US ECONOMICS ANALYST

October FOMC Preview: Hiking at a Slower Pace

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- Comments from FOMC participants since their last meeting point to a compromise to raise the funds rate every other meeting. This means that the FOMC is set to skip raising rates at its October meeting but is likely to deliver a second hike in December.
- The Fed's hawkish pivot has contributed to a large increase in interest rates that has driven a moderate tightening since September in broad financial conditions, which before then had been little changed on net this year. But the tightening is only a bit more than is usually associated with one rate hike and much less than is usually associated with the four hikes the market has now priced, meaning that the FOMC is unlikely to see it as excessive or a replacement for hikes.
- A key question for the October meeting this week is how the FOMC will modify the sentence in its statement that refers to the hike at the September meeting. We think it might adapt language from Vice Chair Jefferson's recent speech to say, "Any further adjustments to the target range for the federal funds rate to support a timelier return to the Committee's 2 percent goal will depend on trends in the data, the evolving outlook, and the balance of risks."
- We do not expect significant new information from the press conference. The seemingly strong support for hiking every other meeting means there is likely a high bar to deviate from that plan through the end of the year, which should limit the impact of Fed communication for now. And even if the FOMC decides to change course in the future and wants to communicate this to markets, Chairman Warsh's decision not to hint at the slower pace at his September press conference suggests he might prefer to leave that to others.
- If the FOMC sticks to an every-other-meeting pace in 2027, it could consider hiking in March, by which point we will have five more months of inflation data. We do not expect a hike in March because we expect the inflation trend to improve as the effects of tariffs, the energy shock, and AI price pressures diminish. We also suspect that some FOMC participants share our views that the economy is not overheated and that the inflation overshoot caused by past supply shocks will largely have to be waited out, and they might prefer to limit the total size of the hiking cycle. If concerns about growth or employment emerged, that would likely bring hikes to an end too.
- That said, a March hike is possible if the inflation numbers are worse than we

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expect. The most important risk is that oil futures are above our forecasts, largely reflecting concerns about potential further conflict with Iran. The more extreme and long-lasting the energy shock becomes, the more FOMC participants will worry that inflationary pressures could broaden and the greater the risk of a larger "January effect" in the inflation numbers as companies take the opportunity provided by start-of-the-year price increases to pass along their higher costs.

- Market pricing of the Fed's path has taken out one hike and now peaks at just over 4.5%. Our baseline and probability-weighted Fed forecasts are considerably less hawkish, both because we are skeptical that the FOMC will hike four times and because we expect cuts down the road.

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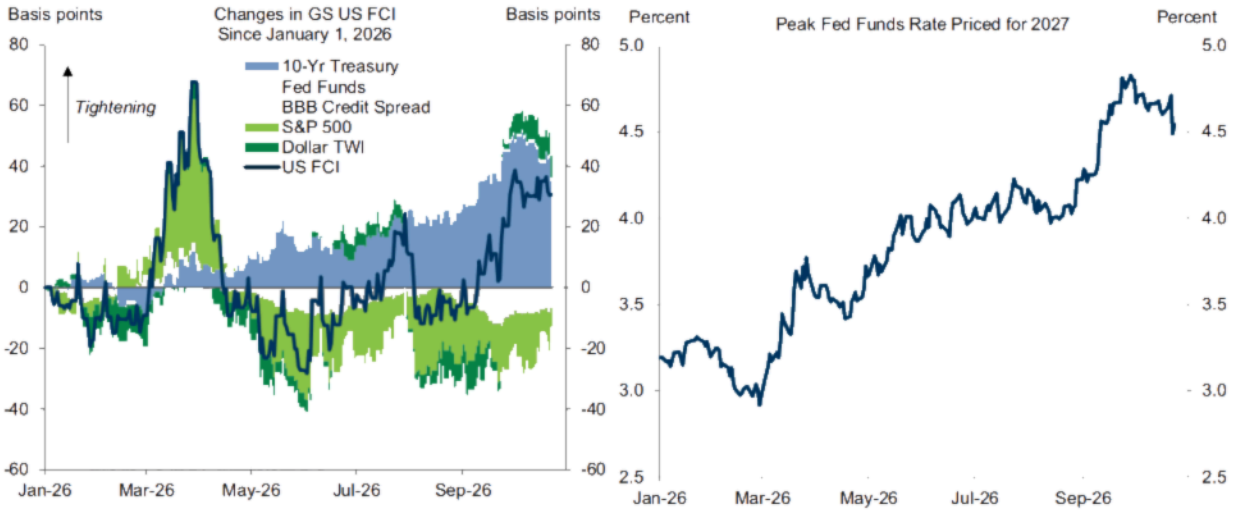
Comments from FOMC participants since their last meeting point to a compromise to raise the funds rate every other meeting. As our latest FOMC Chatterbox highlighted, participants have said that they do not see "urgency" to deliver additional hikes and that hikes "do not need to come at consecutive meetings, but they should be in place in an acceptable period of time," as Governor Waller put it.

