

Recalibrating Rates, Not Tightening Policy

Markets love simple narratives. A rate cut is dovish. A rate hike is hawkish. A pause falls somewhere in between. The Federal Reserve's latest 25 basis point increase has therefore been interpreted through a familiar lens: tighter policy, more pressure on growth, and another obstacle for risk assets.

That interpretation may be too simplistic.

Not every move in the federal funds rate signals a change in policy direction. Sometimes a central bank adjusts nominal rates simply to maintain the same degree of restraint. The key distinction is between nominal and real rates. Monetary policy is ultimately transmitted through the latter. If inflation expectations rise while policy rates stand still, the real stance becomes easier. A modest increase in nominal rates may therefore represent recalibration rather than tightening.

Recent market pricing provides important context. Long-term inflation expectations, as captured by 5-year, 5-year forward inflation rates, have remained broadly stable for months, suggesting that current inflation pressures have not become embedded in longer-term expectations. A limited and well-signaled increase may therefore prove to be a recalibration rather than the start of a sustained tightening cycle.

The complication is that policy rates no longer tell the whole story.

Broader financial conditions matter more than policy rates in isolation. Credit spreads, equity valuations, the dollar

and long-term bond yields are what determine financing conditions for households and businesses. A widely anticipated 25 basis point increase that has already been discounted by investors may have little incremental effect. By contrast, the rise in longer-dated Treasury yields over the past year has exerted meaningful tightening pressure without any additional action from the Fed.

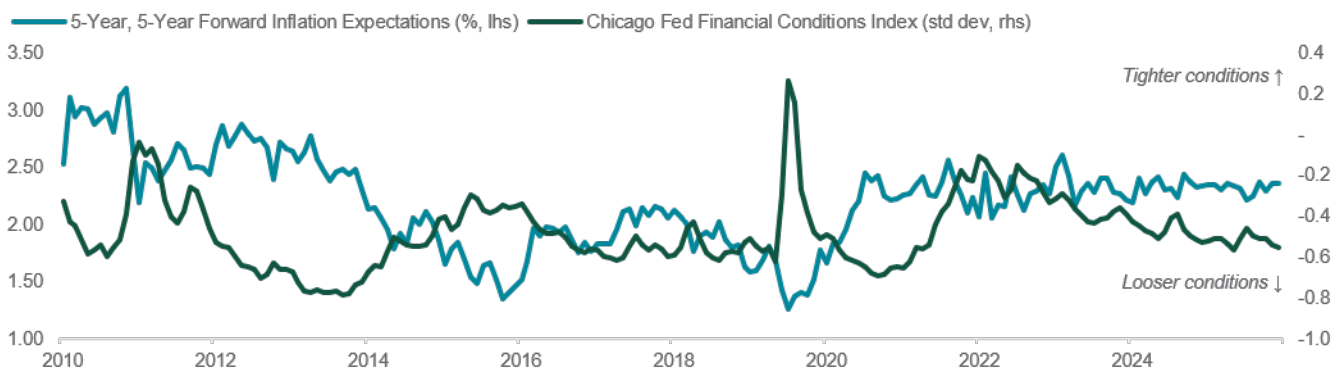
There is also the uncomfortable reality that inflation is not solely a demand story. Sticky services inflation continues to reflect structural supply constraints, while energy-price shocks remain capable of lifting headline inflation regardless of policy settings. History suggests monetary policy has only limited influence over either.

This is why investors should focus less on the next 25 basis points and more on the trajectory beyond it. As the old market adage goes, historically it has often been the last rate hike, rather than the first, that causes trouble. A cumulative 75 basis point recalibration spread over six months is manageable and largely priced in. The genuine risk would be something more aggressive: a sustained tightening cycle exceeding 125 basis points over the course of a year. That would signal a meaningful shift in policy intent rather than a technical adjustment.

For now, the Fed may simply be recalibrating the dial, not turning the screws. The distinction is subtle. For markets, it is everything.

ROOM TO RECALIBRATE – LOOSE FINANCIAL CONDITIONS, ANCHORED INFLATION EXPECTATIONS

Long-term Inflation Expectations vs. Financial Conditions



Source: Northern Trust Asset Management, Chicago Fed, Federal Reserve Board, Bloomberg. Data from 9/1/2010 through 9/22/2026. Historical trends are not predictive of future results.

