Atakan Bakiskan, US Economist | atakan.bakiskan@berenberg.com | +44 20 3207 7873

US FED OUTLOOK: ON HOLD - UNLESS THE LABOUR MARKET COLLAPSES

Berenberg Macro View

No reason to cut in 2025: The Fed faces a difficult decision: Should it pre-emptively cut rates to protect the labour market from the impact of tariffs and heightened uncertainty, or keep rates steady (perhaps even raise them) amid rising inflationary pressures? We still expect the Fed to prioritise inflation over growth. Therefore, it will likely hold the policy rate steady throughout 2025. In contrast, Bloomberg consensus expects two 25bp cuts this year, while futures and swaps markets anticipate three (see Chart 1). We predict that inflation (as measured by the core PCE) will accelerate from its current rate of 2.8% yoy to above 3% in Q3 and end the year at 3.2%. Several factors contribute to this rise: i) near-term inflation expectations are rising (see Chart 6, 7 and 8), ii) businesses will pass tariff costs to consumers through higher prices, iii) a weaker dollar will add to import price inflation, and iv) a tight labour market will place a floor under price increases for services (excluding shelter). The drift even further away from the 2% inflation target will most likely prevent rate cuts. The Fed still views the economy being in solid shape (with the labour market near full employment) despite elevated uncertainty and intensifying headwinds to growth.

Not another policy mistake: In recent years, the Fed took a series of missteps. First, it characterised the post-pandemic inflation as transitory and delayed rate hikes for too long. Second, the Fed then overreacted to the rising unemployment rate last summer. It initiated a short-lived easing cycle, cutting the its funds rate corridor by an excessive 100bps, from 5.5% (upper bound) in September to 4.5% in December. Cutting rates this year under the assumption that the impact of tariffs on prices will prove transitory would be a third mistake. It would risk un-anchoring long-term inflation expectations. This could trigger a persistent wage-price spiral. The Fed wants to prevent the recent rise in near-term inflation expectations from feeding into long-term expectations. Therefore, cutting rates in response to tariffs seems unlikely for now. In addition, ongoing uncertainty around trade, immigration and fiscal policies reinforces the case for the Fed to maintain its current "wait-and-see" approach.

Watch out for the labour market: The Fed may consider cutting rates if the labour market collapses. If companies freeze hiring and lay off workers, the unemployment rate could rise toward 5% from 4.2%. Although hiring plans are slowing substantially, the current macro environment and leading labour market indicators such as Worker Adjustment and Retraining Notification (WARN) notices, job openings, initial unemployment claims and Conference Board's Employment Trend Index (ETI) do not point to such a sharp rise in unemployment. Unless recessionary labour market conditions emerge, we believe the Fed will keep rates on hold.