An every-other-meeting pace means that the FOMC, having just hiked in September, is set to skip raising rates at its October meeting this week but is likely to deliver a second hike in December. This is in line with our forecast, which calls for a second and final hike in December.

The Fed's hawkish pivot has contributed to a large increase in interest rates that has driven a moderate tightening since September in our Financial Conditions Index, which until then had been little changed this year because higher rates had been offset by higher stock prices and narrower credit spreads (Exhibit 1, left).

The 30bp tightening in our FCI is only a bit more than is usually associated with one 25bp rate hike and is much less than is usually associated with the four hikes the market has now priced or the even larger turnaround in expectations for where the funds rate will stand by 2027 since the start of the year (Exhibit 1, right). The limited size of the move and the fact that it has come from a rise in interest rates that is largely contingent on expectations for further hikes means that the FOMC is unlikely to see the tightening in financial conditions to date as excessive or a replacement for additional rate hikes.

Exhibit 1: Financial Conditions Have Begun to Tighten More Meaningfully Since September, Though the Tightening Remains Limited Relative to the Hawkish Shift in Market Expectations for the Fed's Path



Source: Goldman Sachs Global Investment Research

A key question for the October meeting this week is how the FOMC will modify the sentence in its statement that refers to the hike at the September meeting (Exhibit 2). We think the Committee might adapt language from Vice Chair Jefferson's recent speech to say, "Any further adjustments to the target range for the federal funds rate to support a timelier return to the Committee's 2 percent goal will depend on trends in the data, the evolving outlook, and the balance of risks." This focus on observing trends hints at

waiting to gather a bit more data than is available between consecutive meetings.

If Chairman Warsh views such language as too close to the forward guidance that the FOMC has delivered in the past, an alternative option that would be more of a departure from past Fed practice would be to simply not say anything about the policy outlook.

Exhibit 2: The Statement Might Adapt the Policy Guidance from Vice Chair Jefferson's Recent Speech

Inflation remains elevated. Any further adjustments to the target range for the federal funds rate to ~~Today's policy action will~~ support a timelier return to the Committee's 2 percent goal will depend on trends in the data, the evolving outlook, and the balance of risks. The Committee will deliver price stability.

