

## The Fed's Dilemmas & Distractions

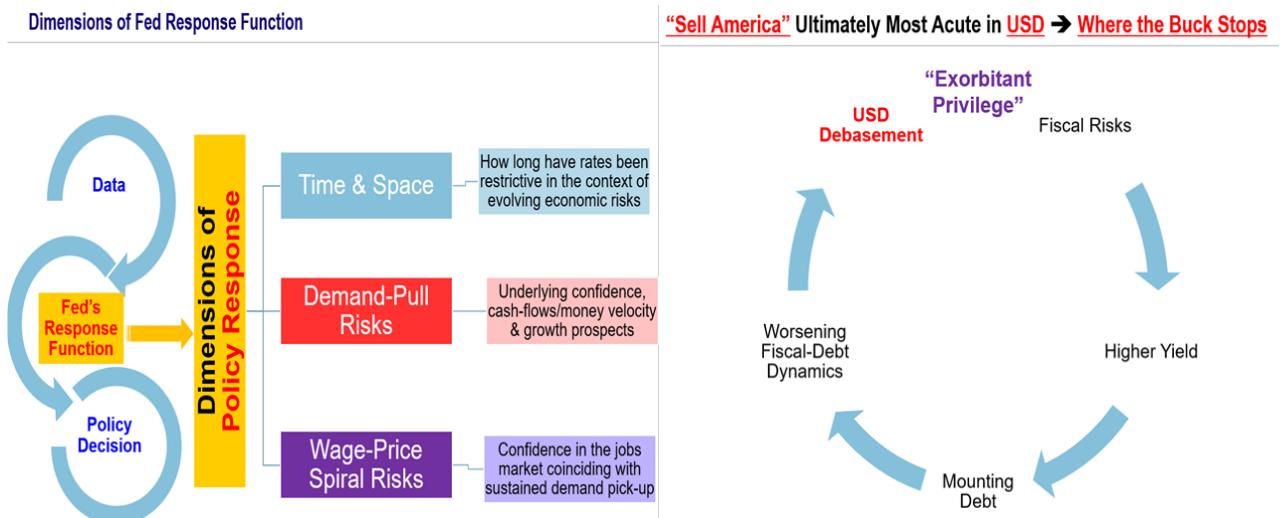
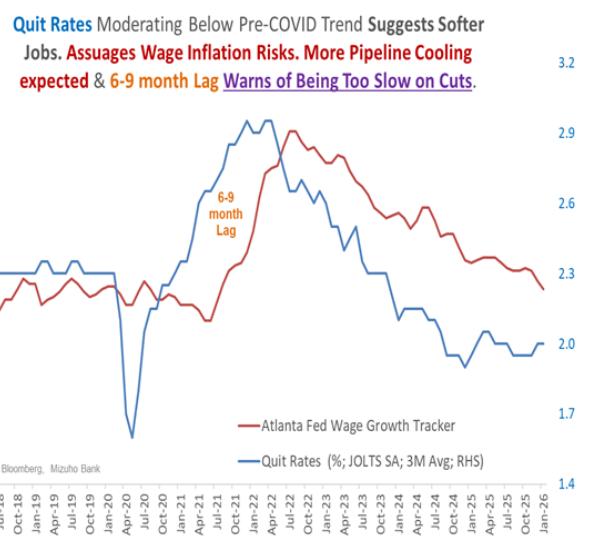
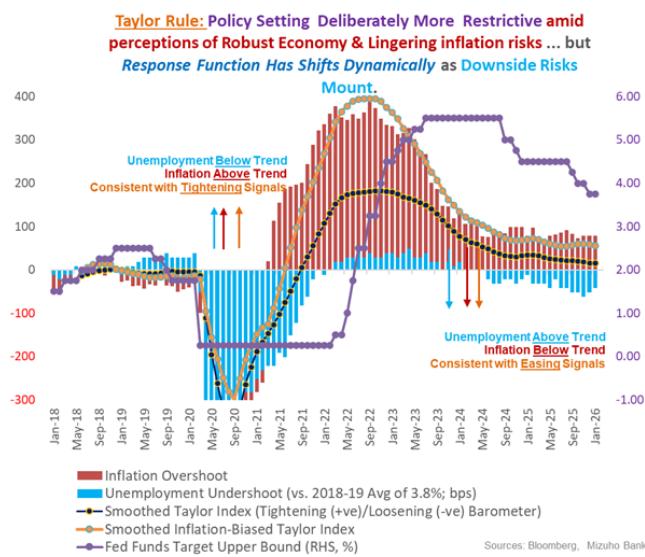
*"Do not assume anything Obi-Wan. Clear your mind must be if you are to discover the real villains behind this plot. —*  
**Master Yoda, Star Wars**