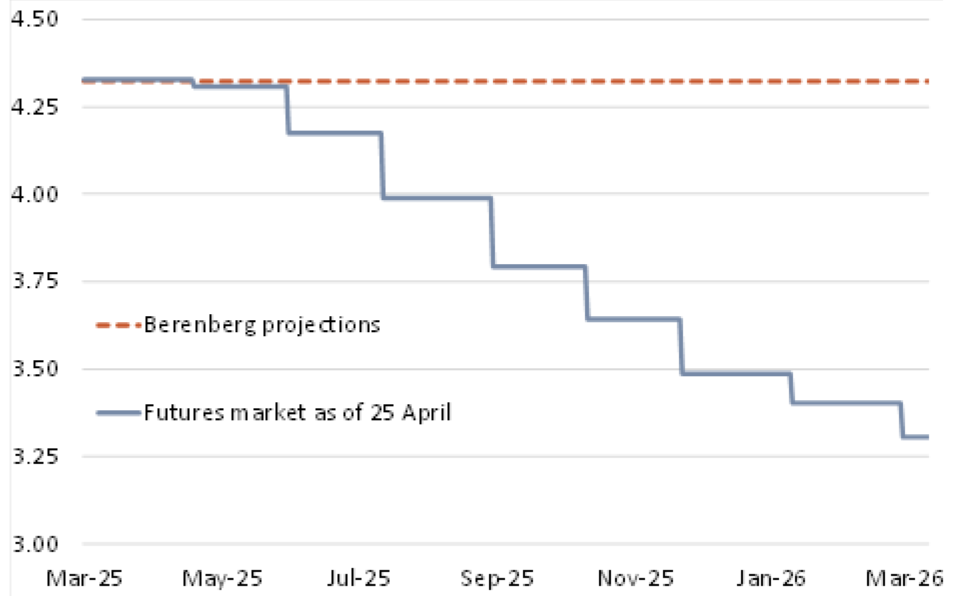
From boom to below-trend growth: President Donald Trump inherited an exceptionally strong economy that was on track to expand nicely for another year. However, it took only three months in office to shift the narrative from "US exceptionalism" to "sell America". Amid Trump's aggressive tariff policy, heightened uncertainty and a sharp reversal in the equity market, we lowered our US growth forecast for end-2025 (Q4/Q4) from 2.4% in February to 1.1% now. As of March, the Fed projected 1.7% growth for end-2025 (Q4/Q4), but that was before the 2 April "Liberation Day" tariff announcements and the imposition of import duties of 145% on China. The Fed's internal projection is likely closer to 1% now. While both we and the Fed expect growth to fall below trend in 2025, an imminent recession remains unlikely. This is due to i) a still-strong labour market supported by non-cyclical industries like health and education services, ii) income-driven consumer spending growth, iii) positive real wage growth, iv) surging new business formations and v) healthy balance sheets.

Trump's drag on growth is more than just tariffs: Tariffs hinder economic growth by raising input costs for businesses, eroding consumer purchasing power and likely squeezing firms' profit margins. However, the way the Trump administration conducts its trade policies causes even more harm. The on-again-off-again tariffs generate record levels of uncertainty, leading businesses to scale back hiring and capital expenditure plans (both show a sharp reversal in April – see Chart 2 and 3). This also dampens business and consumer confidence, as well as their expectations for the economy (see Chart 4 and 5), both of which have sharply declined recently. This could ultimately lead to slower economic activity. Retaliation by other countries, such as China's 125% tariffs on US goods, and foreign consumer boycotts severely impact US exports. Meanwhile, declining international tourism to the US already weighs on aggregate spending, particularly on services. The combination of tariffs, high uncertainty and lower trust in institutions hurts equity prices and drives bond yields higher. Deteriorating financial conditions ultimately impede economic growth, too. They create headwinds for consumption, especially given households' heavy exposure to the stock market and already high borrowing costs.

Some reasons to stay optimistic: We base our forecasts on the assumption that the US will negotiate away roughly half of its new tariffs by the end of Q2, and that Trump will strike trade deals with major partner countries within the next three months instead of escalating his disruptive trade wars further and further (see: Trade war update: the silver lining beyond the chaos). The tariffs currently in place add up to an average effective rate of nearly 24% -- up from 2.5% last year. if they remain in place, inflation could approach 4% yoy in H2. That would be highly unpopular. The economic upheaval – along with a further drawdown in the equity market and higher bond yields (Trump's kryptonite?). To avoid such a dismal fate, the White House has already started trade talks with several countries. Markets would certainly welcome any successes in these negotiations. They would also help consumer and business sentiment to recover. And although they have taken a backseat to Trump's tariff headlines, potential tax cuts – along with an extension of the 2017 Tax Cut and Jobs Act (TCJA) – could boost economic activity (but also inflation). The House accepted the Senate's budget plan earlier this month, which allows room for some tax cuts in addition to extending the TCJA. The 10-year budget plan includes $5.3 trillion in deficit-financed tax cuts (extending the TCJA alone costs about $4 trillion, so the additional stimulus is more like $1.3 trillion) and $521 billion in defence and immigration spending. However, it only introduces a minimum of $4 billion in spending cuts. This means the US government could provide an annual stimulus of nearly $200 billion to the economy, or 0.6% of GDP. The question now is how long it will take to prepare the final bill. That said, both trade and fiscal policies remain increasingly uncertain. That makes it difficult for the Fed to forecast the economy. While the Fed is aware of the potential for negotiations and tax cuts, it will not act until there is greater clarity on these policies.

