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The case for no Fed cuts

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The monetary policy debate: we say no recession, no cuts

There is an interesting monetary policy debate inside the Fed. Opinions are divided into 3 groups: no cuts, mild cuts and aggressive cuts. Behind the debate is the interpretation of the shocks introduced by Trump 2.0: recessionary? inflationary? stagflationary? We stick to our out-of-consensus call: no recession in the US and the Fed on hold.

A mild stagflationary environment ahead of us

In contrast with the market view, we view the combination of policies to be mildly stagflationary, with significant uncertainty regarding the size and timing of the impact on inflation and growth. Given the asymmetric risks to inflation and reputational risk, we think the option value of waiting remains high, to avoid starting the cutting cycle before inflation peaks. Most specifications of Taylor rules are in line with a Fed on hold. And r* is likely higher than the rate implied by the SEP median, adding to the case for waiting.

Persistent inflation meets tariffs pass-through

Inflation keeps showing strong persistency, with trimmed and core measures systematically hovering around 3%. In addition, tariff inflation is starting to show up in the data. Front running of imports and firms' focus on keeping market share is only delaying the pass-through to prices. The re-escalation of tariffs and the higher tariff floor agreed in recent trade deals has increased stagflationary risks. The truce with China may mean more frontrunning of imports and a delay in the pass-through to prices.

Lower payrolls don't mean higher unemployment

We believe those arguing for looking through the tariff shock in order to pre-empt labor market deterioration are focusing too much on payrolls. What matters, in our view, is the unemployment rate. We expect payrolls to drop to 50k but mostly due to tightening of immigration. Therefore, we only expect a mild increase in the u-rate to 4.4% in 4Q25.

Political economy considerations raise the bar for cuts

Beyond economic fundamentals, political interference also raises the bar for cuts, in our view. Trump asks for but may not expect lower rates. Instead, he can claim he warned the Fed if a recession were to happen. We argue that the optimal response to political pressure is to wait and over-focus on inflation. Why? Fed Chairs face disproportionate reputational risks and are remembered by their inflation track record. Coupled with the Fed's recent track record on inflation, this induces a bias towards giving more weight to the inflation objective relative to employment. And Boards hardly ever oppose the Chair.

Fiscal deficit poses upside risks to rates

A headline deficit above 6% of GDP is more than what the economy needs, exerting upward pressure on r*. The apparent lack of political appetite to reduce mandatory spending, coupled with a geopolitically driven reduction in demand for US debt, makes the case for some combination of higher rates, higher inflation, and financial repression.

Refer to important disclosures on page 14 to 16. **12857880**

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Why the Fed should not cut rates

There is an interesting and very open debate, both inside and outside the FOMC, regarding the appropriate stance of US monetary policy. The wide range of opinions can be easily spotted by examining the cross-section of the FOMC dot plot as well as the forecast of sell-side economists (see Exhibit 1 and Exhibit 2).

In terms of market pricing, the front-end of the swaps curve is currently pricing in close to 2 cuts of 25bp for 2025, likely starting in September, and a terminal rate close to 3% in 2026. However, a time series examination of how market pricing has evolved over the last 9 months also exposes a fair degree of confusion, uncertainty and overreaction to headlines.

In April, the market was pricing in more than 100bp of cuts for this year under the assumption that the tariff shock was recessionary, and that the recession would take care of inflation. Interestingly, the recent price action on the back of President Trump re-escalation after the 90-day truce period indicates the reading seems to be somewhat different.

We argued since the beginning of the year that the tariffs coupled with the uncertainty shocks is a stagflationary rather than a recessionary shock. In such a scenario, we made the case that the most prudent stance for the Fed was to remain on hold until having more clarity on how the sequencing of the tariff shock, geopolitical uncertainty and outlook for fiscal policy could impact inflation and growth.

Despite the observed volatility in market pricing and economic forecasts, we stick to our two main out-of-consensus views: no recession in the US and the Fed on hold. That is where we are positioned in this debate and in this report we argue why.

A mild stagflationary environment ahead of us

In contrast with the popular view that tariff shocks are recessionary, we interpreted them as stagflationary, that is, lower growth and higher inflation. The distinction is important because the most popular argument post "Liberation Day" was that the recession would take care of inflation, making a clear case for the Fed to cut rates aggressively. This is why the market priced in an aggressive cutting cycle back then. The recent bout of re-escalation makes this distinction very relevant again.

Exhibit 1: There is disagreement on the Fed path among forecasters
Share of FOMC and Bloomberg survey respondents (%)

Target	2025		2026		2027		Long run
	FOMC	Survey	FOMC	Survey	FOMC	Survey	FOMC
2.375				2			
2.5							11
2.625			5	5	11	7	11
2.75							
2.875			5	14	16	21	21
3							16
3.125			11	23	16	39	5
3.25							
3.375		1	26	25	32	14	5
3.5							11
3.625	11	14	21	18	16	7	11
3.75							5
3.875	42	41	26	11	11	4	5
4							
4.125	11	30	5				
4.25							
4.375	37	13		4		7	
4.5							

Source: BofA Global Research, Bloomberg

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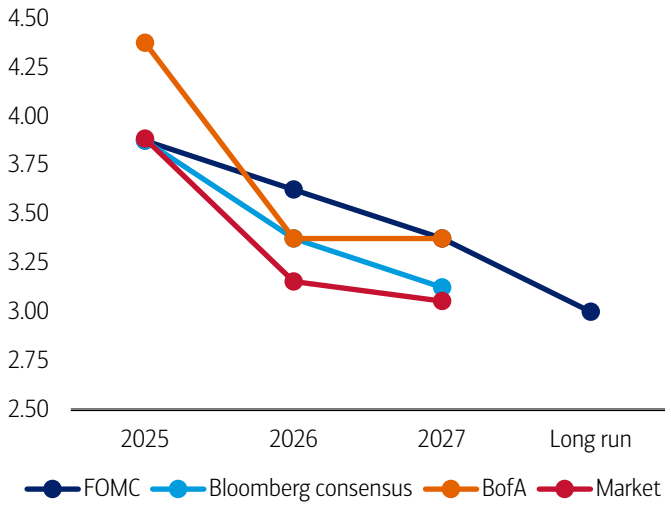
Exhibit 2: We are above the 2025 dot, consensus, and the market
Median FOMC and Bloomberg survey forecast vs BofA and market pricing



Source: BofA Global Research, Bloomberg

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If we think of a tariff shock as stagflationary, there is a non-trivial trade-off for the Fed, which has a dual mandate of inflation and employment (let's leave aside for the moment the third mandate of stability of long-term interest rates). Not knowing how much of the tariff shock would impact inflation and economic activity over time makes a case for remaining on hold until the shock unfolds, including potential retaliation from other countries. With maximum uncertainty, the option value of waiting is also very high.

