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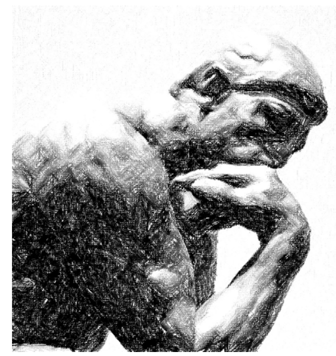
Fed Hikes 25 bps, But the Herd Is Missing the Bigger Picture

The Thinking Man



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With Fed Funds futures pricing a ~92% probability of a hike into this meeting, the FOMC had very little choice. It delivered a 25 bps increase, taking the target range to 3¾%–4%. This is the Fed's first rate hike since 2023, and, somewhat surprisingly, it came on a unanimous 12-0 vote.

Federal Reserve Board – Press Release

The statement said essentially nothing we did not already know:

- Economic activity is "expanding at a solid pace"; domestic spending has remained resilient.
- "Productivity growth is strong, and capital investment is robust."
- Job gains have kept pace with the workforce, and the unemployment rate has changed little.
- "Inflation remains elevated"; today's action is intended to "support a timelier return" to the 2% goal.
- The Committee "will deliver price stability."

The market reaction was orderly but heavy: the S&P 500 closed at 7,551.94 (-0.45%), the Dow at 51,461.78 (-1.21%), the 10-year Treasury yield near 5.01%, and WTI crude around $102. Fed Funds futures now imply roughly a 51% probability of another hike in October and 89% in December, while 16 of the 18 Federal Reserve officials participating in the Fed's Summary of Economic Projections (SEP) are projecting at least one more hike this year.

In short, the Fed ratified what the market was already pricing. Nothing more.

Our View: This Could Prove to be "One and Done"

We think consensus is wrong, and this will ultimately look like a one-and-done move by the time we reach the first quarter of next year. The 16-of-18 projection for at least one more hike will likely look overly hawkish in the rear-view mirror, just as prior projections have consistently over- or undershot at inflection points.

The reason is simple: the market is exhibiting classic herd mentality, extrapolating a handful of hot data points while underweighting three developments that, in our judgment, could materially change the inflation picture over the next two to four quarters.

1. AI-driven productivity is real, broad, and disinflationary:

The Fed itself flagged it in today's statement: *"productivity growth is strong, and capital investment is robust."* That is not a throwaway line. It is a direct acknowledgment of a theme we have been highlighting to clients for the better part of a year: AI is now contributing measurable productivity gains across three distinct layers of the economy.

- **Creators of AI:** the model labs and platform companies whose per-unit compute costs continue to fall and whose products are being embedded into the workflows of nearly every enterprise.

- **Enablers of AI:** semiconductors, data-center developers, power, networking, and the software stack that sits between the models and applications. Capex here is not speculative. It is being consumed almost as quickly as it is being built.

- **Users of AI:** the far larger, and in many ways more important, group. Banks, law firms, call centers, healthcare providers, logistics companies, and small businesses are increasingly using AI to reduce headcount growth, compress cycle times, and increase throughput per employee.

When productivity rises faster than wages, unit labor costs fall, which is inherently disinflationary. This is precisely the dynamic that ended the late-1990s inflation scare, and we believe it is showing up again now. While we believe this dynamic is already underway, timing matters. The technology can be deployed quickly, while mass adoption across large organizations takes considerably longer. As a result, we would not expect AI-driven productivity gains to fully reshape the inflation data over the next six months.

The bigger impact is likely to build over the next 12–24 months as adoption broadens across the economy. The market, in our view, is still underestimating the potential for AI to create a meaningful supply-side disinflationary force. That may ultimately allow inflation to fall without requiring the Fed to keep tightening.

2. Housing inflation is likely overstating underlying price pressures:

Our second, and arguably more urgent, point is that the inflation indices the Fed is reacting to are structurally biased upward by their lagging shelter methodology. Shelter represents roughly one-third of headline CPI and closer to 40% of core CPI. It is measured largely through Owners' Equivalent Rent (OER), a survey-based construct that adjusts slowly to changes in market rents. In a slowing housing market, this means the official data can continue to show relatively elevated shelter inflation even after real-time rents have moderated. What we are seeing on the ground is a dead housing market:

- **Existing-home transaction volumes remain** near multi-decade lows in unit terms.
- **New listings** that do come to market are taking longer to clear.
- **Asking rents** on new leases have been much softer than the shelter component of official inflation.
- **Homebuilder pricing power** has weakened, with incentives and mortgage rate buy-downs increasingly being used to support demand**.**

The important point is not that housing inflation is actually zero. Private-market measures are still showing positive rent growth, with Zillow's asking-rent measure around 2.5% year over year, while shelter CPI and PCE housing inflation remain closer to 3%-3.5%.

