

What to expect from the Fed in 2026?

At the beginning of 2026, our baseline macroeconomic view for the United States was broadly constructive. A powerful wave of artificial intelligence (AI) related capital expenditures, improving productivity dynamics, and the gradual normalization of shelter inflation were expected to create a “Goldilocks” environment for the US economy. In such a scenario, economic growth would remain robust while inflation continued to moderate. This combination would be further supported by the Federal Reserve (Fed) to proceeding with the monetary easing cycle that began in September 2024, gradually bringing policy down to more accommodative levels.

US Fed fund rate
 (% per year, 2021-2026)



Sources: Haver, QNB analysis

However, the optimistic narrative has been challenged early in the year. A series of adverse developments has raised question marks about the macroeconomic outlook. These include renewed trade policy tensions, increased volatility in US foreign policy, and major disruptions in global commodity markets following the geopolitical shock. The combination of this and supply constraints, particularly in energy markets, has pushed hydrocarbon prices sharply higher. As a result, financial markets have started to consider more conservative macroeconomic assumptions for the US economy. In particular, investors have increasingly focused on the possibility that new

negative shocks could generate “stagflationary” dynamics, potentially preventing the Fed from delivering any further rate cuts or even pushing it to enact rate hikes this year.

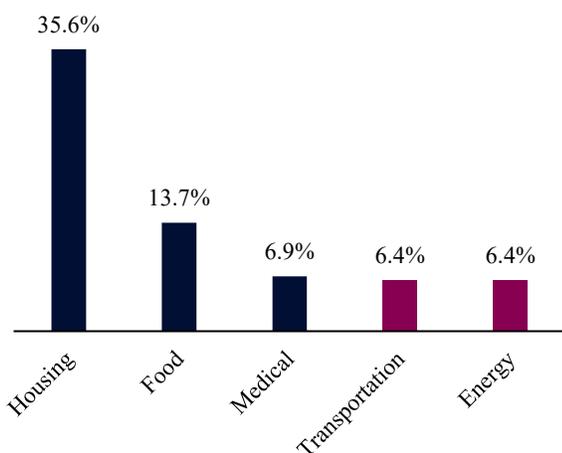
In our view, such concerns are overstated. While recent developments have complicated the macroeconomic landscape, they are unlikely to fundamentally alter the Fed’s medium term policy trajectory. We continue to expect the Fed to deliver two additional rate cuts in 2026, extending the easing cycle that started in September 2024 and bringing the policy rate to around 3.25% by year end. Three factors sustain our view.

First, supply side shocks and inflationary pressures driven by geopolitical developments tend to be temporary and are largely immune to interest rate changes. Monetary policy operates primarily by influencing financial conditions and aggregate demand. It is therefore poorly suited to address disruptions that originate from the supply side of the economy, including energy shortages, trade restrictions, or logistical bottlenecks. Historical experience shows that central banks typically “look through” such episodes when they are expected to be temporary. Attempting to offset supply driven inflation through tighter monetary policy would risk amplifying the negative effects on economic activity while doing little to reduce price pressures. As long as geopolitical disruptions appear to be temporary as of today, the Fed is likely to treat them as transitory developments rather than as a reason to halt its easing cycle.

Second, although higher hydrocarbon prices contribute to inflation, their overall impact on the US consumer price index (CPI) is limited. Energy and transportation together account for only about 12.8% of the US consumption basket. Even significant increases in fuel or oil prices therefore translate into relatively moderate effects on headline inflation. Moreover, other components of inflation are already showing clear signs of moderation. Housing inflation, which has been the most persistent source of price pressures in recent years, is gradually decelerating as rental markets cool and new housing supply comes online. Given that housing related costs represent the largest component of the CPI

basket, continued moderation in shelter inflation is likely to offset part of the upward pressure generated by higher energy prices. As a result, the overall inflation trajectory should remain consistent with a gradual return toward the Fed’s target.

Breakdown of US CPI basket
 (% of total by major component)



Sources: Haver, QNB analysis

Third, the balance of risks for the Fed has increasingly shifted from inflation toward employment. Labour market conditions have softened noticeably in recent quarters. Job openings

have declined significantly from their post pandemic peaks, layoffs have accelerated in several sectors, and private payroll indicators point to further moderation in hiring conditions. At the same time, the rapid adoption of AI technologies is encouraging companies to improve efficiency and rationalize labour costs. This combination of cyclical cooling and structural productivity improvements suggests that the US labour market is transitioning from a period of excess demand to one characterized by gradually increasing slack. For a central bank operating under a dual mandate of price stability and maximum employment, signs of labour market deterioration will strengthen the case for additional policy easing.

All in all, while geopolitical tensions and commodity price volatility have complicated the macroeconomic outlook for 2026, they are unlikely to derail the broader disinflationary trend in the US economy. In our view, as of today, supply impact on inflation should remain contained, and labour market conditions are gradually softening. Taken together, these factors support our expectation that the Fed will continue its gradual normalization of monetary policy, delivering two additional rate cuts this year and bringing the policy rate to 3.25%.

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