

RESEARCH · MACRO NOTE · JULY 4, 2026 · 8 MIN READ

Calibrated to the Headline: The Cost of a Reaction Function No One Can Write Down

In four weeks the market repriced the Federal Reserve's policy path four times, on a hot CPI, a hawkish projection, an energy-driven PCE print, and a payroll miss. News about the economy moves any expected path. The rest of the movement priced something else: how a committee bound by no rule would choose to read that news. Data dependence is the honest name for discretion, and the honesty does not lower its price.

MONETARY POLICY

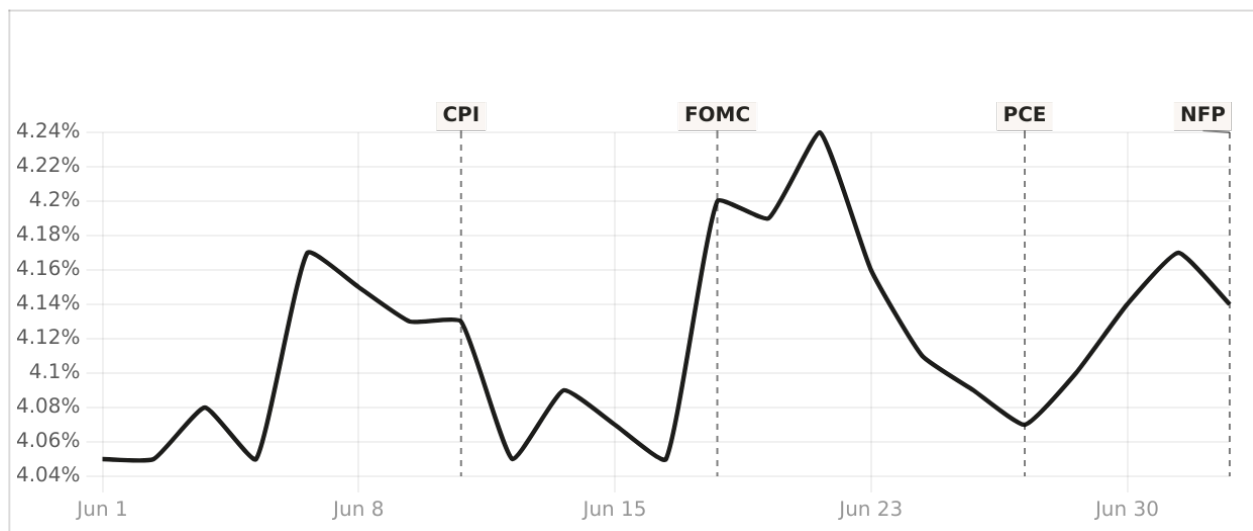


FIG. 1 · LINE CHART OF THE 2-YEAR TREASURY YIELD, DAILY, JUNE 2026, WITH CPI, FOMC, PCE, AND PAYROLLS EVENT MARKERS

In the four weeks between June 10 and July 2 the market moved its estimate of the Federal Reserve's policy path four times. A hot May inflation print opened the sequence on June 10.¹ A week later the Federal Open Market Committee held the funds rate steady while raising its median projection for year-end 2026 from 3.4% to 3.8%, erasing the cut it had penciled in March and putting a hike on the table.² The May PCE release carried the energy spike the Middle East war has put into prices. On July 2 the June employment report landed on the other side of the ledger: payrolls grew by just 57,000, less than half what forecasters expected.³ Figure 1 traces the two-year Treasury yield through all four.⁴ It jumped on the projections, held the gain for a week, surrendered it by the PCE release, and rebuilt

it before the payroll miss clipped it back.⁵ Each turn is the market repricing the same policy rate on new information, four times in a month.

The prints themselves pull in opposite directions, and the tension is visible once the inflation number is taken apart. In its June statement the Fed attributes elevated inflation in part to supply shocks that have driven price increases in energy, a claim the decomposition in Figure 2 supports as far as it goes. Energy prices rose 24.3% over the year to May, against 4.1% for the headline index, and the gap between headline and core is the wedge that spike drives.⁶ The alibi ends at core. Core PCE inflation stood at 3.4% in May, 1.4pp above target. In June wage growth ticked up to 3.5% while hiring came in at roughly half the expected pace. No war explains core inflation at that level. A labor market where pay accelerates as hiring stalls is a picture of an economy whose inflation no longer arrives from outside.

