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Cornered into a hike?

Javier Amador, Iván Fernández

August's core CPI reading broke a streak of target-consistent prints, bolstering the case for a rate hike this week

Underlying domestic demand remains strong, likely reinforcing hawkish concerns about the risk of demand-driven inflation pressures. Second-quarter GDP growth slowed to 1.5% annualized from 2.1%, largely reflecting weaker net exports, inventory accumulation and government spending. Yet final sales to private domestic purchasers were revised up to 4.2% from the 3.9% advance estimate, their fastest pace since 1Q23. Consumption growth jumped to 3.4%, while nonresidential investment maintained strong momentum, expanding 8.5% annualized after 10.6% in 1Q26 (Figure 1). Real retail sales fell 0.6% m/m in July, largely due to weaker auto and non-store sales, the latter likely reflecting the earlier timing of Prime Day, while clothing and food-service posted modest growth. While consumption will likely slow in 3Q as tax refund tailwinds fade, it should remain resilient. Meanwhile, July's surge in AI-related imports—computers and computer accessories rose 25% and 33% m/m, respectively—suggests investment momentum remains strong even as it will likely widen the drag from net exports on third-quarter GDP. Indeed, the Atlanta Fed's GDPNow estimates that net exports will subtract nearly 1.5pp from third-quarter growth, but still projects GDP growth at a strong 4.4%, supported by robust consumption and investment. Overall, activity data offer hawks little reason to delay tightening on growth concerns alone.

The latest jobs report dealt a significant setback to the dovish case for a September pause, reversing much of the concern that had emerged a month earlier. July initially raised concerns about labor market conditions, as payrolls fell 23k and downward revisions to May and June lowered the three-month average gain to just 20k (Figure 2). Much of the weakness, however, reflected volatile government employment, while the unemployment rate edged down to 4.1% and layoffs and jobless claims remained low. August then largely reversed those concerns. Payrolls jumped 162k, with gains extending to leisure and hospitality (+62k), construction (+22k) and manufacturing (+16k), while July payrolls were revised from a 23k decline to a 21k gain. The unemployment rate remained at 4.1% despite a 0.2 pp rebound in participation. Thus, the argument that slower population growth means fewer jobs are needed to maintain labor market equilibrium continues to gain traction. Wage growth moderated only slightly to 3.1% y/y. Overall, while current near-full-employment conditions remain vulnerable to a sudden deterioration in the balance between labor demand and supply, a preemptive rate hike aimed at restoring a sustained downward inflation trend would likely pose limited near-term risks to the labor market. Moreover, the labor market is not currently the Fed's primary concern.

The August CPI report further complicated the case for holding rates steady this week by interrupting the recent run of favorable inflation readings. Core PCE inflation rose 0.2% m/m in July, leaving the annual rate elevated at 3.3% y/y. The August PPI report followed with final-demand prices rising 0.4% m/m and 5.4% y/y, though largely reflecting higher energy and goods prices. However, the subsequent CPI snapped a three-month streak of target-consistent core inflation readings, as it accelerated above expectations to 0.3% m/m (up from 0.2% in July). Annual core inflation nevertheless edged down to 2.4%, its lowest since March 2021 (Figure 3). Core goods inflation moderated further, suggesting that tariff-related price pressures continue to fade, but core services accelerated by one-tenth to 0.33% m/m, mainly reflecting stronger shelter and communication prices (driven by a likely one-off increase in mobile services prices). More importantly, while the risk of a renewed acceleration in core inflation likely remains contained, the inability of the US economy to string together a sustained sequence of favorable readings makes it difficult for the FOMC to dismiss the persistence of underlying price pressures. Repeatedly looking through such setbacks could eventually raise questions about the Fed's commitment to 2% and reinforce perceptions of a higher “soft” inflation target—an interpretation Warsh explicitly rejected early in his tenure.

Recent data have considerably narrowed the case for another pause, shifting both the FOMC debate and market pricing toward a rate hike this week. The July minutes revealed broader support for tightening than the 9-3 vote implied, with “several participants” favoring a hike, while Warsh reinforced the hawkish message at Jackson Hole by warning that the Fed would “have work to do” unless inflation moves toward 2% “clearly and at sufficient speed.” New York Fed President Williams, and particularly Governor Waller, subsequently opened the door to another pause if summer disinflation continued, but the latest CPI report likely failed to meet the condition they had laid out for supporting another pause. Markets have responded accordingly: fed funds futures now assign roughly a 92% probability to a hike this week, while the 2-year Treasury yield has climbed to around 4.6%, roughly 50bp above its early-August level, and the 10-year yield has approached 5% (Figure 4). Unlike the term-premium-driven rise earlier this summer, the sharp increase at the front end suggests that the recent move increasingly reflects expectations of tighter Fed policy.

