MONETARY AFFAIRS:

Preview: Fed Likely But Not Certain To Remain on Hold in July, While The Need for a Rate Hike by September Is High

by

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28 July 2026

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Executive Summary

- **Expected Decision**: *We expect the Fed to keep rates unchanged in July (60% probability) even if we can't rule out a rate hike (40% probability) as the FOMC is divided on the matter.* In line with consensus, with a 60% probability, we expect the Fed to maintain its target Fed funds range at 3.50% - 3.75% in July. At its June meeting, the Fed left interest rates unchanged, removed language suggesting a bias toward future rate cuts, and significantly shortened its policy statement, eliminating forward guidance. While our baseline is a hold we cannot rule out a hike for many reasons. Regarding *balance sheet policy,* in May last year the FOMC decided to slow down the pace of QT.
- **Policy Discussion**: *The Federal Reserve is widely expected to keep rates unchanged this week, as softer inflation and a cooling labour market have eased pressure for immediate tightening*. However, rising oil prices and Middle East tensions, renewed tariffs on import, strong aggregate demand driven by the AI capex boom and inflation above target have reinforced expectations of further rate hikes later this year, possibly starting already in September.

  Recent Fed speeches have maintained a hawkish tone, with many officials stressing that inflation remains well above the 2% target and that rates may need to rise if price pressures persist. Chair Kevin Warsh has reaffirmed the Fed's commitment to restoring price stability while offering little forward guidance, leaving future policy dependent on incoming data.

  Markets have consequently raised expectations for further tightening, with futures pricing an 38% probability of a rate hike in July and a 82% probability of a September rate hike, up from 53% a week ago. With limited guidance expected at next week's meeting, upcoming inflation and labor market data will remain the key drivers of Fed expectations, while elevated energy prices and geopolitical tensions continue to support the US dollar and bond yields.

Key Picture: US Federal Reserve Forecasts – 2025-2028

	2026*f*			2027*f*		2028*f*		Longer Run	
	Latest Reading	June Report	March Report	June Report	March Report	June Report	March Report	June Report	March Report
GDP *(real growth, y-o-y)*	2.7	2.2	2.4	2.3	2.3	2.1	2.1	2.0	2.0
Unemployment rate *(%, y-o-y)*	4.3	4.3	4.4	4.3	4.3	4.2	4.2	4.2	4.2
PCE Inflation *(%, y-o-y)*	2.8	3.6	2.7	2.3	2.2	2.0	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	3.3	3.3	2.7	2.5	2.2	2.1	2.0	-	-
Federal Funds Rate *(%)*	3.75	3.8	3.4	3.6	3.1	3.4	3.1	3.1	3.1

Source: Federal Reserve *'Summary of Economic Projections' March and June 2026*. *Note:* 1. GDP reading for Q1-2025; 2. Unemployment rate as of May 2026; 3. PCE and core PCE inflation as of April 2026; 4. Projections reflect the median of FOMC projection.

Analysis

- **EXPECTED DECISION**: *On July 29, we expect the US Federal Reserve's FOMC to keep its Fed funds range at 3.50% - 3.75% while we cannot rule out a rate hike (40% probability).* At its June meeting, the Fed left interest rates unchanged, removed language suggesting a bias toward future rate cuts, and significantly shortened its policy statement, eliminating forward guidance. The updated dot plot no longer projected a rate cut this year, instead indicating that a rate hike is possible, though not guaranteed.

  Reflecting Chair Kevin Warsh's preference for greater policy flexibility amid elevated uncertainty, the FOMC also abandoned explicit forward guidance, reinforcing his skepticism toward detailed policy signalling and economic forecasts.

  Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June. The Committee will continue reduce the size of its balance sheet made of Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in April, the Committee slowed the reduction of its securities holdings by lowering the monthly Treasury redemption cap from $25 billion to $5 billion, while keeping the agency debt and mortgage-backed securities cap at $35 billion.

