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No More Hand-Holding: Bonds Navigate the Silent Treatment

Before we get into this month's topic, a note on what to expect from this piece—and from our monthly Investment Updates going forward. We expect to spend more time discussing the Federal Reserve itself than we have historically, reflecting a meaningful period of transition at the institution. Kevin Warsh took the helm in May and has already begun reshaping elements of the Fed's communications and policy-review process. He has moved away from the use of forward guidance, established several outside task forces to examine issues ranging from the Fed's balance sheet to the measurement of inflation, and is reportedly considering changes to the Committee's meeting schedule. At the same time, long-term interest rates have moved meaningfully higher, while the July FOMC meeting highlighted some uncertainty around how the new Chair intends to communicate the Fed's reaction function and longer-term policy framework.

None of these developments necessarily signals a fundamental change in the Fed's mandate or policy objectives. But taken together, they suggest that the framework through which the Fed communicates and implements policy is evolving, with potentially important implications for how fixed income markets assess interest-rate and inflation risk. We had originally planned to focus this month's update on the quality of government economic data—a topic we still believe matters and one the Fed itself is now formally studying. However, given the market developments surrounding the July meeting, we think the Fed's evolving policy framework warrants a closer look.

What happened at the last two FOMC meetings

Warsh has now chaired two meetings: his first in mid-June, and his second on July 29th. At both, the Fed left its benchmark rate unchanged in the 3.50%-3.75% range, in line with expectations. At the July meeting, three of the twelve voting policymakers dissented in favor of an immediate quarter-point hike, an unusually hawkish split for a committee that spent most of the past two years debating the pace of cuts, not the case for tightening. The dissenters cited a resilient labor market and inflation pressures that, in their view, warranted action now rather than later.

The inflation backdrop driving that hawkish pressure is real. The Iran conflict that erupted in February shut down a large share of tanker traffic through the Strait of Hormuz for several months, and while a memorandum reopening the strait was signed in June, oil prices had already surged, with Brent crude up nearly 40% for the year at one point. That shock has worked its way into the numbers: the Fed's own June projections raised its expected year-end reading for PCE inflation, its preferred gauge, to 3.6%, up from 2.7% projected as recently as March. Gasoline prices at the pump are roughly 30% above year-ago levels. None of this is subtle, and it's a big part of why several committee members are losing patience with a "wait and see" posture.

What was more consequential for markets, though, wasn't the vote. It was what Warsh said, and didn't say, afterward.

The press conference that moved the curve

Warsh has been explicit since taking office that he intends to strip forward guidance out of the Fed's communications. This practice, in place for more than two decades, was designed to help markets better anticipate policy changes.

His logic, echoed by economists like Torsten Slok of Apollo Global Management, has some real merit: explicit rate commitments can lock a central bank into a path that becomes hard to unwind when conditions change, and they can create a false sense of certainty that encourages investors to take on more risk than the underlying data really supports. Removing that guidance, in principle, restores a cleaner link between incoming data and market pricing. We think there is something to this: the investment management community gets paid to decipher risk markets and make informed decisions about how to allocate capital. It was never the purpose of the Fed to use forward guidance to dampen volatility and provide explicit directionality on how to deploy risk; that judgment belongs with investors, not the central bank.

The challenge is that removing forward guidance on rates only works well if the Fed replaces it with clarity about its framework, the rules of the game it's using to get to its destination, even if the exact timing of the next move stays data-dependent. At the July press conference, Warsh offered the opposite: a firm rhetorical commitment to fighting inflation, paired with little explanation of what would trigger a hike, no acknowledgment of why the committee chose to hold rather than act, and, most notably for investors, ambiguity about which inflation measure the Fed is targeting. Asked directly what gauge he relies on, Warsh gave the standard answer of 2% PCE inflation, then added that "who knows, come after next January, what we might say about strategy," pointing to his newly formed task forces as a possible source of change.

In congressional testimony a few weeks prior, he had similarly described CPI and PPI as merely "imperfect measures of the state of underlying inflation," a technically defensible point, but one that, combined with the hint about a future strategy review, left investors wondering whether the target itself might eventually move rather than the policy rate.

Markets reacted to that combination of hawkish rhetoric, inaction, and doubt about the yardstick. The Treasury curve "bear-steepened" sharply: the 30-year yield jumped to just above 5.2%, its highest level since 2007, while shorter maturities were more mixed, reflecting reduced clarity on the near-term path for policy rates. The dollar weakened and gold rallied, both classic signs of a market questioning a central bank's inflation-fighting resolve rather than simply repricing the timing of the next move.

We want to be careful here about what this is, and is not. This is not a market call that the Fed has lost control of inflation, and it is not, in our view, evidence that Warsh is compromised or unserious about the 2% target that he has reiterated repeatedly and unambiguously. What it reflects is a market that has been trained over twenty-plus years to expect the Fed to explain its reaction function, encountering a Chair who has deliberately withheld that explanation at a time when inflation data is already surprising to the upside. Uncertainty about the destination is manageable; uncertainty about the map is what unsettles a bond market that prices risk over ten- and thirty-year horizons.

What we're watching next

A few things will determine whether this period of volatility subsides or persists. First, the near-term inflation prints still matter enormously: a run of softer CPI and PCE reports would ease pressure on the Fed regardless of how it defines its target, while a hot print would validate the hawkish dissenters and could increase pressure on the Committee to act. Second, we're watching how quickly, and how transparently, the data and inflation-framework task forces get their reports out; Warsh has said recommendations are due by year-end, and any signal that the target measure itself might change before then would likely reignite the volatility we just saw. Third, the Fed is reportedly considering meeting less frequently than its current schedule, which by itself could introduce more, not less, uncertainty between decision points if it isn't paired with better communication in the interim. And finally, geopolitical developments around oil supply remain a live wildcard for the inflation path. The July CPI and PPI reports, released in August, came in essentially in line with consensus expectations, which on its own doesn't give the Fed a clear reason to shift its current posture.

Portfolio implications

We have not made wholesale changes to your portfolio's duration in reaction to a single press conference, and we don't think that would be the right response to what is fundamentally a communication problem rather than a change in the economy's trajectory. But the repricing has real, practical consequences we are managing around. The bear-steepening move has made the long end of the curve cheaper on a relative basis, though we want more clarity on the Fed's framework before committing meaningfully further out the curve.

We are also maintaining a somewhat more cautious stance on credit risk than we might otherwise hold in a resilient economy, since a bond market pricing renewed uncertainty about the inflation-fighting reaction function is also a market where risk premiums can move quickly if sentiment sours further. In short: we see the recent repricing as a reason for patience and selectivity, not for dramatic repositioning.

That instinct toward caution is really an extension of a longer-running theme in how we've positioned our clients' portfolios against their benchmarks. Over the past eighteen months, we have meaningfully reduced risk relative to benchmark indexes, a deliberate response to what we viewed as an increasingly unattractive opportunity set in risk markets rather than any single event. That positioning has meant giving up some upside optionality along the way, but we felt it was the prudent trade-off to make: it leaves us better prepared to react decisively should risk assets sell off from here, rather than being caught flat-footed with excess exposure. We will be watching the incoming data, and the Fed's next opportunity to clarify itself, just as closely.

We'll continue to keep you updated on developments related to the Fed and its new leadership. Please don't hesitate to reach out if you'd like to discuss the implications for your specific portfolio.