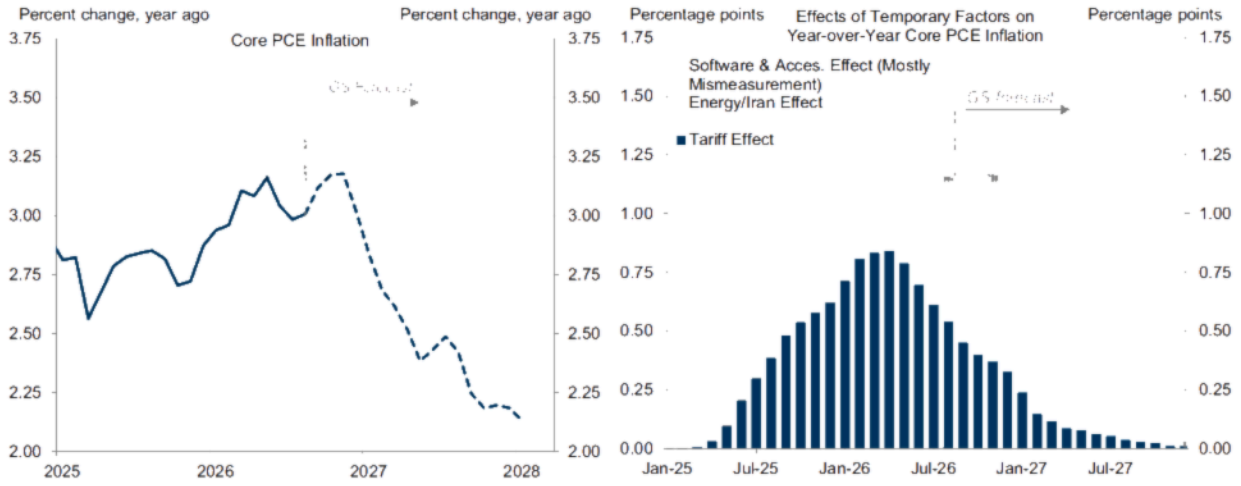
Source: Goldman Sachs Global Investment Research

We do not expect significant new information from the press conference. The seemingly strong support for hiking every other meeting means there is likely a high bar to deviate from that plan through the end of the year, which should limit the impact of Fed communication for now. And even if the FOMC decides to change course in the future and wants to communicate this to markets, Warsh's decision not to hint at the slower pace at his September press conference suggests he might prefer to again leave that to others.

Warsh could give an initial update on the work of his task forces, but it is probably too early for any final conclusions. We recently described our expectations for the Fed's task forces and suggested a possible direction for the task force on the Fed's inflation framework.

If the FOMC sticks to an every-other-meeting pace in 2027, it could consider hiking two meetings after the December meeting in March, by which point we will have five more months of inflation data. We do not expect a hike in March because we expect the inflation trend to improve as the effects of tariffs, the energy shock, and AI price pressures diminish. This would be significant for the inflation picture because, as Exhibit 3 shows, we estimate that the effects of tariffs, the war, and just the mismeasured part of AI price pressures account for all of core PCE inflation's current 1.1pp overshoot of the 2% target.

Exhibit 3: We Estimate That Tariffs, the Iran Energy Shock, and the Mismeasured Part of AI Price Pressures Account for All of Core PCE Inflation's Current 1.1pp Overshoot of the 2% Target



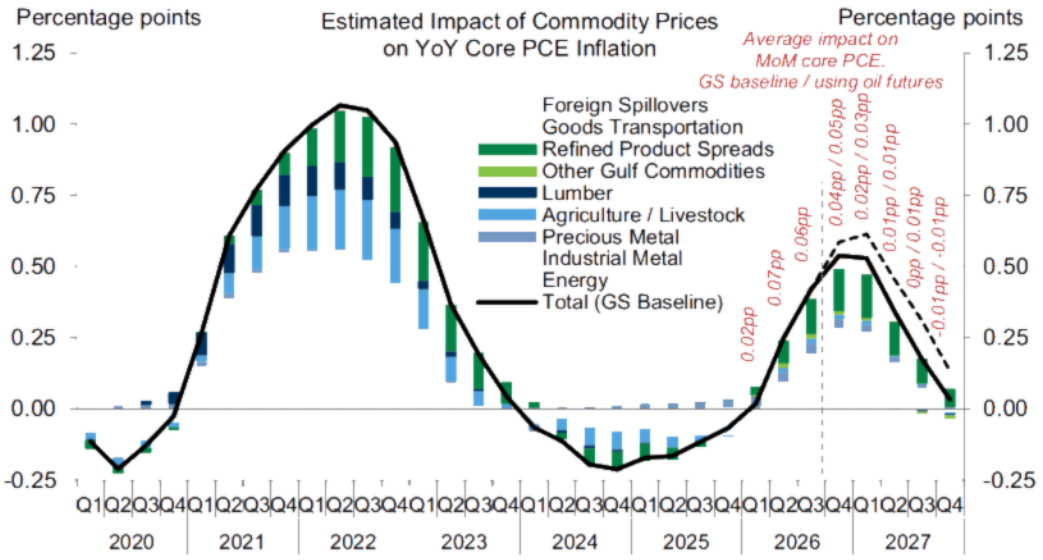
Source: Goldman Sachs Global Investment Research, Department of Commerce

