A Firm, Fixed Target
Why We Are Reading the Fed Differently This Month

by John E. Chapman

In the August Private Client Letter, my central point was that July's technology selloff was a positioning event rather than a thesis-ending event. August confirmed that read. The market recovered, technology led again, and the companies at the center of the artificial intelligence buildout delivered results stronger than most expected.

While our observation proved correct, August handed us something more important. In our judgment, the central question facing investors has changed. It is no longer when the Federal Reserve will begin cutting rates. It is whether the next move is a hike.

Why We Think Jackson Hole Mattered

On August 28, Chair Kevin Warsh delivered his first Jackson Hole address. We read it closely, and we consider it was the month's most consequential event. Warsh called 2% inflation "a firm, fixed target." He noted that twelve-month PCE inflation stands at 3.7% while the six-month annualized rate is 4.1%, meaning inflation has been accelerating rather than converging, and that 54% of PCE components are running above 3%.

He then said what central bankers rarely say aloud: "Responsibility for 65 months of sustained, elevated inflation sits squarely with the central bank." Finally, he retired forward guidance and described the Committee as "committed to a discipline, not to a decision."

Here is my interpretation. For two years, markets have read the Fed as an institution that would eventually accommodate. Warsh is deliberately breaking that habit. Whether the Committee hikes on September 16 is, to us, the less important question: the reaction function has changed, and a Fed that will not tell investors what it intends to do obligates them to hold a wider range of outcomes.

Hike odds moved from roughly 38% mid-month to 55% or 60% after that speech, even as 90% of surveyed economists still expected a hold. We are watching that gap closely, because it is where the next surprise likely comes from.

Our Reading of a Weakening Labor Market and Uncooperative Inflation

What makes this difficult is that the Fed is contemplating tighter policy into an economy softening on the other side of its mandate. July payrolls fell 23,000 against an expected 83,000 gain, with prior months revised down by another 103,000. I do not read that as a recession signal, and here is why: with immigration sharply curtailed, the breakeven pace of hiring needed to hold unemployment steady is now roughly 15,000 to 87,000 per month, far below the six-figure number many investors still carry in their heads. Unemployment held at 4.1% and we would call that a slowdown, not a collapse. Still, retail sales were down 0.6%, housing starts down 12.4%, and confidence is sitting at a seven-month low - all pointing in a challenging direction.

Inflation improved only at the margin. Headline CPI eased to 3.4%, but core PCE, the measure the Fed actually targets, held at 3.3%, one-year inflation expectations returned to 4.0%, and six months into the Iran conflict, oil near $89 and record August gasoline at $4.06 remain a live input rather than a fading one.

Second quarter GDP was confirmed at 1.5%, yet beneath that headline consumer spending grew 3.4% and corporate profits rose $400.9 billion, the second largest quarterly increase on record. Clearly, this is not a weak economy. It is one with a cooling labor market, a stubborn level of ongoing inflation, and a corporate sector that keeps performing.

The Markets We Found Most Informative

Equities rose in again in August. The S&P 500 gained roughly 3.0% and set a record close on August 13, the Nasdaq gained 4.1%, and emerging markets led at 4.8%. This said, we found the other moves more instructive. Gold rose about 10% to roughly $4,530 and bitcoin cleared $80,000. The 30-year Treasury yield touched 5.3%, its highest since 2007, on the same day gross federal debt passed $40 trillion for the first time.

Then on August 19, Treasury announced off-cycle that it would at least double its long-dated buyback operations. The stated purpose was liquidity and long bonds rallied briefly only to give it all back.

My summary of the month is this: the Treasury tried to reassure the long end of the curve, and the long end declined to be reassured. In fairness, neither gold nor bitcoin made a new high in August, so both are rebounds within drawdowns rather than breakouts. However, when a central bank retires guidance, debt crosses $40 trillion, and the fiscal authority intervenes at the long end, investors reprice the currency in which everything else is priced.

The Development We Are Most Focused On

Second quarter earnings were strong. Underlying S&P 500 growth was roughly 31%, with the median company up about 14%. As impressive as these numbers appear, we are skeptical over the widely circulated 50% blended figure, which is inflated by a single company's non-operating gains. Even so, hyperscaler capital expenditure guidance for 2026 now approaches $700 to $730 billion against roughly $410 billion in 2025, and Nvidia's revenue grew 106%. The AI buildout is not slowing.

What is changing is how it is financed, and this is the observation we consider most underappreciated. Roughly $500 billion of AI-related debt has been issued globally in 2026, about 18% of U.S. investment grade supply, with roughly one third of hyperscaler capital spending now debt-funded. Yet only about 2% of S&P 500 companies have quantified an actual earnings benefit from artificial intelligence.

When a capital cycle is funded from cash flow, disappointment produces a lower stock price. When it is funded in the credit markets, disappointment reprices debt, and credit transmits stress far more broadly than equity does. High yield spreads at 2.63% pay you very little to accept that possibility, and in private credit the strain is already visible, with default rates at a record 6%. That extends the caution Bob Doll raised earlier this summer, and I believe he was simply early - rather than wrong.

What We Are Doing About It

Our positioning is unchanged in spirit and sharper in emphasis. We favor quality over beta, because companies that fund their own growth do not need capital markets to stay hospitable. We prefer short and intermediate maturities over reaching for yield at the long end. We remain committed to foreign equity exposure, and we hold a modest gold allocation in most strategies as insurance with a purpose, a case August strengthened. Lastly, we are keeping liquidity available. The September FOMC meeting, Canadian tariff retaliation on September 8, and November 3 midterms form a dense sequence of challenges. Liquidity potentially turns such a sequence into an opportunity rather than a problem.

Conclusion

The tailwinds remain real: strong earnings, near-record profitability, a reasonably healthy consumer, and an innovation cycle that still justifies the capital directed at it. The turbulence remains equally real: unresolved inflation, a cooling labor market, a Fed that has withdrawn the guidance investors relied on, and a bond market asking harder questions about $40 trillion of debt. Both remain true at once, which has been our framework all year. What August added is that the margin for error narrows further when policy becomes less predictable.

Warsh's phrase, "committed to a discipline, not to a decision," happens to describe how we manage capital as well. We do not know what the Committee will do on September 16, and our plans do not require us to. Long-term wealth building still depends on the same discipline it always has: staying grounded in fundamentals, remaining diversified, and distinguishing between a durable thesis and an overextended trade.

Thank you for the trust you place in Clearwater Capital Partners. Please reach out to us should you have any follow-up questions or concerns. As always, it is our privilege to serve you and your family.

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