Recent academic studies validate our approach[1]. Temporary tariffs in the US have a negligible effect on inflation and growth, although they improve somewhat the current account balance, as the intertemporal approach (i.e. tariff frontrunning) to the balance of payments would dictate. However, permanent tariff increases have a temporary effect on inflation and induce a tightening of monetary policy, with more limited impact on growth and no effect on the current account balance.

When uncertainty meets confusion

A permanent tariff shock is supposed to generate at most a one-time increase in the price level, that is, a temporary inflation shock, which in theory the central banks can look through. However, the tariff shock was more than that. It was a perceived change in the rules of the game. It generated significant uncertainty and confusion, with tariff hikes and cuts sometimes announced during the same day, the 90-day tariff pause to negotiate, and jumping between escalation and deals.

This uncertainty shock created a lot of confusion since people disagreed on the impact of the shock on economic activity and inflation. This combination of uncertainty and confusion was supposed to lead the US economy into a recession that would more than outweigh the inflationary shock and justify an aggressive Fed's easing, according to the most popular views.

However, faced with this dilemma, we argued then and now, the Fed has an incentive to remain on hold. First, the Fed cannot be blamed for the recession since it was not generated by excessively tight monetary policy but by an uncertainty shock that would induce companies to hold back investment plans and households to reduce consumption until uncertainty gets resolved.

Moreover, absent a resolution of the root cause (i.e. the change in the rules of the game), that triggered the increase in uncertainty, cutting interest rates doesn't do much to stimulate the economy, since companies and households would hold up investment and consumption decisions for precautionary motives until uncertainty resolves.

At the same time, the potential impact of tariffs on inflation and inflation expectations can be exacerbated by the cut in interest rates, impacting the credibility of the Fed. This last point is critical, given the recent misreading of the inflation process post COVID that induced the Fed to significantly delay the hiking cycle. And the recent political pressure to cut interest rates only make matters worse.

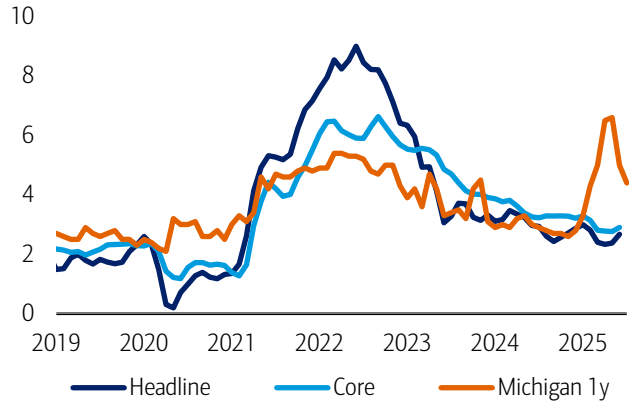
Inflation is very persistent and most likely on the rise

No matter how we slice it and dice it, the inflation process has been very persistent in the US. Core PCE inflation remains stuck slightly below 3% since the end of '23 and even though core PCE services is moving lower, it does so from high levels. In addition, deflation in core goods is not helping anymore and will contribute to higher inflation once tariffs are being pass-through to prices (see Exhibit 3 and Exhibit 4).

Of course, core measures of inflation have many caveats. If instead we do the analysis using trimmed measures of inflation, the message is the same. This persistence in inflation post-pandemic is independent of tariffs and more related to a combination of still somewhat disrupted supply chains and residual monetary and fiscal stimulus.

[1] See Schmitt-Grohé, Stephanie, and Martín Uribe. *Transitory and Permanent Import Tariff Shocks in the United States: An Empirical Investigation.* No. w33997. NBER, 2025.

Exhibit 3: No significant progress on inflation over the past year
CPI inflation (% yoy) and 1-year-ahead inflation expectations (U-Mich)



Source: BofA Global Research, Haver

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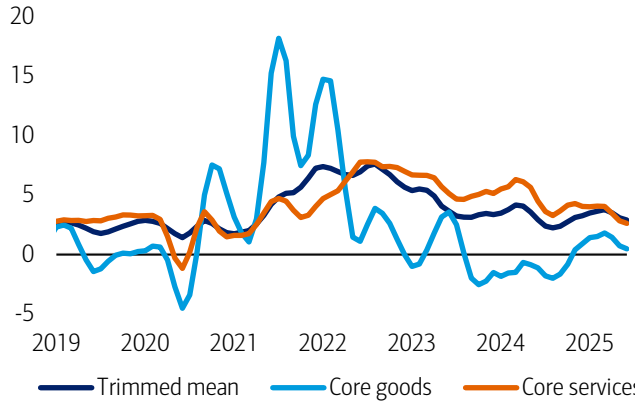
Exhibit 4: Sequential inflation is sticky and goods will no longer help
3m/3m annualized CPI inflation (%)



Source: BofA Global Research, Haver

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Will tariffs show up in the inflation data?

The next question for inflation is when tariffs will show up in the price of final goods. Is the fact that we haven't seen it yet a signal that we shouldn't expect inflation to pick up? The answer is no. In fact, we can see some impact of tariffs in the June inflation data.

The reason for the delayed impact has to do with the optimal response to the tariff shock from the firms' perspective. The front running of imports ahead of the tariff hikes allowed companies to build a cushion in inventories that allow them to gradually increase prices to avoid losing market share.