That said, a March hike is possible if the inflation numbers are worse than we expect. How confident can we be that each of these three sources of inflationary pressure will really diminish?

First, on tariffs, our analysis suggests that the incremental passthrough to consumer prices from earlier tariff rounds is now essentially over, so the year-on-year rate should continue to fall because of favorable base effects. The effective tariff rate is likely to come back up a bit as the White House replaces earlier tariffs that were overturned by the courts, but this should have only a modest impact because the effective tariff rate is likely to rise only slightly and because our analysis indicates that removing tariffs had a minimal effect on consumer prices, so restoring them should too.

Second, on the energy shock, we estimate that higher oil prices and refined product spreads have boosted core PCE inflation by 0.3pp so far and would boost it a further 0.1-0.15pp under our baseline forecast, which incorporates our commodity strategists' forecasts. But oil futures are now above our forecasts, reflecting concerns about further conflict in the Middle East, and this represents the clearest upside risk to our inflation forecast. If oil prices follow the futures, this would add another 0.1pp to our core PCE inflation forecast by March (Exhibit 4) and about 0.4pp to our headline forecast.

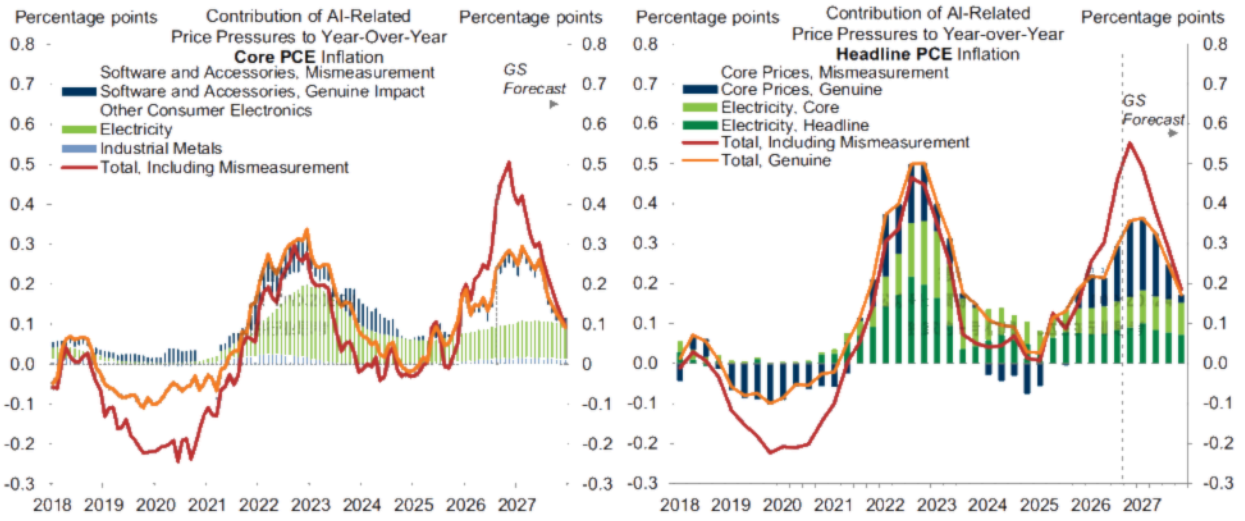
Exhibit 4: We Estimate That the Energy Shock Has Boosted Core PCE Inflation by 0.3pp and Will Boost It by Another 0.1-0.15pp Under Our Oil Forecast or 0.25pp If Oil Prices Instead Follow the Higher Futures Curve



