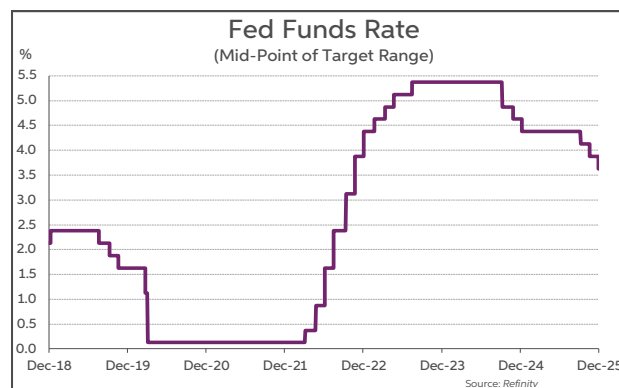


Fed cuts, but fissure emerges among voting members

The Federal Reserve Open Market Committee (FOMC) meeting for December saw the central bank cut interest rates by 25bps, with the target range for the Fed funds rate lowered to 3.50-3.75%. This was the third rate cut from the central bank in 2025, totalling 75bps. The Fed has now reduced rates by 175bps since its started to ease policy in September 2024. The decision to cut rates by 25bps was in line with market expectations as it had been well sign-posted by key voting members. However, the voting breakdown showed some differing views within the FOMC. Three members dissented, the highest in six years. Governor Miran continued to vote for a 50bps reduction in rates, while Goolsbee and Schmid voted to hold rates steady. Meanwhile, the Fed also announced it will purchase short-term Treasury bills to maintain liquidity following recent system stress, beginning at \$40bn per month.

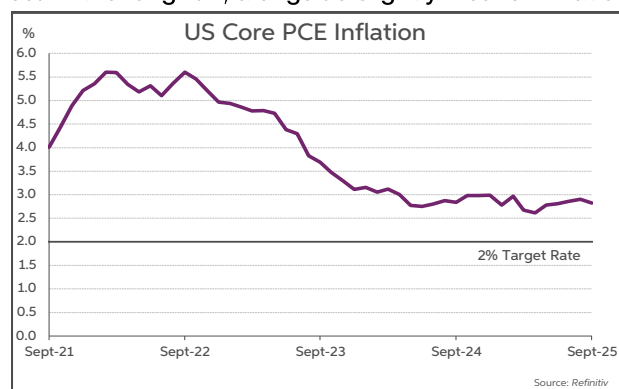


Aside from the key policy announcements, the meeting statement for December contained a few other subtle yet important changes. The committee continued to describe the economy as “expanding at a moderate pace”. However, it removed its comment that unemployment “remained low” from the October statement, suggesting a slight dovish tilt towards labour market concerns. Its characterisation of the inflationary backdrop was that inflation remained “somewhat elevated”.

The post meeting press conference saw Chair Powell espouse a broadly neutral tone, declaring the FOMC is “well positioned to wait”. This suggests the Fed now has a higher bar for further cuts in 2026. However, there were other aspects of Powell’s remarks that also had a more dovish slant, particularly on the labour market. He mentioned that the recent deterioration in labour market conditions may have been faster than previously expected, and that payrolls growth was probably negative, on average, since April, suggesting a -20k rate instead of the “overcount” of +40k in the official numbers. He reiterated this by saying “it doesn’t feel like a hot economy”.

The interest rate projections (i.e. dot plot) from the Fed were published after the FOMC meeting. These dots were broadly in line with the September edition, and continued to indicate a relatively gradual pace of policy easing from the Fed over the next 2-3 years. The median projection for 2026 among the Committee remained 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 3.0%. The FOMC also judged near term GDP growth would be much stronger at 2.3% in 2026, compared to 1.8% in September, easing to 1.8% in the long run, alongside slightly weaker inflation which remains above target until 2027/28.

The overall balanced tone from Powell’s press conference saw little move in market rate expectations. Futures contracts indicate the market is not pricing in a full rate cut until June 2026, with a total of 55bps of easing priced in for next year. Prior to yesterday’s meeting, the market was pricing around 50bps of cuts in 2026. Thus the market continues to envisage a more aggressive pace of rate cuts next year compared to the Fed. Futures contracts imply that the market sees US official rates getting down towards 3.1% by the end of 2026 versus the Fed’s projection for 3.4%.



Overall, it is clear from the December Fed press conference that the central bank remains split on the outlook, given rates are now close to neutral territory. The departure of Powell as Chair adds further uncertainty, as does the prospect of an external pick to replace him, who might be seen to be doing President Trump’s bidding by arguing to aggressively cut rates, as Governor Miran has reliably since departing the White House and joining the FOMC. However, the recycle of regional Fed presidents onto the FOMC in 2026 might add something of a bulwark, with four new members expected to retain the hawkish bias currently seen among the 2025 voting Fed presidents.

