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FOMC Watch - Fed will lower rates, but shouldn't

- **The Fed will lower the policy rate by 25bps in the September meeting, forced by recent weak labour market reports**
- **Currently, inflation is above target, while the labour market is still mostly in balance**
- **With the labour market and inflation outlook both deteriorating, the Fed should choose the mandate which is most at risk and/or harder to get back to target**
- **The outlook remains one of more concerning inflation dynamics**
- **A 'recalibration' cut of 25bps will not materially affect the outlook, but a substantial easing cycle may incite the next inflation wave**

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The Fed is set to reduce the policy rate by 25 bps in next week's FOMC meeting. Throughout the year, the Fed has been in 'wait-and-see' mode, awaiting hard data on the impact of tariffs, to see which side of the mandate requires more urgent attention. In recent months the Fed has felt increasing pressure from the Trump administration and markets (who may be pricing in that political pressure) to support the labour market and start easing. The labour market seemed to be gradually cooling, but the two non-farm payroll releases since the last FOMC meeting changed the story. Weak monthly job gains, and a substantial negative revision to the months before now show a picture of an almost stalling labour market. This makes a 25 bps cut next week essentially inevitable. While we do not think a 'recalibration' of 25 bps towards neutral will materially affect the outlook, we do think a forward-looking Fed should rather keep rates on hold.

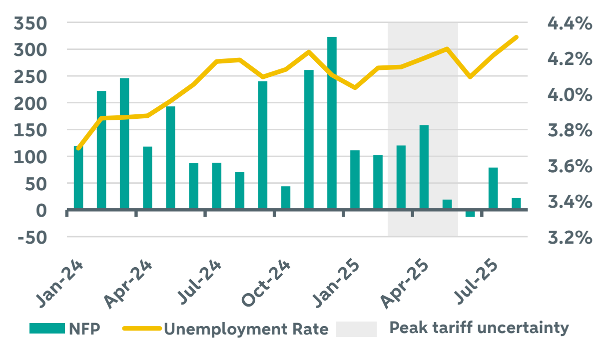
Let's start with the big picture. The Fed is about to ease with inflation still well above target - core PCE is at 2.9%, and accelerating - and an unemployment rate at 4.3%, up from the trough at 3.4% in 2023, but still low in a historic context. The Trump administration's policies, and in particular tariffs and immigration policy, are stagflationary; they increase inflation and lower growth. The increasing inflation and decreasing job growth we see in the data are a sign of both the direct impact of tariffs and immigration enforcement, and indirect effects from the uncertainty generated by the haphazard way policy was implemented. The distinction and timing between these two components is important in understanding the dynamics. We think the current slowdown is predominantly attributable to the latter, while the direct effect of tariffs will take some more time. Realizing that the Fed will not be able to steer the economy towards both price stability and full employment jointly in the short term, they have to choose. They should choose the part of the mandate that is most likely to spiral out of control and/or will be harder to get back to target. We think that is inflation.

The labour market has weakened, but this is predominantly a supply-driven slowdown. The three-month moving average decreased from over 200k at the start of the year to about 30k now. Following the annual benchmark revision, which revealed that job gains between April 2024 and March 2025 were overstated by more than 900k, we now know that the slowdown was likely from a considerably lower level (perhaps 75k lower). But that is still a significant slowdown. The decline is concentrated in industries most exposed to tariffs, such as manufacturing, construction and transportation, which have been shedding jobs for several months now. The slowdown in jobs growth is accompanied by a similar slowdown in labour force growth, predominantly on the back of tighter immigration policy. Our best estimate of labour force growth suggests that supply is actually stalling more quickly than demand. 'Break-even' non-farm payrolls (i.e. the level at which the unemployment rate holds steady) are therefore a lot lower than they were last year. So despite a slowdown in NFP that looks remarkably similar to the one we observed before the September cut last year, the situation is different. Quickly rising unemployment rate at that time triggered the 'Sahm rule,' because the lack of demand was accompanied by strong supply growth. With both growth rates down at the current juncture, we've seen less of an uptick in the unemployment rate.

The various labour market rates paint a less worrying picture. Monthly data increases, such as NFP, have always been difficult to estimate and are subject to substantial revisions. There are issues with decreasing survey responses - although those are limited to the initial release - but the harder part is population growth and the firm birth-death model. These lead to substantial annual revisions. Rates, such as the unemployment rate, get revised a lot less, and give a more reliable signal. As stated above, the unemployment rate has been inching up, reaching a post-pandemic high of 4.3%, after hovering between 4.1 and 4.2% for a year. Unemployment is concentrated in the younger age brackets, consistent with early evidence of AI driven changes in the workforce. The layoff rate is not yet elevated; we are seeing a somewhat suppressed hiring rate, although it has not materially worsened in the past year. The economy is in a low hiring, low firing mode, a 'curious' balance.

Payrolls weak, unemployment rate contained

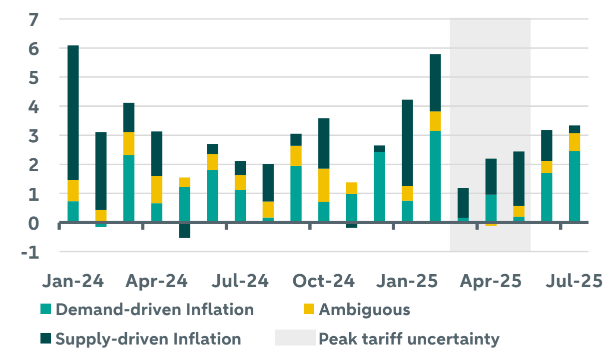
lhs: NFP, thousands. rhs: unemployment rate, %.



