

Not an inflation emergency

The Fed raises rates by 25 basis points to reinforce its inflation-fighting credibility

IN A NUTSHELL

- The Fed raised rates by 25 basis points, prioritizing inflation-fighting credibility over near-term weakness in rate-sensitive parts of the economy.
- The move looks more like policy fine-tuning than the start of an extended hiking cycle, with the path from here dependent on inflation and economic resilience.
- Higher yields offer more attractive fixed-income entry points, while equities remain supported by earnings but increasingly sensitive to further increases in long-term Treasury yields.

Heading into this week's Federal Open Market Committee (FOMC) meeting, the 25-basis-point rate hike to 3.75-4.00% that the U.S. Federal Reserve (the Fed) just delivered was almost fully priced in. Long-term yields have already risen sharply over the past few months, with the 10-year Treasury yield touching just above 5%, its highest level since 2007, amid oil above USD 100 per barrel and heavy government and corporate borrowing. Meanwhile, economic data offered mixed signals. In August, labor market conditions remained firm, with payrolls increasing by 162,000 and unemployment holding at 4.1%, while retail sales rose 1.2%. However, households remained cautious, with the University of Michigan's preliminary September consumer sentiment index¹ falling to its second-lowest reading on record.²

Inflation, however, remains the central challenge facing the Fed. Price pressures have stayed above the Fed's 2% target for more than five years, with recent trends pointing upwards. Headline CPI rose by 0.4% in August and was up 3.4% from a year earlier, with gasoline accounting for more than a third of the monthly gain. Core CPI rose a firmer-than-expected 0.3% in August, even as annual core inflation eased to 2.4%. With oil still above USD 100, the risk that higher energy costs feed through to broader prices added to concerns that returning inflation sustainably to the Fed's 2% target would prove difficult.

The bond market has already tightened financial conditions considerably, with 10-year and 30-year Treasury yields reaching nearly two-decade highs. Before yesterday's decision, markets were pricing close to 90 basis points of cumulative tightening over the coming quarters. Investors are therefore less focused on the impact of a single 25-basis-point move and more on how much additional tightening may ultimately be needed, particularly as higher borrowing costs weigh on housing and parts of the consumer economy.

That debate has been complicated by an evolving message from Kevin Warsh. As DWS's George Catrambone points out, markets have effectively seen three different versions of Warsh since he took over the Fed. In June, Warsh scaled back the Fed's forward guidance, giving policymakers more room to respond to incoming data. By July, his focus on the inflation target and the importance of restoring credibility had become clearer, while he also acknowledged that higher Treasury yields were already tightening financial conditions.

¹ Sources: Bloomberg Finance L.P.; University of Michigan as of 9/16/26

² Any data points are taken from Bloomberg Finance L.P. as of 9/16/26 if not stated otherwise.

At Jackson Hole, Warsh struck a more hawkish tone. He said the Fed would have more work to do unless underlying inflation moved clearly and quickly enough toward 2%, and that responsibility for 65 months of elevated inflation “sits squarely with the central bank.” He also appeared more willing to look through weakness in rate-sensitive parts of the economy, including housing, but, pointing to strong AI-driven investment and tight credit spreads, did not see broad financial conditions as restrictive. The question for investors has therefore been how Warsh will balance the need to reinforce the Fed’s inflation-fighting credibility against the risk that further tightening eventually exposes those weaker parts of the economy.

Warsh’s emerging approach also appears different from the more structured communications framework investors became accustomed to under Ben Bernanke and Jerome Powell. His greater emphasis on judgment, market signals and flexibility, while relying less on explicit forward guidance, has some similarities to Alan Greenspan’s risk-management style of central banking. The clearest historical parallel may be the Fed’s 1994–95 tightening cycle:³ although observed inflation was falling, the Fed raised rates by 300 basis points within a year in anticipation that stronger growth would eventually generate price pressures. Today’s move likewise appears to be driven more by credibility and preemption than by an immediate inflation emergency. Going into this meeting, the policy move itself was therefore only part of the story: investors were equally focused on what it might reveal about Warsh’s reaction function and the path of monetary policy from here.

