Home Alone: inflation and the new Fed chair; investing in China's AI ecosystem; Prediction markets

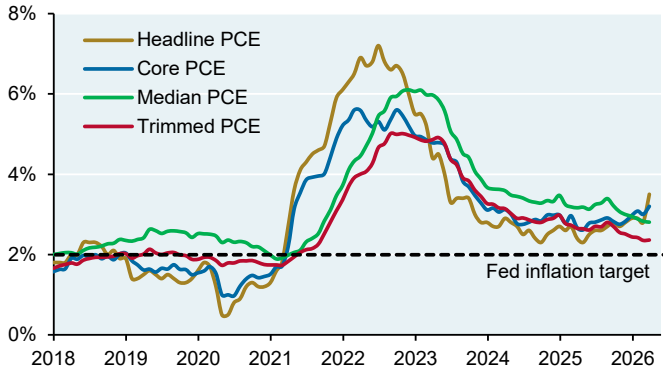
***Summary*. The new Fed chair Kevin Warsh, like Kevin McCallister in *Home Alone*, faces a lonely vigil: survive until the adults get home again. Also: investing in China's home-grown AI ecosystem, and the predation in prediction markets.**

The new Fed chair has highlighted an inflation measure that sends an all-clear signal on easing: "trimmed" PCE inflation[1]. Good luck with that; trimmed inflation did a very poor job identifying the 2021 Biden-flation surge which the GOP understandably cites as a policy failure. In this Eye on the Market we look at inflation signals Warsh faces as he deals with pressure from Trump, who stated that the Fed should cut rates ASAP and that the US should have "the lowest rates in the world"[2]. Similarly, when asked last December where rates should be a year from then, Trump responded by saying "1% and maybe lower than that."[3]

Before getting into the details, three big picture charts below: the surge in US commodity prices which may feed into core consumer and producer price inflation, at least temporarily; the rising sensitivity of the US business cycle to changes in inflation; and deteriorating US public finances. During Warsh's term (if he lasts as long as prior Fed chairs), he will preside over the dreaded crossover point: in 2031 entitlements, interest and other mandatory outlays are projected to permanently exceed Federal tax revenues for the first time. In other words, the scope for a monetary policy mistake is getting narrower by the day, and rising Treasury yields are rapidly shrinking the equity risk premium earned by investors.

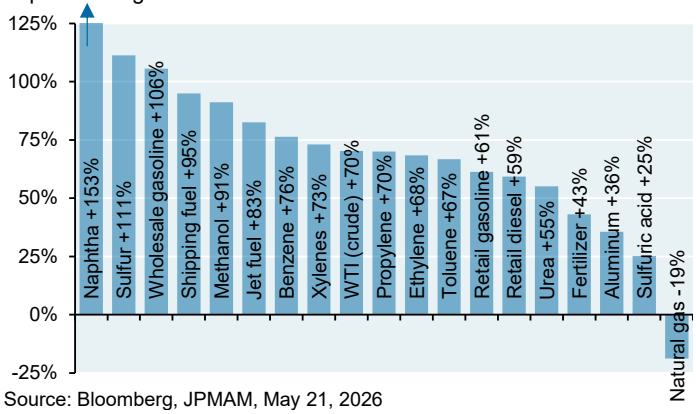
Michael Cembalest
JP Morgan Asset Management

Personal Consumption Expenditure (PCE) inflation
y/y % change



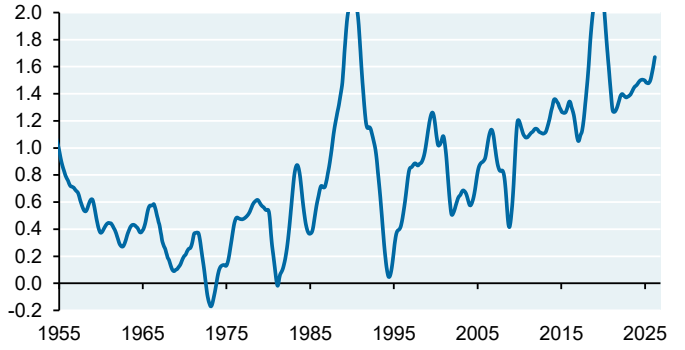
Source: Federal Reserve Bank of Dallas, Bloomberg, JPMAM, March 2026

Absolute YTD US commodity price changes
% price change



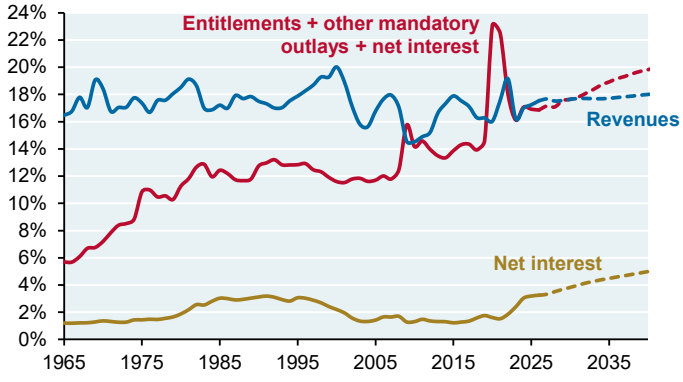
Source: Bloomberg, JPMAM, May 21, 2026

Inflation sensitivity to the business cycle
Beta of monthly ISM Prices Paid relative to ISM New Orders



Source: ISM, Bloomberg, April 2026. Beta calculated using a 5 year look-back and smoothed with a 12 month moving average

Entitlement spending, mandatory outlays and net interest payments vs revenues, % of GDP



Source: CBO, JPMAM, 2026

[1] *"Warsh gave his preferred way for measuring inflation. It could come back to bite him"*, CNBC, April 22, 2026

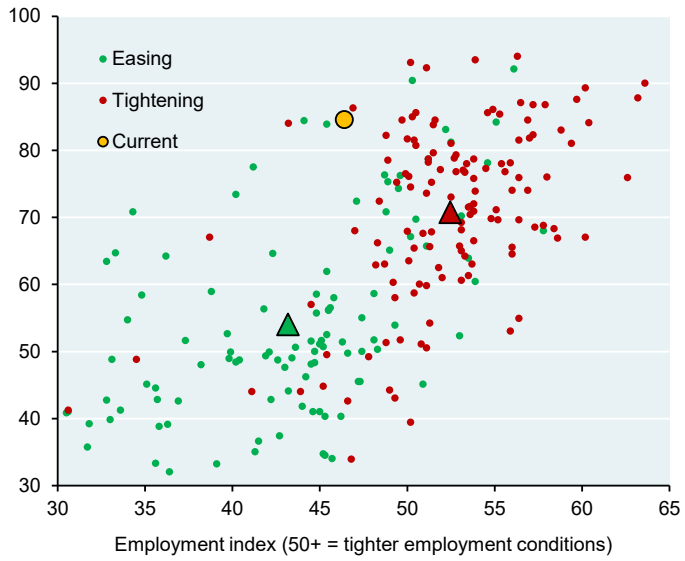
[2] "*Trump says Fed nominee should cut rates right away*", The Hill, April 21, 2026

