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Preview: Fed To Keep Rates Unchanged and Signal Being on Hold, Given Heightened Tariff-Induced Inflation Concerns

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Executive Summary

- **Expected Decision**: *We expect the Fed to hold rates in May.* In line with consensus, we expect the Fed to hold steady its target Fed funds range at 4.25% - 4.50% in May. Regarding *forward guidance*, the Fed will continue to be data-dependent regarding further policy changes, with investors eagerly looking for signs regarding the timing for a potential rate cut while the Fed will signal that the bar to rate cuts remains high given concerns about higher inflation from tariffs. Regarding *balance sheet policy,* in May last year the FOMC decided to slow down the pace of QT.
- **Policy Discussion**: *The Federal Reserve is expected to keep interest rates unchanged and signal a high bar to rate cuts as it monitors the economic and inflationary impact of President Trump's tariffs.* Markets are watching for signals of a potential rate cut in June. So far, the Fed has taken a cautious stance and is likely to remain on hold even in June, waiting for clearer data amid rising uncertainty from new trade policies. Tariffs introduced in April are expected to raise prices and slow hiring (a stagflationary shock), complicating the Fed's mandate to balance inflation and employment. Chair Jerome Powell said on April 16 that the labor market remains "solid and broadly in balance," while inflation in March stayed above target at 2.6%.

  Despite stable official data, surveys point to growing concerns. Business leaders and consumers fear tariffs could raise living costs and hurt activity, potentially leading to both higher inflation and a recession. Preliminary data showed the economy contracted 0.3% in Q1, likely due to pre-tariff import surges, with some mis-measurement of inventories biasing the GDP estimate downwards.

  Traders now expect rate cuts starting in June, potentially totalling 1% by year-end. But economists correctly warn that persistent inflation is likely to delay action, especially if businesses pass on higher costs and possible second round effects do occur. Cleveland Fed President Beth Hammack said the "cone of possibilities" remains wide, with risks of both inflation and slowing growth. Meanwhile, President Trump has criticized Powell for not cutting rates sooner, though he appears to have backed off threats to remove him. Powell has stated his term runs through May 2026 and cannot be ended by the president alone.

  We expect that the economy will weaken over the next few months: the rise in inflation caused by tariffs could lead the core PCE to rise towards 4% by the end of the year; the resulting hit to real disposable income growth – as wages will grow at a more sluggish rate than inflation – together with a hit to consumer and business confidence will weaken the economy by Q3 and stall it by Q4. The US is likely to experience a short and shallow recession by Q4 of this year.

  In spite of the tariff shock being stagflationary the impact on the inflation rate will not be persistent as the Fed is credibly committed to anchor inflation expectations; thus, the impact of the tariff shock is not likely to lead to second round effects and thus there will be an increase of the price level rather than a persistent increase in the inflation rate and its expectations. This Fed credibility together with as softening of demand once the economy weakens would allow the Fed to cut rates – most likely twice this year in September and December – once the hard data on output and labor show clear signs of softening. The resulting recession is likely to be short and shallow and show a recovery by the middle of 2026 as powerful technology tailwinds will support private sector capex. The Fed will wait to cut rates till when the hard data – employment, unemployment rate, job opening, capex or capital goods orders – significantly weaken.

Key Picture: US Federal Reserve Forecasts – 2025-2027

	2025*f*			2026*f*		2027*f*		Longer Run	
	Latest Reading	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report
GDP *(real growth, y-o-y)*	2.0	1.7	2.1	1.8	2.0	1.8	1.9	1.8	1.8
Unemployment rate *(%, y-o-y)*	4.2	4.4	4.3	4.3	4.3	4.3	4.3	4.2	4.2
PCE Inflation *(%, y-o-y)*	2.3	2.7	2.5	2.2	2.1	2.0	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	2.6	2.8	2.5	2.2	2.2	2.0	2.0	-	-
Federal Funds Rate *(%)*	4.327	3.9	3.9	3.4	3.4	3.1	3.1	3.0	3.0

Source: Federal Reserve *'Summary of Economic Projections'* December 2024 and March 2025. *Note:* 1. GDP reading for Q1-2025; 2. Unemployment rate as of April 2025; 3. PCE and core PCE inflation as of March 2025; 4. Projections reflect the median of FOMC projections

Analysis

- **EXPECTED DECISION**: *On May 7, we expect the US Federal Reserve's FOMC to hold its Fed funds range at 4.25% - 4.50%.* In 2024, as expected, the Fed cut interest rates for three consecutive meetings, for a total of 100bps of easing. Markets are looking for any signs on May 7 that rate cuts could begin in June but that is quite unlikely as inflation will start to rise in late spring given high tariffs. Futures suggest the Fed may lower rates by a full percentage point this year, with short-term rates potentially ending 2025 near 3.5%. However, incoming data will likely shape both Fed policy and market expectations in this uncertain environment and any rate cut will be smaller and later than what markets expect.