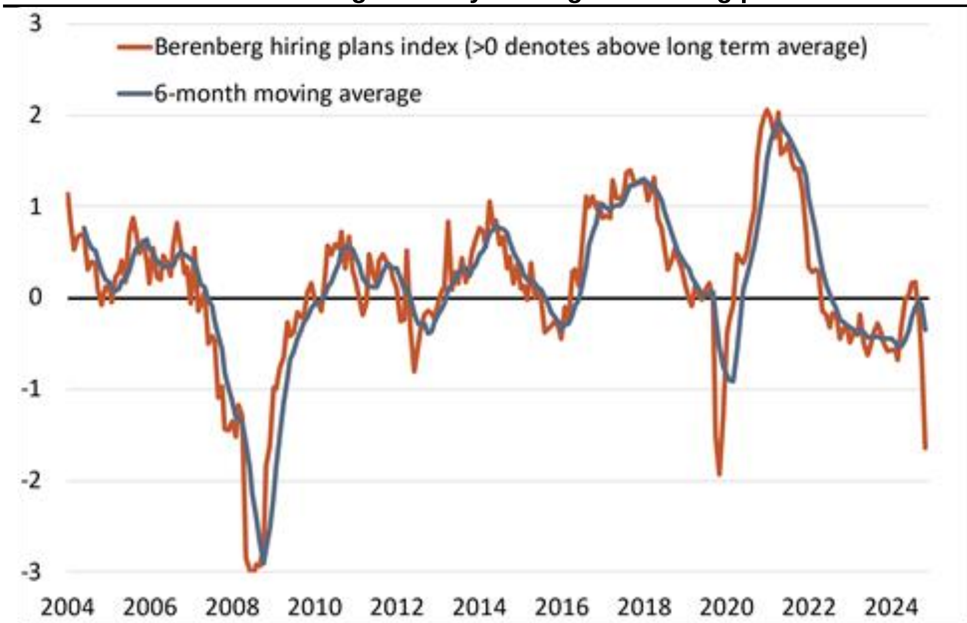
Rising pressure on the Fed: Trump's comments last week about firing Fed Chair Jerome Powell quickly became history when he stated on Monday that he has no intention of doing so. However, even after Trump backed down from firing Powell for now, the mere discussion exacerbates uncertainty, which is the last thing the economy and markets need right now. It further erodes trust in institutions, pushing up the risk premium on US assets (higher long-term yields, a weaker dollar and a declining equity market) and damaging trend growth. While Trump has backtracked on his firing threat – possibly after advisers warned him about market reactions – there is no guarantee that he will not revive it. The Supreme Court is currently revisiting the "Humphrey's Executor" law, which prevents Trump from firing commissioners at independent agencies, including Powell. Even if the result of the judicial proceedings favours Powell, Trump could still try to dismiss him "for cause" if he finds a plausible cause. Unless Trump finds a way to oust Powell, which we consider unlikely, he must wait until the end of Powell's term as Fed Chair in May 2026 to replace him with his preferred candidate (Kevin Warsh?). Adriana Kugler's term as Fed governor ends in January 2026, so Trump can appoint a new governor at that time, who could then replace Powell as Chair in May 2026. The president's nominations for Fed governor, Chair, and Vice Chair must be confirmed by the Senate. With the Republican majority, this should not be a problem as long as Trump proposes reasonable candidates. Trump only controls the Fed governors (there are seven, including Powell). He does not control the presidents of regional banks (there are twelve). The regional bank presidents also participate in monetary policy, but they are appointed by non-governmental selection committees. All 19 members take part in the Summary of Economic Projections (EP), but only 12 can vote. Governors are permanent voters. The remaining five seats are rotated among the twelve regional bank presidents. Under pressure from Trump, Powell and the other six governors may have to consider the tail risk that Trump could find a way to force them out. However, their desire to appear independent will likely outweigh these concerns upon charting the course of monetary policy.

