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Divided Fed set to proceed with final 2025 rate cut

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A key takeaway will likely be that the room for "risk-management" cuts has run their course and the Fed will pause early next year

Activity seems to remain resilient on strong AI capital spending, though delays in hard data continue to limit full visibility into early Q4 conditions. The release of Q3 GDP, originally scheduled for late October, will now be available in late December, but some uninterrupted soft indicators offer some more timely insight. The ISM services index rose again in November, confirming the sector's relative strength. In contrast, the September industrial production report showed output stagnated over Q3, while the ISM manufacturing index contracted for a second consecutive month in November—this time driven by weaker new orders, which had only briefly rebounded in October. The most recent retail sales report pointed to softer consumption in September, while consumer sentiment in the University of Michigan survey fell to a three-year low in November—likely due to the shutdown, affordability pressures and ongoing policy uncertainty. That survey also noted that "consumers with the largest tercile of stock holdings posted a notable 11% increase in sentiment," suggesting that recent equity market gains driven by the AI boom may be disproportionately supporting spending among wealthier households. Still, investment remains underpinned by AI-related demand, as evidenced by robust imports and orders of tech equipment (Figure 1). Taken together, relatively stable economic activity continues to contrast with a softer labor-market outlook, raising again the key question of whether growth will slow further to match weaker job creation or employment will rebound to meet still-resilient output.

Uncertainty lingers over the extent of downside labor-market risks, as both delayed official data and alternative indicators continue to shape the Fed's assessment. The private-sourced ADP employment report showed a modest rebound of 42,000 new jobs in October, offsetting earlier declines, but still consistent with weak hiring momentum. The delayed BLS employment report for September, released late last month, pointed in the same direction: nonfarm payrolls rose by 119,000 (Figure 2), driven by health care and food services, while transportation and manufacturing jobs declined. The unemployment rate rose 0.1 pp to 4.4% as a surge in labor force participation more than offset the increase in employment—pointing to a softening rather than collapsing labor market. The BLS' announcement that October household survey data—from which the unemployment rate is estimated—will be permanently unavailable, along with the delay of official payroll figures for both October and November until mid-December, has kept the spotlight on the ADP series as the most timely source of labor market information. The latest release showed a 32,000-job decline in November, reversing

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October's gain and underscoring the lack of a convincing recovery trend in job creation. This is echoed in the ISM employment subindexes from the past two months, which indicate a modest rebound in services employment but renewed weakness in manufacturing jobs, with neither sector signaling a clear turn in labor demand prospects in the near term. Furthermore, while the October Beige Book had described employment as "largely stable," the November edition noted that "employment declined slightly," with about half of the districts reporting "weaker labor demand." This reinforces the case for a third "risk-management rate cut." Some FOMC members—most notably Waller—assert that labor market weakness is primarily demand-driven rather than stemming from supply or immigration factors, a view that is likely to divide opinion within the Committee and prompt an unusually split vote. Jeff Schmid is the most likely dissenter, as in October. Susan Collins, Austan Goolsbee, and governor Michael Barr have also signalled limited support for further rate cuts.

No strong signals have emerged (yet?) to warrant renewed caution on the inflation front despite limited price data since the last FOMC meeting. The BLS announced that the October CPI data collection was significantly affected by the government shutdown. As a result, it will only publish a limited set of indexes based on non-survey data sources. The next full CPI release—covering November and including any available non-survey-based data for October—will be published on December 18. Similarly, the release schedule for the October and November PCE deflator is still pending. This prolonged inflation data blackout has left usual soft indicators as the main reference, and they continue to suggest that the pass-through from tariffs to consumer prices remains limited. The ISM manufacturing prices index fell sharply in October and edged up only slightly in November, remaining near its 10-year average. While the ISM services prices-paid index jumped to a three-year high in October, it retreated meaningfully in November (Figure 3). Meanwhile, long-term inflation expectations in consumer surveys edged down, and market-based measures remain well anchored. With inflation surprising to the downside for most of this year, a majority of FOMC members will likely continue to view inflation risks as secondary to labor-market risks—making it unlikely that tariff-related uncertainty alone would justify a pause. That said, we expect the Fed to convey a data-dependent approach for future decisions to prevent markets from pricing out inflation risks entirely.

Market expectations for a December rate cut increased as recent dovish comments from key Fed officials outweighed October's cautious tone from Powell. Following October Chair Powell's warning that a rate cut in December was not a "foregone conclusion" and, in fact, was "far from it," the meeting minutes showed there were indeed "strongly differing views" on the upcoming rate decision. "Several" favored another rate cut, but "many" considered that it would likely be better to keep rates unchanged in December. This drove the futures market in mid-November to change its expectations and price in a 60% chance of a rate pause, from fully pricing a rate cut just a month earlier. Since then, FOMC officials have continued to voice mixed views on the appropriate policy path, but recent statements by New York Fed President Williams in favor of a cut—supporting "a further [rate] adjustment in the near term" to bring policy closer to neutral—and from Fed Governor Christopher Waller a few days later, who argued that a rate cut was appropriate given a weakening labor market, the odds of a rate cut jumped again. The futures market now assigns approximately a 90% probability to such a move (Figure 4).

