

Fed set to pause, but eyeing December hike

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The Fed will seek further evidence before deciding whether sticky inflation warrants lifting the fed funds rate beyond the two hikes signaled in the latest SEP

Underlying domestic demand remains resilient despite uneven growth, as a struggling housing sector contrasts with strong consumption and AI-related investment.

Second-quarter GDP growth was revised up to 2.2% annualized from 1.5%, mainly reflecting stronger consumption and investment. Final sales to private domestic purchasers were revised up to 4.6% from 4.2%, reinforcing the strength of underlying demand ([Figure 1](#)). Consumption appears to have remained solid into 3Q, although September showed signs of moderation. Nominal retail sales fell 0.4% m/m in July before rebounding 1.3% in August and rising another 0.8% in September. However, the latter gain largely reflected higher gasoline prices, with control-group sales rising just 0.15%, down from 1.2% in August. Meanwhile, housing starts fell 5.2% m/m in September, underscoring continued weakness in rate-sensitive sectors. A growing drag from net exports lowered the Atlanta Fed's 3Q GDPNow estimate from 5.1% in mid-September to 3.5% last week. Early 4Q surveys point to continued strength elsewhere, with October's flash PMIs suggesting solid activity despite rising input costs and supply constraints. Overall, resilient domestic demand keeps the case for further tightening intact, but uneven growth and vulnerabilities in rate-sensitive sectors argue against rushing into consecutive hikes.

September's weaker-than-expected employment report pointed to slower hiring, but did little to challenge the FOMC's assessment of a broadly stable labor market. Nonfarm payrolls increased by just 29k, below expectations (90k), while July and August gains were revised down by a combined 60k, leaving the three-month average at 51k ([Figure 2](#)). Job creation remained concentrated in healthcare and social assistance (+23k), while government employment declined by 17k. AI-related shifts also became more evident, with IT-related employment falling by over 10k even as data center construction supported a 12k increase in nonresidential specialty trade contractors. The unemployment rate edged up to 4.2% from 4.1%, largely reflecting a rebound in labor force participation to 61.8%. Average hourly earnings rose just 0.1% m/m, lowering annual wage growth to 3.0%, -0.7pp below inflation, suggesting muted risks of wage-driven inflation pressures. Importantly, layoffs and jobless claims have remained low, while slower labor force growth has likely reduced the pace of hiring needed to maintain equilibrium. Overall, employment conditions appear sufficiently stable to accommodate further tightening, although softer hiring and wage growth strengthen the case for avoiding consecutive hikes.

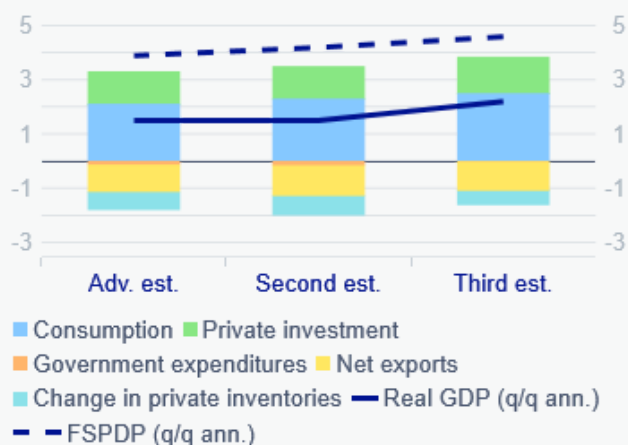
September's inflation data offered little reassurance that underlying price pressures are easing sustainably, keeping the case for additional tightening alive. Headline CPI rose 0.6% m/m, pushing annual inflation to 3.7% from 3.4%, largely reflecting a 9.1% jump in gasoline prices. More importantly, core CPI increased 0.33% m/m, above expectations (0.2%), lifting the annual rate to 2.6% from 2.4%. The acceleration was relatively broad-based. Core goods prices rose 0.3%, including used vehicles (+0.7%), while shelter inflation accelerated to 0.4%, alongside firmer medical and recreational services prices. The latest CPI reading is consistent with the recent PCE inflation trend ([Figure 3](#)). Although energy-related disruptions amid the Middle East conflict and supply constraints explain part of the inflation picture, broader core price increases raise concerns that disinflation may be progressing more slowly than anticipated. While the latest data could justify a second consecutive hike, Fed officials showed little appetite for immediate action ahead of the blackout window. A pause, therefore, will likely be a "hawkish hold" that emphasizes the Committee's commitment to restoring price stability.