The implication for inflation dynamics is that we should not expect a significant temporary spike in inflation but a more gradual increase over time. This gradual increase will add more inflation persistence in 2H25. The recent round of re-escalation clearly indicates that tariff-related uncertainty will remain despite the announced trade deals, which simply reinforces these dynamics and delays even further in time the peak in inflation, making the Fed's job even more complicated, as they could be cutting rates with inflation still moving higher (see Some unpleasant tariff arithmetic: beware stagflation risks and US-EU agreement: is this a big deal?).

Are the announced deals good or bad for inflation?

As we have discussed repeatedly, our view from the get-go, has been that Trump wants to negotiate comprehensive, country-specific deals involving trade, immigration, defense and energy. The recently announced deals with Vietnam, Indonesia, Japan and EU are clear examples that confirm our core view. Coming next are probably Korea and India and eventually China. The truce with China though continue creating incentives for front-running of imports that will contribute to the delayed impact of tariff on inflation.

The announced deals contribute to reduce tariff uncertainty as the direction of travel becomes clearer, which is good news. The bad news though is that the effective level of tariffs validated by those deals is closer to 15%, somewhat higher than the 10% we expected in the first place. Currently, we expect core PCE to peak at 3.2% in November, and the recent round of re-escalation and deals add 20 to 30 bps of upside/downside risk to our inflation/growth forecasts for the US.

Employment dynamics not far from equilibrium

The labor market continues showing resilience despite being impacted by both supply and demand shocks. In particular, the immigration shocks (both the boom and the tightening) make the labor market very hard to read. Even though the recent June payroll number surprised to the upside, the creation of private jobs slowed down to 74k vs 137k in May, partly due to softer labor demand.

The unemployment rate is one of the main variables that the Fed watches to understand the slack of the labor market, together with the ratio of jobs to vacancies, which remains pretty stable around equilibrium levels.

However, slow job growth doesn't necessarily mean higher unemployment. If lower job growth is driven by supply rather than demand shocks, the unemployment rate can remain stable despite lower payrolls. The tightening of immigration is a clear example of a negative supply shock.

Disentangling supply and demand shocks in the labor market

In a recent report, our US team quantified the impact of supply (immigration restrictions) and demand (tariff uncertainty and DOGE cuts) shocks on the labor market, which is critical to understanding the relationship between payrolls and unemployment (see From borders to budgets: Disentangling labor supply and demand shocks).

Based on that analysis, we lowered our nonfarm payroll forecasts to an average of about 50k in 2H 2025 and 70k in 2026 from 70k and 75k, respectively. But we expect most of the slowdown to be due to supply rather than demand. Given our estimate of a 70k breakeven pace, we mark down our u-rate forecasts slightly. We now expect the u-rate to climb by only about a tenth per quarter for three quarters, reaching 4.4% in 4Q 2025 and peaking at 4.5% in 1Q-3Q 2026 (vs 4.6% earlier) (see Exhibit 5 and Exhibit 6).

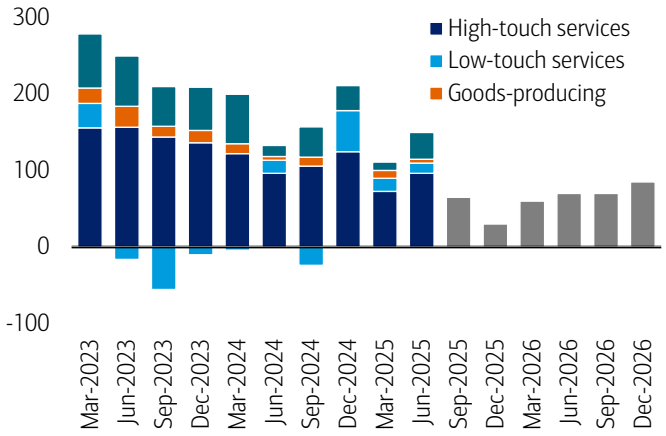
Understanding breakeven employment growth

The equilibrium or breakeven job growth is the number of jobs that the economy needs to create to keep the unemployment rate constant. That number was close to 100k before the pandemic, jumped to 160k during the immigration boom under Biden and we now estimate will drop to 70k due to the tightening of immigration.

Notice that new estimate of equilibrium payrolls do not differ much from our payroll forecast. In other words, the economy needs to create fewer jobs to absorb a smaller labor supply and we expect the economy to create a slightly lower number.

It is worth to highlight that we interpret the immigration shock as a net supply shock, which we expect to impact in sector like leisure and hospitality among others. It can be argued that tighter immigration policies imply lower supply of labor but also lower consumption from those same workers.

Exhibit 5: We expect immigration restrictions, weaker economic activity due to trade uncertainty and DOGE to weigh on payrolls
Nonfarm payrolls (Avg monthly change by quarter, thous.; forecast in grey)



Source: BLS, Haver Analytics, BofA Global Research

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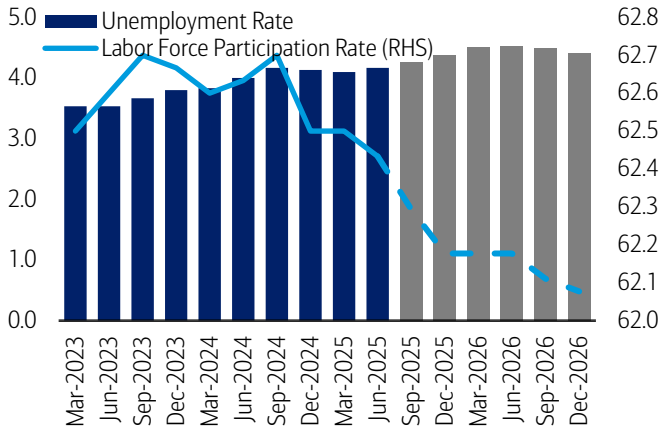
Exhibit 6: To square the difference between demand/supply factors, focus should be on the u-rate, which is likely to show a modest rise
Unemployment and labor force participation rates (%, forecast in grey)



Source: BLS, Haver Analytics, BofA Global Research

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However, a clear characteristic of migrant workers is their high propensity to save and send those saving via remittances to their home countries to help their families. Therefore, for the economy as a whole, tighter immigration policies represent a negative supply shock on net.