Chart 1: Berenberg vs. markets



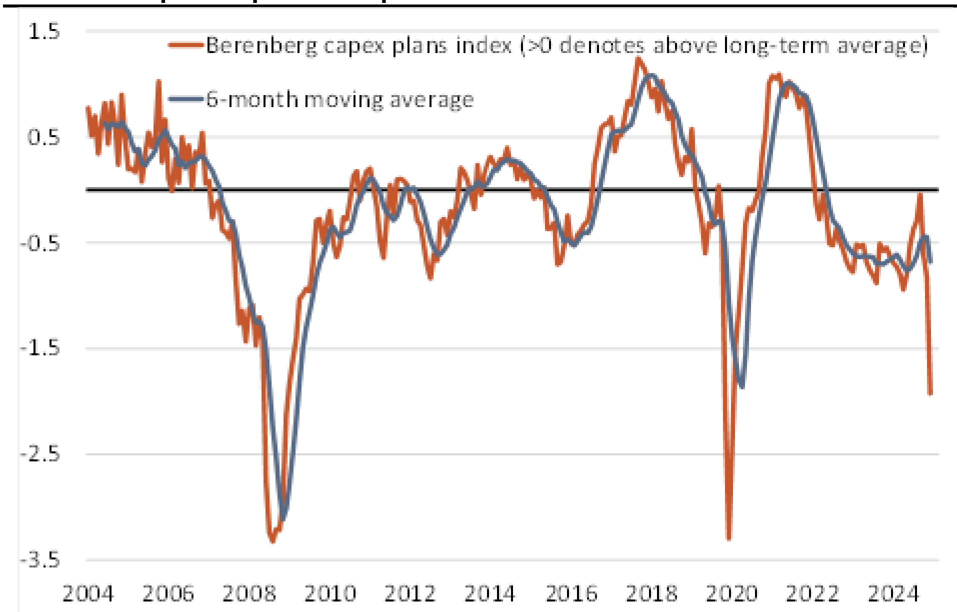
The solid line denotes futures market pricing of the Fed funds rate. Sources: Bloomberg, Berenberg

Chart 2: Businesses are significantly scaling back hiring plans



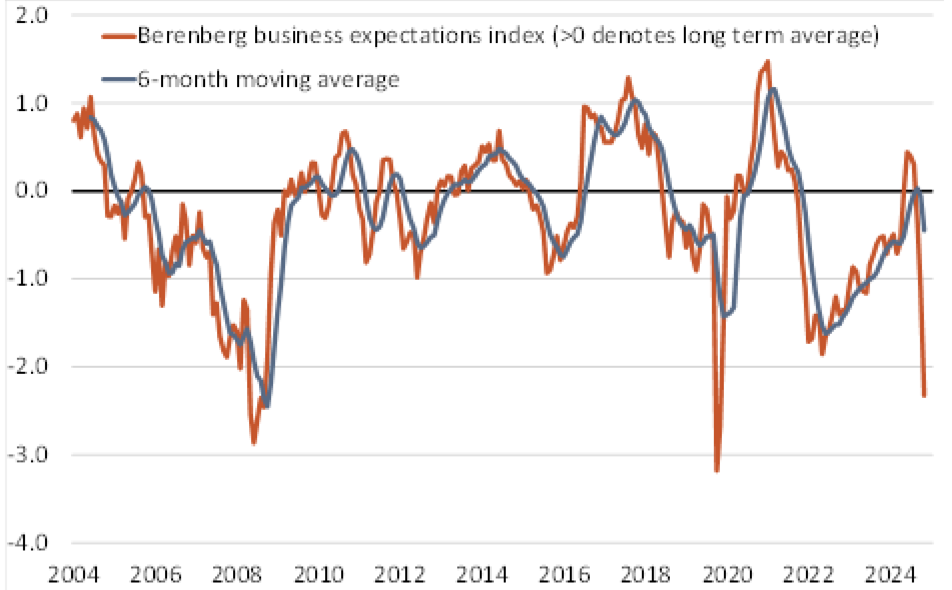
Average of z-scores of businesses' hiring plans. Sources: Census Bureau, Challenger, Gray & Christmas, Dallas Fed, Kansas City Fed, New York Fed, Philadelphia Fed, Chicago Fed, Richmond Fed, NFIB, Cleveland Fed, Business Roundtable, NABE, NAM, Haver Analytics, Berenberg

