Mizuho Brief: FOMC

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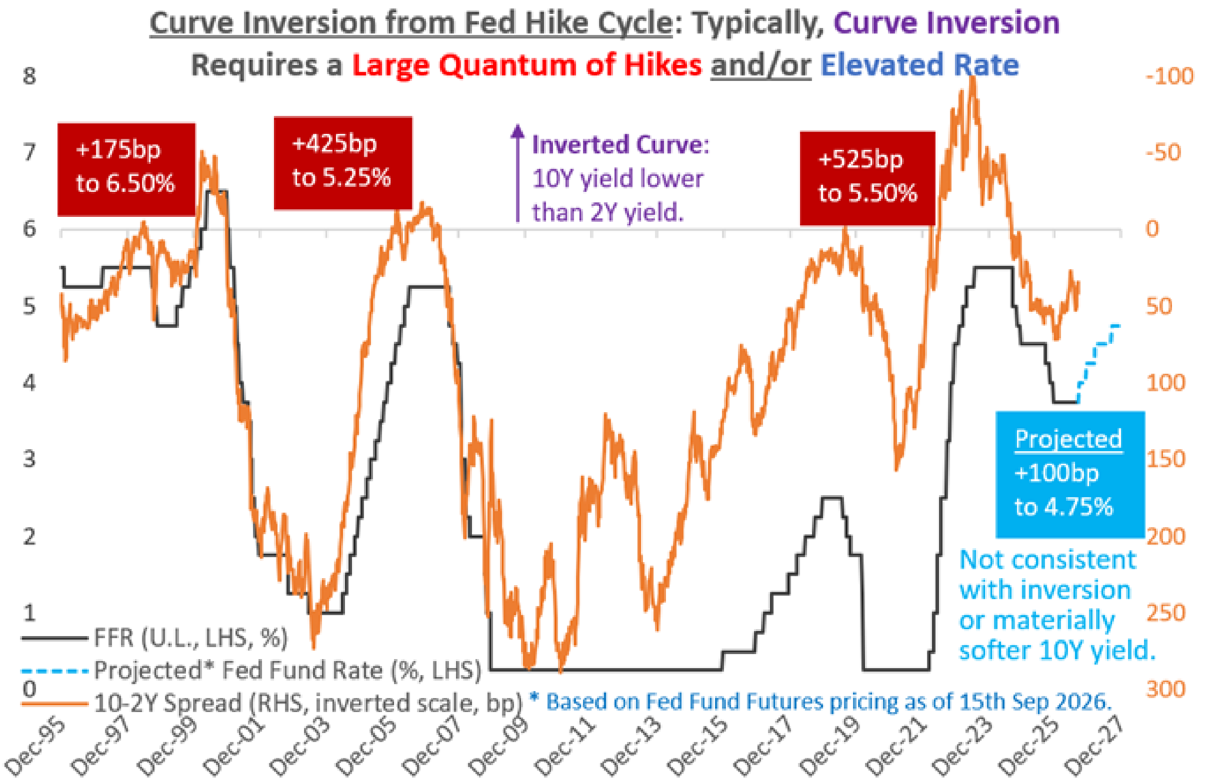
FOMC Preview: Boxed (In), Not Sealed

"The Force is strong with this one." – Darth Vader, Star Wars: Ep-IV: "A New Hope"

In a Nutshell: With markets driving up Sep FOMC rate hike probability to >90% (virtually a done deal) the Fed appears to be **boxed into a rate hike**. ***Yet it* risks falling short of sealing the deal on reining in long-end yields**. For one, **hawkish outrun impacting front-end yields**, *now pricing in nearly 4 hikes by mid-/Q3 2027,* **may overwhelm scope for long-end yields to materially soften on tamed inflation expectations**. Crucially, ***even if the Fed delivers on an adequately hawkish hike*** to avert long-end yields from surging, **long-end yield relief appears to be hobbled** by **a conspiracy of bearish (long-end) bond pressures** – from *surging oil*, *dismal fiscal/debt dynamics*, *supply pressures* (exacerbated by AI issuance) and *structural steepening forces* (including USD debasement risks). Notably, the **argument for** (UST) curve **inversion** to soften long-end yields materially is **challenged** by **Fed hike threshold alongside monumental bearish bond market forces** *sans QE.*



- Boxed(-In), Not Sealed: The **Fed** likely finds itself **in an unenviable bind**, whereby it is **boxed into a rate hike**, but ***yet* risks falling short of sealing the deal on reining in long-end yields**. Not just because **anchoring expectations is a higher bar** (than just a 25bp hike).

- Hawkish Front-End Outrun: But crucially as the **hawkish outrun impacting front-end yields**, *now pricing in nearly 4 hikes by mid-/Q3 2027,* **may overwhelm scope for long-end yields to materially soften** on inflation expectations being tamed.

- Ultra-Hawkish Pricing: Fed Fund futures are pricing in **90-95% probability of a hike** later this week at the September FOMC. For context, this has *jumped from 65% following Warsh's Jackson Hole speech*, which itself was jump from ~35-40% probability pre-Jackson Hole.

- Compromised Options: In effect, the **post-Jackson Hole "sweet spot"** of (60-65%) hawkish bias **has now morphed into a tight corner** that **deprives the Fed of any real option** **–** ***other than to hike***. Point being, **the absence of a hike will impose a high bar for the Fed to reclaim** (perceptions of) **credibility eroded**

- High Hawkish (Hike) Bar: In fact, not only will hawkish talk in lieu of a hike may fall short of feverish hike expectations, but **any hike will probably require adequately hawkish talk *and/or*** 'Dot **Plot**'. In other words, a **compellingly hawkish hike**. Failing which, *long-end yields could potentially be pushed even higher on "behind-the-curve" worries*.

- And (a Sloth of) Bond Bears: ***But even*** then, ***such a hawkish hike may still disappoint*** hope for meaningfully softer long-end yields given the **sloth of (long-end) bond bears** – *feeding off geopolitical energy shock risks, dismal fiscal/debt dynamics and a confluence of structural as well as (AI issuance) supply-driven steepening bias.*

- Materially Softer Long-End Yields a (Very!) Long Shot: The upshot is, there is an **impossibly narrow path for long-end yields to materially and durably soften** – *especially given* already narrowed 10-2Y spreads. Right off the bat, a dovish disappointment will send long-end yields surging higher. Admittedly, a *hawkish hike will bear flatten* the UST curve. *But with* ***emphasis on "bear"*** *rather than "flatten",* hence **succumbing to higher rates** amid a conspiracy of **geo-economic forces that are especially detrimental for longer-dated bonds** (consistent with elevated long-end yields).

- As "Inversion" Eludes: And to be sure, the case for **UST yield curve inversion** (amid rate hikes) **to drive material long-end yield relief** (10Y yields back to low-/mid-4%) is set to be **highly elusive**. **For one, the quantum of hikes priced** is likely **below the threshold unlikely to trigger exceptional "inversion"** outcomes.

- Especially amid Geo-Economic Headwinds sans QE: Crucially, **given** the *above-stated geo-economic bearish bond factors,* raise the bar for long-end yield pullback even more. Especially *without* the benefit of *"active QE"*, which was likely to have exaggerated the propensity for "inversion" post-GFC and in the aftermath of the pandemic.