At its August 9 meeting, the Federal Open Market Committee (FOMC) raised its federal funds rate target from 3.25% to 3.50%. This widely anticipated increase of 25 basis points (bp) was the tenth in a row since June 2004. The most recent press release stated again that “policy accommodation can be removed at a pace that is likely to be measured.” Given this language, market participants expect that the FOMC will continue to raise rates by 25 basis points at each of its next two meetings. Data from the options on federal funds futures indicate that nearly 80% of participants expect the federal funds rate to rise to 4.00% at the November 1 meeting.

The yield curve continued to flatten in August. Since the August 9 FOMC meeting, long-term rates have fallen slightly. Ten-year Treasury bonds are currently trading at 4.20%, down from 4.36% on August 12 and only 0.32 percentage point above the one-year Treasury note (3.88%), possibly because of declining long-term inflation expectations.

Long-term inflation expectations can be estimated by subtracting yields on real Treasury inflation-protected securities (TIPS) from yields on nominal Treasuries. By this measure, 10-year inflation expectations rose slightly in August to 2.36%. However, corrected TIPS-derived inflation expectations have fallen, and now predict that the CPI will average 2.14% over the next 10 years. The Personal Consumption Index, which many believe the FOMC watches more closely, is usually about 50 bp lower.