



Macro MATTERS: Could the Fed hike rates in 2026? - Transcript

Executive Summary

This episode of Macro MATTERS discusses the evolving outlook for Federal Reserve policy, specifically the shift in market expectations from rate cuts to potential rate hikes. The conversation highlights key factors contributing to this reassessment, including higher-than-expected inflation, a stable labor market, and a re-evaluation of the Fed's current policy stance. The speakers also touch upon the broader increase in bond yields globally, attributing it primarily to changes in Fed policy expectations rather than term premia.

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Cleaned & Structured Transcript

Introduction to Fed Rate Hike Discussion

[00:00] : Podzept, the podcast from Deutsche Bank Research, with interviews on current economic and financial topics. Listen as economists and analysts from Deutsche Bank present their views.

Matthew Luzzetti: Welcome. You are listening to another episode of Macro MATTERS on Podzept, a series where we discuss some of the best ideas coming out of Deutsche Bank Research. I'm Matt Luzzetti, Chief U.S. Economist, and I'm once again joined by Matt Raskin, U.S. Head of Rates Research. Welcome, Matt.

Matthew Raskin: Thanks, Matt. Great to be here again. Today we wanted to talk about the outlook for Fed hikes.

Matthew Luzzetti: Hikes, not cuts.

Matthew Raskin: Hikes, not cuts. It's not something we thought a couple of months ago we'd be talking about at this point, but we've seen a very significant repricing in markets over the last couple of months, a period that corresponds with the conflict in Iran. We went from pricing between two and three 25 basis point cuts in the Fed's policy rate through the middle of next year, and we're now pricing about 35 basis points or so of hikes. So, a very significant shift in the outlook for Fed policy as reflected in market pricing. We were in London last week, and this was a big topic of discussion: the prospect for Fed rate hikes, what could lead them there, what could the sequencing be? So I thought we'd spend today talking through that. Maybe to start, I mentioned the repricing obviously corresponds with the war in



Iran, but maybe we can set the stage from a fundamental perspective. How are you thinking about the economic outlook here? What's changed for you over recent months, and where does that leave us in the Fed?

Shifting Economic Outlook and Inflation Dynamics

[00:02:00] Matthew Luzzetti: If you go to our outlook for 2026 that we published back in November, we had one rate cut in our forecast. As we described, we didn't have a lot of confidence in that rate cut or the reason that the Fed should be delivering it. We thought that you could get enough disinflationary pressures this year, and that when Kevin Warsh or whoever the new Fed Chair was going to be would come in, that might be able to lead to a somewhat more dovish Fed reaction function.

Matthew Raskin: That was mostly in circumstances where it was kind of a close call, maybe under his leadership they might choose to cut.

Matthew Luzzetti: Correct. We've talked about on this podcast a few times, there was, if you go back, this curious premium being built into the June FOMC meeting when the new Fed Chair would come in and the market believed that they would cut rates. We never believed in that. But I thought maybe in close calls, a chair that was influential and could lead a committee potentially in a dovish direction in a close call. We thought that you'd see enough maybe disinflationary pressures to produce those close calls. If you go back within the past month or two, we've taken out that rate cut, and that has been driven by an upward revision to our inflation forecast. Most importantly, we now see core Personal Consumption Expenditures (PCE) inflation for this year at 2.9%, very close to 3%. That is up about 50 basis points from where we were in November.

[00:04:00] Importantly, that reflects mostly backward-looking developments, so just the excess inflation that we've seen in recent months, more than it does building in a lot more forward-looking inflation over the next several months driven by the war in Iran. But I think you've also seen stabilization in the labor market take place. That's broadly in line with our expectations, but maybe it's happening a little bit earlier with a little bit more confidence than I would have expected back in November. You've seen payroll gains pick up. You've seen measures of labor market slack being broadly stable, and there are pockets of the labor market that look to be tightening. For example, the construction sector of the labor market looks to be tightening and wage growth accelerating. That backdrop, it's changed, but I think fundamentally, we should be having this conversation about whether the Fed should hike in this environment. We're having the conversation, but I think markets should be debating which direction the next move should be in, and premiums should be built in around Fed rate hikes. The most important development from my perspective is that I am rethinking how to think about inflation dynamics and the inflation outlook.

