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Fund Connect Quarterly: A Hawkish Lead Into the Second Half

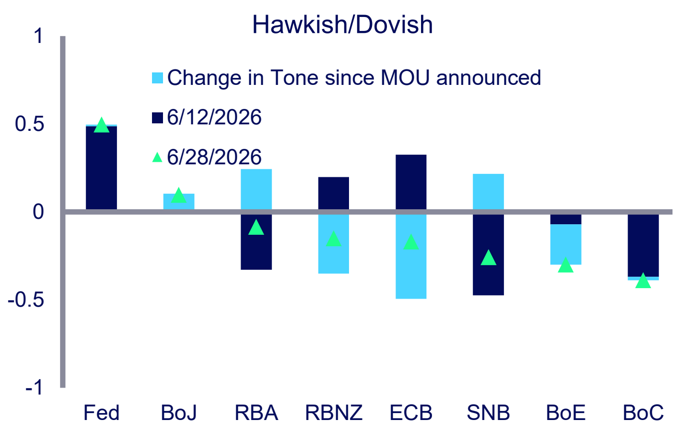
The second half of 2026 is shaping up to be a pivotal period for cash investors. Markets are navigating a unique combination of cooling inflation pressures, resilient economic growth, a structurally hawkish Federal Reserve, and abundant system liquidity. While the Trump Administration's agreement with Iran has reduced some geopolitical risks and eased immediate inflation concerns, Chairman Warsh's Fed has maintained a firm policy stance, challenging expectations for an imminent shift toward easing. Against this backdrop, investors are reassessing the outlook for rates, liquidity, cash allocation, and the USD. In this update, we examine whether the Fed is approaching peak hawkishness, what markets are pricing for the path of policy, and how real-money investors are positioning for the months ahead.

The final third of Q2 brought significant catalysts for change. First, the Trump Administration signed an MOU with Iran, marking a meaningful step toward reducing geopolitical uncertainty and inflation risks. Second, Chairman Warsh took over the helm of the Fed, ushering in a broad agenda for policy and institutional reform. As we look toward the second half of the year, a key question for investors is whether the Fed's newfound hawkishness can persist—and what that means for cash markets, liquidity conditions, and the broader macro outlook.

Have we reached peak?

As commodity deflation begins to filter through the economy, with oil prices falling back towards pre-invasion levels, investors are increasingly asking what it means for the Federal Reserve. Figure 1 suggests that the Fed remains just as hawkish today as it was prior to the MOU, implying that the current net hawkish stance may prove more durable than many expect. In fact, the Fed now stands out as one of the most hawkish major central banks, while many of its peers have shifted in a more dovish direction. Recent communications from the RBNZ, ECB, and BOE point to either diminishing inflation concerns, rising growth risks, or both. As a result, the policy divergence between the Fed and the rest of the world is likely to widen. More importantly, the Fed's continued hawkishness despite a moderation in inflation risks suggests that commodity disinflation alone is not enough to turn hawks into doves.

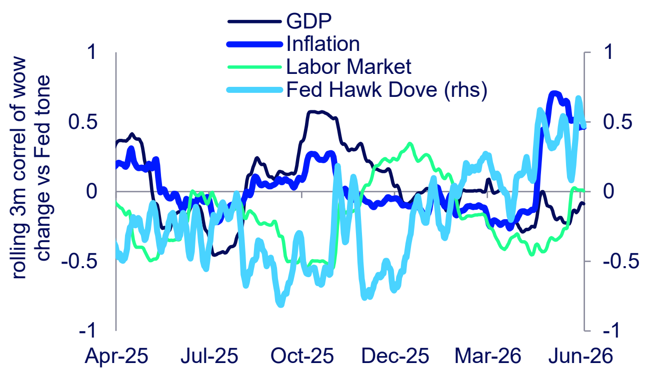
Figure 1 The Fed is the most hawkish of all



Source: State Street Markets, MKT MediaStats

With the Fed not far from its peak hawkishness since 2023, the next question is whether we have reached a peak. Breaking down the relationship between Fed tone and intensity of media coverage of inflation, labor markets, and growth, it is clear that inflation has been the primary driver of the recent shift toward a more hawkish stance. Now that the MOU has been signed, is it time for the Fed to change its tone? Perhaps on the margin, yes. Inflation is expected to receive meaningful near-term relief on a month-over-month basis due to favorable base effects and commodity deflation—a trend also confirmed by PriceStats.

