GENERALI ASSET MANAGEMENT

Sliding inflation will dampen the Fed's hawkish tilt

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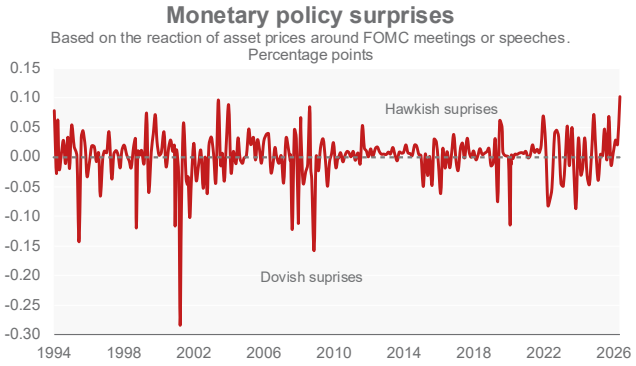
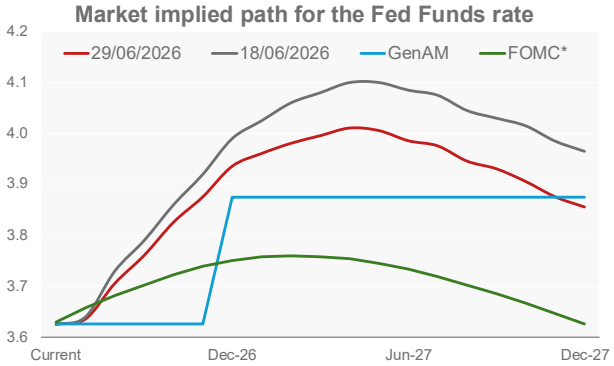
Our Focal Point series explores topical issues on macro, markets and investment

- **The June FOMC meeting delivered a hawkish surprise. We now expect only one rate hike, as a credibility move. Markets price a roughly 50% probability of a second rise in H1 2027.**
- **Energy prices remain the key swing factor. Cheaper oil, assuming the Gulf conflict deescalates, should limit second-round pressure and help expectations decline. Fading tariff effects and stabilising chip prices will help tame the AI-related surge in tech goods inflation.**
- **Sticky services inflation should gradually ease as housing costs and wage pressure cool. Rent and house-price indicators point to slower shelter inflation ahead, while lower quit rates and weaker job-finding prospects suggest the labour market is stabilising rather than overheating. We see core PCE at 3.1% year-on-year in Q4, with some downside risk, also due to methodological changes in inflation measurement.**
- **The main market implication is a steeper curve, in line with our forecast. The short end should eventually price out some tightening beyond year-end as inflation cools. By contrast, less Fed forward guidance and the resulting higher policy uncertainty could keep term premia elevated and limit any rally at the long end, especially if growth remains resilient and disinflation proves slower than markets expect.**

The June FOMC meeting delivered a hawkish surprise. The Committee left rates unchanged, but the updated projections showed that 9 out of 19 participants now expect a rate increase by year-end. According to San Francisco Fed estimates, this was the most hawkish monetary-policy surprise in more than 30 years. Markets had already priced some tightening as the oil-price shock linked to the Iran conflict added to existing inflation concerns and labour-market data looked firmer. Futures briefly moved close to pricing one hike by year-end and an 80% probability of a second move by spring 2027. They then retraced after better news on the Gulf conflict pushed oil prices lower; futures now assign an around 50% probability to a second hike by mid next year.

