Research @ Citi Markets Edition: Hawkish Central Banks, USDJPY and the Return of Bitcoin

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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 me today is Alex Saunders, our Head of Quant Macro. Welcome to the show, Alex.

Alex Saunders (00:16)

Thanks, Dirk. Great to be back.

Dirk Willer (00:18)

We are recording this podcast at 8:30 am on Monday, Sept. 21, 2026.

Over the last two weeks, markets have been hit with a whole host of hawkish central-bank meetings. From Kevin Warsh's Fed to the ECB, to the BoE. How should we trade rates and also equities in light of such hawkish surprises? Let's dive right in.

The Fed delivered a hawkish 25-basis-point rate hike with Chair Kevin Warsh signaling a commitment to policy discipline. The median federal funds projection, the summary of economic projections, was raised to 4.1% for end-2026 and remained there for 2027.

On rates, there are a few rules of thumb how to trade a hiking cycle. First, you're supposed to pay around six months before the first hike. You're supposed to stay paid until there's only one hike left or so, and then you should start to receive. And you should focus your payers on the front end as the curve tends to bear-flatten.

Of course, that is much easier said than done, as we never know the timing of the first hike or the extent of the cycle in advance. But it still gives you a good framework to think through.

At this stage, there are a couple of different possibilities. Citi Economics thinks it's one and done, which would mean that payers are already mature and we should switch to receivers soon. But of course, it's extremely rare that the Fed hikes only once. Mostly

1997 comes to mind, but the reason for the Fed to change back then was the Asian crisis, spilling into Russia, into LTCM, and eventually getting us those Fed cuts. We therefore should also think about the more hawkish outcomes than the base case from Citi.

There are two separate cases. One is that the FOMC comes to the conclusion that the last three cuts were essentially too much, as they were done preemptively to avoid a weakening of the labor market. And the labor market never really weakened, and therefore those three cuts probably exposed, though it would appear necessary, and therefore we could move up to the upper end or just above the range of estimates for neutral, and then we would get two or three more hikes.

And that is more or less what the market is pricing at this stage. So if that is the case, there would not be much PnL for payers here. And in any case, if you are supposed to receive again, when there's only one hike left, then the time period for payers really is moving away from us very quickly.

But of course, there's even a more hawkish outcome that's plausible. And that is that the AI bubble keeps inflating and eventually it's a much broader strength than just in the AI-related industries themselves. And that leads to a much larger hiking cycle because you get a strong labor market and maybe wages rising. And then the Fed would have to do more.

Of course, in 1999 to 2000, they were forced into 175 basis points of hikes. And if that were the right analog, then, of course, payers would continue to give.

There is probably a case for cuts as well. There would be a bursting AI bubble. But at this stage, we think the skew is, from what is priced, the risk is for a larger cycle and higher rates rather than the cycle being cut short by problems in the equity market and the AI boom. So that leaves us really cautious on front ends here, in spite of the large moves that already happened.

What about the back end? We also think we have to be cautious on the back ends because we think if we were to get this larger hiking cycle, we don't think 30-year has peaked either. So, the issue really here for Chair Warsh at the moment is growth much more than credibility that could undermine the back end, which we think in the end will likely sell off at the front end.

So, we think overall, Mr. Bessent got a little bit unlucky, first with oil, then with a more hawkish Fed, which made this 5.30, 11.30s quite difficult to hold. We think he has bullets left, so we would express bearish views if we have them at the front end, but higher oil prices will certainly make life difficult even for the back end.

Alex, let's move to equities. How do they behave across these hiking cycles by the Fed?

Alex Saunders (04:08)

You get those typical sort of short-lived jitters around the fast hike. Equity markets in the median case tend to bottom six weeks, maybe two months after that first hike, and then that gets faded. This time around actually coincides with the U.S. midterm election season, which is heating up now, and around those elections you get increases in implied roll. Now having said that, the MOVE Index hadn't, pardon the pun, moved that much around this first hike that we saw.

We often get the question from clients — or we have recently — if there's a level of yields that, quote unquote, breaks the equity market. And our studies have shown that that's usually not the case. Number one, the composition tends to matter much more than the level, and the composition this time around has been relatively benign. It's not been from swap spreads. It's been much more break-even, it's been much more real yields driven.

And then the other thing is that the changes matter more, i.e. the term premia matters more. The term premia has been relatively well behaved, it's even declined. And we've seen some flattening, as you had mentioned, Dirk. So in terms of equities, the big-picture backdrop still seems OK in our view. But you do get these jitters, both around elections and around the fast hike of the cycle.

The other thing that's sort of important, and it is a risk that we've flagged before, is the AI story and regulation. Now, obviously, that's come to the fore with the Hugging Face incident. But for now, it seems like the pacing story is much more about shaping regulation than something that would be severe enough to lower the demand for compute.

