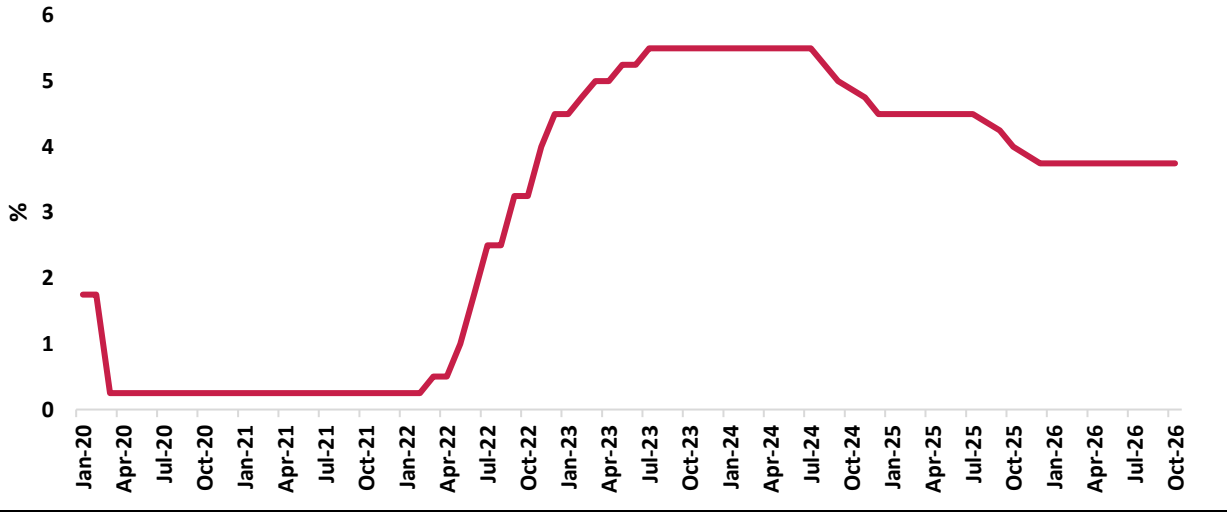
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US Federal Reserve Review: Hawkish Pause Keeps December Hike in Focus

Fed Leaves Rates Unchanged, But Tightening Bias Remains

- The US Federal Reserve (Fed) left the Federal Funds Rate unchanged at 3.75%-4.00% at its October FOMC meeting, a decision that was widely anticipated by financial markets. However, while the headline outcome was a pause, the underlying message was notably more hawkish than many investors had expected.

Chart 1: Federal Fund Rate (FFR)



Sources: Bloomberg, Bank Islam

- The policy statement acknowledged that the US economy continues to expand at a solid pace, supported by resilient household spending, a healthy labor market and sustained business investment. Policymakers also indicated that inflation remains above the Fed's 2.0% target and that risks to the inflation outlook remain tilted to the upside.
- The Committee reiterated its commitment to returning inflation sustainably to target and maintained that future policy decisions would remain dependent on incoming economic data. Two policymakers dissented in favor of an immediate 25bps hike, highlighting growing concern among some members that current policy settings may not be sufficiently restrictive to contain inflationary pressures.
- The voting pattern itself is noteworthy. The existence of hawkish dissents suggests that internal discussions are increasingly focused on the risk of inflation becoming entrenched rather than concerns over slowing growth. Taken together, the meeting outcome suggests that the Fed is not signaling the end of the tightening cycle but rather choosing to gather additional evidence before potentially delivering another rate increase.

Warsh's Remarks: Strong Growth Allows the Fed to Remain Restrictive

- During the post-meeting press conference, Fed Chair Kevin Warsh struck a balanced but hawkish tone. He emphasized that:
  - ✓ Economic activity remains stronger than previously anticipated.
  - ✓ Household consumption continues to expand despite elevated borrowing costs.
  - ✓ Corporate investment remains supportive of economic growth.
  - ✓ Labor market conditions remain healthy with unemployment close to historical lows.
  - ✓ Inflation remains uncomfortably above target despite moderation from peak levels.
- Importantly, Warsh reiterated that the Fed remains prepared to take further action if inflation does not continue to move towards the 2.0% objective. While acknowledging that tighter financial conditions and higher market interest rates are beginning to weigh on parts of the economy, he stressed that policymakers are unwilling to prematurely declare victory over inflation.
- Overall, the remarks reinforced the market perception that the Fed remains firmly focused on ensuring inflation expectations stay anchored. Unlike previous pauses that carried more dovish undertones, this meeting was interpreted as a "hawkish hold", where policymakers intentionally preserved optionality for further tightening.