What about wage inflation?

Since workers who leave the labor force are also consumers, immigration restrictions should slow both supply and demand. And since we expect the u-rate to tick up going forward, we don't foresee a strong impulse to wage inflation from immigration policy.

However, the story will probably vary a lot across sectors. Those that rely heavily on immigrant labor, such as construction, agriculture and leisure & hospitality, could face labor shortages and a resurgence in wage inflation. The supply shock will be a bigger story in these sectors since immigrants make up a big share of the workforce but don't have a high share in consumption.

Also, the gig economy should be more than proportionally impacted, which means upward pressure on wages in those sectors. We will be watching this story closely in the coming months.

Consumption resilient despite deceleration in lower income brackets

The decent pace of job creating in the labor market, coupled with healthy balance sheets of the private sector, keep aggregate consumption resilient. The last retail sales print, although not as high as we predicted, keep showing consumers are keeping their consumption patterns.

There is however some slowdown in consumption for lower income brackets, but they do not represent more than 20% of aggregate consumption. For those on middle- and high-income brackets, the strong runup in financial assets and their ability to lock in low mortgage rates when interest rates collapsed during the pandemic, given them with very solid balance sheet and consumption power.

Taylor Rules are consistent with a Fed on hold

Interest rates rules, popularly known as Taylor Rules, are useful benchmarks for checking how appropriate is a particular policy stance. They relate the policy rate to a small number of economic variables, typically deviations of inflation and unemployment rates from their targets. Being simple monetary policy rules, they are subject to limitations, but still serve as a guidance for the FOMC. Obviously different functional forms of interest rates rules will yield different prescriptions, so we explore the five most popular specifications, usually cited in the Fed's Monetary Policy Report (see Exhibit 7).

Exhibit 7: Alternative Taylor rules
We use alternative Taylor rule specifications to assess the trajectory of the Fed funds rate

Monetary Policy Rules	
Taylor (1993) Rule	$R_t^{T93} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t{}^{LR}) + (u_t{}^{LR} - u_t)$
Balanced-approach rule	$R_t^{BA} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t{}^{LR}) + 2(u_t{}^{LR} - u_t)$
Balanced-approach (shortfalls) rule	$R_t^{BAS} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t{}^{LR}) + 2\min\{(u_t{}^{LR} - u_t), 0\}$
Adjusted Taylor (1993) rule	$R_t^{T93adj} = \max\{R_t^{T93} - Z_t, ELB\}$
First-difference rule	$R_t^{FD} = R_{t-l} + 0.5(\pi_t - \pi_t{}^{LR}) + (u_t{}^{LR} - u_t) + (u_{t-4}{}^{LR} - u_{t-4})$

Source: Federal Reserve Board. Note: R_t represents the nominal federal funds rate. r_t^{LR} and $u_t{}^{LR}$ are, respectively, the neutral real federal funds and unemployment rates expected in the long run. π_t is the yoy core PCE inflation in quarter l. u_t is the unemployment rate in quarter l. R_{t-l} denotes the average midpoint of the target range of the federal funds in quarter $t-l$. Z_t is the cumulative sum of past deviations of the federal funds rate from the prescriptions of the Taylor (1993) rule when the rule prescribes setting the rate below an effective lower bound (ELB) of 12.5 basis points.

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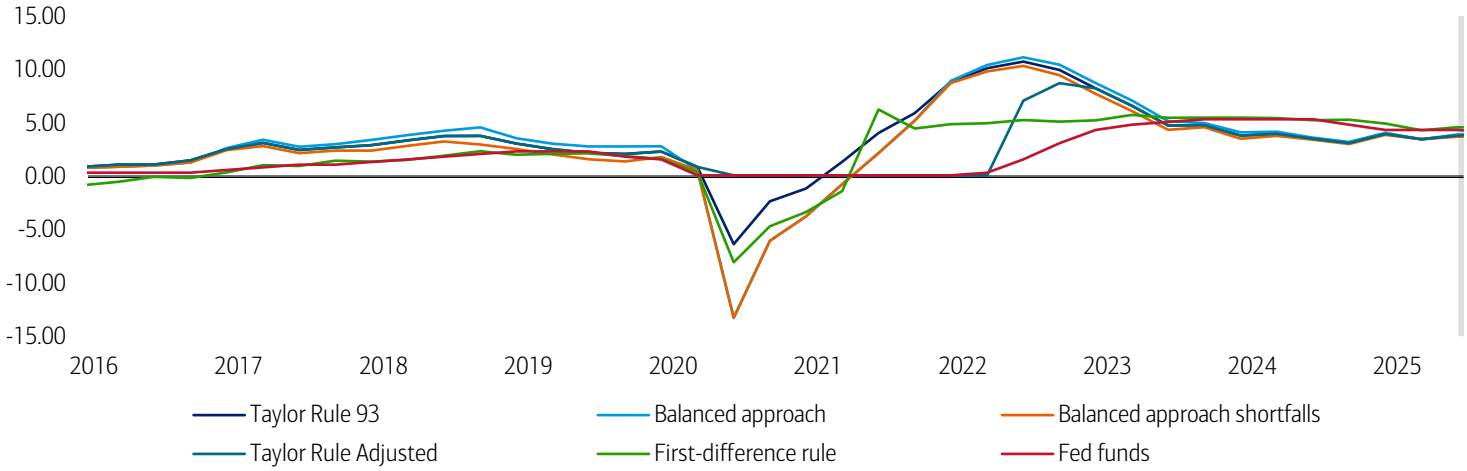
Exhibit 8: Most Taylor rules prescribed earlier and many more hikes than the Fed validated, but current policy stance is broadly consistent with Taylor rules
Fed funds rate vs alternative Taylor rule prescriptions using median values in Summary of Economic Projections (%)



Source: BofA Global Research, Federal Reserve Board, Haver

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In Exhibit 8 we evaluate those 5 functional forms with realized values for PCE inflation and unemployment and compare them with the realized Fed Fund rate. As can be seen, there has been some discrepancy between most Taylor Rule prescriptions and the Fed Fund path chosen by the FOMC. Part of these differences are predicated on the absence of a lower bound for the policy rate (except in the adjusted Taylor rule).

