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FX RATES UNITED STATES

Fed to delay rate cuts as war clouds the outlook

The Middle East conflict will push up prices, but it will also likely harm US growth and job prospects. We see this as a Fed rate-cut delayed rather than removed story, unlike 2022 when a demand shock, combined with a supply shock, fuelled inflation and led to rate hikes



We expect the Federal Reserve to remain on hold on 18 March. We see rate cuts as being delayed

Rising inflation constrains the Fed

The outlook for Federal Reserve policy changes has been upended by events in the Middle East. Financial markets have swung from anticipating two 25bp rate cuts this year to now pricing in barely one. Markets are solidly backing a no-change outcome on Wednesday, 18 March and we agree.

The military action in Iran and the resulting reluctance of shipping to navigate the Strait of Hormuz has led energy prices to spike higher. While the US itself gets very little crude oil from the Persian Gulf and is self-sufficient in natural gas, prices for oil are set globally. We are already seeing US retail gasoline prices up above \$3.60 per gallon with the real prospect of the national average pushing imminently towards \$4.25/gallon. This will put up supply and distribution costs, with airline fares also likely to push higher. The longer that the disruption lasts, the greater the chance it lifts prices in other sectors, including fertiliser, food prices and the cost of plastics. In consequence, we are now looking at inflation moving towards 3.5% by the summer, well above the 2% target.

The impact on growth and jobs is less clear-cut at this stage. The ISM business surveys for February were at levels historically consistent with 3% GDP growth, but the news on jobs is not

as rosy. The February jobs report showed the economy shed 92,000 jobs with the unemployment rate rising to 4.4%, suggesting the Fed's decision to remove the assessment that "downside risks to employment rose in recent months" from the January FOMC statement, was premature. A ramping up of geopolitical and economic uncertainty is not going to help bring better news on jobs and will do little to boost activity outside the US' energy sector.

Fed to signal a delay to rate cuts

Given this situation, we will be closely watching the Fed's new forecasts. In December, the Fed were pencilling in one rate cut in 2026 with one further 25bp cut in 2027. There is huge uncertainty over how long and how intense the conflict and the disruption will be, so the Fed will have little conviction in their forecasts. Fed Chair Powell will be certain to underline the challenges in setting policy in this situation at the press conference. Nonetheless, we suspect they will trim growth marginally, push up their inflation forecast and then delay the 2026 rate cut until 2027.

ING's expectations for updated Federal Reserve forecasts

	2025	2026	2027	2028	Longer run
Change in real GDP (4Q YoY%)	2.0	2.2	1.9	1.9	1.8
Previous Fed projection (Dec)	1.7	2.3	2.0	1.9	1.8
Unemployment rate (% year end)	4.5	4.4	4.2	4.2	4.2
Previous Fed projection (Dec)	4.5	4.4	4.2	4.2	4.2
Core PCE inflation (4Q YoY%)	2.9	2.7	2.2	2.0	-
Previous Fed projection (Dec)	3.0	2.5	2.1	2.0	-
Federal funds rate (year end)	3.6	3.6	3.1	3.1	3.0
Previous Fed projection (Dec)	3.6	3.4	3.1	3.1	3.0

Source: Macrobond, ING

Risks still skewed towards lower rates

We have been forecasting two rate cuts for September and December, but as the market has already done, we acknowledge the risk is that they are delayed into next year. While the Fed has a dual mandate of price stability and maximising employment, a central bank needs to defend its inflation credibility, and it is difficult to justify rate cuts when inflation is above target and rising further away from it.

The Fed's position in early 2022 was that inflation is transitory during a supply shock, and they needn't raise rates. However, robust hiring, soaring wage growth, pent-up demand coming out of lockdowns and stimulus checks meant consumer spending jumped significantly and inflation spiralled higher. The Fed then had to play catch-up, hiking rates 525bp between March 2022 and July 2023.