[3] WSJ, December 12, 2025

Act I: the US is nowhere near easing territory using history as a guide

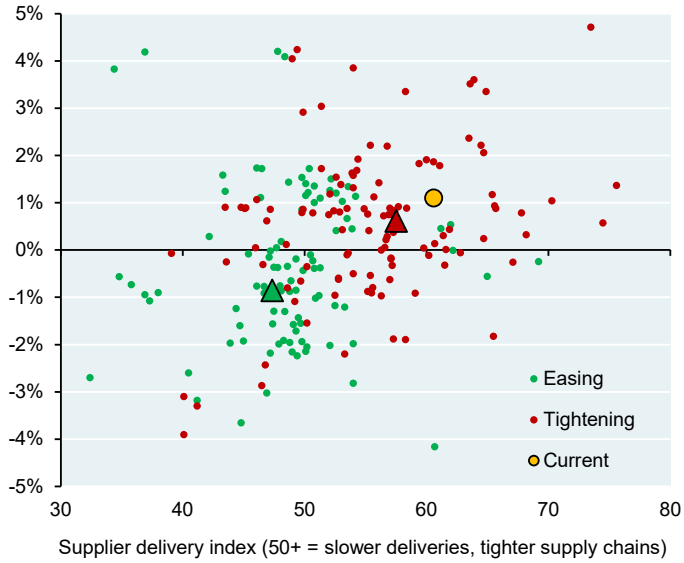
Inflation indicators the Fed watches include labor market tightness, price pressures in the manufacturing sector, supply chain tightness and the "output gap" which measures how far actual growth is above/below potential growth. The next two charts plot these four variables at the time of prior Fed decisions to increase or cut policy rates; green dots indicate when the Fed cut, red dots indicate when the Fed tightened and yellow circles show today's values. **In other words: current values are much closer to conditions that have historically prompted the Fed to *raise* policy rates rather than to *lower* them.** That may be why the futures curve is now pricing in Fed hikes instead of the cuts that were priced in at the start of the year. Superwonky: averaging several different monetary rules of thumb (Taylor rules, inertial, alternative r*, forward-looking) yields a Fed Funds range of 4.00% - 4.85% compared to the current range of 3.50% - 3.75%.

Fed easing & tightening as a function of manufacturing employment & prices paid surveys, 1960 - 2026
Prices paid index (50+ = increasing prices)



Source: ISM, Federal Reserve, Bloomberg, JPMAM, April 2026

Fed easing and tightening as a function of supplier delivery conditions and the output gap, 1960 - 2026
Output gap (actual GDP relative to potential GDP, %)

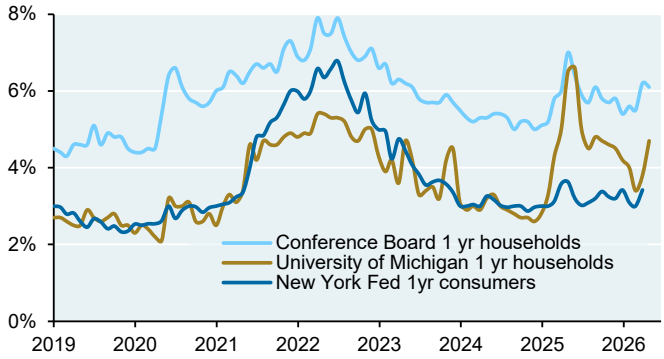


Source: ISM, Federal Reserve, CBO, Bloomberg, JPMAM, April 2026

Act II: inflation expectations have risen gradually since the war began

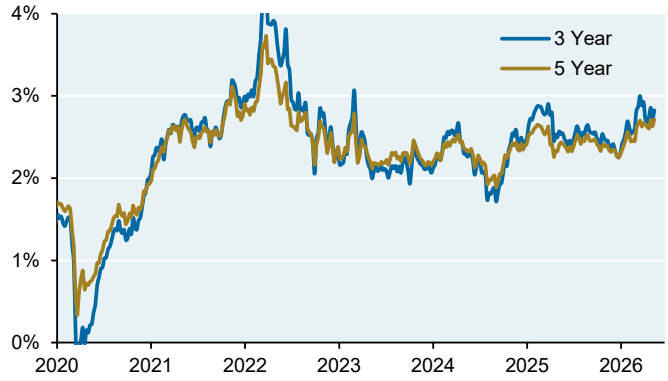
Inflation expectations can be derived from household surveys and from inflation-linked bond markets. Both have risen a small amount since the war began.

US short term inflation expectation surveys of households and consumers, Percent



Source: Conference Board, NY Fed Survey, UMich Survey, Bloomberg, JPMAM, April 2026

Traded US inflation expectations
Percent, breakeven rate, derived from TIPS

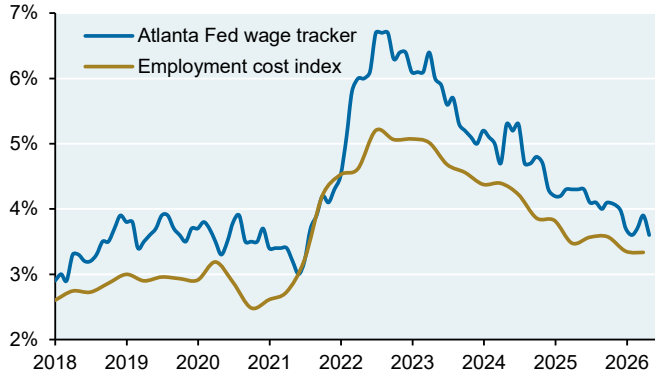


Source: Bloomberg, JPMAM, May 15, 2026

Act III: wage inflation and unit labor costs look benign with little signs of a wage-price spiral

