A CHALLENGING SITUATION

No surprises – or were there?

From one point of view, the Federal Reserve gave the world what was expected this week. The Fed lowered policy rates by 25 basis points at its September 17 policy meeting. The first rate move this year brought the federal funds rate to 4.00-4.25%, still higher than what is widely regarded as a neutral rate, ie which neither boosts nor restricts the economy. More cuts are likely to come. Chair Jerome Powell signaled after the meeting that this rate cut marked a restart of an easing cycle that had begun a year ago, but only lasted for three months.

US markets that have been on a tear during September were initially slow to react. By week's end U.S. small-caps and the Magnificent Seven had performed best, rising 2.5% and 3.7%, respectively. MSCI ACWI was up 0.7%. Fixed income markets were generally flat, and the US Yield Curve steepened.

The surprise from the meeting was not about monetary policy itself. Instead, it was about how the rate decision was reached and what policy makers indicated about their expectations going forward. All but one member of the policy committee agreed about the rate cut. The one dissenting member – newly appointed Fed Governor Stephen Miran, who has held on to a White House position while filling a temporary Fed slot – argued for a bigger cut. He was alone in the discussion in his push for 50 basis points, as well as in the final decision. Going into the meeting, that was not a sure thing. Two other Trump-appointed Governors – Christopher Waller and Michelle Bowman – voted with the majority. Both had earlier indicated that they thought rates were too restrictive.

A non-response from markets to the much anticipated meeting was probably just what Chair Powell and colleagues wanted. It suggests that – amid confusing data on where the economy is headed and a lot of political noise – the Fed managed to find a path that did not give critics on either side much traction. Some outsiders had noted that with inflation still above target and no longer decelerating, this is not the time to cut rates. Others, including President Trump, have been calling loudly for a large cut to ward off a possible slowdown in growth.

Chair Powell acknowledged that the central bank faces "a challenging situation." Recent labor market data show that there is a risk of rising unemployment. The labor market that seemed solid before the summer looks weaker now. Large downward revisions were just announced to the payroll numbers reported for the year to April. And the summer data for jobs were weaker than in the Spring.

So why keep rates at what the Fed believes is still a restrictive level? The answer is that inflation is still running above target. Moreover, a projected return to the price stability goal of 2% has been pushed further out, to 2027. The Fed's quarterly Summary of Economic Projections (SEP) issued with the rate decision showed inflation on its preferred measure at 2.6% next year, compared with a 2.4% projection in June.

For the central bank, it is no longer a case of judging which way the balance of risks tilts and then moving – or not moving – rates accordingly. The two goals set by Congress – maximum employment and price stability – are in tension. There "is no risk free path" as Chair Powell said. This argues for caution.

Markets anticipate less caution going forward. The prospect of lower rates, combined with a steadying of growth indicated by stronger data late this week on manufacturing and jobs, buoyed US equities. The outlier in the Fed's dot plot – presumed to be Stephen Miran – projected 4 more cuts this year. That won't happen. Miran is in a minority now.

But the Fed is divided – and may become more so. The range of the dot plots that Fed policymakers put down for the end of this year stretched to 150 bp at this meeting, more than twice as large as usual. President Trump will have the opportunity to appoint more Fed officials (as we discussed in our last Letter), including a new Chair in May 2026. So far his attempt to fire Governor Lisa Cook has not succeeded, so it may take time to remake the Fed. But if new appointees follow the lead of Miran, we will see a different central bank going forward. There are a number of variables at play, including an eventual Supreme Court decision on Governor Cook, and Senate Republicans' willingness to support new Fed nominations with views out of the mainstream.