Today, the labour market is in a far weaker position with job creation and real household disposable income stalling over the past six months. At the same time, confidence has been eroded by tariff worries and job security fears, so there isn't the same demand impetus to fuel inflation. This should mean inflation is indeed "transitory" this time around.

Instead, we suspect that today's energy shock risks being demand destructive, which ultimately leads to lower core inflation. If there was an equity market correction, then the demand destruction would be all the greater. Consequently, we continue to have a bias to lower Fed funds rates over the next 12-18 months.

While tax refunds are expected to be quite substantial this year (around \$4000 on average versus \$3200 last year) we would likely need to see a larger fiscal boost, such as stimulus checks, to generate enough demand that would entrench inflation pressures and trigger Federal Reserve rate hikes. Bond markets would undoubtedly take fright, in part due to concern over higher debt levels and in part due to inflation worries and this would ignite talk of highly damaging 1970s-style market dynamics. Hence, we see this as a low probability event.

Will the Fed comment on the stickiness in the effective funds rate? Really they should

Since the Fed re-commenced T-bill buying in mid-December 2025, they have bought a cumulative US\$165bn. Overall, the Fed's holdings of all securities (including bills) are up US\$130bn, to US\$6.26tn. That has coincided with a rise in bank reserves, by US\$180bn, to just over US\$3tn (helped by a moderate spend down in the Treasury cash balance). Given the net US\$130bn of balance sheet expansion, the Fed should be disappointed that the effective funds rate has not eased lower, even if only by a few basis points.

Remember, the effective funds rate used to trade just 8bp above the funds rate floor, and the ratchet higher to 14bp through September/October 2025 prompted the policy of renewed T-bills buying in the first place. The back-story saw bank reserves dip below US\$3tn, and repo had shown a marked tendency to tighten, with bank reserves at sub-US\$3tn. That repo tightness, in a relative value sense, was the genesis of the rise in the effective funds rate. Rate cuts have dominated, of course, but the issue is the rise in the effective funds rate within the (25bp) funds rate range.

The effective funds rate has refused to budge from the 3.64% level. And by the way, that's just 1bp below the rate paid on reserves (3.65%). It's actually tough to get to 3.65%, as then eligible counterparties have a choice between two windows (reserves vs funds rate). It should not go above, though. Whether the Fed comments on this or not is an open question. It does deserve a question from the reporters though. They tend not to go there, but really they should. Efficient market functioning is an important base to have in times like these.

In terms of wider rates, and in particular, direction for bonds – the Fed is getting a feed of

higher nominal yields, higher real yields and higher inflation breakevens. That combination is hardly one that is conducive to rate cuts. In fact, every leg of it argues that a hold makes the most sense. And, for now at least, we will likely see more of the same. A 10yr yield in the 4.3% to 4.5% range is entirely possible before real yields finally cave and commence a journey back down.

Fed caution should keep the dollar supported

As around the whole world, the Middle East energy shock has prompted a hawkish re-pricing of short-end US interest rates as doors seem to close on easing cycles. While the adjustment in US rates has been less than in many other parts of the world, that has had little effect on the dollar. The macro shock of higher energy prices is by far the largest driver of currency trends now, while rate differentials have temporarily fallen away in importance.

That probably means that a mildly hawkish FOMC meeting on Wednesday, where the Fed pushes the median 25bp cut back to 2027 from 2026, will not have an outsized reaction on the dollar. However, a Fed leaning into the risk of higher energy prices, even as the US jobs market seems to be holding up, will be mildly dollar supportive. Certainly, the re-pricing of the Fed cycle has compounded the energy shock faced by Europe, Asia and most emerging markets. This has upended the narrative of a benign decline in the dollar this year.

As long as energy prices stay high or go higher, it is hard to see the dollar handing back this month's gains. The only big supply of dollars we could see in this environment could come from the official sector, where Japan looks likely to intervene in USD/JPY above 160. Joint US-Japanese FX intervention to sell USD/JPY would be a surprise and trigger a broader dollar correction. But unless energy prices reverse, FX intervention would just be an exercise in containment.

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