

Federal Reserve Watch

Change in Fed call: pushing cuts out to 2H 2027

No mas

We no longer expect the Fed to cut rates this year. We have pushed the two cuts in our forecast out from Sep-Oct '26 to Jul-Sep '27. The terminal rate stays at 3.0-3.25%. We think Warsh will push for lower rates, but the data flow precludes cuts for now. However, cuts should be in play by next summer, with inflation much closer to target (Exhibit 1).

What took us so long?

We have long argued that additional cuts aren't warranted because i) productivity has raised the neutral rate more than the Fed thinks, and ii) even with the Fed's neutral rate estimates, policy is slightly easy/neutral in real terms. Yet we stuck with our forecast of cuts this year on the premise that i) Warsh is likely to call for cuts, and the Fed Chair usually gets what they want, and ii) the majority of the FOMC was still leaning dovish.

Why change now? The Fed's tone has shifted...

However, recent Fed commentary has been hawkish. Doves such as Daly and Waller have advocated for a pause, at least in the near term. Goolsbee and Musalem have pushed back against Warsh's call for cuts in anticipation of AI-driven productivity.

...Inflation is inexcusable, and the labor market is stable

Moreover, inflation is stuck well above target. Core PCE rose to 3.2% y/y in Mar (2.5% ex of tariffs per our estimates, Exhibit 2). And pass-through from the oil shock is still in the pipeline. Therefore, it would have taken a weak April jobs report to keep the balance of risks within a range where Warsh could push cuts through. Instead the data were solid. Private payrolls have averaged 86k this year, the fastest 4m rate since Dec '24. Though the unrounded u-rate ticked up, there are no clear signs of increasing slack (Exhibit 3).

Still, our conviction remains low

Supply shocks fatten the tails of the policy distribution by pulling the two mandates apart. The economy is facing three negative supply shocks – Iran, tariffs & immigration policy – and a positive one – AI. There is uncertainty about when and how much each shock will impact labor and inflation. In addition, we have an incoming Fed Chair with a strong dovish leaning, but whose influence on the rest of the FOMC is to-be-determined.

The tails are fat

Therefore, we see plausible paths to i) quicker and deeper cuts (if the labor market rolls over with a lag because of the impact of the war), ii) an indefinite hold (if activity remains resilient, convincing the Fed that policy is and should remain neutral), or iii) 50-100bp of hikes. If the Fed were to hike, we think the move would be framed as a reversal of last year's cuts. We see about a 15-20% chance of this outcome.

What would it take for the Fed to hike?

For hikes to be on the table under Warsh, we think the u-rate would need to fall to/below 4% and core PCE would need to get closer to 3.5%, even as tariff effects roll off the y/y rate. The case for hikes would strengthen if wages start accelerating again, or inflation expectations de-anchor (Exhibit 4).

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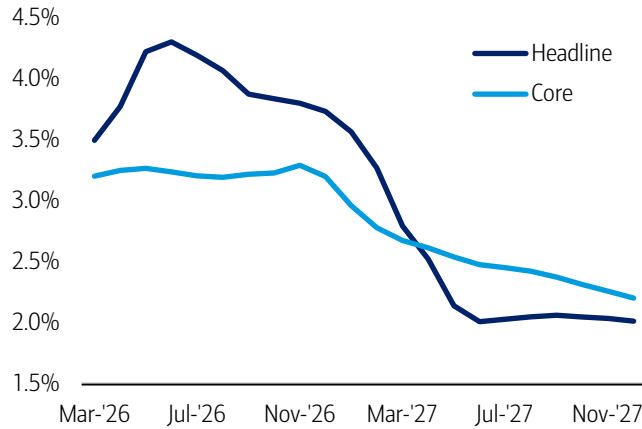
Economics
United States

US Economics
BofAS

Aditya Bhawe
US Economist
BofAS
+1 646 855 9929
aditya.bhawe@bofa.com

Exhibit 1: We expect inflation to be close to the Fed's target by 2H '27

BofA Global Research PCE inflation forecasts (% y/y)

