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FOMC majority unlikely to support near-term rate cuts

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Uncertainty over the end level of tariffs and its inflation impact, along with a still solid labor market, give the Fed room to wait

Incoming data since the June FOMC meeting continued to depict a resilient economy, though with some signs of slowing momentum. After a weak May (-0.9% m/m), retail sales rebounded by 0.6% in June, with broad-based gains except for gasoline and furniture. Business investment also held firm. Following strong equipment investment in Q1—likely driven by tariff front-running—momentum carried into Q2, supported by solid core capital goods shipments in May (0.5%) and June (0.4%). Industrial output rose 0.3% in June (vs. -0.03% in May), but this was largely due to volatile utilities. The headline figure masked a deceleration in manufacturing, where output slowed to 0.1%, down from 0.3% in May. Survey data echoed this lack of output dynamism: while the ISM services index returned to expansion in June, the manufacturing index remained in contraction, weighed down by persistent declines in both the employment and new orders subindices, which have been trending down since February. The Atlanta Fed's GDPNow estimate points to 2.4% growth in Q2, down from a peak of 4.7% in early June. The official advance estimate for Q2 GDP will be released on Wednesday morning, just ahead of the FOMC announcement. Downside risks for the labor market from the continued manufacturing softness may give FOMC doves grounds to advocate a rate cut, but the resilience of consumer spending and the services sector are likely to keep most in the Committee aligned with a wait-and-see approach.

A solid labor market keeps pressure off for now; it is likely still too soon for the Fed to view the economy as at risk of moving worryingly away from full employment. Non-farm payrolls rose by a healthy 147,000 in June (Figure 1), but the gain was again largely concentrated in health care and government hiring, with manufacturing and retail registering only modest increases. Survey data also support a mixed picture: small business hiring intentions have softened notably, and while the JOLTS report for May showed job openings rose to 7.77 million and layoffs remained low, the quits rate also stayed subdued—pointing to waning labor market dynamism from both the demand and supply sides. That contrasts with the unemployment rate, which has remained low despite signs of slowing job creation. It edged down in June to 4.1%, reflecting a sharp rise in the household measure of employment and a decline in the labor force, likely tied to a steep drop in foreign-born participation amid the intensifying ICE-led immigration crackdown. While some may argue this masks actual slack in labor demand—justifying a dovish tilt—others may be more inclined to the opposite view: that tighter labor supply raises the risk of persistent wage pressures amid the potential hit of tariffs to

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productivity, and particularly in light of the recent post-pandemic inflation experience. Wage growth did slow to 0.2% m/m in June, but the still-elevated 3.7% annual rate will likely continue to be viewed by many Fed members as inconsistent with the 2% inflation target. We expect this latter view to remain dominant at this week's meeting, favoring a continued pause.

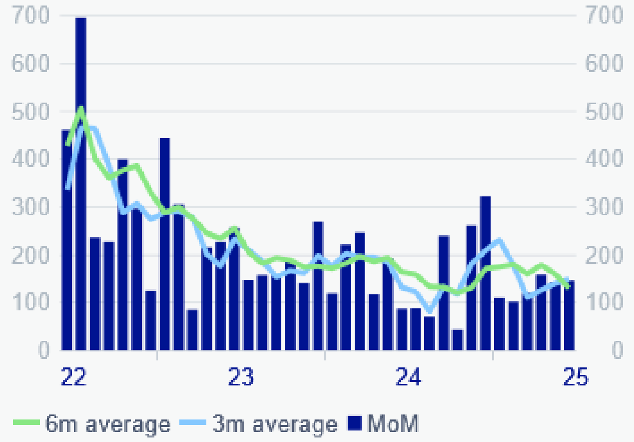
Inflation data have continued to point to limited tariff-related effects, though early signs suggest those price pressures may be gradually building. Core PCE inflation scored a target-consistent 0.18% m/m in May, and June's CPI print showed a modest, below-consensus 0.23% m/m increase. However, within the latter, core goods prices rose 0.2% (vs. -0.04% in May), driven by all major components except transportation commodities, which fell by 0.2% driven by both new and used vehicle prices. Indeed, core goods excluding vehicles rose by 0.5%—the fastest pace since February 2022—led by a 1.0% increase in household furnishings and a 0.8% gain in recreational commodities (Figure 2). The ISM manufacturing and services prices subindices also remained elevated, with survey respondents continuing to cite rising input costs and tariff-related supply chain disruptions. It has been argued that the muted passthrough to consumer prices so far reflects firms drawing on pre-tariff accumulated inventories. Even if this is accurate, it suggests broader price effects are set to emerge—or intensify—as those buffers are exhausted. Additionally, the renewed delay of reciprocal tariffs—originally set to expire earlier this month—has likely pushed those effects further out. Deals with Japan and the EU point to a 15% broad-based tariff, up from 10% when the "reciprocal tariffs" were on hold. In a context of resilient consumption, a still stable labor market, and signs of higher-than-previously thought tariffs (15% vs 10%), it is likely that core inflation will edge higher in the second half of the year even if shelter-related inflation continues to ease. And while still well-anchored, the recent uptick in market-based long-term inflation expectations (Figure 3) will further reinforce the Fed's cautious stance.

