MARKET COMMENTARY

The Fed lets markets do part of the tightening.

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- **The Fed kept rates unchanged, but Chair Warsh warned that this was not a pause in the fight against inflation. Three regional governors dissented in favour of a rate hike.**
- **Higher nominal and real yields are tightening financial conditions, helped by the end of forward guidance.**
- **Despite the reiteration of the commitment to fight inflation, markets took the lack of action as dovish. We expect a hike in December, but the odds of a move in September have clearly risen.**

The Federal Reserve kept rates unchanged today, but three regional governors dissented in favour of a hike. Chair Warsh repeatedly stated that remaining on hold should not be read as a soft signal on inflation; rather, it marks a different way of tightening policy. Market did not look fully convinced.

The press releases contained little new information compared to June just the reassurance that the ample reserve system regime will not turned around soon.

> The Federal Open Market Committee approved the following statement for release by a ~~12 – 0~~9 – 3 vote:
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> The Committee decided to maintain the target range for the federal funds rate at 3-1/2 to 3-3/4 percent, in support of the Federal Reserve's dual mandate. The Committee ~~reaffirmed~~is continuing its policy of maintaining ample reserves in the banking system.
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> Economic activity is expanding at a solid pace despite elevated uncertainty that owes, in part, to the conflict in the Middle East. Productivity growth and capital investment are strong. Job gains have kept pace with the workforce, and the unemployment rate has changed little.
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> Inflation remains elevated relative to the Committee's 2 percent goal, in part reflecting supply shocks that have driven price increases in certain sectors, including energy. The Committee will deliver price stability.
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> Voting against the monetary policy action were Beth M. Hammack, Neel Kashkari, and Lorie K. Logan, who preferred to raise the target range for the federal funds rate by 1/4 percentage point at this meeting.

Warsh described the meeting as focused on whether, after five years of above-target inflation, the past has really passed, or whether recent shocks have left deeper marks on price dynamics.

The discussion was collegial, but also active and robust. Warsh treated the presence of three dissenters as a design feature rather than a weakness. The central issue was how best to restore price stability, and when the Fed should move again.

The economic backdrop is still solid, with resilient growth, a steady labour market and strong investment. AI-related capex is rising rapidly and could support future growth, although the timing of that boost remains hard to predict.

That resilience makes the Fed's task harder because strong activity can support employment and income, but it can also make inflation more persistent if price increases spread beyond the original shocks. A core task for the FOMC is therefore to understand how these shocks propagate through the economy; this was the most widely discussed theme during the meeting.

The Fed is clearly not comfortable with inflation remaining above 2% after five years of overshooting. Above all, it wants to avoid any perception that it has become tolerant of excessive inflation. PCE inflation remains the key target, at least until the task force on price measurement reaches a conclusion endorsed by the FOMC.

Warsh noted that nominal and real yields have risen notably since the June meeting, and that financial conditions have tightened materially even without further Fed action. In that sense, markets are doing part of the Fed's job.

The Fed wants to observe how markets react to incoming data without contaminating that reaction through heavy guidance. According to Warsh, higher yields, especially real yields, signal that investors are taking the inflation objective seriously.

That is the key policy shift Warsh is advocating. The Fed is stepping back from forward guidance because too much guidance can reduce the information value of market prices; if the central bank nudges markets too heavily, it learns less from them. Providing extensive information and guidance made sense in crisis times, but in more normal conditions the Fed wants markets to react more directly to economic news.

This does not mean the Fed is constrained by markets, especially by expectations for the federal funds rate, as Warsh pointed out. The point is that market prices can be a useful source of information, provided the signal is not overly shaped by the Fed's own guidance.

Looking at price moves, however, it seems Warsh could not provide a convincing answer to why the Fed is not moving despite stubborn inflation and a strong commitment to bring it down. The market interpreted the tone of the meeting as dovish, raising doubts about the strength of the Fed's inflation-fighting commitment. The policy-sensitive 2-year Treasury yield fell by about 5bps and fed funds futures are currently pricing in 18bp of hikes at the September meeting, down from closer to 25bp before the statement. By contrast, the 30-year yield rose by 12bp during the meeting, reaching 5.2%, the highest level since mid-2007.

We have pencilled in a rate hike at the December meeting. However, the hawkish shift within the FOMC and the need to persuade markets more convincingly raise the odds of a move in September.