Inflation doubts to keep the Fed on hold until December

Amidst a slight cooling in economic activity, inflation has been making decent progress towards the 2% target. However tariffs and a spike in energy prices mean a mini-resurgence is likely to delay the Fed's abilities to cut rates until the final meeting of the year

We expect the Fed to remain on hold on 18 June and see the first rate cut in December

Updated Fed forecasts could suggest just one cut in 2025

The Federal Reserve is widely expected to leave monetary policy unchanged on 18 June. Central Bank officials have suggested they will be patient in assessing the impact of the President's tariff policy on growth and inflation, implying little prospect of a rate change before September. The key thing to watch will be updated Fed forecasts and whether they continue to point to 50bp of rate cuts both this year and next. Given this remains in line with market pricing we sense they will choose to stick with them, but the risk is that switches to 25bp for this year and 75bp for next given uncertainty on how quickly inflation will slow after tariffs hit.

ING's expectations for Federal Reserve projections

	2025	2026	2027	Longer run
Change in real GDP (4Q YoY%)	**1.5**	**1.8**	**1.8**	**1.8**
Previous Fed projection (Mar)	1.7	1.8	1.8	1.8
Unemployment rate (% year end)	**4.4**	**4.4**	**4.3**	**4.2**
Previous Fed projection (Mar)	4.4	4.3	4.3	4.2
Core PCE inflation (4Q YoY%)	**3.2**	**2.5**	**2.0**	**-**
Previous Fed projection (Mar)	2.8	2.2	2.0	-
Federal funds rate (year end)	**3.9**	**3.4**	**3.1**	**3.0**
Previous Fed projection (Mar)	3.9	3.4	3.1	3.0

Source: Federal Reserve, ING

Growth risks point to further rate cuts over time

While the 'Liberation Day' tariffs have been scaled back in the wake of some significant market angst in April there is concern that some damage has resulted and there continues to be the risk of occasional flare-ups in tensions.

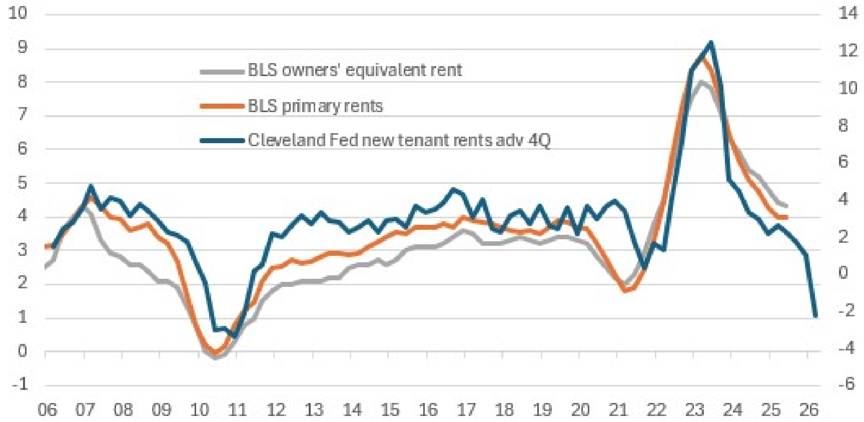
Steep falls in consumer confidence suggest downside risk to consumer spending growth as households worry that tariff-induced price spikes will squeeze spending power at a time when perceptions of the jobs market are deteriorating. Meanwhile, a lack of clarity on the trading environment means there is the potential for corporates to delay decisions on hiring and investment. The latest Beige Book, which heavily influences Fed monetary policy, was downbeat on the growth story. It warned a majority of Fed Districts are reporting "slight to moderate declines in activity" while "comments about uncertainty delaying hiring were widespread". With the Fed funds rate still up at 4.5% versus their 3% forecast for where they see the policy rate settling over time, this indicates that a case is building for renewed interest rate cuts.

But inflation challenges mean it could be delayed

However, tariffs do risk higher goods prices and this is likely to keep the Fed cautious. The Beige Book commented that "there were widespread reports of contacts expecting costs and prices to rise at a faster rate going forward. A few Districts described these expected cost increases as strong, significant, or substantial". So while recent benign inflation prints are welcome, we think investors should be braced for the month-on-month rates to pick up to 0.4% or even 0.5% from July onwards. Tariff-induced price hikes could be amplified further if the spike in energy prices in the wake of the Israeli attacks on Iran is sustained.

We therefore think September is too soon for the Fed to be comfortable cutting interest rates. We will only have data for July and August by that point and we don't think there will be enough evidence of labour market stress to offset the fears that near-term elevate inflation readings could persist.

Housing costs could help to offset the impact of tariffs



Source: Macrobond, ING

A December cut, potentially of 50bp, is our call

Instead we think that December is the more likely start point for the Fed to start cutting interest rates. We see tariffs and energy costs prompting elevated MoM inflation prints for July through to October, but thereafter we are looking for much softer readings. The squeeze on spending power from higher goods and energy prices could lead to cuts to discretionary spending that impacts the service sector and cools inflation faster there. At the same time the jobs market is cooling and wage inflation is slowing rather than rising, which is what allowed the supply shock post pandemic to morph into rapid inflation that nearly hit 10%. There is also evidence of softer housing-related inflation on the way with new tenant rents already turning negative. Housing accounts for around 40% of the core CPI basket by weight and that process will help inflation to return to 2% in 2026.

We don't disagree with the market pricing of 50bp of cuts this year, but rather than 25bp moves in September and December, we are favouring a 50bp move in December followed by three 25bp cuts in 2026. This would be a similar playbook to the Federal Reserve's actions in 2024, where they waited until being completely comfortable to commit to a lower interest rate environment.

Chair Powell should brace for some questions on liquidity management

In terms of liquidity circumstances, it's quite a comfortable story. This stems back to the debt ceiling, which limits the ability of the US Treasury to engage in net issuance. That in turn means that tax income taken in by the US Treasury gets spent down quite quickly, resulting in a boost to bank reserves. In consequence, despite the quantitative tightening (QT) done, there is no sense of bank reserves dipping into a state where there might be liquidity issues. The lift of the debt ceiling would put all of this into reverse, resulting in a material reduction in bank reserves and tighter conditions. The glide path for QT already engineered by the Fed has set the stage for this, and in that sense the Fed is broadly ready. Chair Powell may or may not choose to comment on this at the press conference.

A juicier element that Chair Powell likely will be questioned on is the recent suggestion from Senator Cruz that the Fed should not compensate banks for holding (excess) reserves. Traditionally minimum bank reserves were a regulatory requirement that paid zero interest. But, because of the large QE engineered during the GFC, banks had to be compensated at market rate levels for holding more reserves than they really needed. That coincided with a change in the way the funds rate was managed, with the rate charged on bank reserves operating as something of a soft ceiling (IOER at 4.4% currently). And loosely, the effective floor rate is proxied by the rate set on the reverse repo facility (RRP at 4.25% currently). Both represent liquidity pools, and both are avenues that the Fed employs to help manage liquidity circumstances. Moreover, they are two Fed levers that help guide the funds rate within the policy floor and ceiling rates (currently 4.25% to 4.5%).

In our opinion, any decision that removes a rate compensation on bank reserves is certainly un-practicable, and potentially unworkable. Banks would then choose not to hold excess reserves, likely channeling liquidity excesses into reverse repo balances. But doing so would make the Fed's liquidity management job more difficult. Chair Powell won't bring this up voluntarily at the press conference, but it is likely a hot question that someone will ask.

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