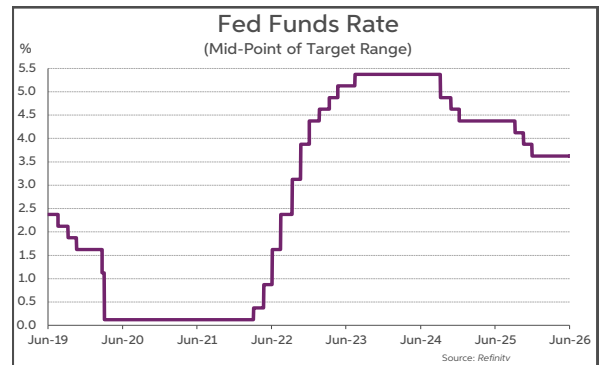


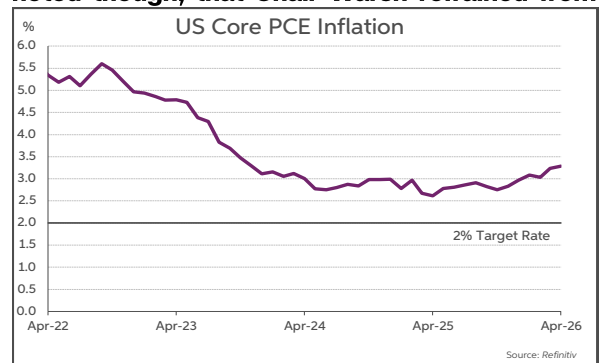
Fed opens the door to rate hikes

The June meeting of the Federal Reserve Open Market Committee (FOMC) saw the central bank leave interest rates unchanged. The target range for the Fed funds rate was maintained at 3.50-3.75%, for a fourth consecutive meeting. The decision to leave rates on hold was unanimous, and it was in line with market expectations.

However, new Chair Warsh's impact at the FOMC was clearly evident in the meeting statement. The statement was much more condensed than previous versions, and it also lacked any forward guidance - a policy Chair Warsh has been critical of in the past. Nevertheless, the Fed continues to view the economy to be expanding "at a solid pace despite elevated uncertainty". Furthermore, it was noted once again that the unemployment rate "has changed little" recently. The statement also referenced that inflation remains elevated, and said that this reflected "supply shocks that have driven price increases in certain sectors, including energy". It concluded with a strong message reinforcing the Fed's inflation fighting credibility, stating, "the Committee will deliver price stability".



The updated Summary of Economic Projections indicates that Fed officials now expect inflation to remain elevated for longer. The median core-PCE projection was revised higher to 3.3% in Q4 2026 (was 2.7%). Furthermore, core-PCE is now expected to be 2.5% in Q4 2027 (was 2.2%), and 2.1% in Q4 2028 (was 2.0%). Thus, the median projection is for inflation to stay above the Fed's 2% target throughout the forecast period. Meantime, the Fed is pencilling in slightly more modest growth of 2.2% y/y in Q4 2026 (was 2.4%). Thereafter, GDP is forecast to remain in a tight 2.2-2.3% range in 2027 and 2028, which is broadly in line with the March projections. The unemployment rate forecasts were also little changed from March, with the jobless rate expected to remain between 4.2-4.3% in the years ahead. **It should be noted though, that Chair Warsh refrained from submitting any economic projections.**



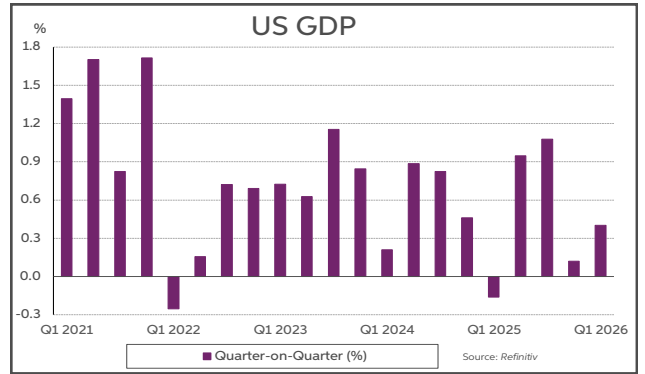
Given there was no expectation of any rate changes from the Fed, a key focal point for markets was on the Fed's updated interest rate projections (i.e. the dotplot). Most notably, nine members of the FOMC are now pencilling in rate hikes this year. Three members are forecasting one hike, five expect two hikes and one anticipates three increases. However, it should be noted that eight officials think policy will be left unchanged this year, while one expects a rate cut. Previously, the median projection was for a rate cut in 2026. Further out, the median projection is for rates to operate in a 3.50-3.75% range in 2027 (was 3.00-3.25%) and a 3.25-3.50% range in 2028 (was 3.00-3.25%).

Fed Chair Warsh's first post-meeting press conference as head of the central bank also marked a significant break with his predecessors. Chair Warsh stated at the press conference that "I can't give you any guidance on what we're going to do next", indicating that forward guidance is unlikely to be a feature of his tenure as head of the central bank. Indeed, the main talking point from the press conference had nothing to do with near-term US rates policy, but rather centred on the announcement that five taskforces will be set-up to evaluate the Fed's communications, balance sheet policies, data sources, productivity and the inflation framework.