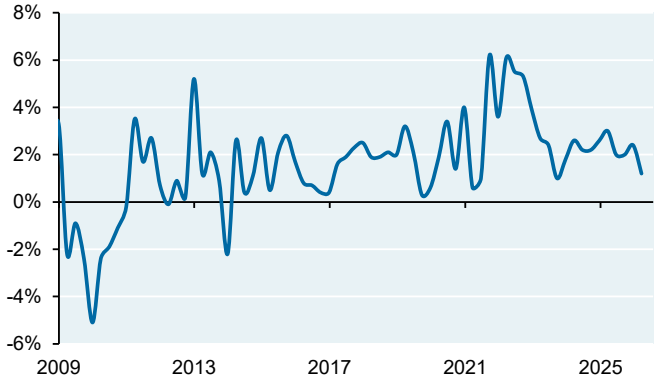
Net immigration in 2025-2026 will likely range from zero to -1 million people; this compares to roughly +1 million in the pre-COVID era. Even so, wage inflation hasn't risen in immigration-sensitive sectors such as childcare, cleaning, construction, healthcare and food preparation. One reason: slower net immigration (including both legal and undocumented) follows a period when it was way above trend as shown in the fourth chart, so the stock of such documented and undocumented workers is still much higher than in it was in 2020.

Wage inflation measures
y/y % change



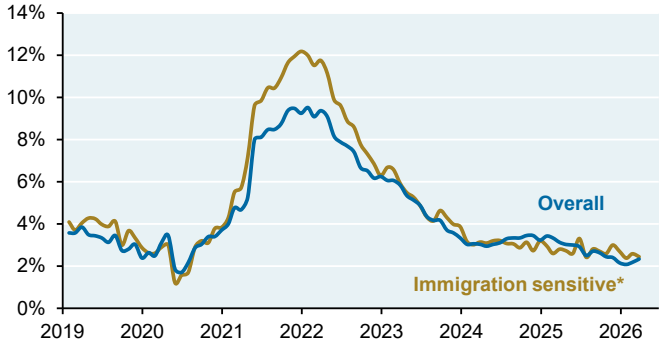
Source: BLS, Atlanta Fed, Bloomberg, JPMAM, April 2026

Unit labor costs for US nonfarm business sector
Percent, y/y



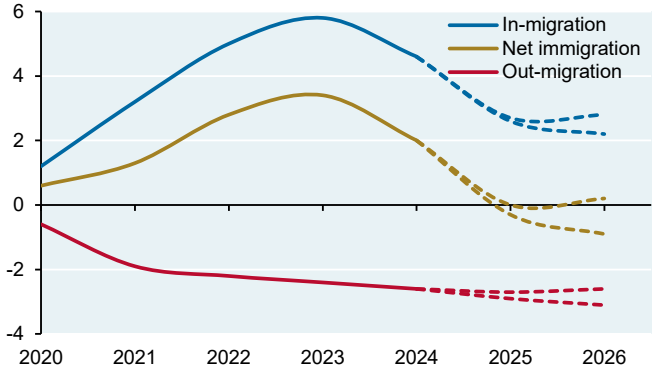
Source: Bloomberg, JPMAM, Q1 2026

Wage growth: overall economy vs immigration sensitive industries, Percent, y/y



Source: Indeed, JPMAM, March 2026. *Avg across childcare, cleaning, construction, food preparation and service, home health, retail

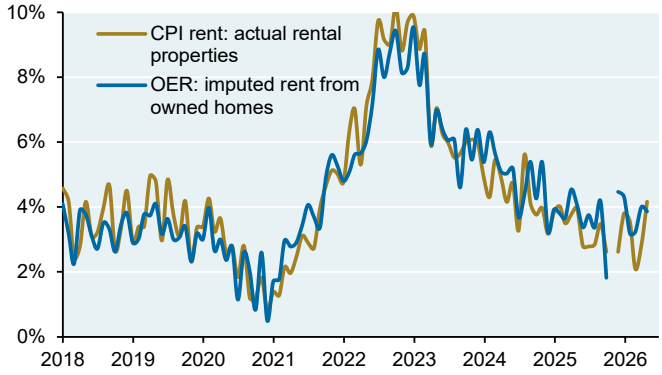
Migration flow estimates
Millions of people per year (includes legal & illegal immigration)



Source: Brookings, January 2026

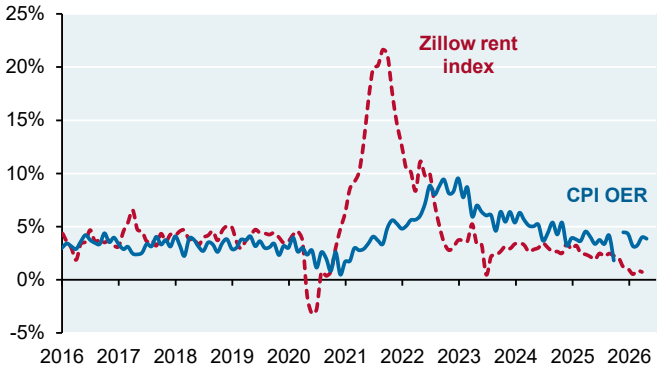
Act IV: shelter inflation, mostly benign

CPI shelter inflation measures
Percent, m/m annualized



Source: BLS, BBG, JPMAM, April 2026. Adj for delayed gov shutdown data

Timely residential rent measure vs CPI owners equivalent rent, Percent, m/m annualized

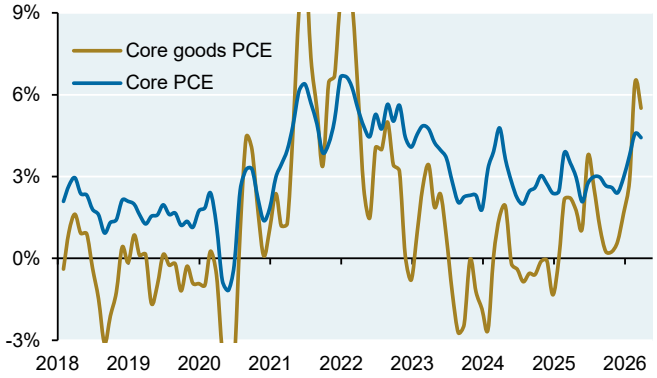


Source: BLS, BBG, Zillow, JPMAM, April 2026. Adj for gov shutdown delay

Act V: PCE inflation looks higher than CPI inflation, mostly reflecting weight differences