- **POLICY DISCUSSION**: *The Federal Reserve is expected to leave interest rates unchanged at this week's meeting, as softer-than-expected inflation, benign producer prices, and signs of a cooling labor market have reduced the urgency for immediate policy tightening; but a rate hike in July is possible (40% probability) even if it is not our baseline*. However, the outlook beyond July has become more uncertain. Renewed oil-driven inflation, following crude prices' rise above $100 per barrel amid escalating Middle East tensions, new tariffs on imported goods, strong aggregate demand driven by the AI capex boom, has strengthened the case for further tightening later this year.

  Recent speeches by Fed officials have maintained a hawkish tone, with policymakers emphasizing that inflation remains well above the 2% target and warning that interest rates may need to rise if price pressures fail to ease further. While acknowledging encouraging recent inflation data, officials have stressed that additional evidence of sustained disinflation is needed before considering a policy shift. Chair Kevin Warsh has reaffirmed the Fed's commitment to restoring price stability but has deliberately avoided providing forward guidance, leaving future decisions firmly dependent on incoming economic data.

  The case for a rate hike – as early as in July and more likely in September – is that inflation has been running well above target for over 5 years now and inflation expectations are still above target. Also, the crumbling of the ceasefire in the war with Iran is now leading to another spike in energy prices; moreover, the Trump administration has replaced tariffs blocked by courts with new Section 301 tariffs of 12.5% on 66 US trading partners. Economic growth is remaining strong among an AI driven capex boom that is putting upward pressures on many goods and services in a relative tight labor market. High inflation expectations above target keep long bond yields too high and failure to raise policy rates if inflaton rises could de-anchor inflation expectations and lead to even higher long bond yields.

  Warsh – in his recent Congressional testimonies - has reiterated the Fed commitment to price stability and has argued that while negative aggregate supply shock – energy and tariffs – can lead to an increase in the price level it is the job of monetary policy to ensure that it doesn't lead to a more persistent increase in the inflation rate and its expectations. Thus, if Warsh were to decide that a rate hike is warranted already in July, he could convince the rest of the FOMC including the other two relative doves in the troika – vice chair Jefferson and NY Fed chair Williams – to go along with a hike. Still, on balance a rate hold is more likely in July than a rate hike and – if inflation were to remain elevated – a rate hike will be likely as early as September.

  Consequently, markets have increasingly shifted toward expecting the Fed to resume tightening later this year. Futures now price an 82% probability of a September rate hike, up from 53% a week ago, while the probability of a hike at this week's meeting has increased to 38% from below 12%. With the Fed expected to offer little guidance at its July meeting, market expectations are likely to remain highly sensitive to upcoming inflation and labor market releases. Meanwhile, persistent geopolitical tensions and elevated energy prices are expected to continue supporting the US dollar and keeping upward pressure on global bond yields.

- **MACROECONOMIC ANALYSIS:** *US inflation cooled much more than expected in June, and core prices unchanged, reflecting broad-based easing in price pressures beyond lower gasoline prices. But the recent rise in oil prices is highly legibly to lead to a rise in inflation in the July and August reports.* The US economy grew at an annualized 2.1% in Q1, revised up from 1.6% and rebounding from 0.5% in Q4 2025. The upgrade was driven by stronger business investment, particularly in AI-related equipment, and a smaller drag from imports. However, consumer spending was revised lower, reflecting weaker demand amid higher gasoline prices, while residential investment continued to decline under the weight of elevated interest rates.

  US inflation slowed sharply to 3.5% in June from 4.2% in May, below expectations of 3.8%, as lower gasoline prices drove the largest monthly CPI decline (-0.4%) since April 2020. Core inflation also eased to 2.6% from 2.9%, reinforcing signs of moderating price pressures. The softer-than-expected data reduced pressure on the Fed to tighten policy immediately, allowing Chair Warsh to maintain a hawkish stance on returning inflation to target without signaling a near-term rate hike.

  Job growth slowed to 57K in June, well below expectations of 115K and down from a revised 129K in May, while payrolls for April and May were revised down by a combined 74K. Although the unemployment rate edged down to 4.2% in June from 4.3% in May, the decline was driven by 720,000 people leaving the labor force, pushing the participation rate to its lowest level in more than five years.

