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**Preview: Fed In a Hawkish Pause in Its Mini Tightening Cycle
Ahead of Mid-Term Elections, Despite Persistent Inflation**

by

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26 October 2026

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Executive Summary

- **Expected Decision:** *We expect the Fed to hold interest rates at 3.75-4.00% at its October 27-28 meeting,* just ahead of the November midterm elections, in line with market expectations. While Chair Kevin Warsh has offered limited guidance, a Reuters poll found that 94 of 100 economists expect rates to remain unchanged in October, with all anticipating another hike in December. In September, the Fed delivered its first rate hike in over three years to contain persistent inflation, with projections signalling another increase later in 2026. Meanwhile, it reaffirmed its “ample reserves” framework, indicating no immediate acceleration of balance sheet reduction despite Chair Warsh’s preference for faster quantitative tightening.
- **Policy Discussion:** *The Fed maintains a tightening bias as persistent inflation and rising energy costs risk spilling over into broader inflation.* September CPI inflation reached 3.7% y/y, while producer prices rose 6.3%, with inflation expected to remain above the Fed’s 2% target until at least 2028. Meanwhile, AI-driven investment and resilient consumer spending continue to support growth and put upward pressure on inflation from the demand side. Rising living costs also pose a political challenge for President Trump and Republicans ahead of November’s midterm elections, where affordability remains a key concern. Most policymakers anticipate another rate hike in 2026, while nearly 60% of economists expect rates to peak at 4.00–4.25% and 41% foresee at least two further increases.

Nevertheless, markets expect the Fed to pause in October before resuming tightening in December. A Reuters poll found that 94 of 100 economists anticipate rates remaining at 3.75–4.00% in October, while all expect a December hike. Vice Chair Philip Jefferson and New York Fed President John Williams have also signalled little urgency to tighten in the short term (October). Chair Kevin Warsh’s shift away from forward guidance has increased uncertainty over the timing and pace of future rate increases; but indirect forward guidance is provided by the other two members of the Fed’s Troika.

Despite expectations of an October pause, Warsh’s hawkish stance, persistent inflation and relatively loose financial conditions leave room for a surprise hike, however unlikely that hike may. Such a move could trigger market volatility and a significant repricing of interest rate expectations. Rather, a hawkish pause or skip will also provide a signal for the market that hikes may continue even after December. Attention will also then shift to the Fed’s December projections for signals on further tightening in early 2027 and potential operational changes under Warsh’s leadership.

The October pause isn’t likely to be unanimous as at least two FOMC members may dissent and vote for an October hike. The recent market induced tightening in financial conditions (FCI) given the AI-related markets correction may allow Warsh to justify the hawkish skip of October during his presser; and in September Warsh said that he favors a tightening in financial conditions but without a clear framework on how such conditions affect monetary policy. Thus, the market reaction to Warsh statements on FCI may be dovish or hawkish; markets may overreact to any mention of the role of FCI. But Warsh will be pushed to explain more this pause. His slightly fudged answer will stress looking at trends of inflation and the lags of monetary policy; of course, a hike right before the midterm elections would enrage President Trump who is pushing for rate cuts but a truly independent Fed would have hiked in October. Still, markets will look through this Kabuki theater between the Fed and Trump and focus on whether any indirect forward guidance or other tea leaves suggest that, after December, further hikes (and how many) will occur in 2027. Warsh will be hard pressed during the press conference to avoid giving any signal on possible 2027 hikes.

Key Picture: US Federal Reserve Forecasts – 2026-2029

	2026 ^f			2027 ^f		2028 ^f		2029 ^f	Longer Run	
	Latest Reading	September Report	June Report	September Report	June Report	September Report	June Report	September Report	September Report	March Report
GDP (<i>real growth, y-o-y</i>)	2.2	2.3	2.2	2.4	2.3	2.2	2.2	2.1	2.0	2.0
Unemployment rate (% <i>y-o-y</i>)	4.2	4.1	4.3	4.1	4.3	4.1	4.2	4.1	4.2	4.2
PCE Inflation (% <i>y-o-y</i>)	3.4	3.7	3.6	2.3	2.3	2.1	2.0	2.0	2.0	2.0
Core PCE Inflat. (% <i>y-o-y</i>)	3.0	3.4	3.3	2.5	2.5	2.2	2.1	2.0	-	-
Federal Funds Rate (%)	4.00	5.1	3.8	5.1	3.6	3.9	3.4	3.6	3.1	3.1

Source: Federal Reserve 'Summary of Economic Projections' March and June 2026. Note: 1. GDP reading for Q2-2026; 2. Unemployment rate as of September 2026; 3. PCE and core PCE inflation as of August 2026; 4. Projections reflect the median of FOMC projection.

