MONETARY AFFAIRS:

Preview: Fed Cut in December, with Data-Dependent Forward Guidance

by

Nouriel Roubini, Brunello Rosa
and Nato Balavadze

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Executive Summary

- **Expected Decision**: *We expect the Fed to cut in December.* In line with consensus, we expect the Fed to cut its target Fed funds range by 25 bps to 3.50% - 3.75% in December. Regarding *forward guidance*, the Fed will continue to be data-dependent regarding further policy changes; thus, market talk of a "hawkish cut" is a bit excessive. Regarding *balance sheet policy,* in May last year the FOMC decided to slow down the pace of QT and end it in December; the balance sheet may organically increase modestly in 2026. December's cut is likely to be part of a broader policy recalibration rather than the final move. The Median end of 2026 dot should hold at 3.375%, though it could head lower if one voter shifts views. Markets still price the December cut at roughly 85%.
- **Policy Discussion**: *The Fed's December meeting is expected to be contentious, with several dissents likely on a widely anticipated 25bp rate cut.* Labor data continue to cool and inflation shows little sign of re-accelerating, strengthening market expectations for a cut to 3.5–3.75%. The latest core PCE reading—0.2% in September and 2.8% year-on-year—pushed the odds of a move to nearly 85%.

  Yet the FOMC remains divided. Some members point to rising layoff signals and weakening labor conditions as reasons to ease further and even more than 25bps in December, while others warn that persistent services inflation and tariff effects call for caution. Economists expect at least two hawkish dissents, with Kansas City Jeff Schmid, Boston's Susan Collins, and Chicago's Austan Goolsbee among the likely holdouts. On the dovish corner, Governor Stephen Miran is expected to advocate for a larger 50bp cut. The mixed backdrop—softening labor data but still-solid headline growth (much of it driven by AI-related investment) and core inflation still above target and sticky, has deepened the split. Nearly half of surveyed economists argue the Fed should prioritize inflation, while only a small minority favor putting more weight on employment.

  This week's meeting will almost certainly deliver a cut, but it will also expose widening divisions over the policy path ahead. Looking to 2026, the arrival of a Trump-appointed, dovish-leaning Fed chair – most likely Kevin Hassett, could intensify the debate between hawks and doves over control of the committee.

  Whether the December cut will be "hawkish" or not is a bit ambiguous. The Fed will clearly suggest that it remains data dependent. It is unlikely that Powell would clearly signal a pause in January – a strongly hawkish signal – as weak labor market data (with two upcoming employment reports) could force it to cut rates again as early as January. On the more hawkish side, a few dissenters on the need for a December cut and Powell mentioning that in the presser may be a partially hawkish signal; but Powell will insist on the data dependency while signaling that the bar to further rate cuts is very much depending on the economy weakening further.
- **Expected Changes to Economic Forecasts:** *Given the lack of new data after the government shutdown, the updated SEP may not shift dramatically.* The September projections pointed to a cut to 3.6% in December, followed by one normalization cut in 2026 (to 3.4%) and another in 2027 (to 3.1%). Markets, however, expect both cuts to come in 2026, with futures implying moves in April and September. The December SEP could show two rate cuts in 2026 if one voter slightly changes in a dovish direction; but that is not our baseline.

  Still, recent data—cooling labor markets and contained inflation—suggest a slightly more accommodative tilt. Economists expect the 2025 SEP to show higher unemployment and lower inflation, and the 2026 projections to show small increases in GDP and unemployment alongside slightly lower inflation. Together, these revisions would raise the odds of a lower policy path, with risks skewed toward a softer 2026 dot.