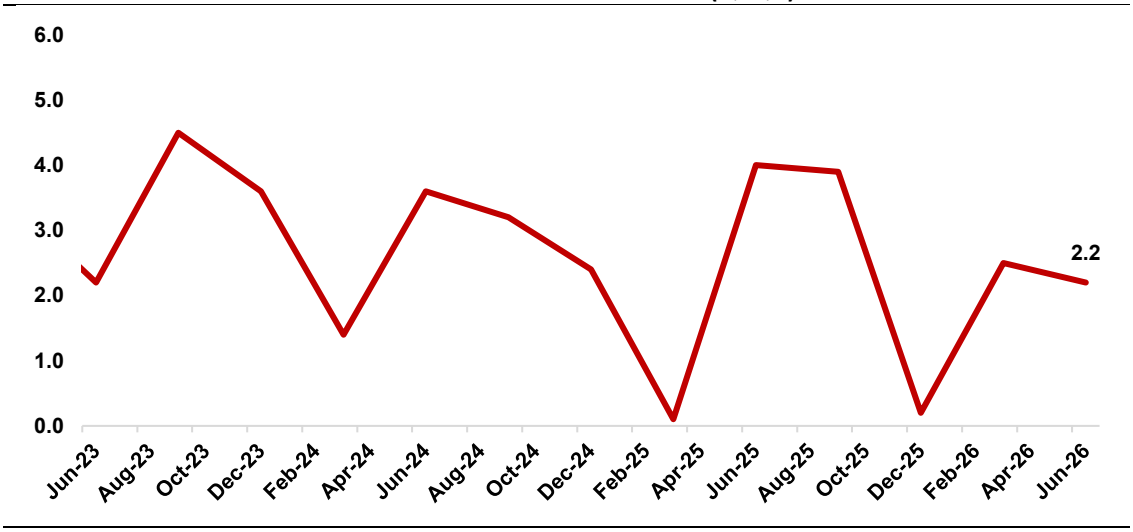
Economic Backdrop Remains Supportive of Additional Tightening

- Recent economic data provide sufficient justification for maintaining a restrictive policy stance. Several developments continue to support the Fed's cautious approach:

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  - ➢ **Growth Remains Resilient -** The US economy has continued to perform better than expected despite the cumulative effects of earlier rate hikes. Consumer spending remains resilient, supported by healthy wage growth and a still-tight labor market. Business investment has also been supported by ongoing infrastructure spending, technological investment and reshoring initiatives.

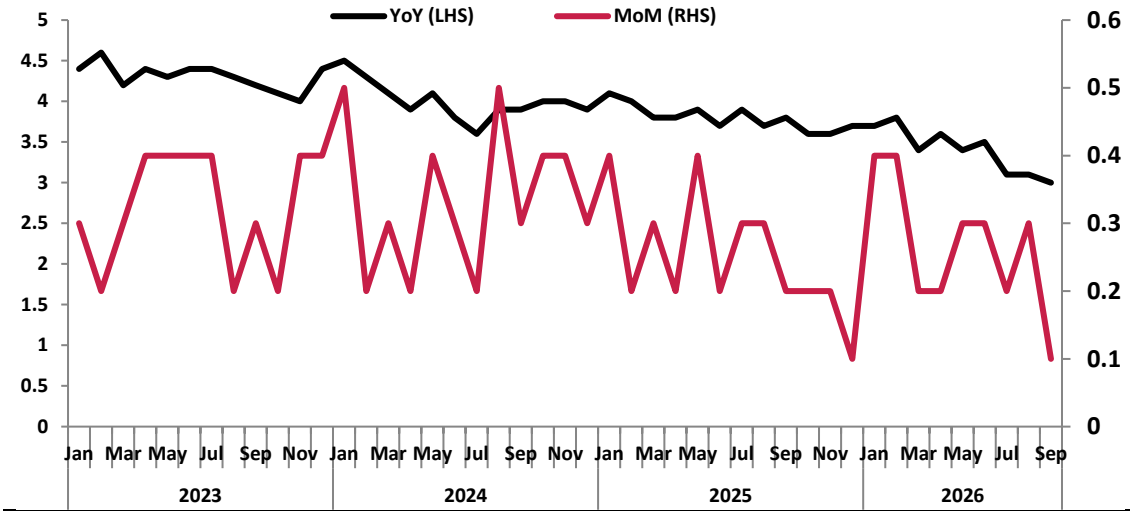
Chart 2: US GDP Growth (QoQ%)



