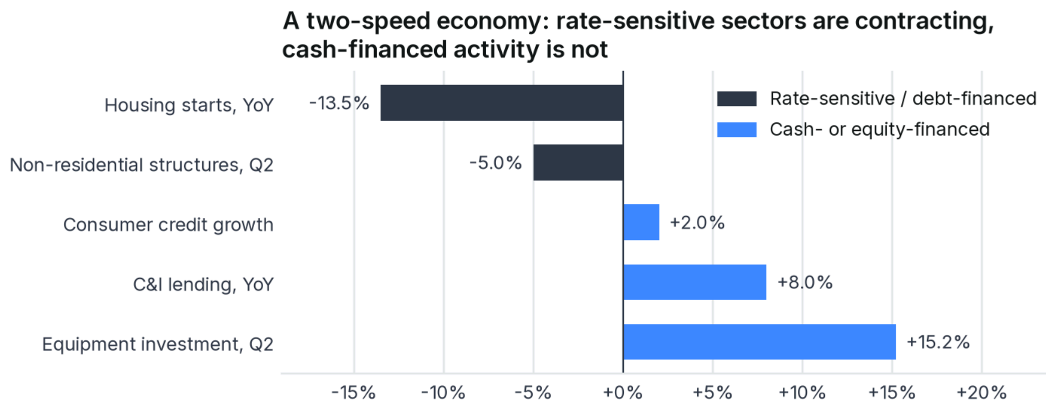
Real Final Sales to Private Domestic Purchasers rose 3.9% annualised in Q2. The underlying economy is not weak. But recent data are less encouraging: retail sales **−0.6% in July** (first monthly decline in nine months), the personal saving rate down to **2.7% against a 30-year average of 5.7%**, credit-card balances near record highs (~$1.26tn), and serious delinquencies climbing from 7.6% to 12.8% quarter-on-quarter. Consumption has been financed by *less saving and more borrowing*, a mechanism with clear limits.



Source: BEA; NY Fed Household Debt & Credit Report

04 Policy Restrictiveness: Restrictive, but unevenly transmitted

Housing is under clear pressure: mortgage rates 6.6–6.8%, starts **−13.5% YoY**, existing home sales ~4m annualised, first-time buyer affordability ~70 against a 100 baseline. Non-residential structures fell ~5% in Q2. Meanwhile C&I lending is +8% YoY, high-yield spreads ~271bps, equipment investment +15.2%, and AI-related capex exceptionally strong. The transmission mechanism is working *selectively, not systemically*.



Source: Census, BEA, Federal Reserve H.8

05 Conclusion: Recalibration, not stimulus

The case does not depend on declaring victory over inflation or diagnosing a recession. It depends on recognising that the **balance of risks has changed**: inflation risk is smaller and more supply-driven; employment risk is rising; the consumer is more fragile; and real restraint is quietly increasing as inflation falls. A gradual reduction lets the Fed keep policy restrictive at a lower nominal rate while cutting the risk of unnecessary damage to jobs and growth.

Note on charts: monthly paths for inflation and labor force participation are illustrative traces consistent with the levels cited in this brief, not exact published BEA/BLS series. Sources: BEA, BLS, Census Bureau, Federal Reserve H.8, NY Fed Household Debt & Credit Report, Truflation.