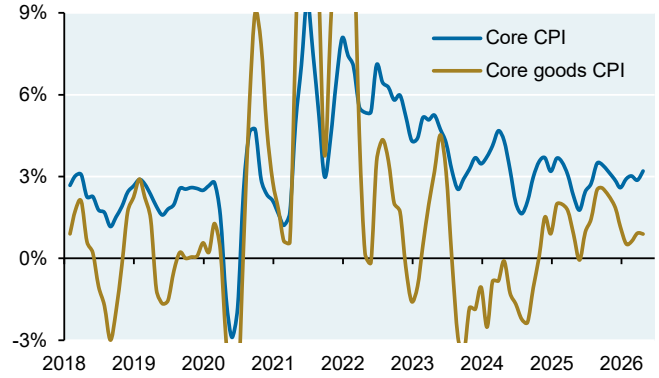
I'm not going to torment you by listing all the differences between PCE inflation and CPI inflation; the Fed looks at both but reportedly has a preference for the former. One major difference: housing inflation is more heavily weighted in CPI while computer software and accessories are more heavily weighted in PCE. Since March 2025, software inflation has exceeded housing inflation by 9% (12% vs 3%).

Core PCE and PCE goods inflation
3 month % change, annualized



Source: BEA, Bloomberg, JPMAM, March 2026

Core CPI and CPI goods inflation
3 month % change, annualized

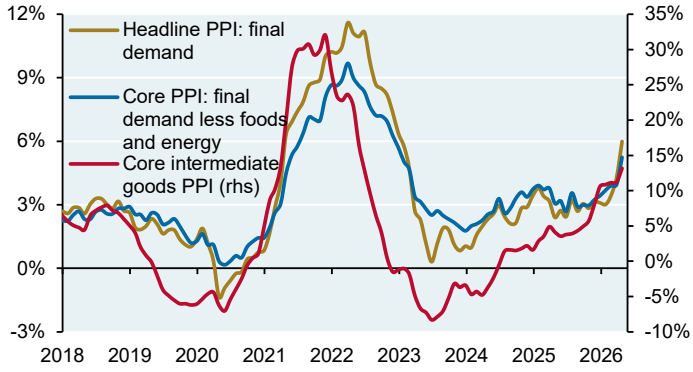


Source: BLS, Bloomberg, JPMAM, April 2026

Act VI: rising producer prices

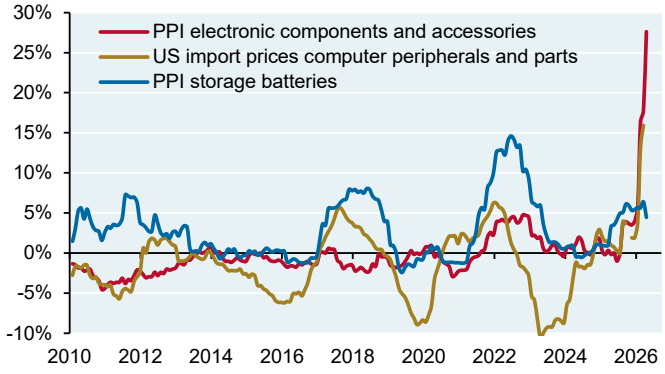
Producer prices are rising for several reasons: rising transport costs due to higher energy prices; copper and aluminum demand for energy storage, solar panels and EV production; soaring costs for electronic components and memory chips due to the AI boom; rising costs for application software (at least until the Agentic AI shock shows up in the data); higher US tariffs; and new export controls from China on rare earths and medical equipment. Silver lining: core PPI is often a poor predictor of future PCE inflation.

Headline and core PPI inflation
y/y % change



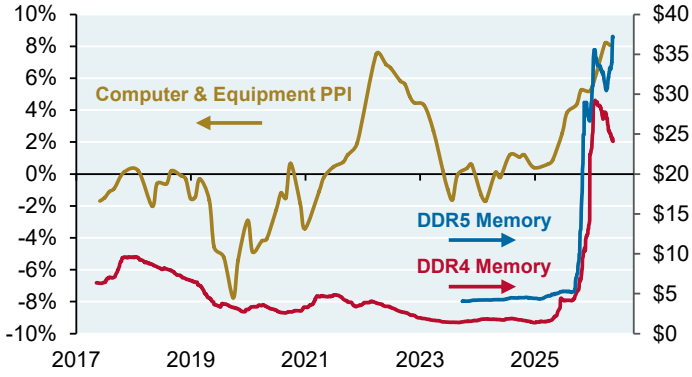
Source: BLS, Bloomberg, JPMAM, April 2026

AI-related electronics inflation
y/y % change



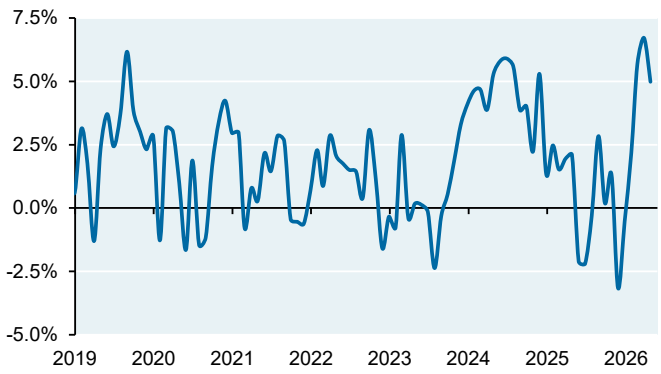
Source: BLS, Bloomberg, FRED, JPMAM, April 2026

PPI (computers & equipment) vs. memory chip prices
y/y % change | Price, US$/chip



Source: Bloomberg, BLS, JPMAM, May 21, 2026

PPI US application software inflation
y/y % change



Source: BLS, Bloomberg, JPMAM, April 2026

Act VII: the US productivity story

While it's impossible to know the precise reasons for it, US productivity has picked up since the launch of GPT in the fall of 2022 with even larger gains in the information sector and in the IT data processing subset. The Warsh view on AI focuses on its potential to boost the supply side of the economy which would argue for lower rates. This differs from the Powell view that in the short run, AI capital spending is likely inflationary on the margin. JP Morgan's economists believe that the FOMC staff and much of the rest of the committee are likely more aligned with Powell on this issue, and do not foresee a scenario where the committee gets enough clarity on productivity gains (which generally come with a multi-year lag) to justify lower rates in the near term.