Across the Atlantic, the European Central Bank (ECB) sees more clarity, at least on inflation. The ECB held rates steady when it met on September 11 and celebrated that inflation is back on target. Not all its critics agree that rates have come down enough to support the economy going forward. In Europe, unlike in the US, concerns are focused on whether there could be an undershoot in inflation. One factor holding down inflation has been the strength of the euro this year – a mirror image of the dollar's weakness. The ECB tries to stay out of politics. But, as noted below, political turmoil in France after yet another Prime Minister was forced out over proposed budget cuts is showing up in a blow out in spreads. President Emanuel Macron moved quickly to put in place a new Prime Minister. But this was not enough to soothe an angry public, with protests on the streets this week.

Japan rounded out the central bank news this week. As expected, Governor Ueda and colleagues left rates unchanged on September 19 amid political uncertainty in the world's fourth largest economy (Germany has nudged it from third place). However, there was a slight hawkish tilt as two central bankers voted to raise rates and a small move to contract the balance sheet was agreed. The long-awaited rate hike is most likely coming in early 2026. Although bad inflation numbers could bring that forward into December.

CHINA STILL MATTERS

Leaders of the two biggest economies in the world have finally spoken. The September 19 call between Presidents Xi and Trump dealt mainly with the social media platform TikTok, much loved by young people including Trump supporters.

The two countries have still not reached broader agreement on trade and tariffs. That matters for both. China has leverage with its control of real earth exports and of imports from key US firms, notably Nvidia. President Xi has less to worry about from popular dissent than many leaders. But trade limitations are hurting, and may make it difficult for China's leaders to make their growth targets. Housing continues to be a drag on the economy, with new home sales in Beijing down nearly 20% from a year ago and prices still falling. Retail sales in August grew by only 3.4%, not enough to make up for lost export sales.

Diplomats are hoping that the call will open the way for the two Presidents to meet in person this year, and make deals. Both economies would benefit.

LIES, DAMNED LIES AND STATISTICS?

The famous quote – usually attributed to Mark Twain – always has some resonance for economists. Data is essential to understand what is happening to key economic variables, from GDP to jobs and inflation, and to predict what will come next. For policy makers, especially at the central bank where use of the monetary tools is closely driven by data – in a “data dependent” world – statistics are needed to guide actions and measure their impact. But measuring a complex and diverse economy such as the US is difficult. Recently, it has become even more difficult.

Recent large revisions to jobs data changed Fed views of economic developments and likely affected its approach to rate cuts. Others are also troubled. Former Director of the Office of Management and Budget (OMB) and current CEO of Lazard investment bank, Peter Orzsag, has written in the Atlantic about the data problems plaguing official sources and the possibility of using private and public data together to improve each. Under the heading “The Economy is Turning into a Black Box” Peter Orzsag talks of how survey responses have dwindled in recent years, making it more difficult for the government to randomize its samples. The drop off has been concentrated in lower income households, leading to overestimates of what has happened to real incomes in the economy.

EQUITIES

Now that the Fed’s easing cycle has resumed, key questions are whether lower rates will sustain the bull market, and, separately, trigger capital rotation into areas that have so far been lagging, most notably small caps.

The AI investment cycle has been the clear growth driver for equities in recent months. Investors have crowded into the biggest companies in this space, both hardware makers, such as Nvidia, and AI developers.

Companies in the first category are reaping the rewards of an unprecedented capex cycle. The second category includes big tech companies Microsoft, Google, and Meta which retain their strengths of strong moats and reliable cash flow while being directly exposed to AI as they work to develop their own models.

Rate cuts could reinforce the momentum for AI-related companies, but concentration risks are rising. Nvidia already commands roughly 60% of its addressable market revenues—how much longer can such growth be sustained? Meanwhile, the major cloud players – Amazon, Microsoft, Alphabet – may face stiffer competition from challengers such as Oracle and CoreWeave. Growth deceleration, margin compression, and intensifying competition remain risks in what has become an expensive and crowded trade.

Beyond AI, much of the U.S. market tied to the real economy continues to wrestle with headwinds: uncertain trade policy, tariffs, sticky inflation, and a softening labor market. Rate cuts should ease some of these concerns. As described above, the economy’s path remains quite uncertain. If job losses are contained and retail sales remain strong – as they were in August – investors may be emboldened to re-engage with non-AI sectors.

