



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

The System Open Market Account held \$473.3 billion in domestic securities as of the September 3 release, essentially unchanged from the prior release of August 27, a reported change of \$0.0 billion. The portfolio remained concentrated in Treasury coupon securities, with notes and bonds accounting for \$411.7 billion of the total and Treasury bills making up \$21.7 billion. Staff noted that these figures describe SOMA holdings only — total size, composition, and the week-over-week change — and do not encompass repo or reverse-repo operation results, for which no point-in-time-safe data source is currently available.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff review characterized the incoming data as consistent with a broadly weak economy. Core PCE inflation on a twelve-month basis stood at 1.97 percent, essentially at the 2 percent objective. The labor market, by contrast, had clearly softened: the unemployment rate was 6.1 percent, more than a full percentage point above the estimated 5.05 percent natural rate, and initial jobless claims were elevated at 441,000. The Chicago Fed National Activity Index registered -2.58, a reading well below trend and indicative of a pronounced slowing in overall activity. The Employment Cost Index stood at 109.1, and M2 was reported at \$7,725.9 billion.

The most recent Beige Book, based on information collected on or before August 25, reinforced this picture. Reports from the twelve Districts described the pace of activity as slow in most areas, with business conditions frequently characterized as 'weak,' 'soft,' or 'subdued.' Consumer spending was slow, concentrated on necessities, with retrenchment in discretionary purchases and auto sales falling or steady at low levels. Manufacturing declined in most Districts, residential real estate remained soft, and loan demand eased, particularly for residential mortgages and consumer loans. On prices, almost all Districts continued to report pressures from elevated energy, food, and commodity costs, with contacts in several Districts indicating they had raised selling prices in response to higher input costs; some noted declines or slower increases for certain industrial commodities. Wage pressures were characterized as moderate amid a general pullback in hiring.

STAFF REVIEW OF THE FINANCIAL SITUATION

Financial conditions showed meaningful strain. The financial stress index stood at 0.6033 on a scale where higher readings indicate tighter conditions, and the VIX at 25.47 reflected elevated volatility, though staff characterized it as anxiety rather than outright panic. The Baa corporate spread of 3.35 percentage points over Treasuries pointed to rising borrowing costs and credit stress for lower-rated issuers. The 3-month Treasury bill was trading roughly 0.35 percentage point below the current 2



percent funds rate, a configuration consistent with flight-to-safety flows and some anticipation of near-term easing. The 10-year/2-year yield curve spread remained positively sloped at 1.39 percentage points, showing no acute inversion signal.

STAFF ECONOMIC OUTLOOK

Staff projections drew on the real forward-looking quantities available. With the estimated real neutral rate near 1.74 percent and the nominal funds rate at 2 percent, real policy was judged to be only modestly accommodative relative to the neutral level, particularly in light of the sizable gap between actual unemployment and its estimated natural rate. Inflation momentum was low, at 0.025, suggesting little near-term acceleration in prices despite the cost pressures documented in the Beige Book, while unemployment momentum of 0.2 indicated the jobless rate was still rising rather than stabilizing. Taken together, these figures pointed toward continued labor-market slack widening more than any offsetting build in inflationary pressure over the projection window.

The reference-rule outputs spanned a wide range and were judged not reliable for this meeting. The Taylor rule prescribed 75 basis points, reflecting an inflation reading close to target and less weight on the emerging slack; the First-Difference rule pointed to no change; and both the Balanced Approach and ELB-adjusted rules called for a 25 basis point reduction. The deterministic policy engine, weighing these against the momentum terms and the neutral-rate estimate, produced a loss-minimizing recommendation of -25 basis points. The dispersion across rules, and their assessed unreliability, implied an unusually wide band of uncertainty around the appropriate stance, with the balance of the framework tilting toward easing.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

Participants agreed that inflation, at a core PCE reading of 1.97 percent, was essentially at the 2 percent objective and was not the immediately binding constraint on policy. They likewise agreed that the real economy had weakened materially, citing unemployment of 6.1 percent against a 5.05 percent natural rate, initial claims of 441,000, and a Chicago Fed activity index of -2.58 that placed activity well below trend. The disagreement, which persisted across all four rounds, was over how to weigh persistent cost-side price pressures and financial fragility against this clear labor-market deterioration.

