

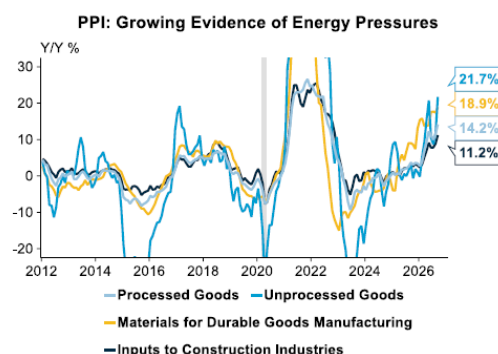
When a Gradualist Fed Collides with Hot Inflation

WEEKLY VIEW FROM THE DESK | October 19, 2026

[LINK TO WEEKLY RETURNS TABLE](#)

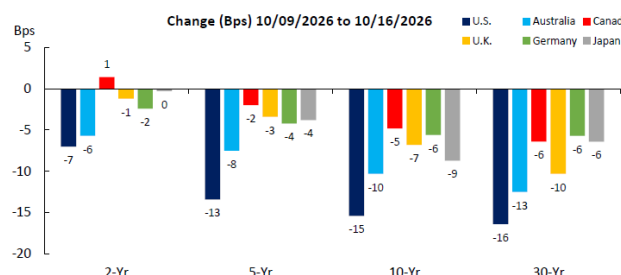
MACRO

- As we look forward after last week's AI jitters, interest-rate outperformance, and geopolitical developments, we continue to see a U.S. economy where elevated inflation shows little signs of retreating. Yet, Fed officials appear set on taking a gradual tightening approach, which we believe carries policy ramifications heading into 2027.
- We see U.S. GDP coming in at an above-trend pace of 2.3% for 2026 with support coming from continued consumer spending and the AI-investment boom. On the labor side, we see stable to improving conditions with a falling unemployment rate and job creation that continues to exceed our estimated breakeven rate of zero to 40,000 (i.e., the job growth needed to keep the unemployment rate constant).
- Meanwhile, September's inflation data came in hot across all major indicators, including core and headline CPI, producer and import prices, and anecdotally in the Fed's Beige Book report. Furthermore, when we assess the PPI reading, energy pressures on input costs are readily visible and point to ongoing price pressures (see accompanying chart).
- Furthermore, the market has started to price in our base case of a "Prolonged Quagmire" in the Middle East with our estimated price range of \$90-\$120 / barrel on Brent crude. Futures no longer treat a quick return below \$90/bbl as the default outcome, and the difference is in the tail risks. The market still sees risks skewed to the downside, consistent with some form of settlement, whereas we see them skewed to the upside and towards escalation.
- However, Fed officials, such as New York Fed President John Williams, appear to be advocating for a gradual approach to tightening monetary policy, and Fed Chair Warsh didn't push back against that concept in his comments at last week's IMF meetings (we believe Warsh would like to move faster, but currently lacks the votes). The combination of a gradually moving Fed and hot inflation runs the risk of further embedding inflation and ultimately requiring more policy tightening.
- As a result, we adjusted our U.S. monetary policy call last week to where we are no longer expecting a rate hike at next week's Fed meeting. Instead, we now expect 100 bps of additional tightening, up from 50 bps previously, with the next rate hike coming in December and followed by one per quarter thereafter.



DEVELOPED MARKET RATES

- Developed market rates received a reprieve and outperformed last week as risk-off sentiment outweighed firm U.S. macro data (see the accompanying chart). As noted above, if the Fed proceeds gradually with additional hikes, we see scope for a short-covering rally in the U.S. that may be followed by a tightly-framed, range-trading environment.
- Non-U.S. markets have performed well recently amid relatively favorable fundamentals. Several other developed markets have more favorable growth/inflation fundamentals and, in some cases, steeper forward curves. Given those differences, non-U.S. developed-market rates could continue to outperform Treasuries on a hedged basis with more Fed tightening potentially to come.
- We maintain a positive short-term view on MBS from a valuation standpoint. Longer term, we continue to emphasize carry in the sector while favoring seasoned 30-year pools for their better convexity and fundamental value.



Sources for charts: PGIM and Macrobond.