Sources: Bloomberg, Bank Islam

➢ **Labor Market Remains Tight** - Employment conditions continue to indicate limited slack in the economy. Although job creation has moderated compared with the post-pandemic recovery phase, wage growth remains elevated relative to levels that would be consistent with the Fed's inflation target.

Chart 3: US Wage Growth (%)

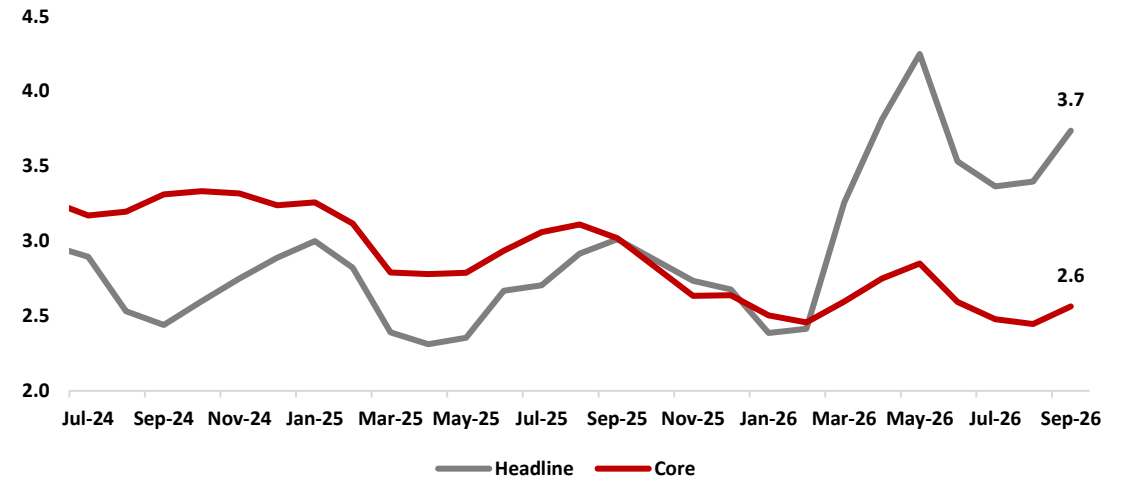


Sources: Bloomberg, Bank Islam

➢ **Inflation Progress Has Slowed -** While headline inflation has fallen significantly from its peak, recent data suggest that the pace of disinflation has become less consistent. Services inflation, particularly shelter, healthcare and labor-intensive services, remains elevated. Furthermore, recent increases in energy prices and geopolitical uncertainty continue to pose upside risks.

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Chart 4: US CPI (%)



Sources: Bloomberg, Bank Islam

- Consequently, policymakers appear increasingly concerned that inflation may stabilise above the Fed's target if financial conditions ease prematurely.

Outlook: December Rate Hike Remains the Base Case

- We maintain our expectation that the Fed will deliver a 25bps rate hike at the December FOMC meeting, bringing the Federal Funds Rate to 4.00%-4.25%. Several factors support this view:
  - **Inflation Remains Above Target** - Although inflation has moderated considerably from its peak, it remains above the Fed's comfort zone. Importantly, progress in services inflation remains gradual and policymakers continue to express concern that inflation expectations could become entrenched.
  - **Economic Activity Has Not Slowed Materially** - The economy continues to demonstrate resilience despite restrictive monetary policy. As long as growth momentum remains intact, the Fed has room to maintain a tightening bias.
  - **Labor Market Conditions Remain Supportive** - Persistent labor market tightness and elevated wage growth reduce urgency for rate cuts and provide justification for maintaining restrictive policy settings.
  - **Increasingly Hawkish FOMC Composition** - The latest meeting revealed greater support among policymakers for further tightening, as reflected by the two dissents favoring an immediate hike.
  - **Market Pricing Supports the View** - According to CME FedWatch estimates, markets are pricing roughly a 78% probability of a December rate increase, indicating that investors increasingly expect one final rate hike before year-end.