I think we've largely aligned with the Fed's view over the past 6 to 12 months, which is that there are temporary forces lifting inflation, tariffs being the most prominent one, a new inflation shock coming from energy prices, and also agreeing with the Fed that the labor market is not a source of disinflationary pressures.

Matthew Raskin: And their view had been that the labor market was not a source of inflation pressures. Sorry, yes.



Matthew Luzzetti: Not a source of inflationary pressures, basically imbalance and not putting upward pressure on inflation. I frame that as kind of the consensus view of the world. And once we get beyond these temporary effects, we're largely fine. I wrote a piece now about two weeks ago, and it was questioning some of the underpinnings of that view. It laid out a few reasons, five reasons, I think, in the piece. I'm not sure I'll remember all five for the podcast, but why I'm a bit more skeptical of their view. A few to highlight:

One, I think demand is a more important source of inflationary pressures than commonly believed and viewed. Two data points there: the output gap according to the Congressional Budget Office (CBO) is plus 1.1 percentage points in the US. That is consistent with elevated inflation. The San Francisco Fed does the decomposition. They find that demand is the most important source of upward inflationary pressures today.

Second, and this is a topic that dominated our conversations across the pond in London where we're meeting with clients, I think that there's a debate to be had about whether AI is disinflationary in the future. But I think the debate has largely been settled that it is inflationary today. You see it in the inflation data, software prices, as an example, are up almost 60% annualized over the past six months. You see it in computer and peripheral equipment. So we can definitely debate the future, but today AI is a source of inflationary pressures.

The third thing that I'll just highlight is I am worried about near-term inflation expectations. The Fed focuses on long-run measures. They haven't moved. They're broadly anchored. But short-run measures have, and I think that they are more important for price and wage setting. There's San Francisco Fed work on this. Other regional Feds have talked about that more recently. And you've seen the market pricing for inflation move, not just one year, but one year, one year. So one year, one year Consumer Price Index (CPI), inflation swaps are now around 2.7, 2.6, 2.7%. In the core PCE space, you are pricing inflation that is probably between 2 1/2 and above, even two years out now.

Matthew Raskin: I think that's a really important point and one that came up, as you say, a lot in the discussions last week. If you look at one year, one year CPI swaps, while we were in London, reached 2.75%. You were making the point that once you account for the shape of the oil futures curve, those CPI swaps are actually implying a higher level of core CPI inflation. And then once you adjust for the wedge between PCE and CPI inflation, they may actually be pricing a slightly higher core PCE inflation than that. And so that just emphasizes the need to interpret those levels of inflation pricing against that broader backdrop.

Matthew Luzzetti: Yeah, and I think that's a meaningful shift in kind of market pricing. It is now not just about a temporary story where inflation is going to be elevated over the next year driven by tariffs and other factors, but the market is pricing a bit more of a persistent inflationary story, one that the Fed should probably recognize, and I think they are through their own communications now, but also sets up this reasonable considerations around will the Fed hike rates and should the Fed hike rates.

[The Fed's Policy Stance and the Neutral Rate](#)

[00:08:00] Matthew Luzzetti: I think one other element going into that discussion and debate is where is the Fed's policy stance today? One of the reasons that the



market was leaning towards rate cuts has been the Fed has framed their policy stance as mildly, somewhat restrictive, but above neutral and that the direction of travel is towards lower rates. We've been writing a few things in this area. How do you think about the Fed's policy stance and how does that kind of feed through into how you think about possible rate hikes?

