

Fed is fighting the wrong battle

- ▶ We view the Fed's 16 September hike to 3.75-4.00% as a mistake: it targets inflation the Fed cannot reach, while tightening the parts of the economy that are already weakening.
- ▶ Three weeks on, a bear-steepening yield curve, stronger USD, record equities and a rally in the bitcoin suggest markets doubt the hike addresses the underlying problem.
- ▶ We expect Fed to deliver one further 25bp hike before Q1 2027, followed by cuts in H2 2027 – a more dovish path than markets currently price.

What the Fed did

The FOMC voted 12-0 to raise the federal funds target range by 25bp to 3.75-4.00%, its first increase since July 2023, citing headline inflation stuck at 3.4% and resilient activity. The guidance was more hawkish than the move itself: 16 of 18 officials project another hike this year, and the median 2027 dot was lifted to 4.1%, erasing the easing penciled in as recently as June.

Why we think it was a mistake

Inflation is supply-driven. August's 3.4% headline CPI is largely an energy story. The energy index is up 16.3% y/y and gasoline 27.4%, reflecting the Middle East conflict, while core CPI eased to 2.4%, its lowest since March 2021. Higher policy rates do not produce more oil; they only compress the demand that remains once households have paid at the pump.

The AI debt binge is rate-insensitive. The US hyperscalers – Alphabet, Amazon, Meta, Microsoft and Oracle – are expected to spend around USD750bn on capex this year, according to S&P Global Ratings, and Goldman Sachs estimates close to USD500bn of AI-related debt issuance so far in 2026. These companies are mostly cash-rich, highly rated borrowers funding strategic, multi-year programs; an extra 25bp does not change their calculus. The bond market is already disciplining this borrowing through wider new-issue concessions – without the Fed's help.

Housing is being squeezed. The 30-year mortgage rate reached 7.28% on 1 October (Freddie Mac), its highest since November 2023 and nearly a full point above a year ago (exhibit 1) – adding more than USD200 a month to the payment on a median-priced home. Housing is the most rate-sensitive sector of the economy, and it was already soft.

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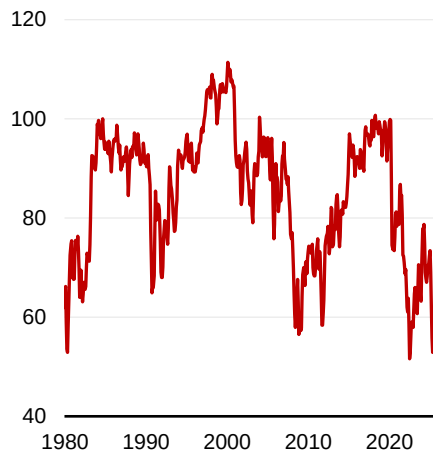
The consumer is where the hike bites. Nominal retail sales are up 6.0% y/y, but much of that is price. Real wage growth has been negative since April, consumer sentiment sits near the lowest level in the University of Michigan survey's history (exhibit 2), and September payrolls rose by just 29k as unemployment ticked up to 4.2%. Real retail spending is volatile m/m, but underlying volume growth is a fraction of the nominal headline. This is the segment the hike actually reaches.

Exhibit 1: US 30 year fixed mortgage rate (%)



Sources: Bloomberg, ADCB Asset Management

Exhibit 2: University of Michigan consumer sentiment index



Sources: Bloomberg, ADCB Asset Management

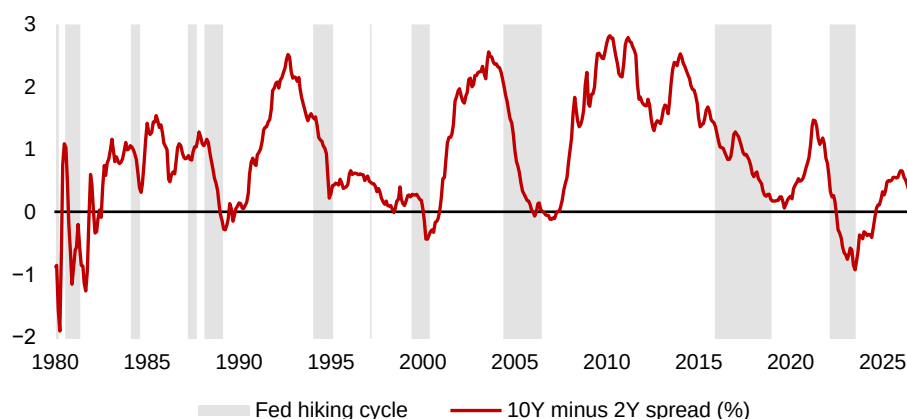
The asymmetry is the crux: the hike does little to the sources of inflation and much to the sectors that are already slowing down.

The market's verdict since September 16, 2026

In a credible tightening, front-end yields lead, the curve flattens, the dollar firms and risk assets soften. Only part of that script has played out: global bond indices are indeed down 1.5%. Risk assets, however, including equities and bitcoin marched higher in defiance. While the USD strengthened as expected, it was in part driven by weakness in the EUR caused by concerns of fiscal stress in France.

The curve did flatten for two sessions after the decision – the 2s10s spread narrowed from 33bp on the eve of the meeting to 25bp – but the long end has since led, pushing the 10-year to its highest level since 2002. A curve that bear-steepens after a hike is signaling concern about inflation persistence and fiscal supply, not confidence that policy is working (exhibit 3).

