



Higher Inflation Tests Fed and Markets

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The latest inflation report crossed an important threshold for the Federal Reserve. Core CPI rose 0.3% for the month but that was enough to push futures-market expectations for a rate increase to around 90% last Friday morning. Combined with continued credit expansion, a strong labor market and higher market interest rates, I believe the Fed is likely to raise the federal funds rate by 25 basis points at this week's meeting.

This will be the most difficult decision Kevin Warsh has faced since becoming Fed chair. President Trump has made clear that he wants lower rates, but the Fed cannot allow political pressure to undermine its inflation-fighting credibility. The market itself is sending a powerful signal. The two-year Treasury yield is roughly 100 basis points above the federal funds rate, and both the two-year and ten-year yield curves suggest that short-term rates should be higher. Credit expansion is also running well above a pace consistent with 2% inflation, particularly relevant because Warsh specifically identified credit growth as an important indicator that he is watching at his Jackson Hole speech.

I would expect a 25-basis-point increase, not 50. In fact, I believe the greater risk to the markets would be the Fed failing to act. Warsh could face four or five dissents if he holds rates unchanged, which would raise questions about the Fed's credibility. A rate hike could even bring long-term yields down if investors see the Fed as more committed to containing inflation.

Oil remains the critical wild card. WTI surged above \$100, while diesel prices have moved above \$6 and could continue rising rapidly. The geopolitical risks surrounding Iran, the Strait of Hormuz and disruptions involving the Houthis remain substantial, making energy prices one of the most important variables for both inflation and markets in the weeks ahead.

What impresses me is how well equities have absorbed all of this. The S&P 500 is only a few percentage points below its high despite higher inflation, oil above recent levels and sharply higher bond yields. The economy continues to chug along: this month's employment report was strong, jobless claims remain low and there is still no meaningful deterioration in consumer demand. The resilience of stocks tells me there is considerable liquidity and underlying demand for equities.

Valuations, however, are facing a more difficult environment. Ten-year TIPS yields around 2.5% are nowhere near the 4%-plus real yields we saw around the technology peak in 2000, but they are high enough to challenge equity multiples without another positive catalyst. With the earnings season largely finished, I would not be surprised to see the equity market trade relatively flat or down over the next three or four weeks. The next major catalyst is third-quarter earnings in October, and there is little evidence today suggesting that demand has weakened enough to prevent another good earnings season.

This Wednesday could be something of a clearing event. My point estimate is firmly for a 25-basis-point hike. If the Fed acts decisively and oil stabilizes, markets can move beyond the immediate inflation and credibility debate and refocus on economic growth and October earnings.

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