Source: Goldman Sachs Global Investment Research

Third, on AI price pressures, our recent analysis concluded that the impact on year-over-year core PCE inflation is likely to peak over the next few months before dropping off meaningfully next year as memory and computer price growth slow due to both more moderate growth in AI demand and recent investment in new production capacity for memory (Exhibit 5). But the month-to-month impact of higher memory prices on consumer prices has been somewhat erratic and unpredictable this year, so we see some uncertainty about the impact over the next several months.

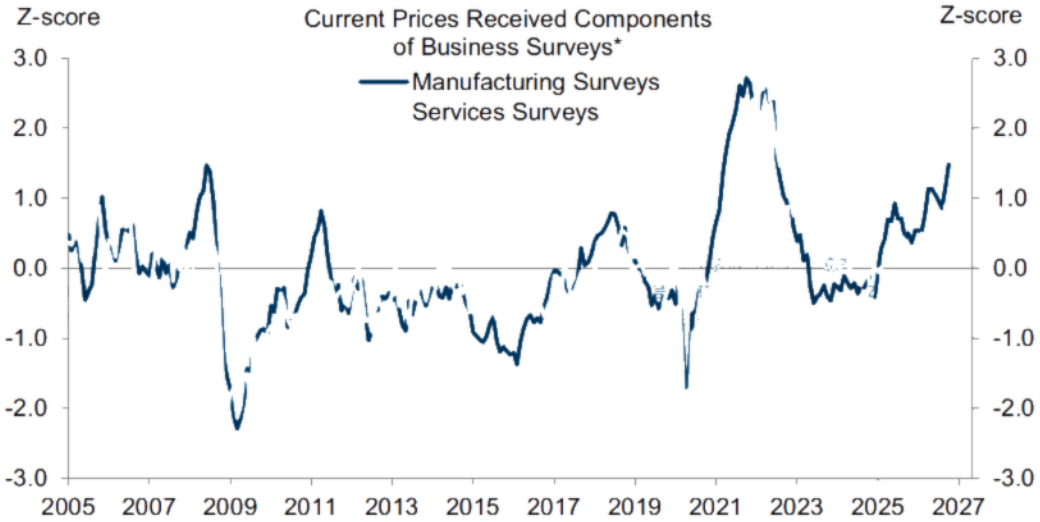
Exhibit 5: We Expect the Impact of AI Demand on Year-over-Year Core PCE Inflation—Both the Genuine Effects and the Effects of Mismeasurement—to Peak at the End of 2026 and Decline Sharply in 2027



Source: Goldman Sachs Global Investment Research

If tariffs, the energy shock, or AI price pressures prove more extreme and long-lasting than we expect, FOMC participants might worry that inflation could broaden. So far, the prices received components of business surveys have risen substantially in the manufacturing sector—likely in part reflecting the direct effects of some of these forces—but remain at more normal levels in the services sector (Exhibit 6). More prolonged pressure from these sources would also increase the risk that companies could take the opportunity provided by start-of-the-year price increases to pass along their higher costs, resulting in a larger "January effect" on the second-to-last inflation print ahead of the March meeting.

Exhibit 6: The Prices Received Components of Business Surveys, a Potential Measure of Inflation Broadening Out, Have Jumped for Manufacturing but Remained at More Normal Levels for Services



* Average of z-scores of the current prices received components of the manufacturing and service surveys from the New York Fed, Philadelphia Fed, S&P Global PMI, Kansas City Fed, Dallas Fed, Richmond Fed, and ISM.