IG CORPORATES

- Last week saw new issuance of about \$23B, with deals 3.4x oversubscribed and coming with a 3 bps concession. Weakness throughout the week was driven by technology, as concerns intensified around AI financing, returns on AI investment, higher rates, and the rising cost of capital. The selloff was concentrated in TMT and AI-linked issuers rather than IG broadly, which overall has managed to hold up well.
- Bank earnings have come in solidly, though not quite as strong as the prior quarter. Asset quality continues to be firm, and bank spreads widened broadly in line with the overall market, despite bank and financial issuance dominating the week's supply.
- It was a calmer week for European IG as cash spreads ended the week 2 bps tighter at an OAS of +94. Relative stability in OATs last week enabled French risk to mildly bounce, especially in global French names that had previously taken outsized hits.

LEVERAGED FINANCE

- The U.S. high-yield market posted a negative total return last week, as higher oil prices, U.S. CPI, and renewed concerns over the sustainability of the AI buildout drove a sharp risk-off move. The selloff spread broadly across the technology sector and into lower-quality credits. Lower-quality, higher-beta names underperformed materially, as every sector widened at the peak of the risk-off move.
- The holiday-shortened week and market volatility combined to produce just \$2.6B in high-yield supply, well below dealer forecasts, as numerous issuers opted against proceeding with planned transactions. The technical backdrop remained under pressure, with spreads wider, yields higher, and new-issue supply well below expectations.
- Total returns were mixed across U.S. HY sectors. The best performers were food & drug retail, hotel, and food/beverage/tobacco. The worst performers were paper, air transportation, and telecom. Flows were negative for the week, the sixth weekly outflow in the last eight weeks. The primary market priced approximately \$2.6B across four deals, compared to \$3.8B priced the prior week. Notable transactions included Select Water, INEOS Energy, Buckeye Partners, and Integra LifeSciences.
- U.S. bank loan spreads widened 9 bps on the week. Hyperscalers are not a big part of this market, but one highlight last week came courtesy of AI startup Volta Infrastructure with a \$5B offering.
- European HY spreads were 8 bps wider. We note that BB performance has been distorted by VMED and Ziggo; when excluding those names, BBs have held up well. Loan spreads widened by 17 bps last week.

EMERGING MARKETS

- EM hard currency sovereign spreads were wider, but relatively contained, given last week's backdrop. While broader markets were focused on AI volatility, geopolitics, energy price moves, and DM rate moves, EM performance is a function of positioning, funding needs and country-specific factors. The IMF meetings last week were an opportunity to highlight resilience and relative vulnerabilities of EM debt. The takeaways were consistent in the identification of risks, yet no "risk off" alarm bells were ringing. This further argues for relative value positions as complacency can result in large moves when country developments come to the fore. Witness how Indonesia markets sold off on last week's MSCI news.
- We have reduced risk, particularly in BB and B names, as we think that spreads are likely to widen. We remain overweight EM high yield. We still believe the yield/carry in some segments provides for good relative value opportunities. We are closely watching fundamentals to help differentiate the opportunity set.
- EM corporate spreads widened again last week. Longer duration bonds underperformed with more impact on the infrastructure and transport sectors. Supply is likely to pick up this week.
- EM local yields were flat with many countries reacting more to idiosyncratic stories than to the rally in core rates. However, short-end swaps were lower across the board except for Brazil. In the bond space, Hungary and South Africa were the biggest outperformers in anticipation of deficit and budget-related announcements next week, respectively. MSCI's proposal to reclassify Indonesia as a standalone market triggered a broad selloff across its curve. Within the portfolio, we reduced our overweight in the belly of the Mexican TIE curve as the market outperformed the belly of the U.S. curve in October. We also reduced our underweight in two-year IBR after a recent underperformance of Colombian local rates. Most notably, we further reduced our UST hedge, as the growth narrative started to outweigh inflation concerns. Moreover, the appreciation of forward oil prices has raised downside risks to an otherwise resilient global growth outlook.
- EMFX gained ground last week with mixed performance across regions. These include hotter-than-expected U.S. CPI and PPI, even though UST rates ultimately didn't react higher. USD was weaker on net. Top performers included INR, HUF and PEN, while the worst performers included BRL, EGP and IDR. We continue with a high carry vs. low carry relative value bias, but we have reduced positioning as we are concerned a risk-off macro environment can develop where high carry underperforms. We also continue with a long USD bias, but have reduced this risk as well by reducing Europe exposure by half.

