Mizuho Brief: Fed

Economics & Strategy | Asia ex-Japan

31 August 2026 |
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Jackson Hole: Hawkish Credibility, Not Imminent Cycle

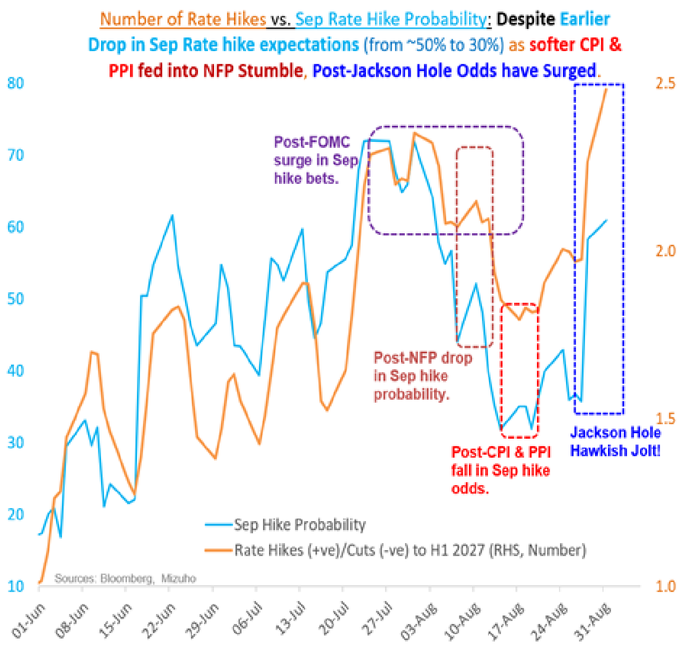
"What you do in this world is a matter of no consequence. The question is, what can you make people believe you have done?" - **Sherlock Holmes, A Study in Scarlet**

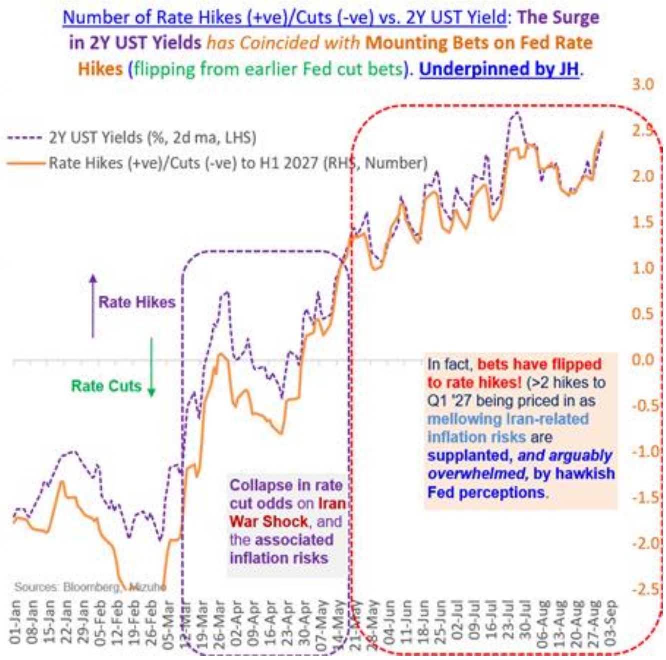
In a Nutshell:

- Admittedly, Fed Chair **Warsh has re-established hawkish credibility** at Jackson Hole with his *unambiguous reference to inflation as the greater risk*.
- Especially in declaring "*work to do*" should inflation not ease back "*clearly with sufficient speed*". Further **complemented by** "*firm and fixed*" *2% inflation target* for *core PCE*.
- Crucially, as he asserts *short-term rates as the Fed's predominant tool* to tackle inflation, unencumbered by financial conditions (higher rates).
- ***But*** this is **neither a commitment of imminent hikes** (in Sep/Oct) ***nor an inclination for sustained hiking cycle***.
- Instead, our view is measured late-2026/early-2027 hike(s) to more than reverse on late-2027/2028 cuts.
- Point being, acutely path-dependent policy remains subject to **two-way risks for highly unpredictable geo-politics** and **peaking AI-related capex growth/market exuberance**.
- Furthermore, a **smaller** and **less activist Fed balance sheet espoused** by Warsh **requires pre-emptive rate cuts** *to mitigate/avert adverse financial shocks* to the system.
- Market Implication:
  - Near-term bear flattening is *subject to front-end volatility through split FOMC bets.*
  - Whereas structurally higher long-end yields, *whilst interrupted by "Treasury Twist",* looks set to ultimately reinstate steepening.
  - **USD, relatively buoyed by Fed's proximate hawkis**h bias, likely to *soften AXJ* broadly and *hurt "twin deficit" AXJ more acutely.*