The Fed hiked less than prescribed by Taylor rules…

In particular, we can see that as the economy was coming out of the pandemic, with the exception of the first-difference rule, most other rules were recommending much lower policy rates than the one chosen by the Fed. These differences are explained by the much higher rates recommended by these rules when inflation spiked post-pandemic. Being unable to distinguish between temporary and permanent shocks, those specifications of the Taylor rules recommended aggressive hikes. In sharp contrast, the Fed read the shock as temporary and short lived, which is why the FOMC decided to keep rates low for too long.

…but the current policy stance is broadly consistent with them

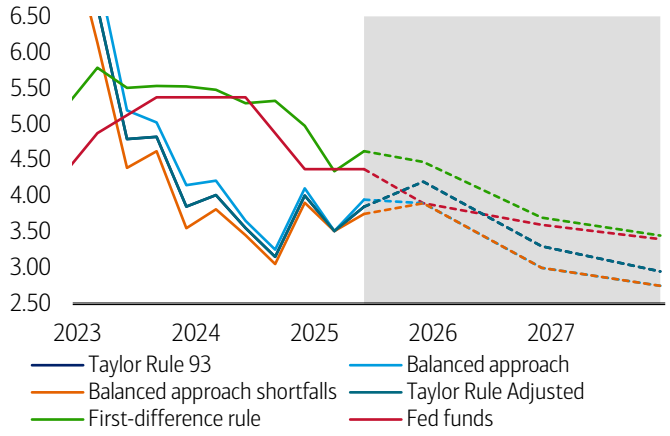
Taylor rules are roughly consistent with no front-loaded cuts and there are very small differences in their prescriptions for a 12-month horizon. For the current policy stance, most specifications indicate that the policy rate is not far away from its current level. To understand what the different policy rules would project for the relevant policy horizon, we evaluate them using the median for inflation and unemployment as well as the terminal rate implied by the latest SEP forecast (see Exhibit 9). We find that most of the policy rules recommend no cuts, or even hikes, for the remaining policy meetings of 2025. The most dovish ones recommend only minor cuts. If we replace the SEP forecasts with our own, results are not that different (see Exhibit 10).

Scenario analysis with Taylor rules

According to the different Taylor rules, what levels of inflation and unemployment do we need to observe to justify the implied market rates? Of course there are many combinations, but we present 3 for the sake of simplicity.

We can also use the Taylor rules in Exhibit 7 to do sensitivity analysis. It is interesting to note that, assuming inflation hovering around 3% for the end of this year, the adjusted Taylor rule would prescribe a rate around current levels with the unemployment rate at 4.4% by year-end. To validate 50bp cuts this year, unemployment should reach north of 4.8%.

Exhibit 9: Taylor rules do not prescribe cuts in the near term...
Fed funds rate vs alternative Taylor rules using median SEP (%)



Source: BofA Global Research, Federal Reserve Board, Haver

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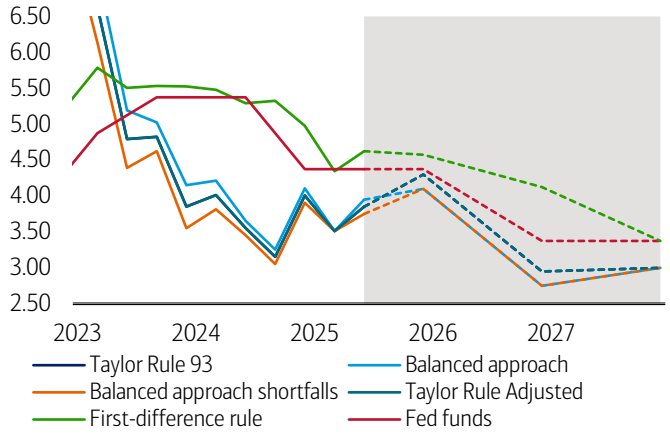
Exhibit 10: ...and generally prescribe hikes using our own forecasts
Fed funds rate vs alternative Taylor rules using BofA forecasts (%)



Source: BofA Global Research, Federal Reserve Board, Haver

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Doing the same exercise with the first-difference rule (which is close to the Fed path recently) the rule would prescribe rates above current levels unless the unemployment rate climbs to 4.6%. And unemployment would need to be above 5.1% to validate market pricing.

If, in line with our forecast, we assume an unemployment rate of 4.4% by year-end, then the burden of proof would be on inflation, which would need to fall to unplausible levels and reach target by year-end to justify market pricing. In our view, the market keeps getting carried away.

Another important consideration beyond this sensitivity analysis is that, to evaluate each policy rule, we have always used the median long run (nominal) neutral rate implied by the dot plot, currently 3%. However, with upside risks to r* that can be argued in light of the post-pandemic economic and interest rate dynamics, the option value of waiting for the Fed increases even further.

R star is in the eye of the beholder

Let's dig deeper on r*. Another point of discrepancy among FOMC members and also market participants is the level of r*, that is, the level of real interest rate that is consistent with inflation being at target and the economy at full employment.

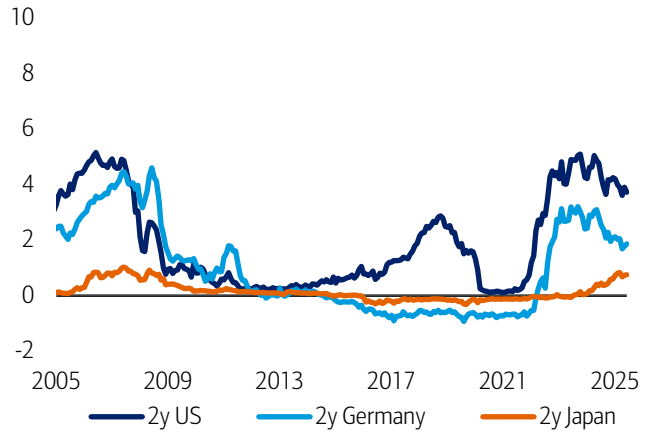
Estimates of r* are usually downwardly biased, due to the impact of the great financial crisis on equilibrium interest rates. These types of crises tend to create what are called balance sheet recessions, which take many years to unfold as companies heal from the impact of the crisis. As economies normalize, interest rates tend to come back to more normal levels.

