MARKET COMMENTARY

The Fed sees slower growth and higher inflation but points to a slower path of rate cuts

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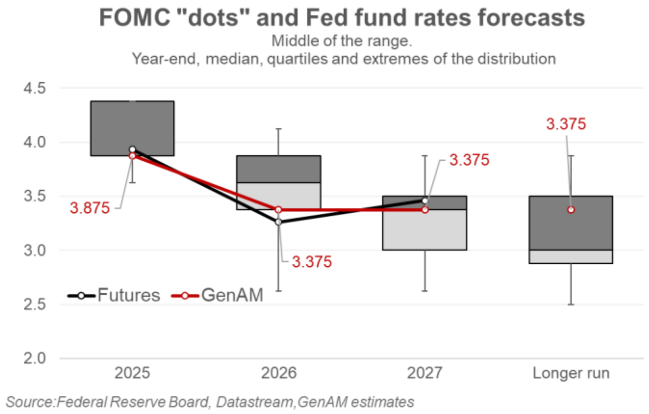
• The Fed maintains its projection of two rate cuts this year, but members are increasingly leaning toward a less accommodative stance. A slightly clearer understanding of the impact of tariffs has led to a downgrade in the growth and labor market outlook, alongside a rise in expected inflation. Without the tariffs, Powell repeatedly emphasized, the Fed would be ready to resume easing policy.

• Given the unprecedented situation, uncertainty remains high. The Fed must wait to assess how tariffs feed through to retail prices, with evidence expected to accumulate over the summer. Solid demand growth and low unemployment allow the FOMC to remain patient. The median path for the policy rate now includes only one rate cut in both 2026 and 2027, possibly reflecting a higher equilibrium rate—even though the long-run estimate remains unchanged.

• Despite a deteriorating outlook for activity, the message from this meeting was clearly hawkish, as reflected in the initial decline in both stock and bond prices. Our baseline forecast still includes two cuts this year, but it will be updated in light of the meeting's tone.

In an otherwise uneventful meeting, Powell emphasized the role of the looming tariff spike in worsening the economic outlook and the importance of the Fed not acting prematurely before the effects of trade policy are fully understood. However, for a growing number of members, "waiting" now implies not cutting rates at all this year. Somewhat surprisingly—given the potentially long-term negative impact of tariffs on growth and employment—the Fed has reduced the projected number of rate cuts in 2026 from two to one.



The press release contained only minor changes compared to May; some reference to the first crack appearing in the labour market (especially the upwards drift in claims) and a recognition of more clarity on the outlook.

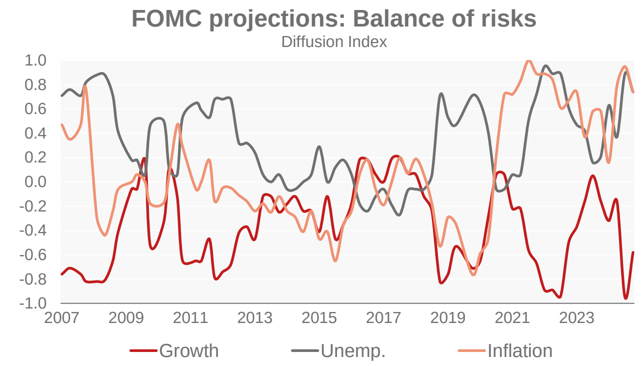
Although swings in net exports have affected the data, recent indicators suggest that economic activity has continued to expand at a solid pace. The unemployment rate ~~has stabilized at a low level in recent months~~remains low, and labor market conditions remain solid. Inflation remains somewhat elevated.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. Uncertainty about the economic outlook has ~~increased further.~~diminished but remains elevated. 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~~.

The most significant development was the substantial revision of projections, showing a marked deterioration for this year and a more moderate weakening for 2026. Notably, the negative effects of tariffs on inflation and unemployment are now expected to persist into 2027. While risks to the outlook remain elevated—particularly for inflation and unemployment—they have eased somewhat from the peak observed in March. The upward revision to the policy rate path implies that the Fed now sees the rate in 2027 as approximately 40 basis points above the neutral rate, whose estimate remains unchanged. This could suggest a higher terminal rate for the current cycle. However, as is often the case, Powell was quick to downplay the significance of projections beyond the current year, noting that each member has pencilled in what they consider the “least unlikely scenario.”

