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# Energy Drives Inflation, But It Can Be Contained

BY KONRAD PUTZIER

Six months into President Trump's Iran war, rising oil and gasoline prices are driving up inflation. Diesel on Friday topped $6 a gallon for the first time on record, and gasoline prices remain near the highest levels since 2022.

At the same time, beyond the gas pump and airline terminal, there are few signs these soaring fuel costs are filtering into the broader economy, raising prices for products such as food and clothing.

For most Americans, oilfueled inflation shows up most quickly in their gas tanks. Gasoline prices took off quickly after the U.S. and Israel attacked Iran at the end of February, reached a national average of about $4.30 Friday and are up 44% since the war began, accord-ing to AAA.

Meanwhile, airfares were up 23.4% in August from a year earlier. Federal data show Americans are increasingly willing to spend big on trips, making it easier for airlines to pass higher jet fuel costs on to travelers. And that may not change soon as high stock prices continue to fatten travel budgets.

"The boomers who are traveling and eating out won't cut demand just because the fed funds rate rose by 25 basis points," LPL Financial chief economist Jeffrey Roach wrote in a note Friday.

The big question is whether fuel prices will eventually start increasing prices for other goods and services.

While diesel cars are rare, the fuel is vital behind the scenes and especially expensive. Diesel prices are up more than 60% since late February, outpacing regular gasoline, and recently hit the highest level on record.

The fuel powers farmers' tractors and combines, and the rising price has made it more expensive to transport produce to supermarkets. Perishable goods such as seafood and dairy are particularly vulnerable because refrigerated transport is more fuel-intensive, said David Ortega, an economist at Michigan State University.

The good news for inflation- weary consumers is that the toll has been limited thus far. Core prices excluding food and energy were up 2.4% in August from a year ago, matching analysts' expectations and slightly cooler than July's yearly increase, the Labor Department reported Friday.

Food prices are a bit higher, up 2.7% in the year ending in August, but economists say they aren't seeing signs energy prices are having much impact on food.

The effect of higher energy prices had a very small impact on core inflation in the second quarter, said Grace Zwemmer of Oxford Economics. She estimates the impact will grow in the third quarter, but remain muted. While core inflation excludes the direct cost of energy, oil and gas prices still influence it.

Businesses are often reluctant to pass on higher energy bills to their customers, according to economist Sung Won Sohn. Many firms hedge against rising fuel prices, and oil prices cooled over the summer before their most recent spike. Crude oil hovered around $100 a barrel on Friday afternoon, up about 45% from early July.

If businesses no longer think that their fuel bills will come back down soon, they become more likely to raise prices. Consumers expecting prolonged inflation often rush into purchases, which puts even more upward pressure on prices.

"Energy inflation does not stay at the gas station," Sohn wrote in a note to clients Friday. "It travels by truck, airplane and cargo ship into nearly every store in America."

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*Investors stopped treating September as a question about one meeting.*



# Fed's Tough Call: Is One Hike Enough?

## Warsh's aversion to signaling the path leaves few tools to manage expectation

BY NICK TIMIRAOS

Investors have all but concluded the Federal Reserve will raise interest rates next week for the first time in three years. The harder question is what comes after that.

Because almost no one at the central bank thinks a quarter- point increase will do much on its own to bring inflation down, a decision to raise rates next week would reflect a judgment that interest rates have been in the wrong place. If that is the case, one increase won't fix it.

The Fed rarely moves until officials are convinced one move won't be enough. "If we get a hike next week, certainly we'll get additional ones," said Richard Clarida, a former Fed vice chair who is at Pimco.

Note

Since the Fed identified the federal-funds rate as its primary tool for shaping borrowing costs in the 1990s, the U.S. central bank has only once raised rates in a one-and-done fashion, in 1997. A likely move next week, Clarida predicted, "is certainly not one and done."

Fed Chairman Kevin Warsh gave investors reason to think the same when he said in July he doesn't put much stock in the Fed's ability to steer the economy with small adjustments. "I don't think we're great in the fine-tuning business," he said. A chairman skeptical of fine-tuning is an unlikely candidate to raise rates a quarter point and declare the job done, analysts said Friday.

Fed governor Christopher Waller made the same point last week while outlining scenarios under which the Fed could afford to wait: Raising rates by a quarter point at one single meeting versus another isn't going to bring inflation down to 2%.

"Once you make the decision to tighten, you're going to move up enough that you feel like you've changed the level of restriction in a meaningful way," said Kurt Lewis, a former senior Fed adviser who is a strategist at Piper Sandler.

### Firmer than expected

Waller's conditional case last week for holding rates steady, as officials did in July, rested on the Fed's forecast. Officials projected in June that monthly inflation would slow in the second half of the year as tariff effects rolled off, and June and July validated it. Friday's report went the other way: A key measure of underlying consumer prices was firmer than expected in Au--gust. It followed better news on hiring and renewed rises in oil prices from tensions in the Persian Gulf.