In Exhibit 11 and Exhibit 12 we can see the evolution of short- and long-term interest rates for the US and Europe, as well as for Japan. It is very clear that after the pandemic, interest rates are moving towards levels more in line with the pre-financial crises shock.

Massive deterioration of fiscal stance across countries also contributed to explain higher levels of equilibrium interest rates. This aspect is very important, because if r* is higher than what most Fed estimates indicate, the monetary policy stance is much closer to neutral than currently perceived.

The median level of real neutral rate or r* is around 1%. If we think of the pre-financial crisis average as the more normal level for r*, this would be between 1.75% and 2%, which coupled with an inflation target of 2% it would yield a nominal r* close to 4%.

Exhibit 11: We are in a higher interest rate regime…
2-year interest rates (%)



Source: BofA Global Research, Bloomberg

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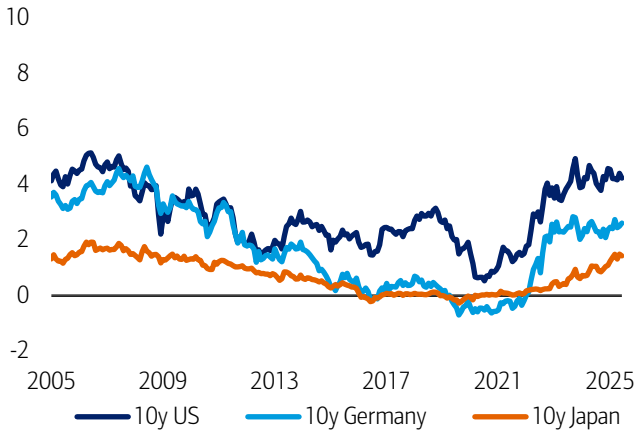
Exhibit 12: … with rates more in line with the pre-GFC levels
10-year interest rates (%)



Source: BofA Global Research, Bloomberg

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Playing devil's advocate: cut rates and go away

In this section we address two common questions we receive. The first one has to do with the different reaction function implied in our forecasts when compared to the Fed. The second one is more related to the case of Fed dissenters, which argue that given that in theory tariffs are a temporary shock to inflation, the Fed should cut rates.

If our forecasts don't differ much from the Fed, why we don't expect cuts?

A natural question would be: if the median forecasts are pretty similar to US, and the Fed told us in the SEP that they would cut twice with 3.1% core PCE inflation and a 4.5% inflation rate, why we don't have cuts for this year?

The answer is twofold. On the one hand, we think r* is somewhat higher than implied by the SEP, on the other hand the balance of risks around re-escalation and the bias created by the political pressure to cut rates can explain the difference. If the gap between the current rate and r* is smaller, given the uncertainty about the impact of tariffs on inflation, the option value of waiting is higher.

Arguments to cut rates: risky strategies

Some Fed officials made the case that tariff-originated inflation is by definition transitory and therefore the Fed should look through them and start cutting rates before the labor market starts to weaken much faster. However, theory doesn't always work as smooth in practice.

Self-fulfilling expectations can push expected inflation higher as realized inflation increase due to higher tariffs and the Fed is cutting rates at the same time. If people do not fully believe that tariffs have a transitory effect on inflation or perceived the Fed cut rates due to political pressure, inflation expectations can quickly de-anchor, exacerbating the stagflationary effects of the tariff shock.

The uncertainty surrounding the potential impact of tariffs on inflation is an important argument for the Fed to keep its risk management approach to inflation to contain inflation expectations, in particular given the post-pandemic inflation spike where the Fed ended up waiting too much to bring inflation down.

Are bondholders from Mars and equity holders from Venus?

Financial conditions are far from tight, and the record levels of the equity market strongly supports this view. This is another interesting debate, because it is at the core of the discussion regarding whether overly tight monetary policy can be leading the economy into a recession.

While the bond market is pricing in 2 cuts for this year and a terminal rate of 3% by the end of 2026, the stock market has recently been making new highs almost every day. Are the bond and stock markets pricing in two completely different economic scenarios? Not necessarily. However, it might happen that both bonds and equities are being driven by the same "exogenous" variable: liquidity. In other words, bonds and equities are cointegrated.

Let's start by assuming that fundamentals rather than liquidity are the main driver of both stocks and equities. In that case, one plausible outlook to rationalize the current price action is that markets are expecting a "benign disinflation", that is, tariffs do not have an impact on inflation, disinflation continues towards the 2% target as Trump de-escalates on tariffs and the economy muddles through, picking up towards potential towards the end of the year.

An alternative scenario is that even though inflation will be persistent and eventually increase towards the end of the year, the labor market will weaken mildly for the Fed to cut rates while the economy muddles through.

In both scenarios, the rally in bonds and stocks seems to be internally consistent, in particular if in addition markets expect some type of deregulation of the banking system. A scenario that would mark some inconsistency between the bond and the stock market is one where the stock market is pricing in higher inflation and the Fed on hold with the economy muddling through or even accelerating as fiscal stimulus dominates tariff uncertainty while the bond market would expect a slowdown in activity and limited pick up in inflation to justify the cuts that are currently priced in.

However, the most likely scenario is one where (global) liquidity is still abundant, money needs to be parked somewhere, and the US still offers the best risk-adjusted prospects, in particular now that the USD corrected the positioning-driven overvaluation triggered by the US exceptionalism pre-tariffs shock. This is most likely the reason why stock markets are making new highs and 10y yields are below 4.5%.