While Fed communication and market pricing point toward a pause this week, the Committee's tightening bias will likely remain firmly intact. The September minutes showed that "many participants" favored a higher policy-rate path on "risk-management grounds," while "most participants" considered another hike appropriate by year-end, without signaling a prolonged tightening cycle. Subsequent remarks by voting members Williams ("no need for urgency") and Jefferson ("take more time") ahead of the blackout period reinforced expectations of a pause. Fed funds futures now assign roughly a 90% probability to that outcome, while still pricing a high likelihood of another hike by December. Meanwhile, Treasury yields have retreated after rising sharply earlier this month. The 10-year yield briefly reached around 5.3% before falling back toward 5%, while the 2-year yield returned to levels near those prevailing after September's meeting ([Figure 4](#)). The reversal appears to reflect both reduced conviction in an aggressive tightening cycle and renewed buying interest at elevated yields, challenging the narrative of an indiscriminate Treasury selloff. Overall, markets appear increasingly aligned with a gradual pace of policy tightening rather than a rapid succession of rate hikes.

We expect the FOMC to leave the fed funds target range unchanged at 3.75-4.00% this week, pairing the pause with a hawkish narrative. Most officials appear to see limited costs to waiting another meeting, particularly as further tightening may do little to restrain AI-related investment while increasing vulnerabilities in rate-sensitive sectors should technology valuations correct sharply. Nevertheless, the risk of another hike this week cannot be dismissed. The post-pandemic inflation experience has likely heightened policymakers' sensitivity to falling behind the curve, potentially making them willing to surprise markets to reinforce their inflation-fighting credibility. While some dissents in favor of a hike are possible, we expect Warsh to defend the pause by emphasizing the value of assessing broader economic trends without weakening the Committee's commitment to 2% inflation. His remarks will also be important for gauging whether the Fed still favors a risk-management approach or is becoming more inclined toward a prolonged tightening cycle, a risk suggested by Waller's recent reference to "additional hikes." With no updated SEP scheduled for release this week, clearer evidence of a policy shift may not emerge until December.

Second-quarter GDP growth was revised up amid stronger consumption and investment

FIGURE 1. 3Q26 REAL GDP GROWTH (%)



Source: BBVA Research, Macrobond

Nonfarm payrolls increased by just 29k, below expectations (90k)

FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research, Macrobond

The latest CPI reading is consistent with the recent PCE inflation trend

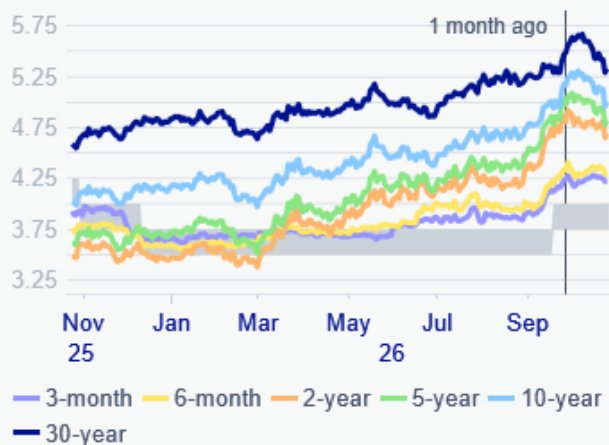
FIGURE 3. CORE INFLATION (%)



Source: BBVA Research, Macrobond

The reversal of Treasury yields challenges the narrative of an indiscriminate selloff

FIGURE 4. TREASURY YIELDS (%)



The gray area indicates the fed funds rate target range
Source: BBVA Research, Macrobond

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