



VIEWPOINT

Economic Commentary:

Diesel Prices Emerge as Primary Inflation Risk

October 2026

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September was marked by the Federal Reserve's decision to raise the target range for the federal funds rate by 25 basis points — the first monetary policy move since rates were cut in December 2025. The new target range is 3.75%–4.00%. The Fed is contending with three overlapping supply shocks — strong AI investment demand, increased trade protectionism and a global energy-supply crunch — whose inflationary effects threaten to spread across a broader range of consumer prices. Of these three shocks, tightness in refined petroleum product markets is emerging as the greatest upside risk to the inflation outlook. The unintended consequences of raising rates in a bifurcated economy will need to be monitored closely, as higher rates will further slow activity in areas of the economy already under pressure.

Energy costs pose primary inflation risk

The August headline Consumer Price Index (CPI) rose 0.4%, in line with expectations, leaving year-over-year inflation at 3.4%. Core CPI increased 0.3%, above expectations, although the year-over-year rate declined to 2.4% from 2.5%. The monthly increase in core inflation was concentrated in nonhousing core services, particularly transportation services, underscoring the risk that higher energy costs could pass through to broader consumer prices. By contrast, core goods inflation is running at just 0.7% year over year and has remained below 2.0% for three years, despite concerns about the inflationary impact of tariffs.

The U.S. Bureau of Economic Analysis revised its methodology for calculating the personal consumption expenditures (PCE) price index, retroactive to 2021, to better reflect actual spending patterns. The revisions are estimated to have reduced measured core inflation by 0.3 percentage points. In August, headline PCE increased 0.3% and was up 3.4% year over year. The Fed's preferred measure, core PCE, was softer than expected, rising 0.2% and 3.0% year over year. Importantly, the three-month annualized trend in core PCE is now 2.0%, compared with 2.6% at this time last year. Although the easing in inflation pressures has been uneven, the underlying trend remains favorable.

The inflation outlook remains vulnerable to energy prices and fiscal pressures. The surge in diesel prices represents the primary upside risk to inflation. Higher diesel and freight costs could feed into core inflation by increasing the cost of producing and transporting consumer goods. The energy shock is entirely exogenous and, in its economic impact, is akin to a tax increase. The implication of Fed Chair Kevin Warsh's position on monetary policy is that demand destruction may be the only transmission channel available to bring inflation back to the Fed's 2% target unless oil prices decline rapidly. Because the current inflation pressure is fundamentally supply-driven rather than demand-driven, the principal mechanism through which higher interest rates can counter it is by weakening demand enough to offset the loss of supply.

Stronger growth amid household strain

The final report on second-quarter GDP showed annualized growth of 2.2%, up from the previously reported 1.5%. Annual revisions also pointed to a stronger economy and lower core inflation. Categories most sensitive to the AI infrastructure buildout accounted for roughly two-thirds of the upward revision. One important consequence of the revisions was stronger near-term productivity growth, as higher real output was achieved without an increase in hours worked.

The consumer remains under pressure. Real consumer spending increased 0.6% in August, or 2.6% year over year, even as real disposable income was flat on a monthly basis and up just 1.3% year over year. As a result, the personal saving rate declined to 4.1% from 4.6%, its lowest level since November 2022. The ongoing squeeze on household purchasing power is also evident in corporate earnings reports. Consumer confidence has fallen to a 12-year low, according to The Conference Board, and notably has dropped below the trough reached during the COVID-19 recession in 2020.

Steady activity with rising input costs

The Institute of Supply Management (ISM) manufacturing index was little changed in September, marking the ninth consecutive month of expansion. New orders, employment and backlogs all improved. At the same time, higher oil prices are pushing input costs sharply higher, with the prices index approaching levels last seen during the early months of the Iran conflict. Combined with slowing supplier deliveries, these developments suggest that manufacturers will face increasing price pressures in the near term.

The ISM services index edged down to 54.9 in September from 55.4 in August. New orders remained near August's strong level even as business activity cooled from elevated levels. Backlogs rose to their highest level since July 2022, pointing to a healthy pipeline of work heading into fourth quarter 2026. Hiring returned to expansion territory, while order backlogs increased further. The primary concern remains inflation, with firms reporting their largest price increases in more than four years.

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Hiring slows and wage growth eases

Nonfarm payrolls increased by just 29,000 in September, well below the consensus expectation of 90,000. Job gains for July and August were revised lower by 31,000 and 29,000, respectively. Private-sector payrolls rose by 46,000 in September, with most sectors posting weaker job gains than in August. The labor market appears to be slowing in line with a smaller pool of new workers. Slower job growth and modest wage gains should provide less fuel for inflation. Labor market slack also appears to be building: Average hourly earnings increased just 0.1% in September, bringing year-over-year wage growth down to 3.0%, the lowest since May 2021. With productivity growth running above 2%, the labor market is currently not a significant source of inflationary pressure. Sustained inflation would be difficult to maintain without stronger wage growth.

The unemployment rate edged up to 4.2% in September from 4.1% in August, as a 485,000 increase in the labor force exceeded the 406,000 increase in household employment. More than half of the increase in household employment came from part-time positions. The share of the workforce holding multiple jobs rose to 5.5%, not only the highest level of the year but also toward the upper end of its range over the past 25 years.

Rate hike with limited near-term urgency

As noted at the outset, the Fed raised the federal funds rate by 25 basis points at its September meeting, with no dissenting votes. Although markets have been aggressively pricing in three to four additional rate hikes over the next 12 months, three Federal Open Market Committee (FOMC) members have indicated over the past week that there is no urgency to raise rates. This suggests that a rate hike at the October 28 meeting may be unlikely. The combination of softer employment data and improving PCE inflation trends gives Warsh some room to hold rates steady for now, particularly with the meeting occurring just six days before an election.



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