GENERALI ASSET MANAGEMENT

MARKET COMMENTARY

The Fed stays put as risks for both inflation and unemployment rise

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May 8, 2025

• The FOMC stayed put yesterday given the extreme uncertainty related to the looming impact of tariffs. Importantly the press release stressed the increased risk of both higher inflation and unemployment, which put the central bank in an extremely difficult position.

• In the Q&A session chair Powell underlined the strength of the economy so far and reminded that soft data like surveys has have been in the past poor predictors of actual outcomes. Still, he noted that the large tariff hike is likely to bring about higher inflation and a weaker labour market.

• We confirm our view of three rate cuts in the H2 (July, September, December), with another one in Q1 2026 to get to the neutral 3.25%-3.5% range. Risks are tilted to a later beginning of the easing cycle, depending on the speed and magnitude of the hit to employment.

As widely expected, the FOMC neither moved rates nor provided any strong guidance on how it will react to the change in the economic outlook brought about by the sharp increase in tariffs. The expected rise in both inflation and unemployment will create a hard to deal with tension between the two pillars of the Fed mandate, and with no hard data available yet and a still solid economy, the FOMC can afford patience before acting. The press statement reiterated the message already delivered several times after "Liberation Day", namely the sharp increase in both inflation and unemployment risk.

> ~~Recent~~Although swings in net exports have affected the data, recent indicators suggest that economic activity has continued to expand at a solid pace. The unemployment rate has stabilized at a low level in recent months, and labor market conditions remain solid. Inflation remains somewhat elevated.
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> The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. Uncertainty ~~around~~about the economic outlook has increased further. The Committee is attentive to the risks to both sides of its dual mandate and judges that the risks of higher unemployment and higher inflation have risen.

High uncertainty was also the leading theme of the Q&A session. Chair Powell toned down the rate guidance of the March Meeting (two rate cuts by year end) and added that the cost of waiting for a clearer picture is currently relatively low given the strength of the economy: therefore, the Fed is in no hurry to move rates.

Powell duly noted that so far the worsening in the outlook is visible only in soft data like surveys, which in the past were not very good at anticipating changes in domestic demand and unemployment, even though he conceded that the speed and scale of the recent deterioration is clearly concerning. In the end however, the FOMC will need to react to hard data, which will start to be meaningfully affected by tariffs only over the next couple of months.

US Activity Heatmap

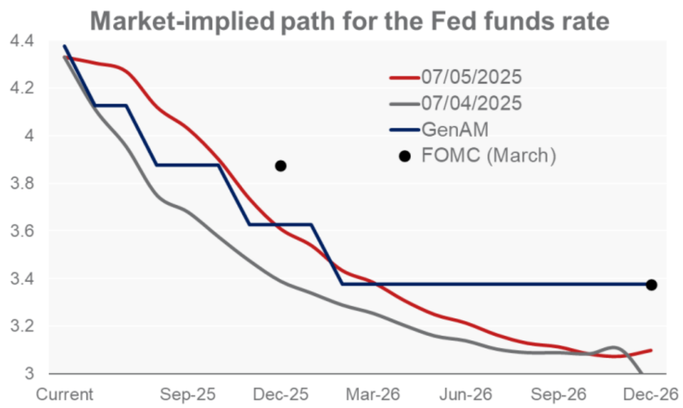
	Indicator	Transformation	May-25	Apr-25	Mar-25	Feb-25	Jan-25	Dec-24	Nov-24
Domestic Demand	Industrial production	6m % chg			1.51	0.85	0.38	-0.26	-0.84
	Construction activity	6m % chg			-2.3	8.3	7.8	14.8	-0.8
	Real consumption	6m % chg			1.6	1.4	1.4	2.2	1.8
Labour Market	Employment - private	6m % chg		0.8	0.71	0.74	0.66	0.65	0.43
	Unemp. Rate	6m chg.		0.1	0.1	-0.1	-0.2	0	0.2
	Job openings/unemp.	3m avg.			1.1	1.1	1.1	1.1	1.1
Sentiment	Cons. Confidence	3m avg.		70.2	76.4	81.6	84.6	85.0	82.9
	PMI -Manufacturing	3m avg.		49.3	50.1	50.1	49.5	48.2	47.6
	PMI-services	3m avg.		52.0	52.4	53.4	53.1	54.1	54.3
	NAHB Construction	3m avg.		40	43	45	46	45	43
Leading indicators	Orders, Dur. Ex transp	6m % chg			0.91	1.33	1.26	0.9	0.94
	Housing permits	3m avg.			1466	1471	1483	1465	1446
	SM Man. Orders to inventorie	3m avg.		1.02	1.07	1.12	1.11	1.06	1.00
	Inital unempl. Claims	4wk avg	221	223	229	216	214	224	227.0
Financial Conditions	Bank lending impulse	% GDP - 6m chg.			-0.4	-0.3	-0.4	-0.4	-0.4
	Stock Market	6m % chg.	-6.5	-10.1	-1.9	7.2	8.7	8.2	9.1
	BBB Spread	6m chg.	31.7	36.6	5.8	-17.7	-22.3	-15.2	-14.1
	Real Effective exchange rate	6m % chg		4.9	4.3	2.8	2.8	0.2	0.1

US Inflation Heatmap

	Indicator	Transformation	May-25	Apr-25	Mar-25	Feb-25	Jan-25	Dec-24	Nov-24
Surveys	Medium term inf. Exp	yoy % chg.	2.13	2.17	2.16	2.14	2.11	2.08	2.08
	ISM Price paid - Manuf	Index		69.8	69.4	62.4	54.9	52.5	50.3
	ISM Price paid - Serv	Index		65.1	60.9	62.6	60.4	64.4	58.5
Input	PPI - Fin. Dem	6m % chg			1.2	1.9	2.1	1.6	1.5
	PPI- Retail trade	6m % chg			-0.2	0.9	1.6	-0.2	-0.8
	Median Wage	yoy % chg.		4.3	4.3	4.3	4.1	4.2	4.3
Underlying inflation	Trimmed PCE	6m % chg			2.7	2.8	2.6	2.5	2.4
	Core Sticky CPI	3m % chg ann.			3.3	3.5	3.4	3.0	3.4

The uncertainty created by the unprecedented rise in tariffs makes it extremely difficult for the Fed to decide which leg of the dual mandate should be prioritised ("we don't know which way this is going to shake out"). He also noted that, unlike 2019, high and sticky inflation prevents any pre-emptive ("insurance") rate cut: therefore, the bar for a rate cut in the short term looks much higher. He repeatedly refused to lay out any precise indication on the timing of the next move nor on which threshold for unemployment could trigger action.

The May meeting provided no additional information for us to change our rate outlook. We expect that, by the July 29-30 meeting, enough evidence of the adverse impact of tariffs on activity would have materials for the Fed to start cutting rates. The July move will likely be followed by further 25bp cuts in September and December. Another move in early 2026 would bring the policy rate within our estimated 3.25%-3.5% range. This is broadly in line with market pricing for this year. However, and as shown by the recent upward repricing of the policy rate path, risks appear tilting to a later start of the easing cycle, for two reasons: firstly, the Fed may put a higher weigh on taming inflation expectations than we think; secondly, the deterioration in employment may be slower than we anticipated. This would put a hard floor to the anticipated decrease in long term rates.



Source: FRB, Datastream, GenAM