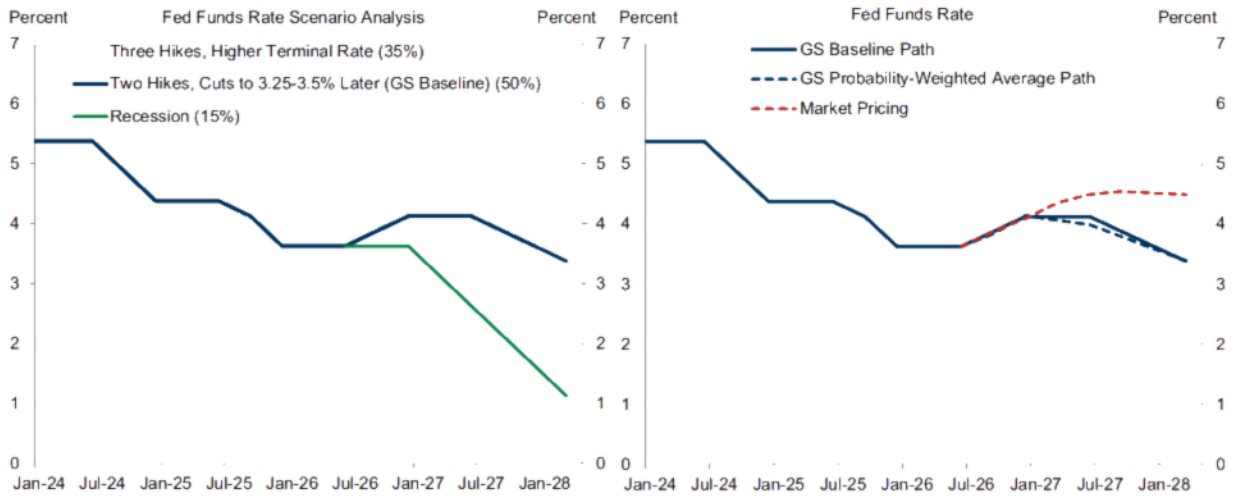
Source: Goldman Sachs Global Investment Research

While we see some upside risk, we think our baseline inflation forecast is consistent with the hiking cycle ending in December. We also suspect that some FOMC participants share our views that the economy is not overheated and that the inflation overshoot caused by past supply shocks will largely have to be waited out because the employment costs of offsetting them by tightening monetary policy to reduce demand would be too great. FOMC participants who share these views might prefer to limit the total size of the Fed's hiking package.

Finally, some participants might have been on the fence about the effectiveness of rate hikes but might have seen gradual and limited hikes as largely harmless from a starting point where growth and the labor market were solid. If concerns about growth or employment emerged—perhaps as a result of higher energy prices eroding real income and weighing on consumer spending, or a more substantial tightening in financial conditions than seen so far—they would likely want to stop raising the funds rate.

Market pricing of the Fed's path has taken out one hike since the end of September and now peaks at about 4.55% in the fall of 2027, implying just under three additional hikes for a total of four (Exhibit 1, right). Our baseline and probability-weighted Fed forecasts are considerably less hawkish than market pricing (Exhibit 7), both because we are skeptical that the FOMC will hike four times and because we expect the FOMC to lower the funds rate down the road when inflation approaches the 2% target.