We expect a third consecutive rate cut 25bp this week to 3.50-3.75% as concerns over a weakening labor market continue to outweigh inflation risks. While a highly divided vote is likely, we see little upside for the Fed in delivering a surprise pause. The main takeaway will likely be that the room for “risk-management” cuts has run their course and the Fed will pause early next year. The bar for further cuts—needed to bring down rates toward neutral—will be higher with inflation still near 3%. Attention will thus shift to the tone of the Q&A (i.e., whether the Fed delivers another hawkish cut) and to the updated economic forecasts in the SEP. With little new information to prompt revisions, major changes to the projections are unlikely. Thus, the dot plot will continue to show a divided FOMC. It will likely still point to just one 25bp cut in 2026 and another in 2027—bringing rates to 3.50 and 3.25%, respectively— implying less policy easing than both market pricing and our baseline, which projects 3.25% by end-2026.

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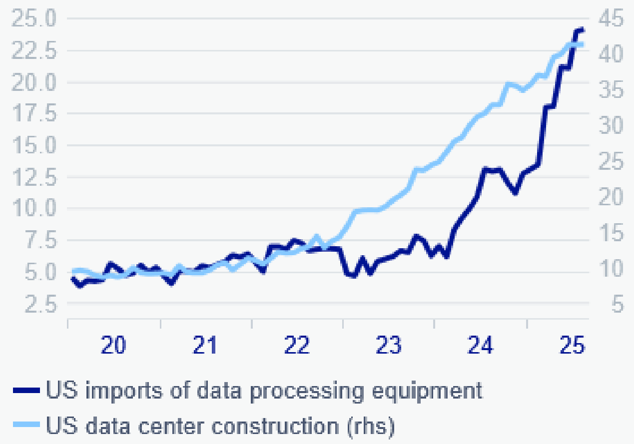
Investment remains underpinned by AI-related demand, as evidenced by robust tech imports

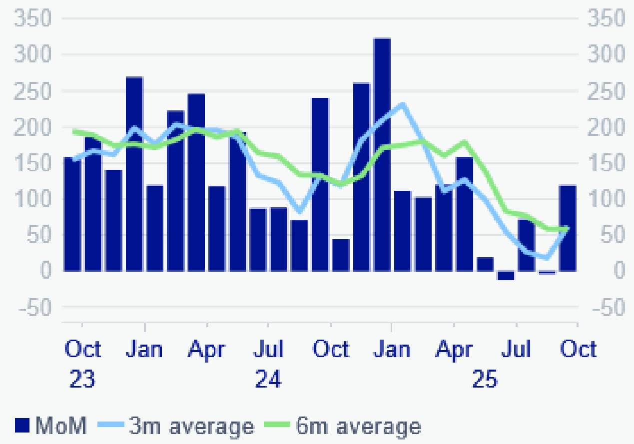
FIGURE 1. US IMPORTS OF DATA PROC. EQUIP. & DATA CENTER CONST. (BN USD)



* HS codes 847150, 847180 & 847330
Source: BBVA Research / Census Bureau

Payrolls rose by 119,000 in September, driven by health care and food services

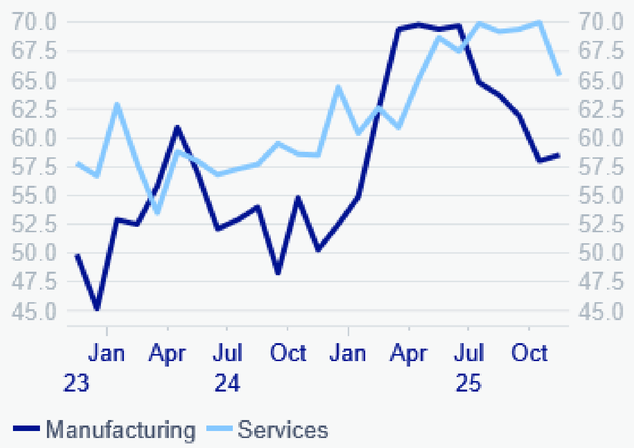
FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

Soft data continue to suggest the pass-through from tariffs to consumer prices remains limited

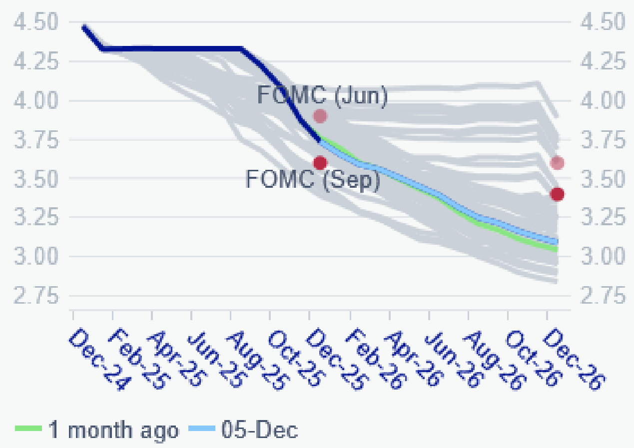
FIGURE 3. ISM PRICE INDEXES (%)



Source: BBVA Research / ISM

The futures market now assigns approximately a 90% probability of a rate cut this week

FIGURE 4. FUTURES-IMPLIED FED FUNDS RATE (%)



The gray lines indicate weekly implied rate paths over the past year
Source: BBVA Research / CME / Fed

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