The decision between raising rates or holding steady "has been a close call for a long time," said Lewis. Friday's report "was the straw that broke the camel's back."

As a result, investors this week stopped treating September as a question about one meeting. Expectations for cumulative rate increases through next June rose to at least three, up from two. Before this week, swings in interest- rate markets had moved the timing of increases while leaving the endpoint alone.

Warsh laid the groundwork to argue that rates were in the wrong place during a speech in Wyoming last month. He said he saw little evidence that borrowing conditions were restraining the economy and that the better inflation readings in June and July hadn't convinced him the underlying trend was improving.

A move justified on those grounds invites the obvious follow-up: how much higher? Fed chairs have long dealt with this by explaining what a move is for—a recalibration, an insurance policy, a risk-management adjustment—without necessarily promising what comes next. Warsh has been reluctant to explain how the Fed arrives at its decisions and has argued for years that guidance ties the central bank's hands.

Without an explanation, a quarter-point increase can turn into something larger in the market's hands. "If you haven't socialized it, that raises the risk that your policy action will be extrapolated and therefore overdone," said Vincent Reinhart, chief economist at BNY Investments and a former director of the Fed's monetary affairs division.

Markets assume a first move means more are coming, he said, and they price in too many. Without guidance, "you can't tamp it down," Reinhart said.

The Fed has one instrument that could help to shape expectations next week. Four times a year, officials submit projections for growth, unemployment, inflation and where they expect interest rates to go. The anonymized forecasts, which Warsh declined to participate in during his first meeting in June, could show how many increases the committee has in mind.

"There will be more than the usual signal" in the projections, said Dean Maki, chief economist at hedge fund Point72 Asset Management.

Warsh could go further and put a limit on expectations himself. If he said, for example, the increase was taking back some of last year's cuts, Maki said, investors would read it as two or three at most. "But it would cut against his notion that the Fed's job isn't to provide forward guidance of that type," he said.

**Boxed-in Fed**

Reinhart said he is concerned that markets are boxing the Fed into a rate hike it may not yet need to deliver. Investors have overreacted to energy- driven swings in inflation, in his view, and the slow-moving part of inflation has been coming down gradually, obscured by high-frequency moves in energy prices.

A rate increase could help settle longer-term yields, which have risen in recent weeks, said Ed Al-Hussainy, a fixed-income portfolio manager at Columbia Threadneedle Investments. Holding rates steady could make that selloff more disorderly if investors thought the Fed would tolerate higher inflation.

San Francisco Fed President Mary Daly has framed the Fed's choice as between two economies. In one, the shocks of the past two years roll through and the Fed's current setting is sufficient to bring inflation down. In the other, the shocks compound, inflation broadens, and the Fed needs a much larger adjustment than a quarter point. In early August, scenario one remained her base case, but the two have moved closer together in probability, she said.

Daly said the second scenario could require more than quarter-point adjustments and a departure from the gradualism that the Fed has used to feel its way through an uncertain economy.

Officials who have been eager to move have made the opposite argument from the same premise. "Earlier, gradual, incremental interest-rate increases are preferable, less disruptive, less costly than potentially later more abrupt interest-rate changes," said St. Louis Fed President Alberto Musalem, who supported a July rate rise, in a speech last month.

Their case rests on what's ahead: high diesel prices driven by President Trump's Iran war that have yet to filter through shipping networks, new rounds of tariffs, an AI build-out and lofty stock prices supporting consumer spending.

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# Sturdy Inflation Nudges Fed Closer to Rate Hike

BY JUSTIN LAHART AND MATT GROSSMAN

The annual inflation rate stayed stubbornly hot last month, putting even more pressure on a sharply divided Federal Reserve to raise rates at its meeting in a few days.

The Labor Department said Friday that the inflation rate held steady at 3.4% in August, matching analyst expectations and even with July's 3.4%. A key measure of underlying price trends, however, came in stronger than expected.

Markets now see a rate increase next week as very likely. Interest-rate futures imply about an 85% chance that the central bank will increase its target range on overnight rates by a quarter percentage point. Before Friday's report, those chances were about 70%.

"If you don't raise rates now you better have a damn good story on why you didn't," said Omair Sharif, head of advisory firm Inflation Insights.

At the Fed's latest meeting, in July, when the central bank

held rates steady, three officials dissented in favor of raising rates, and others have since said they could join them if inflation doesn't improve. President Trump installed Kevin Warsh as Fed chairman this year after he repeatedly attacked his predecessor, Jerome Powell, for not lowering rates.

