Daily: Markets look to Jackson Hole

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From the studio

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Thought of the day

US Treasuries came under renewed pressure ahead of Federal Reserve Chair Kevin Warsh's Jackson Hole speech today. The 30-year yield has risen 3 basis points to 5.2% since Monday's close, and the 10-year yield has moved 4 basis points higher to 4.68%.

Investors will be watching closely for any signals about the Fed's policy outlook, particularly as inflation remains elevated. The core personal consumption expenditures price index, the Fed's preferred measure of underlying inflation, rose 3.3% year over year in July. This marked the eighth consecutive month in which inflation exceeded 3%, leaving it well above the central bank's 2% target.

Our base case remains that incoming data should confirm that inflation is gradually easing, allowing the Fed to keep interest rates unchanged for the rest of this year before lower inflation opens the door to potential rate cuts in the first half of 2027. We think the Fed appears comfortable keeping rates modestly restrictive while monitoring whether inflation is broadening and becoming embedded in expectations.

But uncertainty over the exact path of interest rates is likely to remain elevated given Warsh's communication style, the ongoing war in the Middle East, and continued strength in AI investment.

Warsh's less-guided approach to monetary policy has increased policy uncertainty. Since taking office in May, Warsh has attempted to move the Fed away from forward guidance on policy rates. The aim is to give policymakers greater flexibility to respond to real-time economic data and prevent them from being boxed into a corner when it comes to policy. However, this approach also makes the Fed's likely response to changing economic conditions harder to predict, and that uncertainty has been reflected in the recent move up in long-dated yields as compensation for holding bonds over longer periods. Whether Warsh will use the Jackson Hole speech to reassure markets about the Fed's reaction function remains to be seen.

Fed officials have highlighted their concerns about inflation risks. While Warsh has offered limited guidance on the policy outlook, recent comments from other Fed officials have underlined inflation risks. Kansas City Fed President Jeffrey Schmid said on Thursday that inflation is still "stubborn" and "sticky," and that the Fed has "got to continue to find ways" to get it back to 2%. He noted that the US central bank's current policy rate did not appear sufficiently restrictive to slow inflation. Cleveland Fed President Beth Hammack expressed similar concerns and reiterated her ongoing willingness to hike rates to bring price pressures back under control. Chicago Fed President Austan Goolsbee also warned of sticky inflation, although he said rates could be lowered gradually if there were clear evidence that inflation was returning toward the 2% target.

Geopolitical risks and AI investment could add to price pressures. Our base case is that disruptions to global energy supply should remain limited as the US, Iran, and mediators continue to work toward reopening the Strait of Hormuz. We expect oil prices to remain well below levels that could cause a major shock to global growth. However, energy prices are still considerably higher than they were before the conflict. This means inflation may decline more slowly and unevenly than previously expected. Additionally, recent inflation data showed tentative signs that stronger AI-related demand may be contributing to price pressures. Such demand-driven inflation pressures are likely to be a source of concern for policymakers.

Against this backdrop, we continue to recommend that long-term investors keep diversification at the center of their portfolios. We believe resilient economic growth and robust earnings offer room for global equities to move up, while a steady Fed policy should see yields on shorter-dated bonds move lower, benefiting quality bonds with short to medium maturities. We also think exposure to gold and broad commodities can provide additional diversification.

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