Exhibit 3: US 10Y-2Y Treasury spread (%) with Fed hiking cycles shaded

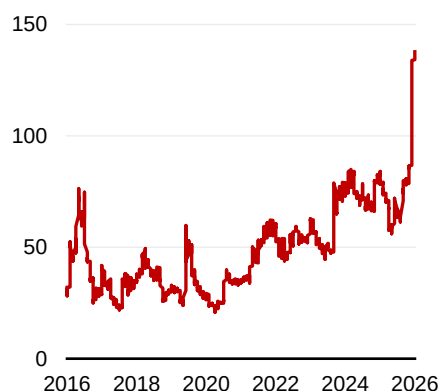


Sources: Bloomberg, ADCB Asset Management

Spillovers: Europe and lower-quality credit

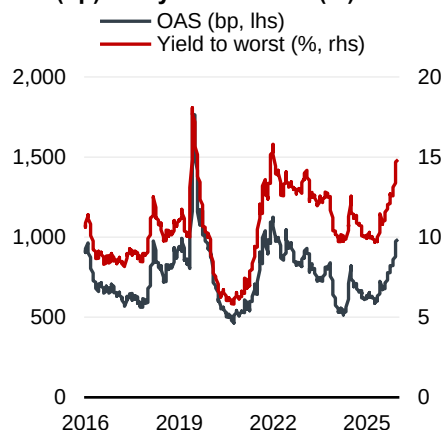
Eurozone sovereigns. Higher US yields are exporting tighter financial conditions. The 10-year OAT-Bund spread has widened from about 85bp in early September to 127bp, after touching roughly 147bp – its widest in more than a decade – as France’s fiscal and political strains are re-priced (exhibit 4).

Exhibit 4: France 10Y OAT – Germany 10Y Bund spread (bp)



Sources: Bloomberg, ADCB Asset Management

Exhibit 5: US CCC rated high yield: OAS (bp) and yield to worst (%)



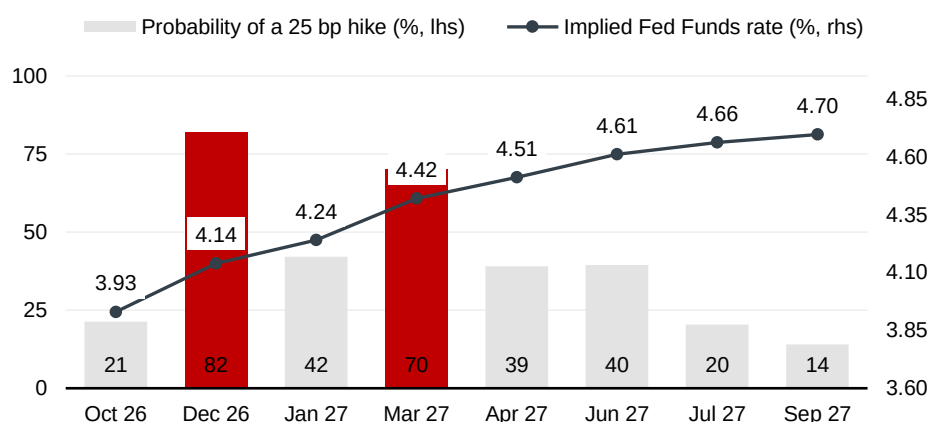
Sources: Bloomberg, ADCB Asset Management

CCC-rated credit. The ICE BofA CCC & lower option-adjusted spread reached its highest since late 2022, even as the broad high-yield spread remains near 3.1%. Stress is concentrated among the weakest, floating-rate-dependent borrowers – historically an early warning that tighter policy is beginning to bite the weakest link.

What markets are pricing

Markets have largely adopted the Fed's hawkish script. Fed funds futures imply a policy rate of about 4.2% by January 2027 – one further hike this year – with two additional hikes priced for 2027. Prediction markets put the odds of a hold on 28 October at roughly 84%, but a December hike at around 82%. In short, the market sees no easing in 2027.

Exhibit 6: Market implied Fed Funds rate and hike probability by FOMC meeting
(red column indicates the base-case)



Sources: Bloomberg, ADCB Asset Management

Our view: one more hike, then cuts in H2 2027

Having signaled further tightening, the Fed is unlikely to reverse course quickly. We expect one more 25bp hike – most likely in December and in any case before the end of Q1 2027 – taking the target range to 4.00-4.25%. Beyond that, we see the case for easing building through 2027: energy base effects should pull headline inflation lower, a softening labor market and negative real wage growth will weigh on demand, and housing will feel the full force of 7%+ mortgage rates. We therefore expect rate cuts to begin in H2 2027, a meaningfully more dovish path than markets currently price.

The key risks to our view are a further escalation in the Middle East that pushes oil higher and feeds into core inflation and expectations, and stronger-than-expected AI-driven growth that keeps the labor market tight.

Portfolio implications

- ▶ **Fixed income:** Lock in attractive yields in the 2-5 year segment, which stands to benefit most once the market prices the easing cycle; remain cautious on the long end until term premium stabilizes.
- ▶ **Credit:** While we remain pro-risk with overweight on global high yield, we would also reiterate our cautious view on lowest-quality high yield, where spreads are widening fast.
- ▶ **Equities:** Stay invested but selective. AI leadership is underpinned by earnings; while housing-linked and rate-sensitive consumer sectors remain vulnerable. By sector, we keep our preference for technology, industrials, financials, and healthcare. By country, we like the US, Japan, and Europe – the latter is low conviction.

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