Economic and policy implications

According to Christian Scherrmann, Chief U.S. Economist, the Fed’s decision was broadly in line with expectations but points to a nuanced policy outlook: “As expected, the Federal Reserve increased its policy rate by 25 basis points at its September meeting – the first such move since 2023 – raising the rate to a new range of 3.75% to 4.00%. The decision was unanimous, and the accompanying statement said the rate hike would help achieve the 2% inflation target more quickly. Although central bankers anticipate inflation cooling in the upcoming quarters, they likely recognize that further action is needed to reach this goal. The median dot plot indicates a preference for an additional rate increase in 2026. In 2027, however, preferences diverge. Some indicate another rate increase, some see rates holding steady, and a few indicate that lower rates might be warranted. Interestingly, the longer-run policy rate, associated with the neutral rate, increased from 3.1% to 3.2%. This suggests that central bankers anticipate a slight structural shift. Again, Fed Chair Kevin Warsh did not submit forecasts.

During the press conference, Fed Chair Kevin Warsh referenced his Jackson Hole speech, noting supportive financial conditions in a robust economy that appears to be strengthening. He said the move took “a dose of accommodation” off these conditions. Regarding inflation, he reiterated his view that too many subcategories were rising at a pace of 3% or more, which does not satisfy his standard for inflation moving toward the target speedily enough. Contrary to the forward-looking behavior principle he set out at Jackson Hole, Warsh primarily linked today’s decision to past economic developments.

To us, a cycle of one or two rate hikes is more akin to fine-tuning the economy than recalibrating monetary policy. However, if inflation does not cool down in the coming quarters, one or two rate hikes may not suffice. Similarly, one or two rate hikes will likely not solve problems caused by external shocks, such as rising oil prices and renewed uncertainty from tariffs. Nevertheless, there are good reasons to believe that inflation will trend lower and that tightening to the point where domestic demand slows is unnecessary. Overall, we believe the main motivation this time was credibility, given bond market pricing and recent developments in oil markets. Despite his hawkish stance, Fed Chair Warsh’s optimistic outlook on the economy may be music to many ears.”

³ Federal Reserve Bank of St. Louis, “Risk Management and Monetary Policy: The 1994–95 FOMC Tightening Episode,” *Federal Reserve Bank of St. Louis Review*, April 2025.

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Asset-class implications

Fixed Income

The Fed's 25-basis-point rate hike initially triggered a repricing at the front end of the Treasury curve, with two-year yields rising by around 10 basis points to 4.73%. Longer-dated yields were comparatively stable, suggesting that the move reinforced the Fed's inflation-fighting credibility without materially increasing concerns about a more aggressive tightening cycle. At the start of European trading, however, yields were slightly lower across the curve.

The market is now pricing roughly equal chances of another hike or a pause in October. As George Catrambone, Head of Fixed Income, Americas, notes: "While short-term momentum could push yields somewhat higher, the Fed's projections suggest that policymakers favor a gradual reversal of the 2025 cuts rather than a rapid series of increases. This should limit the risk of a more pronounced sell-off at the longer end of the curve."

"In our view, both nominal and real yields remain attractive," he adds. "A more credible Fed should help contain long-term inflation expectations, while further rate hikes against a backdrop of already strained consumers and elevated energy prices could become an increasingly significant headwind for consumption and growth. That combination should limit the rise in longer-dated yields and could ultimately pull them lower, creating selective opportunities in duration. Near-term volatility may nevertheless remain elevated as markets reassess the timing and extent of further tightening."

Treasury demand is another factor to monitor. According to Treasury data⁴, foreign investors sold a net USD 3.6 billion of long-term Treasuries in July, the first month of net selling since December 2025, with sales concentrated among investors in Canada and the euro area. One month does not establish a trend, but weaker foreign demand could add pressure to longer-term yields if it persists.

Catrambone concludes: "Overall, the decision avoided the tail risks associated with either a 50-basis-point hike or no move at all and reduced the likelihood of a disorderly market reaction. For fixed-income investors, attractive nominal and real yields, the prospect of a gradual hiking path and the potential for growth concerns to contain the long end support a selective approach to duration, while recognizing that near-term yield momentum may remain upward."