Source: LSEG, ABN AMRO Group Economics

Inflation still running hot, not just tariffs

Annualized monthly core PCE contributions, pp.



Source: San Francisco Fed, ABN AMRO Group Economics

Meanwhile, inflation remains above target and is set to increase. Core CPI stood at 3.1% in August, with the 3m annualized rate at 3.6%. We've seen some evidence of tariff inflation, and our view is that ultimately about 70-90% of the tariffs will be passed on to customers. The data suggests that foreign companies are not keen on lowering their prices to offset the tariffs, and US companies seem to have the pricing power to push through price increases. The big question is whether this will be a one-off transitory price increase, or whether it will lead to more persistent inflationary pressure due to second round effects. Our view is that in principle, it is a one-time, but not all-at-once, price shock, that will keep inflation moderately elevated for an extended period. Second round effects should be limited, although policy choices may enable them.

Second round inflation effects of tariffs are a real possibility if the Fed favours the employment mandate over its price stability mandate. An argument to lower rates now is that the weaker economy will anyway suppress the inflation path due to weak demand, and that therefore inflation will not remain far-removed from target. Strong easing in the coming period would however start to stimulate demand, going against that argument, and hence inflation would certainly rise more. The bigger worry is that, while inflation expectations, especially market-based, remain at levels only marginally above pre-pandemic levels, they might become unanchored. As UMich consumer inflation expectations showed, they are now a lot more responsive to changes in policy than they were; less anchored if you will. While 5-year inflation expectations remained mostly flat throughout actual inflation in 2021-2023, they have risen in response to tariff policy. Unsettled inflation expectations can become a self-fulfilling prophecy and require much more radical responses from monetary policy to undo. Steepening yield curves suggest markets feel similarly that easing now might lead to more significant inflation and higher rates in the future.

The previous inflation wave may not have been fully beaten either. After a sequence of mild services inflation readings, the last two months saw elevated readings again. The chart above shows that recent monthly PCE inflation readings came in above 3% annualized and are predominantly demand-driven, meaning that in most categories prices increased in conjunction with increasing consumption. Inflation is not reflecting an economy that needs stimulus to increase demand. Demand driven inflation averaged more than 2% in June and July, compared to an average of about 0.2% during recessions since 2000. Demand is still driving up inflation, rather than keeping a lid on it. A significant part of tariffs, which are taking time to show up due to the buildup of inventories and delayed pricing decisions in the face of massive uncertainty, still have to come on top of that.

Policy uncertainty explains the current slowdown, hitting inflation immediately, and the labour market a bit later. As the above two charts show, dynamics in both the labour market and inflation changed dramatically around the period of peak policy, and in particular tariff, uncertainty. Demand driven inflation immediately stopped during this period as consumers became more careful. Hiring continued for a month or two, but stopped almost completely after tariffs were implemented on a large scale. Now that uncertainty has decreased, consumer demand, and its impact on inflation, has bounced back strongly, and we also expect a modest recovery in the labour market, with again a bit of a delay. Ultimately, tariffs will have a direct negative impact on the labour market as well, and the unemployment rate will tick up a bit, but our base case does not see a 'non-linear' acceleration in unemployment.

There is however a risk of a rapid rise in unemployment in the absence of rate cuts. Unemployment shooting up, and the risk of hysteresis - a rise in unemployment that persists even after the initial shock has passed – were the primary reasons for the aggressive easing cycle during the pandemic. The speed at which unemployment came down following the pandemic was probably unique, in that the cause of unemployment was not the business cycle, but the pandemic shock. The current downturn is mostly driven by policy choices from the Trump administration and is therefore also unlikely to completely follow historical patterns. Still, from a cyclical perspective, the US is currently probably in a more vulnerable space compared to the period immediately before the pandemic.

Given the role of Trump administration policy in the current downturn, one can wonder how effective easing would even be in reversing this trend. Financial conditions remain relatively easy. Credit policies are generally expansionary. Equity prices are at all-time highs. The US is still running the largest fiscal deficit in non-recession history. With this kind of fiscal support, R-star, the neutral rate, is going to be higher. An aging population and productivity gains from AI will likely also push it higher in the coming years. Perhaps most importantly, the last two years showed that the US economy can grow at a strong 3% pace per year, even under the burden of these restrictive rates. The current impact is concentrated in, although not entirely limited to, tariff-affected parts of the economy. It is not clear how much lower rates would have to be to support companies that face 20% effective import tariffs, and moreover, it is unlikely that lower rates would solve structural competitiveness issues. At the same time, it clearly risks overheating other parts of the economy.

In light of the pressure on the Fed, maintaining inflation fighting credibility is the most important objective. The irony is that rates would have likely been closer to neutral by now, had it not been for Trump's policies, or his attack on the Fed's independence. Even just considering the effect of Trump's policies, it would have been a lot easier for the Fed to ease in the absence of all the political interference, as cutting now could be construed as caving to political pressure rather than a reasonable interpretation of the current data. The ultimate cost to the economy of having to raise rates substantially in the face of runaway inflation – the second such wave in too short a time span - is likely greater than the cost of a further gradual cooling of the labour market due to erring on the restrictive side for now.

The current economy can handle a 25 bps ‘recalibration’ without inflation rebounding strongly. Our base case is that the Fed will gradually cut rates, but not ease beyond the point where it would lead to further inflation problems. This entails a hold on rates after September, until they start cutting again in at 25bps per quarter in 2026 after a rotation in the voting regional FOMC members. On the other hand, Trump has called for total cuts of more than 300 bps, and is making every effort to exert influence over the Fed. Stronger, rapid, easing would almost certainly ignite another inflationary wave, and is unlikely to overcome the structural problems in the labour market caused by Trump’s tariff and immigration policy.