Matthew Raskin: As you know, there's kind of evolving language that Chair Powell and others have used to describe the policy stance: moderately restrictive, mildly restrictive, in a plausible range of neutral. I think a lot of that discussion is kind of implicitly taking some view on the neutral policy rate in real terms, adding 2% to it and treating that as the nominal rate or the neutral rate rather in nominal terms, and then sort of gauging where the Fed is relative to that. I think that's a misleading way to approach things. And the reason is that inflation currently is not at 2%. And so the nominal Fed funds rate that would be needed to achieve, for example, a 1% real rate is not simply 3% today. It is significantly higher because underlying inflation is, I would argue, close to 3%. Most measures of trend inflation are running closer to 3% than 2%. It's very misleading to sort of evaluate the Fed's policy stance purely in nominal terms, given how far above their target inflation is.

Matthew Luzzetti: Yeah, and I think that's tying in what we were just talking about. The fact that the market is now pricing in near-term inflation expectations are elevated. It's a common retort to what you're saying is, yes, spot inflation is high today, but look at forward-looking inflation is much lower, and therefore you can build in 2%, let's say. But the idea that we're actually pricing in very elevated near-term inflation expectations, even as far as two years, does suggest I think you want to be building in something more when you're thinking about the nominal rate.

Matthew Raskin: So I would agree with that. And I guess first, I just note, St. Louis Fed President Alberto Musalem a couple of weeks ago explicitly made the point that once you account for where inflation is or expected to be, the Fed's policy stance in real terms may not be restrictive at all. In fact, it may be accommodative. I think that's a really important point, consistent with this idea that you really want to be thinking about the policy stance in real and not nominal terms. But to your point about market pricing of inflation and expected inflation, I think, yes, even once you account not just for where the realized data has been, but where expectations are, it doesn't look like the Fed is especially restrictive or restrictive at all here.

[00:12:00] And there's a couple of different ways to look at that. I guess one, in a note we published earlier this week, we looked at where one year and one year and one year real SOFR rates have been over recent years and found that those forward-looking real rates, which are implicitly embedding market expectations for where inflation is likely to go, have been materially below even 1% in real terms for the last 15 or 18 months. 1% is a level that would be consistent with R-star implicit in the Summary of Economic Projections (SEP) projections for the longer run nominal Fed funds rate. So even relative to Fed estimates of the neutral real rate, which I think you and I would argue look a bit too low, but even relative to those conservative estimates of neutral, the market has been pricing a real rate that looks accommodative.

A different lens on that is to look at policy rules. So you can look, there are things like the Taylor rule, the balanced approach rule, other monetary policy rules that the Fed includes in their semi-annual monetary policy reports. And those are prescriptions for where the Fed's policy rate should be, given a view on neutral, given a view on the longer run unemployment rate, and then given where inflation



and unemployment either have been or expected to be. And if you look at those policy rules today, they're telling you, given where inflation and unemployment are and have been, and again, even relative to a conservative, i.e., low estimate of neutral, current Fed policy looks like it is mildly accommodative. It was really the 75 basis points of cuts, sort of risk management cuts that the Federal Open Market Committee (FOMC) delivered late last year alongside the big shift up in inflation and in expected inflation that has pushed their policy stance, at least by those measures, into accommodative terrain. I would just note that even if you take those policy rules in the monetary policy report, they're done based on realized economic data. But if instead you feed into them measures of expectations for the unemployment rate and inflation, either our own, the Fed's Bloomberg consensus, those still show you that the policy setting today looks like it is accommodative, like it is below a level that would be consistent with these policy rules.

Matthew Luzzetti: I think that is a really important consideration. I thought President Musalem's indication that they could be accommodative was incredibly important. It makes sense in the context of everything that you just mentioned. But once a Fed official indicates that they might be accommodative against a backdrop of inflation being too high, that kind of naturally has to open up the discussion around, do you need to hike rates? Because not only given the economic backdrop, should they be at neutral, you could argue that they should be restrictive in the current context, which I think must open that up.

Matthew Raskin: I agree. So maybe that's a great time to pivot. How are you thinking about the prospects for Fed rate hikes from here? What are the conditions that they would need to see the committee in order to hike rates? What kind of timeline or sequencing do you think would maybe make sense? How are you thinking about those issues?