Assuming housing inflation eventually normalizes toward 2%, the impact on overall inflation could be meaningful:

Scenario	Current headline	If housing = 2%	Reduction
CPI	3.4%	≈3.05%	-0.35 pp
PCE	3.7%	≈3.47%	-0.23 pp

Illustrative impact, assuming other components remain unchanged.

The housing component does not need to go negative. It simply needs to normalize. That alone could bring inflation meaningfully lower without requiring a significant deterioration in demand or employment.

Importantly, shelter's adjustment happens with a lag. We therefore see housing as more of a medium-term disinflationary force as official measures gradually catch up with the softer conditions already visible in market rents.

3. A moderate resolution of the Iran conflict could provide an additional inflation tailwind:

A third, and more immediate, catalyst is the possibility of a de-escalation of the Iran conflict. The recent rise in oil prices has added a meaningful source of inflation pressure at precisely the wrong time for the Fed. With WTI around $102, energy is once again becoming an important swing factor for headline inflation. A reduction in geopolitical tensions could reverse part of that move through lower oil prices and reduced geopolitical risk premia.

The impact would extend beyond gasoline. Lower energy costs feed through into transportation, logistics, chemicals, manufacturing, and other energy-intensive parts of the economy, while a normalization in shipping and insurance costs could provide an additional benefit to goods prices. This would represent a supply-side disinflationary shock rather than one driven by weaker economic activity, with headline inflation potentially responding relatively quickly and lower input costs gradually working their way through the broader economy.

We are not assuming a full resolution or a return to pre-conflict conditions. Even a moderate de-escalation could be enough to remove some of the inflation premium currently embedded in energy markets.

Taken together, these three forces create a different inflation outlook from the one implied by today's hawkish reaction. Energy could provide the most immediate relief if geopolitical tensions moderate. Housing inflation should become a more meaningful disinflationary force over the medium term as official shelter measures continue to catch up with softer market rents. AI-driven productivity is the longer-term structural force, with its impact likely to build over the next 12–24 months as adoption broadens across the economy.

Together, these forces suggest that today's inflation picture may prove less persistent than the market currently assumes.

Portfolio Implications

We are not changing our strategic posture on the back of today's meeting. If anything, today's decision reinforces the trades we already favor:

- **Duration.** We continue to add to intermediate- and long-duration Treasuries and high-quality corporates on any backup in yields. A 10-year yield around 5% is, in our view, a gift if you believe, as we do, that the next surprise in the inflation data will be to the downside.

- **Quality equity compounders exposed to AI productivity.** We remain constructive on the creators, enablers, and increasingly the users of AI, where the earnings leverage from productivity gains is only beginning to show up in margins.

- **Housing-adjacent credit and select real assets.** Counterintuitively, a Fed that is closer to done than the market thinks is exactly what an over-shorted, under-owned housing complex needs to begin healing. We are patient, but watching closely.

- **Cash.** Front-end yields remain attractive, but we are actively redeploying maturities further out the curve rather than reflexively rolling T-bills.

More broadly, a recent Goldman Sachs analysis suggests that portfolio management fees, flash memory prices, tariffs, and energy account for approximately 1.7 percentage points of current PCE inflation. Goldman estimates that the normalization of these factors alone could reduce PCE inflation by roughly 1 percentage point over the next six months, even without additional Fed tightening. This provides another reason to believe that a meaningful portion of today's inflation could prove temporary.

Conclusion

The Fed did today what it had to do. The market got the meeting right and, we suspect, the trajectory wrong.

In our view, the Fed is increasingly responding to market pressure, while Mr. Market itself remains highly influenced in the short term by the prevailing media narrative. With the 2-year Treasury yield already reflecting today's hike before the meeting, the Fed largely ratified a move financial markets had already made.

There are echoes here of the Greenspan-era Fed, when policy at times followed the market rather than led it.

None of these needs to happen perfectly for the inflation trajectory to improve meaningfully. Together, they suggest that today's inflation picture may prove less persistent than the market currently assumes.

We think today marks the top of this hiking cycle, not the middle of it.

As always, we welcome the conversation.

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