POSITIONING SCENARIOS

Productivity Upside (25% probability)

AI-related investment drives broad-based productivity gains that support above-trend economic growth without generating meaningful inflationary pressure.

Two-Speed Expansion (50% probability)

Monetary policy and a bifurcated economy govern what would otherwise be a stronger growth environment, resulting in a trend-like expansion and eventual disinflation next year.

Economic Fault Lines Broaden (25% probability)

The economic expansion is cut short by persistent supply-side restraints, energy headwinds, or AI-related disruption that weakens activity and/or tightens financial conditions.

Note: Probabilities are assumed from proprietary research and are subject to change.

Additional Index Definitions:

Bloomberg Treasury Bills 1-3 Months: The Bloomberg U.S. Treasury Bills: 1-3 Months Index tracks the market for treasury bills issued by the U.S. government with time to maturity between 1 and 3 months. US Treasury bills are issued in fixed maturity terms of 4, 8, 13, 17, 26 and 52 weeks.

Bloomberg U.S. Treasury: The Bloomberg US Treasury Index measures US dollar-denominated, fixed-rate, nominal debt issued by the US Treasury. Treasury bills are excluded by the maturity constraint but are part of a separate Short Treasury Index. STRIPS are excluded from the index because their inclusion would result in double-counting. The US Treasury Index is a component of the US Aggregate, US Universal, Global Aggregate and Global Treasury Indices. The index includes securities with remaining maturity of at least one year.

Bloomberg Global Treasury: The Bloomberg Global Treasury Index tracks fixed-rate, local currency government debt of investment grade countries, including both developed and emerging markets. The index represents the treasury sector of the Global Aggregate Index.

Bloomberg Municipal Bond Index: The Bloomberg Municipal Bond Index is a flagship measure of the US municipal tax-exempt investment grade bond market. Included in the index are securities from all 50 US States and four other qualifying regions (Washington DC, Puerto Rico, Guam, and the Virgin Islands). The index includes state and local general obligation bonds and revenue bonds. All bonds in the Municipal Bond Index are tax exempt and hence are not eligible for other indices that include taxable bonds, such as the Bloomberg U.S. Aggregate.

Bloomberg U.S. TIPS: The Bloomberg US Treasury Inflation-Linked Bond Index (Series-L) measures the performance of the US Treasury Inflation Protected Securities (TIPS) market. Federal Reserve holdings of US TIPS are not index eligible and are excluded from the face amount outstanding of each bond in the index.

Bloomberg Global Inflation-linked: The Bloomberg Global Inflation Linked Index (Series-L) measures the investment-grade, government inflation-linked debt from 12 different developed market countries. Investability is a key criterion for inclusion of markets in this index, and it is designed to include only those markets in which a global government linker fund is likely and able to invest.

Bloomberg U.S. Aggregate: The Bloomberg US Aggregate Bond Index is a broad-based flagship benchmark that measures the investment grade, US dollar-denominated, fixed-rate taxable bond market. The index includes Treasuries, government-related and corporate securities, fixed-rate agency MBS, ABS and CMBS (agency and non-agency). Provided the necessary inclusion rules are met, US Aggregate-eligible securities also contribute to the multi-currency Global Aggregate Index and the US Universal Index.

Bloomberg Global Aggregate: The Bloomberg Global Aggregate Index is a flagship measure of global investment grade debt from twenty-seven local currency markets. This multi-currency benchmark includes treasury, government-related, corporate and securitized fixed-rate bonds from both developed and emerging markets issuers.

JP Morgan GBI – EM Global Diversified Composite Index: The J.P. Morgan Government Bond Index-Emerging Markets Global Diversified Index tracks the performance of local-currency-denominated government bonds issued by emerging-market countries that are accessible to international investors. The diversified methodology limits the weights of larger countries to reduce concentration.

Bloomberg U.S. High Yield: The Bloomberg US Corporate High Yield Bond Index measures the USD-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on the indices' EM country definition, are excluded. The US Corporate High Yield Index is a component of the US Universal and Global High Yield Indices.