Analysis

✦ **EXPECTED DECISION:** *On October 28, we expect the US Federal Reserve's FOMC to hold its Fed funds range at 3.75% - 4.00%.* At the September meeting, the Fed voted unanimously to raise rates to 3.75-4.00%. Despite robust economic growth and higher-than-expected inflation, Fed officials favour a cautious approach to further rate hikes, while Chair Kevin Warsh has offered little guidance on the next policy decision. A Reuters poll found that 94 of 100 economists expect the Fed to hold rates at 3.75-4.00% in October, while all anticipate a December hike, reflecting growing concerns over persistent inflation despite strong economic growth.

Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June. The Committee will continue reduce the size of its balance sheet made of Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in April, the Committee slowed the reduction of its securities holdings by lowering the monthly Treasury redemption cap from \$25 billion to \$5 billion, while keeping the agency debt and mortgage-backed securities cap at \$35 billion. In the last few weeks, the Treasury has conducted a series of enhanced buyback operations in order to stem the rise in long-term yields. While initially these operations helped stabilise the market, lately they have proved ineffective, because the market is less convinced of the Fed's anti-inflationary credentials.

✦ **POLICY DISCUSSION:** *The Fed maintains a tightening bias as persistent inflation and rising energy costs, driven by Middle East supply disruptions, threaten to spill over into broader prices.* September CPI inflation reached 3.7% y-o-y, while producer prices rose 6.3%, reinforcing concerns over entrenched inflationary pressures. Inflation is expected to remain above the Fed's 2% target until at least 2028, while AI-driven investment and resilient consumer spending continue to support economic growth. Rising inflation also poses a political challenge for President Trump and Republicans ahead of November's midterm elections, as affordability and the cost of living remain central voter concerns. Higher fuel and household expenses could intensify public dissatisfaction with the administration's economic policies. Most policymakers anticipate at least one further rate hike in 2026, with updated projections due in December. Nearly 60% of economists expect the policy rate to peak at 4.00-4.25%, while 41% anticipate at least two further increases, highlighting upside risks to the monetary policy outlook.

Nevertheless, markets broadly expect the Fed to hold rates steady in October before resuming tightening in December. A Reuters poll found that 94 of 100 economists expect rates to remain at 3.75-4.00% in October, while all anticipate a December hike. This outlook is supported by recent remarks from Vice Chair Philip Jefferson and New York Fed President John Williams, who have signalled little urgency to tighten further. However, Chair Kevin Warsh's departure from traditional forward guidance

has increased uncertainty over the timing and pace of future rate increases. His reluctance to signal policy decisions in advance also makes it harder for markets to assess whether the Fed will follow its previously indicated policy path.

Despite expectations of an October pause, the possibility of a surprise hike cannot be ruled out. Warsh's hawkish stance, persistent inflation and relatively loose financial conditions could strengthen the case for earlier tightening, particularly as robust AI-related investment continues to support economic activity. An unexpected increase could trigger significant market volatility and a repricing of expectations for the pace and ultimate extent of monetary tightening. Beyond October, attention will shift to the Fed's December projections for signals regarding further rate increases in early 2027, alongside potential changes to the central bank's operations under Warsh's leadership.

- ✦ **MACROECONOMIC ANALYSIS:** *US inflation rose to 3.7% y-o-y in September, driven by surging energy prices amid the Iran war, intensifying cost-of-living pressures and reinforcing expectations of further Fed rate hikes.* The US economy expanded at an annualised rate of 2.2% in Q2 2026, revised up from 1.5%, supported by robust consumer spending and AI-related business investment. Consumer spending grew by 3.8%, while underlying domestic demand rose by 4.6%, highlighting economic resilience despite persistent inflationary pressures and weakening consumer confidence. The stronger estimate reflected upward revisions to investment, consumer and government spending.

