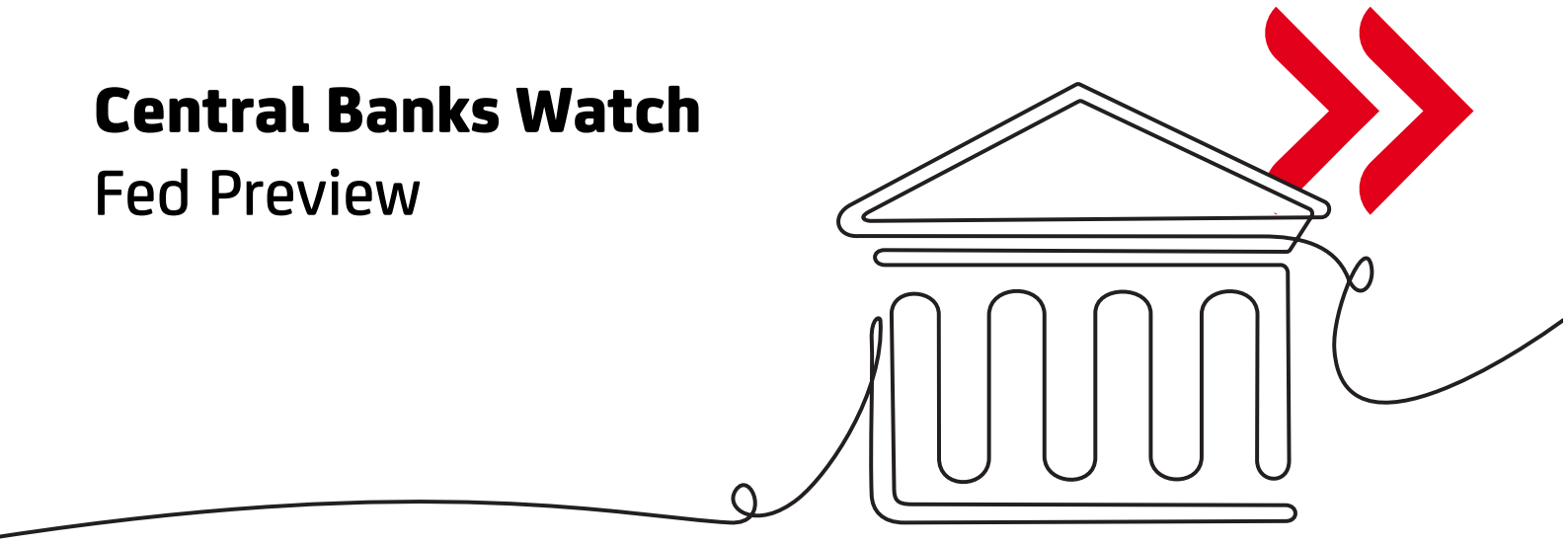
Central Banks Watch
Fed Preview



October pause, December hike

26 October 2026

On hold, but tightening bias to remain firmly in place

We expect the Fed to keep interest rates unchanged this week. This is likely to be only a pause, with the FOMC remaining on track for a December hike.

A wait-and-see mood is unlikely to provide any relief to USTs

A still resilient economic picture, persistent inflation and a Fed on hold – with Chair Warsh probably indicating the need to remain hawkish – leave little scope for a marked decline in yields, especially following the recent UST rebound.

The tone of the meeting will be key for USD

Assuming rates remain unchanged, the USD's reaction is set to depend largely on the Fed's tone regarding the possibility of further tightening. The USD could weaken further in the face of a more relaxed tone, while it is likely to soar, along with UST yields, if the Fed sounds more hawkish than expected.

We expect the Fed to leave the policy rate at 3.75-4.00% at Wednesday's meeting. The likelihood of a rate hike appears low. In September, the dot plot showed that only four FOMC participants projected an additional 50bp of tightening by year-end, suggesting limited support for consecutive rate increases. Recent remarks by Fed Vice Chair Philip Jefferson and New York Fed President John Williams further support the view that the Fed can afford to remain patient as it awaits additional information on the outlook for growth and inflation. The weaker-than-expected September nonfarm payrolls report strengthens the case for no policy action at the upcoming meeting.