Bloomberg Global High Yield: The Bloomberg Global High Yield Index is a multi-currency flagship measure of the global high yield debt market. The index represents the union of the US High Yield, the Pan-European High Yield, and Emerging Markets (EM) Hard Currency High Yield Indices. The high yield and emerging markets sub-components are mutually exclusive.

MSCI AC World: The MSCI ACWI captures large and mid cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries.

MSCI USA: The MSCI USA Index is designed to measure the performance of the large and mid cap segments of the US market.

S&P 500: The index, a gauge of the large-cap U.S. equity market, includes 500 companies that represent approximately 80% of the market capitalization of publicly traded U.S. equities.

Russell 2000: The Russell 2000® Index measures the performance of the small-cap segment of the US equity universe.

Russell 1000 Growth: The Russell 1000® Growth Index measures the performance of the large-cap growth segment of the US equity universe. It includes those Russell 1000 companies with relatively higher price-to-book ratios, higher I/B/E/S forecast medium term (2 year) growth and higher sales per share historical growth (5 years). The Russell 1000® Growth Index is constructed to provide a comprehensive and unbiased barometer for the large-cap growth segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect growth characteristics.

Russell 1000 Value: The Russell 1000® Value Index measures the performance of the large-cap value segment of the US equity universe. It includes those Russell 1000 companies with relatively lower price-to-book ratios, lower I/B/E/S forecast medium term (2 year) growth and lower sales per share historical growth (5 years). The Russell 1000® Value Index is constructed to provide a comprehensive and unbiased barometer for the large-cap value segment. The index is completely reconstituted annually to ensure new and growing equities are included and that the represented companies continue to reflect value characteristics.

MSCI World: The MSCI World Index captures large and mid cap representation across Developed Markets countries.

MSCI World ex US: The MSCI World ex USA Index captures large and mid cap representation across 22 of 23 Developed Markets (DM) countries*--excluding the United States. With 778 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI Europe: The MSCI Europe Index captures large and mid cap representation across Developed Markets (DM) countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European Developed Markets equity universe.

MSCI Japan: The MSCI Japan Index is designed to measure the performance of the large and mid cap segments of the Japanese market. The index covers approximately 85% of the free float-adjusted market capitalization in Japan.

MSCI Emerging Markets: The MSCI EM (Emerging Markets) Index is a free-float weighted equity index that captures large and mid cap representation across Emerging Markets (EM) countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country.

MSCI China: The MSCI China Index captures large and mid cap representation across China A shares, H shares, B shares, Red chips, P chips and foreign listings (e.g. ADRs). The index covers about 85% of this China equity universe. Currently, the index includes Large Cap A and Mid Cap A shares represented at 20% of their free float adjusted market capitalization.

S&P Global Natural Resources: The index includes 90 of the largest publicly-traded companies in natural resources and commodities businesses that meet specific investability requirements, offering investors diversified and investable equity exposure across 3 primary commodity-related sectors: agribusiness, energy, and metals & mining.

S&P 500 Equal Weight Index: The index comprises the same constituents as the S&P 500 Index, with each constituent assigned an equal weight at each quarterly rebalance

S&P Global Infrastructure: The S&P Global Infrastructure Index is designed to track 75 companies from around the world chosen to represent the listed infrastructure industry while maintaining liquidity and tradability. To create diversified exposure, the index includes three distinct infrastructure clusters: energy, transportation, and utilities.

MSCI ACWI IMI Core Real Estate: The MSCI ACWI IMI Core Real Estate Index is a free float-adjusted market capitalization index that consists of large, mid and small-cap stocks across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries* engaged in the ownership, development and management of specific core property type real estate. The index excludes companies, such as real estate services and real estate financing companies, that do not own properties.

Chicago Fed National Financial Conditions Index: The index measures financial conditions across US money markets, debt and equity markets, and the banking system. Positive readings indicate tighter-than-average financial conditions, while negative readings indicate looser-than-average conditions.

5-Year, 5-Year Forward Inflation Expectation Rate: The rate measures market-implied inflation expectations over the five-year period beginning five years forward, based on nominal and inflation-adjusted US Treasury securities.

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