One participant, weighting inflation risk most heavily, resisted easing throughout. This participant acknowledged the genuine weakness in growth and the tightening in credit conditions but emphasized that the Beige Book documented widespread price pressures from energy, food, and commodities, with firms passing higher input costs into selling prices. The concern was that cutting into unresolved pass-through risk could re-anchor inflation expectations higher and compromise credibility, and that at



a 2 percent funds rate policy was already accommodative. This participant noted that the moderate wage pressures and hiring pullback in the Beige Book limited second-round inflation risk somewhat but did not eliminate the upside concern, and favored holding to preserve optionality.

A participant focused on the labor market argued the other side with equal force, contending that with unemployment more than a point above its natural rate, rising unemployment momentum, and elevated claims, restrictive policy was not justified while inflation sat at target. This participant read the moderate wage pressures amid a hiring pullback as undercutting the case for holding, and viewed a measured 25 basis point cut as the appropriate step — enough to support employment without appearing panicked. A participant attentive to market signals reached the same conclusion by a different route, noting that the 3-month bill trading 35 basis points below the funds rate priced in roughly a quarter point of near-term easing, so that a 25 basis point move would align policy with efficiently-priced expectations while the still positively sloped yield curve and a VIX at 25.47 argued against reading the environment as an emergency.

Two participants held to a steady stance in the predictive rounds while acknowledging the case for a cut. The participant most attentive to financial stability judged the stress serious — an index at 0.6033, a Baa spread of 3.35, and the negative bill spread all pointing to funding strain — but concluded the stress had not yet reached a systemic threshold that warranted spending limited policy room preemptively, and worried that an unexpected cut could itself signal alarm to fragile markets; holding with a bias to ease was preferred. A participant emphasizing a literal reading of the data landed similarly, finding that near-target inflation combined with still-evident price pressures and no acute panic in the numbers supported holding while retaining readiness to act. These considerations produced a predictive split of three participants favoring no change and two favoring a 25 basis point cut.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, the alignment shifted. Several participants observed that the Taylor rule's 75 basis point prescription was an outlier and that the reference rules were judged unreliable this meeting, so greater weight fell on the Balanced Approach and ELB-adjusted rules, both at -25 basis points. With inflation momentum at only 0.025, unemployment momentum at 0.2, and the real neutral rate near 1.74 percent leaving policy only barely accommodative, the participant focused on labor, the one attentive to market signals, and the data-focused participant all found the easing case persuasive on the merits. The financial-stability participant, revisiting an earlier hold, concluded that mounting credit deterioration now dominated and that holding would leave policy too tight against building fragility, and so accepted the cut. The inflation-focused participant alone continued to decline, accepting that -25 basis points was optimal



under the framework's loss function but maintaining that inflation weighting justified holding while commodity pass-through remained unresolved. Participants generally recognized that the gap between the predictive hold and the framework's easing recommendation reflected a stance near a knife-edge, with the arithmetic seeing room to cut and caution over price pressures and financial signaling holding the near-term stance steady.

COMMITTEE POLICY ACTIONS

In the predictive vote, the Committee's stance was to hold the federal funds rate at 2 percent, with three of the five members favoring no change and two favoring a 25 basis point reduction. On the deterministic framework's loss-minimizing recommendation of a 25 basis point cut, four of the five members endorsed the recommendation as-is — the participants focused on the labor market, on financial stability, on a literal reading of the data, and on market signals — while one member, the participant weighting inflation risk most heavily, declined, accepting the recommendation as optimal under the framework's loss function but preferring to hold given unresolved commodity pass-through. There were no partial positions.