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FX RATES UNITED STATES

Kevin Warsh navigates a hawkish Fed shift

Improved economic momentum and elevated inflation suggest the Federal Reserve will acknowledge the possibility of a future rate hike via new forecasts. New Chair Kevin Warsh isn't a fan of forward guidance though and will likely remain non-committal in his first press conference



We doubt that new Fed Chair Kevin Warsh will vote for a rate cut, despite Trump's demands for lower rates

Inflation and regained momentum swing hawkishly

Optimism is rising that we are inching closer to a deal to reopen the Strait of Hormuz, but even with a deal, global energy prices will likely remain elevated until at least early 2027. European and Asian inventory rebuilding will keep a strong bid in markets through the second half of the year. At the same time, uncertainty over the scale of damage to infrastructure in the region and the willingness of shipping companies to put their vessels back potentially into harms way, should the deal subsequently fail, limits supply. In consequence, we expect no real relief from higher prices this year.

The US economy is more insulated from Middle East risks than most countries due to its energy independence, but it is not immune. An abundance of natural gas and a lack of storage mean domestic prices have fallen, which is helpful for keeping utility bills in check. However, higher motor fuel costs are adding to cost pressures with spillover effects already in freight

rates and airline fares, with inflation breaching a three-year high of 4.2%.

Amid rising inflation, business surveys point to 2-2.5% GDP growth, the economy is adding jobs and equity markets are at record highs. Understandably, market expectations of potential Federal Reserve rate hikes have increased, with a 25bp rate hike priced in this year and around a 50% chance of a second such move next year.

Unanimous vote for stable rates

In terms of Wednesday's FOMC meeting, we expect the Fed to leave monetary policy unchanged, but we do expect a statement that puts greater emphasis on the possibility of an interest rate rise. Remember that last time, Stephen Miran, who has since vacated his governor position for newly appointed Fed Chair Kevin Warsh, voted for a rate cut while three other FOMC members – Beth Hammack, Neel Kashkari and Lorie Logan – wanted the removal of the perceived “easing bias”. The minutes to the meeting subsequently suggested more officials were uncomfortable with the language of the statement, and so we expect to see a unanimous vote in favour of keeping policy unchanged, but with a hawkish shift on language.

With Miran gone, we doubt that Kevin Warsh will choose to dissent against all the other 11 members by voting for a rate cut, despite his appointment as chair by a president who has demanded lower rates.

ING's expectations for the Federal Reserve's central projections

	2026	2027	2028	Longer run
Change in real GDP (4Q YoY%)	2.0	2.4	2.1	2.0
Previous Fed projection (Mar)	2.4	2.3	2.1	2.0
Unemployment rate (% year end)	4.3	4.3	4.2	4.2
Previous Fed projection (Mar)	4.4	4.3	4.2	4.2
Core PCE inflation (4Q YoY%)	3.1	2.3	2.0	-
Previous Fed projection (Mar)	2.7	2.2	2.0	-
Federal funds rate (year end)	3.6	3.4	3.1	3.1
Previous Fed projection (Mar)	3.4	3.1	3.1	3.1

Source: Federal Reserve, ING

In the press conference, he will likely acknowledge that economic conditions do not justify rate cuts at this time. Nonetheless, he could reiterate his view that, in time, tech investment will boost US productivity, meaning faster growth without generating inflation. That would imply a lower neutral interest rate that justifies lower policy rates over the medium to longer term. He has also argued that the Fed's balance sheet is too large. He would like to shrink it relative to the size of the economy, which would be a de-facto tightening that can be offset by lower

policy rates.

Chair Warsh will also be questioned on updated Fed forecasts, which we expect to point to expectations of healthy growth and elevated inflation this year, with stable policy rates. But within the dot plot there may be more officials signalling that they think rates will be higher by the end of the year than there are those who think rates will be lower. However, Warsh has already suggested that the Fed talks too much and isn't a fan of forward guidance, so he will be keen to highlight that there are, in fact, two-sided risks and much can change between now and the end of the year.

