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MONETARY AFFAIRS:

Preview: Fed To Remain in Hold,

Amid Trade and Israel-Iran War-Related Uncertainties

by

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16 June 2025

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Executive Summary

- **Expected Decision**: *We expect the Fed to hold rates in June.* In line with consensus, we expect the Fed to hold steady its target Fed funds range at 4.25% - 4.50% in June. 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 Fed is expected to hold rates steady this week, sticking to a cautious "wait-and-see" stance—despite pressure from President Trump for deep early cuts***.** While Trump has criticized the Fed and Chair Powell for inaction, policymakers prefer to wait for clearer signs of how tariffs are affecting the economy. Markets assign just a 3% chance of a rate cut this month.

  Officials worry that premature easing could reignite inflation, especially as tariffs risk pushing up prices while weakening growth. May meeting minutes warned of possible trade-offs if inflation and unemployment rise together—a concern amplified by market volatility and recession risks. For now, Powell's and other Fed officials view remains that upside risks to both inflation and the unemployment rate and that these risks remain balanced. So for now, the Fed will stick to a wait and see status quo.

  On top of stagflationary trade and tariffs uncertainties there are now additional ones deriving from the recent Israel massive attack against Iran's nuclear and other military facilities that could spike oil prices further and cause another stagflationary shock. **How the Fed will eventually react to such stagflationary shocks will depends on how severe, persistent or temporary they turn out to be**. For now, the markets reaction suggests that investors expect only a mild and temporary stagflationary shock from this war.

  Markets are likely over-estimating how soon and how much the Fed will cut. **We expect two rate cuts in the fall once the real economy weakens clearly, with the first one taking place in September.**

  Although Trump delayed steep import tariffs, including a 145% levy on Chinese goods, uncertainty lingers. Bond market swings, higher yields, and a shifting dollar outlook could have lasting effects.

  For now, steady job growth and subdued inflation support staying on hold. The Fed's policy rate, unchanged since December, remains high after post-pandemic hikes aimed at cooling inflation. While recent inflation and job data exceeded expectations, the impact of new tariffs hasn't yet surfaced. Still, sentiment is deteriorating. Fed officials, including Governor Kugler, warn of inflation risks and pressure on jobs and growth.
- **Expected Changes to Economic Forecasts:** *Rising growth risks point to likely Fed rate cuts ahead*. Markets now see a 60% chance of a September rate cut and an 88% chance of at least two cuts by year-end. In the updated SEP forecasts, **we expect a very modest downward revision to the growth forecast, a modest uptick to the unemployment rate and an upward increase to the inflation outlook**. **We expected the Fed to maintain a median two 25bps rate cuts for 2025**. These forecasts don't incorporate the effects of Israel's attack on Iran on oil prices and market dynamics; over time updated forecasts will imply even higher inflation and lower growth given the stagflationary nature of the most recent Israel-Iran shock.

Key Picture: US Federal Reserve Forecasts – 2025-2027

	2025*f*			2026*f*		2027*f*		Longer Run	
	Latest Reading	June Report	March Report	June Report	March Report	June Report	March Report	June Report	March Report
GDP *(real growth, y-o-y)*	2.1	1.5	1.7	1.8	1.8	1.8	1.8	1.8	1.8
Unemployment rate *(%, y-o-y)*	4.2	4.5	4.4	4.3	4.3	4.3	4.3	4.2	4.2
PCE Inflation *(%, y-o-y)*	2.1	3.0	2.7	2.3	2.2	2.0	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	2.5	3.1	2.8	2.3	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*' March 2025. *Note:* 1. GDP reading for Q1-2025; 2. Unemployment rate as of May 2025; 3. PCE and core PCE inflation as of May 2025; 4. Projections reflect the median of FOMC projections

Analysis

- **EXPECTED DECISION**: *On June 18, 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. Fed rate expectations remain volatile. According to the March dot plot, officials still anticipate a half-point rate cut by 2025, despite uncertainty around Trump's tariffs and fiscal policies.

  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 likely over-estimating how soon and how much the Fed will cut. We expect two rate cuts in the fall once the real economy weakens clearly.

  Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June. The Committee plans to further decrease its Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in April, the Committee will slow the reduction of its securities holdings by lowering the monthly Treasury redemption cap from $25 billion to $5 billion, while keeping the agency debt and mortgage-backed securities cap at $35 billion.

- **POLICY DISCUSSION**: *The Federal Reserve is expected to hold interest rates steady at this week's policy meeting, maintaining its cautious "wait-and-see" approach.* This puts the Fed at odds with President Trump, who continues to demand deep rate cuts of at least 1%. While Trump has criticized the Fed and Chair Jerome ("Too Late") Powell for inaction, policymakers want more time to assess the economic impact of tariffs before adjusting policy. Markets are pricing in just a 3% chance of a cut this month, according to CME's FedWatch tool.