Productivity gains, pre-COVID vs post-GPT

Real GDP method (annualized)	From Q1 2016 To Q1 2020	Q4 2022 Q4 2025	Q3 2023 Q4 2025
Non-financial corporate	1.1%	2.9%	3.3%
Information sector	5.0%	9.9%	7.8%
Data processing	8.0%	15.3%	14.4%

Source: BLS, Bloomberg, JPMAM, Q4 2025

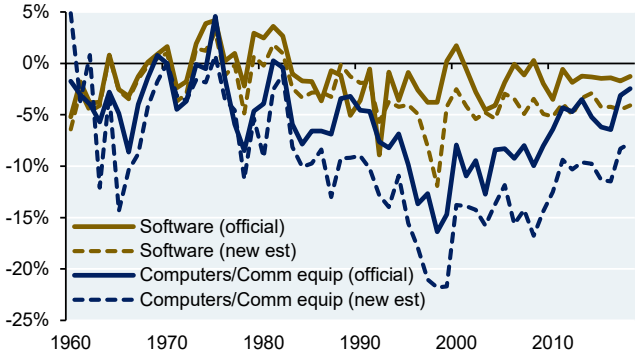
Productivity gains, pre-COVID vs post-GPT

Real gross output method (annualized)	From Q1 2016 To Q1 2020	Q4 2022 Q4 2025	Q3 2023 Q4 2025
Non-financial corporate	1.1%	2.9%	3.3%
Information sector	3.7%	7.9%	6.7%
Data processing	7.8%	11.6%	12.3%

Source: BLS, Bloomberg, JPMAM, Q4 2025

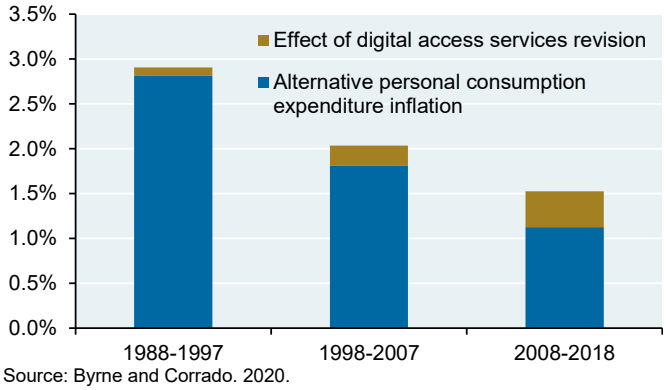
It's also worth remembering that productivity gains often don't get recognized by the Fed until years after the fact. In 2019, Fed researchers recalculated deflation in the Information and Communication Technology sector in the 1990's and found roughly double the ICT deflation than levels reported in official statistics for both software and equipment[4]. They also recomputed PCE inflation for consumer digital services (data, voice and video to households over internet, mobile and cable networks). Even though the consumer digital access basket is only 2.5% of consumption, the revision was large enough to cut ~50 basis points from overall PCE inflation from 2008 to 2018. End result: in both cases, real growth and productivity gains were understated.

New analysis from the Fed shows more ICT deflation than officially reported data, y/y change



Source: Byrne and Corrado. 2019.

Official and alternative inflation, Average annual percent change, personal consumption expenditure inflation



Source: Byrne and Corrado. 2020.

[4] See "*The increasing deflationary influence of consumer digital access services*", Byrne and Corrado, 2020; and "*ICT prices and ICT services: What do they tell us about productivity and technology*?", Byrne and Corrado, 2019

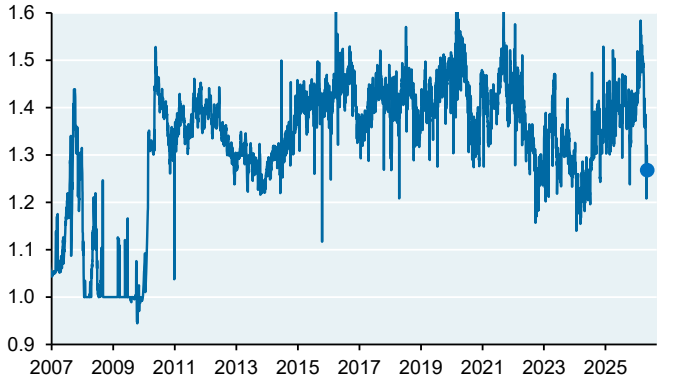
Home Alone: Good Luck Kevin

US 30-year Treasury yields have not consistently exceeded 5% since 2007 but have just crossed that threshold. The US equity risk premium (the estimated excess return in equity markets over bond markets) has been falling and now stands at its lowest level since the early 2000's. Also shown below: investor complacency is rising as illustrated by the declining price for downside protection on the NASDAQ. A lot is riding on normalization of energy prices and an end to the Iran war, since fossil fuel energy independence hasn't insulated the US from sharply rising US commodity prices. Productivity gains from AI will be important to track since they might be the crux of Warsh's argument that the Fed avoid hiking rates even if economic indicators suggest they should. **There's also pressure that will come from the White House to ease**, which might end up being the defining act of Warsh's tenure at the Fed. Let's hope for his sake that he does not end up like Arthur Burns, for whom the adults did not return in time (see next page).

30 year US Treasury yield
Percent

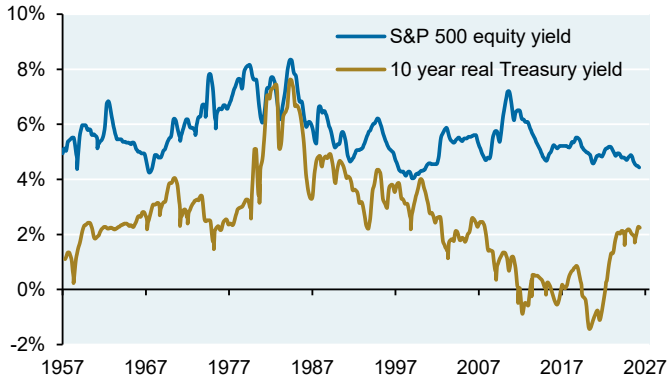
Source: Bloomberg, May 2026

A market without fear: a decline in the price of downside protection, Ratio of implied volatility for 3m NASDAQ 25-delta puts vs calls