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- As such, barring a significant deterioration in labor market conditions or a sharp decline in inflation over the coming weeks, we believe the Fed is likely to proceed with another 25bps increase in December.

Financial Market Reactions

Equities: Relief Rally Despite Hawkish Tone

- US equity markets initially responded positively as investors welcomed the decision to keep rates unchanged.
- The absence of an immediate rate hike provided near-term relief, particularly for rate-sensitive sectors such as technology and consumer discretionary stocks. Investors also viewed the decision as a signal that the Fed remains cautious about overtightening policy.
- However, gains were relatively modest as markets continued to assess the likelihood of additional tightening later this year.
- Key Themes Driving Equities
  - **Technology**
    - Continued support from AI-related investment themes.
    - Strong earnings from major technology companies offset concerns regarding higher interest rates.

➢ **Financials**

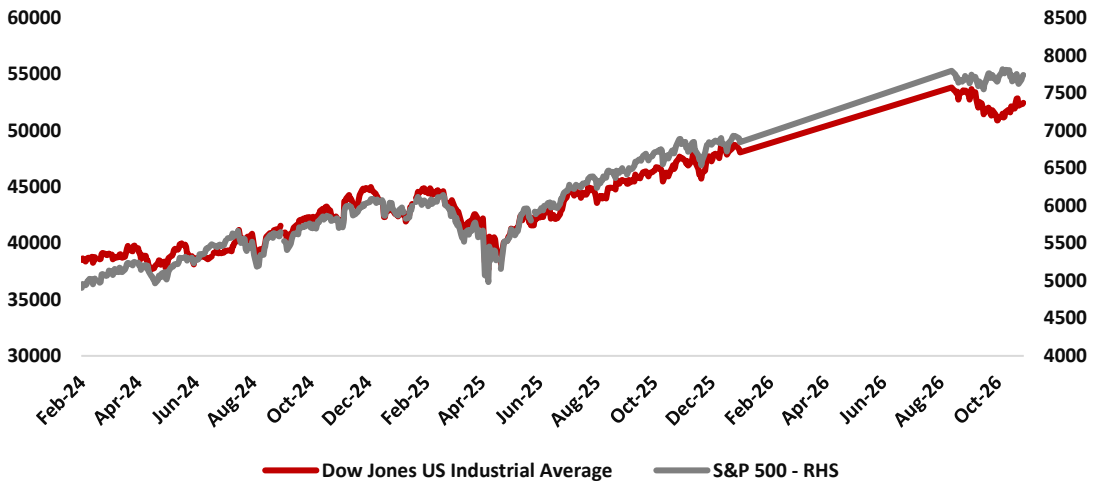
- Benefited from higher long-term yields which support lending margins.
- However, concerns remain over slower credit growth should policy remain restrictive.

➢ **Consumer Stocks**

- Supported by resilient household spending.
- Nevertheless, elevated financing costs continue to pose medium-term risks.

- Overall, the equity market response suggests that investors interpreted the meeting as delaying, rather than eliminating, the possibility of further tightening.