An extended pause is our call

It is a very close call whether the Fed will hike rates this year, but on balance, we think it will instead choose to look through a near-term energy spike and hold rates steady for an extended period. The low-hire, low-fire economy means weak wage growth, with real household disposable income having fallen for three consecutive months. Consequently, elevated energy costs risk demand destruction that should help to dampen core inflation in time. Consumer and market inflation expectations remain in tolerable ranges and slowing housing rents, weak wage growth, a waning influence from tariffs and eventual energy price falls mean that inflation could undershoot the target in the second half of 2027. This environment should give the Fed room to resume moving policy rates back to neutral next year.

Now's the chance for Chair Warsh to walk the talk on balance sheet reduction

This is one meeting where the focus could well be on balance sheet and liquidity management. Kevin Warsh came into the job in the wake of various suggestions that the Fed should reduce the size of its balance sheet. We covered the issue [here](#), and noted that at the end of 2005, the Fed's balance sheet was about 5.5% of GDP. Roll on 20 years, in and out of the global financial crisis and pandemic, and it's now 21% of GDP (quadruple). The driver was bond buying. Total bonds held by the Fed were around 5.5% of GDP 20 years ago. That now equates to 20% of GDP (almost quadruple). Bank reserves were purely regulatory in nature and a puny 0.1% of GDP 20 years ago. Today's bank reserves are closer to 10% of GDP (100-fold).

Kevin Warsh wants to 'fix it', it seems. The technicalities could require the sale of all mortgage-backed bonds (US\$2tr) and at least half of the Treasury bonds (c.US\$2.5tr). So that's some US\$4.5tr in total, and would bring Fed bond holdings back down to around 5.5% of GDP (pre-GFC proportions). That in itself is big, and raises questions about a doable pace. On the other side of the balance sheet there is the complication of transitioning from the current excess bank reserves environment back potentially towards a scarce regulatory bank reserves environment. On the former, a Congress-legislated special purpose vehicle tasked with taking

the bonds off the Fed's balance sheet has been mooted (so they would not be "sold"). On the latter, an easing in bank liquidity ratios would be required.

For now, it's all quite speculative. But what we do know is Kevin Warsh can't simply sell bonds and stop there. He would need to address both sides of the balance sheet, and make regulatory changes to bank liquidity requirements. This is the kind of meeting from which we could well learn more about all of the above.

Dollar can hold gains

The FX market goes into this FOMC meeting in a mildly dollar-bullish frame of mind. In fact, it was the last FOMC meeting in late April and the dissent against the easing bias which laid the foundations for the dollar rally on better US data over the last six weeks.

A removal of the easing bias in Wednesday's statement is widely expected and, as usual, the market will probably react to the median expectation for the policy rate over coming years. This presumably could present some upside risks to the dollar.

When it comes to the press conference, it is probably too early to expect Chair Warsh to push back against market expectations of Fed tightening. After all, the economy and asset markets are already performing well in the face of this energy shock.

Our FX bias would be for the dollar to stay bid against the relative low yielders and whose central banks are trying to look through the inflation shock. Depending on what is happening to energy prices and the risk environment, pairs like USD/CAD and USD/SEK could stay bid, while GBP/USD could stay offered. EUR/USD may well press 1.15 again, but the prospect of another European Central Bank rate hike in July should provide some insulation.

Wednesday's FOMC will come a day after the Bank of Japan meeting. A BoJ rate hike to 1.00% is widely expected, but deeply negative Japanese real rates leave the yen vulnerable. A slightly hawkish FOMC meeting could send USD/JPY well above 160 again and elicit more intervention. Japanese authorities are well aware, however, that intervention is just a containment exercise until energy prices come a lot lower, markets start to think about Fed easing again, and Japanese real rates are much closer to neutral. That looks like a story for the end of this year at the earliest.

Author

James Knightley

Chief International Economist, US

james.knightley@ing.com

Padhraic Garvey, CFA

Regional Head of Research, Americas

padhraic.garvey@ing.com

Chris Turner

Global Head of Markets and Regional Head of Research for UK & CEE

chris.turner@ing.com

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