Fed Watch

AIB Treasury Economic Research Unit

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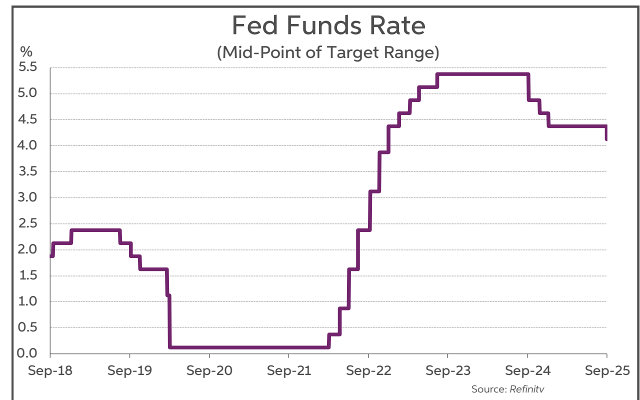
Fed cuts and signals more easing on the cards

The September meeting of Federal Reserve Open Market Committee (FOMC) saw the central bank cut interest rates for the first time since December of last year. The target range for the Fed funds rate was lowered to 4.00-4.25%. The Fed has now reduced rates by 125bps since its started to ease policy back in September 2024.

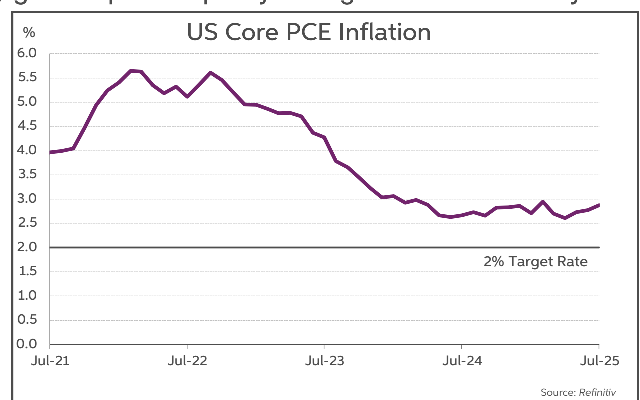


The outcome of last night's FOMC meeting was very much in line with market expectations. All voting members of the committee were in favour of easing policy, with 11 of the 12 members voting for a 25bps rate cut. However, the newly appointed Governor Miran (who is on leave but remains a member of the White House Council of Economic Advisers) preferred a 50bps reduction in rates.

The meeting statement for September contained some important changes, which providing the rationale for its decision to restart its easing cycle. In this regard, the committee cited recent developments in the labour market. Significantly, the Fed no longer views the labour market's performance as being "solid". Its updated assessment noted that "job gains have slowed" and that the "unemployment rate has edged up". It also commented that "downside risks to employment have risen".

In the post meeting press conference, Chair Powell provided some further insight on why the Fed decided to cut interest rates, even though its updated macro forecasts (GDP, inflation and unemployment) were broadly similar to the June projections. He described the decision to ease as a "risk management cut" and that the softening in labour market conditions warranted the reduction in the fed funds rate. However, he continued to emphasise that the Fed would maintain a "meeting-by-meeting" approach to its monetary policy decisions.

With the September rate cut fully expected, a key point of focus for markets was the updated interest rate projections (i.e. dot plot). These latest projections show a slightly more dovish stance within the FOMC. The median projection for 2025 was lowered to 3.50-3.75% by year end, which would see a total of 75bps of easing this year. This entails 25bps of additional easing compared to the June 'dots', which anticipated 50bps of cuts. Meanwhile, the median view for 2026 among the Committee is for one 25bp rate cut to 3.25-3.50%. For 2027, rates are seen as declining to 3.00-3.25% by year end. Further out, the "longer run" view was unchanged at 3%. Overall, the September 'dots' continue to indicate a relatively gradual pace of policy easing over the next 2-3 years.



Market rate expectations are little changed in the aftermath of the Fed policy announcement. Current pricing suggests that markets expect two more rate cuts by year end, in-line with the dotplot projections for this year. Futures contracts indicate the market sees around a 90% chance of a 25bps rate cut at the next FOMC meeting in October, with rates falling back to below 3.7% by year-end. **Despite, the dovish shift in the Fed's 'dots', the market continues to envisage a more aggressive pace of rate cuts from the Fed next year.** Markets are currently pricing in around 75bps of policy easing in 2026, which would see the target range end the year back at 2.75-3.00%. This is 50bps below the median FOMC projection for rates to be lowered to 3.25-3.50% over the same period.

Overall, while the Fed has outlined a somewhat more dovish outlook on the path for rates, it is clear from the September FOMC that policy will ultimately be determined by incoming data. Specifically, labour market data will be very much in focus for their policy deliberations, with the Fed now assuming that any tariff related impact on inflation is likely be temporary. If the current weakness in job numbers persist, and the unemployment rate continues to tick higher, then a 25bps rate cut at each of the final two meetings (October and December) of 2025 is very much on the cards. This would put the Fed funds range at 3.50-3.75% heading into 2026.