Median Projection

	2025	2026	2027	Longer run
Change in real GDP	1.4 ↓	1.6 ↓	1.8	1.8
March projection	1.7	1.8	1.8	1.8
Unemployment rate	4.5 ↑	4.5 ↑	4.4 ↑	4.2
March projection	4.4	4.3	4.3	4.2
PCE inflation	3.0 ↑	2.4 ↑	2.1 ↑	2.0
March projection	2.7	2.2	2.0	2.0
Core PCE inflation	3.1 ↑	2.4 ↑	2.1 ↑	
March projection	2.8	2.2	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	3.9	3.6 ↑	3.4 ↑	3.0
March projection	3.9	3.4	3.1	3.0



Source:Federal Reserve Board, GenAM

The distribution of the dots reveals the hawkish tilt the FOMC took at this meeting. The median dot remained at 3.38, but thanks to just one vote. Moreover, the FOMC looks split, with as many as seven members calling for no cuts this year (up from four in March) and eight sticking to two cuts. In the end 9 out of 19 members sees the need at most one cut this year.

Distribution of the projected rate

2025		2026		2027		Long term	
Mar-25	Jun-25	Mar-25	Mar-25	Jun-25	Mar-25	Mar-25	Mar-25
4.38	4.38	4.13	4.13	3.88	3.88	3.88	3.88
4.38	4.38	4.13	3.88	3.88	3.88	3.75	3.75
4.38	4.38	4.13	3.88	3.63	3.63	3.63	3.63
4.38	4.38	3.88	3.88	3.63	3.63	3.63	3.63
4.13	4.38	3.63	3.88	3.63	3.63	3.50	3.50
4.13	4.38	3.63	3.88	3.63	3.38	3.50	3.50
4.13	4.38	3.38	3.63	3.38	3.38	3.38	3.38
4.13	4.13	3.38	3.63	3.38	3.38	3.13	3.13
3.88	4.13	3.38	3.63	3.13	3.38	3.00	3.00
3.88	3.88	3.38	3.63	3.13	3.38	3.00	3.00
3.88	3.88	3.38	3.38	3.13	3.38	3.00	3.00
3.88	3.88	3.38	3.38	3.13	3.13	2.88	2.88
3.88	3.88	3.38	3.38	3.13	3.13	2.88	2.88
3.88	3.88	3.38	3.38	3.13	3.13	2.88	2.88
3.88	3.88	3.38	3.38	2.88	2.88	2.88	2.88
3.88	3.88	3.13	3.13	2.88	2.88	2.63	2.63
3.88	3.88	2.88	3.13	2.88	2.88	2.63	2.63
3.63	3.63	2.88	2.88	2.63	2.63	2.50	2.50
3.63	3.63	2.88	2.63	2.63	2.63	2.50	2.50

At the press conference, the Chair repeatedly emphasized the negative impact that tariffs are expected to have on an otherwise healthy economy. Recent data show that inflation is declining, particularly in services, with the Fed estimating core PCE inflation at 2.6% year-over-year in May (headline inflation is projected at 2.3%). This moderation is largely attributed to a labour market that, while still strong, is no longer exerting inflationary pressure. The unemployment rate stands at 4.2%—low by historical standards—and has remained within a narrow range over the past year. A broader set of indicators suggests that labour demand and supply are broadly balanced, and the market "does not cry for a rate cut." While unemployed individuals are finding it harder to secure jobs, those currently employed face a low risk of layoffs.

Moreover, although trade flows ahead of the tariff hikes distorted Q1 GDP, the economy appears to be growing at a pace of 1.5% to 2%, possibly faster. What prevents the Fed from cutting rates now is the uncertainty surrounding how inflation will respond to the tariff increases in the medium term. Powell noted that, after several months of decline, inflation expectations—both market-based and survey-based—have started to rise again. Many firms have indicated plans to pass on some or all of the cost increases to consumers. However, it remains difficult to assess how tariffs will ripple through the various stages of supply chains without more data. So far, only a minor uptick has been observed in prices of some imported goods, such as PCs, but many firms are still selling inventory purchased before the tariffs took effect. According to Powell, a clearer picture is unlikely to emerge before the end of the summer.

Monetary policy, therefore, is well-positioned to respond to the uncertain outcomes of the tariffs. Powell described it as only modestly restrictive, supported by the continued strength in demand and the labour market. He attributed the wide divergence in views on the appropriate policy rate for end-2025 to both the range of forecasts regarding the inflationary impact of tariffs and differing views on the optimal policy response. The Fed's key task is to ensure that inflation expectations remain anchored so that the price-level increase from tariffs does not evolve into a more persistent inflation problem. As more data become available, the FOMC will be better able to assess the trade-off between inflation and unemployment goals. Future rate decisions will depend on how far the economy deviates from these targets and the expected timeline for returning to them.

The FOMC is also discussing updates to its monetary policy framework, with conclusions expected by late summer. These changes may include revisions to how its views are communicated, particularly regarding economic projections.

Markets took note of the overall hawkish tone. The S&P 500 fell 0.1% following the announcement, before partially recovering, while the 10-year Treasury yield edged up by 1 basis point to 4.4%.