Exhibit 7: Our Baseline and Probability-Weighted Fed Forecasts Are Less Hawkish Than Market Pricing, Both Because We Expect Only Two Hikes and Because We Expect Cuts Further Down the Road



Source: Goldman Sachs Global Investment Research

David Mericle

The US Economic and Financial Outlook

(% change on previous period, annualized, except where noted)

	2023	2024	2025	2026	2027	2026 Q1	2026 Q2	2026 Q3	2026 Q4	2027 Q1	2027 Q2	2027 Q3	2027 Q4
OUTPUT AND SPENDING													
Real GDP	**2.9**	**3.0**	**2.3**	*2.3*	*2.1*	**2.5**	**2.2**	*3.3*	*1.5*	*1.8*	*2.0*	*2.1*	*2.3*
Real GDP (annual=Q4/Q4, quarterly=yoy)	**3.4**	**2.6**	**2.0**	*2.4*	*2.1*	**2.6**	**2.2**	*2.0*	*2.4*	*2.2*	*2.1*	*1.9*	*2.1*
Consumer Expenditures	**2.3**	**2.9**	**2.6**	*2.3*	*2.2*	**0.7**	**3.8**	*3.4*	*1.5*	*1.9*	*2.0*	*2.1*	*2.2*
Residential Fixed Investment	**-8.1**	**3.2**	**-2.7**	*-2.7*	*-1.0*	**-7.6**	**2.8**	*2.3*	*-2.5*	*-4.0*	*-1.0*	*1.0*	*2.0*
Business Fixed Investment	**7.7**	**3.9**	**5.4**	*7.2*	*6.3*	**9.9**	**9.0**	*10.2*	*6.8*	*5.1*	*5.1*	*5.1*	*5.1*
Structures	**16.1**	**3.8**	**-2.2**	*-3.9*	*3.9*	**-9.4**	**0.1**	*15.1*	*-0.2*	*3.5*	*3.5*	*3.5*	*3.5*
Equipment	**4.9**	**3.3**	**8.8**	*11.1*	*7.3*	**15.5**	**13.4**	*10.0*	*9.5*	*5.5*	*5.5*	*5.5*	*5.5*
Intellectual Property Products	**5.6**	**4.6**	**6.8**	*9.6*	*6.5*	**15.6**	**9.2**	*8.0*	*7.8*	*5.5*	*5.5*	*5.5*	*5.5*
Federal Government	**3.5**	**3.6**	**-1.3**	*-1.2*	*0.4*	**10.9**	**-2.4**	*-2.0*	*1.0*	*1.0*	*1.0*	*1.0*	*1.0*
State & Local Government	**5.1**	**5.0**	**3.3**	*1.3*	*0.9*	**1.4**	**1.2**	*0.3*	*1.0*	*1.0*	*1.0*	*1.0*	*1.0*
Net Exports ($bn, '17)	**-910**	**-1,024**	**-1,101**	*-1,185*	*-1,365*	**-1,020**	**-1,099**	*-1,300*	*-1,323*	*-1,340*	*-1,357*	*-1,374*	*-1,391*
Inventory Investment ($bn, '17)	**38**	**28**	**7**	*20*	*78*	**-35**	**-63**	*99*	*80*	*80*	*80*	*75*	*75*
Nominal GDP	**6.8**	**5.6**	**5.0**	*6.1*	*5.0*	**5.8**	**8.5**	*5.7*	*5.5*	*4.3*	*4.5*	*4.4*	*4.5*
Industrial Production, Mfg.	**-1.0**	**-1.0**	**0.8**	*1.5*	*2.8*	**1.8**	**5.5**	**0.7**	*2.6*	*2.9*	*3.1*	*3.2*	*3.3*
HOUSING MARKET													
Housing Starts (units, thous)	**1,421**	**1,370**	**1,356**	*1,334*	*1,288*	**1,418**	**1,345**	*1,295*	*1,277*	*1,265*	*1,284*	*1,296*	*1,308*
New Home Sales (units, thous)	**666**	**684**	**679**	*638*	*596*	**622**	**650**	*664*	*618*	*599*	*590*	*595*	*602*
