BNY | INVESTMENTS

THE FED TAKES AIM AT PERSISTENT INFLATION

September 2026

KEY POINTS

- The Fed's 25bp hike marks a shift from hawkish rhetoric to action with policymakers indicating further tightening ahead.
- We support the Fed's decision and expect two more 25bp hikes over the next 12 months.
- We believe market pricing appears overextended and expect the Fed to hike more than the dots suggest, but less than markets imply.

The U.S. Federal Reserve's (Fed) 25 basis point (bp) rate hike on September 16 marks the beginning of its effort to bring inflation back toward its 2% target. Under Chair Warsh, the Fed's actions are now aligning with its hawkish rhetoric.

The rate hike was widely anticipated and in line with market expectations.

However, the Federal Open Market Committee took a restrictive stance: The median projections (dot plots) suggest one more hike by the end of this year. The decision reflected a "solid pace" economic expansion despite considerable geopolitical uncertainty. This assessment was also supported by firmer projections of real gross domestic product (GDP) growth, lower unemployment and a slightly higher, although stickier, path of core inflation to reach the Fed's target.

In our view, the hike was becoming overdue. Inflation risk was beginning to rise, driving the need for a tougher monetary policy response. In fact, market pricing of inflation has risen and expectations for a much higher terminal federal funds rate have also lifted real yields, contributing to much of the recent widening of nominal bond yields across the U.S. Treasury yield curve.

The Fed's projections implicitly acknowledge this point of higher-for-longer real rates. The latest Summary of Economic Projections (SEP) now forecasts core Personal Consumption Expenditures (PCE) price index inflation at 2.2% and the fed funds rate at 3.9% in 2028. These projections suggest a higher real policy rate is needed to bring inflation back down to its 2% target. By contrast, the June 2026 SEP projected core inflation at 2.1% and the fed funds rate at 3.4%. In other words, the medium-term required real policy rate just rose to 1.7% from 1.3%.

More Hikes on the Horizon

We believe the Fed may need to hike at least once more than the dot plots indicate, but less than current market pricing, which seems overstretched given lagging pipeline pressures from earlier energy and tariff shocks on core inflation. Moreover, the rising cost of semiconductors and information processing equipment will likely also take a toll in a few months' time.

However, we disagree with market expectations for four 25-basis-point hikes over the next 12 months. With federal tax refunds trailing and headline inflation above 3%, consumer real wages are stalling. These trends imply overall consumption may quickly come under more pressure than what is currently priced in. Additionally, any slowdown in AI capital expenditures (capex) is a risk that may also slow the economy more than what GDP Nowcasts and Purchasing Managers' Index (PMI) metrics currently imply.