  The S&P Global US Composite PMI rose to 53.6 in July from 51.9 in June, its highest level since November, driven by an eight-month high in services activity, while manufacturing growth slowed. Hiring returned to growth for the first time in three months and business confidence reached an eight-month high. However, supply chain disruptions intensified, with supplier delivery times deteriorating the most in nearly four years, while input cost inflation hit a 14-month high and selling price inflation approached a four-year peak. The July strength may prove temporary, supported by FIFA World Cup-related tourism and celebrations marking the 250th anniversary of the US.

- **MARKET IMPLICATIONS:** *Market will react to Warsh's press conference. In case of a rate hike*, the market will likely have an adverse market reaction given the surprise. *In case of hold*, as the statement will give away little information, all eyes will be on Kevin Warsh's press conference, in search for confirmation of a rate hike in September. While he will avoid pre-committing, to be loyal to his own mantra of not proving forward guidance, journalists will press him on economic data and conditionalities to gather a sense about an imminent rate increase. All this while US Treasury yields rose as escalating Middle East tensions and higher oil prices fueled inflation concerns and strengthened expectations of a near-term Fed rate hike, weighing on both government and high-yield bonds amid a broader risk-off environment. To put things into context, *in the fixed-income space*, as of 27 July, and since the last meeting in June, the 2y UST rose by 15 bps to 4.32% (+84 bps y-t-d) and the 10y UST also edged up 18 bps to 4.64% (+47 bps y-t-d). *In the currency space*, rising US and global bond yields, elevated geopolitical tensions, higher energy prices, and expectations of a Fed rate hike have supported the US dollar. The dollar index rose to 101.5 (+3.2% y-t-d, modestly firmer since the June meeting), while EUR/USD fell by 1.2% to 1.14 (-3.2% y-t-d). *In the equity space*, US equities ended the week mostly lower as concerns over the returns on large-scale AI investment and a surge in oil prices weighed on investor sentiment. As of 27 July, the S&P 500 decreased by roughly 0.1% since the June meeting to 7,413.918(+8.1% y-t-d).

- **APPENDIX (Macro Background):** *US GDP growth revised up for first quarter.* In Q1, the US economy expanded to an annualized 2.1% (*c*: 1.6%; *p:* 0.5%). N et trade weighed less on growth than initially estimated (-0.37 pp vs. -1.25 pp), as import growth was revised down (11.8% vs. 21.1%) despite softer exports (10.9% vs. 13.1%). Private domestic investment was revised higher to 7.9% (vs. 7.0%). Consumer spending was revised sharply lower to 0.5% (vs. 1.4%), reflecting weaker services demand, while government spending rose 4.4%, unchanged from the previous estimate, as activity recovered following the end of the government shutdown.

  Composite PMI rose to its highest level since November, driven by an eight-month high in services activity. In July, *the S&P Global US Composite PMI* rose to 53.6 (*p:* 51.9). The Manufacturing PMI fell to 53.8 (*p:* 53.9). Service PMI edged up to 53.6 (*p:* 51.2), marking the fastest expansion this year.

  The US job creation cools in June. In June, *the unemployment rate* edged down to 4.2% (*c:* 4.3%; *p:* 4.3%). NFP added by 57K (*c:* 110K; *p:* 129K). Wage growth increased by 3.8% in May (*p:* 3.6%). The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, fell to 7.8% (*p:* 8.1%).

  US inflation slowed sharply, as lower gasoline prices eased price pressures. In June, the *personal consumption expenditures* (*PCE*) – the Fed's preferred inflation gauge – rose by 4.1% y-o-y (*c:* 4.1%; *p*: 3.8%). The *core-PCE* – which excludes volatile energy and food prices – increased to 3.4% y-o-y (*c:* 3.4%; *p:* 3.3%). In June, headline and core inflation rate eased off to 3.5% y-o-y (*c:* 3.8%; *p:* 4.2%) and 2.6% y-o-y (*c:* 2.8%; *p:* 2.98%) respectively.