1 September 2026

Reading the Markets USD

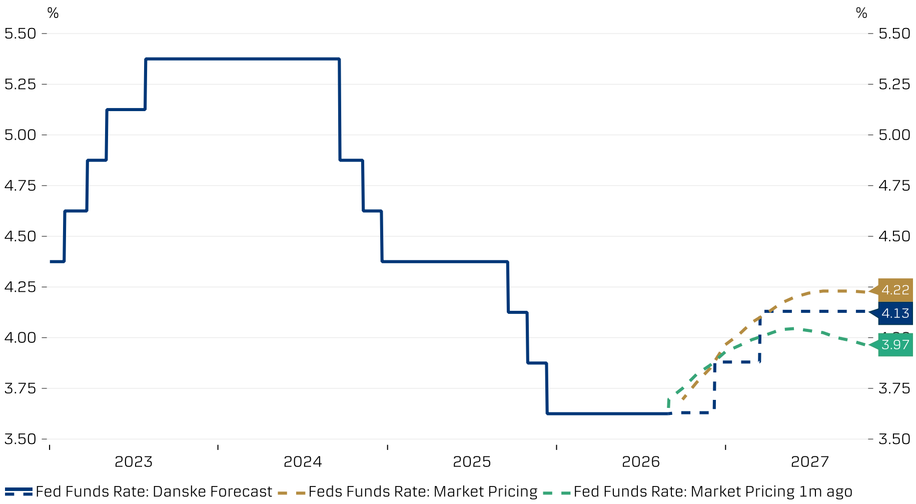
We doubt Warsh can turn the FOMC in two weeks

Fed chair Warsh delivered his first keynote speech at the Jackson Hole Symposium hosted by the Kansas City Fed. He set out his clearest views yet on the economic outlook as Fed chair.

Overall, Warsh's tone was hawkish, especially compared with the press conference at the July meeting. On inflation, he said: "Inflation is running above our 2 percent target. So, the Fed's predominant focus right now should be on prices." He also confirmed the Fed's 2% PCE objective as a firm target. We interpret Warsh's view of the economy as follows: inflation is above target, financial conditions are not clearly restrictive, the labour market is steady, growth is generally solid, but uneven across sectors.

We maintain our call for Fed rate hikes at the December and March meetings, but the risk is tilted towards earlier hikes than our forecast suggests. Market pricing changed sharply after the speech, making our call look relatively dovish (see chart 1). Fed funds futures now price a 60% probability of a hike at the next meeting in September, while an October hike is almost fully priced. Markets now look to the upcoming FOMC meetings to see if Warsh is following through on his inflation concerns. If not, market pricing could quickly revert.

Chart 1. Fed market pricing turned more hawkish after Warsh's speech



Source: Macrobond, Federal Reserve, CBOT, Danske Bank

Note: Past performance is not a reliable indicator of current or future results.

Key views

- **Macro:** Cyclical outlook remains healthy, even if stagnant labour supply growth weighs on real growth. GDP +2.0% in 2026, close to consensus of +2.2%.
- **The Fed:** 25bp hikes in December and March. Rates held at 4.00-4.25% for the rest of 2027 (below market pricing).
- **EUR/USD:** Relative macro and monetary policy outlook push EUR/USD lower towards 1.12 on a 12M horizon. Below consensus and forward.
- **10Y UST:** 5.00% in 12M (above forward at 4.90%).

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Booming profits

The cyclical outlook looks better after the revised Q2 national accounts confirmed our view of stronger growth but also broader inflation pressures. Perhaps the most striking detail was the rise in business profitability, which soared 22.8% y/y, from 12.8% in Q1 and the fastest pace since Q4 21. Higher unit profits pushed inflation up, even as unit labour cost growth remains near zero (see chart 2). Strong profitability will continue to incentivise investment and hiring, boosting both growth and inflation. The unemployment rate is already low at 4.1% and a further pick-up in demand will push wages higher, lift unit labour costs and cause inflation to overshoot expectations unless the Fed reacts. Furthermore, consumption growth was revised up to 3.4% q/q SAAR from 3.2%, while imports were revised up to 12.5% from 11.5%, both adding slightly to the outlook for upward inflation pressure.

This is very similar to Q2 and Q3 21, when the Fed did not deliver hikes until March 2022. Having learnt from the past, we expect the Fed to be alert to curbing underlying inflation pressures, in particular with Warsh at the end of the table, supporting our call for monetary policy tightening towards year-end.

Job growth resumed in August

Friday's August Jobs Report will provide more information on labour market tightness. Continuing jobless claims edged lower through August as labour market balance tightened further. We forecast NFP growth at +65k, up from -23k in July. ADP's weekly private-sector employment estimates rose slightly over the reference period but remain low compared with April-June, when NFP growth averaged around 100k per month. Employment growth is constrained by weak labour supply growth due to negative net immigration and a falling participation rate. We expect the unemployment rate to remain at 4.1%, suggesting continued tight labour market conditions.

Later today, ISM will publish its August manufacturing index. The regional Feds' manufacturing indices have risen markedly on average and point to a further uptick in the headline ISM (see chart 3). We will also watch today's July JOLTs data closely, especially job openings, which have been a good leading indicator of wage growth. Job openings declined in both May and June but remain elevated compared with the very low levels seen in Q1. We expect hiring to trend gradually higher, while involuntary layoffs likely remain near historically low levels.

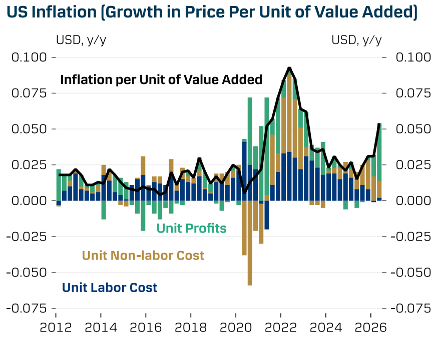
The front-end of the curve hit

US interest rates rose – in particular in the front-end of the curve - and EUR/USD dropped on the back of Fed Chair, Kevin Warsh's speech at Jackson Hole. The views and market reaction were reminiscent of the developments around the June FOMC meeting. The market now discounts about 15bp of hikes in September and 1½ hikes by year-end.

The market now has two hawkish observations to judge Warsh on. The big question ahead of the September FOMC meeting instead becomes whether he will be able to convince a majority of the FOMC that the time is ripe for a hike. As mentioned, we do not expect the NFP to stand in the way of a hike – the next inflation release and the sense of urgency in the FOMC will be key.

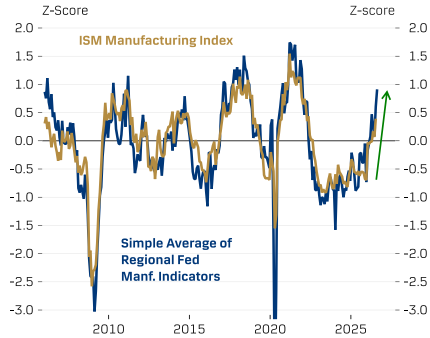
EUR/USD fell back below 1.16 again. Speculative positioning had returned closer to neutral ahead of Jackson Hole, i.e. there was room for USD buying on the hawkish news. We think EUR/USD has further room to drop.

Chart 2: High unit profits are increasingly inflationary



Sources: Macrobond, U. S. BEA, Danske Bank

Chart 3: Manufacturing activity picks up the pace



Sources: Macrobond, ISM, Regional, Danske Bank

Chart 4: Warsh speech fuelled rate hike expectations

Sources: Macrobond, Bloomberg

Note: Past performance is not a reliable indicator of current or future results.

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