SECURITIZED PRODUCTS

- Securitized product spreads were generally wider last week. Benchmark conduit CMBS AAAs widened roughly 3–4 bps, while RMBS experienced more pronounced pressure from the higher-rate environment. RMBS has cheapened meaningfully with new-issue spreads around 150-155 bps, approximately 30 bps wider than local tights six weeks earlier.
- AAA RMBS generally looks attractive. Following the repricing, we see relative value in AAA RMBS, particularly given changes toward sequential-pay structures and the characteristics of the underlying collateral and coupons.
- CLOs have held up better: Floating-rate CLOs have generally outperformed more rate-sensitive areas of structured products. ABS also proved relatively resilient, widening only around 1-2 bps.
- We are more cautious on CMBS. Higher interest rates could negatively affect underlying commercial real-estate valuations and debt-service coverage, making us more guarded toward the sector.

MUNICIPALS

- Muni performance has been volatile, but has generally been positive over the last two weeks with yields approximately 20-25 bps lower on the front end and approximately 12 bps lower on the back end.
- Muni/Treasury yield ratios have fallen on the front end as investors focus on the oversold part of the curve. Ratios still look attractive on a historical basis, especially on the longer end.
- New York state's tax collection surged in the first six months of 2026 to \$68.5B, \$7.3B more than projected, fueled by financial-institution profits.

THE RETURNS TABLE AS OF OCTOBER 16, 2026

	Duration	YTM	OAS	WTD	Yield / OAS change (bps)				Prior year	WTD	MTD	Total return (%)		
					MTD	QTD	YTD	QTD				YTD	Prior year	
Sovereign rates														
U.S. 2-Year	1.83	4.71	---	-8	-18	-18	123	128	0.22	0.50	0.50	0.76	1.34	
U.S. 5-Year	4.32	4.87	---	-15	-22	-22	114	132	0.71	1.04	1.04	-1.85	-1.94	
U.S. 10-Year	7.69	5.08	---	-17	-21	-21	91	110	1.33	1.71	1.71	-3.52	-4.22	
U.S. 10-Year Breakeven	--	2.35	---	0	-2	-2	10	7	---	---	---	---	---	
U.S. 10-Year TIPS	4.27	2.73	---	-16	-19	-19	83	103	1.52	1.82	1.82	-2.19	-2.78	
U.S. 20-Year	12.03	5.47	---	-18	-20	-20	68	92	2.17	2.49	2.49	-4.62	-6.78	
U.S. 30-Year	14.68	5.42	---	-17	-21	-21	58	84	2.62	3.11	3.11	-4.90	-8.09	
U.S. SOFR	---	---	---	1	-2	-2	1	-42	0.08	0.17	0.17	2.98	3.85	
UK 10-Year	7.55	5.37	---	-7	-5	-5	90	87	0.51	0.54	0.54	-1.51	-0.50	
Germany 10-Year	8.27	3.42	---	-6	-16	-16	57	85	0.42	1.24	1.24	-1.58	-3.27	
Switzerland 10-Year	8.41	0.53	---	-1	-3	-3	25	40	0.16	0.24	0.24	-1.62	-2.72	
Japan 10-Year	7.68	2.92	---	-9	-13	-13	86	127	0.57	0.89	0.89	-3.67	-6.17	
Australia 10-Year	7.95	5.23	---	-10	-12	-12	49	108	0.67	0.89	0.89	0.74	-2.60	
Canada 10-Year	8.02	3.83	---	-5	-17	-17	40	75	0.36	1.37	1.37	0.14	-1.65	
Major fixed income multi-sector indices		YTW												
Global Aggregate Unhedged	6.19	4.32	34	0	1	1	6	4	0.89	0.81	0.81	-1.88	-2.09	
Global Aggregate Hedged	6.19	4.32	34	0	1	1	6	4	0.67	1.03	1.03	-0.41	-0.54	
U.S. Aggregate	5.86	5.39	33	1	1	1	6	4	0.88	1.32	1.32	-1.63	-1.67	
Euro-Aggregate (Unhedged)	6.10	3.86	61	-1	4	4	19	14	0.54	0.87	0.87	-1.67	-2.40	
Japanese Aggregate	7.81	2.68	1	1	0	0	0	1	0.38	0.71	0.71	-3.94	-5.99	
Major fixed income credit indices		YTW												
Mortgage-Backed (Agency)	5.73	5.74	41	1	-3	-3	19	12	0.89	1.53	1.53	-1.82	-1.40	
Global IG Corporate Bonds	5.78	5.39	89	2	4	4	9	7	0.89	0.89	0.89	-2.34	-2.26	
U.S. IG Corporate Bonds	6.60	5.89	84	3	4	4	7	6	0.86	1.33	1.33	-1.82	-2.03	
European IG Corporate	4.49	4.13	94	-2	3	3	15	14	0.45	0.76	0.76	-0.45	-0.85	
U.S. High Yield Bonds	3.53	8.38	331	24	20	20	65	40	-0.33	-0.09	-0.09	0.01	1.38	
European High Yield Bonds	3.32	7.03	357	13	36	36	76	51	-0.15	-0.70	-0.70	-0.39	0.50	
U.S. Leveraged Loans	0.3	9.99	503	9	21	21	48	42	-0.13	-0.30	-0.30	3.11	4.52	
European Leveraged Loans	0.3	8.96	518	15	46	46	44	23	-0.33	-0.98	-0.98	1.83	3.14	
EM Hard Currency Sovereigns	6.07	7.11	193	7	11	11	4	28	0.64	1.04	1.04	0.40	2.66	
EM Corporates	3.96	6.87	185	1	2	2	4	8	0.35	0.51	0.51	0.86	1.91	
EM Currencies	---	6.12	---	0	0	0	0	0	0.20	0.06	0.06	3.34	5.03	
EM Local Rates	5.18	6.45	6	0	0	0	1	1	0.00	0.71	0.71	1.67	2.82	
CMBS	3.57	5.57	71	2	4	4	-4	-6	0.51	0.79	0.79	-0.28	0.17	
ABS	2.91	5.26	48	5	7	7	-5	-6	0.33	0.59	0.59	0.86	1.51	
CLOs	3.87	5.82	127	0	0	0	-5	-7	0.08	0.20	0.20	3.81	4.90	
Municipal Bonds	7.34	4.48	---	-18	-30	-30	89	91	1.31	2.02	2.02	-2.24	-1.65	

