

Fed set to drop easing bias as inflation returns to top priority

Javier Amador, Iván Fernández

Fewer worries about the labor market have reduced the urgency that led the Fed to start cutting rates last year

The US economy remains broadly resilient despite higher energy prices and lingering geopolitical uncertainty. While first-quarter GDP growth was revised down to 1.6% annualized in the second estimate, from an initial 2.0%, the broad picture is that domestic private-sector demand remained solid. Final sales to private domestic purchasers—a key gauge of underlying demand—expanded at a 2.4% annualized pace, as strong business investment more than offset a modest slowdown in consumption. Investment continued to be boosted by the deployment of AI-related infrastructure and software ([Figure 1](#)). More recent data suggest that this resilience has likely extended into the second quarter. Retail sales and personal spending indicate that households have begun to feel some pressure from higher gasoline prices, but overall consumption continues to expand at a pace consistent with moderate growth. Meanwhile, manufacturing activity has continued to show further signs of recovery. The Atlanta Fed's GDPNow model currently points to second-quarter growth of around 3.3% annualized. Overall, incoming data suggest that growth has remained on a solid footing heading into the June meeting, despite persistent uncertainty surrounding the conflict in the Middle East and its implications for energy prices.

Concerns about downside risks to the labor market have eased, reducing one of the key motivations behind the Fed's rate cuts last year. Nonfarm payrolls increased by a stronger-than-expected 172k in May, marking the third consecutive upside surprise and bringing the three-month average gain to 188k ([Figure 2](#)). The improvement has also become more broad-based. After years in which healthcare accounted for a disproportionate share of job creation, private payroll growth excluding healthcare is beginning to strengthen. At the same time, job openings moved higher in April and unemployment claims have remained broadly stable, suggesting that labor demand has held up better than previously feared. That said, the labor market remains a long way from overheating, with conditions still better characterized as stable rather than tight. The unemployment rate has held steady at 4.3%, broadly in line with the Fed's estimate of its longer-run level, while wage growth has continued to moderate. The broader message is that labor market conditions are not deteriorating as materially as feared earlier this year. As a result, the argument that labor market risks remain tilted to the downside is becoming increasingly difficult to sustain. Even so, policymakers are likely to remain cautious given lingering geopolitical uncertainty.

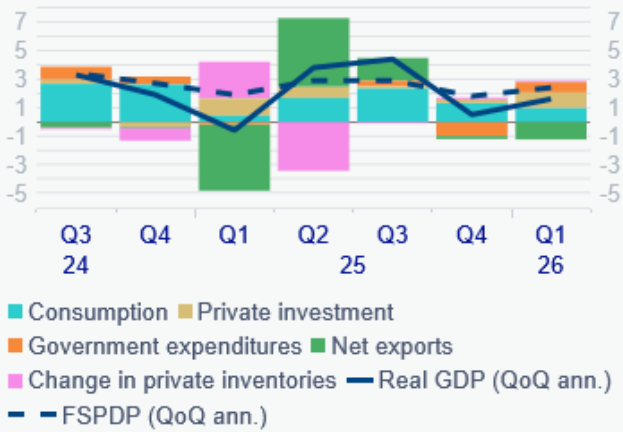
Progress toward the 2% inflation target has become less convincing, although much of the setback reflects higher energy prices. Headline CPI rose from 3.3% in March to 4.2% in May, largely driven by higher gasoline and electricity prices linked to the conflict in the Middle East and its impact on global energy markets. By contrast, underlying inflation pressures remained more contained. Core CPI increased by just 0.2% m/m in May, with falling goods prices partly reflecting the likely fading effects of last year's tariffs. Even so, the broader inflation picture remains inconsistent with a timely return to target. Core PCE inflation rose to 3.3% in April, with monthly gains remaining above rates consistent with the Fed's 2% objective ([Figure 3](#)). Producer price data also suggest that some pipeline price pressures remain elevated. But at the same time, inflation expectations appear to remain well anchored, while signs of broader spillovers from the energy shock remain limited. Most participants are nevertheless likely to judge that inflation has not made sufficient progress, reinforcing the case for two-way guidance.