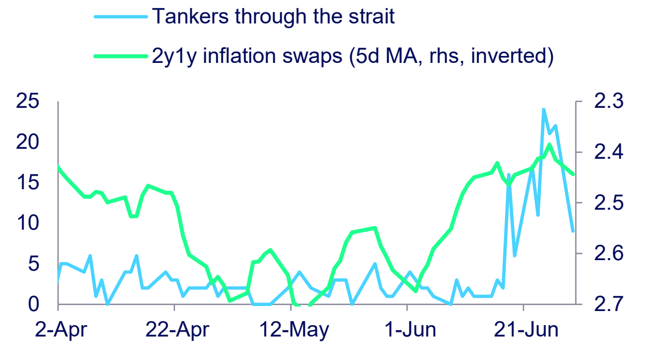
Figure 2 Inflation in the driver seat



Source: State Street Markets, MKT MediaStats, Bloomberg

However, the commodity story remains far from resolved which makes it challenging for the Fed to turn net dovish. Oil flows through the Strait remain severely constrained; as of June 30, only 13 tankers had transited the waterway, well below the 60-plus daily norm seen before the conflict. This has not been missed by inflation watchers; inflation swaps have pivoted higher in response (Figure 3). As such, the world is not yet out of the woods when it comes to commodity price pressures.

Figure 3 We're not out of the woods

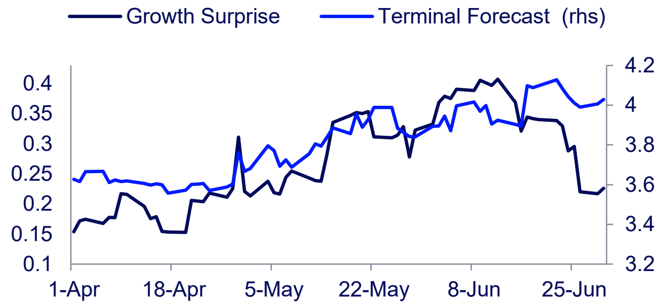


Source: State Street Markets, Bloomberg

Simultaneously, the growth outlook continues to look firm. With unemployment at 4.2%, NFP growth trending above 100k and wage growth trending at 3.5% yoy the likelihood that less money being spent at the gas station will bolster demand elsewhere is rising. Even prior to the MOU, May retail sales grew at an annualized rate of nearly 7%, roughly 3ppts greater than pre-Covid norms- a clear nod to a consumer that is willing and able to spend, at least at the aggregate. Moreover, market expectations of US growth for 2026 have stabilized around 2.10% while 2027 forecasts are being revised higher, increasing 10bps in June to 2.10%.

However, the magnitude of positive economic surprises is beginning to moderate. As growth data consistently exceeded expectations throughout Q2, markets responded by pricing in progressively more Fed tightening (Figure 4). A slowdown in upside surprises does not necessarily signal economic weakness; rather, it suggests that economic forecasts have adjusted to the prevailing environment. As a result, fewer positive surprises may generate a more muted market response and reinforce expectations for only two additional rate hikes. Against this backdrop, even if there are signs the Fed is nearing peak hawkishness, we would be hesitant to fade higher front-end rates. Continued labor market and economic resilience supports the view that the monetary easing delivered in '24 and '25 could ultimately be reversed.

