Higher rates. Higher stakes.

25 basis point rate hike

INSIGHTS FROM THE OFFICE OF THE CIO

As was highly anticipated, the FOMC voted unanimously to raise the federal funds rate by 25 basis points on September 16th. The message to investors was straightforward: the Fed is not yet comfortable declaring victory on inflation. Initial indications are that the FOMC expects an additional hike this year. From our perspective, the decision is less about one or two additional quarter-point moves and more about the Fed's willingness to protect its credibility and send a message. Many market participants may not welcome tighter policy in the near term, but they may respect a central bank that is prepared to lean against inflation before expectations become more difficult to anchor.

The key market test will be the Treasury yield curve. In a clean policy-credibility outcome, the front end of the curve would reflect the higher policy rate while the long end would stabilize or rally as investors conclude the Fed is serious about containing inflation. That would likely produce a flatter curve and signal that the bond market sees the hike as a credible step toward restoring price stability, with improved inflation visibility helping restore confidence in high-quality assets.

If the curve does not flatten, however, investors should take that message seriously. A long-end selloff after a Fed hike would suggest that the bond market's concerns extend beyond near-term inflation and into a broader fiscal backdrop. Persistent U.S. debt growth and ongoing budget deficits may be forcing investors to demand a higher term premium, even when the Fed is tightening policy. In plain terms, the market may be saying that monetary policy credibility is necessary, but not sufficient, if fiscal discipline remains absent.

The risk for the economy is that higher rates land on a consumer already under pressure. Mortgage rates, credit card balances, auto loans, and small-business financing costs are elevated, while energy prices continue to absorb discretionary income. A hike may be justified to reinforce inflation credibility, but it also raises the risk that policy tightens into an uneven economy before the full effect of the prior market-based rate increase has been felt.

From a portfolio perspective, the message is not simply that higher rates are bad for bonds. If the market views the hike as credible, intermediate and long-duration Treasuries could find support even as cash rates move higher, with the curve flattening as the long end benefits from improved inflation confidence. Risk assets, however, would have to confront the possibility of slower nominal growth and tighter financial conditions. The adverse scenario is a Fed that tightens enough to damage demand but not enough to quickly lower inflation, leaving investors with a double dose of restraint: elevated prices, tighter credit, and a consumer with less room for error. If the curve does not flatten and long rates rise despite Fed action, that would send a different and more troubling signal: the bond market may be demanding greater compensation for U.S. debt levels and ongoing budget deficits, not just inflation risk. In that environment, portfolio discipline matters most—maintain liquidity, favor quality, and avoid assuming that one Fed move can resolve every pressure facing markets.

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For equities, the start of a rate-hiking cycle can create a more difficult near-term trading environment, particularly when investors are uncertain about the ultimate pace and duration of policy tightening. History suggests that stocks often experience bouts of volatility in the early months after an initial hike, but a rate cycle by itself does not necessarily end a bull market. The 2022 experience remains an important cautionary example, as an unusually aggressive tightening campaign helped end that bull market and forced a broad repricing of long-duration assets. This cycle, however, should not need to be as forceful if inflation expectations remain better anchored and the Fed can move more deliberately. As a result, equity investors may need to tolerate additional choppiness in the weeks ahead, but that volatility could also create opportunity for disciplined investors to upgrade quality, add selectively to durable earnings streams, and take advantage of dislocations rather than react emotionally to them.

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