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Flash Fixed Income

16 September 2026

Why markets may be wrong on rate hikes

The Federal Reserve's (Fed) 25 basis point (bp) interest rate hike on September 16 did not come as a surprise. Having delivered a hawkish speech at Jackson Hole last month, a hot inflation print for August had effectively tied the hands of Kevin Warsh, unless he wished to revisit the sort of steepening in the US Treasury (UST) curve he saw after the Fed's July meeting.

After all, the arguments for a hike were numerous: strong growth boosted by AI-driven spending, a stable labour market operating at full employment, and inflation that has now been running above target for 65 consecutive months and, thanks to the conflict in Iran, is currently on the rise.

That said, you could argue that this unwelcome trend has been driven by several shocks – Covid-19, tariffs, Iran – that will eventually fade from the numbers, while inflation expectations (as measured by breakeven rates) have been remarkably stable and close to 2%. While the labour market is at full employment, wage growth has declined from the peak in 2022 and, in our view, is more consistent with a level of core inflation at 2%. Hiking now might endanger a growth backdrop that is already experiencing some level of demand destruction from commodity price increases, so hiking into a supply shock could have the effect of magnifying the issues rather than suppressing them.

These are the discussions we believe Warsh and his Federal Open Market Committee (FOMC) will have had, versions of which we have heard from various central bankers (in the US and beyond) since the end of February.

Key takeaways

- The Fed's September rate hike bolstered its credibility on inflation, but bond yields have essentially been tracking the oil price in their recent grind higher.
- Market pricing points to three more hikes from the Fed, but we think this assumes oil prices stay high without hitting growth and dismisses the chance of a resolution in the Middle East.
- With two-year UST yields at around 4.7%, we think short end yields may offer an attractive potential hedge against both downside growth catalysts and lower oil prices.

Bond yields have tracked the oil price

However, a simpler way to look at this, particularly in recent weeks, is that the bond market is following the oil price. Market pricing has essentially gone from pricing two 25bp cuts from the Fed (and the Bank of England) this year to multiple hikes, with the short end bearing the brunt of the curve bear flattening. The differential between two- and 10-year UST yields has shrunk by 30bp since the end of February, with both maturities becoming more sensitive to oil (WTI) price movements in the recent grind higher (see the two-year move in Exhibit 1), reflecting a market that appears increasingly despondent about the prospect for some form of concrete resolution to hostilities in the Middle East.

Credit market performance

	Total return YTD (%)	Total return last 30 days (%)	Yield (%)	Duration (yrs)
EUR IG	-0.85	-1.45	4.13	4.31
GBP IG	-0.30	-0.24	5.87	5.53
US IG	-0.78	-0.36	5.68	6.26
EUR HY	0.95	-1.13	6.08	3.10
GBP HY	2.64	0.05	9.08	2.68
US HY	1.84	-0.60	7.59	3.20
EM HY	4.08	-0.62	7.70	3.91
Euro Senior Banks	-0.49	-1.24	3.99	3.55
COCO	2.40	-0.88	6.28	3.65