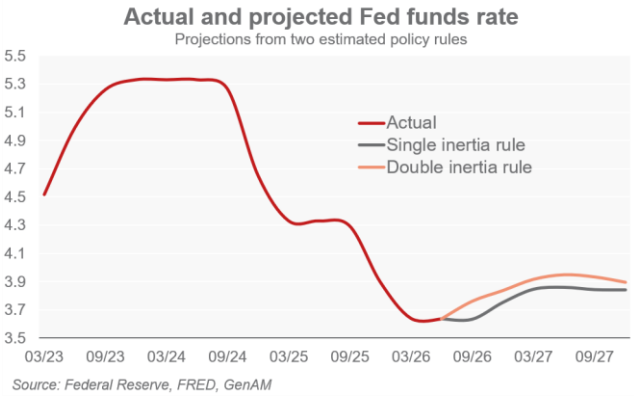


Source: San Francisco Fed, GenAM



*Source: Refinitiv, GenAM. * Cubic interpolation of the yearend projections from the dots*

Our baseline has moved to one rate hike, most likely in December. The Fed has a clear incentive to protect its inflation-fighting credibility, but data volatility argues for patience. A hike before the November primaries would also be politically sensitive. A rate rise is consistent with our estimated policy rules (see appendix). Still, the risk is tilted towards no action if falling oil prices improve the inflation outlook. We do not see the conditions for additional monetary tightening.



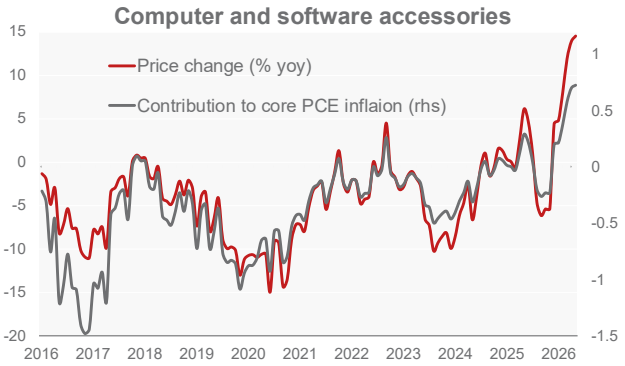
Source: Federal Reserve, FRED, GenAM

Oil delays, but does not derail, disinflation

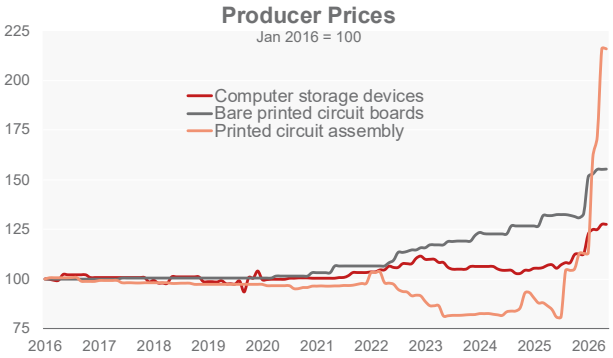
Inflation remains the key constraint on the Fed, but the drivers probably matter more than the headline number. Core PCE stood at 3.4% in May and may remain uncomfortable in the near term, but we expect it to peak soon and fall to 3.1% year-on-year in Q4, 0.1pp below the FOMC median projection. If oil prices remain close to pre-conflict levels, the feared second-round effects on core inflation should be smaller, while survey-based inflation expectations should partly reverse as gasoline prices fall.

The sharp rise in goods prices has been a key driver of the recent inflation pickup. Tariffs played an important role by lifting the price level, but their effect on annual inflation has likely peaked and should moderate over the coming months. We also do not expect the upcoming tariff reshuffle to raise the overall rate. More recently, the tariff impulse has been gradually replaced by the AI-boom. The spike in memory-chip prices between Q4 2025 and Q1 is feeding into computer software and accessories inflation, which rose from 4.4% year-on-year in December to 13.9% in May. This component contributed around

70bp to annual core inflation in April and May. Recent data show that chip prices are stabilising, and we expect this inflation component to fall quickly around the turn of the year. Still, as Apple's recent 20% price increase for some products shows, the pass-through to retail inflation may last longer. The sharp rise in tech prices may reflect a structural shift colliding with supply bottlenecks, making it unclear whether tighter monetary policy would be the right response.