Hawkish Credibility

- At the weekend's Jackson Hole Symposium **one could argue that Warsh made a far stronger case for relinquishing forward guidance** *than for urgently vanquishing inflation.*
- Although to be fair, , **Fed Chair Kevin Warsh unwaveringly established solid inflation credibility**.
  - "Calling Out": Notably, he **identified inflation as** the **unambiguously greater concern** *in pursuit of the Fed's dual mandate.*
  - "Calling Time": Second, he alluded to "*work to do*" ***if*** **inflation does not ease back** "*clearly and with sufficient speed*". Thereby, **potentially calling time on** "*watchful thinking*".
  - Rejecting (Automatic) Reversion: Crucially, he declared that **price stability is not self-executing**, and **inflation need not automatically mean revert** (to 2%).
  - Anchoring Goalposts: What's more, he assured that the **2% target** based on the Fed's **core PCE** measure was "*firm and fixed*".
  - Reclaiming Agency: Above all, **Warsh reclaimed agency** (*from bond markets*) by;
    - *a)* declaring ***short-term rates as the Fed's tool/responsibility*** and;
    - *b)* further *assessing that overall financial conditions are not restrictive*.





Not Commitment to Hiking Cycle

- ***But*** to be clear, this is **neither commitment to (***much less a forgone conclusion of)* **imminent rate hikes nor an inclination for a sustained hiking cycle**.
- *Point being,* **incoming data** are **sufficiently mixed** - with ***soft spot in jobs*** and ***restraint in inflation*** – such that "***contemporaneous trends"*** do not flash red (for hikes).
- Hence, September **FOMC may not demand an urgent hike,** and **October has a higher (political) bar** given political noise ahead of Mid-terms in November.
- Admittedly, late-2026 (Dec) and early 2027 (Jan/Mar) are set up for (25-50bp) of hike(s) *if worse-case "Iran-Hormuz" pressures* a, *El-Nino shocks* and *"chip-flation"* conspire.
- But the **case for pre-emptive hikes** (and sustained tightening) now are **challenged** by **acutely path dependent outcomes**, **reliant on dynamic interaction betwee**n;
  i. *Highly unpredictable geo-politics*,
  ii. *Lingering risks of supply shock* amplification from food, China reinstating crude demand
  iii. *Growing tensions* between the *sheer scale of* **AI capex build out** and *peaking* demand growth (*second derivative*) expectations
  iv. ***Knife-edge extension of AI exuberance in markets*** entailing *potential financial channel shocks.*

Non-Linear Rate Path

- Necessarily, **Fed call** has to be **non-linear** and *subject to tighter inflection points.*
- In fact, our view is for **policy to inflect back to an easing bias**, albeit back-ended into 2027.

Fed & Rates Outlook

	Q1 2026	Q2 2026	Q3 2026	Q4 2026	Q1 2027	Q2 2027	Q3 2027	Q4 2027
FOMC Baseline	3.50-3.75	3.50-3.75	3.50-3.75	3.50-3.75	3.75-4.00	3.75-4.00	3.50-3.75	3.00-3.25
FFR Mid*	3.625	3.625	3.625	3.625	3.875	3.875	3.625	3.125
SOFR (3M)	3.682	3.734	3.785	3.875	3.955	3.995	3.725	3.185
2Y UST	3.796	4.175	4.285	4.055	4.165	4.195	3.875	3.345
10Y UST	4.319	4.466	4.805	4.835	5.095	5.255	4.995	4.505

*Fed Fund Rates Range and mid-point

- ***Initially*** as *"contemporaneous trend" of easing inflationary pressures* coinciding with *further softening in jobs* – so long as ***fresh cost shocks are averted***.

To Ultimately Lower Rates?

- But ***at a more structural level***, this rests on the **intersection of two critical policy tenets** (in his speech):
  1. **Pursuit (not trade-off) of both sides of the "dual mandate"**: *Significant productivity gains from AI,* setting the stage for **non-inflationary growth pick-up**, arguably makes a **compelling case for lower (neutral) rates**
  2. **Limiting the Fed's Policy Toolkit to Short-term rates** *curtailing Balance Sheet Accommodation (outside of crises): Intent to shrink the Fed's balance sheet,* all else equal, argue for ***pre-emptively* lower rates to avert/mitigate adverse shocks**.

Market Implication:

- Volatile Bear Flattening: Near-term bear flattening on dynamic rate hike bets *subject to front-end volatility through split FOMC bets.*
- Structural Steepening Interrupted, but Intact: Whereas structurally higher long-end yields, *whilst potentially interrupted by "Treasury Twist" and* looks set to ultimately reinstate steepening, unravelling the interim, Fed-inspired flattening.
- FX: USD Underpinned: **USD, relatively buoyed by Fed's proximate hawkis**h bias, likely to *soften AXJ* broadly and *hurt "twin deficit" AXJ more acutely amid higher UST yields.*