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US CPI report is important for Fed hike expectations & USD

11th September 2026

Research Portal: Global Markets Research - MUFG Research

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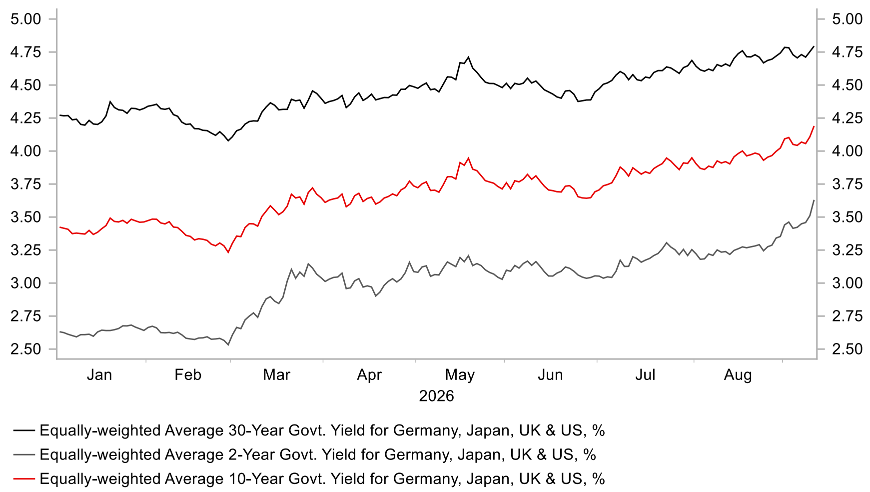
USD: Stronger PPI report adds to Fed hike expectations ahead of CPI report

The main focus in financial markets at the end of this week is the deepening sell-off in global bond markets although the spillovers (click here) into the FX market have been modest so far. The Japanese yen and the Norwegian krone have been the top performers this week, while the Swedish krona, New Zealand and Australian dollars have underperformed. The price action is more consistent with more risk-off trading in the near-term reflecting the negative impact on risk assets from rising energy and bond yields. Nevertheless, the pullback in global equities from recent record highs has been limited. MSCI's ACWI global equity index has fallen by less than 2%. The risk of a deeper correction lower for global equity markets if energy prices and bond yields continue to push higher would increase the likelihood of bigger spillovers into the FX market.

The sell-off in global bond markets accelerated yesterday alongside rising energy prices with the price of Brent hitting a fresh high of overnight at close to USD110/barrel. Axios reported yesterday that Saudi Crown Prince Mohammed bin Salman called US

BOND MARKET SELL-OFF IS ACCELERATING AT THE SHORT-END



Source: Bloomberg, Macrobond, MUFG Research

President Donald Trump twice on Thursday, urging him to launch strikes against the Houthis as the militant group gained ground in Yemen. The request was reportedly declined. The Iran-backed Houthis are reportedly advancing toward coastal areas bordering the strategic Bab al-Mandeb Strait. The sell-off in global bond markets was also reinforced by the release of the stronger than expected US PPI report for August which has added more weight to the case for the Fed to begin hiking rates next week. There are no 18bps of hikes priced into the US rate market ahead of next week's FOMC meeting up from 13bps at the end of last week highlighting that market participants are now leaning more heavily in favour of a hike. The PPI report revealed that the components that feed into the PCE deflator were firmer than expected. According to Bloomberg, they are likely to add close to 0.1ppt to the August print. Healthcare costs rose by 0.3%M/M and airfares by 3.2%M/M.

The stronger PPI report makes it even more important that the release of today's US CPI report comes in softer than expected if the Fed is keep rates on hold for longer while the energy price shock is getting worse. The dollar index initially strengthened after the US PPI report was released but has quickly given back those gains. The key focus today will be on the core CPI reading. The consensus forecast is for a reading of 0.2%M/M. If the reading is in line with the forecast or stronger the US rate market will continue to expect the Fed to hike rates supporting the USD. Whereas a softer reading could trigger a bigger sell-off by encouraging the US rate market to scale back Fed rate hike expectations while other major central banks are expected to continue tightening policy. If the Fed stays on hold for longer it could fuel fears that it is falling behind the curve weighing more heavily on the US dollar and long-term US Treasuries.

EUR: Further ECB hikes to provide more support as long as growth holds up

The biggest sell-off happened in the European rate market yesterday after the ECB's policy update. The 2-year German government bond yield has jumped by around 15bps to price in more active tightening in response to the worsening energy price shock. The ECB delivered a hawkish policy update indicating that further hikes are likely to be required lifting the policy rate into restrictive territory. The combination of rising energy prices, resilient activity and stickier medium-term inflation projections has strengthened the case for further tightening. The ECB now expects inflation to remain higher for longer above their target. In the adverse scenario which appears more relevant than the baseline forecasts given current energy price levels, headline inflation is expected to average 3.2% in 2027 and core 2.8%. Please see our latest FX Focus report for more details (click here).

The euro initially weakened following today's ECB meeting, with EUR/USD briefly falling back below 1.1600. However, the move lower was primarily driven by US dollar strength after the release of the latest US PPI report for August. Nevertheless, the hawkish repricing of ECB rate expectations remains supportive for the EUR. We expect that support to persist as long as the euro-zone economy is still proving resilient to the energy price shock. The performance of EUR/USD may increasingly hinge on the Fed's policy response. If the Fed leaves rates on hold while the ECB continues to tighten more actively, EUR/USD could break higher towards 1.2000. Conversely, if the Fed finally starts to hike rates this month, the pair could retreat towards the lower end of its current 1.1400-1.1800 trading range. Overall, we continue to believe that an intensifying energy price shock should ultimately favour a stronger US dollar and a weaker euro given the bigger negative terms of trade hit for Europe.

KEY RELEASES AND EVENTS

Country	BST	Indicator/Event	Period	Consensus	Previous	Mkt Moving
SZ	10:15	SNB's Schlegel Speaks in Lucerne				!!
US	13:30	CPI MoM	Aug	0.4%	0.1%	!!!
US	13:30	Core CPI MoM	Aug	0.2%	0.2%	!!!
EC	15:00	ECB's Lagarde Speaks in Paris				!!
US	15:00	U. of Mich. Sentiment	Sep P	51.0	51.7	!!
EC	18:00	ECB's Lane Speaks in Wexford, Ireland				!!

Source: Bloomberg & Investing.com

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