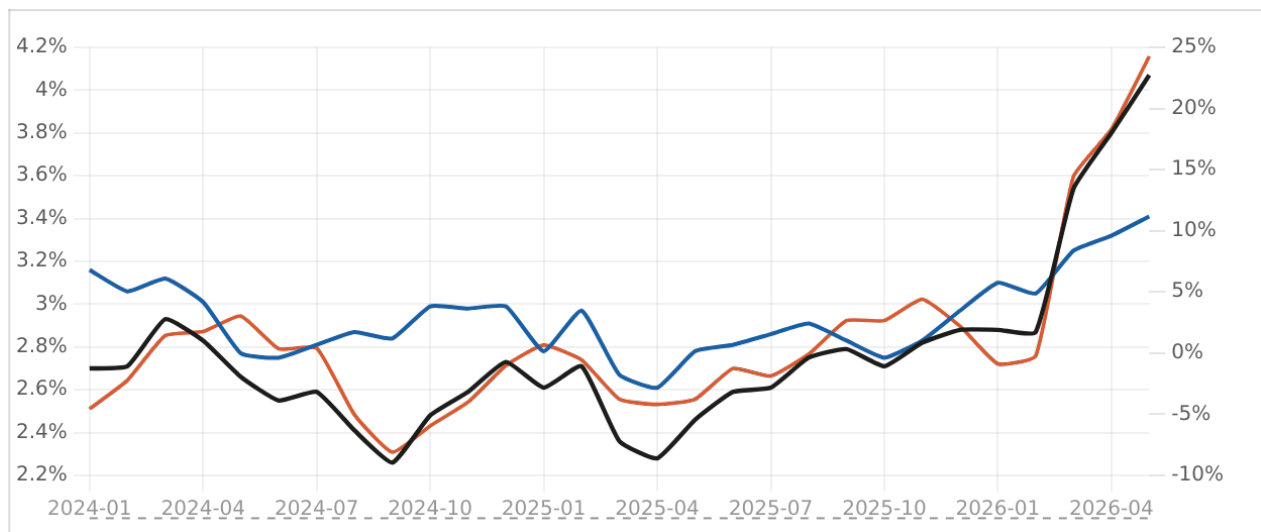


FIG. 2 · LINE CHART OF HEADLINE, CORE, AND ENERGY PCE INFLATION YEAR OVER YEAR, MONTHLY, WITH A 2 PERCENT TARGET LINE

A framework exists that is built for exactly this reading. The productivity norm, developed in its modern form by Selgin, directs the central bank to stabilize nominal spending and to let genuine supply shocks pass through to the price level, on the argument that a price change reflecting real scarcity is information the economy needs rather than an error the central bank should fight.⁷ Under that logic the war premium in energy is a relative price change requiring no monetary response; tightening against it would compound a real loss with a nominal squeeze. That energy case rests on the norm's demand-stabilization logic, and the same logic reads core inflation above 3% alongside accelerating wages as a different object, a signal of nominal spending running ahead of capacity, the one movement the norm instructs the central bank to correct. Core and wages are proxies here, since the norm targets nominal spending directly and the second-quarter spending data does not yet exist. Shrinking labor supply is itself a movement the norm would partly accommodate, so the assignment carries real ambiguity at the margin. The dual-mandate tension the June data created survives under the norm, but as an assignment: ignore the energy print, answer the core trend, and read the payroll number for what it says about spending instead of as a standalone verdict.

The assignment is the point, and it is what discretion cannot supply. A rule of this kind sorts releases in advance into those the central bank will answer and those it will ignore, and the sorting is public.

Under any regime the expected path moves when genuine news arrives about the state of the economy; a rule removes one layer only, the uncertainty about how the committee will map that state into a rate. Markets holding the norm would have stripped the energy contribution from the June 10 print and repriced the smaller demand signal inside it. Judging by the two-year yield, which barely moved that day, that signal was small. What followed added the second layer. The committee the markets actually face has committed to no mapping at all, so every release reopens the question of how it will be read, and the yield in Figure 1 tracks the committee's likely reading of the economy as much as the economy itself. It also moved on days with no release attached, in a month when term premium and safe-haven flows were pushing on the same series, so no single day carries the attribution cleanly. Taken whole, the window does: a month of swings in both directions, driven as much by re-estimates of the committee as by news about the economy.