The US labour market weakened in September, with nonfarm payrolls rising by just 29,000, well below expectations of 84,000, while unemployment increased to 4.2%. July and August employment figures were revised down by a combined 60,000, and annual wage growth slowed to 3%, its lowest since May 2021.

Inflation accelerated to 3.7% in September from 3.4% in August, exceeding expectations of 3.6%, driven largely by surging fuel prices amid the Iran war. Core inflation also rose to 2.6% from 2.4%, signalling broader price pressures, while annual wage growth slowed to 3%, eroding purchasing power. The data pushed Treasury yields higher and strengthened expectations of further Fed rate hikes, although an October increase remained uncertain.

The S&P Global US Composite PMI rose to 58.4 in September from 56 in August, marking the strongest expansion in private-sector activity in over five years. Manufacturing PMI was also up, despite a downward revision from the preliminary estimate of 57.0, marking its highest level since May 2022. Services PMI marked the strongest expansion since July 2021, accelerating across technology, consumer businesses, industrials and healthcare, supported by the fastest increase in new orders in over four years.

- ✦ **MARKET IMPLICATIONS:** *The October pause and a December hike is fully priced in by markets, and Warsh won't provide forward guidance; but markets will try to assess whether this is a truly hawkish pause.* The US dollar weakened as Fed Chair Warsh's lack of clear policy guidance at the IMF meetings dampened expectations of further rate hikes. During the week, US Treasury yields declined as concerns over AI-related corporate borrowing triggered a sell-off in technology stocks and a flight to safer assets, despite oil prices approaching \$100 per barrel. To put things into context, *in the fixed-income space*, as of 26 October, and since the last meeting in September, the 2y UST fell by 2 bps to 4.70% (+124 bps y-t-d) and the 10y UST also edged down 3 bps to 4.99% (+80 bps y-t-d). *In the currency space*, the Dollar rose after the hotter-than-expected inflation, but came under pressure as disappointing megacap earnings raised doubts over the sustainability of the AI trade, while escalating Middle East tensions supported alternative safe-haven currencies. The index rose on Monday as investors positioned ahead of key central bank decisions that could fuel market volatility. The dollar index rose by 1.7% to 101.9 (+3.6% y-t-d), while EUR/USD declined by 2.4% to 1.119 (-4.7% y-t-d). *In the equity space*, major US stock indices ended the week mostly lower as an AI-related sell-off, stronger-than-expected inflation and the start of Q3 earnings season prompted a rotation from growth stocks into value and defensive sector. As of 26

October, the S&P 500 increased by 1.7% since the September meeting and trades at the time of writing at around to 7,679 (+12.0% y-t-d).

✦ **APPENDIX (Macro Background):** *The stronger estimate reflected upward revisions to investment, consumer and government spending.* In Q2, the US economy expanded at an annualized rate of 2.2% (c: 1.5%; p: 2.5%). Personal consumption rose 3.8%, its strongest increase since Q3 2025, while fixed investment jumped 7.7%, supported by AI-driven equipment and intellectual property spending. Residential investment returned to growth, while lower government spending and a surge in imports weighed on the expansion. The GDP expanded by 2.2% y-o-y (p: 2.6%).

Composite PMI marked the strongest expansion in private-sector activity in over five years. In August, the S&P Global US Composite PMI rose to 58.4 (p: 54.5). The Manufacturing PMI declined to 55.9 (c: 57.0; p: 53.9). Service PMI edged up to 58.8 (c: 58.7; p: 56.5).

US job growth slowed sharply in September. In September, the unemployment rate edged up to 4.2% (c: 4.1%; p: 4.1%). NFP added by 29K (c: 90K; p: 133K). Wage growth increased by 4.2% in August (p: 4.2%). The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, eased to 7.6% (p: 7.7%).

US inflation climbs to 3.7% amid rising fuel costs.. In August, the personal consumption expenditures (PCE) – the Fed’s preferred inflation gauge – stood at 3.4% y-o-y (c: 3.3%; p: 3.0%). The core-PCE – which excludes volatile energy and food prices – increased to 3.0% y-o-y (c: 3.3%; p: 3.3%). In September, headline inflation rate accelerated to 3.7% y-o-y (c: 3.6%; p: 3.4%), while core inflation rose to 2.4% y-o-y (c: 2.5%; p: 2.4%).



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