In Europe, recent winners have been domestically focused sectors—banks, defense, and others less exposed to trade frictions. If export markets were to stabilize as trade flows adapt to the new world of tariffs, there could be possible upside for the more trade-dependent multinationals where valuations are no longer as stretched.

Asia is broadly benefiting from the AI hardware cycle, which also carries secondary wealth effects. In Japan, activist investors have responded to corporate governance reforms that are now gaining traction. Corporate share buybacks are running 8% ahead of last year and more than 50 companies faced shareholder proposals at their June annual meetings. In the first half of 2025, the 10 largest activist funds invested over $6 billion in Japan, a record high. Structural changes may prove as important to the bull case for Japan as global rate policy which will in due course see relative rises in Japanese rates versus the US (and Europe).

Key risks to markets in Europe and Asia emanate mostly from the unsettled nature of global trade with continued overhang and uncertainty from USidimposed tariffs. Ironically, the impact of trade disruption is likely to be bigger on the open economies of Asia and Europe than for the relatively closed US where imports and exports account for a smaller proportion of GDP.

FIXED INCOME AND CURRENCIES

After a notable rally in fixed income markets in August, rates along the yield curve fell further ahead of the Fed meeting this month. The curve flattened as two-years dropped 8 bp while 30 year yields were down 27 bps ahead of the meeting, and the 10-year, which is important for mortgage, consumer and auto loans, had dropped by 19 bps. Bond traders seemed unsurprised on the whole by the Fed's decision and projections. Rates moved only slightly into the close following the announcement, and by the end of the week were less than ten basis points higher.

Recent rate moves have continued to produce strong returns for bondholders. The Bloomberg US Aggregate is now up 6.5% for the year and – at mid-month – is experiencing its best September since 2003, rising 1.4%. This month's strong performance has been led by the longer maturities in the index, 10-years and beyond. This segment of the index has risen by nearly 4%. This is notable given the broader concern expressed by many investors that US fiscal pressures will push yields in the back-end of the curve higher. For the moment, those concerns seem to not be top-of-mind.

Short term interest rate markets have also rallied in recent weeks, with the turning point coming after Fed Chair Powell's August 22 speech at Jackson Hole. Markets repriced after the speech to build in three rate cuts between September and the end of the year. With this week's Fed meeting, the mid-point of the dot plot has moved to mirror market pricing. Looking to 2026, markets expect the FFR to settle between 2.75% to 3.00% by the end of the year, while the Fed expectations incorporated in the dot plots are for a range fifty basis points higher. In 2024, markets had priced in nearly seven cuts at the beginning of the year only to get the equivalent of four. If President Trump is able to move the balance of power in the Fed, the markets may get it right this time.

Elsewhere, European bond markets were generating headlines as French spreads continued to widen, amid ongoing upheaval in the French government. Investors now require a premium over Italian, Greek, Spanish, and Portuguese debt to hold French OATs. In emerging markets, local and hard currency fixed income are putting up strong returns with broad measures of both up roughly 1.5% so far in September. Indeed, many investors point to emerging market bonds as one of the few sources of substantial real yield – not to mention potential added tailwinds in a weakening dollar environment.

The dollar was hovering in mid-September around its 2025 lows, briefly setting a new low on the broadest measure following the Fed rate cut decision. This month gold has risen the most against the greenback, rallying 6.3% and setting a new all-time, inflation adjusted, high. Emerging market currencies are also faring particularly well this month with a broad basket rising 0.9% against the dollar and select currencies, including the Colombian Peso, Brazilian Real, and Hungarian Forint all up by 2.0% or more in September. Positioning data indicates hedgers and speculators continue to expect further dollar depreciation, with DXY futures hovering around their most extreme net short levels since 2011.