Chart 3: Capital expenditure plans in free fall



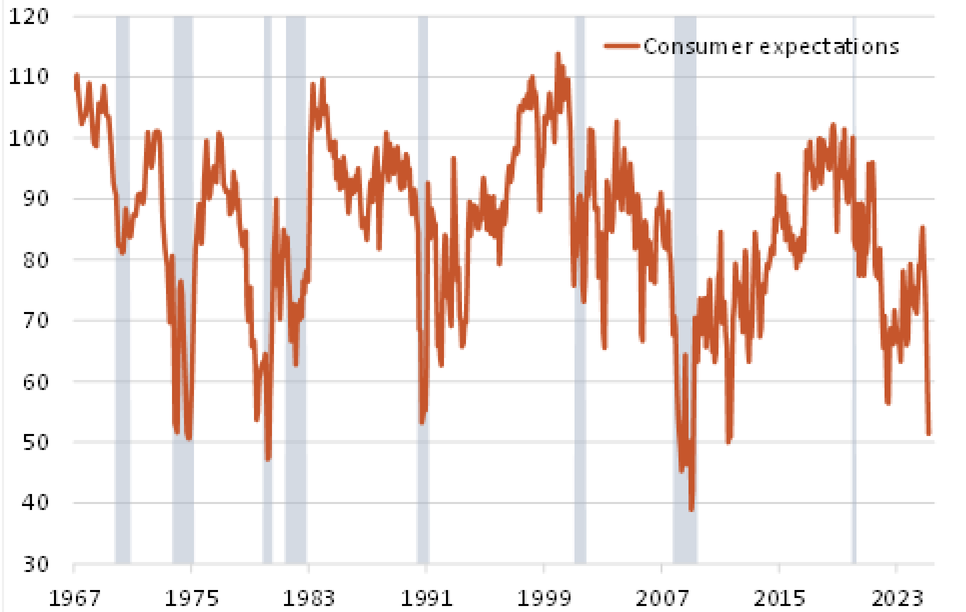
Average of z-scores of businesses' capex plans. Sources: Richmond Fed, Philadelphia Fed, New York Fed, Kansas City Fed, Dallas Fed, Chicago Fed, NFIB, Cleveland Fed, Business Roundtable, NABE, NAM, Haver Analytics, Berenberg

Chart 4: Businesses increasingly pessimistic about the future



Average of z-scores of business expectations. Sources: Chicago Fed, Dallas Fed, Kansas City Fed, Richmond Fed, Philadelphia Fed, New York Fed, Cleveland Fed, NFIB, Creighton University College of Business, Duke University, Atlanta Fed, NABE, Vistage International, Business Roundtable, Haver Analytics, Berenberg