Data dependence is nonetheless the defensible posture for the institution the Fed actually is. A committee holding a dual mandate and no binding framework should not ignore a 57,000 payroll print, and the June decision to hold while the projections tilted hawkish is a reasonable judgment on the evidence in front of it. Even the projections supply a path of sorts; part of the June repricing was markets aligning with the new 3.8% median. A forecast the committee may revise at any meeting still communicates a judgment, and carries no commitment about the next one, so the revision itself becomes the thing markets must price. The concession has a boundary. The cost of meeting-by-meeting judgment sits in the variance markets must carry between decisions, priced and repriced at every release, because nothing constrains where judgment lands next. Each decision taken alone is defensible. The sequence they form has no anchor. Data dependence is the honest name for discretion, and the honesty does not lower its price.

The July meeting offers a test that does not require waiting on the task forces Warsh set running in June.⁸ A committee developing an actual reaction function would begin saying what it will not respond to: which components of the next print it reads as supply and which as demand. A committee re-litigating the latest release will produce another paragraph of judgment and another repricing. One path marks the beginning of something markets can price in advance; the other is the pattern Figure 1 already records, and every print between now and the framework review's conclusion will extend it.

Footnotes

1. The all-items consumer price index for May 2026, released June 10, 2026, rose 4.2% over twelve months, the largest increase since April 2023. See "May CPI Shows Inflation Rose at Its Fastest Pace in 3 Years," Kiplinger, June 10, 2026.
2. FOMC statement and Summary of Economic Projections, June 17, 2026 (Board of Governors of the Federal Reserve System). The median federal funds rate projection for year-end 2026 rose from 3.4% in March to 3.8%; the 2026 inflation projections rose to 3.6% headline and 3.3% core. The statement attributes elevated inflation in part to supply shocks that have driven price

increases in energy.

3. Bureau of Labor Statistics, The Employment Situation — June 2026, released July 2, 2026. Payrolls +57,000 against consensus estimates ranging from roughly 110,000 to 115,000 (CNBC; FXStreet); unemployment 4.2%; labor force participation 61.5%, down from 61.8%; average hourly earnings +3.5% year over year. Payroll figure confirmed against FRED series PAYEMS. BLS notes the print sits near the trailing twelve-month average monthly gain; the miss is against expectations, and the expectations embedded a reacceleration that did not arrive.
4. Market-implied probabilities from the CME FedWatch tool as reported: July hike odds near 6% in early June, rising to near 34% by early July after the June projections and inflation prints; September priced out after the July 2 employment report with October still carrying hike probability. CNBC, July 2, 2026; TradingKey, July 2, 2026.
5. Two-year par yield, U.S. Department of the Treasury daily yield curve, July 2, 2026 close of 4.14%. Figure 1 plots the FRED mirror of the H.15 release (DGS2); the July 2 observation, which the mirror posts with a holiday-extended lag, is taken directly from the Treasury release, which DGS2 reproduces.
6. Energy component is the PCE energy goods and services chain-type price index (FRED series DNRGRG3M086SBEA), May 2026 over May 2025, the series plotted in Figure 2. Press summaries of the BEA release reported the energy increase near 23.5%; the figure here reproduces the FRED vintage retrieved July 3, 2026.
7. George Selgin, *Less Than Zero: The Case for a Falling Price Level in a Growing Economy* (London: Institute of Economic Affairs, 1997). The norm stabilizes nominal spending and lets productivity-driven and supply-driven price movements pass through, treating them as relative price information that policy should not offset.
8. At his June 17, 2026 press conference Warsh announced five task forces reviewing the inflation framework, productivity and jobs, data sources and methodology, communications, and the balance sheet, to conclude by year-end. See *Pattern and Pretence: The Dot the Chairman Declined to Submit* on the communications review.

N.K. Originally published at nikkhosravipour.com/post/calibrated-to-the-headline

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