If we coupled this with a 10% weaker USD relative to 6 months ago, a boom in private credit and resilient housing prices, then we must conclude that financial conditions are not tight, and the current policy rate is not far from r*. In a nutshell, another reason for the Fed to remain patient.

Game theory: People react to incentives

So far, we discussed the state of the economy and why the prospects for inflation and employment are consistent with the Fed on hold. But in addition to economic fundamentals, let's add a new element of political economy and use game theory tools to understand how the political economy of public policy decisions may affect interest rates.

Game theory provides a framework to think about the relationship between President Trump and Fed Chairman Powell. At the end the President and the Chairman of the Fed are people, not robots, and people generally react to incentives, more so given that reputational costs are at stake.

How can we rationalize Trump's incentives to pressure Powell to cut rates? It seems clear to us that if there is a recession in the US, it would not be generated by excessively tight monetary policy but due to the uncertainty shock generated by the tariffs. However, political considerations intrude, and Trump's strategy might not be to pressure Powell on the expectation that he will cut rates, but rather to point to the Fed as being responsible for the recession if it happens.

If this is the case, given Trump's apparent strategy, the potential response from Powell's perspective is not to cut rates unless there is a very strong economic case for cutting rates (i.e. much weaker economic activity or a clearer downtrend in inflation). Moreover, perceived incentives are for the Fed to wait longer to cut rates than it would be the case

absent political pressure. Otherwise, Powell and the Fed will lose credibility and being close to finishing his mandate, Powell's reputation is at stake. If he cuts rates and inflation moves higher, he will incur a reputational cost.

What is the equilibrium in this game? Trump's statements appear to be blaming Powell for the high cost of debt and for potentially leading the economy into a recession, and Powell sticks to no cuts. Moreover, by using this strategy, Trump likely raises the bar for cuts, but this may not a problem given that he expects Powell not to cut rates anyway.

Two points are worth discussing: 1) Why is Powell so important if the monetary policy stance is decided by the FOMC (a collegiate body) and not just one person? 2) Why would Powell just care about inflation and not about avoiding a recession?

Listen to the Chairman, ignore the sirens of the dissenters

Does anyone remember who was on the Fed Board when inflation surged under Arthur Burns, or during the massive Volcker disinflation, or more recently during Bernanke's taper tantrum? Of course not.

In any central bank in the world, the organizational structure is pretty similar. A Board and a Chair with mandates established by a Charter. However, different from the rest of the board, the Chair has a disproportionate amount of reputational risk. And absent very rare exceptions, monetary policy decisions are consistent with the Chair's views. It is almost never the case that the Chair votes in minority. Because that is the facto the end of the Chair's leadership. A panel analysis (i.e. combining time series and cross section of central bank decisions) can confirm that presumption.

That is why in those central banks where for the sake of transparency it is customary for board members to speak publicly, such as the Fed, it is important to discount the statement of board members relative to the statements of the Chairman. Every board member has skin in the game, but the Chair has disproportionately more.

Fed Chairmans are remembered because of inflation, not growth

The conduct of monetary policy of the Fed seeks to achieve two goals: price stability and full employment, understood as a target of 2% for PCE inflation and unemployment close to estimates of the "natural rate". There is a third mandate too, stability of long-term interest rates, which is rarely in the forefront. However, the most important consideration for the reputation of a Fed Chairman is price stability.

Everybody remembers Volcker positively because he brought back price stability, not negatively because he engineered a deep recession to achieve the price stability goal. Arthur Burns is remembered for the opposite reasons. Ben Bernanke is probably remembered more for avoiding a massive deflationary spiral that could lead of a depression, although this was a unique situation given that he had to deal with a massive financial crash.

The point being, if left to choose, the Chair of a central bank with dual objectives will generally have a bias to achieve price stability at the expense of full employment if needed, because economic growth is mostly the outcome of sound policies more in the realm of the executive branch of government.

In other words, the payoff for a central bank Chair is asymmetric: if they achieve high inflation and high growth, they will be blamed for delivering high inflation and the Ministry of Finance or the President will claim glory for achieving sound economic growth. The opposite case applies when the central bank achieves low growth for low inflation.

Chair Powell is less than a year away from finishing his mandate, inflation is above the target, inflation risks are tilted to the upside and the labor market and aggregate consumption are holding up pretty well. Based on the argument above, it seems clear how incentives will bias his reaction function.

US fiscal policy: Fed independence is at stake

Fiscal policy is the Achilles heel of the US economy. The headline fiscal deficit will reach 6.5% of GDP next year, with 3.3% of GDP being the interest bill (and growing). These numbers are simply too high for this stage of the cycle. Public debt is already above 120% of GDP and the Treasury is clearly increasing the fraction of debt issuance on the front end of the curve to avoid validating much higher rates in the long end. Gradually, the US is starting to check all the boxes that lead to fiscal dominance.

Recently, President Trump urged the Fed to cut interest rates arguing that the US government is paying a higher interest rate than its credit rating would justify. Although not advisable, it is not unusual that Presidents express their views on monetary policy. However, pushing the central bank to cut rates to reduce the government's interest bill is not a compelling argument, flirting with a case of fiscal dominance.