Existing Home Sales (units, thous)	**4,103**	**4,067**	**4,076**	*4,020*	*3,946*	**4,053**	**4,120**	**3,993**	*3,913*	*3,880*	*3,924*	*3,968*	*4,012*
Case-Shiller Home Prices (%yoy)*	**5.3**	**3.8**	**1.3**	*1.5*	*0.7*	**0.9**	**1.3**	*2.0*	*1.5*	*0.8*	*1.0*	*0.5*	*0.7*
INFLATION (% ch, yr/yr)													
Consumer Price Index (CPI)**	**3.3**	**2.9**	**2.7**	*3.7*	*1.8*	**2.7**	**3.8**	**3.5**	*3.8*	*3.3*	*2.3*	*2.3*	*1.7*
Core CPI **	**3.9**	**3.2**	**2.6**	*2.6*	*1.9*	**2.5**	**2.7**	**2.5**	*2.7*	*2.4*	*2.1*	*2.0*	*1.9*
Core PCE** †	**3.2**	**2.9**	**2.9**	*3.0*	*2.2*	**3.0**	**3.1**	*3.0*	*3.1*	*2.7*	*2.4*	*2.4*	*2.2*
LABOR MARKET													
Unemployment Rate (%)^	**3.8**	**4.1**	**4.4**	*4.2*	*4.2*	**4.3**	**4.2**	**4.2**	*4.2*	*4.2*	*4.2*	*4.2*	*4.2*
U6 Underemployment Rate (%)^	**7.2**	**7.6**	**8.4**	*7.6*	*7.6*	**8.0**	**7.9**	**7.8**	*7.6*	*7.6*	*7.6*	*7.6*	*7.6*
Payrolls (thous, monthly rate)	**210**	**122**	**10**	*72*	*55*	**73**	**81**	**79**	*55*	*55*	*55*	*55*	*55*
Employment-Population Ratio (%)^	**60.1**	**59.9**	**59.7**	*59.1*	*58.9*	**59.2**	**59.0**	**59.1**	*59.1*	*59.0*	*59.0*	*59.0*	*58.9*
Labor Force Participation Rate (%)^	**62.5**	**62.5**	**62.4**	*61.7*	*61.5*	**61.9**	**61.5**	**61.7**	*61.7*	*61.6*	*61.6*	*61.6*	*61.5*
Average Hourly Earnings (%yoy)	**5.1**	**4.4**	**4.0**	*3.0*	*3.5*	**3.6**	**3.2**	**3.2**	*3.0*	*3.1*	*3.3*	*3.5*	*3.5*
GOVERNMENT FINANCE													
Federal Budget (FY, $bn)	**-1,694**	**-1,833**	**-1,775**	*-2,000*	*-2,000*	--	--	--	--	--	--	--	--
FINANCIAL INDICATORS													
FF Target Range (Bottom-Top, %)^	**5.25-5.5**	**4.25-4.5**	**3.5-3.75**	*4-4.25*	*3.5-3.75*	**3.5-3.75**	**3.5-3.75**	**3.75-4**	*4-4.25*	*4-4.25*	*4-4.25*	*3.75-4*	*3.5-3.75*
10-Year Treasury Note^	**3.88**	**4.58**	**4.18**	*4.75*	*4.40*	**4.30**	**4.44**	**5.29**	*4.75*	*4.65*	*4.55*	*4.45*	*4.40*
Euro (€/$)^	**1.11**	**1.04**	**1.17**	*1.12*	*1.14*	**1.15**	**1.14**	**1.12**	*1.12*	*1.12*	*1.12*	*1.12*	*1.14*
Yen ($/¥)^	**141**	**157**	**157**	*163*	*160*	**159**	**163**	**158**	*163*	*165*	*165*	*165*	*160*

* Weighted average of metro-level HPIs for 381 metro cities where the weights are dollar values of housing stock reported in the American Community Survey. Annual numbers are Q4/Q4.
** Annual inflation numbers are December year-on-year values. Quarterly values are Q4/Q4.
† PCE = Personal consumption expenditures. ^ Denotes end of period.
Note: Published figures in bold.

Source: Goldman Sachs Global Investment Research