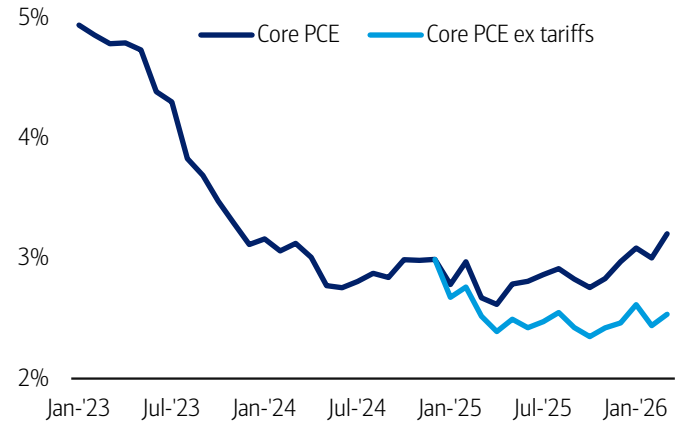


Source: BofA Global Research

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Exhibit 2: Even ex of tariffs, progress on core inflation has stalled

Core inflation including and excluding the tariff impact (% y/y)

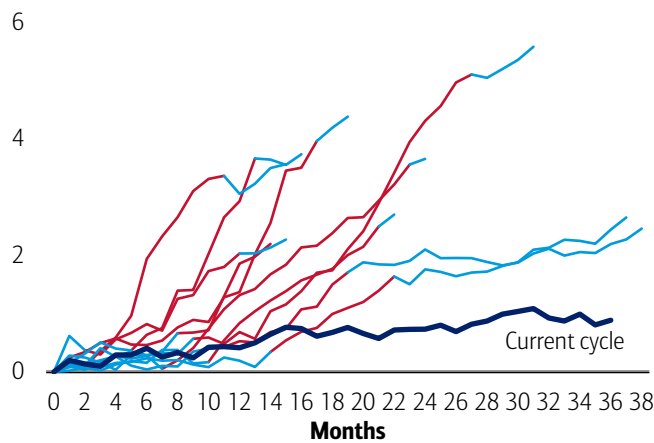


Source: BofA Global Research, Bureau of Economic Analysis

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Exhibit 3: This time really is different for the labor market

Change in u-rate from trough to peak in each business cycle (percentage points)

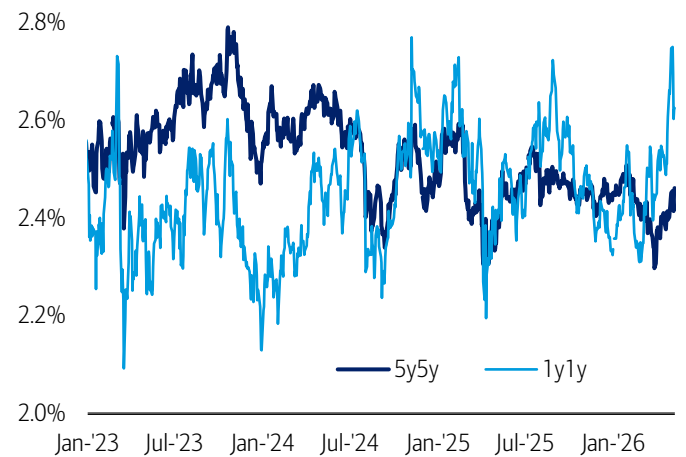


Source: BofA Global Research, Bureau of Labor Statistics. Note: the light blue and red lines show prior cycles. Light blue = expansion, red = recession. We have omitted the March-April 2020 recession to make the chart easier to read. The u-rate troughed in February 2020 and peaked in April.

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Exhibit 4: Longer-term inflation expectations remain benign, but medium-term expectations have responded to the war

5y5y and 1y1y inflation swap rates (%)



Source: Bloomberg

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