Figure 4 Four or more is baked in



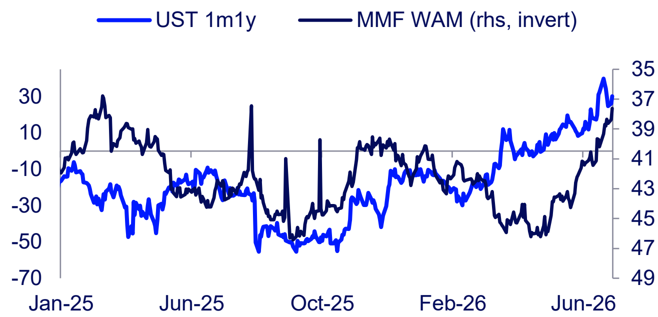
Source: State Street Markets, Bloomberg

When are the hikes coming?

Multiple market-based measures point to at least one Fed hike in the second half of 2026, followed by another in early 2027. Since June 21, September Fed funds futures have fluctuated between 17 and 25bps of tightening priced, while December contracts imply roughly 37bps, suggesting that one hike this year is fully priced and a second remains a meaningful possibility. Options markets tell a similar story: SOFR options imply nearly a 70% probability of at least one hike by year-end, while the likelihood of no change has fallen below 20%. Looking further ahead, SOFR options assign greater than a 50% probability to two cumulative hikes by March 2027.

Cash managers at the largest money market funds have taken notice. Weighted average maturities (WAMs) have declined from a Q1 peak of 46 days in April to 37 days currently, reflecting a preference to retain flexibility and reinvest at potentially higher yields (Figure 5). That said, a 37-day WAM does not signal expectations for an aggressive tightening cycle. During Fed's 2022–23 hiking campaign, WAMs fell below 10 days. Rather, current positioning suggests money market managers anticipate a gradual rise in short-term rates and want the ability to redeploy assets at more attractive yields over the coming quarters.

Figure 5 Hawkish MMF pivot

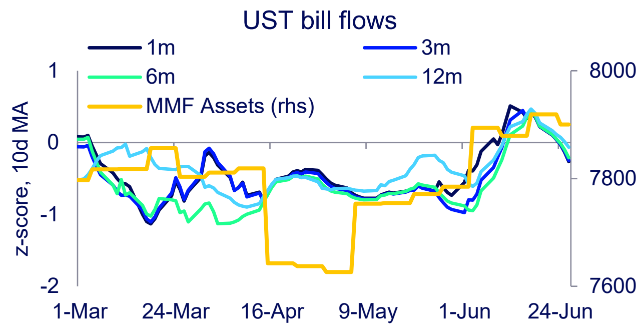


Source: State Street Markets, Bloomberg

Fluctuating cash management

In the second half of Q2, real-money demand for bills increased alongside a rise in money market fund assets (Figure 7). While several factors contributed to the increase in cash across the system, including elevated Treasury bill and corporate debt issuance, the resulting excess liquidity helped drive funding rates meaningfully lower through the quarter. Although funding rates have since normalized, they do not currently signal liquidity pressures, as overall market liquidity remains ample. More recently, inflows into bills have slowed, and cash allocations remain relatively limited as multi-asset investors continue to take a glass-half-full approach to asset allocation.

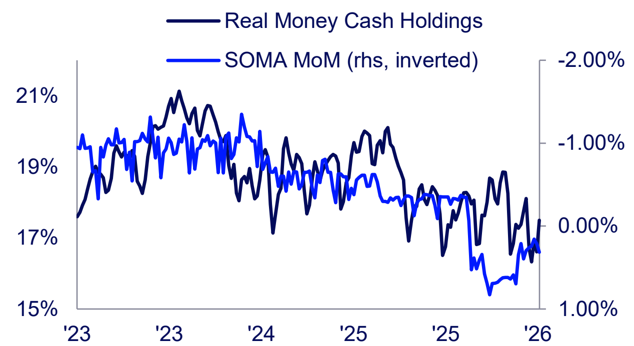
Figure 8 A brief pop in bill demand



Source: State Street Markets, Bloomberg

Our Behavioural Risk Scorecard has not signalled a risk-off stance since April 2, reinforcing the broader appetite for risk. This remains evident in portfolio positioning, with equity allocations still nearly 6 percentage points above historical averages, albeit modestly below the roughly 7 percentage point overweight reached in May. While cash allocations have risen from the multi-year lows seen ahead of the Fed's 2022 QT cycle, the increase has been modest—from 16.3% to 17.8% in June—suggesting that real-money investors are not meaningfully building cash buffers. In part, this reflects an environment of abundant liquidity, as the Federal Reserve continues to expand its securities holdings (Figure 6). Ultimately, ample liquidity remains a key support for both risk appetite and asset valuations.