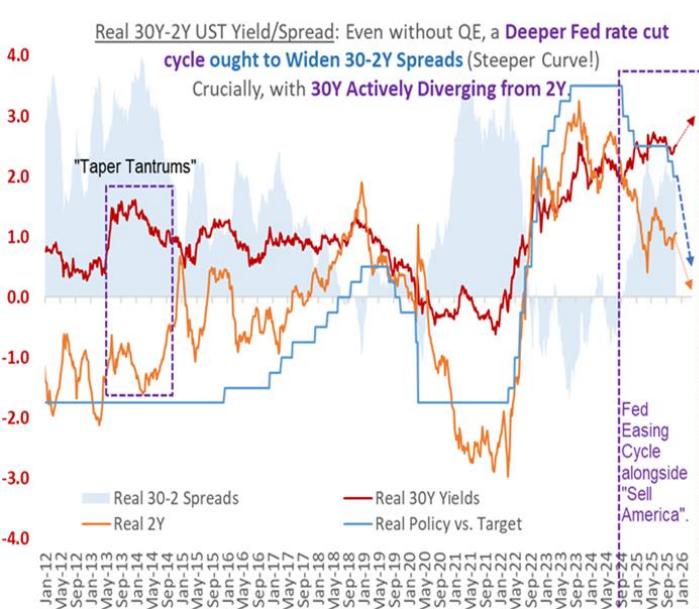
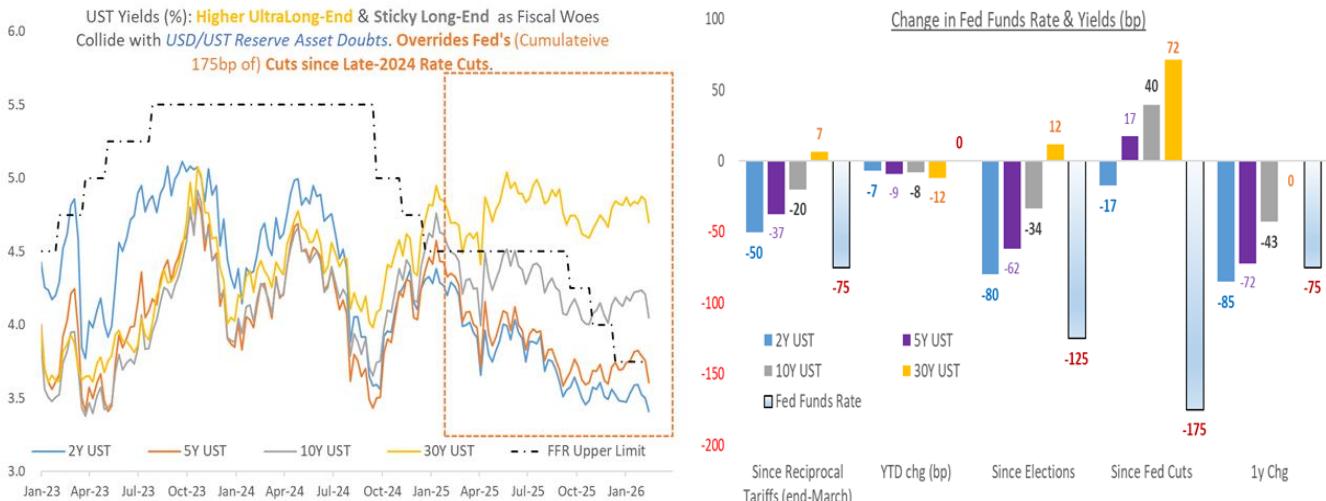
- The palpable relief over somewhat cooler-than-expected US CPI reveals **underlying tensions within the Fed** amid **diverging views on pertinent (for policy) risks**.
- The upshot though is that all this agonizing over opposing inflation and jobs risks – and for some **stagflation-type dilemma** – that divides the Fed is justifiable, but **ultimately a distraction** from the **overarching, albeit obscured, threat of “too little, too late”**.
- More so, given **weak underlying demand dynamics set to override, tariff-induced price shocks**, which are more likely to fade than fester.
- Point being, risk of **inflationary spirals are contained** as **neither** the post-pandemic, pent-up “YOLO\*” demand agitations **nor** any price shock akin to the persistent “oil shock” of the 1970s are likely to be sustained.
- Especially not when **adverse tariff shocks, fragile confidence, softening job sentiments** and **disinflationary energy dynamics** conspire to **dampen overheating risks** from **demand-pull** and **wage-price** dynamics.
- Hence, even if dovish inclinations are presently hamstrung by prominent inflation risks, **demand deficiency will overtake as the more persistent threat, warranting further policy easing**.
- Nonetheless, the **current policy quagmire** is **unavoidable given acute uncertainty**. And so, the **probability of belated policy response rises**.
- But the **greater intervening risk** is **perceived challenges to policy independence from misguided political interference** that **undermine policy credibility** and **complicate policy calculus**.
- Ultimately, the **greatest policy danger** is from **high-stakes US geoeconomic adventurism**, inadvertently **gambling with USD's reserve currency dominance** alongside **UST reserve asset allure**.
- Resultant **USD debasement threats** as **US credit worthiness** takes a knock in the wake of **geoeconomic-fiscal upheaval will feature as structurally higher term premium**.
- In any case, **fiscal slippage woes, stagflation risks, and Fed easing** (further out) will **steepen the curve**.
- **Wrap: Runaway inflation risk is a red herring**. But **impaired transmission\*\*** poses a serious **problem**, compounded by **impeded rate cuts amid superficially conflicting risks**. **Attacks on Fed independence** and **“de-dollarization” risks** are the Fed's **greater structural challenges**.
- **Ripples Beyond (the Fed)**: The repercussions from which are not just **profound** but **pervasive**.
  - a. Sharper Fed rate catch-down later in 2026 may **cyclically** induce **enlarged volatility** in **JPY, AUD, NZD** (given relatively divergent hawkish BoJ, RBA and RBNZ).
  - b. **Structurally**, **surge in demand for non-fiat monetary alternatives** (e.g. Gold), at the expense of “stable portfolio returns”, could perversely incentivize **greater, compensatory, risk-taking** elsewhere.

c. Yet, amid structurally higher term premium means that **risk re-pricing** may be **more pronounced** and **differentiated** as significantly and durably **term premium conspires with more intense demand for capital** (accentuated by AI capex demand). This **sets up EMs for sharper differentiation along fiscal-monetary and governance risks**.

\* “YOLO” is shorthand for “you live only once” approach that prioritizes gratification/consumption over associated risks and resultant debt/future liabilities.

\*\* Evident in sticky long-end yields (holding above 4% despite a cumulative 175bp of rate cuts).





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