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Fed to push back against calls for rate cuts

Presidential demands for lower interest rates are falling on deaf ears at the Fed as near-term inflation concerns limit the scope for action. Nonetheless, the US economy is cooling and that can pave the way for major rate cuts in the second half of the year

The Federal Reserve's latest Beige Book is the most bleak we have seen in a long time

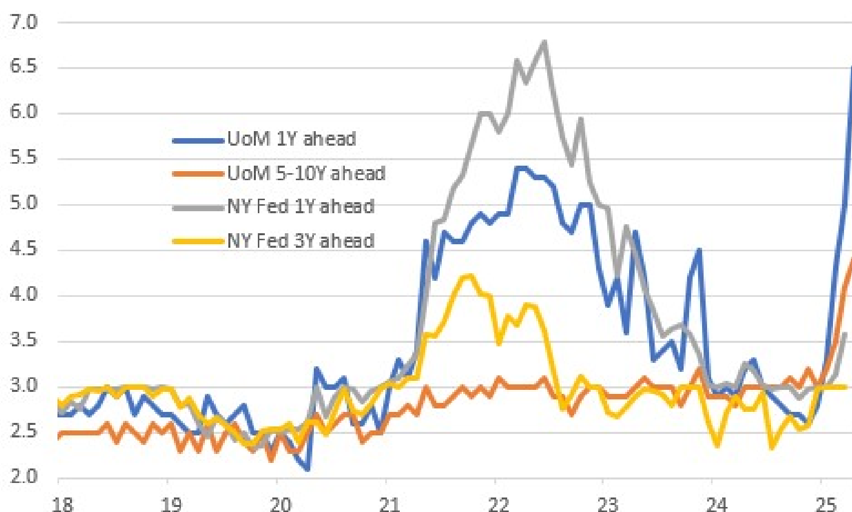
Fed officials remain wary of cutting rates too soon

Despite overt pressure from President Donald Trump and Treasury Secretary Scott Bessent to cut the policy rate, the Federal Reserve is widely expected to leave monetary policy unchanged at the 7 May FOMC meeting. In his most recent comments on 16 April, Fed Chair Jay Powell suggested that the central bank is in a "wait and see mode" despite warning that unemployment looks set to rise with the economic impact from tariffs likely to be larger than they had previously been thinking.

In that regard Powell suggested that the jobs market is in decent shape, as confirmed by Friday's jobs report. But he signalled that the US can't have a strong labour market without price stability, stating that "our obligation is to keep longer-term inflation expectations well anchored and to make certain that a one-time increase in the price level does not become an ongoing inflation problem". This suggests little prospect of a near-term interest rate cut.

Fed Governor Chris Waller was more explicit suggesting a move is unlikely at the May or June FOMC meetings, arguing that because of the 90-day pause on reciprocal tariffs "I don't think you're going to see enough happen in the real data in the next couple of months, until you get past July".

Household inflation expectations spike on tariff fears (YoY%)



Source: Macrobond, ING

But the outlook is becoming more uncertain after a weak first quarter

The outlook for growth, inflation and jobs is uncertain right now. First-quarter GDP did contract, but that was due to a surge in imports as companies brought forward purchases of foreign made goods in order to avoid tariffs. However, we are now seeing a steep drop-off in new orders for goods with shipping from overseas slowing rapidly. The CEO of the Port of Los Angeles has warned that incoming volumes are imminently going to be down by more than a third versus the same period last year while the CEOs of Walmart and Target reportedly warned President Trump of disrupted supply chains and the potential for empty shelves in the weeks ahead. A supply shock overlaying tariff-induced price hikes runs the risk of a more prolonged period of above-target inflation that will make the Fed nervous of cutting interest rates.

Tariffs are already having an impact on sentiment with the clear risk that this become more pronounced the longer the uncertainty lasts. Households are worried that higher prices will squeeze their spending power and at the same time anxiety about jobs and access to entitlements is intensifying amidst government spending cuts. With the outlook for prices, incomes and household wealth becoming headwinds for spending, it is also little surprise that business is becoming more nervous. That points to slower hiring and investment spending

ahead at a time when the Federal government is looking for ways to dramatically cut back expenditure.

Rate cuts from the third quarter

Weaker economic activity and rising inflation is likely to leave the stagflation narrative in place, but we don't think inflation will persist. While goods prices are likely to rise noticeably, the service sector is seeing the opposite pressure with falling tourism and leisure and hospitality spending resulting in some substantial price falls for airline fares and hotel costs.

Moreover, the cooling jobs market is set to limit wage gains so we shouldn't get the second-round price effects that drove US inflation up above 9% in 2022. Housing inflation could also start to dominate the story in early 2026. Housing has a 40% weighting of the core CPI basket and a weaker economy is likely to mean that landlords become more conservative in their pricing with the Cleveland Fed's new tenant rent series already falling YoY. This decline in service sector inflation combined with tariffs' influence on inflation fading next year means we think the Fed will become increasingly confident that inflation will be back at target by late 2026. This should open the door to meaningful rate cuts in the second half with 100bp our base case with the risks skewed towards a more aggressive response to any economic weakness.

The Fed poses a positive impulse for Treasuries, as a net buyer, and even on a longer hold theory

The Fed 'tapered the taper' last time out (cutting the roll-off to $5bn per month for Treasuries). For this meeting, nothing new is expected on this front. There is however a stated ambition to get the Fed's mortgage-backed-securities off its books over time, preferring to have Treasuries in their place. That policy objective has not been translated into a specific agenda, but could become one at some point in the future should circumstances allow. The issue is MBS holdings are quite long in maturity, so to get them off the Fed's balance sheet sooner would require a debt swap of sorts. This is all supportive of Treasuries, as the Fed remains a net buyer of Treasuries at a very minimum, to the tune of anything more than $5bn that rolls off the curve. That can be anything from approximately $20bn to $60bn on any given month.

Given that the US Treasury remains under the debt ceiling constraint, the tendency over the coming months will be to spend down the cash pile they currently hold (approximately $675bn) to finance government spending. This will add reserves back to the banking system, in turn holding off the day when bank reserves become too tight. This backdrop also means the Fed will not have to overly focus on this space, at least not for now. The overall prognosis for markets is positive, as the Fed remains a net buyer of Treasuries. The Fed is also projected to cut rates, which is a bullish impulse ahead, especially for shorter dates. However, should the Fed delay on cuts, it likely acts to pull longer dated Treasury yields down,

on a theory that a longer hold means less cushion for the economy, ultimately taming longer dated yields.

Fed unlikely to move the dollar needle

Normally the dollar would be expected to move in line with short-dated US yield on a FOMC day, where the exchange rate is effectively seen as an extension of monetary policy. However, the recent gyration in US asset markets suggest there may be not such a clear cut relationship this time. For example, does a Fed dragging its feet on an easing cycle hit US equities and once again demand a higher risk premium of the dollar?

With the market now pricing so little easing before the July FOMC meeting, we doubt the dollar needs to move too much on what should be another round of equivocal comments from Chair Powell. Instead, the dollar remains more beholden to trade updates and especially to hard US data.

Last week, we felt that the rally in US equities helped to take some of the financial risk premium out of the dollar. If the dollar is to rally further it may be more against the yen, given that short USD/JPY positioning looks quite stretched amongst the leveraged fund and particularly asset management communities. EUR/USD looks more of a 1.12-1.14 range for the time being – without a clear lead from the Fed.

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