Conditions for Fed Rate Hikes

[00:15:00] Matthew Luzzetti: To set the stage, our baseline is still that the Fed is on hold indefinitely close to what we think neutral is. We don't have them either cutting or raising rates. But we have written pieces outlining conditions that we thought could have led to rate hikes potentially. A lot of that is through the lens of the policy rules, types of policy rules that you just mentioned. I think that it helps to give you a gauge on how a typical central bank should be responding to differences in their economic forecast and outlook. The types of conditions that we outlined were, if the unemployment rate were to remain close to current levels, call 4.3%, the Fed had a year-end forecast of 4.4% in their March SEP. If core PCE inflation were to rise at the end of this year, above 3%, we had written about 3.2%, that would be something I think that could motivate sharper discussions around rate hikes of the Fed and perhaps even considerations around raising rates.

Now, in the March Summary of Economic Projections, the Fed had 2.7% for their core PCE year-end inflation forecast. We are closer to 3%. Consensus is closer to 3%. So it's moved much closer to a world in which I think we could see conditions under which the Fed might want to hike. But there's probably two other considerations here, at least two other.

One is that I think the Fed is currently inclined to look through near-term inflation, still believing that it is being lifted by temporary factors such as tariffs and energy prices. So it could be more important how their year-ahead inflation forecast evolves. That'll be something I will be watching very closely at the June FOMC



meeting.

The second consideration will always be about the labor market. And at the moment, it looks like it's stabilizing. But if it were to re-tighten, so the unemployment rate were to decline or the quits rate rise and wage inflation were to pick up, that would certainly be a motivating factor that would make the Fed less inclined to look through near-term inflation data.

Third, Kevin Warsh is coming in as the Fed Chair. I think he will be sworn in tomorrow. We are speaking on Thursday the 21st. We haven't heard from him in a while. So it is unclear how much he will lean against hiking pressure at this point in time. I think that there has been a prevailing view that he will lean more dovish, but the backdrop has changed considerably and the committee has changed considerably. So I think at the very least, he has to tack towards the center. He's likely to tack towards the center in his communications.

Final point would just be inflation expectations. Those are the thing that if they begin to move, particularly long run measures, do get the Fed worried and what would cause them to potentially think about accelerating or bringing forward the conversation around rate hikes. So given our outlook, I would expect that we continue to move in a direction where hikes remain live on the table, being debated at the coming meetings. But at the moment, our base case is still that the Fed keeps rate on hold for an extended period here.

Broader Trends in Bond Yields

[00:18:00] Matthew Luzzetti: Got it. Maybe as a final point of discussion here, we've been hyper-focused on hikes in the front end of the curve. But that's not the only area where we've seen action in the bond markets in recent weeks. You've seen 30-year yields in the US rising above 5%. I think 10-year yields in the US rose above 4.6%. You've seen other bond markets showing significant upward pressure at the long end as well. Japan seems to be a clear example. The UK last week while we were there. So just how were you thinking about the Fed in this context of broader upward pressure on bond yields?

Matthew Raskin: Yeah, so we've had a big global move in yields. In the US, as you note, the 10-year Treasury yield, I think last week got up a touch above 4.65%. We came into the year with an expectation that yields would rise, mostly on a repricing in the Fed path. We thought that the Fed was at neutral and the market would likely come around to that view and also saw upside from term premia, which in our view still don't look especially high by long run historical standards once you take account of uncertainties around inflation, upside risks around inflation, the outlook for fiscal and bond supply, not just in the US but globally.