The April FOMC minutes revealed a Committee increasingly focused on upside inflation risks and less concerned about downside labor market risks. While "most participants" still judged labor market risks to be tilted to the downside at the time, "the vast majority of participants" noted a higher risk that inflation could take longer to return to target and saw a case for maintaining the current policy stance for longer. Importantly, support for removing the easing bias appeared broader than suggested by the three dissents recorded at the April meeting, with "many participants" indicating that they would have preferred removing it from the statement. Much of that support came from non-voting participants, as a voting majority would presumably have removed the easing bias in April. The futures market continues to fully price a pause this week, but it currently assigns roughly a 55% probability to a 25bp rate hike by December and around a 70% probability by June next year ([Figure 4](#)).

The FOMC will most likely keep the fed funds target range unchanged at 3.50-3.75% this week and shift to a more two-sided approach to future policy guidance. The case for maintaining an easing bias has weakened materially as labor market downside risks appear to have diminished, while inflation progress has become less convincing. However, neither development is likely to be sufficient to warrant a tightening bias. Instead, the most likely outcome is a return to greater policy optionality in both directions. Such a shift would preserve flexibility amid elevated geopolitical uncertainty. We expect the dot plot to show that some participants who projected up to two rate cuts in March have shifted toward one or none, while a few who previously projected no change may begin to incorporate the possibility of future hikes. This could shift the median projection for 2026 from one rate cut to keeping rates unchanged. Further out, more participants are likely to pencil in one or two rate hikes in 2027. The meeting will also provide the first indication of how Chair Warsh intends to balance his policy preferences with the need to preserve confidence in the Fed's independence. Market participants will look for signs of a shift in focus from core PCE inflation toward trimmed-mean and other underlying inflation metrics.

Strong business investment more than offset a modest slowdown in consumption in 1Q

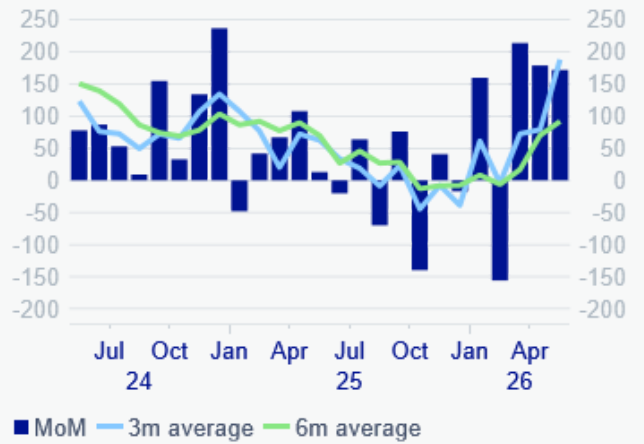
FIGURE 1. REAL GDP GROWTH (%)



Source: BBVA Research / BEA

Nonfarm payrolls increased by 172k in May, marking the third consecutive upside surprise

FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

PCE monthly inflation remain above rates consistent with the Fed's 2% objective

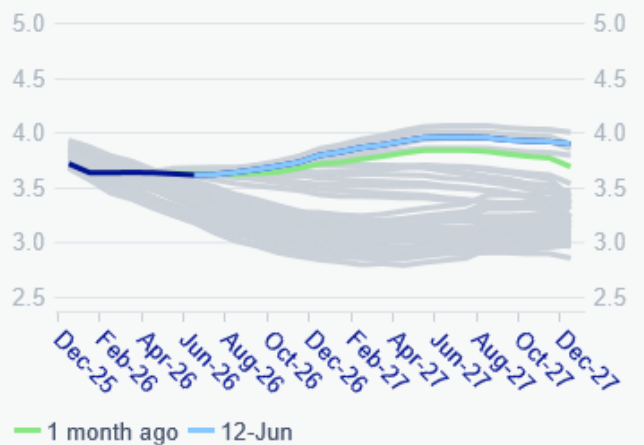
FIGURE 3. CORE PCE INFLATION (%)



Source: BBVA Research / BEA

The futures market assigns roughly a 55% probability to a 25bp rate hike by December

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



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

DISCLAIMER

The present document does not constitute an “Investment Recommendation”, as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse (“MAR”). In particular, this document does not constitute “Investment Research” nor “Marketing Material”, for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA on its website www.bbvarsearch.com.