

## Hawkish hold from the Fed to test Trump's patience

Robust activity, a solid jobs market and sticky inflation justify the Fed's decision to hold interest rates steady. The hawkish tilt from officials may in part be a message to President Trump that they won't bow to his will on interest rates and suggests a clear and unambiguous weakening in the data is required to prompt further action. We think it will come, but not before June



US Fed Chair Powell at today's press conference in which interest rates remained on hold

### Fed holds rates steady at 4.25-4.5%

No surprises from the Federal Reserve at today's FOMC meeting with a unanimous decision to leave the Fed funds target range at 4.25-4.5%. After 100bp of cuts through the final four months of 2024 the Fed had already signalled a desire to take time to evaluate the impact of their actions and to also gain greater clarity on how President Trump's policy thrust may impact the economy.

That said, within the accompanying statement there is a hawkish shift in language that suggests we need to see an unambiguous softening in the data for them to deliver further interest rate cuts. It repeats that economic expansion remains "solid", but they have removed the comment that inflation has "made progress" towards the 2% target, saying merely that "inflation remains

somewhat elevated” – although in the press conference Chair Powell downplayed the significance of this. They also state that unemployment has “stabilised” with labour market conditions “solid”. In December they said that labour market conditions had “generally eased”.

## Fed funds target rate and market expectations



Source: Macrobond, Bloomberg, ING

## President Trump wants lower interest rates

The Fed will no doubt be braced for criticism from President Trump who told last week’s Davos World Economic Forum that “with oil prices going down, I’ll demand that interest rates drop immediately, and likewise they should be dropping all over the world”. The Fed under Jay Powell, whose term expires next year, will only acquiesce if to do so would be consistent with their mandate. Their December forecasts do indicate an inclination to cut interest rates – they are projecting two cuts this year – but their concern is likely to be that Donald Trump’s policy thrust of tax cuts and less regulation should be growth supportive while tariffs and immigration controls are likely to be somewhat inflationary. With tomorrow’s GDP data expected to show the economy grew 2.8% last year and with unemployment a little above 4% and core inflation lingering around 3% the Fed are likely to pause here for a number of months. This was confirmed by Chair Powell in the press conference when he said “we do not need to be in a hurry to adjust our policy stance”.

## Slower and more gradual moves from the Fed

Our forecast had been three Federal Reserve interest rate cuts in 2025 – March, June and September – but this was heavily dependent on President Trump’s enacted policies as well as the evolution of data. We remain optimistic on a further moderation in annual inflation rates in the months ahead, helped by slowing housing cost increases. We also anticipate that next month’s payrolls benchmark revisions will indicate a much weaker job creation path than initially reported. However, with Donald Trump threatening 25% tariffs on Mexico and Canada and 10% on China from this weekend the narrative could rapidly change – indeed Powell admits “we don’t know what will happen with tariffs, with immigration, with fiscal policy, with regulatory policy”. But in an environment of renewed Fed wariness we are leaning in the direction of a slower rate cutting path of two 25bp rate cuts in the second half of 2025 with a further 25bp cut in early 2026 while acknowledging that the range of possible outcomes is, if anything, widening.

## Treasuries eye issues with rate cut ambition, while QT end not made an issue just yet

It's clear that inflation is still an issue at the Fed. Not as severe as it was, but let's say, not a fully resolved issue. Treasuries have had the same view over recent months. This is a 3% inflation economy, and therein lies the genesis of the funds rate not getting back down to neutral (3%) and the 10yr Treasury yield remaining above 4.5%. The impulse reaction for Treasuries is negative due to this. We're not fully convinced this is the beginning of resumed bear market just yet, as we have the PCE inflation report this week. The worry will be that the Fed has seen it, and maybe is not thrilled by it. If so, that's not great for Treasuries.

On the likely end to QT by mid year (our view), the short FOMC statement chose not to mention it. Maybe not big for them now. But they certainly must have talked about it. The issue here is excess liquidity (which we define as bank reserves plus reverse repo balances). It is likely to hit levels that the Fed would prefer not to go below from the middle of 2025 onwards, partly depending on how the debt ceiling saga evolves. The key number here is US\$3tn for bank reserves, representing about 10% of GDP. We are currently at US\$3.3tn. However, with QT running at US\$60bn per month, ongoing QT would bring reserves down in net terms. The Fed will want to end QT before things get overly tight.

But clearly the Fed did not want to make a big deal on the end of QT, as it will end. Rather the "no change" outcome is smothered by inflation stubbornness, although in the end smoothed over by another ever-calm Chair Powell performance.

## Dollar gets a brief lift

A mildly hawkish FOMC statement has seen the dollar take its cue from the USD rates market and edge a little higher. This in no way compares to December's big shift in Fed communication and projections which helped propel the DXY dollar index to a high of 110 in early January. And in fact, those modest dollar gains have proved fleeting today.

Instead, the FX market will probably take a little more interest in Friday's release of the December core PCE inflation release and a lot more interest in whether the weekend sees the Trump administration follow-through on threats to impose tariffs on Canada, Mexico and China.

In particular, in its Monetary Policy Report released today, the Bank of Canada has tried to model the impact of a 25% US tariff on all Canadian goods and retaliatory Canadian tariffs by the same amount. The conclusion is that Canadian growth would be 2.5% below baseline forecasts in Year 1, while the inflationary impact would see CPI being a full 1% above baseline forecasts by Year 3.

Importantly, a separate research article in that publication estimates that of the 7% rise in USD/CAD since October, 6% of that rise has been driven by a risk premium. In other words, and we agree, the threat of tariffs has been a major driver of FX rates and that will probably be the case as FX markets await trade developments this weekend. And if not this weekend, uncertainty around findings of a major US trade review in April looks likely to keep the dollar bid over coming months.

In short, tariffs and not rate differentials are the major FX driver now. But a slightly hawkish Fed can only help a market currently positioned overweight the dollar.

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