The move that we've seen, I think, has really been largely driven by the dynamics that we're discussing, a real reassessment of the Fed policy path. It looks to me like most of the repricing that we've gotten up till now has been driven by a revision in expectations for the path of Fed policy. Measures of term premia have up till the last couple of days been pretty stable. The measure that we use, which is based on the slope of the yield curve, once you've adjusted for expectations for the near-term policy stance have been quite steady. We like those measures because they can be observed in real time. They're sort of model agnostic. They can be traded. But also, standard term structure model-based measures, things that come from ACM or Kim Wright, these term structure models that people look at, for the most part have



been indicating that the repricing we've gotten has been in policy expectations, though we've seen some sharper moves in these model-based measures of term premium more recently. It's also the case that the 10-year Treasury yield has followed the terminal rate pricing. So that is kind of the low point on the SOFR futures curve during the cutting cycle very, very closely, all of which is just to say, I think, as you might expect, long-term yields are moving alongside the move that we've seen in Fed pricing and front-end yield. And I think those moves have really been driven by this reassessment of the inflation outlook, the state of the labor market, and the balancing of those two.

Matthew Luzzetti: And I guess everything that we just talked about with the Fed, we think fundamentally it makes sense that we're seeing some of this repricing, rates on hold at least for longer, maybe some conversations around rate hikes. It would make some sense that maybe sustainably we see long-end rates at higher levels for a longer period of time.

Matthew Raskin: I think so. We came into the year with a forecast that the 10-year would move up to 4.5% this year. We liked positioning around that as far back as January. Over recent weeks, we touched that. Our expectation is that we were still from there further upside to yields. So we're clearly in a more balanced place than we were, but I think there are lots of reasons to expect that yields will stay at this more elevated level, and there are certainly upside risks to yields, I think, from here.

Matthew Luzzetti: That makes sense. So Matt, why don't we stop it there? Really enjoyed the conversation. If you'd like more information on anything discussed, please reach out to your Deutsche Bank sales representative. This is Matt Luzzetti and Matt Raskin, and you've been listening to Macro MATTERS.

Podzept, the podcast from Deutsche Bank Research.

Key Takeaways

- **Shift in Fed Policy Expectations:** Market pricing has significantly shifted from anticipating two to three 25 basis point rate cuts to pricing in approximately 35 basis points of hikes, largely influenced by the conflict in Iran and evolving economic data.
- **Upward Revision to Inflation Forecast:** Deutsche Bank Research has revised its core PCE inflation forecast for 2026 to 2.9% (close to 3%), an increase of 50 basis points from November, primarily due to recent excess inflation.
- **Stabilizing Labor Market:** The labor market is stable, with payroll gains picking up and slack broadly stable. Pockets of the labor market, such as construction, are tightening, with accelerating wage growth.
- **Rethinking Inflation Dynamics:** There's a re-evaluation of inflation drivers, emphasizing demand as a significant factor (CBO output gap +1.1%, San Francisco Fed analysis).
- **AI as an Inflationary Factor:** AI is currently seen as an inflationary force, with software prices up 60% annualized and increases in computer and peripheral equipment prices.
- **Elevated Near-Term Inflation Expectations:** While long-run inflation expectations remain anchored, short-run measures, crucial for price and wage setting, have risen. Market pricing for CPI swaps and core PCE inflation suggests persistent elevated inflation.



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- **Fed Policy Stance May Be Accommodative:** The Fed's policy stance, when evaluated against current inflation and expectations in real terms (rather than nominal), appears to be mildly accommodative rather than restrictive, a view supported by St. Louis Fed President Alberto Musalem and various policy rules.
 - **Conditions for Rate Hikes:** Potential conditions for Fed rate hikes include the unemployment rate remaining around 4.3%, core PCE inflation rising above 3.2%, re-tightening of the labor market (declining unemployment, rising quits rate, accelerating wage inflation), and a shift in the new Fed Chair Kevin Warsh's communication.
 - **Global Bond Yield Pressure:** Global bond yields, including 10-year and 30-year US Treasury yields, have experienced significant upward pressure, primarily driven by the reassessment of the Fed's policy path and inflation outlook rather than term premia.
 - **Sustained Higher Long-End Rates:** The fundamental economic outlook suggests that long-end rates could sustainably remain at higher levels for an extended period.

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Appendix 1

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