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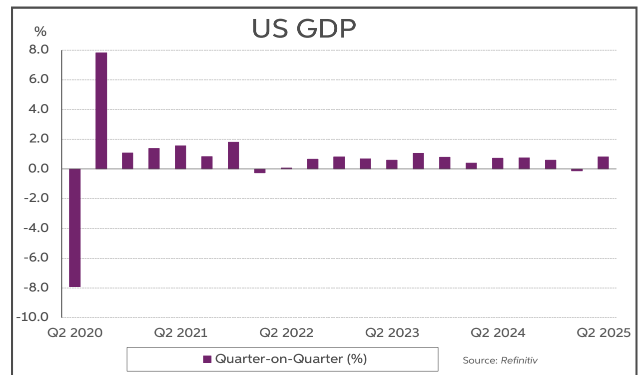
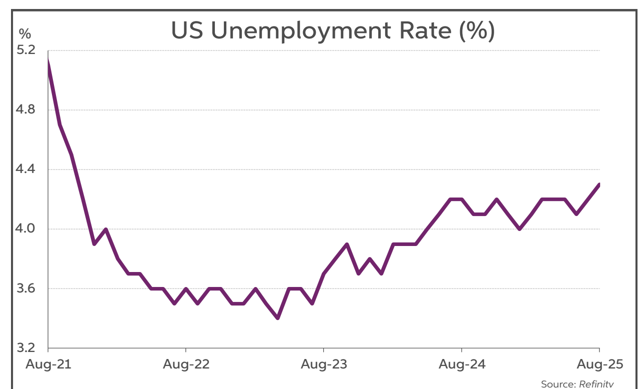
The Fed's dual mandate is in greater tension



US economic growth has slowed markedly in the first half of 2025. GDP contracted by 0.1% in the first quarter before rebounding by 0.8% in the second. However, very sharp swings in imports have created significant volatility in the data. Indeed, goods imports surged by 10.9% q/q in Q1 before falling by 7.7% in Q2. A closer examination of the data, though, also indicates that the US economy has lost some underlying momentum. Personal consumption has risen more slowly, up by 0.1% in Q1 and by 0.4% in Q2, compared to an average growth rate of 0.9% per quarter in 2024. Meanwhile, government spending essentially flat-lined in the first six months of 2025. Fixed investment has been the one bright spark, increasing at a faster pace in the first half of 2025 (2.7%) compared to last year (2.2%). Against this backdrop, real domestic final sales expanded by just 0.8% in H1 2025, down sharply on the 1.3% and 1.9% rates of expansion seen in 2023 and 2024.

However, the available hard data indicate that the economy may have gathered some steam in Q3, largely due to a consumer-led rebound. Retail sales increased by 0.6% m/m in July and August, with the control group (core sales metric) rising by 0.5% m/m and 0.7% m/m during the same period. Nominal consumption rose by 0.5% m/m in July also, the second fastest pace of expansion this year. Industrial production has underperformed though, recovering by a meagre 0.1% in August, following a 0.4% contraction in July. **Survey data have been somewhat mixed in Q3.** The services PMI has averaged 53.5 in the first two months of the quarter, down from 55.1 in Q2. Furthermore, the August reading of 51.7 was the lowest since January. Similarly, the manufacturing PMI has averaged 51.4, compared to 51.7 in Q2. At the same time, the manufacturing ISM has stayed in contraction mode in July and August, although the non-manufacturing ISM strengthened to 52.0 in August, its highest reading since February. Elsewhere, both the Michigan and the Conference Board measures of consumer confidence remain at weak levels, albeit they are above their recent nadirs.



Regarding the labour market, conditions have softened at an accelerating pace this year. Payrolls fell for the first time since December 2020 in June, and the overall pace of expansion slowed to just 30k in the three months to August, down from 111k in Q1, and from 167k during 2024. Meanwhile, the unemployment rate rose to 4.3% in August, having oscillated between 4-4.2% in the 15 months prior. At the same time, labour demand has weakened. JOLTS job openings were just below 7.2m in July, which is their lowest level this year. Against this backdrop, average earnings growth has eased, falling to +3.7% y/y in August, matching the year-to-date low from June.

Meanwhile, after some disinflation at the start of the year, there are tentative signs of tariff-related inflationary pressures emerging. Headline CPI fell to 2.3% in April, its lowest level since February 2021, before re-accelerating in three of the four months since. It stood at 2.9% in August. Elsewhere, core-CPI declined to 2.8% between March-May, but rose thereafter to 3.1% in July and August. Similarly, core-PCE edged down to a low of 2.6% in April, only to re-accelerate steadily to 2.9% in July. Looking ahead, the Fed sees core–PCE rising to 3.1% in Q4.

In summary, US economic conditions have deteriorated this year. High levels of uncertainty, especially regarding US trade policy, has weighed on activity. At the same time, conditions in the labour market have weakened. Furthermore, signs are emerging that higher tariff rates are exerting some inflationary pressures on consumer prices. Recently though, the US has agreed several trade frameworks with some of its key trading partners, which should remove some of the uncertainty that has impacted the economy. Secondly, weaker population growth (owing to fewer migrants entering the US) means that the slowdown in jobs creation is not as pressing an issue as it would have been previously. Nevertheless, slower growth is expected this year, with the IMF forecasting US GDP will rise by 1.9%, compared to 2.8% in 2024. It should be noted though, that 1.9% growth is still relatively solid. Thus, the potential re-emergence of inflation may play a greater role in policy deliberations and could become a key challenge for the Fed in the coming quarters, amid the ongoing political pressure to cut rates aggressively.

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