

# September FOMC: Doves capitulate

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At its September 2026 meeting, the Federal Open Market Committee (FOMC) raised the federal funds rate target range to 3.75%–4.0%, its first hike in more than three years. Chair Warsh stayed on brand, providing little forward guidance about the Fed's next move, but the updated Summary of Economic Projections (SEP) indicates that the median participant expects one additional hike this year. The SEP also showed stronger forecasts for growth and the labor market, alongside higher inflation.

Warsh continues to emphasize that the policy rate is only one measure of monetary restraint. Higher longer-term US Treasury yields since the July meeting have not yet fed through to tighter financial conditions, though this could potentially reduce the amount of additional tightening needed through the federal funds rate. Chair Warsh noted that he had been “hard pressed” to describe financial conditions as restrictive leading up to the meeting and that today's action was removing “a dose” of policy accommodation. How much work higher market yields are doing for the Fed could therefore influence the pace and extent of further hikes.

## Inflation leaves little room for complacency

Inflation remains above the Fed's target, supporting policymakers' decision to resume rate hikes both to bring inflation down and reinforce the Fed's inflation-fighting credibility. The ongoing Iran conflict presents an additional upside risk. The longer the conflict persists, the greater the likelihood that energy prices remain elevated and higher input and transportation costs feed through to a broader range of goods and services. While longer-term inflation expectations remain relatively contained, a sustained energy shock could put upward pressure on near-term expectations and slow progress toward the Fed's 2% objective. The latest core PCE reading (0.25% month over month in July) is closer to a pace some dovish policymakers may view as acceptable, but limited progress thus far raises the risk that the Committee desires more restrictive policy rates.

Businesses are also reporting greater ability to pass through higher costs, particularly in service sectors. Combined with tighter labor market conditions, this could contribute to firmer wage growth and more persistent inflation. An important offset is the potential for AI-driven productivity gains and automation to expand productive capacity and moderate unit labor costs. Warsh appears to be counting on these gains to help bring inflation back toward target while supporting stronger growth. The key uncertainty is timing: AI's productivity benefits may take time to materialize, leaving the Fed to contend with more immediate inflation pressures.

## Bond market testing the Fed's resolve

US Treasury yields have risen sharply amid persistent inflation, expansionary fiscal policy, heavy issuance, and expectations that policy rates will remain elevated—pressures also evident across other developed markets. While the move has predominantly been driven by higher policy rate expectations, that could change if investors become less confident in the Fed's commitment to returning inflation to target or more concerned about the US fiscal trajectory—in which case we could see 10- and 30-year yields continue to move higher.

Against this backdrop, Treasury could further expand its buyback program, as it did last month, providing additional demand for longer-duration securities and potentially offsetting some upward pressure on long-term yields. While buybacks may alleviate near-term market pressures, they are primarily a tool to improve market functioning rather than address broader fiscal challenges. There is also a potential tension with monetary policy: If higher long-term yields are doing some of the Fed's work, efforts to reduce those yields could partially offset that restraint. Moreover, efforts perceived as seeking to contain borrowing costs could raise concerns about tolerance for large fiscal deficits, potentially putting upward pressure on inflation expectations and term premia.

## **Looking ahead: how will the Fed shrink its balance sheet?**

Investors also focused on the Fed's Balance Sheet Policy Task Force, which is reviewing the long-term framework for managing its assets and liabilities. Early indications suggest the group is exploring ways to operate with a smaller balance sheet while potentially also improving coordination among monetary policy, Treasury cash management, and bank regulation. We expect these outcomes to include renewed balance-sheet runoff, further reductions in mortgage-backed securities holdings, and a portfolio increasingly concentrated in US Treasury securities.

Any changes are likely to be gradual but could have important implications for rates markets. A smaller Fed footprint could leave private investors to absorb more Treasury duration, potentially putting upward pressure on term premia and longer-term yields. The ultimate impact will depend on the pace and composition of balance-sheet reduction and how those changes interact with Treasury issuance and investor demand.

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