  Fed officials remain wary of cutting rates too soon, concerned that Trump's tariffs could reignite inflation, which has recently cooled to near the Fed's 2% target. According to May meeting minutes, the Fed officials warned they may soon face tough trade-offs if inflation and unemployment rise at the same time—a scenario made more likely by financial market volatility and growing recession risks. Although

President Trump later postponed steep import tariffs, including a proposed 145% levy on Chinese goods, which had rattled markets and fueled downturn fears, the Fed remains concerned about the uncertain policy environment. Officials noted that bond market volatility, rising Treasury yields, and shifts in the dollar's safe-haven status could have lasting economic effects.

Tariffs pose a dilemma: they could push prices higher while also weakening the economy and job market. If inflation rises, the Fed may hold rates higher for longer; if growth falters, rate cuts may follow. For now, recent data supports staying put—job growth is steady, and inflation remains subdued. For now, no FOMC official has been advocating for a change. The Fed's benchmark rate, raised aggressively after the pandemic to combat inflation, has remained flat since December amid rising uncertainty following Trump's return to power.

On top of stagflationary trade and tariffs uncertainties there are now additional ones deriving from the recent Israel massive attack against Iran's nuclear and other military facilities that could spike oil prices further and cause another stagflationary shock. How the Fed will eventually react to such stagflationary shocks will depends on how severe, persistent or temporary they turn out to be. For now, the movement of oil prices, US and global equities and US bond yields suggests that the markets are pricing only a mild stagflationary impact from this war.

Market pricing – especially oil prices rising only by 7.5% since the war started – suggest that markets are pricing only a 15% probability that this war will lead to a major disruption in the production and exports of energy from the Gulf; the probability that the Straits of Hormuz will be blocked is currently still relatively low. If the oil shock from the war remains mild and temporary, the Fed may look through it and not react over time as any additional inflationary pressure would affect the price level and not the inflation rate in a persistent way. But if the conflict were to escalate and cause a much stronger and persistent increase in oil prices, the risk of a de-anchoring of inflation expectations and the larger rise in the inflation rate would force the Fed to stay high – or even *higher* in an extreme scenario - for longer in spite of a further weakening of economic activity and the risk of a recession.

- **EXPECTED CHANGES TO ECONOMIC FORECASTS:** *Rising growth risks suggest more rate cuts may be needed ahead.* Although the "Liberation Day" tariffs were scaled back after April's market turmoil, concerns remain about lingering damage and the risk of renewed tensions. Some drops in consumer confidence point to weaker spending ahead, as households fear tariff-driven price hikes and a worsening job market. Uncertainty around trade policy is also prompting businesses to delay hiring and investment decisions.

  Recent government data shows inflation is easing and the labor market remains stable, though less strong than a year ago. May's CPI and job reports beat expectations, but the effects of President Trump's new tariffs have yet to appear in the data. Still, consumer and business sentiment is weakening. Fed officials, including Governor Adriana Kugler, warn of rising inflation risks and potential pressure on jobs and growth. Markets now expect the first Fed rate cut in September, with bond futures pricing in a 60% chance of a cut then and an 88% chance of at least two cuts by year-end.

  In the updated SEP forecasts, we expect a very modest downward revision to the growth forecast, a modest uptick to the unemployment rate and an upward increase to the inflation outlook. We expected the Fed to maintain a median two 25bps rate cuts for 2025. These forecasts don't incorporate the effects of Israel's attack on Iran on oil prices and market dynamics; over time updated forecasts will imply even higher inflation and lower growth given the stagflationary nature of the most recent Israel-Iran shock. Cuts may start in September or be delayed to December depending on the impact of trade and war uncertainties on growth and inflation.

- **MACROECONOMIC ANALYSIS:** *Concerns are growing that Trump's broad import tariffs could trigger a spike in inflation and push the US toward recession.* The dollar dropped to a three-year low due to concerns over US tariffs and the economic outlook. The Bloomberg Dollar Spot Index fell 0.8% on Thursday, hitting its lowest level since April 2022. The euro reached its highest since 2021, the pound hit a three-year high, and all G-10 currencies rose against the dollar.

The US economy contracted less than initially estimated in the Q1, with revised data showing a 0.2% annualized decline—up from the previously reported 0.3%—marking the first economic contraction since 2022. The downturn follows a 2.4% expansion in Q4 2024 and reflects a mix of rising imports, slowing consumer spending, and reduced government expenditure. A key factor was a surge in imports, as firms accelerated purchases of foreign goods ahead of President Trump's "liberation day" tariff announcement in early April. This spike distorted trade figures without a corresponding increase in inventories or consumer demand. While investment and exports posted gains, they were largely offset by a slowdown in consumer spending growth, particularly in services and housing, as households faced higher prices and uncertainty linked to the ongoing trade war.