Source: BEA, GenAM

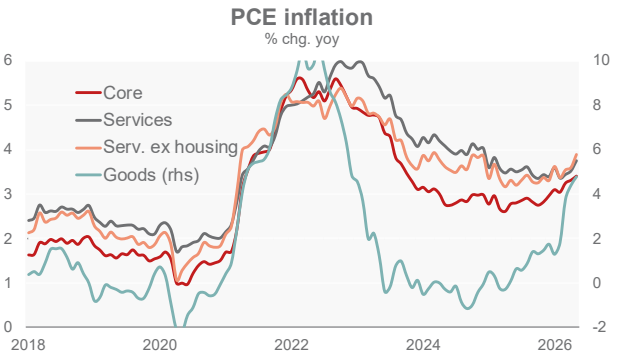


Source: FRED, GenAM

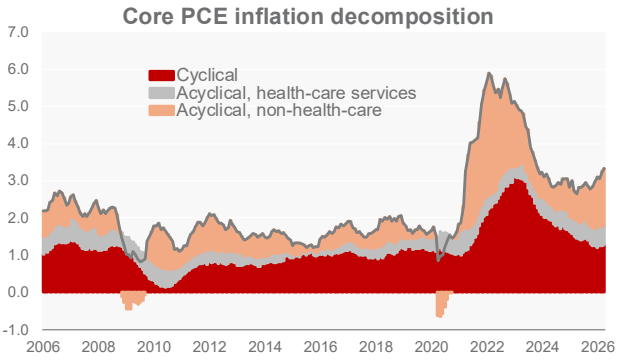
Services inflation remains the main domestic obstacle to a cleaner disinflation story, but the evidence is becoming less worrying. Rent growth is cooling: the Zillow index, a relevant leading indicator for official rents, rose by 1.9% year-on-year in April, about one percentage point less than a year earlier. House-price growth has slowed even more sharply, from 3.3% year-on-year in March last year to 0.7% this March and should feed into rents with a six-to-nine-month lag. Elevated mortgage rates are an important part of this adjustment and are unlikely to fall quickly, with the 30-year rate still around 6.5% after fluctuating between 6% and 7% over the past two years.

Outside housing, services inflation reached 3.9% yoy, with bouts of volatility from specific sectors such as air fares pushed up by fuel prices or brokerage commissions linked to swings in the S&P 500. An important structural driver is labour costs, and going forward these should not generate the genuine demand-driven pressure that should concern the Fed most.

More broadly, San Francisco Fed indicators suggest that core inflation remains elevated mainly because of factors with limited links to the business cycle, including tariffs and oil. Once these factors fade, and provided there are no further adverse supply shocks, inflation should continue to cool gradually.



Source: BEA, GenAM

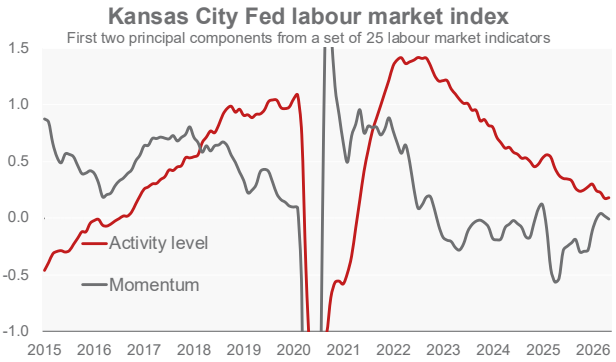


Source: San Francisco Fed, GenAM

The labour market is stable, not overheating

Recent strong nonfarm payrolls readings may suggest an overheating labour market, but broader indicators point to stabilisation. Job creation has stopped falling and the unemployment rate, at 4.3% in May, is close to most estimates of full employment. However, the labour market's ability to absorb the unemployed remains below its pre-pandemic average. Crucially for wage growth, the quit rate has fallen sharply, reducing the risk that wages keep services inflation sticky. Stronger productivity should also help by compressing unit labour cost growth.

Finally, the main rationale for a rate hike is to make sure that medium-term inflation expectations do not drift away from the 2% target. Household survey-based medium-term expectations remain high, but they should trend down given their strong correlation with gasoline prices, which we expect to fall. Financial-market expectations, which should matter more under Warsh's preferred approach, remain range-bound. This should reduce the need for a large monetary tightening.



