To the point!

Cross-Asset- and Strategy-Research

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September 11, 2026

All eyes on the Fed

Kevin Warsh struck a hawkish tone in Jackson Hole. What now?

Kevin Warsh got off to a false start after taking office in May. Investors did not take kindly to the new Fed chair's sparse public communication. Nor did they welcome his hints that he might favor a different inflation gauge as the benchmark for policy. The suspicion of manipulation was tangible in some quarters.

At the annual central-bank gathering in Jackson Hole in Wyoming Warsh struck a markedly different tone. Inflation remains too high, he told us all – though everyone already knew it. And unless inflation moves closer to the 2% target, the central bank has "work to do." Indeed, contrary to the ECB, the Fed has not met its 2% inflation target since February 2021 (fig. 1).

Kevin Warsh corrects his false start

Investors fear a weaker dollar

Some observers have attributed the recent rise in long-term interest rates to higher inflation expectations. That seems unlikely. More plausibly, confidence in the government's ability to pursue sustainable fiscal policy has eroded. As has the confidence that the Fed would lean against any inflationary trend, come hell, high water or Donald Trump. The fact that gold and bitcoin have risen despite higher rates is strong evidence that investors fear a debasement of the dollar and are seeking protection against it. Treasury Secretary Scott Bessent's attempts to lecture investors and talk up the fundamentals have proven predictably futile. The strain on public finances will continue to grow as interest payments rise and the costs of an aging population mount. In the U.S., after all, the federal government is ultimately responsible for funding retirees' pensions and health care through Medicare.

The only remedy now would be a credible plan to reduce the deficit. Bessent has hinted at one. Needless to add, nothing has happened since. So close to the midterm elections, that is hardly

Fig. 1: Inflation rate U.S. (%)

Source: Federal Reserve Bank St. Louis, LBBW Research

No figure for October 2025 because of the government shutdown.

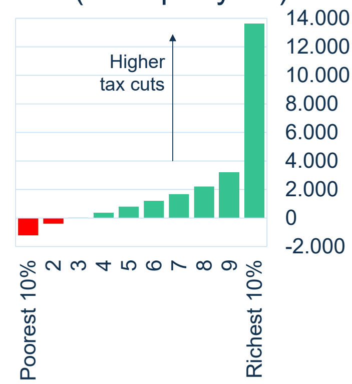
surprising. Nor is anything likely to happen afterward. Donald Trump sees government as a nuisance and has made his mark chiefly through tax cuts – worth roughly USD 3,000 per taxpayer annually, on average, over the next ten years. He cannot reverse course overnight, still less when doing so would alienate his wealthy supporters – and donors (fig. 2).

No fiscal consolidation is in sight

What does this mean for the Fed?

Next Tuesday and Wednesday, the Federal Open Market Committee (FOMC) will meet to decide on interest rates. The minutes of its last meeting show three votes in favor of a rate increase. Other committee members are open to raising rates should inflation fail to recede. Warsh increasingly seems to be coming round to that view, too. The first rate hike since the summer of 2023 looks increasingly plausible. Warsh even dared a wordplay in Jackson Hole by stating that he had gone on a hike along the wandering trails at the Rockefeller Preserve.

Fig. 2: The OBBBA distributional effects favor higher income households (USD per year)



Source: Peterson Institute, LBBW Research

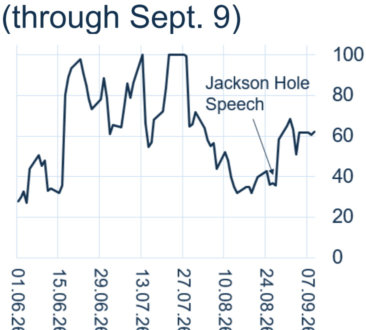
One might argue that rising long-term rates have already done the Fed's work. After all, higher borrowing costs curb consumption and investment, thereby restraining inflation. But that is partly wishful thinking. Long-term rates have also risen because market participants increasingly doubt the Fed's willingness to withstand political pressure from Trump and to bring inflation down. The U.S. central bank must therefore restore its credibility through words – and perhaps deeds. It must show that it will not subordinate monetary policy to the interests of a heavily indebted government.

Bessent is treating the symptoms, not the disease

Bessent's foray into central-bank territory, through purchases of long-dated Treasuries, should not sway the Fed. What the Treasury Secretary is attempting resembles paying off a mortgage with a credit card. The effort is doomed unless the underlying cause is addressed: massive and steadily rising public debt. The central bank must show the government that it will not ease up in its fight against inflation. Whether the Fed would ultimately have to buy Treasuries on a large scale again, should investors shun them and a financial crisis loom, is another matter. But it should make that outcome as unlikely as possible.

August inflation may prove decisive

Fig. 3: Probability of a rate increase next week (through Sept. 9)



Source: Bloomberg, LBBW Research

Today, at 2:30pm Central European time, the Labor Department will publish U.S. inflation data for August. If inflation stabilizes – or even falls – most FOMC members are likely to favor keeping rates unchanged. If, however, inflation rises markedly, the Fed may have to raise rates as early as next week, even at the risk of provoking a Trump tantrum. Interest-rate futures put the odds of a rate increase at around 60 % (see fig. 3). LBBW Research is among those who expect the Fed to hold rates steady and do not (yet) anticipate a sharp rise in inflation. Either way, it is getting more interesting for Fed-watchers everywhere. Also here in Stuttgart.

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This document is a translation of Kraemers Klartext, “Alle Scheinwerfer sind auf die Fed gerichtet“, original publication date: 11.09.2026. The translation has been made for convenience only with the German original always prevailing in all aspects, especially in case of potential discrepancies resulting from the translation.

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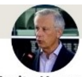

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