Key Picture: US Federal Reserve Forecasts – 2025-2027

	2025*f*			2026*f*		2027*f*		2028*f*	Longer Run	
	Latest Reading	December Report	September Report	December Report	September Report	December Report	September Report	December Report	December Report	Sept Report
GDP *(real growth, y-o-y)*	2.1	2.0	1.6	2.0	1.8	1.9	1.9	1.8	1.8	1.8
Unemployment rate *(%, y-o-y)*	4.3	4.5	4.5	4.4	4.4	4.3	4.3	4.2	4.2	4.2
PCE Inflation *(%, y-o-y)*	2.7	3.0	3.0	2.6	2.6	2.1	2.1	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	2.9	3.0	3.1	2.5	2.6	2.1	2.1	2.0	-	-
Federal Funds Rate *(%)*	4.327	3.6	3.9	3.4	3.4	3.1	3.1	3.1	3.0	3.0

Source: Federal Reserve '*Summary of Economic Projections*' June and September 2025. *Note:* 1. GDP reading for Q2-2025; 2. Unemployment rate as of August 2025; 3. PCE and core PCE inflation as of September 2025; 4. Projections reflect the median of FOMC projectio

Analysis

- **EXPECTED DECISION**: *On December 10, we expect the US Federal Reserve's FOMC to cut its Fed funds range by 25 bps to 3.50% - 3.75%.* In October, FOMC was divided: Powell and 9 others voted for the policy; voting against the action were Stephen I. Miran, who favored a 50-basis-point rate cut, and Jeffrey R. Schmid, who preferred leaving the target range unchanged. The Fed made its latest policy decision with limited economic data due to the ongoing five-week government shutdown.

  Regarding *forward guidance*, the Fed will continue to be data-dependent regarding further policy changes with decisions being made meeting by meeting. Thus, unlike market talk of a "hawkish cut" given a hawkish forward guidance we believe that the forward guidance will be more neutral: Powell will signal that further cuts and their timing will dependent on the incoming economics data that are still partially distorted by the "fog" created by the recent government shutdown.

  Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June and end QT in December. In 2026 the balance sheet may start to rise modestly as the rise in nominal GDP and some concerns about liquidity in markets may justify an organic increase in the balance sheet. December's cut as part of an ongoing recalibration rather than a final move. The median 2026 dot is expected to stay at 3.375%, though it could fall 25bps lower if once participant shift lower to signal two 25bps rate cuts in 2026. Market odds of a December cut remain near 85%.

- **POLICY DISCUSSION**: *The Fed's December meeting is expected to be somewhat contentious, with several dissents likely on the widely anticipated 25bp rate cut.* Recent labor indicators point to a gradual cooling in the US economy, while inflation continues to show few signs of re-acceleration. Against this backdrop, the Federal Reserve is widely expected to cut interest rates this week, though the decision is set to be unusually contentious. Markets anticipate a 25bp reduction to 3.5–3.75%, as softening labor conditions warrant further easing.

  The latest inflation data — delayed by the shutdown and therefore the final input before the meeting — strengthened that case. Core PCE rose 0.2% in September and 2.8% year-on-year, slightly below expectations and down from 2.9% in August. Headline PCE increased 0.3% on the month and 2.8% on the year. The moderation and signals from influential FOMC members such as NY Fed's Williams helped push market-implied odds of a rate cut to nearly 87%.

Still, the FOMC remains sharply divided. One camp sees growing labor-market fragility as justification for continued easing; another insists that persistent services inflation and the lagged effects of Trump-era tariffs argue for caution. New York Fed President John Williams has signaled a willingness to cut again as insurance against further slowdown, while several regional presidents have warned against moving too quickly.

Economists expect at least two dissents and possibly three dissents — the most in several years. Kansas City Fed President Jeff Schmid is viewed as the most likely to oppose the rate cut, with Boston's Fed Susan Collin's and Chicago Fed's Austan Goolsbee also possible hawkish dissenters. Dovish Governor Stephen Miran, most aligned with President Trump's views, is expected to repeat his call for a more aggressive 50bps cut.

The mixed macro backdrop has fueled the division. Despite a stronger-than-expected September payrolls report, unemployment has drifted up and private-sector data point to gradually rising layoffs. Nearly half of economists surveyed say the Fed should prioritize price stability over employment, while only 5% favor emphasizing the labor side of the mandate.