Consumer prices rose less than expected in May, with inflation showing little immediate impact from President Trump's tariffs. Headline inflation rose 0.1% m-o-m and 2.4% y-o-y, while core inflation also increased 0.1% m-o-m and 2.8% y-o-y.

Falling energy prices, including a 2.6% drop in gasoline, helped offset price pressures, while vehicle and apparel prices unexpectedly declined. Shelter and food rose 0.3%, with shelter accounting for most of the monthly CPI increase. Annual shelter inflation eased to 3.9%, the lowest since 2021. Real average hourly earnings rose 0.3% in May and 1.4% over the year. Analysts cautioned that tariff-related price hikes may take several months to appear.

NFP rose by 139K in May, slightly above expectations of 130K , according to the Bureau of Labor Statistics. April's figure was revised down to 147K from 177K. The unemployment rate held steady at 4.2%, while the labor force participation rate dipped to 62.4% from 62.6%. Wage growth remained at 3.9% year-on-year, beating the forecast of 3.7%. Despite a stable headline unemployment rate, economists note growing signs of weakness in the labor market, with more people experiencing prolonged job searches. Jobless claims rose to their highest since late 2021, suggesting unemployed workers are struggling to find jobs.

- **MARKET IMPLICATIONS:** *UST yields climbed Friday after Israeli airstrikes on Iran pushed energy prices up, raising fears of renewed inflation*. It's the first time the US Treasury market was not perceived as a full safe haven, which would have reduced UST yields. During the press conference, market participants will eagerly look for signals about the timing of the next move, likely to be a rate cut. But Powell will be cautious in not pre-committing.

To put things into context, *in the fixed-income space,* UST yields surged after April's nonfarm payrolls report came in stronger than expected, boosting investor confidence. As of Monday, the 2*y UST* rose by 19 bps to 3.97% since the last meeting on May 7 (-79 bps y-t-d). The *10y UST* edged up by 17 bps to 4.44% since the last meeting (-12 bps y-t-d). *In the currency space,* the Dollar weakened Monday amid fading safe-haven demand, renewed US-China trade worries, and rising expectations of Fed rate cuts ahead of this week's meeting. As of June 16th, and since the last meeting in May, the *dollar index* edged down by 2.1% and trades around 97,6 (-10.7% y-t-d). *EUR/USD* rose by 2.5% to 1.16 since May meeting (+4,9% y-t-d). *In the equity space,* stocks fell sharply after Israeli airstrikes on Iran escalated geopolitical tensions and drove up energy prices. However, stocks rebounded Monday as easing oil prices and hopes of a contained Israel-Iran conflict boosted investor sentiment. The Dow rose 405 points (1%), the S&P 500 gained 1.1%, and the Nasdaq jumped 1.6%. since the last meeting in May,S&P 500 rose by 7.1% and trades around 6,032 (+2.8% 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 0.2%, marking the first decline since Q1 of 2022 (*c*: -0.3%; *p:* 2.4%). Still it represents a slight improvement from the initial estimate of a 0.3% decline due to stronger-than-expected fixed investment. Consumer spending cooled (1.2% vs 4.0% in Q4) marking its slowest rate since Q2 2023. Government spending contracted (4.6% vs 4.0%) and residential investment also shrank (-0.6% vs 5.5%). Exports rose (2.4% vs. -0.2%), while imports surged more (42.6% vs. -1.9%).

  The US business activity rebounds after April's 19-month low. In May, *the S&P Global US Composite PMI* rose to 53.0 (*c*: 52.1; *p:* 50.6). The *Services PMI* also increased to 53.7 (*c:* 52.3; *p:* 50.8), marking a solid expansion. The *Manufacturing* PMI rose to 52 (*c*: 52.3; *p:* 50.2).

  Labour market is slowing but still robust. In May, *the unemployment rate* stood at 4.2% as expected. Total nonfarm payroll employment increased by 139K (*c:* 139K; *p:* 147K). Wage growth increased by 34.6% in April (*p:* 3.8%). The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, stood at 7.8%.

  Inflation pressures ease. In May, the *personal consumption expenditures* (*PCE*) – the Fed's preferred inflation gauge – eased off to 2.1% y-o-y (*c:* 2.2%; *p*: 2.3%). The *core-PCE* – which excludes volatile energy and food prices –cooled off to 2.5% y-o-y (*c:* 2.5%; *p:* 2.7%). In December, headline inflation rose to 2.4% y-o-y (*c:* 2.5%; *p:* 2.3%), while core inflation stood at 2.8% y-o-y (*c:* 2.9%),