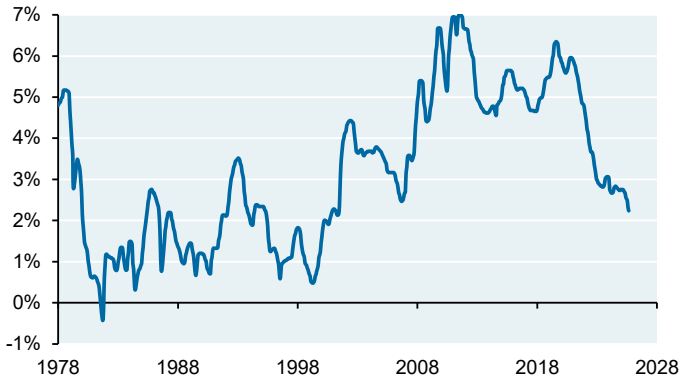
Source: Bloomberg, JPMAM, May 22, 2026

Estimated equity yields vs real Treasury yields
Percent



Source: JPMorgan Flows & Liquidity Report, May 20, 2026

US equity risk premium
S&P 500 equity yield less real 10 year Treasury yield



Source: JPMorgan Flows & Liquidity Report, May 20, 2026

Comments on equity risk premia charts

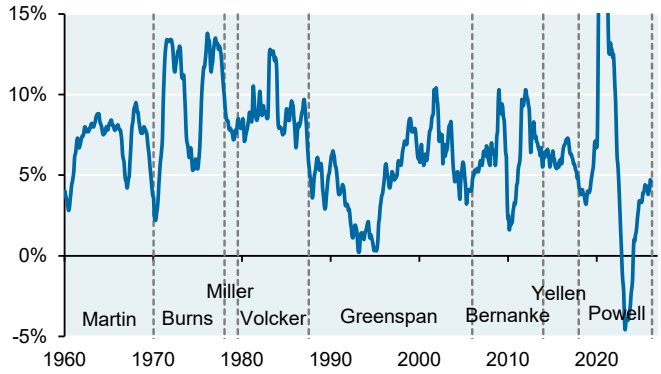
While real yields on Treasury bonds are easily observed (nominal yields less long term inflation expectations), the yield on equities is a more subjective exercise. JP Morgan's Flows & Liquidity team estimates the equity yield using a long term fair value model based on a dividend discount approach[5]. As shown in the first chart, other than the period from 1967 to 1981, US equity yields were mostly unaffected by the volatility in real bond yields. However: the **equity risk premium** (the gap between these two series, which is a proxy for equity returns over bonds) has been narrowing sharply and is now at its lowest level since the early 2000's. Bottom line: equities are looking more expensive relative to bonds now that Treasury rates are rising faster than inflation expectations, leaving equity markets more exposed than usual to an interest rate shock.

[5] JP Morgan Flows & Liquidity Report, "*Are bond yields becoming a problem for equities*", May 20, 2026

Arthur Burns, Nixon monetary policy co-conspirator and former Fed chair

When running for re-election in 1972, Nixon wanted to bring unemployment down to the 3.5% level which prevailed at the end of the 1960's. He found a co-conspirator in Fed Chair Arthur Burns who resisted FOMC calls for a higher discount rate, supported wage and price controls and oversaw money supply expansion that peaked at 13%, the highest money supply growth until the Fed's COVID bomb. The Burns era at the Fed coincided with high unemployment, inflation and a decade of 0% real returns on stocks and bonds.

US money supply growth: the Burns bonfire
y/y % change



Source: Bloomberg, Federal Reserve, JPMAM, Q1 2026

History suggests that Burns agreed to easy money policy only after substantial pressure from the White House. When Burns resisted pressure to guarantee full employment, the White House planted negative stories about him in the press and planted a false story that Burns was requesting a large pay raise when Burns had offered to take a pay cut. Nixon's people also floated stories about diluting the Fed Chairman's power by doubling the Board's members. Nixon warned Burns, "this could be the last conservative administration in Washington" and described liquidity concerns as "bullsh*t". Nixon wrote to Burns: "There's no doubt in my mind that if the Fed continues to keep the lid on with regard to increases in money supply and if the economy does not expand, the blame will be placed squarely on the Fed." In 1971, H.R. Haldeman spoke about the effectiveness of Nixon's strategy: "We have Arthur Burns by the [expletive deleted] on the money supply".

Here is Arthur Burns in 1971. The similarity to the iconic *Home Alone* picture of Macaulay Culkin is remarkable, isn't it.

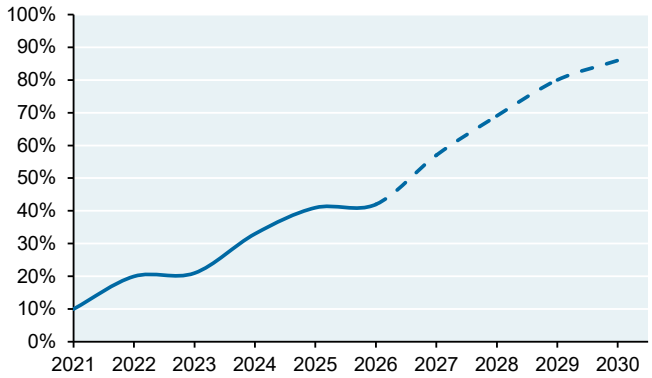
Sources: "*Secrets of the Temple: How the Federal Reserve Runs the Country*" by William Greider; "*Before the Fall: An Inside View of the Pre-Watergate White House*" by William Safire, and "*Monetary Policy and the Great Inflation in the United States: The Federal Reserve and the Failure of Macroeconomic Policy*" by Thomas Mayer

China's AI ecosystem for investors

By imposing a large array of sanctions on China, the US effectively compelled China to adopt a "Home Alone" strategy for AI. In our 2026 Outlook, the third section walked through China's efforts to build a parallel AI ecosystem, from lithography machines to high bandwidth memory to semiconductor production and fabrication. Since that time, China has been making progress which markets have increasingly been rewarding:

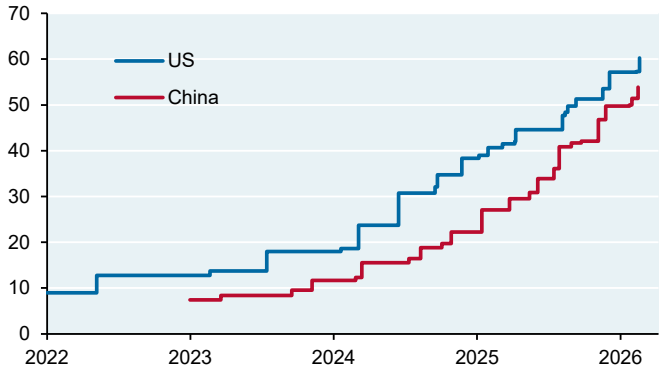
- Leveraging its large domestic market, China is accelerating AI adoption across consumer and enterprise use cases, particularly via low-cost, open-source models and integrated platforms
- Capex, data center expansion and AI cloud growth enable large-scale deployment/inference growth
- Domestic AI chips are narrowing the compute gap with the West, resulting in greater GPU self-sufficiency and improved LLM performance as shown in the first two charts. Also: competitiveness is increasingly evaluated on total cost per compute rather than chip-specific computing power (third chart). Total cost per MW of compute includes chips and associated rack installations, buildings, HVAC and power. Note in the fourth chart how token consumption for top Chinese models is soaring in 2026
- Daily active users for Chinese AI models: Doubao/ByteDance 100-150 mm, Qwen/Alibaba 50-70 mm and YuanBao/Tencent 30-50 mm vs 190 mm for ChatGPT/OpenAI

