Research @ Citi Markets Edition: Writing on the Wall(er) — Fed Hawks Are Back in Town

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Transcript:

Opening Teaser: (00:00)

Research @ Citi Markets Edition.

Dirk Willer (00:03)

Welcome to Research @ Citi Markets Edition, where we break down global macro in 10 minutes or less. I'm your host, Dirk Willer, Citi's Global Head of Macro, and with you today is Adam Pickett, our Head of Macro in London.

Adam Pickett (00:13)

Great to be here, Dirk.

Dirk Willer (00:14)

We are recording this podcast at 9 a.m. on Monday, Nov. 16, 2026.

Last week was a triple whammy for U.S. rates. It was a combination of a high CPI, hawkish Fedspeak, and also higher equities. Let's unpack those three factors to see what the future holds.

On the CPI, there is some signs of high energy costs passing through. However, the PPI is pointing less clearly to that factor. We do see continuing rises in PC and electronic prices, so the impact of AI is there.

And the PPI suggests a 0.27 month-over-month reading for the PCE in October, which is, of course, the main focus for the Fed. So, another rounded 0.3. And shelter also was sticky.

Now, going forward, inflation readings for the next few months might also be strong. The year over year will go up mechanically due to the government shutdown last year. And then January and February are usually strong, due to residual seasonality, which is something the seasonality procedures don't quite pick up. And firms are, of course, setting higher prices for the coming calendar year. Only after that will the more positive base effects from oil potentially kick in. So, on the CPI side, we probably get more of what we just got.

Adam Pickett (01:22)

And Dirk, Waller was on the tapes talking about 50 [basis points for a hike], but doesn't look like the rest of the committee back him. But the rate pricing still stayed quite sticky. What do you make of it all?

Dirk Willer (01:33)

Yeah, exactly. Fedspeak was the second big negative that we got for rates last week, right?

So we had Waller, as you point out. But I think all that is doing, it's resetting the agenda a little bit. Because if at least one committee member calls for 50, then what happens is the three possibilities on the agenda are 25 per quarter, which was the current state of affairs; and then on the other end of the spectrum, we have the 50; and in the middle, you have somewhere the 25, followed by a quick second 25, and maybe a quick third 25.

And just given how these committees work, you would imagine that if that is how the agenda has been set, the easiest compromise is to go on a 25-each-meeting type of agreement. And that, indeed, is probably a rising probability to happen. I mean, our economists still believe one hike, but they're very open to the likelihood of a second one. And, of course, if the inflation data should remain challenging, the third one can clearly not be ruled out.

The third factor was equity markets, which we covered. That, of course, is maybe the least clear factor at this stage. So we have, on the one hand, the third aircraft carrier arriving in the region, so there is still meaningful Iran risk over the next few weeks, I think. And then secondly, of course, the AI story keeps rumbling on in the background as well. So that would be maybe the one risk to a more-bearish view on U.S. rates.

And so, taking all these three factors together, what do we make of it? What we had done to analyze it, we thought the best way to summarize it is the Warsh shadow rate, which is essentially taking all the indicators that Chair Warsh mentioned as important during the Jackson Hole speech. And these indicators are actually lining up. If you sort of average them up and take a Z-score, they're really lining up quite nicely with Fed decisions during the Greenspan years.

And that's relevant because Greenspan is likely the favorite Fed chair of Mr. Warsh. The indicator breaks down after the GFC, and the Fed stayed dovish much longer than that indicator would have suggested. But this is, of course, a time when Chair Warsh left the Fed at the time, being somewhat unhappy about the prolonged Fed dovishness. And subsequently, the indicator again has become a bit more correlated with Fed funds, but it's more leading than it used to.

So if you take that at face value, we still think even that this indicator really is at the highs right now that Chair Warsh is on the hawkish side of this camp. There is, of

course, a question a little bit whether he controls the committee sufficiently, but the committee, of course, has been quite hawkish too lately, and so that is really our base case.

