At the September meeting, the U.S. Federal Reserve Open Market Committee voted to raise the Fed funds rate by 0.25% to 3.75-4.00%, the first hike in three years. There were no dissents.

The formal statement continued to be released in its new briefer format, remaining generally positive about economic growth and labor, with noted uncertainty related to geopolitics, yet domestic spending has been "resilient." Also, inflation "remains elevated," without added detail about the causes, but that actions "will support a timelier return to the Committee's 2 percent goal." The quarterly Summary of Economic Projections (SER) (or 'dot plot') noted a median expected Fed funds rate of 4.1% for year-ends 2026 and 2027, 3.9% for 2028, and 3.6% for 2029, along with an expected long-term rate of 3.2% (around what they consider neutral).

CME Fed funds futures have certainly bounced around more than usual, with market odds of a hike falling over the summer, but steadily rising again over the past few weeks, especially after the still-elevated CPI and PPI reports. Some commentators described Fed credibility as being on the line, given their tough rhetoric in wanting to fight inflation. Odds also remained high for a Dec. hike, as well as up to several more hikes over the next 12 months (now both Mar. and Dec. 2027), to end next year at 4.50-4.75%. (Markets realize so-called 'one and done' rate hikes have been rare, with 1997 under Greenspan the last exception.) Another hike as soon as October is seen as possible, but potentially too aggressive and unnecessary, let alone the pushback around the proximity before the mid-term elections (warranted or not). The Atlanta Fed's Taylor Rule tool, which calculates 30 different iterations of that formula, currently points to an average ideal Fed funds rate of 5.8%, still well higher than the ending rate even after several possible hikes. The hawkishness of that output is largely driven by the higher inflation number but also buffered by low unemployment and decent economic growth. There's been disagreement on the committee about whether inflation has been improving or not, and/or how to 'look through' it (beyond tariffs from last year and now the Middle East), and whether or not current policy is 'restrictive' or not.

<u>Economy</u>. U.S. GDP growth for the 2nd quarter came in at 1.5%, down a bit from Q1's 2.1%, with some offsetting trade effects. Debate continues over whether the economy remains 'K-shaped' (sustained by higher-income household spending) or has morphed into more of a 'C-shape' (with lower-income prospects improving and higher-income flattening), as well as how much of the economic growth number is artificial intelligence-driven (which has proven to be a bit less interest rate-sensitive). The manufacturing component appears to be at least AI-related, but also has benefited from reshoring activity due to deglobalization trends/tariffs, as well as shorter-term stockpiling in response to Middle East tensions. The Atlanta Fed GDPNow indicator estimates a far stronger result of 5.1% for Q3, with leadership from the consumer and private investment continuing, as well as a solid inventory rebuild. The SER noted slightly upgraded real GDP growth expectations of 2.3% for 2026, 2.4% for 2027, 2.2% for 2028, 2.1% for 2029, and the usual trend-like 2.0% over the long run. While not growing at an incredible clip, growth is strong enough to not get in the way of monetary policy changes for other reasons.

<u>Inflation</u>. For August, headline CPI rose 3.4% over the trailing 12 months, while core CPI ex-food and energy rose 2.4%, similar to July, with downward progress having stalled. Core PCE for July continued to run above-target at 3.3%. The SER noted core PCE expectations of 3.4% for 2026, 2.5% for 2027, 2.2% for

2028, and a target-like 2.0% for 2029. Above-target inflation remains the key underpinning for raising rates, with members split over the speed of the 'look through' part.

Employment. Labor markets continue to operate in a difficult-to-measure 'low-hire, low-fire' environment. While openings remain contained, as are nonfarm payrolls, jobless claims and the overall unemployment rate remain low. The SER noted an unemployment rate of 4.1% for 2026 through 2029, and 4.2% over the long run. Demographic changes in immigration, household formation, and retirements have altered the job market statistics, but a lack of 'bad' news has kept labor from being a reason for the Fed to ease policy and cut rates.

With Kevin Warsh at the helm, a variety of new initiatives are being reviewed, including how inflation is measured and evaluated. Inflation targeting has gotten a bad rap as of late, particularly because the particularly specific target of 2% in the U.S. hasn't been hit since pre-pandemic. Other countries with an inflation-targeting mandate, such as Australia, Canada, and the U.K., approach it through a range, like 1-3% or 2-3%. That allows some wiggle-room without abandoning the objective completely. However, the more stringent U.S. target inevitably draws more scrutiny, especially the longer inflation runs hot.

U.S. Treasury yields have also been in the news increasingly as of late, with the 10-year and 30-year running at 20-year highs. The bellwether 10-year touched 5% briefly this week, and appears to still be running within a 'fair value' range when looked at in the context of expectations for inflation, real economic growth, and fiscal/budgetary concerns. The recent rise in long-term Treasury rates serves to accomplish some of the Fed's tightening job for it, as they've alluded to. The rise in yields has drawn comments and a change in approach from the U.S. Treasury department (purchasing more longer-term debt financed by shorter-term debt), as it obviously creates a headwind for government financing costs. Markets have perceived Treasury buyback 'twists' as insufficient to matter much on the technical supply/demand side, but do serve as a signal the government is aware of the concerns. They're also no doubt cognizant of side effects, such as foreign owners selling Treasuries to raise cash for other reasons, like currency stabilization. Though, the high deficits and debt levels at over 100% of U.S. GDP go beyond the Fed and Treasury's capabilities, and require deeper governmental fiscal action, which would hopefully happen prior to financial markets continuing to demand larger risk premiums for U.S. borrowing. The Fed has been reluctant to comment on this, because it delves into the political sphere, and practically, they can't do lot about it.

It's been noted that the past 20 years were characterized by high savings levels resulting in too much capital chasing too few projects (pushing prices up and yields down). However, that pattern seems to have flipped with AI, and higher inflation, now with an abundance of projects potentially exceeding required capital (causing yields to rise as an incentive for investment). Such patterns are intuitively supply/demand driven and cyclical. Fed rate hikes have traditionally been related to an overheating economy and very strong demand, although the inflation-fighting impact of just a few quarter-percent moves remained under debate, with likely larger downward inflation impacts resulting from the passage of time, as the tariff and Middle East shocks wear off from a rate of change standpoint. On the near-term side, economic conditions continue to run at a trend-like pace, and the byproduct of corporate earnings even stronger than that, keeping recession fears out of immediate sight.

Ryan M. Long, CFA

Sources: CME Group, Federal Reserve Bank, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, Advisory Solutions Group, LLC, calculations.