While far from a done deal, Warsh’s Fed has effectively cornered itself into a hike with its hawkish rhetoric. We now lean toward a 25bp rate hike aimed at preserving policy credibility, though a hold remains a distinct possibility. Despite the near-certainty implied by market pricing, 43 of the 111 analysts surveyed by Bloomberg still expect the Fed to stay put this week at the time of writing. The remaining ~60% now likely agree that the case for a hike has significantly strengthened: activity remains resilient, the latest jobs report eased downside labor market concerns, and inflation failed to extend its recent run of target-consistent prints. The three July FOMC dissenters are very likely to favor a hike again this week. Beyond them, the June SEP showed that another six participants projected at least one rate hike this year. Assuming Warsh—who did not submit a projection at the previous meeting—joins them, a September hike could command a majority if just half of those six are voting Board members and choose to act this week.

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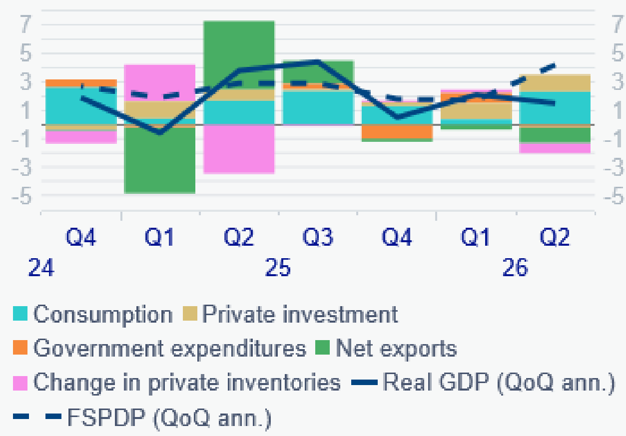
Consumption growth jumped to 3.4%, while fixed investment maintained momentum in 2Q

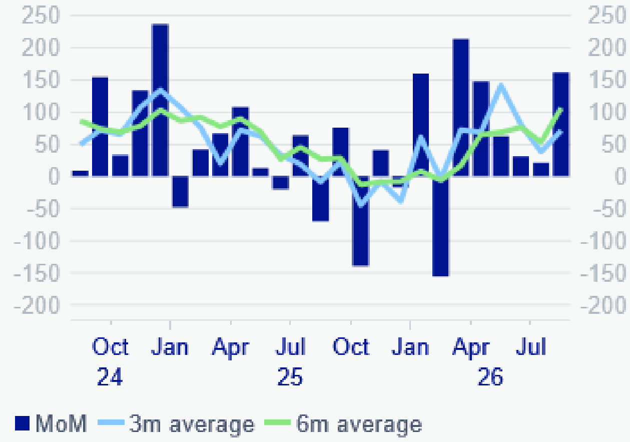
FIGURE 1. 1Q26 REAL GDP GROWTH (%)



Source: BBVA Research, BEA

The labor market is not currently the Fed's main concern: payrolls jumped 162k in August

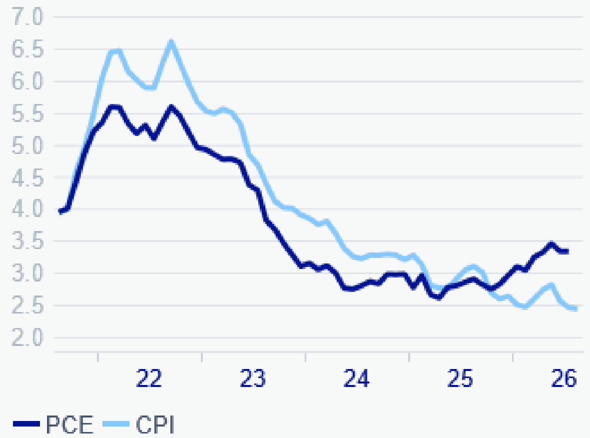
FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research, BLS

The August CPI report further complicated the case for holding rates steady this week

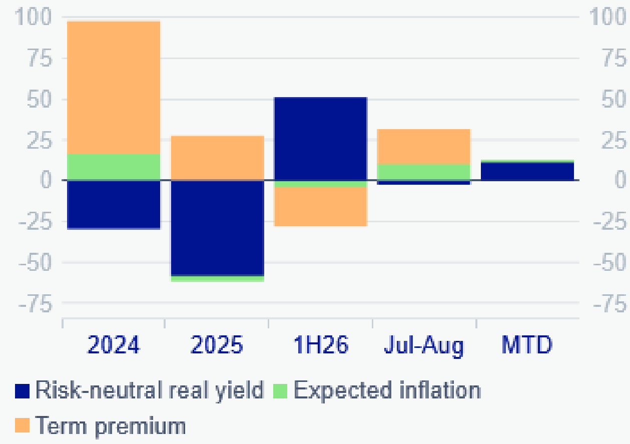
FIGURE 3. CORE INFLATION (%)



Source: BBVA Research, BLS, BEA

The recent move of long-term Treasury yields reflects expectations of tighter Fed policy

FIGURE 4. 10-YEAR TREASURY YIELD CHANGE BREAKDOWN (BPS)



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

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