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RATES UNITED STATES

## Hawkish Fed members fire warning shot across Warsh's bow

The Federal Reserve held rates steady with Stephen Miran again voting for a cut, but three members – while not voting for a hike – signalled a growing sense of unease on the inflation front. This suggests a tougher two-way debate on rates at Kevin Warsh's first FOMC meeting as Chair in June



The Federal Reserve left rates unchanged at Jerome Powell's final meeting as Fed Chair

### Fed hawks find their voice

The Federal Reserve has left monetary policy unchanged with officials voting 8-4 in favour of keeping stable rates. Those four are broken down as Stephen Miran again voting for a 25bp rate cut, but with three others – Beth Hammock, Neel Kashkari and Lorie Logan – while not voting for a rate hike, "did not support inclusion of an easing bias in the statement at this time".

The confusing aspect is there isn't specifically a reference to an easing bias. The statement itself says, "The Committee is attentive to the risks to both sides of its dual mandate." This is an unusual way of characterising a vote and it maybe they wanted it included as a shot across the bow of Kevin Warsh, who will be leading the Fed at the next FOMC meeting. They perhaps

want to make it clear that they will not be easily swayed to his way of thinking that rates in time can be lowered.

Certainly, the Fed says they will be assessing "a wide range of information, including readings on labour market conditions, inflation pressures and inflation expectations, and financial and international developments". It maybe that the minutes will show they wanted to signal an intention to hike rates if inflation expectations started to push meaningfully higher, risking a more prolonged and broader inflation threat. Markets interpreted it as a hawkish shift, with Fed funds futures contracts discounting stable rates through to year-end, having priced 10bp of cuts in 2026 on Friday.

### **More disagreement and more market volatility**

Today's Senate Banking Committee 13-11 vote in favour of putting Kevin Warsh's nomination to a full Senate ballot means it looks a virtual certainty that he will be signed in as the new Chair just ahead of the 15 May expiration of Jerome Powell's term. The messaging from Warsh is he seemingly wants less of the consensus-driven approach we have seen under previous Chairs, which critics suggest has led to group think that led to slow responses to new events. Instead, Warsh is advocating for an environment where debate and disagreements are encouraged and that looks set to be the case in June. This implies the potential for more surprises and therefore more market volatility. Powell has also said he will continue to serve as a Governor for a "period of time" – his term for that position continues until January 2028 – and this is likely to keep tensions between the President and a more hawkishly positioned Fed, elevated.

### **Inflation still seen as transitory, but the Fed needs to protect its credibility**

Both headline and core inflation have been above the 2% target for five years and looks set to break above 4% next month on gasoline and air fares, so it is understandable why markets and Fed officials are nervous. Officials want to ensure that we don't see higher energy prices feed through into the cost of other goods and services, and so we expect them to talk very tough on this front. This hawkish rhetoric is likely to be stepped up over the next few weeks and until a deal is done in the Middle East that will hopefully provide relief.

Nonetheless, companies have not had much success in passing on the significant cost of tariffs to consumers with CPI goods prices ex-food and energy barely rising 1% year-on-year. Importantly, the current supply shock, focused on fuel prices, is not as broad as the pandemic-related supply chain stresses in 2020/21, and we don't have the same sort of demand impetus that would risk a broader, more persistent inflation story.

Real household disposable incomes are already flatlining amidst a stagnating jobs market, so we see higher fuel prices as being demand destructive via reduced spending power. This is set

to weigh on core inflation, and we also need to remember the importance of shelter costs within the US inflation basket (35.5% weighting for headline and 44% for core), which we expect to moderate further. Moreover, if Middle East tensions ease and oil prices drop, there is a high probability of sub-2% year-on-year inflation being achieved in 2027.

Right now, the outlook is highly uncertain and could change very quickly due to developments in the Middle East. We expect the Fed to hold rates steady throughout the summer. Our view, for some time, has been a September rate cut and a December rate cut, but we do recognise that the risk is they are delayed given the current lack of signs of a potential deal. Nonetheless, we still see the prospect of eventual rate cuts being more likely than rate hikes.

### **Curve flattens on front end scare factor**

Earlier, the US 10yr yield had gapped higher, and hit 4.4%. Actually, the whole curve gapped up. The hold-out in the Strait of Hormuz was the catalyst. Some duration selling makes a lot of sense here, where we are in “nowhere land” on a resolution to the war. Extrapolate this, and we could sail back up to the 4.5% area that we hit a few weeks ago. Some of this was echoed in the decision of three Fed members to step away from the underlying easing bias that had dominated policy changes since the wider rate-cutting process began. For these three members, that journey is at an end. The main follow-through from the FOMC outcome is a consolidation at 4.4% for the 10yr, and a further rise in the 2yr to above 3.9% – a flatter curve from the front end. More to come, at least for as long as the hold-off in the Strait continues, and the prognosis there is for the status quo to be in an uncomfortable place.

Between March and April, the implementation notes that accompany the FOMC statement are operationally unchanged, but the tone shifts from active reserve support to maintenance – suggesting the plumbing has calmed enough for the NY Fed Desk to stand down, even as policy stays on hold. Last week the NY Fed cut T-bill buying from US\$40bn to US\$25bn per month, pointing in the same direction, and indicative of some comfort over the plumbing of the system. The missing ingredient here is the ongoing elevation in the effective funds rate. It remains at 3.64%, a mere 1bp below the rate on reserves at 3.65% (unchanged). It used to be 7bp below (September 2025). The Fed, ideally, would prefer to get it back there. But no big stress here. In all probability, the effective funds rate will be coaxed down as bank reserves slowly rebuild in line with ongoing T-bills buying, even if at a slower pace.

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