

How much more monetary accommodation can the Fed deliver?

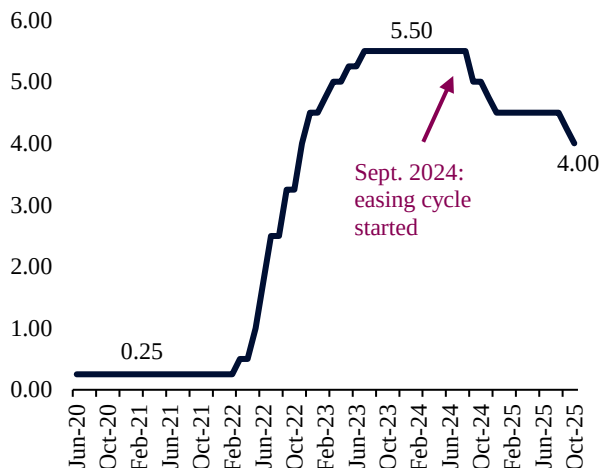
The US Federal Reserve (Fed) is once again at the forefront of the global macro agenda, after a period dominated by US-driven trade negotiations, fiscal debates and geopolitical conflict. Economic policy uncertainty has been reduced significantly on the back of a plethora of trade deals and a less contentious fiscal framework from the Trump administration. Importantly, inflation uncertainty has also been reduced as prices are proving to be less responsive to higher tariffs than previously expected.

However, despite the significant stabilization of the overall policy environment, monetary policy is becoming a more contested space. While the Federal Open Market Committee (FOMC) of the Fed decided for another 25 basis points (bps) rate cut late last month, continuing with the easing cycle that started in September 2024 and resumed this September after eight months of pause, there is clearly significant dissent amongst FOMC Board members. In fact, during the last FOMC meeting, Fed Governor Stephen Miran dissented in favour of a larger 50 bps cut, whereas Kansas City Fed President Jeffrey Schmid dissented in favour of no reductions at all. This “two-sided” dissent is a very rare occurrence in a historically more consensus-prone Fed.

direction of Fed fund rates between markets and policymakers going forward. Investors are currently expecting the Fed to continue with the rate cutting cycle that started in September 2024, with one more 25 bps cut “priced in” for December 2025 and three further rate cuts throughout 2026, for a cyclical terminal rate of around 3%. But Jerome Powell, the Fed’s chairman, is less certain about this outcome, stating recently that further policy rate cuts are far from a foregone conclusion.

In our view, there is space for two more 25 bps rate cuts, likely in December and again in early 2026. Hence, we believe that both the “hawkish” central bankers that want to pause again the monetary easing cycle and their “dovish” colleagues that advocate for much deeper rate cuts are likely too aggressive in their positions. Similarly, prevailing market expectations are likely too optimistic in their assessment about four further cuts to a 2026 end-year rate of 3%. Two main points sustain our view.

US Fed fund rates
(%, 2020-2025)

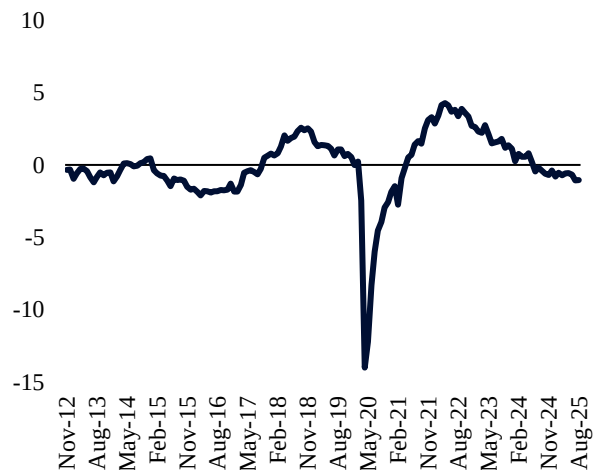


Sources: Haver, US Federal Reserve, QNB analysis

Moreover, there seems to also be widening differences in conviction about the timing and even

US capacity utilization index

(0 = capacity, negative = below potential, 2012-2025)



Sources: Haver, QNB analysis

First, we believe that there is still more room for a couple more rate cuts because current policy rates are still too tight vis-à-vis existing macro conditions in the US. At 4%, policy rates are restrictive or around 50 bps above what we consider to be the neutral rate, i.e., the level at which rates are neither supportive nor

restrictive for activity. US capacity utilization, measured in terms of the state of the labour market as well as the level of industrial activity, indicates that the US economy is set to run below potential. In H2 2025, for the first time in more than four years, the “jobs gap” is suggesting that the labour market is loose rather than tight, i.e., the sum of job openings and employment is lower than the total civilian labour force. This is because new job openings have been reduced significantly from more than 12 million new posts per month in early 2022 to around seven million in recent months. Importantly, coincident labor data from private sources are indicating an accelerating trend of US layoffs. US based employers cut more than 150 thousand jobs in October, marking the biggest reduction for the month in more than two decades, as companies are seeking to reduce costs, mitigate tariff-related margin pressures and increase efficiency with AI adoption. Moreover, industrial activity is running below its long-term trend. These conditions, that together inform our US capacity utilization index, point to below potential growth and support additional rate cuts to neutral levels over the coming quarters, i.e., policy rates that are at the estimated neutral threshold of around 3.5%.

Second, while there is room for additional policy easing, the further deeper cuts supported by the “dovish” members of the Fed and expected by markets seem to be too aggressive. The US economy adjusted significantly and slowed down from close to 3% growth in both 2023 and 2024 to around 2% growth this year. But there is little evidence of an incoming sharper downturn or deterioration, not to mention any potential recession. Investments have been strong on the back of record capex from tech companies seeking to lead the AI wave, whereas consumption has been slowing only gradually as US households still benefit from their strongest net financial position in decades. In other words, in the absence of new negative shocks, further downside pressure for US growth is limited. Hence, there appear to be no justification to reduce the policy rate further from neutral down to accommodative levels.

All in all, we expect the Fed to moderately continue with its easing cycle, cutting the Fed funds rate twice more to 3.5%. Below trend labour and capacity utilization justify continued policy rate cuts, while limited downside potential places the adequate floor to rates around neutral levels.

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