Fed acknowledges slowing US economy as two vote for an immediate rate cut

Two FOMC members voted for a 25bp rate cut, having openly stated that they agreed with the President there was a case for lower borrowing costs. However, the rest of the committee are reluctant with Chair Powell setting himself on a renewed collision course with the President by hinting that they could be seen to be "looking through" inflation by not hiking

Fed Chair Powell announces rates remain on hold, despite two dissenters voting for a rate cut

Two dissenters as Fed holds, but Chair Powell lobs in a hawkish grenade

The Federal Reserve has left monetary policy unchanged with the Fed funds target rate range remaining at 4.25-4.5%. Nonetheless, there was dissent. President Trump has been pushing hard for lower interest rates and two of his appointees to the Federal Reserve, Chris Waller and Michelle Bowman, supported that action today, voting for a 25bp rate cut. They both suggested recently that weakness in the jobs market was the big issue for them. However, Fed Chair Powell chose to put himself back on direct collision course with the President by suggesting that it could be viewed that the Fed are “looking through” tariff induced inflation by not HIKING rates today.

The rest of the committee seemingly have sympathy with Chair Powell's position. They believe they have time to wait, especially in light of the recent firmer-than-expected June jobs report, today's above consensus GDP print and ongoing uncertainty about how inflationary the President's tariffs will be.

Officials still hint at cuts, but it won't be enough for the President

In terms of changes to the press release, the FOMC acknowledges that "recent indicators suggest that growth of economic activity moderated in the first half of the year." Nonetheless they state that "unemployment rate remains low, and labour market conditions sold... [while] inflation remains somewhat elevated". After all, the Fed was stung by criticism after suggesting the post-pandemic supply shock price hikes would be "transitory", only for inflation to hit 9% in 2022. Most members will not have wanted to cut rates today on a hunch and only have to backtrack again if inflation remains persistent.

As for the press conference, amongst his less incendiary comments, Chair Powell repeated that while uncertainty remains elevated the US economy is in a "solid" position and that a reasonable base case to assume is that the inflation effect from tariffs is "short-lived". In this environment he suggests a "modestly restrictive" policy stance remains appropriate. When asked about a September rate cut he, unsurprisingly, refuses to pre-commit given there are two rounds of inflation and jobs data between now and then.

We continue to favour a December rate cut and it could be a 50bp move

Ahead of Powell's comments about not hiking rates the market was pricing 17bp of a potential 25bp cut priced for September and a cumulative 46bp priced for the end of this year. After the comments we are now at 12bp and 39bp respectively. September is certainly possible, but with inflation likely to be pushed higher by tariffs over the next few months, we are unlikely to get confirmation of more benign month-on-month inflation prints until the October and November reports. Obviously, this comes after the September FOMC and October FOMC meetings so if inflation is still hot we would need to see significant weakness in jobs to trigger a rate cut by then with chair Powell suggesting that the "main number" to look at is the unemployment rate.

We do think that tariffs are a one-off price adjustment and the month-on-month inflation rates will swiftly drop back to more benign readings late this year. Energy costs are contained, and the weaker jobs market means that wage growth, which contributed to the acceleration in inflation in 2021/22, is not strong enough to do so this time round. Moreover, the shifting dynamics of the housing market will mean housing costs, which have been a major driver of inflation in recent years, will increasingly become a source of disinflationary pressure as rents moderate.

Consequently, we think December will be the likely starting point, but that it may be a 50bp cut, if the evidence on weaker jobs and GDP growth becomes more apparent as we anticipate. This would be a similar playbook to the Federal Reserve's actions in 2024, where it waited until it was completely comfortable to commit to a lower interest rate environment. Then it made a 50bp move in September, followed by 25bp cuts in November and December.

Powell gives the dollar a boost

Dollar bears might have been hoping that today's FOMC meeting would have been dovish enough to restart the dollar bear trend. The only small crumbs of comfort seem to be the Fed acknowledging that economic growth has moderated in the first half of the year and Chair Powell outlining a base case that the inflationary impact from tariffs would be short-lived.

But that was about as good as it got for dollar bears – and the EUR/USD bounce stalled at 1.1500 – before the rest of the press conference swung the other way. Here the emphasis that economy was coping well with modestly restrictive policy and seemingly quite a high bar for a rate cut saw the market price the terminal rate for the easing cycle some 5bp higher.

There may also be the case that investors are questioning the magnitude of the easing cycle if policy is only modestly restrictive. For the rates market, we've seen some decent bearish flattening of the yield curve – a classic dollar positive. The curve is roughly 5-7bp higher on the day.

Given the prospect that the Fed might need to keep its foot lightly on the monetary brake a little longer, the G10 activity currencies such as the Swedish krona, Australian and New Zealand dollars and the euro are all off 1-1.2% against the dollar today.

The thing is this dollar correction may not be over yet. This week still needs to see what could be an upside surprise on the June core PCE deflator tomorrow, and an ok jobs report on Friday – where Powell has highlighted the importance of the unemployment rate. There's also the small matter of the 1 August tariff deadline on Friday. In all, we think there's still room for the market to price out the remaining 12bp of easing currently in place for September.

Given short dollar positioning and thinning summer markets, this EUR/USD correction could extend a little further. 1.12/1.13 seems quite far – but can't be ruled out in a short, sharp unwind of crowded trades. However, we're still pretty comfortable with a year-end forecast for 1.18 and will probably be looking out for the deterioration in US labour market data to swing EUR/USD back the other way over coming months.

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