Chart 5: US Equity Market

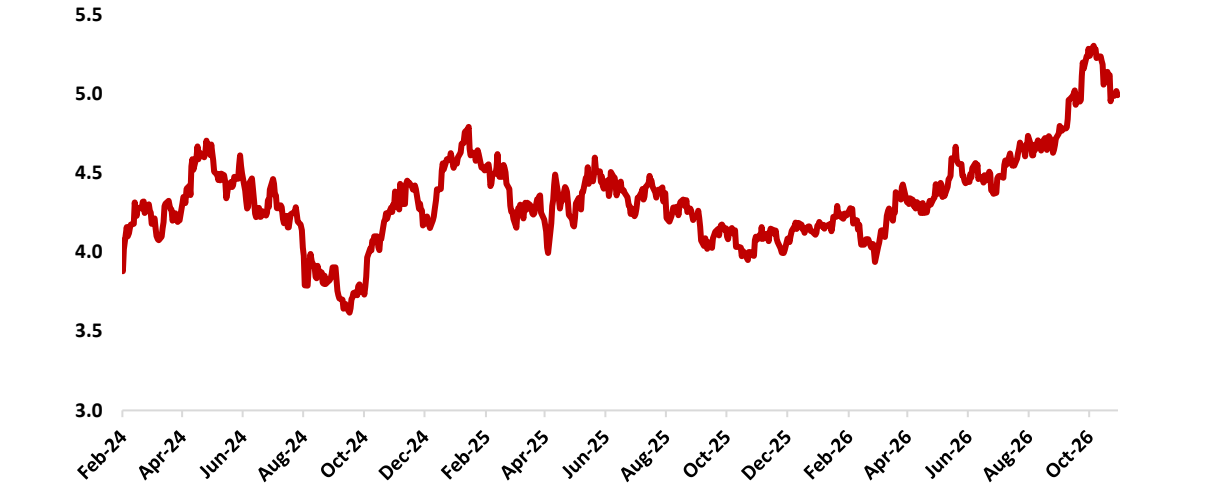


Sources: Bloomberg, Bank Islam

US Treasury Market: Yields Move Higher

- The bond market reaction was considerably more hawkish than the equity market response.
- Following the meeting, Treasury yields rose as investors increased expectations of a December rate hike and adjusted for a higher-for-longer policy outlook.
- **US 10-Year Treasury Yield** - The benchmark US 10-year yield climbed above the psychologically important 5% level and remained elevated. The move reflected:
  - ✓ Expectations of additional monetary tightening.
  - ✓ Stronger growth projections.
  - ✓ Concerns that inflation may remain above target for longer.
  - ✓ Increased Treasury issuance and fiscal deficits.
- The fact that long-term yields rose despite an unchanged policy rate highlights that markets viewed the Fed's messaging as hawkish.
- From a broader perspective, elevated Treasury yields tighten financial conditions independently of changes in the policy rate. Higher yields increase borrowing costs across mortgages, corporate bonds and consumer credit, effectively reinforcing the Fed's efforts to slow inflation.

Chart 6: UST 10Y (%)