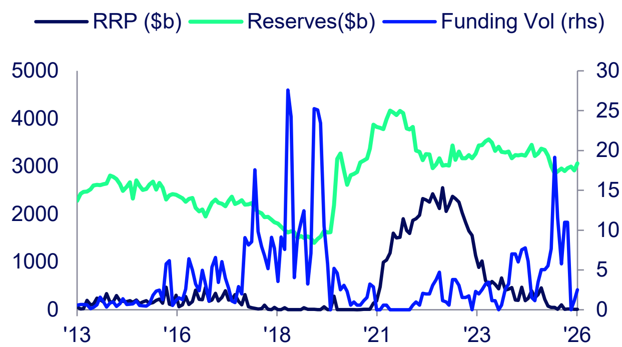
Figure 5 Contained appetite for cash



Source: State Street Markets, Bloomberg

The size of the Fed's balance sheet continues to influence investor behavior and, by extension, cash allocation decisions. While Chairman Warsh has made clear his preference for a smaller balance sheet over time, he recently reassured markets that any meaningful tightening is unlikely in the near term. As a result, investors increasingly view future balance sheet reduction as likely to be gradual and limited, particularly if the Fed continues to operate within an ample-reserve framework. This outlook supports expectations for limited funding stress through Q3, as ongoing SOMA operations continue to support growth in both the Fed's balance sheet and reserve balances (Figure 7). As long as liquidity remains abundant, there is a limit to cash allocation as investor willingness to maintain exposure to risk assets continues.

Figure 7 Ample for now

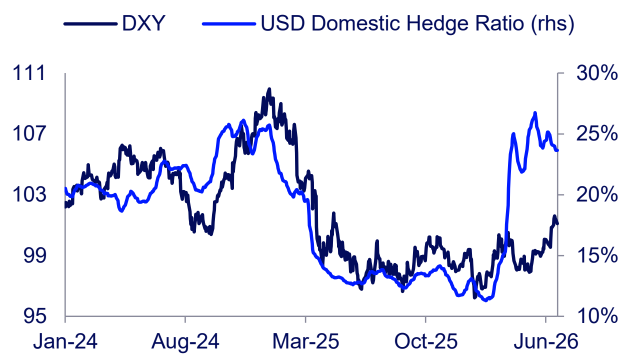


Source: State Street Markets, Bloomberg

The USD king again?

For treasurers and cash managers, the recent bout of USD strength remains an important consideration. While real-money investors are not yet net buyers of the dollar, 20-day flows below the 30th percentile still indicate net selling. Even so, the USD remains the most significant underweight within the G10, suggesting there is still a sizeable pool of investors with ample room to increase exposure. Moreover, our hedge ratio data indicate that U.S. investors are no longer actively reducing their hedges on non-USD currency exposure. Last year, declining hedge ratios coincided with USD weakness as investors anticipated foreign currencies would appreciate against the dollar. That dynamic has since faded. As a result, we believe there remains scope for further USD strength in the months ahead. Read our current views here.

Figure 8 Americans not betting against the home team



Source: State Street Markets, Bloomberg

Conclusion: While the Fed may be approaching peak hawkishness, the combination of resilient growth, lingering inflation risks, and abundant liquidity argues against a meaningful policy pivot in the near term. As a result, front-end rates may remain elevated and funding markets should remain well supported through the second half of the year. At the same time, ongoing underweights in the U.S. dollar and shifting hedging behavior suggest further room for USD appreciation. For cash investors, the message is clear: despite growing questions around peak hawkishness, the environment continues to favor maintaining flexibility, preparing for gradual policy tightening, and positioning for a world in which liquidity remains abundant but not limitless.

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