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The hawkish case will likely remain, but not for immediate action

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June’s incoming data reduced the urgency to tighten, but not the Committee's broader concerns about inflation risks

The composition of growth in Q2 appears to have shifted as household demand regained momentum while net exports became a larger drag on growth. While the third estimate of first-quarter GDP growth was revised up to 2.1% from 1.6% in late June, the improvement reflected a smaller drag from imports rather than stronger domestic demand, with real final sales to private domestic purchasers revised down to 1.7% from 2.4% due to softer personal consumption (Figure 1). Even so, incoming data suggest household demand rebounded in the second quarter. Control-group retail sales rose 0.5% m/m in June, while business investment continued to benefit from AI-related capital spending despite flat manufacturing output during the month. The May trade report lowered the Atlanta Fed's GDPNow estimate for second-quarter growth from around 2.5% to 1.2%, largely reflecting weaker net exports and a softer outlook for private investment. Subsequent releases on consumption and business activity, however, lifted the nowcast back to around 1.7% more recently. Overall, the intermeeting data suggest activity has remained resilient enough to sustain the FOMC's concerns about demand-driven inflation risks, although not strong enough to signal a meaningful reacceleration in growth.

While the June employment report was weaker than expected, the broader picture still points to a stabilizing labor market rather than a deteriorating one. Nonfarm payrolls increased by just 57k in June, well below expectations (113k), while April and May payrolls were revised down by a combined 74k. Even so, the three-month average remained at a still-solid 111k (Figure 2). Job creation remained concentrated in professional and business services (+36k), social assistance (+25k) and health care (+22k), while leisure and hospitality unexpectedly shed 61k jobs despite the FIFA World Cup, likely reflecting weaker-than-usual seasonal hiring. The unemployment rate edged down to 4.2% from 4.3%, largely because labor force participation declined to 61.5% from 61.8%, while average hourly earnings rose 0.3% m/m, leaving annual wage growth at a moderate 3.5%. Broader indicators also continued to point to labor market stability. Initial jobless claims remained low, ISM employment indices improved in June, and Chair Warsh recently pointed to relatively few layoffs, limited variation in job openings and solid nominal wage growth. Overall, incoming labor market data since the June meeting provide little evidence that employment conditions have evolved enough in either direction to alter the Committee's policy assessment.

Inflation also came in lower than expected, dampening the case for an immediate rate hike but doing little to ease broader concerns about upside inflation risks. Headline CPI fell 0.4% m/m in June, lowering the annual rate to 3.5% from 4.2%, while core CPI was unchanged on the month, bringing the annual rate down to 2.6% from 2.9% (Figure 3). The softer reading reflected lower energy prices following the temporary easing of the Iran conflict, but also broad-based moderation in underlying inflation, with core goods prices declining, core services posting only a muted increase and shelter recording its smallest monthly gain since January 2021. There was also little evidence that the FIFA World Cup generated the expected increase in travel-related prices. Even so, policymakers are likely to remain cautious. Inflation remains above target, and one favorable report is unlikely to be sufficient to conclude that a sustained disinflationary process is finally underway. Moreover, the possibility that AI-related demand and renewed energy supply disruptions could keep underlying inflation elevated is likely to remain at the forefront of the Committee’s concerns. As with the labor market data, the latest inflation readings weaken the case for an immediate rate hike but are unlikely to materially alter the Committee's medium-term assessment of inflation risks.

Renewed escalation of the Iran conflict heightened inflation uncertainty, complicating how policymakers interpret incoming data. The June FOMC minutes noted that only “a few participants” saw a case for raising rates immediately, leaving the debate open between the chances of either maintaining the current policy stance or tightening at subsequent meetings. Chair Warsh's first Congressional testimony reinforced the Committee’s "no tolerance for persistently elevated inflation" while emphasizing the Fed’s independence and data-dependent approach. Although markets continued to assign a high probability to the Fed remaining on hold this week, that conviction eased from around 85% to roughly 65% following the renewed escalation of the Iran conflict and the rebound in Brent crude prices to around USD 100/bbl. At the same time, the recent rise in long-term Treasury yields has been driven by a higher term premium rather than a significant reassessment of the expected policy rate path (Figure 4).

While the Fed is set to keep the fed funds rate target range unchanged at 3.50-3.75% this week, Chair Warsh is likely to maintain a cautiously hawkish tone. While the intermeeting softer-than-expected employment report and encouraging CPI reading weaken the case for an imminent hike, the renewed escalation of the conflict with Iran and the corresponding rebound in oil prices add fresh uncertainty to the inflation outlook. The stability of inflation expectations gives the Fed some room to avoid drawing strong policy conclusions from the recent oil-price rebound. However, Chair Warsh will likely reinforce the Committee’s hawkish lean by pointing to the AI investment boom as a potential source of demand-driven inflation, a risk policymakers are increasingly acknowledging even as tariff-driven pressures on goods prices are fading. With no updated SEP at this meeting and forward guidance removed from the statement, the main near-term policy signal will come from Warsh’s press conference, while the minutes will later reveal whether the balance of views shifted materially in either direction since June.

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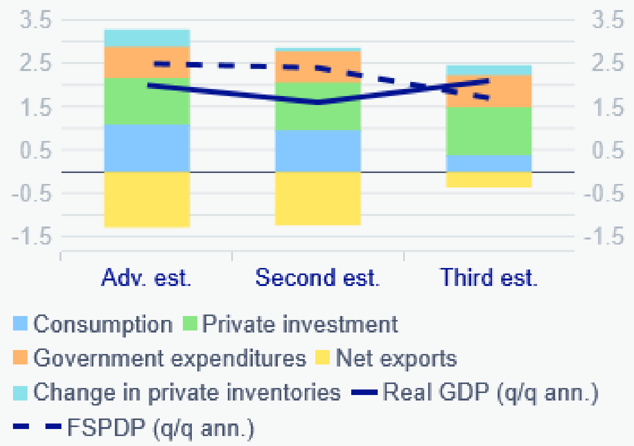
1Q real FSPDP was revised down to 1.7% from 2.4% due to softer personal consumption

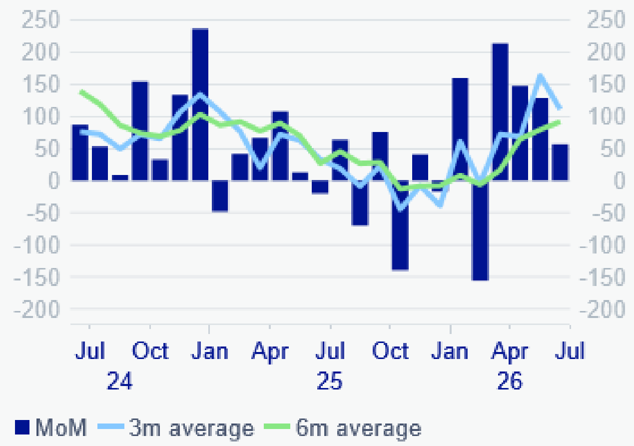
FIGURE 1. 1Q26 REAL GDP GROWTH (%)



Source: BBVA Research, BEA

Nonfarm payrolls increased by just 57k in June, well below expectations (113k)

FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research, BLS

Core CPI was unchanged in June, bringing the annual rate down to 2.6% from 2.9%

FIGURE 3. CORE PCE INFLATION (%)

Source: BBVA Research, BLS

The recent rise in long-term Treasury yields has been driven by a higher term premium

FIGURE 4. 10-YEAR TREASURY YIELD BREAKDOWN (%)

Based on the NY Fed ACM model
Source: BBVA Research, Fed

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