Source: Kansas City Fed, GenAM

Source: BLS, GenAm

Methodological changes introduced by the Bureau of Economic Analysis are another source of downside pressure on PCE inflation. Changes to price measurement for computer software and accessories, portfolio management services and legal services could reduce year-on-year inflation by as much as 0.2pp by year-end.

Less Fed guidance points to a steeper curve

If this baseline materialises, the market should reprice the expected Fed path, with the biggest impact at the short end of the curve.

The impact on the long end would likely be smaller. Governor Warsh is keen to reduce the amount of guidance the Fed provides. If markets receive less forward guidance, they may price the resulting uncertainty through higher risk premia across the curve. Warsh argues that financial markets perform best when they react to incoming data rather than trying to anticipate how the Federal Reserve will respond. He is also inclined to make the Fed more of a price taker from financial markets, arguing that "financial market prices are probably the most important source of information to guide central bankers". Yet recent research by Fed economists shows that "official guidance can simultaneously improve average forecast accuracy while reducing the speed with which new information is incorporated into expectations". Scrapping guidance too aggressively could therefore be partly counterproductive by lifting policy uncertainty, rate volatility and term premia.

The Treasury curve implication is therefore more nuanced than a simple "more hikes, higher yields" story. In our baseline, the short end should eventually price out part of the tightening currently embedded beyond year end, as investors conclude that one hike is enough for the Fed to preserve credibility. Two-year yields should benefit most from this repricing once inflation data confirm that oil, tariffs and goods-price pressures are fading.

The long end is less straightforward. Softer inflation is normally supportive, but reduced forward guidance, higher policy uncertainty and rate volatility could keep term premia elevated. This would add to upward pressure from resilient growth, a slower decline in inflation than markets currently price and, more structurally, higher expected debt and inflation risk premia. The result is a curve-steepening bias, in line with our forecast.

APPENDIX: Estimating the Fed Reaction Function

Standard Taylor-type rules are commonly used to describe and predict the behaviour of the Fed and other inflation-targeting central banks. They link policy rates to inflation and economic slack, usually proxied by the gap between the observed unemployment rate and an estimate of its equilibrium value. Empirically, central banks adjust rates gradually, smoothing changes in the level of rates over time. The standard model used so far assumes "single inertia", meaning that the central bank smooths the level of the policy rate. Recent Fed research shows that gradualism also applies to the pace of rate changes. The "double inertia" framework captures persistence not only in the level of policy rates but also in their changes. In practice, rate moves tend to come in sequences of similar size and direction, while abrupt reversals are uncommon.

Original Taylor Rule	$i_t = r^* + \pi^* + \beta_\pi(\pi_t - \pi^*) + \beta_u(u_t^* - u_t) = TR_t$
Single Inertia	$i_t = \rho i_{t-1} + (1-\rho)\ TR_t$
Double Inertia	$\Delta i_t = \gamma \Delta i_{t-1} + (1-\rho)\,(TR_t - i_{t-1})$

The Fed paper shows that empirically, the double-inertia specification fits US monetary policy better than standard rules. It explains more than twice as much of the variation in quarterly policy-rate changes, as shown by the R-squared statistics. It also captures rate

persistence more effectively, as indicated by the Durbin-Watson statistic. A value close to 2 suggests that the explanatory variables have absorbed most of the persistence in the dependent variable. Estimates point to strong inertia: most of the current policy rate reflects its past level, while a significant share of previous changes carries over to subsequent decisions.

These findings suggest that monetary policy operates along two dimensions: smoothing of the level of interest rates and smoothing of the pace of rate changes. This helps explain both gradual tightening episodes and sustained rapid adjustment phases in recent cycles.

Estimated Parameters

	Single Inertia	Double Inertia
ρ	0.92	0.95
γ		0.60
r^*	1.14	0.98
β_π	1.84	1.53
β_u	1.67	1.10
R-sq.: level	0.96	0.98
R-sq.: change	0.27	0.55
Durbin Watson	0.61	2.03

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