

Daily: Strong US jobs data likely to tip the balance for the Fed

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From the studio

Podcast: Signal over noise. Listen to Ulrike Hoffmann-Burchardi's latest views on the Fed. Apple/Spotify/Podcast: Jump Start | We now see Fed hiking twice this year (5 mins) Video: Four reasons to take a closer look at Taiwanese equities (5 mins)

Thought of the day

What happened? Expectations for a more hawkish Federal Reserve intensified on Friday after data showed US job creation accelerating in August. Nonfarm payrolls increased by 162,000, of which private payrolls contributed 127,000, compared with consensus expectations for 55,000. Positive revisions added another 55,000 jobs to prior months, lifting the three-month average increase in private employment to 75,000, above estimates of the 0-60,000 breakeven range needed to keep the unemployment rate stable.

Hiring was also broad-based across industries, while the unemployment rate remained at 4.1% as job creation was offset by increased labor force participation.

The data come after the personal consumption expenditures measure of inflation for July beat expectations, rising 3.7% on the year. It also follows more hawkish comments from Fed Chair Kevin Warsh at Jackson Hole. Investor attention will now shift to the August consumer price index report, due on 11 September, which is the final major data release before the Fed's policy meeting on 15-16 September.

Investors responded to Friday's data by increasing expectations for near-term Fed tightening. Market-implied odds of a September rate hike rose from around 50% to approximately 60%. Two-year US Treasury yields initially increased, while the US dollar strengthened. The response from equities was relatively muted, with the S&P 500 falling 0.4% on Friday.

What do we think? Our previous base case was for rates to remain unchanged through 2026. However, hawkish communication, rising inflation risks from supply bottlenecks, and August labor data have come in strong enough to change that call:

First, Warsh sharpened the policy debate at Jackson Hole, saying that underlying inflation must be moving toward the Fed's 2% objective "clearly and at sufficient speed." He emphasized six-month and 12-month measures, and this week's inflation data will likely leave core trends above 3%.

Second, supply bottlenecks have arguably increased upside inflation risks since the last Fed meeting. Worsening supplier-delivery times in the latest ISM and PMI surveys will likely reduce policymakers' confidence that inflation will return to target quickly enough. In the recent inflation data, there have been emerging signs that AI-related demand pressures could be broadening as well.

Third, employment demand remains firm and economic activity is holding up. The activity data, job

growth trends, and GDP growth tracking are strong enough to suggest that policy is not restrictive, reducing confidence that inflation will continue to move lower without higher rates.

Finally, market-implied odds of a September hike have risen back above 60% as we've entered the blackout period before next week's Fed meeting. An early August Financial Times article citing sources close to Warsh indicated that he would be "prepared to hike" if "markets ratchet up their expectations."

We now expect the Fed to raise interest rates twice in 2026, by 25bps in both September and December, taking the federal funds target range from 3.50-3.75% to 4.00-4.25%. Monthly core inflation prints closer to 0.3% in 2H26, with a growing share of items rising over 3% would support a three-hike path. However, if inflation readings through October average below 2% annualized and bring the six-month annualized inflation rates below 2.5%, it's possible the second hike is postponed.

The economic growth effects of two rate hikes should be fairly modest, and we still expect growth to stay near trend as tailwinds from AI capex should continue. Friday's labor report supports the case for solid 2H consumption with better overall wage income growth. The Fed's models suggest that two hikes would create only a few 10ths of a percentage point of growth drag.

We also raised our forecasts for US Treasury yields: We believe 2-year yields will trade at 4.25% by June 2027, 100bps higher than our previous forecast, and 10-year yields will trade at 4.5%, only 40bps higher than our prior forecast based on the assumption that Fed hikes also bring some stability to the back end of the yield curve.

How do we invest? From an investment perspective, we think the key question is not simply whether the Fed hikes or holds, but the backdrop against which the Fed acts. A rate hike accompanied by slower-than-desired progress on disinflation while economic growth indicators remain solid has different implications to a hike accompanied by persistent inflation alongside muted growth.