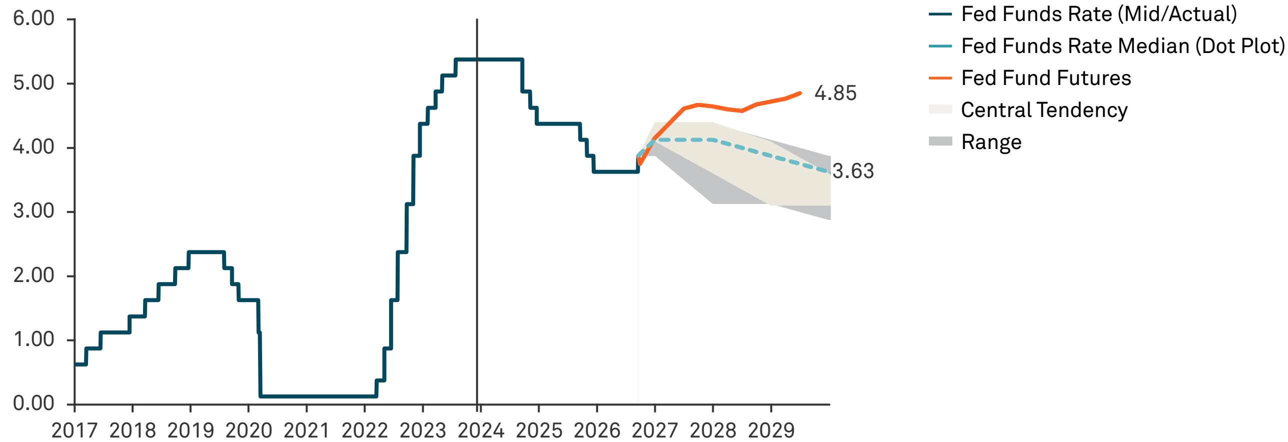
A Closer Look at Real Rates

We agree with the Fed's decision, aligning its rhetoric with specific actions to reduce elevated inflation. Even though the policy response may need to be strengthened more than what the Fed has intimated so far, we think real rates appear slightly overstretched, potentially creating opportunities to be more supportive of U.S. sovereign bonds.

Market pricing of Fed policy appears overextended.

Fed vs. Market

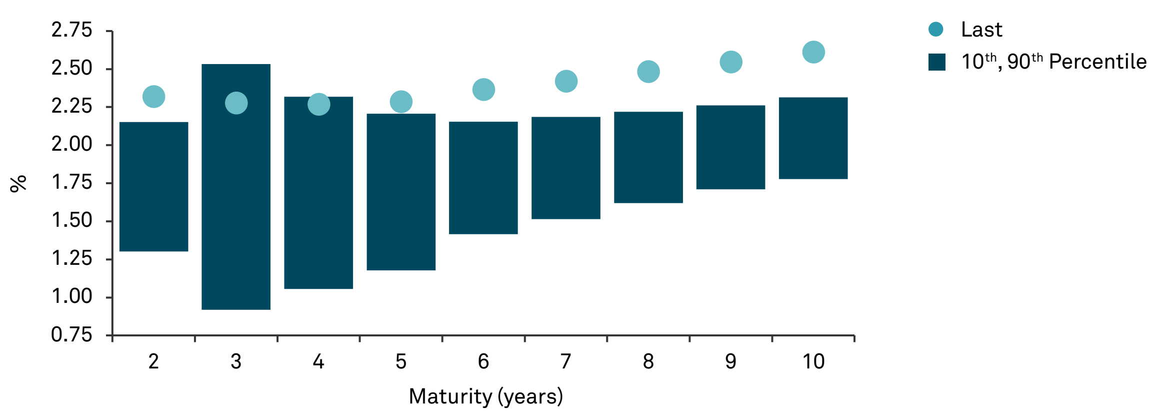
Dot Plot as of September 2026 Meeting



Source: BNY Investment Strategy & Research Group, September 17, 2026. Past performance is not indicative of future results. Chart is for illustrative purposes only.

Real rates across the Treasury Inflation-Protected Securities (TIPS) curve have cheapened, potentially raising opportunities in U.S. fixed income.

Real Rates Percentile Relative Trailing 3-Year



Source: BNY Investment Strategy & Research Group, September 16, 2026. Past performance is not indicative of future results. Chart is for illustrative purposes only.

Appendix

Core personal consumption expenditures (PCE) price index is a measure of the prices paid by consumers for goods and services in the U.S., excluding food and energy. The **federal funds rate** is the interest rate banks charge each other for overnight loans of their reserve balances held at the Federal Reserve. **Fed fund futures** are financial contracts traded on the Chicago Mercantile Exchange (CME) that track the effective federal funds rate, which is the overnight interest rate banks charge each other for loans. The **Purchasing Managers' Index (PMI)** is a monthly economic indicator that measures the health of the manufacturing and services sectors by surveying supply chain executives. **Treasury Inflation-Protected Securities (TIPS)** adjust their principal value with inflation to protect your purchasing power over time.

Risks

Bonds are subject generally to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines.

Important Information

MARK-1003276-2026-09-17

GU-943 - 1 April 2027

BNY | INVESTMENTS