However, there are risks there if we did get a broader incident. Then regulation may become more stringent. Difficult to trade, that is headline risk, obviously post-election as well. Depending on the result, we may get more stringent regulation but that's speculative for now.

Dirk, you had gone through, I think, the price of resilience has been those higher yields. But one central bank that hasn't out-hawked expectations, if you will, was the BOJ. What's your thinking on that?

Dirk Willer (06:20)

You're right. That was actually a more dovish meeting of the G10 central banks that we got. And in particular, two doves, which were both government appointees, voted for hold. And given that the number of appointees will go up in July of next year, the market took that meeting as dovish.

But interestingly, it was mostly the FX market that reacted, while the rates market didn't move as much. I think partly because there's some view, that also Citi Economics holds, that the central bank might be forced to actually speed up the hikes a little bit if they think they will not be able to have a quorum as easily to be reached once the BOJ composition changes. And so the front didn't do much, but dollar-yen higher.

And it seems to me it does make sense, in that part of the yen strength was driven by the idea that the BOJ could out-hawk the Fed, because for a while it looked like the Fed might be patient. And for the BOJ, we put more hikes into the curve. But at this stage, with a more hawkish Fed, it seems much less likely that the BOJ can actually out-hawk the Fed. And so I think the long yen positions, which had grown over time, were certainly pared back over the last week or so.

But I think it's important to keep in mind that the bullish yen story was not just the BOJ becoming more hawkish. It was also a pension fund, GPIF, which remains a very bullish yen force. And it is the world's largest pension fund, managing over 300 trillion yen. Back in 2014, when they cut domestic bonds from 60 to 35 percent and bought foreign equities, it triggered a massive yen depreciation.

Now, of course, the suggestion is the opposite might be happening, partly driven by the surprise board meeting that we had in August. So it's plausible that the local bonds will move up by 10 percentage points or so, probably funded by reducing foreign bond holdings. And those are just structurally very, very large repatriation flows. The 10 percentage points obviously are 30 trillion yen. And that would be, of course, a major tailwind, both for the yen and for JGBs.

Maybe a bigger deal for JGB just because liquidity is less, but both would really benefit. And in the end, it's one of the reasons why we cut our JGB in the way that we had for quite a long time on and off, because the F risk would be really quite supportive.

But let's quickly talk to finish up on something completely different, Alex. Bitcoin is one asset that completely ignored the hawkish Fed. What's going on there?

Alex Saunders (08:55)

Yeah, it's not just the hawkish Fed, Dirk. The CLARITY Act failed in the Senate, failed to get enough votes for cloture. And yet we've seen a rally in price.

And this goes back to — and we discussed it on the pod — the debasement trade and the announcement of Treasury buybacks, which was a boost for gold and Bitcoin a few weeks ago. We found it difficult to disentangle how much of the crypto price action was from this debasement trade and how much was from regulation, as there were some headlines around regulation around the same time.

Well, now it appears to have been — or we see at least a little bit more evidence — around the regulation because despite the failure of the CLARITY Act, we've seen new rules and we think that the SEC will still go ahead with rulemaking around crypto markets, which has generated more interest.

As you know, and as we've discussed, crypto markets are among the most reflexive and sentiment-driven. We're now trading above 200-day moving averages and other moving averages. Trend-following works particularly well in crypto markets.

And then an interesting one that we had flagged about a year ago now is that it's also been useful for trading the Nasdaq, right? So, if Bitcoin's trading above its 55-day moving average, typically Nasdaq returns tend to be higher, reflecting that investor risk appetite and sentiment, if you will.

Dirk Willer (10:19)

Great. Thank you very much, Alex.

This brings us to the end of the show. So in summary, G10 central-bank meetings were largely hawkish, including the Fed. We think the time to receive is when there's only one hike left. And again, there are several cases that you could consider.

Citi Econ, of course, in the case that that is already the case right now. But there are certainly risk cases that we have to take seriously. And so, we stay somewhat cautious on front ends and duration in the important G10 curves. The impact on equity is usually fairly short-lived.

The most dovish surprise was the BOJ, pushing the dollar-yen higher. But we really have to keep the GPIF flows in mind here, especially for JGBs as well.

Thank you for joining us. This episode was recorded on Sept. 21, 2026. And I'm your host, Dirk Willer. For more details, Citi clients can check our reports on Citi Velocity.

Next week's Research @ Citi Markets Edition will be hosted by Scott Chronert, Citi's Head of U.S. Equity Strategy. And be sure to watch out for other Research @ Citi offerings, which you can view on the same channel. The macro strategy team will be back in two weeks. Stay sharp!