

Early-2026 Recalibration

Fed pauses after December cuts, ECB prepares the ground, while markets test the “soft landing” narrative*

- The Federal Reserve held rates steady at its January meeting after three consecutive cuts into year-end (2025), while the ECB maintained its policy stance but signaled increasing confidence in the disinflation process.
- Financial markets entered 2026 with strong momentum, yet January-February volatility has revealed a more selective and fragile risk environment.

United States: A pause after three cuts, with financial conditions doing part of the easing

The Fed’s January hold confirms a shift from active recalibration to cautious monitoring, as markets debate how much easing is still to come. At its late-January meeting, the Federal Reserve kept the federal funds target range unchanged at 3.50%–3.75%, following the cumulative 75 bps of cuts delivered between September and December 2025. The statement reinforced the now-familiar message of data dependence, highlighting continued progress on inflation while acknowledging signs of moderation in labour-market momentum.

Headline inflation has moved closer to target, with core measures trending downward but still slightly above 2%. Growth indicators for Q4 2025 and early Q1 2026 suggest a cooling but not contracting economy. Consumer spending remains resilient, though more uneven, and business investment has softened. As for hiring data, these point to gradual normalization rather than abrupt deterioration.

Interest rate markets initially priced a high probability of further cuts by mid-2026. However, stronger-than-expected January payroll data and stable services activity have led to some repricing. Two-year Treasury yields, which had fallen into the low-3% range at year-end, have moved higher (3.5–3.6 %) during February, reflecting reduced urgency for immediate additional easing.

Beyond policy rates, the broader financial environment has loosened meaningfully compared with mid-2025. Equity valuations remain elevated, credit spreads tight by historical standards, and mortgage rates have declined relative to their 2024 peaks. As in late 2025, the effective stance of policy may be more accommodative than headline rates suggest, potentially limiting the

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Fed's room for aggressive further cuts unless macro data deteriorate more visibly.

The ECB's next move is more likely to be a cut than a hike as inflation hovers around target

Euro Area: Holding steady, but with easing bias strengthening

The ECB maintains its pause, yet communication suggests that the next move is more likely to be a cut than a hike. At its January meeting, the European Central Bank kept its key rates unchanged, holding the deposit facility at 2.00%. The Governing Council reiterated that inflation is “around target,” with both headline and core measures hovering close to 2%. Wage growth remains firm but shows tentative signs of peaking, while credit conditions continue to weigh on investment.

Recent activity data point to weak but positive growth in the euro area. Services have stabilized, and there are early indications that manufacturing contraction may be bottoming out, particularly in Germany. However, fiscal consolidation pressures in several member states and still-tight bank lending standards argue for caution.

Markets have interpreted recent ECB communication as preparing the ground for a potential cut in Q2 2026, conditional on further confirmation that inflation will remain sustainably at target. The divergence that dominated much of 2025 (Fed easing vs. ECB pause) is now narrowing, as the Fed pauses and the ECB edges closer to renewed accommodation.

The euro has traded in a relatively stable range (1.16-1.18) against the dollar in early 2026, with currency dynamics increasingly influenced by relative growth expectations and political risk premia rather than rate differentials alone.

Global markets: Strong start, rising dispersion, and February reality checks

January opened with strong risk appetite. U.S. equities extended their late-2025 rally, with broadening participation beyond mega-cap technology. European equities also benefited from lower energy-price volatility and expectations of more accommodative financial conditions later in the year.

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However, February has brought more nuanced price action. Volatility has picked up across rates and equity markets as investors reassess the timing and magnitude of further central bank easing. The “soft landing plus lower yields” consensus remains intact but is less one-directional than at year-end.

In fixed income, curves have modestly steepened in both the U.S. and parts of Europe as long-end yields stabilized while short-end expectations adjusted. Credit markets remain resilient, though issuance has accelerated, raising questions about valuation discipline if growth momentum slows further.

Commodities have shown mixed performance. Energy prices have remained contained despite geopolitical tensions, while precious metals continue to benefit from portfolio hedging demand and ongoing central-bank purchases. The U.S. dollar, after weakening into late 2025, has stabilized in early 2026 amid reduced expectations of rapid Fed easing.

Overall, markets appear to be transitioning from liquidity-driven optimism to a more earnings- and data-sensitive phase. Sector rotation has intensified, with investors favouring quality balance sheets and defensively positioned cyclicals over high-duration growth exposures.

A fragile but evolving equilibrium

The early-2026 backdrop resembles a recalibration rather than a regime shift. Inflation is no longer the dominant threat, but neither is it fully vanquished. Growth is moderating, yet recession risks remain contained for now. Central banks are moving from active adjustment to conditional fine-tuning.

For the Fed, the challenge is to avoid easing too quickly into still-robust financial conditions. For the ECB, it is to ensure that any renewed cuts reinforce, rather than undermine, credibility on price stability and fiscal discipline within the euro area.

Markets continue to price a benign macro path (gradual disinflation, moderate growth, and incremental easing) but this equilibrium remains exposed to confidence shocks, whether from geopolitics, fiscal tensions, or pockets of credit stress.

As 2026 unfolds, the key question is no longer whether the tightening cycle has ended. It is whether central banks can manage the next phase, normalization without complacency, in a world where policy credibility, financial stability, and geopolitical fragmentation remain tightly intertwined.

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Notes

- * This article was written prior to the escalation of conflict in Iran. Any resulting disruption to commodity markets, particularly oil, could introduce additional upside risks to inflation, with potential implications for the path of monetary policy at both the Fed and the ECB.