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Fed announcement: In the eye of the storm?

Ali Jaffery ali.jaffery@cibc.com

The Fed held rates steady but reduced the amount of expected easing over the projection slightly. The accompanying June projections show the median voter still favors two cuts this year as they had in March, but one cut in each of the next two years for a total of 100bps of easing over the cycle. In March, the Fed had an extra cut in 2026. However, there is greater disagreement this time around, with the committee split almost equally in two camps -- one favoring 0 to 1 cut and the slightly majority favoring 2 to 3 cuts this year. There is also a wider distribution in 2026. One can view that change in the 2025 distribution as slightly more hawkish relative to March, but there was no ground-breaking shifts in the committee's view of the path of monetary policy.

The median view on the nominal neutral rate remained unchanged at 3%, or 1% in real terms, but the real fed funds rate stays steady around 1.5% over the course of the Fed's projection which is probably a better gauge of where the committee thinks neutral should be. The inflation forecast rose to 3% this year, which is consistent with our views (See our recent forecast publication Different strokes for different folks) and the Fed now expects a modest amount of slack to open up with the unemployment rate rising to 4.5% this year and next. Overall, the projection paints a picture of an economy that will slow but certainly not break, and monetary policy providing a helping hand to smoothen out the shocks coming from the new administration.

No major surprises from Powell during the presser. He seemed fairly confident that the soft inflation readings over the past few months were temporary, reflecting pre-tariff inventories, and that tariff pass-through is coming over the summer given the material level of tariffs. The Fed also has an open mind about who bears the tariffs, which leans in the direction of the view that tariffs could be partly absorbed into exporter and importer margins -- something that didn't happen as broadly during the US-China trade war according most of the literature. In a potential signal that Powell could be in the zero to one cut camp, he argued with greater conviction that the Fed needs to be careful that one-time price level shock doesn't turn into ongoing persistent inflation, an argument that Kugler also laid out in a recent speech. On the implications of the oil price shock, Powell didn't seem very fussed as past Middle East tensions have resulted in oil price shocks fading quickly. The US economy is also now a net exporter of oil and that limits the downside impacts on the economy as well.

We don’t find much to disagree on with Powell today or with what the committee wrote down -- we favor one cut this year in December but three next year for the same amount of total easing. The direction of travel for the economy is clearly down and inflation is going to rise in the coming months and given where the economy sits today, the Fed should wait-and-see how the range of policies shake out and actually start to impact the economy. That is all sensible. A further escalation of the conflict in the Middle East is a growing risk, especially if the US is drawn into it and defense spending needs to rise sharply, but it's very difficult to speculate how that will shake out.

Maybe the big lesson of all this is that the US economy has become so well internally diversified that its very robust to multiple shocks. The period of painful post-financial crisis household deleveraging, low inflation and low interest rates allowed the right rebalancing of capital and labor, and the post-pandemic fiscal policy, while excessive in adding some extra inflation, kept that process intact. Perhaps I will have to eat those words in the coming months as we might be in the eye of the storm, but midway through 2025 with an effective tariff rate moving around like market rates but comfortably in double-digit territory and a hardline immigration strategy, not everyone would have expected this level of calm and stability on the economic front.