  Regarding *forward guidance*, the Fed will continue to be data-dependent regarding further policy changes with decisions being made meeting by meeting. Markets expect short-term interest rates to finish 2025 near the mid-3% range, though that outlook will depend as much on upcoming economic data amid ongoing uncertainty as on guidance from the Fed, including statements at the May 7 meeting and beyond. Markets are over-estimating how soon and how much the Fed will cut. We expect two cuts this year starting in September once the real economy weakens clearly.

  Regarding *balance sheet policies*, in May the FOMC decided to slow down the pace of QT. The Committee plans to further decrease its Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in June, it tapered the rate of decline in its securities holdings by lowering the monthly redemption limit on Treasury securities from $60 billion to $25 billion. The monthly redemption limit on agency debt and agency mortgage-backed securities remains at $35 billion, with any excess principal payments being reinvested in Treasury securities. However, the Fed will have soon to discuss and decide when to stop its QT at some point this year. Difficult decisions will have to be made on what the composition and size of long-term assets held by the Fed will be. Since the Fed is still holding very large amounts of long-term Treasuries and mortgage-backed securities the Fed will need to come with a plan on what the long-term holdings of such assets will be.

- **POLICY DISCUSSION**: *The Federal Reserve is expected to keep its benchmark interest rate unchanged, as policymakers assess the potential economic and inflationary impacts of President Donald Trump's tariffs*. The attention is focused on whether officials will hint at a possible rate cut in June; that is quite unlikely given the surge in the inflation rate that the tariffs will trigger. The Fed has taken a cautious approach so far, opting to hold off on major policy moves until clearer signs emerge about how the Trump administration's swift changes to trade policy are affecting the economy. We expect the Fed to cut rates only starting in September.

The tariffs introduced in April are anticipated to drive prices higher and dampen hiring— stagflationary developments that would challenge the Fed's dual mandate of maintaining stable prices and full employment. Fed officials have emphasized patience, as the labor market remains strong and inflation will rise because of the tariffs. Chair Powell noted on April 16 that the job market is "in solid condition and broadly in balance." With core inflation at 2.6% in March—still above the 2% target—the Fed is cautious about cutting rates too soon.

While official data remains steady, such as inflation in March, and the labor market in April, forecasts and sentiment surveys suggest potential challenges ahead. Tariffs have added to economic uncertainty, with their full impact yet to show in data. Business leaders and consumers alike express concern that tariffs could drive up living costs and negatively impact business activity in the near future, with some warning of a possible recession. Meanwhile, the U.S. economy contracted in Q1 at an annualized rate of 0.3% last quarter, likely due to a surge in imports ahead of tariff hikes, according to preliminary government data released on April 30. By Q3 the economy will weaken and by Q4 it will stall into a near recession. Thus, the Fed will cut rates once employment weakens and the unemployment rate starts to increase, in our view by September.

Thus, traders are betting that a weakening economy will prompt the Fed to start cutting rates by June, possibly lowering borrowing costs by a full percentage point by year-end. Those expectations grew after data showed the economy contracted last quarter and inflation was flat in March. But the rise in the inflation rate that the tariffs will trigger will keep the Fed on hold until they are strong signs of economic deceleration and a rise in the unemployment rate, most likely by September and certainly not earlier than July. The Fed caution is also driven by uncertainty not only about tariffs but also about fiscal policy; until the reconciliation bill is passed it will not clear if the fiscal impulse for 2026 will be a fiscal drag as opposed to a fiscal loosening.

Indeed, economists caution that while rate cuts are possible by Q4, inflation remains high and could rise further as retailers pass on higher import costs to consumers. As Cleveland Fed President Beth Hammack recently noted, the "cone of possibilities" remains wide, including the risk of stubborn inflation alongside slowing growth—forcing the Fed to prioritize one challenge over the other.

President Trump has criticized Powell for not cutting rates faster but appears to have stepped back from calls to remove him. The Fed Chair has previously stated that the president cannot lawfully dismiss him before his term ends in May 2026. The Fed is actually helping the administration by signaling no rate cuts any time soon as this anchors inflation expectations and long bond yields.

- **MACROECONOMIC ANALYSIS:** *The US economy shrank in the first quarter of 2025, contracting at a 0.3% annualized rate amid a surge in imports sparked by President Trump's renewed tariff push at the start of his second term.* The weak GDP report adds uncertainty ahead of further developments in Trump's trade agenda. It marked the first quarterly decline since early 2022, falling short of economists' expectations for a 0.4% gain. Imports jumped 41.3%—the largest increase since 1974 outside the pandemic—driven by a 50.9% rise in goods as companies and consumers rushed to beat April's tariff hikes. Since imports subtract from GDP, they dragged the headline figure down by over 5 percentage points. Exports rose 1.8%. Imports played a role in the slowdown, as businesses and consumers accelerated purchases to stock up on goods ahead of expected price increases due to a series of tariff announcements by the Trump administration.