China GPU self-sufficiency
Percent



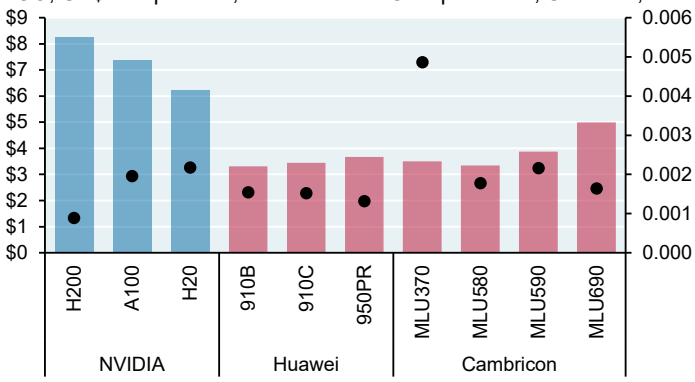
Source: Morgan Stanley Asia Technology, May 10, 2026

Frontier language model intelligence
Score



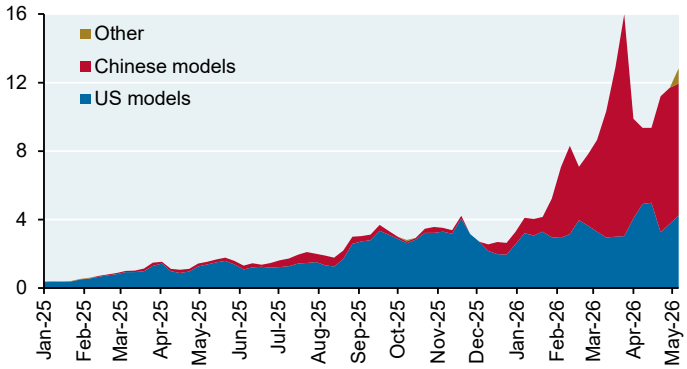
Source: Artificial Analysis, May 18, 2026

Total cost of ownership (TCO) and per token
TCO, US$ mm per MW, bars Cost per token, US cents, dots



Source: Morgan Stanley Asia Technology, May 10, 2026

Weekly token consumption of top 9 models through OpenRouter API calls, Trillions of tokens



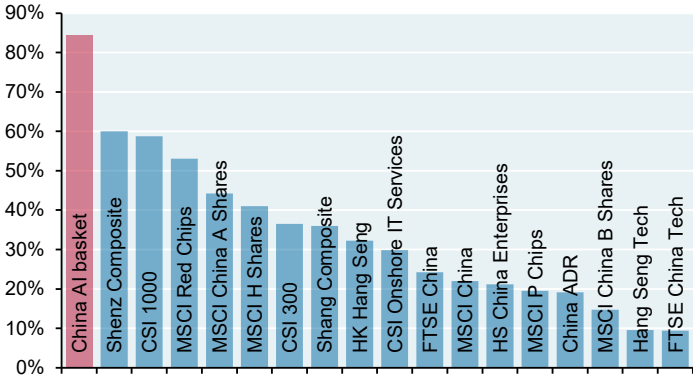
Source: OpenRouter LLM Ranking Leaderboard, JPMAM, May 11, 2026

I reached out to our China portfolio managers at JP Morgan Asset Management and asked for their take on the leading Chinese companies involved in its AI effort. They identified 32 companies across the sectors shown below in the footnote[6]. We then compared these 32 stocks to the 42 S&P 500 stocks in our US AI basket. China AI stocks have performed well since January 2024, roughly tracking the US AI basket and outperforming all of the other China index categories shown on the right. The median earnings growth for the China AI basket is 22% vs 17% for the US, although the dispersion (standard deviation) of China AI earnings growth is much higher as well, 360% vs 94%. Median China AI trailing P/E ratios are also higher, 48x vs 33x although these stats are very fluid when companies are growing earnings rapidly.

Total return of AI market cap weighted baskets
Total return index (100 = Jan 1, 2024)

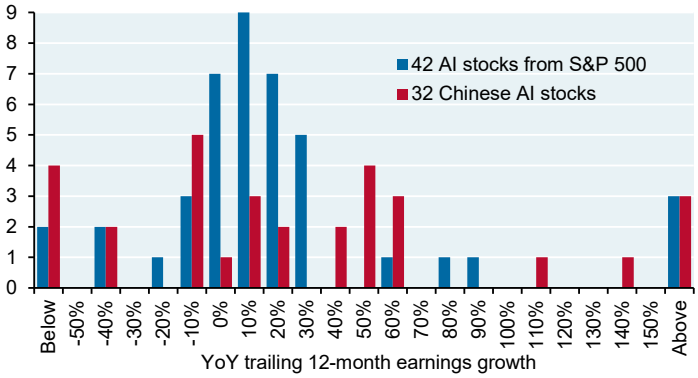
Source: Bloomberg, JPMAM, May 20, 2026

China index returns, January 2025 to May 2026
Percent



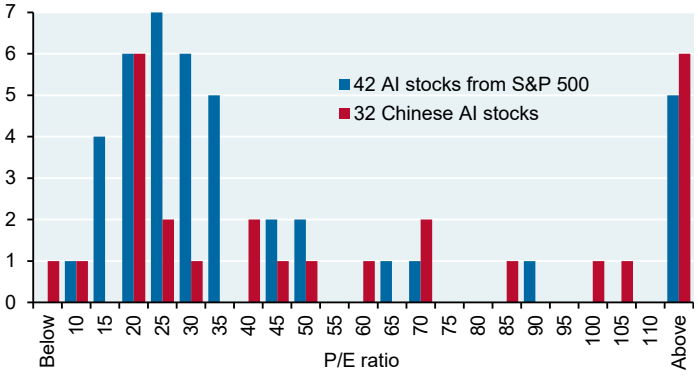
Source: Bloomberg, JPMAM, May 2026

Earnings growth distribution for AI market cap weighted baskets, Number of companies



Source: Bloomberg, JPMAM, May 21, 2026

Price to earnings distribution for AI market cap weighted baskets, Number of companies



Source: Bloomberg, JPMAM, May 21, 2026

Many China AI companies trade on mainland China A-share exchanges. Both institutions and individuals can typically access China A Shares through Stock Connect, a market access program linking mainland China and Hong Kong markets. A more complicated alternative: a total return swap with a financial counterparty that entails financing costs, ISDA agreements, minimum investment sizes, daily mark-to-market and collateral.

