Opinion | 16 October 2026

THINK Ahead: The AI-inflation tug of war that's driving markets crazy

Strong inflation, HIKE RATES! Dodgy data centres, CUT RATES! In a week when markets couldn't make up their minds on the direction of US monetary policy, **James Smith** gets to the heart of the question: why exactly is the Federal Reserve hiking rates?



Source: Imgflip

The AI-inflation tug of war that's driving markets crazy

Even by this year's crazy standards, this week's move in the US rates market was WILD.

Here's how it went down. US inflation came in hot. Two-year swap rates rose by a whopping 20 basis points. Then, only hours later, the move completely reversed as news broke of the troubles at GPU cloud provider CoreWeave, seen by investors as a harbinger of doom for leveraged data centre providers/all data centres/the whole AI story/the US economy/all of humanity (delete as appropriate).

That's almost an entire rate hike that went into, and then out of, market expectations in just a matter of hours.

And it speaks to the question at the heart of the US rates market right now: why exactly is the Federal Reserve hiking rates?

Is it simply that inflation has been too high for too long, exacerbated by the Middle East crisis? Or does the AI investment boom mean financial conditions have become way too loose and interest rates much too low?

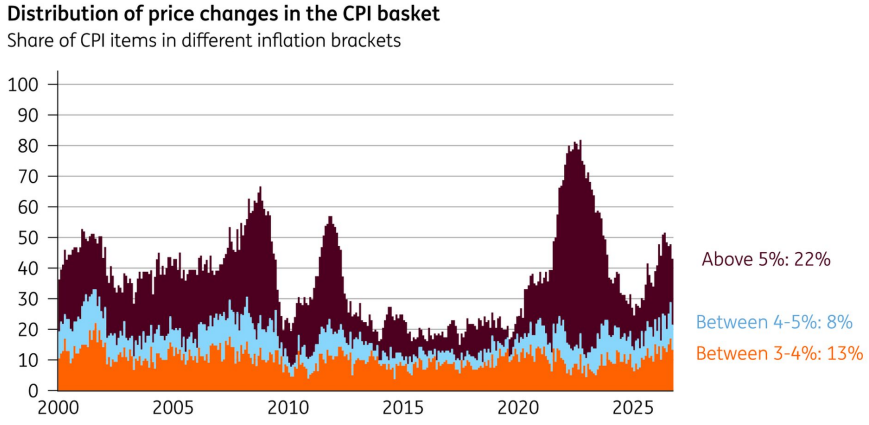
Fed officials can't agree on this, by the way. And this week's drama in the bond market suggests investors aren't too sure either.

If it really is mostly about inflation, though, then there are still good reasons to think the Fed needn't panic.

Sure, this week's data wasn't great. Both consumer and producer price inflation surprised to the upside, and unlike last month, there was no single area clearly skewing the numbers higher. As my colleague James Knightley noted afterwards, the three-month annualised rate of headline CPI, a decent sense of recent momentum in prices, is back above 3%.

And by my maths, Fed Chair Kevin Warsh's favoured gauge of price pressures, the share of components with an inflation rate north of 3%, is still very elevated, albeit a little lower than it was.

The share of inflation components with a rate above 3% is still elevated



Source: Macrobond, ING

But as I argued a few weeks back, this measure is highly flawed. All it really tells us is that tariffs have boosted a lot of small goods categories with relatively low weights. That effect should rapidly dissipate now that tariff refunds are flowing in after the Supreme Court decision earlier this year.

There are other reasons for optimism, too. Rental costs, which make up a whopping 44% of the core inflation basket, should continue to gradually ease given the cool state of the US housing market. Wage growth is down at 3%, and James K reckons it could go even lower.

Put that together, and it's not difficult to see how inflation gets much closer to 2% by the second quarter of next year, when the energy story also starts to filter out of the annual comparison. So what about AI?

There is no doubt it's having an enormous impact on US investment. And the companies behind it seem almost indifferent to the rising cost of capital. James K recently estimated that it has contributed about a third of economic growth so far this year. Its mark on financial markets has been bigger still.

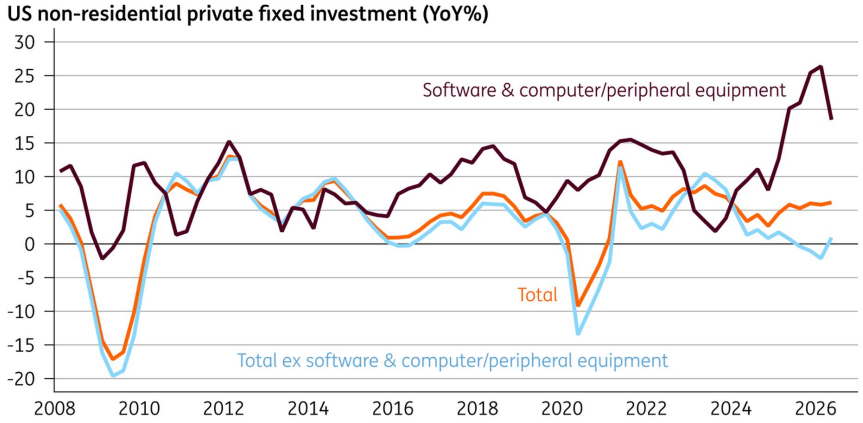
The most eye-catching thing Warsh said back in September was that the Fed was "removing a dose of accommodation", a sign that he doesn't think monetary policy is particularly restrictive right now.