Consumer spending remained positive but slowed, with personal consumption up just 1.8%—the weakest since Q2 2023—though March saw a stronger-than-expected 0.7% monthly gain. Federal spending fell 5.1%, partly due to cuts linked to Elon Musk's Department of Government Efficiency, shaving about 0.3 points off GDP. Private domestic investment surged 21.9%, led by a 22.5% jump in equipment spending, possibly also tariff-related.

A key inflation gauge cooled in March, signaling easing price pressures ahead of most Trump-era tariffs taking effect. Consumer prices rose 2.3% year-on-year, down from 2.7% in February. Core inflation, which excludes food and energy, fell to 2.6% from 3%, suggesting inflation was easing before tariff impacts fully materialize.

Despite falling confidence, consumer spending rose a strong 0.7% in March, driven largely by a rush to beat Trump's new tariffs—especially the 25% auto duty effective April 3. Auto spending surged 8.1%, likely front-loading demand. Spending on restaurants and hotels also rebounded, reflecting continued discretionary appetite despite growing economic concerns. Economists warn the inflation slowdown may be short-lived, with tariffs expected to push prices higher in coming months.

- **MARKET IMPLICATIONS:** *US Markets have recovered from the "Liberation Day" Sell-Off, But The Outlook Remains Uncertain.* Markets are expecting a dovish signal from the Fed in May, i.e. a signal that it may start to cut rates possibly as early as June and more likely by July. Since we are less dovish than markets expectations and believe that the Fed needs to keep its inflation credibility intact, we expect that the communication from the Fed in May will be less dovish than markets expect. Thus, equities could correct and 2-year Treasury yields rise while the dollar may strengthen following hawkish Fed communication. The US Treasury yields surged as President Trump's new tariffs took effect. Selling pressure at the long end of the curve remained intense, fueling a rise in European yields as well.

  To put things into context, *in the fixed-income space,* UST yields surged on Friday after April's nonfarm payrolls report came in stronger than expected, boosting investor confidence. As of May 2nd, the 2*y UST* decreased by 15 bps to 3.82 % since the last meeting on March 19 (-42 bps y-t-d). The *10y UST* edged up by 6 bps to 4.31% since the last meeting (-25 bps y-t-d). *In the currency space,* in April the dollar hit 3-year low on on worries for further escalation in tariffs, fears of recession. As of May 2nd, and since the last meeting in March, the *dollar index* edged down by 3.2% to 99.8 3% (-8.6% y-t-d). *EUR/USD* rose by 3.6% to 1.13 since March meeting (+2.3% y-t-d). *In the equity space,* US U.S. stocks ended the week higher, with the S&P 500 notching a second straight weekly gain and the Nasdaq climbing 3.42%, driven by strong earnings from major tech firms. Early gains were fueled by easing trade tensions, as President Trump scaled back some auto tariffs and officials signaled progress on a major trade deal. Later in the week, attention shifted to earnings, with nearly 40% of S&P 500 companies reporting. Despite concerns over limited forward guidance due to trade uncertainty, investor sentiment remained upbeat, reflecting confidence in corporate resilience. As of May 2nd, S&P 500 rose by 0.2% since the last meeting in March and trades closed at 5,687 (-3.1% y-t-d).

- **APPENDIX (Macro Background):** *In Q1, US economy shrank as Trump policy uncertainty weighted on the activity.* In Q1, according to the advanced estimate, the US economy contracted by an annualized 0.3%, marking the first decline since Q1 of 2022 (*c*: 0.3%; *p:* 2.4%) Consumer spending cooled (1.8% vs 4.0% in Q4) marking its slowest rate since Q1 2022. Government spending contracted (-1.4% vs 3.1%) and residential investment decelerated (1.3% vs 5.5%). Exports rose (1.8% vs. -0.2%), while imports surged more (41.3% vs. -1.9%).
  The US business activity marks the slowest growth in 16 months. In April, *the S&P Global US Composite PMI* decreased to 51.2 (*p:* 53.5). The *Services PMI* fell to 51.4 (*c:* 52.5; *p:* 54.4), marking the softest growth rate in services activity in one year. The *Manufacturing* PMI rose to 50.7 (*c*: 49.1; *p:* 50.2). Despite modest growth, this was the fourth straight month of manufacturing expansion.

  US unemployment rate picked up. In March, *the unemployment rate* rose to 4.2% (*c:* 4.1%; *p:* 4.1%). Total nonfarm payroll employment added by 228K (*c:* 135K; *p:* 117K). Wage growth increased by 3.5% in February (*p:* 4.2%). The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, decreased slightly to 7.9% in March (*p*: 8.0%).
  Inflation pressures ease. In March, the *personal consumption expenditures* (*PCE*) – the Fed's preferred inflation gauge – eased off to 2.3% y-o-y (*c:* 2.2%; *p*: 2.7%). The *core-PCE* – which excludes volatile energy and food prices –cooled off to 2.6% y-o-y (*c:* 2.6%; *p:* 3.0%). In December, headline and core inflation eased to 2.4% y-o-y (*c:* 2.6%; *p:* 2.8%) and to 2.8% y-o-y (*c:* 3.0%; *p:* 3.1%).