[6] China AI basket:

- Semiconductors (Tongfu, JCET, Montage, Hygon, Cambricon, Hua Hong, Moore Threads, MetaX, SMIC)
- Power, electrical components & equipment (Sieyuan, Sungrow, TBEA, Deye, CATL)
- Construction machinery & heavy transportation equipment (Weichai); Heavy electrical equipment (NARI)
- Semiconductor materials & equipment (NAURA, AMEC, AccoTest)
- Systems software (Empyrean, MiniMax, Z.ai)
- Electronic components, equipment & manufacturing (Luxshare, Eoptolink, Innolight, Suzhou TFC, Foxconn)
- Broadline retail (Alibaba, PDD)
- Interactive media & services (Tencent, Baidu); Interactive home entertainment (NetEase)

Note: companies like Huawei, SMEE, CXMT and YMTC are still privately held

Predation in Prediction markets

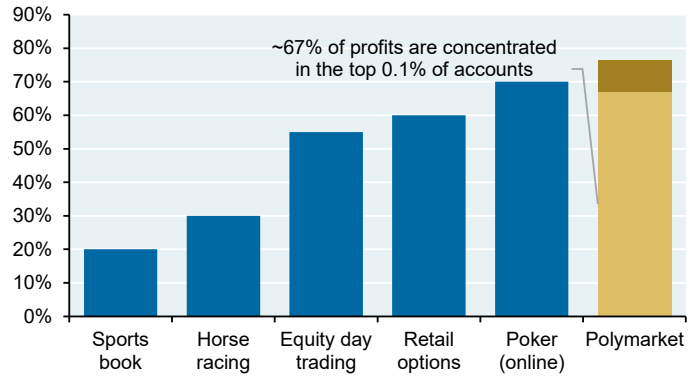
"There's a sucker born every minute" (P.T. Barnum and W.C. Fields)

There's a lot of predation in prediction markets: 1% of participants on Polymarket earn 76.5% of the profits (!!) due to high speed algorithmic bots that reprice prediction contracts based on breaking information faster than the average person[7]. As shown on the left, prediction market profit concentration is much higher than in online poker, day trading, horse racing and other gambling platforms shown below.

These gains accrue overwhelmingly to automated traders (bots). Joshua Della Vedova at the University of San Diego performed a fascinating analysis of over 200 million Polymarket trades from November 2022 to February 2026. Vedova found that **profits are more closely linked to execution timing than to directional accuracy**[8]. Automated traders (bots) achieved 49.9% aggregate directional accuracy (no better than a coin flip), yet earned the only positive aggregate return in the sample at $133 million. Active retail traders achieved 51.3% accuracy but lost $79 million, and other non-bot bettor categories had negative returns as well. The reason is execution, not forecasting: bots win by providing liquidity and entering markets early (~10 bots account for 70% of bot profits), while bettors that arrive after prices absorb relevant information pay entry prices that leave no room for profit, regardless of accuracy.

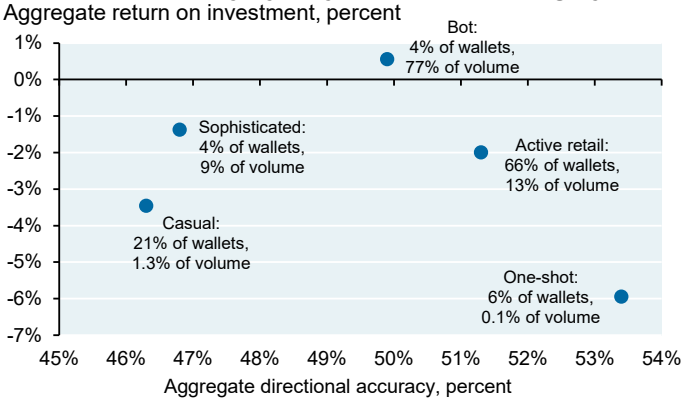
Della Vedova also identifies a subset of accounts whose accuracy and execution are consistent with trading on private (inside) information[9]; stripping those profits out would make the non-bot returns shown on the right look even worse. So…place your bets but be aware that algorithmic bots and insiders will probably beat you to it. And as explained below, if there's a dispute about the outcome, the process can be manipulated…

Profit concentration among top 1% of market participants
Share of profits, percent



Source: Paul Kedrosky, WSJ, University of Toronto, JPMAM, 2026

Returns vs accuracy by Polymarket bettor category
Aggregate return on investment, percent



Source: Joshua Della Vedova (University of San Diego), 2026

Polymarket dispute resolution: ripe for manipulation

If a Polymarket bet does not have a clear outcome, it moves to a third-party token-based voting system called Universal Market Access. Any individual, not necessarily Polymarket users, can purchase tokens from crypto exchanges and cast votes in resolutions, influencing the outcome of resolutions they're actively betting on. For example: a Polymarket bet on whether Ukraine would agree to a critical mineral deal with the US before April 2025 was resolved via UMA. A single voter cast 5 million tokens (25% of votes) and swayed the decision to "Yes" even though the deal was not signed until April 30, 2025[10].

[7] "*Who Wins and Who Loses in Prediction Markets? Evidence from Polymarket*", Martineau et al (University of Toronto), April 30, 2026; "*Why Almost Everyone Loses on Prediction Markets*", WSJ, May 3, 2026;

[8] "*Who Profits from Prediction? Execution, Not Information*", Joshua Della Vedova (University of San Diego Knauss School of Business), February 7, 2026

[9] "*Detecting Informed Trading in Prediction Markets: An Orthogonality Test*", Joshua Della Vedova (University of San Diego Knauss School of Business), April 13, 2026

[10] "*The Polymarket Paradox*", M. Abid (Westminster), April 2026; "*Polymarket's $7M Ukraine Mineral Deal Debacle Traced to Oracle Whale*", Defiant.io, March 27, 2025

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