However, the Fed maintains a clear tightening bias and macroeconomic data that will be published this week are likely to confirm that higher policy rates are warranted – we expect 3Q26 GDP to have expanded at a solid pace of about 3% annualised, while core PCE prices for September likely increased by 0.3% mom and 3.0% yoy.

While the FOMC statement and Fed Chair Kevin Warsh are unlikely to provide explicit forward guidance this week, we expect the press conference to signal that December is the most likely timing for the next rate increase, which would be consistent with our view and market pricing. In our baseline scenario, the Fed remains on hold throughout 2027. However, risks are increasingly skewed to the upside, as strong AI-related capital expenditure continues to support activity while persistently high energy prices and bottlenecks fuel inflationary pressures.

Market reaction

FOMC MEETING UNLIKELY TO SUPPORT USTS, ESPECIALLY AFTER THEIR RECENT RECOVERY

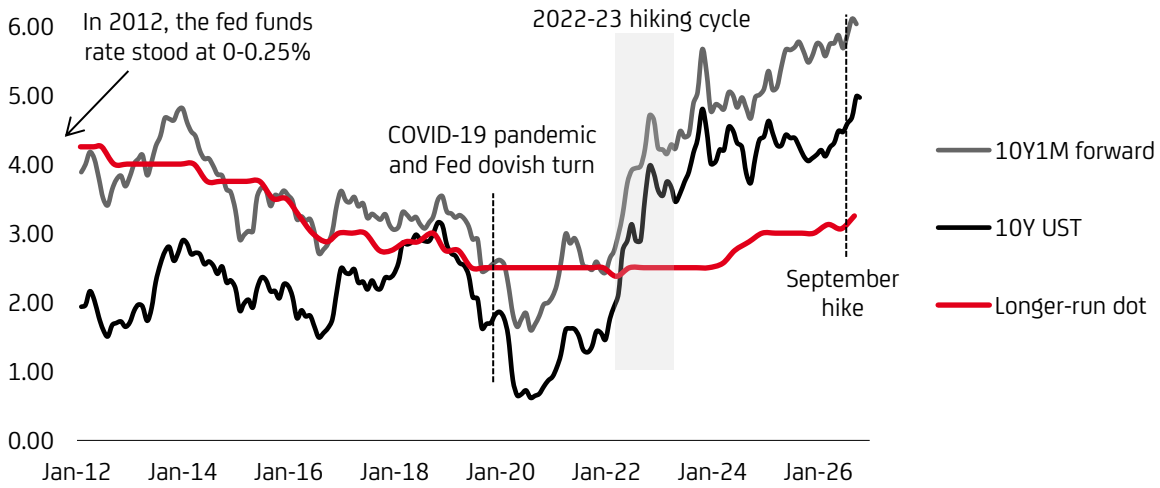
After reaching 5.3% at the beginning of October, the 10Y UST yield has since declined, supported by a flight to quality, and now stands at around 5%, close to its level before the mid-September FOMC meeting. Against this backdrop, market-based inflation expectations have remained stable, with the 5Y USD inflation swap rate at around 2.5%. This seems to confirm market confidence in the central bank's ability to control inflation. By contrast, moves in the shape of the curve have been erratic, with the 2/10Y UST spread flattening after the meeting and steepening around the turn of September and October, before flattening again. It now stands at around 32bp, not far from its level before the previous meeting.

The Fed is widely expected to remain on hold this week, likely resulting in a modest reaction for USTs. Recent data has not brought any particular news on the macroeconomic outlook, which remains characterised by sustained inflation, resilient growth and a stable job market. Financial conditions have tightened since the last meeting, in light of wider credit spreads. Furthermore, the approaching midterm elections also give Fed officials a reason to wait and see.