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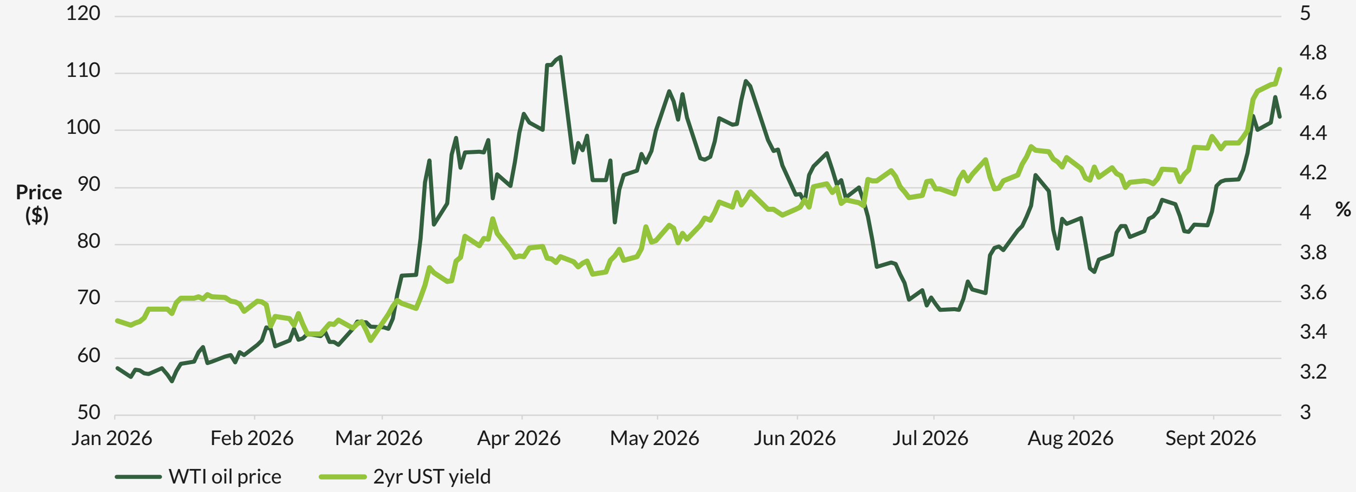
Partner, Portfolio Management, industry experience since 2012.

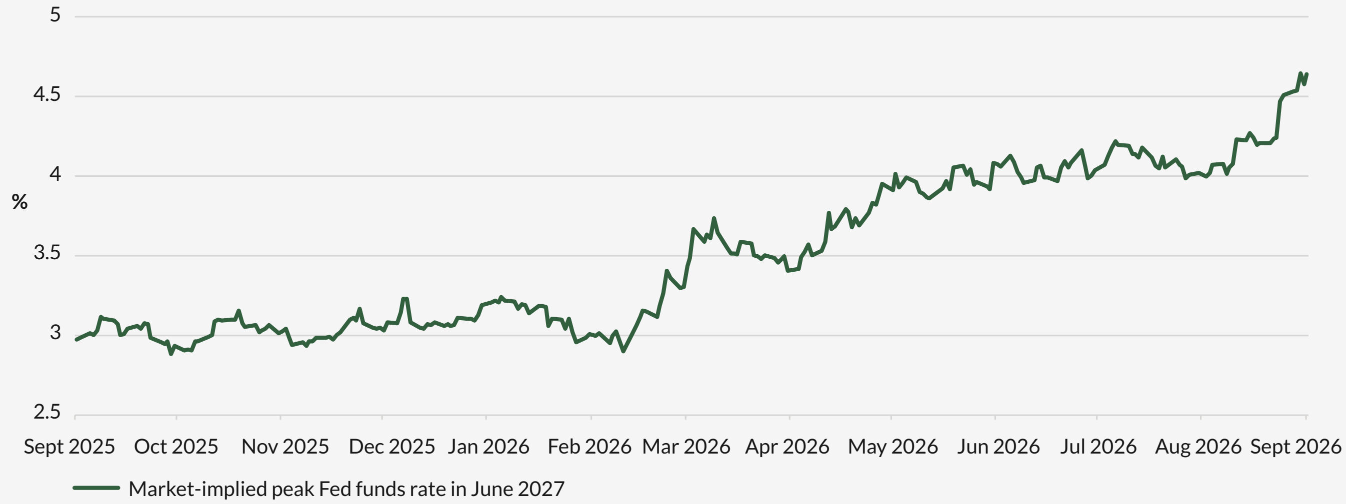
Exhibit 1: Two-year UST yields have followed the oil price



Source: Bloomberg, 16 September 2026

We see this not just in that correlation, but also in what market pricing implies about interest rate moves over the next 18 months. In effect, the market projects that developed market central banks are at the start of a hiking cycle which will see rates peak in the middle of next year and remain there through the rest of 2027. The Fed is projected to hike to 4.5%, the Bank of England to 4.8% and the European Central Bank to 3.25%, which would equate to four, four and five 25bp hikes respectively since the start of 2026. The broadly consistent cycle is interesting in itself given the differences in sensitivity of demand, wage growth and energy dependence between the different economies.