And when Warsh talks about loose financial conditions, given that Treasury yields are north of 5% and the dollar has been getting stronger over recent weeks – both of which have tightened conditions – you've got to assume he's really talking about the Teflon US equity market. That makes this week's CoreWeave drama all the more important.

If markets have got one thing right this week, it's that the health of the AI trade matters enormously for the Fed's ability not only to raise rates further, but to hold them there for any period of time.

And anyway, even if the stock market doesn't fall in the way that many fear, equities are only one way of thinking about US financial conditions. I mentioned the housing market, but it would also be wrong to ignore the impact that higher government borrowing costs are having across the wider economy.

Outside of AI, the US economy is struggling for investment



Source: Macrobond, ING

Even now, anything disconnected from the AI circus is struggling for growth. Capital investment outside the data centre boom hasn't really grown at all for the better part of two years. Among consumers, financial stress in the bottom half of the income distribution continues to emerge, be it in debt-servicing ratios or delinquencies.

There's clearly a danger that the Fed ends up setting interest rates for the AI economy when much of the rest of America is already feeling the squeeze.

That's why, as we outline in our latest monthly update hot off the press this week, we still think the Fed can get away with only hiking once more in December – and why it could be cutting rates again as soon as late 2027.

James Smith

THINK Ahead in developed markets

United States (James Knightley)

- **Sep Housing Starts/Oct PMI Flash** (Tue/Fri): It will be a quiet week for US macro news with housing starts and purchasing managers' indices unlikely to meaningfully move markets. There won't be any Fed speakers either, given the communication blackout period has started ahead of the 28 October FOMC meeting. Right now, pricing suggests around a 30% chance of a rate hike, with the 9 December meeting seen as the most likely opportunity for such a move. We agree.

Canada (James Knightley)

- **Sep Inflation** (Mon): Canadian inflation will have to come in especially hot to nudge market expectations towards anticipating a hike at the Bank of Canada policy meeting on 28 October, coincidentally the same date as the next Fed meeting. The

0.3%MoM/3.3%YoY outcome we expect will likely mean the press release leans hawkishly, with the door held open to a December rate move.

Eurozone (Peter Vanden Houte)

- **Oct PMI Flash** (Fri): Eurozone PMI figures surprised to the upside over the summer months. However, with energy prices rising again and tensions within the eurozone increasing amid France's budget difficulties, some correction looks likely in October. We expect both manufacturing and services PMIs to decline, although the composite index should remain above the 50-point threshold.

United Kingdom:

- **Jobs data** (Tue): There are some tentative signs in the survey data that the UK jobs market is stabilising after a long period of attrition, particularly in consumer services. We don't expect any imminent turnaround, though, and we expect next week's data to emphasise that the backdrop for wage growth remains benign.
- **Inflation** (Wed): We expect headline CPI to rise to 3.5%, on a path towards 4% around the turn of the year. However, we've not seen any sign of indirect effects from higher energy prices just yet and we think that will continue. The threat of 4% inflation looks like it'll be enough to convince the Bank of England to hike rates in November and probably February too, but we're still sceptical that rates will rise as far as markets are pricing, or more importantly, stay that high either. We expect cuts by the end of 2027.

Key events in developed markets

Country	Time	Data/event	ING	
		Monday 19 October		
Canada	1330	Sep CPI (MoM%/YoY%)	0.3/3.3	-0.1/3
	1330	Sep Core CPI (MoM%/YoY%)	-/-	0.1/2.4
		Tuesday 20 October		
US	1330	Sep Housing Starts (mn)	1.3	1.275
Eurozone	0900	Aug Current Account SA (EUR bn)	-	27.6
UK	0700	Aug ILO Unemployment Rate	4.9	4.9
	0700	Aug Employment Change (000s)	20	67
	0700	Aug Average Weekly Earnings (3M YoY%)	3.8	3.9
	0700	Aug Average Weekly Earnings ex Bonus (3M YoY%)	3.6	3.5
		Wednesday 21 October		
UK	0700	Sep Core CPI (YoY%)	2.8	2.6
	0700	Sep CPI (MoM%/YoY%)	0.4/3.5	0.5/3.1
	0700	Sep Services CPI (YoY%)	3.6	3.4
		Thursday 22 October		
US	1330	Initial Jobless Claims (000s)	200	199
Eurozone	1500	Oct Consumer Confidence Flash	-	-16.5
		Friday 23 October		
US	1445	Oct S&P Global Manufacturing PMI Flash	55.5	55.9
	1445	Oct S&P Global Services PMI Flash	56.5	58.8
	1445	Oct S&P Global Composite PMI Flash	57.0	58.4
	1500	Oct Michigan Sentiment Final	46.3	46.3
Eurozone	0900	Oct HCOB Manufacturing PMI Flash	52.2	52.9
	0900	Oct HCOB Services PMI Flash	52.4	53
	0900	Oct HCOB Composite PMI Flash	52.5	53.1
Germany	0830	Oct HCOB Manufacturing PMI Flash	53.2	53.9
	0830	Oct HCOB Service PMI Flash	52.2	52.9
	0830	Oct HCOB Composite PMI Flash	53.1	53.8
France	0815	Oct HCOB Composite PMI Flash	-	51.1
UK	0700	Sep Retail Sales (MoM%/YoY%)	-/-	0.5/2.4
	0930	Oct S&P Global Composite PMI Flash	52	52
	0930	Oct S&P Global Manufacturing PMI Flash	52	51.9
	0930	Oct S&P Global Services PMI Flash	52	52.1
Canada	1330	Aug Retail Sales Final (MoM%)	-	-0.7

Source: Refinitiv, ING

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