The BakerGroup

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What's Next for the Fed?

The Fed last cut rates in December, capping off a 100bp reduction in the Fed Funds Target rate during 2024. No adjustments have been made through the first six months of the year, as the Fed has maintained a steadfast "wait and see" approach. Tariffs and geopolitical concerns have muddied the waters and created debate around whether—and by how much—these obstacles could increase inflation. Will the added import costs from tariffs be passed on to consumers and, if so, how much could that increase CPI and PCE? If war breaks out between Israel and Iran, will the price of oil increase, thus raising headline inflation rates? These are two additional puzzle pieces that the Fed is working to navigate within its broader mandate of Maximum Employment and Long-Term Price Stability.

Following the Fed's most recent meeting, we received two critical pieces of information that can help us evaluate the Fed's current thinking as compared to the first quarter:

1. The Dot Plot
2. The Summary of Economic Projections

The Dot Plot shows the future rate expectations for each member of the Fed. Both voting and non-voting members provide their expectations anonymously, so it can be difficult to discern where each member stands; however, in aggregate, you can get an idea of what the group is thinking. If we compare the Dot Plot for Q1 vs. Q2, we notice a couple of things. The first is that the Fed is still expecting two 25bp rate cuts for the remainder of 2025. The second is that the Fed anticipates it will have to move more slowly on the path to its longer run neutral rate of 3%.

The Summary of Economic Projections is interesting because it provides insight into the Fed's expectations for the data that impact its monetary policy—specifically, expectations for GDP, the Unemployment Rate, and PCE (the Fed's preferred measure of inflation). The glaring takeaway from Q2 compared to Q1 is that the Fed expects slower growth combined with an uptick in unemployment and inflation. This combination points to a more challenging environment for the Fed to navigate in order to achieve its goal of a soft landing.

Looking past expectations, real data has shown cracks as well. Q1 GDP came in negative for the first time since early 2022. Much has been made of the drag that Net Exports (Exports minus Imports) had on GDP, as many businesses boosted imports in the first quarter to avoid paying tariffs, but there was also a noticeable decline in consumer activity. Q2 GDP may well bounce back, but given that roughly 70% of our economy is driven by consumer spending, a continued slowdown of the consumer could have a massive impact on the economy.

Considering the entire backdrop of current data as well as the Fed's own expectations, we can see the challenge they're up against. The Fed expects to cut rates twice through the remainder of 2025. The market is currently betting that the Fed cuts rates closer to three times, with the first cut coming in September. It feels like sentiment for a rate cut is starting to grow, as two voting members have come out publicly saying that they see a case for a July rate cut. The Fed has been very careful to project any movements they've made since they began the easing cycle and, so far, they've been pretty consistent with hitting their short-term targets. If the data continues to remain stable and we don't see any large upticks in the Unemployment Rate or Inflation, it makes sense to defer to the Fed's near-term guidance of two rate cuts, as they have so far been fairly consistent in following their projections.

If we do see two additional rate cuts this year, what could that mean for our balance sheets? Given the strong competition that much of the industry is facing for deposits, it could present a challenge. On one hand, institutions should be able to continue

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reducing cost of funds under cover of rate cuts from the Fed, but the magnitude of the savings on interest expense remains to be seen. If an institution is currently paying below-market rates on core deposits, that is going to limit the flexibility they have to cut costs—especially in more competitive environments. On the asset side of the balance sheet, lower rates will likely mean lower asset yields. This could cause some pressure on margins for the industry if asset yields decline more than cost of funds.

As with anything, proactive management can help mitigate risks. Analyzing the rate environments that present the greatest risk to earnings during the interest rate risk management process, and managing to those risks, remains the best strategy. As deposits remain competitive, having a plan to maintain higher asset yields, rather than relying solely on a decrease in cost of funds, should be a top priority. Used strategically, this is an area where the bond portfolio can really shine, as the right kinds of bonds offer natural falling-rate protection and a hedge against declining asset yields. Loans offer higher yields but carry the risk that customers have significant influence over the rate in falling-rate environments via refinancing and note modifications. Maximizing income with higher loan yields while also not neglecting the bond portfolio can put institutions in a favorable position to limit falling asset yields should we see continued cuts from the Fed.

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