Market View
Central banks face difficult choices ahead

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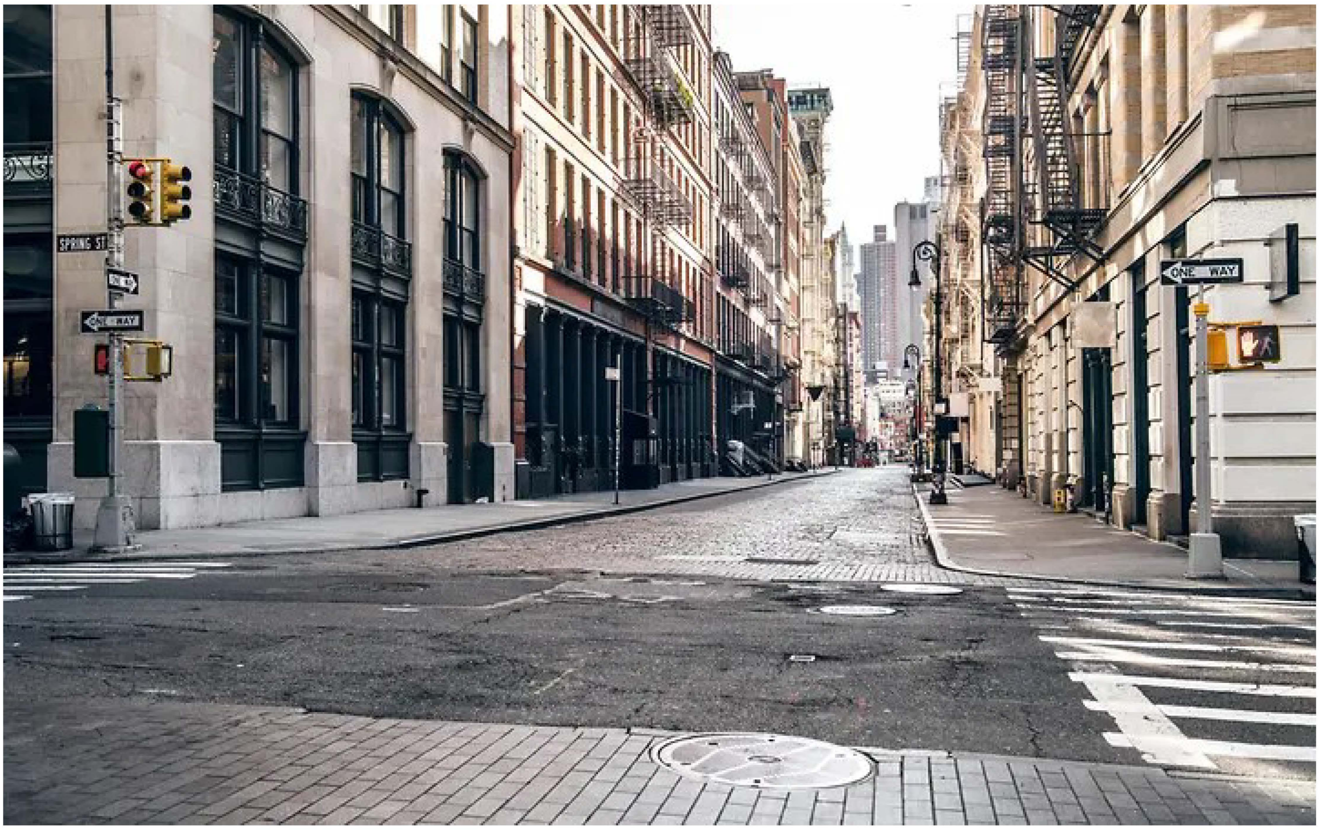

At a glance

Uncertain backdrop: Amid tariff threat, concerns about US economic resilience are rising, with expectations of slower growth and higher inflation.

Confidence in "transitory": The Fed maintained interest rates and viewed tariff impacts on inflation as "transitory" thereby boosting market confidence amid jittery US equity market.

Labour market and inflation dynamics: US administration immigration policy and a desire to re-shore manufacturing could result in higher wage growth putting the Fed in a tough spot.

There has been a plethora of topics to write about this year amid tariff threats, growing geopolitical fractions and German fiscal largesse to name a few. Lately, there has been increasing concern on just how resilient US consumers and businesses are amid an everchanging policy landscape, leading many to believe that US growth will decelerate sharply. The interplay between growth and inflation, and what this means for central bank policy, has been a core focus over the past few years and has come into sharper focus of late. While investors did not expect the Federal Reserve (Fed) to lower interest rates at their meeting earlier this week, there were looking out to see how recent developments changed their thinking.

Transitory 2.0?

Every quarter the Fed publishes their Summary of Economic Projections which includes their median expectations of interest rates and their outlook for the economy. Although their guidance remained for two quarter-point rate cuts this year, some members favoured fewer cuts. This marries up with their growth and inflation forecasts for 2025 which were revised 0.4% lower and 0.2% higher respectively. Soft economic surveys also alluded to an environment of slower growth and higher inflation making the job for central bankers more challenging. Amidst the weak start to the year for US equities, the tone from Chair Jerome Powell sounded rather sanguine. While he did acknowledge the "remarkably high" level of uncertainty given all the tariff noise, he did note that the expected impact on inflation would be "transitory". By using the word "transitory", this marks a reasonable degree of confidence. It was last used in the aftermath of the pandemic when goods prices rose sharply. Eventually it resulted in the Fed acknowledging that other pressures were more persistent which led to swift hiking cycle we saw over recent years. This term became associated with the Fed's early policy mistake before rectifying it. Chair Powell would be well aware of this and cautious of making the same mistake twice, which helped US equity markets recover some of their losses. On the whole, the meeting resulted in boosting confidence in the US economy while keeping rates on hold unless the economy takes an expected turn.

The labour market remains key

Looking back at history, tariffs do generally result in one-off increases in inflation, but the wider backdrop is important to note. The conundrum facing the Bank of England highlights this best. They opted to maintain rates at 4.5% this week despite growth running below potential. In fact, over recent years, the UK's growth rate has been rather soft, especially when compared to the US. Despite this, they have taken a more cautious approach towards rate cuts as inflation has remained stickier. One of the key differentials has been the pace of wage increases. In the UK, wage growth has been running close to 6% while in the US it has been running around 4% and recent dynamics point towards further cooling. The labour supply is a key dynamic whereby the UK has seen an increasing number of people becoming economically inactive while rising immigration in the US has eased pressure on wages. Should the Trump administration succeed in curtailing immigration while incentivising businesses to reshore production back to the US, this could result in a prolonged period of higher inflation. Earlier this week, the release of the National Association of Home Builders survey revealed that a typical cost effect of $9,200 per home from tariff action. The construction industry has higher reliance on immigration so these costs could rise further. The University of Michigan consumer confidence survey showed that longer term inflation expectations have risen to 3.9% which is 32-year high.

The path forward

Given increasing risks of inflation as a result of the policy objectives of Trump's government, the Fed message seemed at odds with the backdrop. However, amid increasing talk of recession and stagflation, it is not surprising that the central bank does not sound the alarm bell. Despite the voice of confidence, it did not please Trump who called for rate cuts. Ultimately, the Fed may find itself in a position where they have to decide whether to focus on growth and the labour market or inflation. If it is deemed to react too aggressively to a slowdown of the former, it could result in investors demanding a greater premium to hold longer dated bonds despite a reduction in interest rates. So far, the Fed has succeeded in restoring some confidence, but it faces a difficult path ahead.