The Fed will not publish updated economic projections this week, following the upward revision in September. The central bank raised the longer-run dot to 3.25%, its highest level since 2016 but significantly lower than both the 10Y UST yield and the 10Y 1M forward rate (Chart 1). This gap has been widening since the second half of 2022, when the Fed started its previous hiking cycle. More generally, long-dated UST yields tend to move more in sync with the current fed funds rate than with the longer-run dot. For reference, from 2012 to 2016, when the fed funds rate was at 0-0.25%, the 10Y UST yield was below the longer-run dot. The gap between market yields and the Fed's projections suggests that Fed officials regarded the previous hiking cycle as temporary, keeping the longer-run dot relatively low. Although Warsh downplayed the importance of the neutral rate, labelling it as an "academic matter", recent indications by him and other officials seem to suggest that the US neutral rate might be above the current longer-run dot. This would indicate a 10Y UST yield in a 4.5-5% range for the foreseeable future.

CHART 1: THE GAP BETWEEN THE 10Y UST YIELD AND THE LONGER-RUN DOT HAS WIDENED

LONGER-RUN DOT VS. THE 10Y UST YIELD AND THE 10Y1M UST FORWARD RATE



Source: Bloomberg, Federal Reserve, The Investment Institute by UniCredit

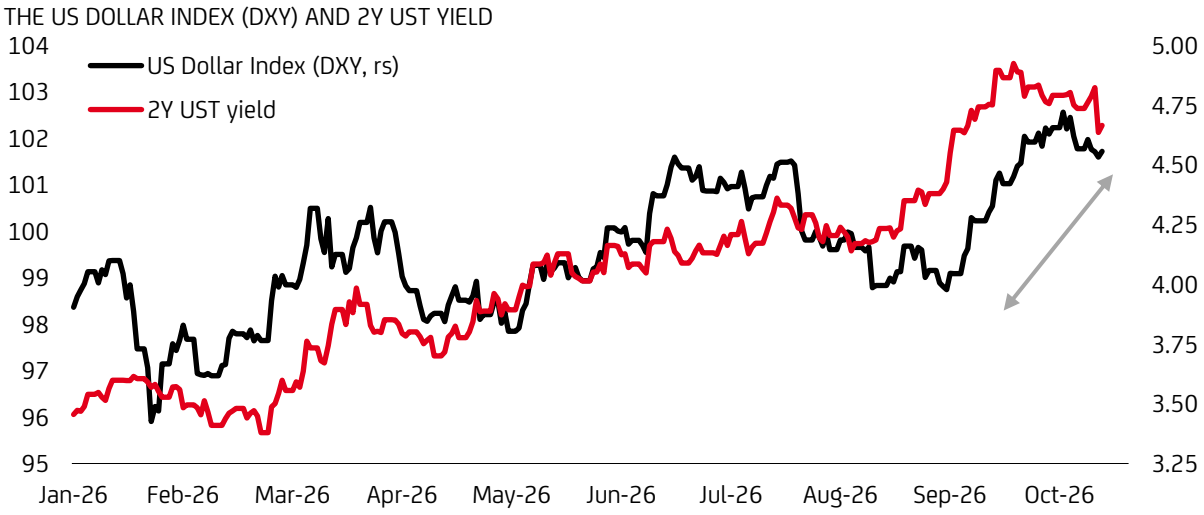
THE FED'S TONE WILL LIKELY HAVE A GREATER IMPACT ON THE USD THAN THE DECISION ITSELF

There has been much debate among investors recently about the likely outcome of this week's FOMC meeting. Markets initially anticipated a rate hike following the previous meeting in mid-September, before scaling back those expectations after John Willimas and Michelle Bowman indicated that more tightening was not urgent.

The US forward curve has scaled back the intensity of further rate hikes, now pricing in a cumulative increase of almost 65bp by September 2027. Assuming rates remain unchanged, the USD reaction is set to depend on how US long-term yields respond, given the strict correlation between the two variables (see Chart 2 below).

Therefore, the tone of the FOMC statement and, even more importantly, the tone Warsh adopts at his press conference will likely be the main driver of the greenback. If he sounds more relaxed, US forward curves could price in less additional tightening, weakening the USD further and giving the other majors some relief. If, on the other hand, the rhetoric remains hawkish, the USD is set to return on bid across the board, with UST yields soaring again.

CHART 2: THE LINK BETWEEN THE US DOLLAR INDEX (DXY) AND UST YIELDS REMAINS STRONG



Source: LSEG, The Investment Institute by UniCredit.

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