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UNITED STATES

Three in a row from the Fed, but more cautious moves expected in 2026

Markets are increasingly confident the US Fed will deliver a third consecutive 25bp interest rate cut on 10 December. But officials are divided over whether inflation or the labour market is the bigger issue, suggesting a split vote. In turn, this suggests a slower pace of rate cuts in 2026. We look for one 25bp cut each in the first two quarters of next year



We're expecting another Fed rate cut from Chair, Jay Powell, next week

The Fed had appeared reluctant to cut

There is a recognition within the Federal Reserve that even after 150bp of cumulative interest rate cuts, monetary policy remains modestly restrictive. However, officials' relative position on the risks to the Fed's dual mandate of price stability and maximum employment is becoming more dispersed.

Expectations have swung wildly in the build-up to the 10 December FOMC meeting. At the press conference that followed the 29 October rate cut decision, Fed Chair Jerome Powell suggested that a further reduction in December *"is not a foregone conclusion, far from it"*. The minutes to that decision showed "many" members were "leaning" against a December rate

cut, and there was a sense that a lack of official data ahead of the December meeting, caused by delayed collection due to the government shutdown, was not going to help change their minds. On 19 November, we got down to just 7bp of a 25bp December cut being priced.

The weaker jobs story now favours a third 25bp cut for the year

In terms of the hawks, several Fed members remain concerned that the potential for stickier, more elevated inflation from tariffs can't be ignored, while higher insurance costs are also an issue. The economy is still growing, equity markets are at all-time highs, and unemployment remains very low, so to them, there doesn't appear to be a pressing need to cut rates again.

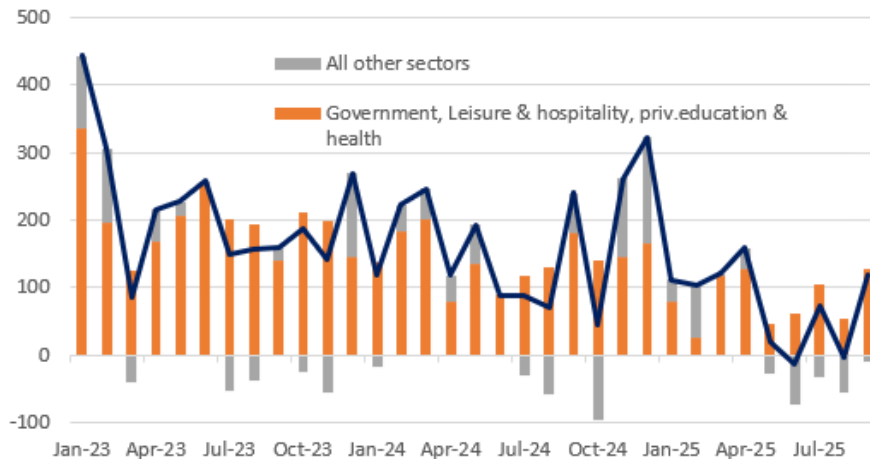
However, the more dovish members of the Fed argue that the second part of their mandate, maximising employment, is looking more challenged. Over the past two years, more than 90% of all US jobs created have originated in the leisure and hospitality sector, government and private education and healthcare services, and these three sectors look vulnerable to government spending changes and weak consumer sentiment. Moreover, all other sectors combined – such as retail, business services, transport & logistics, technology, and financial services – have lost jobs over the previous five months, as you can see in the chart below.

Private surveys on hiring and layoff intentions have been weak, and there have been high-profile job-loss announcements from the likes of Amazon, Target, Paramount, and UPS in recent weeks. The jobs mandate, therefore, argues for further rate cuts from the Fed.

At one point, it did appear that some of the relative doves, including Governor Chris Waller, were wavering on how quickly further rate cuts would come through. However, more robust language has been used in the past few weeks and with New York Fed President John Williams seemingly breaking in favour of a rate cut, who is seen as more of a centrist, there is now a clear sense that momentum has swung back towards a rate cut. Weaker ADP jobs data, Challenger layoff numbers, and a downbeat assessment of the economy from the Fed's own Beige Book offer further support for the rate-cut narrative, with 23 bp of a 25 bp cut now discounted. We agree and look for a 25bp rate cut, but it will be a split outcome with the prospect that we see four members vote for a no-change decision.

