Split at the Fed as it keeps interest rate on hold

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29 July 2026

The US Federal Reserve kept its interest rate on hold at its meeting yesterday in a decision which saw a split on the central bank's interest-rate setting body, with a nine to three vote. The three dissenters wanted an increase in line with movements in the bond market which indicate financial markets expect that inflation will increase over coming months.

The yield on the 30-year Treasury bond rose by 0.11 percentage points to 5.22 percent, the biggest increase in more than a year, to reach its highest level since 2007. And the yield on the 10-year Treasury bonds, which forms the base determinant for mortgage rates and corporate borrowing, rose by 0.07 percentage points to close at 4.67 percent, its highest level so far this year.

The sentiment in the bond market was summed up in a comment by Subadra Rajappa, a leading US interest rate strategist at the financial firm Société Générale.

"The market is concerned that the Fed not hiking is going to result in persistently higher inflation," she said.

An article in the *New York Times* said that investors had become concerned about higher inflation as the continuing war on Iran drives up oil prices while the spending on AI infrastructure lifts prices in the broader economy.

"For months, those inflation worries had remained fairly short-term, pushing up yields on short-dated Treasuries. The moves in the 30-year yield on Wednesday suggested investors are now becoming concerned about inflation remaining higher for longer, even decades, to come."

Here the concern in the financial markets, is that if inflation expectations become "de- anchored" and workers expect price hikes will continually indefinitely, this will fuel wage demands and they will break out of the constraints imposed on them by the trade union bureaucracy which has continually imposed real wage cutting contracts.

They know from the experience of the upsurge in the 1970s that there is nothing more disruptive and dangerous for the operations of finance capital and its speculative profit-making than a major eruption of the class struggle.

Commenting on the sharp upward movement on bond yields, driven by rising inflation expectations, Jonathan Hill, an inflation analyst, told the *Times* that it "speaks to the sensitivity of the long-end yield to Fed credibility."

The three dissenters—Beth Hammack of Cleveland, Neel Kashkari of Minneapolis and Lorie Logan of Dallas—indicated they wanted an increase in the Fed rate of 0.25 percentage points. It was the first time since 2016 that three Fed official had dissented in the same way.

Asked at his press conference about the views of the dissenters, Fed chair Kevin Warsh said they could speak for themselves after what he has called a "good family fight" in the Fed's governing body.

In his prepared remarks, Warsh said the Federal Open Market Committee, which determines the rate, remained resolute in its determination to reach the central bank's goal of 2 percent inflation.

"There is no soft inflation target, there is no soft implicit target—not on this Committee's watch. There is only a target, and it is 2 percent."

But the bond markets are concerned that these words are not being matched by actions. Put on the back foot Warsh tried to counter claims that the Fed was simply sitting on the sidelines.

"There was nothing inertial about our discussions, our policy or our strategy," he said.

But the bond markets clearly think there was and got little joy from remarks he made at his press conference in response to a question.

"I hear from you what I hear more broadly from households and businesses: Impatience. 'Deliver it already.' The suggestion that we're going to be able to do it with our magic wands is one I want to disabuse you of and everyone else of."

Warsh is not only under pressure from the bond markets but from the other side in the form of US president Trump who, after repeatedly denouncing his predecessor Jerome Powell for not lowering rates, appointed Warsh in the hope his demands would be met.

In comments on the eve of the meeting Trump continued to insist that the US should have the lowest interest rates in the world as he backed his appointee while switching his ire to the Fed's governing body.

"Kevin's fantastic, but he's got a board, and the board members are very political, I would say. He wants to do the right thing. I know what he wants to do."

But the Fed is operating in an environment where inflationary pressures are being driven by forces over which it has no control. The rising price of oil and related commodities is being driven by the war on Iran and could undergo a major increase in coming weeks as US oil reserves, the use of which has constrained the price hikes to some extent, continue to be run down.

An oil industry analyst told the *Financial Times* (FT) that reserve oil stocks in the US were at "precariously low" levels.

Another analyst told the FT that the US Strategic Petroleum Reserve had been carrying the burden of trying to keep prices down "but stockpiles are rapidly depleting and this pace of draws cannot persist ad infinitum."

On top of oil, there is the inflationary impact of the massive AI build out. Warsh has maintained that the productivity increases flowing from AI will bring down inflation and enable the Fed to reduce interest rates.

But a warning about the viability of this "happy scenario" has been issued by an analysis from the Bank for International Settlements issued this week. It said the AI boom was blurring the economic signals used by central banks to make their decisions.

These effects were "large and observable" and could increase pressure on prices, while stating that over the long-term AI may prove to be disinflationary.

The time framework in which these forces operated was "uncertain" but that "near-term inflationary effects may already be emerging" while the disinflationary effects were likely to develop more slowly.

There was a risk that if central banks underestimated the inflationary effects of the AI build out, they risked leaving interest rates too low. That also appears to be the verdict of the bond markets on the Fed's latest interest rate decision.