	Level	Total return (%)						Change (%)					
		WTD	MTD	QTD	YTD	Prior year		Spot	WTD	MTD	QTD	YTD	Prior year
Equity / volatility indices							FX / commodities						
S&P 500 Index	7,659	-1.9	0.1	0.1	12.9	16.9	EUR / USD	1.1	0.3	-0.8	-0.8	-4.3	-3.8
DAX	25,623	2.1	1.7	1.7	4.6	5.6	USD / JPY	158.0	-0.2	0.4	0.4	0.8	5.0
Stoxx 600	645	2.1	1.6	1.6	12.0	16.4	GBP / USD	1.3	0.7	0.5	0.5	-1.1	-0.8
Nikkei 225	65,324	-5.4	-2.1	-2.1	31.7	37.5	EUR / CHF	0.9	-0.4	-2.2	-2.2	-0.5	-0.1
Shanghai Composite	3,767	-2.5	-3.2	-3.2	-4.6	-2.9	USD / CHF	0.8	-0.7	-1.4	-1.4	4.0	3.9
MSCI ACWI Index	1,129	-1.6	-0.5	-0.5	12.9	16.7	USD (DXY)	101.8	-0.4	0.4	0.4	3.6	3.6
FTSE 100	10,882	3.2	2.7	2.7	12.5	18.9	Oil	101.4	10.4	12.2	12.2	76.6	76.5
MOVE Index	101	2.7	-8.5	-8.5	58.1	24.5	Gold	4165.6	-0.7	0.2	0.2	-3.6	-3.7
VIX Index	20	34.7	22.3	22.3	33.7	-21.0							

Past performance is not a guarantee or a reliable indicator of future results. Sources: Bloomberg except EMD (J.P. Morgan), HY (ICE BofAML), Bank Loans (S&P), and CLOs (Palmer Square). European returns are unhedged in euros unless otherwise indicated. An investment cannot be made directly in an index.

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Source(s) of data (unless otherwise noted): PGIM as of October 19, 2026.

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