Earlier this month, the futures market had priced in up to a 60% chance of at least three rate cuts this year, but it has since declined to ~20%—roughly back to where it stood ahead of the June meeting. Long-term Treasury yields spiked temporarily in mid-July amid media rumors that Trump was serious about removing Powell from the Fed, though Trump's own swift denial helped bring yields back to prior levels. Still, the episode likely added to growing market concerns over the outlook for Fed independence, contributing to persistently elevated term premia at the long end of the yield curve (Figure 4). Beyond temporary volatility, the combination of those ongoing worries about Fed's independence and lasting concerns around the debt U.S. outlook following the approval earlier this month of a fiscal bill that is expected to keep the deficit near 6% of GDP for years, may now be contributing to a structural rise in term premia, as investors reassess the credibility of U.S. macroeconomic policy (see here for more on the recent evolution of US interest rates). Despite June's dot plot showing two almost evenly split groups between participants projecting one or no cuts and those expecting two or three, the minutes indicated that a clear majority is likely to favor holding rates steady this week despite that a couple of members have signaled openness to easing as soon as this meeting. Waller stated the Fed "should not wait until the labor market deteriorates before we cut the policy rate," while Bowman expressed that "any upward pressure from higher tariffs on goods prices is being offset by other factors." However, they appear to have little support from the rest of the Committee at this point.

We expect the Fed to leave rates unchanged at 4.25-4.50% at this week's meeting and do not anticipate growing support for near-term rate cuts. Recent inflation readings have shown modest upward pressure in select categories—particularly core goods excluding vehicles—yet remain broadly consistent with a disinflation trend. However, with tariff-related cost pressures likely continuing to filter gradually through supply chains, most FOMC members are expected to view the current stance as appropriately cautious. Meanwhile, the labor market remains resilient, and while signs of cooling have become more evident, they have not yet altered the Fed's assessment that the economy is at or near full employment. In this context, we expect the Fed to reaffirm that more evidence is needed before rate cuts can be justified. We anticipate members to continue to "generally agree" that policy is "well positioned to wait for more clarity on the outlook," as reflected in the June meeting minutes. Despite intermeeting threats to Fed independence, Powell is likely to emphasize that the bar for easing remains high amid ongoing tariff uncertainty. We'll be watching for signs that dovish views are spreading and how that may affect the Fed's chances of cutting rates in September—currently seen as a 60% likelihood by the market. But by now we remain comfortable with our expectation of a single 25bp rate cut this year, in December. Should Waller and Bowman both vote for a rate cut, it would mark the first dual dissent since December 1993.

The 147k jobs gain in June was again largely concentrated in health care and govt. hiring

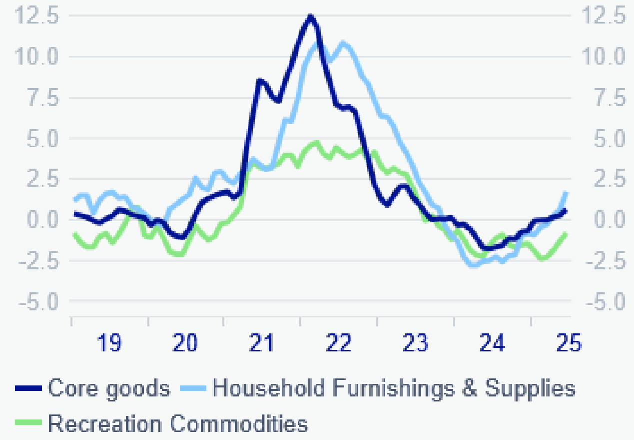
FIGURE 1. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

Prices for HH furnishings and recreational goods show slowly building pressures

FIGURE 2. CORE CPI INFLATION SELECTED COMPONENTS (YoY%)



Source: BBVA Research / BLS

An uptick in mkt.-based inflation expectations may keep most Fed officials cautious

FIGURE 3. BREAKEVEN INFLATION RATES IN TREASURY YIELDS (%)

Source: BBVA Research / Treasury Dept.

Concerns over Fed independence and the fiscal outlook keep term premia elevated

FIGURE 4. 10-YEAR TREASURY YIELD BREAKDOWN (%)

Based on the NY Fed ACM model
Source: BBVA Research / Fed

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