Growth is solid but the economy has become more fragile

US economic growth slowed markedly in the first half of 2025.

GDP contracted by 0.2% in the first quarter before rebounding by 0.9% in the second. However, very sharp swings in imports have created significant volatility in the data. Goods imports surged by 11% q/q in Q1 before falling by 7.7% in Q2. A closer examination of the data, though, also indicates that the US economy lost some underlying momentum in H1. Personal consumption expanded more slowly, up by 0.2% in Q1 and by 0.6% in Q2, compared to an average growth rate of 0.9% per quarter in 2024. Meanwhile, government spending contracted slightly in the first six months of 2025. Fixed investment was the one bright spark, increasing at a faster pace in the first half of 2025 (2.8%) compared to last year (1.1%), led by a ramp-up in AI-related expenditure. Indeed, by some estimates, AI-related spending in the US, contributed to around 90% of GDP growth in the first half of the year.

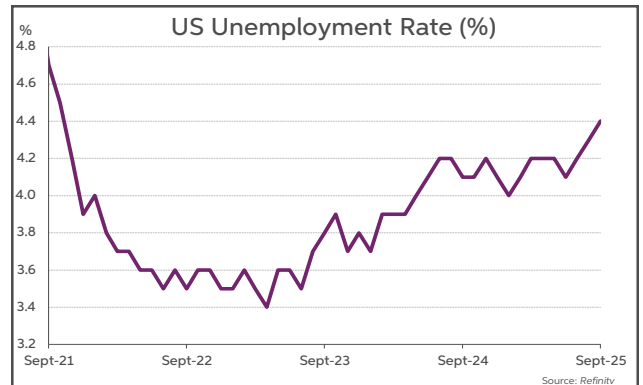


However, hard data indicate that the economy may have gathered some steam in Q3. Retail sales rose by an average of 0.5% per month in Q3, having flatlined in Q2. The control group measure (a key core sales indicator) surged by 1.6% in Q3. Meanwhile, nominal consumption rose by 0.5% m/m in July and August, the second fastest pace of expansion this year. It increased by a solid 0.3% m/m in September also. At the same time, industrial production has expanded by 0.3% in Q3, having risen by 0.4% in Q2 and by 1.0% in Q1.

Meanwhile, the available survey data for Q4 have been somewhat mixed. The services PMI has averaged 54.5 so far in Q4, down slightly from 54.8 in Q3, but still consistent with a solid pace of expansion in the sector. The manufacturing PMI has improved, averaging 52.4 to-date in Q4, compared to 51.6 in Q3. Like-wise, the non-manufacturing ISM has been firmly in expansion territory throughout October and November. However, the manufacturing ISM has stayed in contraction mode and deteriorated during the same period. Meantime, the Michigan and Conference Board measures of consumer confidence remain at weak levels.

Regarding the labour market, conditions have softened.

In June, payrolls fell for the first time since December, and they contracted again in August, before expanding by 119k in September. Overall though, the pace of payroll growth slowed to just 62.3k in Q3, down from 111k in Q1, and from 168k during 2024. Meanwhile, the unemployment rate rose to 4.4% in September, up from 4.0% at the start of the year. Despite this though, average earnings growth has held relatively steady. It fell marginally to +3.8% y/y in August and September, a touch below the +3.9% y/y rate seen throughout Q1.



At the same time, inflation remains elevated. Some tariff related price pressures appear to have contributed to the recent stickiness in inflation. Core-CPI has been range-bound, stuck between 2.8-3.1% since February. It was at 3.0% at the end of Q3. Meanwhile, CPI accelerated throughout the summer months, meaning it too stood at 3.0% in September, up from a low of 2.3% in April. Similarly, core-PCE edged down to a low of 2.6% in April, only to rise steadily to 2.9% in July/August, before inching back to 2.8% in September. Looking ahead, the Fed sees core-PCE averaging 3.0% in Q4, before falling to 2.5% in Q4 2026 and to 2.1% in Q4 2027.

In summary, US economic conditions have deteriorated this year. High levels of uncertainty, especially regarding US trade policy, weighed on activity and contributed to sticky inflation. At the same time, conditions in the labour market have weakened. Thus, with both elements of the Fed's dual mandate in tension, the central bank's policy decisions have become more divisive. The protracted government shutdown has also complicated the Fed's job, as statistical agencies continue to scramble to publish a number of delayed economic reports. Meanwhile, although AI-related investment is boosting US growth at present, there is also significant concern that it may be creating a bubble in financial markets. As a result, the US economy appears more fragile, with slower (albeit still solid) growth expected this year. The IMF is forecasting US GDP will rise by 2.0% in 2024, compared to 2.8% in 2024. GDP is projected to increase by 2.1% in 2026 also.

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