Doves counter that while headline growth remains solid, much of the momentum is concentrated in AI-related investment and tech-driven spending — raising questions about the durability of growth and of the labor market strength. When asked about downside risks, most economists said a 20% drop in the S&P 500 would weaken growth but likely fall short of triggering a recession.

Overall, the Fed faces a highly uncertain policy environment: cooling labor markets, stabilizing but sticky core inflation, and a fracturing consensus inside the FOMC. This week's meeting is likely to deliver a rate cut, but also to expose deep divisions over what comes next. Looking ahead to 2026, a new Trump-appointed Fed chair—likely aligned with the doves – may be able to reshape the committee and its views. This sets up a potential struggle for control between dovish and hawkish factions.

The outlook for growth and inflation in 2026 remains constructive. After a soft patch of lower than potential growth in Q4 and possibly Q1 of 2026, growth should recover given Fed easing, some positive fiscal impulse (given that spending cuts were backloaded until after the mid term elections), still very easy financial conditions (given stock market levels, low bond yields and credit spreads and a weaker dollar), relatively solid balance sheet of households and corporate firms and the still strong tailwinds from AI investments. While inflation in 2026 may fall given that the base effect of tariffs fade while AI-driven productivity gains may reduce unit labor costs. Economic weakness in 2026 could derive from the existing and possibly worsening gap between stronger growth data and weaker employment ones (partly explained by the labor shedding that AI investment are likely to induce), the risk of a equity market correction if AI-related capex slows down, potentially geo-political risks intensifying (not our baseline) and a K-shaped economy leading to weaker consumer confidence if the "affordability" concerns intensify.

- **EXPECTED CHANGES TO ECONOMIC FORECASTS:** *Given the lack of new data after the government shutdown, the updated SEP may not shift dramatically.* The September SEP implied a cut to 3.6% in December, followed by only one additional "normalization" cut in 2026 (to 3.4%) and another in 2027 (to 3.1%), which the Fed views as the neutral rate. Markets currently price both normalization cuts in 2026, with none in 2027; futures imply cuts in April and September next year.

  Recent data support this view. Labor markets have cooled gradually, while inflation remains well-contained if sticky. Economists therefore expect the December SEP update to move in a slightly more accommodative direction. For 2025, forecasters anticipate modestly higher unemployment and lower inflation. For 2026, they expect small upward revisions to GDP and unemployment paired with a slight reduction in projected inflation. Combined, these adjustments increase the likelihood of a lower projected policy rate, with risks skewed toward a softer "dot" for 2026 with two rate cuts rather than one.

- **MACROECONOMIC ANALYSIS:** *US will finish the year with 3% real GPD growth despite the lengthy government shutdown Bessent says.* GDP fell 0.6% in Q1 but rebounded to 3.8% in Q2, driven mainly by lower imports and strong consumer spending with Atlanta Fed estimates putting Q3 growth near 3.5%. Treasury Secretary Scott Bessent said the holiday shopping season has been "very strong" and predicted the US economy will end the year on solid footing, citing recent quarters of roughly 4% GDP growth. He expects about 3% real growth for 2025 despite the shutdown.

  However, consumers remain pessimistic: the University of Michigan sentiment index rose to 53.3 in December but is still 28% lower than a year ago. Trump has dismissed concerns over affordability, calling it a political "scam," though polls show most voters unhappy with his economic management. Bessent blamed lingering inflation on the Biden era and said negative media coverage is shaping public perception, arguing that conditions will improve next year.

  The Fed's preferred inflation gauge, the PCE index, rose 2.8% y-o-y in September from a year earlier, slightly below expectations for 2.9%. Core PCE increased 0.3% m-o-m. But a warning sign emerged in consumer behavior: personal spending was flat in September, though it rose 0.2% excluding food and energy.

  Despite signs of cooling demand, post–Black Friday data shows consumers still spent heavily. US Black Friday retail sales rose 4.1% from last year, Mastercard SpendingPulse reported, while online shoppers spent a record $11.8 billion — up 9.1%, according to Adobe Analytics. But after adjusting for roughly 3% inflation, real spending may have been close to flat.