Now, as I mentioned, markets could still short-circuit that, and whenever the S&P is off 20% from the one-year highs, the likelihood of Fed cuts rises very, very quickly. And, of course, you price out hikes well before the S&P is down that much. So, markets will have to play ball for these more aggressive Fed hikes to happen. But we think the way to trade that, or to position for that, is that receivers for options can really be quite good hedges if you're long equities. Because if that changes, the Fed would change tune really quite fast.

But Adam, the hawkish Fed view can, of course, also be expressed in the relative-value space. How would you go about that?

Adam Pickett (04:30)

That's right, Dirk. I think against the ECB makes the most sense. and especially out to end ‘27, we think there's further room for hawkish Fed vs. dovish ECB divergence to occur, for a couple of reasons. One is, simply, it feels to us from the data that there's more endogenous inflation risk in the U.S., relative to Europe, and that's aided and abetted by the growth picture.

Secondly, Europe clearly has some fiscal concerns related to France, where we feel as though, if the fiscal risk via the sovereign spread channel is to get worse, it's easy insurance for the ECB to take out against that factor by simply slowing down a little bit. Whereas we really think things would have to get considerably worse for them to use TPI.

In the U.S., there isn't really this consideration as much. Perhaps if AI really unraveled, that would cause the Fed to get more dovish. But in the past, we've done work around the concept of the Fed put, and we find it's much closer to a 10% drawdown from the highs in the S&P on average. But when inflation is high and rising, that can be much closer to 20% to 30%.

At the time of this discussion, we're only down about 3% from the highs in the S&P, so quite far away from their put, whereas I almost feel as though the ECB's France put could be closer to the money.

Lastly, on the leadership, you've already discussed the hawkish intonations from Warsh. The factors driving his view in our Warsh shadow rate are at all-time highs. On the flipside, with the ECB, we're moving into a world where it looks likely that de Cos, a dove, is going to be the new ECB head. And really, it's only the external factors like energy that are keeping the ECB hawkish. For now, they don't see second-round effects, and the house view for energy prices is for them to soften into next year.

So, all in all, we think Fed vs. ECB is a good way to play it.

Dirk Willer (06:25)

That sounds as if there should be major FX implications of that view as well, Adam, of course, in particular on the euro.

Adam Pickett (06:30)

That's right, Dirk. And I think if it wasn't for this AI uncertainty, we would be more firmly dollar-bullish. Regular listeners will know we have a model for euro-dollar. It's called Eureka: relative rates, relative equities, relative terms of trade in momentum space, and similarly data momentum.

At the moment, the factors are neutral across the four of them for euro-dollar. But more interestingly, when we dig under the surface as to which factor has performed well this year, by far and away, it's the relative-equity factor. And so, while we've laid out the case for the Fed vs. ECB factor to continue to move in favor of the dollar, the relative-equity factor, for the time being, is actually in favor of Europe. And we still have a ton of question marks around the AI trade in the short term.

So, to wrap it up, I would say if we can get some stabilization in U.S. equities in the AI trade, we're probably going to look a little bit more like U.S. exceptionalism, right-hand side of the dollar smile. But for now, because that factor has been so dominant and because it's so uncertain, it's tough to make a strong dollar case just on the basis of a hawkish Fed.

Dirk Willer (07:38)

That's great. And I think there are other ways to express fears of your weakness, of course.

But to sum it up, so U.S. rates were really hit by a triple whammy: inflation, hawkish Fed speech, and better equities. I think inflation and a more hawkish Fed may continue for now, leading to continued upside risks for U.S. rates here.

Weaker equities are the main factor that could lead to lower rates. And we see therefore the best expression really as positioning in terms of U.S. rates relative to European rates move higher. And on the euro, maybe we would express it more against the basket of G8 really rather than against the dollar.

Thank you for joining us today. This episode was recorded on Nov. 16, 2026, and I'm your host, Dirk Willer.

For more details, Citi clients can check out our report on Citi Velocity, and next week's Research @ Citi Markets Edition will be hosted by Scott Chronert, Citi's Head of U.S. Equity Strategy. Also, check out other Research @ Citi podcasts, which you can view on the same channel.

The Macro Strategy Team will be back in two weeks' time. Stay sharp!

Disclaimer (08:35)

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