Exhibit 2: Market pricing implies US rates may hit 4.5%



Source: Bloomberg, 16 September 2026

Rates dashboard

			Change (bp)		
		Current %	1w	1m	YTD
US Treasury	2yr	4.66	8	50	119
	10yr	4.93	-3	24	76
	30yr	5.28	-8	2	44
UK Gilt	2yr	4.74	-14	38	100
	10yr	5.22	-15	19	74
	30yr	5.74	-19	-5	53
German Bund	2yr	3.23	-1	43	110
	10yr	3.48	-2	27	62
	30yr	3.84	-5	11	36

			Change (bp)		
	Market projection	Current %	1w	1m	YTD
Base rate 4.00%	end-2026	4.28	11	35	118
	end-2027	4.61	7	58	131
Base rate 3.75%	end-2026	4.17	-5	13	83
	end-2027	4.74	-15	44	118
Base rate 2.50%	end-2026	2.84	-2	22	82
	end-2027	3.31	-4	54	98

Indicative market indices, data as at 17 September 2026. Past performance is not a reliable indicator of current or future results. Included for illustrative purposes only. Shown in local currency terms. It is not possible to invest directly into an index and they will not be actively managed. Source: Bloomberg, TwentyFour.

How many hikes?

A bona fide hiking cycle is certainly possible. For this to be a "one and done" rate hike from the Fed would be historically unusual (it did happen once in 1997 before the Asian financial crisis). Ultimately, a quarter-point increase likely wouldn't do much to tighten financial conditions, and if the Fed thinks inflation is too high (for reasons to do with oil as well as other reasons), it would need to tighten financial conditions sufficiently to move the needle on reducing demand. Warsh highlighted as much at the July meeting by saying the Fed was not in the "fine-tuning" business, and he stayed the course at this month's press conference when he said this summer's inflation readings "do not tell me that underlying trends have meaningfully improved."

It is also worth noting that the futures markets that produce the chart above provide a point-in-time estimate for where the Fed funds rate might end up next year, but it is not a forecast. The futures-implied policy path contains a risk premium, and investors might be willing to pay that premium to hedge against higher rates.

Market rate expectations look exaggerated

However, we think the implied policy path shown in Exhibit 2 assumes oil prices increase further from here and stay high, that growth remains solid, and that 100bp or more of hikes on top of the reduction in real income growth from the commodity price increase does nothing to weaken demand.

In our view, that implied policy path would also appear to dismiss the chance of a resolution in the Middle East. While our level of expertise when it comes to US-Iran relations is about the same as many other market participants (i.e. low), we still view both sides as incentivised to come to a deal eventually. While that might mean an escalation in the near term (President Trump is likely to wait until after midterms to re-engage in efforts towards a resolution), we view the chance of no oil flowing through the Strait of Hormuz 12 months from now as relatively low, in part as countries build supply chains away from Iran.

In other words, the bond market seems to be pricing a continuation of the negative supply environment from an oil perspective (in the total volume of hikes being priced, if not the timing) with little chance of a resolution, while ignoring the fact that if the oil price does continue to increase, we should expect growth expectations to start declining.

Short end yields have plenty priced in

One final point is around the neutral rate, the interest rate that neither stimulates nor restricts economic activity. Discussions around "R*" can generally be taken with a pinch of salt since, much like term premium, it has to be inferred and can only be seen after the fact (with a reasonably wide confidence interval). It is true that AI might increase the real neutral rate via higher investment demand and/or higher future incomes, but it could also lower the real neutral rate via lower prices and/or higher savings. Interestingly, the "dot plot" in the Fed's latest Summary of Economic Projections showed the median FOMC member projection for long term rates had moved higher by 25bp in September, though Warsh in his press conference described the neutral rate as being useful academically but not operationally.

We therefore conclude that the market-implied policy path is plausible given the backdrop of strong growth and higher inflation, but we disagree on the destination of that rate path. The market currently appears to be pricing in a 100bp hiking cycle from the Fed into an oil shock that lasts through the next 12 months, and assuming the US economy absorbs that shock from a growth perspective.

In our view, even if that does happen, given two-year UST yields are now sitting above 4.7%, elevated yields at the short end are offering investors a relatively cheap hedge against both downside growth catalysts and lower oil prices.

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