Daily: What a more hawkish Fed means for investors

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From the studio

Video: Why yields are rising and what it means for the dollar (4 mins)Video: Four reasons to take a closer look at Taiwanese equities (5 mins)

Thought of the day

Rhetoric from Federal Reserve officials has become increasingly hawkish in recent weeks. Fed Chair Kevin Warsh's central message from his Jackson Hole speech was straightforward: If inflation does not continue to improve at a “satisfactory speed,” higher interest rates would become the most likely policy response. In addition, he largely dismissed the recent moderation in inflation data and the softer July labor market report. In response, the market-implied odds of a September hike rose sharply.

The upcoming payroll and consumer price index (CPI) reports will be viewed as tests of whether this shift in stance toward more policy tightening is appropriate, and likely to continue. Consensus expects US payroll growth (released 4 September) to rebound to around 50,000 in August, after employment fell by 23,000 in July. Consensus is for US core CPI inflation (11 September) to increase 0.2% month on month and around 2.5% year over year. On Thursday, in more dovish comments than previously, Governor Waller implied that a monthly core personal consumption expenditures (PCE) reading of 0.3% or less would be sufficient for him to recommend rates to stay unchanged at the next meeting.

What is our view? In our view, the Fed's decision is finely balanced. In our base case, the underlying drivers of our investment outlook—AI-related capital spending, broad earnings growth, and resilient economic activity—remain constructive. US growth expands at around 2% in 2026, close to trend, and inflation eases gradually from current levels, enabling the Fed to potentially keep rates on hold.

Yet 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 growth indicators remain solid has different implications versus a hike accompanied by persistent inflation alongside muted growth. In our recent House View monthly publication, “On the ball,” we outlined both possibilities.

In one scenario, "AI liftoff,” the US economy grows at an above trend rate of 2.5-3.0% in both 2026 and 2027 and inflation stays above target. In this scenario, we believe the Fed would hike interest rates up to three times, as the Federal Open Market Committee (FOMC) revises its estimate of productivity growth higher. This would be a comparatively constructive form of interest rates hikes, as stronger AI-related investment and productivity expectations support economic growth, employment, and corporate profits.

In a second scenario, a Fed “policy test,” the Fed could hike interest rates twice in response to inflation proving sticky while growth is muted. This would be a less favorable form of tightening. If inflation remains sticky while growth loses momentum, higher rates could pressure consumers and companies.

Looking ahead to the data releases, evidence of stronger demand in the labor report for August—private jobs growth of over 50,000 and an unemployment rate staying around 4.1% or lower—would represent a move in the direction of our upside scenario. Meanwhile, hotter-than-expected inflation data could be an indicator that we are heading toward the more adverse scenario, particularly if it comes alongside weak payrolls growth (for example, jobs growth of 20,000 or less, alongside a rise in the unemployment rate to 4.2% or more).

How do we invest? 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 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. Meanwhile, we remain watchful for the potential headwinds from tightening against a backdrop of sticky inflation and weaker 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, 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 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 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 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 dollar could create near-term headwinds for gold. But the effect may be offset if the Fed is responding primarily to persistent inflation, geopolitical uncertainty, or concerns about fiscal and monetary credibility. We would therefore continue to view gold primarily 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.

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