  The US added 119K jobs in September, beating expectations and showing solid momentum before the shutdown. But the underlying details were more mixed, pointing to a labor market that has started to soften despite headline gains and layoffs at major companies. Job growth was concentrated in health care, food services, and social assistance, while manufacturing lost 6,000 jobs and transportation and warehousing shed 25,300. The unemployment rate ticked up from 4.3% to 4.4%, partly because 450,000 people entered the labor force. Wage growth also slowed. In recent weeks, major companies including Amazon, GM, IBM, Microsoft, Paramount, Target and UPS have announced large layoffs.

- **MARKET IMPLICATIONS***: After the December cut, the Fed may pause for a little while while being data dependent, or weakening economic data could force recessionary cuts*. Changes in sentiment will depend on the new labor market report on December 16 and coming inflation data. To put things into context, *in the fixed-income space,* the Treasury yields held firm Monday amid rising expectations of a Fed rate cut this week. As of December 8, the 2*y UST* trades around 3.58% (-66bps y-t-d). The *10y UST* edged up by 10 bps and trades around 4.16% since the last meeting (-40 bps y-t-d). *In the currency space,* ahead of the meeting the dollar index hovered near a one-month low, boosting demand from overseas buyers. Gold is benefiting from a weaker dollar and anticipation of a Fed cut. As of December 8, and since the last meeting in October, the *dollar index* edged down by 0.3% and trades around 98.95 (-9.4% y-t-d). *EUR/USD* rose by 0.7% to 1.17 since October meeting (+5.5% y-t-d). *In the equity space,* by mid-November, the S&P 500 was on track for its worst losing streak in months amid growing concerns that AI leaders like Nvidia had become overinflated and were fueling a bubble. But major U.S. indexes rebounded, ending the first week of December higher as investors priced in a potential Fed rate cut. As of December 5, S&P 500 fell by 0.3% to 6870,40 since the last meeting (+17.1% y-t-d).

- *APPENDIX (Macro Background) The better-than-expected GDP growth was mainly driven by a stronger revision to consumer spending.* In Q2, the US economy grew by an annualized 3.8% (*c*: -0.6%; *p:* 3.3%), the fastest expansion since Q3 2023. Consumer spending rose (2.5% vs 0.6% in Q1). Government spending contracted (-0.1% vs -1.0%) and residential investment also shrank (-5.1% vs -1.0%). Exports shrank (-1.8% vs. 0.2%), while imports contracted by far more (-29.3% vs. 38.0%). The economy grew 2.1% y-o-y in Q2 2025, matching Q1 and marking the slowest pace since late 2022, the advance estimate showed.

  Despite the slowdown, the data still signals underlying growth in the US private sector. In October, *the S&P Global US Composite PMI* slipped to 54.2 (*c:* 54.8; *p:* 54.6). The *Services PMI* declined to 54.1 (*c:* 55.0; *p:* 54.8). The *Manufacturing* PMI fell to 52.2 (*c*: 51.9; *p:* 52.5).

  The US added a better-than-expected 119K jobs in, pointing to healthy hiring before the shutdown. In September, *the unemployment rate* edged up to 4.4% (*c:* 4.3%; *p:* 4.3%). NFP rose by 119K (*p:* -4K), marking the biggest job rise in five months. Wage growth increased by 5.0% in July (*p:* 5.0%) in September. The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, eased to 8.0% (*p:* 8.1%).

  Inflation climbed to the highest since January. In September, the *personal consumption expenditures* (*PCE*) – the Fed's preferred inflation gauge – increased to 2.8% y-o-y (*c:* 2.8%; *p*: 2.7%). The *core-PCE* – which excludes volatile energy and food prices – eased to 2.8% y-o-y (*c:* 2.9%; *p:* 2.9%). In September, headline inflation rose to 3.0% y-o-y (*c:* 3.1%; *p:* 2.9%) while core inflation ticked down to 3.0% y-o-y (*c:* 3.1%; *p*: 3.1%).