However, despite Chair Warsh's lack of forward guidance, the overarching tone from the June FOMC was more hawkish than the previous meeting in April. Against this backdrop, market rate expectations firmed in the initial aftermath of the meeting. Current futures pricing indicates the market now sees a 90% chance of a Fed rate hike in September, and circa 50bps of policy tightening by Q1 2027. **Our view following the most recent Fed communications, and a slew of significant upward revisions to US labour market data, is for the Fed to remain on hold this year.** However, given the elevated level of inflation, we note that the risk to our view is tilted towards a potential rate hike, especially if the labour market strengthens or the conflict in the Middle East re-escalates.

US economy gathers steam. However, inflation risks intensify

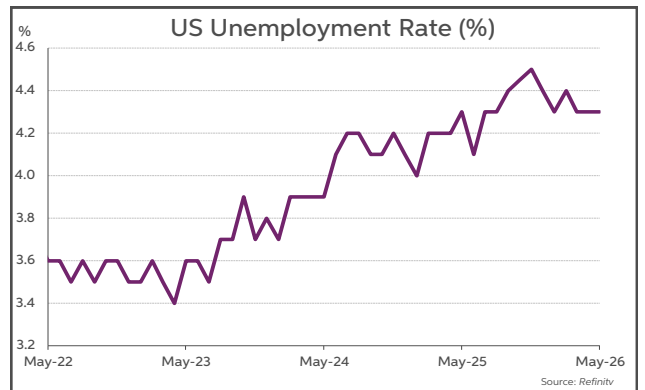
Having expanded by a solid 2.1% last year, the US economy appears to have lost some momentum in Q1 2026. GDP increased by 1.6% annualised in the quarter. Personal consumption and investment remained the main drivers of growth at the start of the year. The former rose by 0.4%, while the latter jumped by 1.6%, boosted once again by the AI build-out. Together, these two components boosted GDP growth by circa 2.1 percentage points (p.p.). Meantime, government expenditure rebounded by 1.1% following the government shutdown in Q4. A rise in defence spending also increased government spending, which added 0.7 p.p. to growth. Elsewhere, imports outpaced exports, meaning that net trade subtracted 1.3 p.p. from the total. However, this was partly offset by a modest rise in inventories, which contributed 0.1 p.p. to GDP in Q1.



Meantime, the available survey data for Q2 have been mixed. The services PMI has improved slightly so far in the quarter, rising to 51 in April and 50.7 in May, having printed in contraction territory in March. In contrast, the manufacturing PMI has printed firmly in expansion mode, rising to 54.5 and to 55.1 in April and May. Similarly, the manufacturing and non-manufacturing ISMs have been consistent with robust and accelerating activity levels in each sector so far in Q2. However, consumer confidence has remained quite weak. The Conference Board indicator has stayed at relatively low levels, while the Michigan measure of consumer sentiment has deteriorated throughout the quarter.

As has been the case for some time though, low consumer sentiment has not resulted in weak consumer spending. Indeed, retail sales have continued to increase at a solid pace in April and May, rising by 0.4% and 0.9% per month. Similarly, the control group measure - a key core sales metric - expanded by 0.5% and 0.7% over the same period. Elsewhere, industrial production has been somewhat volatile. Output jumped by 0.9% in April before edging just 0.1% higher in May.

Meanwhile, labour market conditions appear to have firmed in recent months, following a weak second half to last year. Payrolls fell for a fifth time in nine months in February, but they have since increased sharply in the last three months. Indeed between March and May, payrolls expanded by 188k per month on average. This compares to an average of just 12k per month last year and 168k during 2024. At the same time, the unemployment rate has oscillated between 4.3-4.5% since July. It is currently at the bottom of this range. Meantime, wage growth has slowed. Average earnings growth cooled to +3.4% year-on-year in May. However, the wages component of the Employment Cost Index - the Fed's preferred measure of wage inflation - rose by 0.8% in Q1, up from 0.7% at the end of last year.



On the inflation front, consumer prices have risen markedly over the past number of months. However, before the war in the Middle East broke out and energy prices spiked, CPI inflation was trending lower. It jumped to 3.3% in March though, up from 2.4%, primarily due to a 21.2% surge in gasoline prices - which was the biggest monthly increase since records began in 1967. Furthermore, it rose to 3.8% in April, and to 4.2% in May. The core rate has also increased, albeit at a more modest pace. It was at 2.9% in May. Similarly, core-PCE, which was already on an upward trajectory in the months before the conflict, rose to 3.3% in April.

In summary, headline figures suggest the US economy has gathered some steam in the opening months of 2026. Labour market conditions look to have strengthened, following a weak end to 2025. Meanwhile, AI-related investment is likely to remain a key driver of growth in the near-term. Furthermore, lower taxes following may be providing some support to consumer spending. However, inflation remains a concern. High levels of uncertainty, especially regarding US trade policy, have contributed to sticky inflation, and the war in the Middle East also adds further upside risks to the US inflation outlook. Against this backdrop, the Fed now expects US GDP to expand by 2.2% y/y in Q4 2026 (was 2.4%) and by 2.3% y/y in Q4 2027 (unchanged).

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