Chart 5: Consumer expectations at recessionary terrain

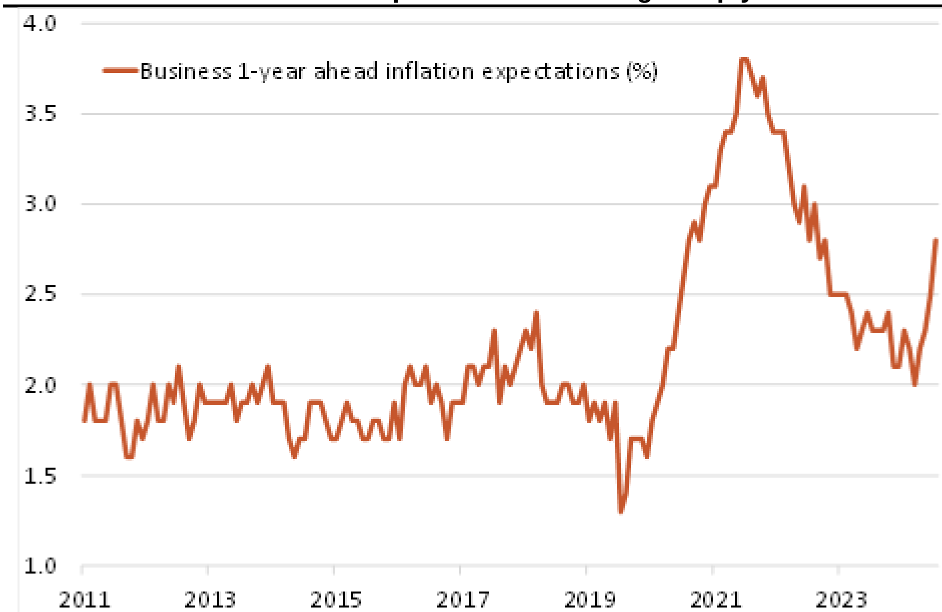


Average of the Conference Board and University of Michigan consumer expectations indices. Consumer expectations refer to short-term outlook on personal finances and economic/business conditions. The April reading for Conference Board is assumed to come down by the same amount it did in March. Shading indicates recession. Sources: Conference Board, University of Michigan, Haver Analytics

Chart 6: Consumer inflation expectations jump amid tariffs

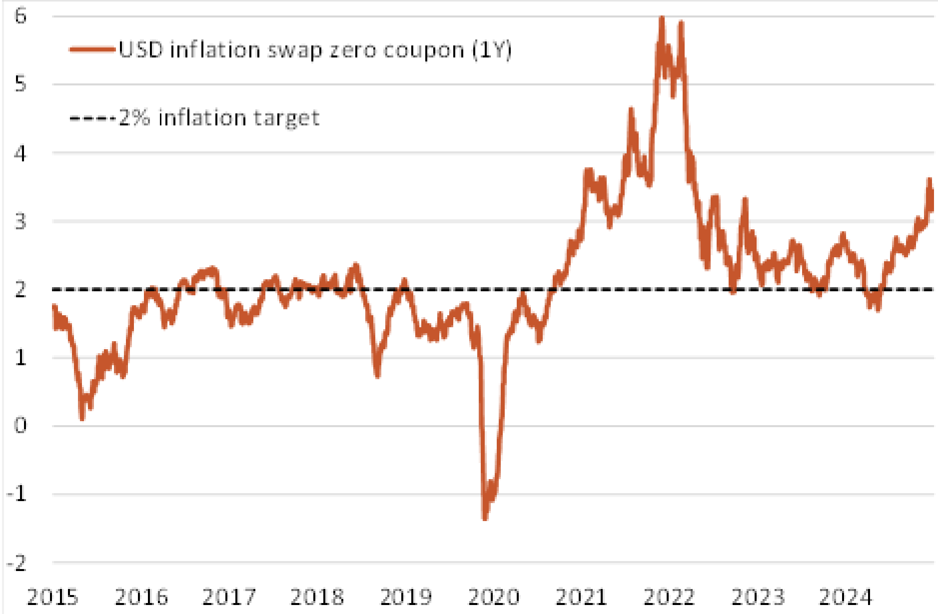
Average of the Conference Board, University of Michigan and New York Fed 1-year ahead consumer inflation expectations indices. The April readings for Conference Board and New York Fed surveys is assumed to increase by the same amount they did in March. Sources: Conference Board, University of Michigan, New York Fed, Haver Analytics

Chart 7: Business inflation expectations are rising sharply



Expected change to unit costs over next 12 months. Sources: Atlanta Fed, Haver Analytics

Chart 8: Swaps market sees inflation reaching 3.4% in January 2026



Source: Bloomberg

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