The August labor report points more toward the first, comparatively constructive outcome. Some of the same forces supporting markets, including AI-related capital spending, resilient economic activity, and broad earnings growth, are also contributing to the more hawkish policy outlook. We therefore do not think the change in our Fed forecast undermines our constructive view on global equities. Higher yields could create short-term volatility and weigh on rate-sensitive areas, but two 25-basis-point hikes should not outweigh these more important medium-term drivers.

In our Monthly letter, we reminded investors of Warsh's mantra to "watch the ball, not the referee." Market volatility surrounding any change in Fed policy could provide investors an opportunity to put that into action. Investors should review their current and target asset allocation and prepare to use market moves around upcoming data points and the Fed announcement to bring allocations closer to target.

This could include, for example, buying potential dips in equities (provided earnings prospects remain strong), taking advantage of elevated medium- to long-duration quality bond yields, reducing excess dollar holdings on strength, or using dips in gold to build a longer-term portfolio hedge.

Equities For equities, we believe the key issue will not be whether the Fed hikes, but against which backdrop.

Tightening accompanied by stronger GDP growth, AI investment, employment, and profits would likely be consistent with a continued supportive backdrop for risk assets, even if markets might experience some short-term choppiness. We continue to position for the upside in equities and continue to favor AI, Power and resources, and Longevity, all of which should benefit from stronger investment, productivity

gains, and structural growth.

Bonds Higher Fed rate expectations have contributed to higher bond yields in recent days, alongside elevated AI-related debt issuance and US debt affordability concerns, which have increased risk premiums.

If the Fed moves onto a hiking path, as we now expect, the relative advantage of short-duration bonds over cash would likely narrow. Investors could still earn attractive income in short-duration bonds, but the potential for capital gains would be more limited and further upward repricing of the policy path could weigh on returns. As such, we would no longer recommend that investors lock in yields in short- to medium-duration bonds as an alternative to cash.

At the same time, we believe attractive portfolio diversification opportunities could be opening up in the medium to long part of the yield curve, given the recent moves higher in yields. This part of the market may ultimately benefit if Fed tightening reinforces confidence in the central bank's inflation commitment, reduces longer-term inflation expectations, or slows GDP growth. Medium- to long-maturity high-quality bonds could therefore offer both attractive income and useful portfolio diversification against any adverse growth outcome. Entry points should nevertheless be assessed carefully, given continued uncertainty around term premiums, government financing needs, and inflation. For example, higher-for-longer short-end rates could worsen US debt affordability concerns, as the US has aggressively shortened its funding profile.

The impact on emerging market bonds and high yield would also depend on the backdrop against which the Fed is hiking. If it is accompanied by stronger growth, then credit spreads are likely to remain compressed, but if the Fed hikes in response to a more negative inflation and growth mix, it could likely prompt some spread widening. Current yields on an index level provide investors with a sizable cushion against negative total returns, although selectivity remains key, as issuer-specific risks might drive divergences in performance.

US dollar A more hawkish Fed would likely initially support the US dollar, particularly if policy divergence with other central banks widens and US economic growth remains comparatively strong. Again, the nature of that support would likely depend on the backdrop behind the hikes. Tightening amid strong growth could sustain the US dollar for longer through stronger capital flows and relative economic performance. In contrast, inflation-led tightening alongside weaker growth would present a more mixed outlook, as higher yields may start to compete with concerns about fiscal sustainability and the longer-term economic outlook.

Gold Higher real interest rates and a stronger US dollar could create near-term headwinds for gold. But the effect may be offset should inflation, geopolitical uncertainty, or concerns about fiscal and monetary credibility persist. We currently view gold more as a portfolio hedge and diversifier, rather than as a tactical expression of the next Fed decision.

More broadly, commodities can potentially provide both a structural source of return and diversification in scenarios where energy disruption or renewed inflation challenges equities and bonds. Electrification, rising power demand, AI infrastructure investment, and constrained supply support the longer-term outlook for the asset class.

The bottom line Investors should not mistake a potential change in Fed rates for a change in the investment outlook. The same forces that have supported our constructive view on markets, particularly AI investment, resilient economic growth, strong employment, and healthy profits, may now be contributing to a more hawkish Fed. The important question is not whether rates move higher, but what

is the backdrop against which they do. A Fed responding to US economic strength is very different from a Fed responding to inflation problems. For portfolios, that distinction matters far more than the next policy meeting.

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