Further complicating the Fed decision, oil prices have surged this month, with the U.S. crude benchmark fetching over $100 a barrel in Friday New York trading, versus $85.76 at the end of August.

Stock prices rose on Friday, in a signal that investors like the idea of a rate hike that could tamp down inflation. The Dow Jones Industrial Average rose 509 points, or nearly 1%, while the S&P 500 gained 0.9%. The Nasdaq Composite also rose 1%.

Treasury yields were mixed, with short-term yields higher and the 30-year bond yield lower.

Prices excluding food and energy—the so-called core that economists watch to help gauge underlying price trends—were up 2.4% from a year earlier. That was in line with expectations.

Over the month, however, core prices rose 0.3%, higher than the previous month and higher than expectations. The reading broke two months of mildly encouraging data that had tentatively validated central bank forecasts that inflation would slow in the second half of the year as tariff effects faded.

The data swung traders' bets in favor of a rate increase next week because of the report's implications for the inflation gauge that the Fed tracks—the personal consumption expenditures price index.

Poring over the CPI numbers, Note many economists now think that the core version of the PCE price index Note rose by 0.3% last month, a pace many Fed watchers have speculated could trigger a rate hike.

The official PCE metric won't be published until the end of September. But it is calculated based largely on the inflation data published this week, which allows economists and Fed officials to proceed based on wellfounded estimates.

A 0.3% August core PCE increase would yield a 12-month core PCE inflation rate of about 3.4%, indicating underlying price trends well above the 2% inflation rate that the Fed targets. Inflation has run above the target since mid-2021.

Frustration with high prices has been souring Americans' feelings on the economy ahead of midterm elections expected to be difficult for Trump and his Republican Party. The University of Michigan on Friday reported that, in a preliminary reading, its index of consumer sentiment slipped to 47.8 this month.

If the preliminary reading holds, it would be the secondlowest level in the index's decadeslong history.

Michigan said that in its surveys, consumers' mentions of both gasoline prices and tariffs have picked up.

Overall inflation stood at 2.4% at the start of the year, and was widely expected to cool, which would have allowed the Fed to reduce rates. The Iran war, and the sharp increase in energy prices it brought on, changed that.

Economists are often in the habit of "looking through" inflation increases that come as a result of temporary shocks, such as rising gasoline prices. That is because if prices merely stabilize, the impact on overall inflation will fade.

But high fuel prices can spill over into prices for other items as well. Diesel averaged a record $6.06 a gallon on Friday, up from $3.71 a year earlier. That is adding to the cost of transporting goods, and at least some of that cost increase will likely get passed on to consumers. Meanwhile, the U.S. trade conflict with Canada risks making the impact of tariffs on inflation more protracted, and the AI build-out is, if anything, accelerating.

The biggest worry is that current, elevated inflation levels could work their way into people's inflation expectations— which can in turn affect future inflation. If workers believe inflation will remain high, for example, they can push for wage increases beyond the price increases they have already seen. Similarly, businesses will raise prices in an effort to offset the higher costs they expect to pay.

During the sharp rise in inflation that occurred after the pandemic hit, inflation expectations remained low. In recent research, economists Ulrike Malmendier and Stefan Nagel argue that came about because the years of low inflation that preceded the pandemic conditioned people to think the inflation run-up wouldn't last.

They caution, however, that a second bout of high inflation could have a more pronounced effect.

In the Michigan survey, median expected inflation over the next year jumped to 4.6% this month from 4% in August.

But inflation expectations over the next five years—a longer-term outlook that economists pay closer attention to—rose only slightly, to 3.4% from 3.3%. That is higher than it was during the two decades that preceded the pandemic, but around what it averaged in the 1990s.

The problem for Fed policymakers is that they are facing a situation where the longer inflation stays elevated, the more of a problem they might face.

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**The Fed could raise interest rates three times. Here's where the market could face the stiffest test.**

Story by Greg Robb 2026-9-12

The Fed could raise interest rates three times. Here's where the market could face the stiffest test.© Natalie Behring/Getty Images

With financial markets convinced the Federal Reserve will hike interest rates next week, two questions naturally follow: How high will rates go, and will tighter monetary policy lead to any breaks in financial markets? –Note

Economists note that the Fed historically has not been content to raise rates only once. –Note

Ian Lyngen, head of U.S. rates strategy at BMO Capital Markets, said he assumes that a quarter-point hike this month would be followed by similar hikes at both the Fed's October and December meetings. –Note

This would effectively undo the 2025 rate cuts pushed by former Fed Chairman Jerome Powell, and would bring the central bank's benchmark interest rate to a range of 4.25% to 4.5%.

**See also:** MarketWatch's live coverage of the August CPI report.

Josh Hirt, senior U.S. economist at Vanguard, said a forecast of three hikes is a "pretty reasonable starting place" for thinking about where the Fed might go. In an interview, he said the range of possible hikes is anywhere from one to six moves.