Equities

"One or two additional hikes are generally considered acceptable for equities, as markets continue to be supported by a resilient economy and solid earnings growth across multiple sectors," says Benjardin Gaertner, Global Head of Equities. While some investors may now speculate about the possibility of a more prolonged tightening cycle, this is not our base case. However, the latest developments inevitably evoke comparisons with the 2017-2018 hiking cycle, when equities initially absorbed higher rates but eventually sold off sharply as investors grew concerned that the Fed might overtighten. The S&P 500 fell roughly 15% in the fourth quarter of 2018 before recovering once the Fed adopted a more flexible stance in early 2019.

Investor tolerance for additional rate hikes appears lower today, suggesting equity markets could become more sensitive to hawkish surprises. Even so, we continue to view AI-related beneficiaries as relatively resilient, supported by strong earnings prospects and ongoing investment across the AI ecosystem. In the near term, developments around Iran and oil prices, together with moves in long-dated U.S. Treasury yields, are likely to remain important catalysts for equities in either direction. Over time, however, markets may again shift their focus from the Fed to the growth and productivity opportunities associated with AI.

⁴ Source: U.S. Treasury: Treasury International Capital Data for July 2026.

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Glossary

One **basis point** equals 1/100 of a percentage point.

Carry (of an asset) refers to the net return or cost of holding an asset over time, typically derived from income such as interest or dividends minus any associated financing or holding costs. A **carry trade** is an investment strategy that seeks to capture this carry by exploiting differences in yields or interest rates between assets, typically by funding at a lower rate and investing in assets with higher returns.

The **consumer price index (CPI)** measures the price inflation as a percentage, year over year, of a basket of products and services that is based on the typical consumption of a private household.

Core inflation excludes items which can be susceptible to volatile price movements, e.g. food and energy.

Credit spread is the difference between the yield (return) of two different debt instruments with the same maturity but different credit ratings.

Each **dot** represents where an FOMC member sees the federal funds rate at the end of each year.

Duration is a measure expressed in years that adds and weights the time periods in which a bond returns cash to its holder. It is used to calculate a bond's sensitivity towards interest-rate changes.

The **Federal Open Market Committee (FOMC)** is the committee that oversees the open-market operations (purchases and sales of securities that are intended to steer interest rates and market liquidity) of the U.S. Federal Reserve.

Federal Reserve Bank is a regional bank of the Federal Reserve System, the central banking system of the United States. There are twelve in total.

Fiscal policy describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

Headline inflation is the raw inflation figure based on the consumer price index (CPI) and not adjusted for seasonality or for the often volatile elements of food and energy prices.

Headline unemployment rate (U3) is the official U.S. unemployment rate measuring people without jobs who have actively looked for work in the past four weeks.

Inflation is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

Monetary policy focuses on controlling the supply of money with the ulterior motive of price stability, reducing unemployment, boosting growth, etc. (depending on the central bank's mandate).

A **monetary-policy tightening cycle** is a period of time during which a central bank raises interest rates with the aim of slowing GDP growth or inflation.

The **neutral real interest rate** is the official interest rate, adjusted for inflation, which is estimated to allow an economy to grow at its trend rate.

In economics, a **nominal** value is not adjusted for inflation; a real value is.

Primary issuance is the sale of newly issued securities, such as bonds or shares, directly by an issuer to investors.

In economics, a **real** value is adjusted for inflation.

The **term premium** is the expected return on an investment minus the return that would be earned on an investment with a shorter term/maturity.

Tightening monetary policy refers to all actions undertaken by a central bank to slow down overheated economic growth. These include regulation of key interest rates, constraining monetary supply or increasing capital requirements for credit risks.

Treasuries are U.S. government debt securities, including Treasury bills, notes, bonds, and inflation-protected securities.

The **U.S. Federal Reserve**, often referred to as "**the Fed**," is the central bank of the United States.

University of Michigan Inflation Expectations Survey of Consumers measures U.S. consumers' expected price changes over future periods.

Yield refers to the income generated by an investment, such as interest or dividends, usually expressed as an annual percentage of its value.

Yield curve shows yields on comparable fixed-income securities across different maturities.

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