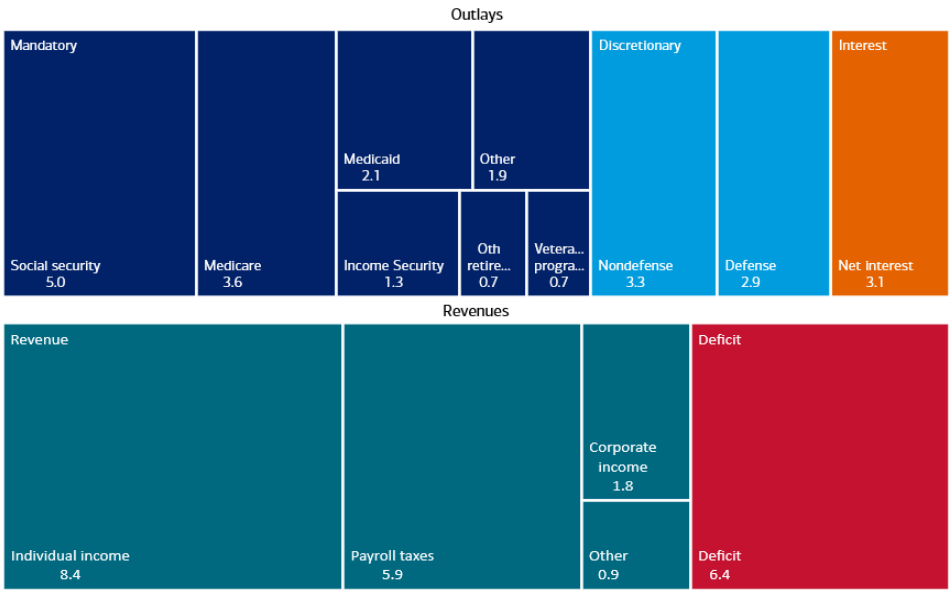
In our view, if the Fed wants to preserve its independence, capitulating to cutting interest rates for fiscal considerations is not an option. If the Fed moves in that direction, it risks de-anchoring inflation expectations and pushing the market to build up higher risk premium in the long end of the curve, eventually increasing real interest rates and with that the cost of servicing the debt.

Without fiscal consolidation, the risk is for higher rates

Geopolitical developments and the weaponization of US Treasuries are reducing the appetite of foreign buyers, which coupled with a persistently high fiscal deficit leaves the government vulnerable to a buyers' strike. It was a buyers' strike that arguably forced a de-escalation of the tariff increase.

Fiscal consolidation entails higher taxes or lower spending. The Big Beautiful Bill shows higher taxes are not an option (though ironically higher tariffs are) and given that 70% of the spending is mandatory, the only realistic way to reduce spending is through Social Security reform that increases the retirement age (see Exhibit 13). Clearly there is no appetite in Washington to move in that direction.

Exhibit 13: The deficit-to-GDP ratio was 6.4% in FY 2024
A breakdown of the FY 2024 Government budget (% of GDP)



Source: BofA Global Research, Congressional Budget Office

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If reducing the deficit is not an option, then we think there are three possible scenarios: higher real rates, higher inflation, or financial repression (i.e. the Fed buying all the Treasuries that nobody wants and/or banking regulation to induce banks to buy more Treasuries). This is particularly important because heightened geopolitical uncertainty is inducing many countries, including China, to reduce their US Treasury holdings in favor of gold and other non-dollar denominated assets.

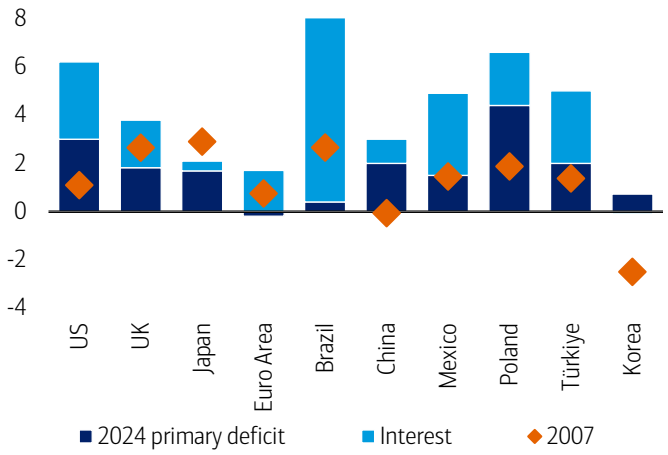
Fiscal deterioration is not only a problem for the US

Fiscal policy deteriorated across countries post-pandemic and the increase in interest rates is threatening debt sustainability absent sizable fiscal consolidation. Fiscal policy is losing power to fight the next recession (see Exhibit 14 and Exhibit 15). The spillover of higher US real rates into global rates and fiscal policy is one of the factors driving a higher r*, at least in the US. Fiscal policy might end up conditioning the conduct of monetary policy. Fiscal dominance is not around the corner but is not light years away either (see report: Around the world in 5 questions).

In a world of extremely low interest rates, governments faced no trade-offs, so they could get away with increasing debt-financed spending in bad times without the need to implement fiscal consolidation in good times. This low interest rate regime led many economists to recommend continually increasing levels of debt as a socially efficient solution to lead with "insufficient demand in a liquidity trap environment" - also referred to as secular stagnation. The argument was based on the debt sustainability condition popularly known as (r - g), which states that if the real rate of interest (r) is lower than the growth rate (g) of the economy, any increase in debt is sustainable.

Central banks were partners in this strategy through different types of quantitative easing policies, effectively becoming buyers of last resort of various kinds of public and private debt that markets were not able to absorb without validating significantly higher interest rates or outright waves of default that would exacerbate the depth of the different crises. Central banks, in the end, monetized sizable fiscal deficits through financial repression by warehousing risk and altering equilibrium market risk premia.

Exhibit 14: Government deficits are much larger than pre-GFC…
Government deficits (% of GDP)



Source: BofA Global Research, Haver

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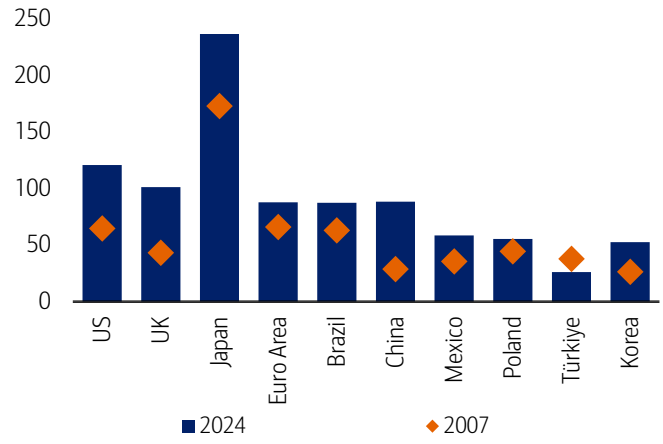
Exhibit 15: … and government debt jumped accordingly
Debt-to-GDP ratios (%)



Source: BofA Global Research, Haver

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