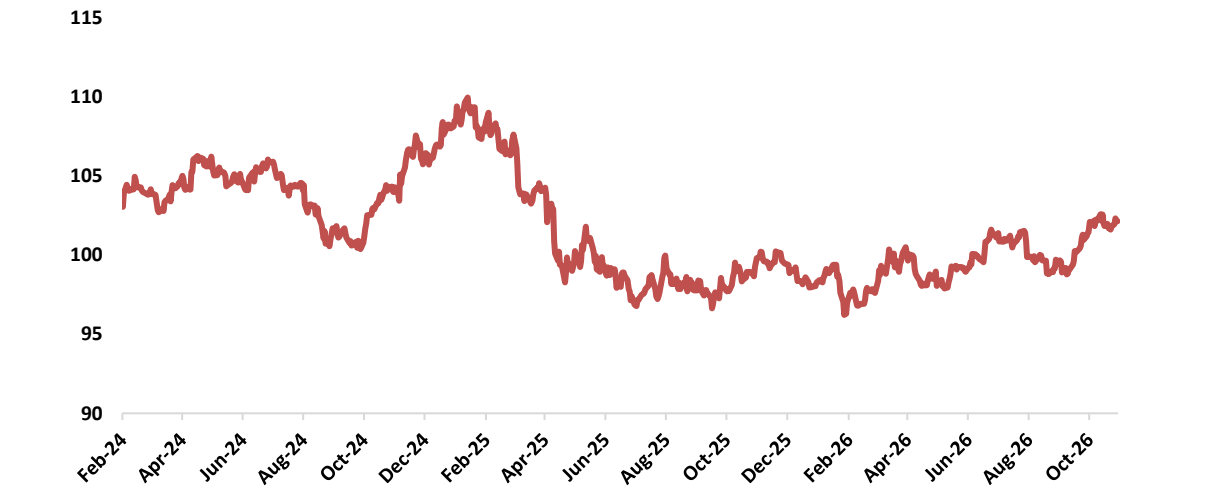
Sources: Bloomberg, Bank Islam

US Dollar Index (DXY): Remains Firm

- The US Dollar Index (DXY) remained broadly supported following the meeting. While the initial market reaction saw some profit-taking in the dollar, the broader fundamentals remain supportive:
  - ✓ Expectations for another rate hike.
  - ✓ Elevated Treasury yields.
  - ✓ US economic outperformance relative to Europe and other major economies.
  - ✓ Ongoing geopolitical uncertainties supporting safe-haven demand.
- Consequently, downside risks to the dollar appear limited in the near term.
- A stronger US dollar continues to tighten global financial conditions, particularly for emerging economies with external financing requirements.

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Chart 7: USD Index (DXY)



Sources: Bloomberg, Bank Islam

Gold: Higher Rates Continue to Cap Upside

- Gold prices experienced some volatility following the meeting. Although geopolitical risks continue to provide safe-haven support, expectations of higher interest rates and elevated Treasury yields remain the primary headwinds.
- Historically, gold tends to underperform when:
  - ✓ Real yields move higher.
  - ✓ The US dollar strengthens.
  - ✓ Markets anticipate additional monetary tightening.
- Therefore, while geopolitical developments could generate intermittent support, the Fed's hawkish stance is likely to limit substantial upside in gold prices in the near term.

Chart 8: Gold Price (XAU)



Sources: Bloomberg, Bank Islam

Implications for Malaysia

Ringgit: External Pressure May Persist

- A stronger dollar and elevated US yields are likely to maintain some pressure on the Ringgit. The widening interest rate differential between the US and Malaysia may continue to encourage capital allocation towards US assets.
- Consequently:
  - ✓ USD/MYR could remain elevated in the near term.
  - ✓ Ringgit appreciation may be gradual despite improving domestic fundamentals.
  - ✓ Periods of risk aversion could trigger renewed volatility.
- However, Malaysia's improving external position, recovering investment activity and relatively stable inflation environment should help prevent excessive currency depreciation.

Malaysian Bond Market

- Higher US Treasury yields tend to spill over into regional bond markets, including Malaysia Government Securities (MGS). Potential implications include:

- ✓ Upward pressure on long-end MGS yields.
- ✓ Reduced foreign demand for emerging market bonds.
- ✓ Higher funding costs across the domestic economy.

- Nevertheless, Malaysia's contained inflation environment and extended pause by Bank Negara Malaysia should help limit the extent of domestic yield increases.

Equity Market

- Sustained higher US interest rates could create a challenging environment for emerging market equities through:
  - ✓ Capital flow outflows.
  - ✓ Stronger US dollar.
  - ✓ Higher global discount rates.
- Nevertheless, sectors linked to domestic infrastructure projects, data centres, tourism and investment activity should remain relatively resilient.
- Banks may also benefit from a higher interest rate environment and healthy domestic credit growth.

Macro Outlook for Malaysia

- The direct growth impact is expected to be manageable. Malaysia's outlook remains supported by:
  - ✓ Resilient household spending.
  - ✓ Continued execution of major infrastructure projects.
  - ✓ Strong pipeline of approved investments.
  - ✓ Expansion in data centres and advanced manufacturing activities.
- However, prolonged US monetary tightening could dampen external demand and increase global financing costs. Export-oriented industries, particularly electronics and manufacturing sectors with significant exposure to developed economies, could face softer demand should US growth moderate in 2027.

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Conclusion

- The October FOMC meeting delivered a pause in interest rates but not a pause in the Fed's inflation fight. Strong economic activity, persistent inflation pressures, hawkish dissents and Chair Warsh's comments collectively point toward a higher-for-longer policy environment.
- We continue to expect a **25bps rate hike in December**, with CME FedWatch currently indicating approximately **78% probability** of such an outcome. While financial markets initially welcomed the decision, rising Treasury yields and a resilient US dollar suggest investors remain focused on the prospect of further tightening.
- For Malaysia, the main transmission channels will be through a firmer US dollar, elevated global bond yields and potentially tighter financial conditions. Nonetheless, resilient domestic demand, ongoing investment inflows and supportive government initiatives should help cushion the impact on the broader economy.