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FX RATES UNITED STATES

FOMC preview: Fed set to hike 25bp in recalibration move

We changed our view to a 25bp Federal Reserve rate hike in September in the wake of Chair Kevin Warsh's address at the Jackson Hole symposium. The data since then has justified that decision. Our projections for jobs and inflation suggest no need for a series of hikes

We expect a 25bp hike on 16 September but think this will be a one-and-done affair

Fed hike not the start of a new tightening cycle

After sounding hawkish in June and then backtracking somewhat at the July FOMC press conference, Chair Warsh was under pressure to clarify the Federal Reserve's reaction function under his leadership at Jackson Hole. He emphasised a focus on inflation, which has been above target for five and a half years, and a sense that financial conditions aren't tight in an environment of full employment. This suggested we needed to change the way we thought about the September Fed decision. Previously, it was that the Fed would hold unless the data justified a hike. That changed to the Fed hiking, unless the data justified a pause.

August's jobs report came in hotter than anyone forecast in Bloomberg's survey of economists and the August CPI report showed headline inflation remains above target at 3.4% while core CPI rose 0.29% month-on-month, nearly double the 0.17% trend rate needed to bring annual inflation down to the 2% target. In an environment where business surveys have hinted at a re-acceleration in economic activity over the summer and where the disruption to shipping out of the Middle East has pushed oil prices above $100/bbl, Chair Warsh's emphasis on trends rather than individual data points suggests he has made his mind up to propose a hike. No-one on the FOMC is openly hostile and Treasury Secretary Scott Bessent is likely in favour as he nervously watches longer-dated Treasury yields climb. Even President Trump has seemingly given him a pass, saying "he'll do what he has to do."

Ordinarily the assumption is that if the Fed hikes, they don't just go once. Financial markets are now pricing two and a half further rate hikes after the all-but-assured 16 September move. However, this time around we think that one and done might be the case. Market and consumer inflation expectations remain in check while consumer confidence is at all-time lows, so we see parallels with the late 1990s cuts in early 1996 before a pause, then one "risk management" hike implemented by Alan Greenspan's Fed in March '97 before a long pause through late 1998.

ING's expectations for Fed forecasts versus the June Summary of Economic Projections

	2026	2027	2028	2029	Longer run
Change in real GDP (4Q YoY%)	**2.2**	**2.3**	**2.2**	**2.2**	**2.0**
Previous Fed projection (June)	2.2	2.3	2.2	-	2.0
Unemployment rate (% year end)	**4.2**	**4.3**	**4.2**	**4.2**	**4.2**
Previous Fed projection (June)	4.3	4.3	4.2	-	4.2
Core PCE inflation (4Q YoY%)	**3.1**	**2.3**	**2.0**	**2.0**	**2.0**
Previous Fed projection (June)	3.3	2.5	2.1	-	-
Federal funds rate (year end)	**3.875**	**3.875**	**3.625**	**3.375**	**3.1**
Previous Fed projection (June)	3.8	3.6	3.4	-	3.1

Since the Federal Reserve's last forecast update, we saw a weaker than expected 2Q GDP report, a softer trend in job creation, notwithstanding the August surprise, while inflation has shown some encouraging signs of decelerating, even if the year-on-year rate remains above 2%. We continue to argue that weak wage growth, tariff refunds and a stagnant housing market, which will slow shelter inflation, will all contribute towards a convergence on the 2% inflation target next year. The risk is energy prices. In general though, we expect the Fed to project slightly lower inflation than they had in their June forecast while the GDP and labour metrics are little changed. We expect them to have 4% as their end 2026 and end 2027 Fed funds forecast before it heads to their previous long-run projection for the Fed funds rate of 3.1%.

Unruly Treasury market circumstances warrant a controlling influence from the Fed

Chair Warsh will be very aware that the 10yr Treasury yield is looking for an excuse to mark at 5%. Now at 4.9%, it's been bullied up there partly by high inflation readings, and more worryingly, a more recent slow ratchet higher in inflation expectations. These are not at sinister levels, but could do with some treatment from the Fed in order to at least help contain them. A 25bp hike could or should help. That said, whether the Fed hikes or not, the 10yr yield is liable to test 5%. It's up there mostly on account of higher real yields in fact. There is not much the Fed can do about that, to the extent that it reflects productivity growth expectations (the good), wider issuance pressure (the bad), or the evolution of the Iran war's effect on oil prices (the ugly).

He will also be cognisant that the 2yr carry spread (spread to the funds rate) has shot out to 90bp. Anything above 75bp on this metric and the market is giving the Federal Reserve the nod to hike. It does not telegraph when. But it lets the Fed know that it's braced and ready for a hike. It's actually a tad surprising that the probability of a September hike has not hardened by more on the back of this, but there is plenty of time for that to happen over the remaining days leading up to the meeting. In terms of the curve shape, we'd prefer to fade the flattening trend seen of late, as we think the carry spread has discounted more than it needs to, and the back end of the curve is primed to test higher regardless. See more here.

Hike can help stabilise the dollar

The DXY dollar index is currently trading close to the centre of this year's 96-102 range. Yet that observation alone masks some reasonably large swings driven by US foreign policy (Greenland, Iran), Kevin Warsh's arrival at the Fed and most recently US Treasury intervention in FX and bond markets.

We think the dollar would welcome a hike in that it would back up the Fed's monetary policy credibility and take a little more steam out of the debasement trade. Remember that trade had evolved last year both from doubts over Fed independence and more recently from US Treasury intervention. Some modestly higher rates at the very short-end of the US curve won't hurt the dollar either.

At the same time, the dollar is under-appreciating the jump in energy prices, where terms of trade continue to tumble in both Europe and Asia. Despite a hawkish European Central Bank, we still favour EUR/USD working its way towards the 1.1500 area over coming weeks and see risks of a correction back to 157/158 in USD/JPY – especially if the Bank of Japan does not meet hawkish expectations when it sets policy two days later. A higher USD/CHF will also be in focus again as rate spreads move against the Swiss franc.

Yet the dollar does not need to rally too far. After all, we think this is a recalibration of Fed policy, not a new cycle. And our house view remains for the dollar to decline through next year – especially in the second quarter when US inflation is back down to target and money markets can switch their focus to easing from tightening. That means June's 101.80 likely marked the high point for the DXY this year.

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