90% of US jobs created in just three sectors - jobs lost everywhere else

Monthly change (000s)



Source: Macrobond, ING

Fed to continue signaling 1 cut in 2026, but the risks are skewed to more action

The key question is what will the Fed signal for next year, given that we will be getting a new forecast update from them. Last time out, they indicated that just one rate cut in 2026 was their central case, in an environment where the economy expands at a 1.8% rate, unemployment holds around 4.4% and core inflation ends the year above target at 2.6%. Given US unemployment is already 4.44% this is subject to some upside risk due to the low-hire, low-fire economy, but we doubt the Fed will suddenly become more relaxed on the inflation narrative given the lack of timely data. As such, the most dovish they could possibly be is to put a second rate cut for their 2026 forecast, but they will be reluctant.

But does this matter, given that we know the Federal Reserve's structure is changing? From May, the Fed will have a new Chair. Kevin Hassett, the current Director of the National Economic Council, is the hotly tipped favourite. He is an advocate for lower rates, and if President Trump is successful in forcing out Governor Lisa Cook, we could see the appointment of a replacement who is equally inclined to lower borrowing costs. This would mean that five of the seven members of the Board of Governors are Trump appointees. Furthermore, in February, all 12 regional Fed presidents are up for reappointment – candidates are nominated by regional Fed banks' management, but can be vetoed by the Board of Governors. This creates the possibility of a revamped Fed that thinks very differently from the current committee.

We suspect the inflation backdrop will become more conducive for interest rate cuts in the coming months, thus giving the doves the justification for further action. While the tariff threat lingers, it is coming through more slowly and less forcibly than feared. This allows more time for disinflationary forces from lower energy prices, slowing housing rents and weaker wage growth to mitigate and, we believe, push inflation closer to 2% more quickly than the Fed is forecasting.

With the inflation backdrop looking less threatening but the jobs story becoming more fragile, we see the Fed cutting rates twice in 2026, with moves in March and in June. In combination with a bit more fiscal support in 2026, this should create the required platform for growth. Nonetheless, the potential for a more dovish FOMC tilts the risks toward additional rate cuts later in the year.

There is still a containment job to be done in the face of liquidity tightness

At the last FOMC meeting the Fed announced a freezing of its balance sheet. The roll-off of the MBS portfolio continues, but is broadly offset by the buying of T-Bills. That should then stabilise bank reserves at or near current levels. A dominant rationale for the balance sheet freeze was the prior rise in the effective funds rate (relative to the other fixed policy rates). The spread from the funds rate to the rate on excess reserves (IOER) was 7bp. That had narrowed to 3bp. Not a great look, reflecting liquidity pressures.

Fast forward to today, and the effective funds rate (3.89%) has drifted up even tighter to the IOER (3.90%); the spread is now just 1bp. It's reflective of continued tightness in conditions and elevated market repo rates. The funds rate can technically go above the IOER, but would likely not go too far above, as there is then an arbitrage back into the IOER bucket from the funds rate bucket. Still, all of this is somewhat sub-optimal as the effective funds rate is then getting closer to the ceiling on the funds rate range (currently set at 4%).

To address all of this, it's quite possible that the Fed decides to buy more bills than required from the MBS roll-off, thus acting to increase bank reserves. We don't think the Fed needs to do anything dramatic here, maybe only to announce that they have that flexibility. In fact, repo has tamed in the past day or so (post the month-end turn), which could in fact pull the funds rate back down a tad before the FOMC meeting. These subtle policy changes won't make the headlines, but they are important, as proper market functioning is a key Fed responsibility.

FOMC is a positive event risk for the dollar

For a market that seems to have so casually priced in an extension of the Fed easing cycle into next year, the December FOMC's reality check with Fed thinking could pose some upside risks for the dollar. Here, the Fed could easily, after three back-to-back cuts, cite the fact that the policy rate is much closer to neutral, requiring some kind of pause in the rate-cutting cycle or

at least a hint at cutting rates at alternate policy meetings.

As the October FOMC meeting showed, press conferences can prove quite dangerous for dollar bears, and it is hard to see Powell delivering a more dovish-than-expected update given the dissent within the Fed. However, that does not mean the dollar has to bounce too far. Market pricing, compared to our own views, is reasonably conservative at pricing only an additional 14bp of cuts by the time of the March meeting (ING -25bp) and an additional 33bp of cuts by the June meeting (-50bp).

There is an outside risk of EUR/USD briefly correcting back under 1.16 and USD/JPY to 156/157 on this Fed event risk. But our bias remains that year-end seasonal dollar weakness, perhaps some soft US jobs data on December 16th, and a BoJ rate hike on December 19th can see EUR/USD and USD/JPY head to the 1.18 and 152 areas respectively by year-end.

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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