Support for tightening grows

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The next policy decision will largely depend on whether upcoming inflation data validate the recent improvement in inflation

The FOMC left the target range for the federal funds rate unchanged at 3.50-3.75%, but the 9-3 voting split underscored the Committee's increasingly hawkish internal debate. All three dissents favored a 25bp rate hike and came from regional Reserve Bank presidents Hammack, Kashkari and Logan rather than Board members. Unless inflation surprises meaningfully to the downside or labor market conditions weaken materially by September, those dissents are likely to persist and could attract broader support within the Committee. The accompanying statement was virtually identical to June's, the only textual change being the replacement of "reaffirmed" by "is continuing" in describing the Committee's policy of maintaining ample reserves in the banking system. It again stated that "economic activity is expanding at a solid pace," that "productivity growth and capital investment are strong," and that "job gains have kept pace with the workforce, and the unemployment rate has changed little." Likewise, it reiterated that "inflation remains elevated," partly reflecting "supply shocks," while reaffirming that "the Committee will deliver price stability."

The press conference was hawkish in tone but deliberately ambiguous on the policy outlook, with Warsh emphasizing the information embedded in financial markets. Chair Warsh's introductory remarks maintained a clearly hawkish tone, describing the U.S. economy as displaying "impressive resilience," reiterating that the Committee has "no soft inflation target," and repeatedly stressing its commitment to restoring inflation to 2%. However, his answers during the Q&A were considerably more ambiguous, offering few clear signals about the conditions that would warrant a rate hike or its likely timing. Instead, he repeatedly shifted the discussion toward market signals, arguing that the Committee is "interested in the reaction of financial markets," which "have done quite a bit" since the June meeting. In particular, he argued that removing forward guidance was intended to allow markets to transmit a more "unfiltered" signal about the outlook. In his view, the rise in long-term yields and the broad strengthening of the U.S. dollar, both driven by signals of "strong economic growth" and "the reduction in forward guidance," indicate that financial markets are already contributing to tighter financial conditions. He did not address the alternative possibility that part of the recent increase in long-term yields instead reflects higher term premia associated with the uncertainty around the renewed escalation of the conflict in the Middle East.

The meeting ultimately strengthened the Committee's hawkish narrative without providing much greater clarity on the conditions that would trigger the next rate hike. Chair Warsh deliberately avoided providing explicit guidance on the timing of the next move, instead preserving policy optionality by emphasizing that the Committee will focus on “trends in the data” rather than individual data releases, while allowing market developments to “help inform” its decisions. Consistent with this ambiguity, Fed funds futures now price roughly even odds of a rate hike in September. The post-meeting market reaction reinforced that interpretation: the 2-year Treasury yield fell somewhat, while the 10-year and 30-year Treasury yields rose slightly, steepening the yield curve. This curve development appears consistent with greater uncertainty surrounding the medium-term policy outlook.

We continue to believe that how long the recent improvement in inflation lasts will be the key determinant of the next policy move. We think downside risks to the broader outlook remain elevated—including renewed geopolitical tensions in the Middle East, a labor market that appears stable but also fragile, and uncertainty surrounding the sustainability of the AI-driven investment boom and its associated wealth effects. Against this backdrop, the cost of maintaining the current policy stance for longer appears low. As a result, another pause in September remains, in our view, a plausible baseline scenario, although we continue to see the risks to our outlook as tilted to the upside.

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