



The Impact of the Fed's Latest Rate Hike on Fixed Income Markets

The Federal Reserve's recent 25-basis-point rate hike represents a measured tightening of monetary policy designed to reinforce policy credibility at a time when inflation remains above the Fed's long-run target. As Chairman Kevin Warsh noted at Jackson Hole, the U.S. economy continues to demonstrate resilience supported by near-full employment and strong corporate balance sheets. Yet inflation has remained in the mid-3% range, well above the Fed's preferred level. By nudging front-end rates higher, the Fed is signaling its continued commitment to restoring price stability.

Despite headline resilience, underlying U.S. growth remains uneven. A disproportionate share of current investment is concentrated in the AI-driven capital expenditure boom, which has boosted productivity but also created pockets of vulnerability. An overly restrictive policy stance risks slowing this investment cycle, potentially undermining one of the country's most important long-term growth drivers. Higher borrowing costs could also pressure labor markets, particularly in rate-sensitive sectors such as construction, manufacturing, and small business. This risk is notable given that inflation already appears to be on a gradual downward trajectory.

Disinflationary forces continue to build. Shelter inflation, one of the largest components of core CPI, is easing as multifamily vacancies rise and single-family affordability deteriorates amid mortgage rates near 7%. These dynamics typically lead housing inflation by several quarters. Meanwhile, geopolitical tensions and oil-related price spikes, while meaningful, are unlikely to generate persistent core inflation. Historically, energy shocks have faded before becoming embedded in wage-price dynamics, particularly when demand growth is moderating.

The Fed's move should be understood not as the start of a new hiking cycle but as a recalibration of front-end borrowing costs to reflect the extraordinary scale of current capital investment. The central bank appears intent on preventing financial conditions from loosening prematurely while avoiding the risk of overtightening an economy that is resilient but not immune to slower growth. **While additional rate hikes may be warranted, we expect the federal funds rate to peak well below 5%.** If policy becomes too restrictive and growth slows materially, rate cuts in 2027 remain possible as the Fed seeks to avoid a monetary policy error.

For fixed-income investors, the key risks include tighter front-end funding conditions, the potential for slower AI-related investment if borrowing costs rise too high, and the possibility that geopolitical energy shocks create short-term volatility without altering the longer-term inflation trajectory. The Fed's challenge is to maintain credibility while preserving the conditions necessary for sustained productivity growth, an equilibrium that will shape fixed-income markets in the years ahead.

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