As far as the repurcussions of such tighter monetary policy, Derek Tang, a policy economist at Monetary Policy Analytics, said two areas of potential financial-market vulnerabilities are clear: the optimism fueling the artificial-intelligence spending cycle, and the insurance sector's holdings of private credit.

"Those are a few things I think people should pay more attention to," Tang said.

There is also growing unease about the U.S. budget deficit. Ruchir Sharma, chair of Rockerfeller International, said in a recent op-ed in the Financial Times that he was worried higher borrowing costs might short-circuit the AI boom. When Big Tech has to compete with a government paying a yield of 5% on its bonds, many firms may be crowded out of the debt markets. –Note

Charlie Ripley, senior portfolio manager at Allianz Investment Management, agreed that a 5% yield on the 10-year Treasury note could tip the tide into a selloff.

In an interview with MarketWatch, Ripley pointed to the heavy borrowing needs of the "hyperscalers" of the AI race, including estimates of $1 trillion in capital expenditures annually over the next few years. Higher long-dated yields push up the cost of all that borrowing.

The International Monetary Fund, meanwhile, has warned about the opaque nature of insurance companies that are partly or fully owned by private-equity firms. These firms have been investing in riskier fixed-income assets, and losses cause by volatility in the interest-rate environment could spill over into the banking sector.

Vanguard's Hirt said the Fed's potential hiking cycle this year is different from previous cycles that led to seminal financial crises, like the collapse of Silicon Valley Bank in 2023 or the municipal bankruptcy of Orange County, Calif., in 1994.

The Fed recently pursued a significant hiking cycle between 2022 and 2024, interest rates generally remain high and it would not be a sudden shift in expectations, he noted. In those famous cases that led to crises, the Fed was flipping the narrative; in this case, it is simply trying to find a level of rates that would put some downward pressure on inflation.

There have been historical exceptions to the idea that one rate hike would lead to several more: In 1997, the Fed hiked rates once, and then made no moves until a rate cut 18 months later.

U.S. stocks were climbed on Friday following the latest consumer-inflation reading, and as oil prices eased.

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Real Wages

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*The best response is to let the Warsh Fed get inflation down.*

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# Trump's Real Problem Is Real Wages

REVIEW & OUTLOOK



The August inflation report came in stubbornly high on Friday, which means there's no reprieve for the White House this election year, or for the Federal Reserve when it meets on monetary policy next week. Only if the Fed focuses on reducing inflation will President Trump get the lift in real wages that he presided over in his first term.

Note

The Labor Department on Friday reported that the consumer price index rose 0.4% in August, and 3.4% over the last year. While energy prices drove most of the monthly surge, that's no consolation to consumers.

The silver lining of Friday's report is that the core index, excluding volatile food and energy, rose 2.4% year-over-year. That's the lowest 12month reading since March 2021 and the same as in February 2020 before the pandemic.

But even here the reprieve has a caveat. The core index in August still climbed 0.3%, with increases for shelter (0.3%), used cars (0.4%), haircuts (0.4%), day care (1%), wireless phone service (5.9%), and motor vehicle maintenance and repair (1.1%). Inflation for many services has proven to be frustratingly stubborn, as anyone who's eaten in a restaurant has surely noticed.

The worst news for workers in the report is that real hourly average wages fell 0.1% in August. They're down 0.3% over the past year, as the nearby chart tracks. The burst of inflation in the spring crushed average earnings, which barely grew in 2025 as well. This goes a long way to explaining why Americans feel sour about the economy, and getting those wages up ought to be the President's highest economic priority. The war in Iran has caused energy prices to rise, but the President's job approval rating on the economy was underwater before he launched the attacks in late February and gasoline prices shot up. A big reason is his border taxes, which have contributed to rising prices.

Mr. Trump wants the Fed to lower interest rates this autumn because he thinks it will help Republicans in the midterm election. That's unlikely at this late point in the campaign. It might even backfire by signaling to financial markets that the Fed doesn't mean what new Chairman Kevin Warsh says about conquering inflation. That could cause long-term bond rates to rise. That's what happened in late 2024 when the Fed cut its benchmark interest rate. The best way to get real wages rising is for Mr. Trump to give Mr. Warsh the running room he needs to get inflation down to the Fed's 2% target. That may start with a quarter- point increase in interest rates at next week's Federal Open Market Committee meeting, which would signal to markets that the central bank is serious about inflation.

Buoyant markets and asset prices suggest that current monetary conditions are far from restrictive. With the economy and especially the labor market (4.1% jobless rate) showing welcome resilience, getting inflation down is the top priority for the Fed. It's also the best political remedy for Mr. Trump.