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Market views and strategy

Ostrum ASSET MANAGEMENT

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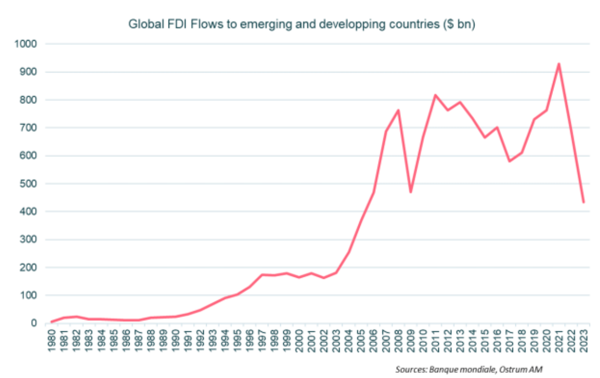
Topic of the week: The Fed's dilemma
by Axel Botte

- The Federal Reserve is uncertain about the direction of interest rates, as tariffs lead to both rising prices and a decrease in consumer demand. Inflation forecasts for 2025 have been raised by 0.3 percentage points to 3.1%, while the anticipated growth has been lowered by the same amount to 1.4%;
- The June "dot plot" shows a significant diversity of opinions among FOMC members regarding the inflation risk in particular;
- Price increases caused by tariffs will likely be offset by disinflation in the services sector, particularly housing costs;
- Labor market conditions continue to deteriorate, and the Fed's reaction function will take employment into greater account in the second half of the year. Once the inflation threat is removed, the Federal Reserve is expected to lower rates toward 3.50%;
- The appointment of Jerome Powell's successor as Fed Chair could nevertheless influence the timing of future interest rate cuts.

Market review: The U.S. strikes Iran
by Axel Botte

- Trump decides to hit Iran's nuclear sites ;
- The Fed hold rates amid divergent views within the FOMC;
- US 10-Yr note yields about 4.40%, oil prices help short-dated breakevens higher;
- High yield spreads widen but stocks rebound on Friday.

Chart of the week



FDI flows to emerging countries have sharply declined, reaching 435 billion dollars in 2023, marking the lowest level since 2005. The decline is observed in all countries, not just in China, which receives one-third of global FDI. This is related to the increase in trade and investment barriers.

These flows are important for developing countries as they help generate economic growth and improve theirs standards of living , particularly in reducing poverty. In 2023, FDI accounted for about half of the external financing for these countries, according to the World Bank. To reverse the trend, it is essential to strengthen institutions and improve the business climate, which are crucial for job creation and achieving development goals.

Figure of the week

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121 words in the G7 communiqué compared with 19 834 in june last year and 108 words in December 2023. Source: DB.

The Fed's dilemma

The Fed is undecided on rates as tariffs both raise prices and hit consumer demand. The June dot plot shows a wide range of opinions within the FOMC. There is nevertheless scope for monetary easing if tariff-induced price hikes are compensated by service disinflation. Labor market conditions are worsening, but the succession of Jerome as the helm of the Fed could have an impact of the timing of cuts.

Between a rock and a hard place

The Fed is facing both upside risks to inflation and downside risks to growth and employment

The Fed pursues a dual mandate of price stability and maximum employment. Subpar growth and above-target inflation means that the U.S. central bank is now between a rock and a hard place. This is the worse situation for policymakers. A 2.5% U.S. economy in late 2024 came to a halt in the 1st quarter 2025 as Trump's tariffs disrupted trade. The subsequent partial roll-back of import taxes during a period of "trade negotiations" has only marginally reduced uncertainty. The same is true of the crackdown on immigration, which represents a negative supply shock.

As per the June Summary of Economic Projections (SEP), inflation risks remain tilted to the upside whilst downside risks prevail on the growth and employment outlook. GDP growth is forecasted at 1.4% in the 4th quarter of 2025 (1.7% in March) as core PCE inflation stays elevated at 3.1% (2.8% in March). The GDP growth estimate for next year is also trimmed by 0.2pp to 1.6% with a bit more inflation (+0.2pp on core and headline PCE to 2.4%). The Fed's assumption is that tariffs will dampen GDP and raise inflation by similar amounts. The range of GDP growth forecasts from FOMC participants is 1.1-2.1% in 2025, which suggests that policymakers make different assumptions about the potential paths for trade policy going forward. The unemployment rate forecasts however fall in a much narrower range of 4.3-4.6% by December 2025. The Fed seems to rule out widespread layoffs in the second half of 2025 and/or expects the jobless rate to be capped by a lower labor force participation rate. The long-run forecasts remain unchanged with potential output growth at 1.8%, 2% inflation and 4.2% unemployment rate.

The dot plot highlights diverging views within the FOMC. Indeed, 7 of the 19 FOMC participants expect rates to remain unchanged throughout 2025 compared with just 4 in March. Among the most hawkish policymakers, we suspect that at least three of them Beth Hammack, Neel Kashkari and Lorie Logan do not vote this year. Governor Adriana Kugler however has repeatedly expressed concern about price developments and likely voted for an extended status quo. It is important to note though that despite forecasts for inflation drifting further away from the 2% goal, no one is advocating for higher interest rates. At the dovish end of the FOMC spectrum, 10 central bankers expect that 2 or 3 rate cuts will be appropriate this year. The mode of the distribution (8 of 19) points to 2 rate cuts, which would likely come in September and December. Beyond year-end, uncertainty about policy rates is even greater but the policy bias is still for monetary easing.

Fedfunds (upper band)	2025		2026	
FOMC	Mar	Jun	Mar	Jun
4.50%	4	7		
4.25%	4	2	3	1
4.00%	**9**	**8**	1	**5**
3.75%	2	2	2	4
3.50%			**9**	**5**
3.25%			1	2
3.00%			3	1
2.75%				1

Source: Bloomberg, Ostrum AM

Will tariff hikes cause sustained inflation?

Judging by Chair Powell's comments at the press conference, larger pass-through of tariffs should show up in consumer prices soon. Tariffs will raise import prices and may even provide some room for U.S. producers to test their pricing power. Accordingly, consumer inflation expectations have increased across a range of surveys (New York Fed, Conference Board, University of Michigan).

Tariff-induced price hikes may be compensated by service disinflation

But the probability that the price shock from higher tariffs morphs into sustained inflation will depend on demand and labor market conditions. And there are clear signs that U.S. aggregate demand is slowing. The U.S. consumer has brought forward spending on durable goods ahead of tariff announcements in March-April but also cut back on expenditure on discretionary items and services. Retail sales then came in on the soft side in May (-0.9%). The shock to confidence is such that households expect lower real income even as the economy still creates jobs for the time being. Likewise, the housing market is clearly weakening. Homebuilder confidence (NAHB survey) has plummeted to a reading of 32 in June, its lowest point since 2022. Housing starts dipped below 1.3 million in May. Home sellers now outnumber prospective buyers. The balance of risks is therefore tilted to the downside. Home prices fell in March for the first time in 3 years. Lower home prices may feed into smaller increases in owners' equivalent rents in the second half of the year. Disinflation coming from the housing sector may dwarf the impact of tariffs on imported goods.

The labor market is also showing signs of cracks despite still low unemployment rate (4.2% in May). However, payroll revisions have been on the downside. Moreover, the drop in the participation rate and the ongoing slide in the employment rate are concerning developments. Foreign-born labor force growth is declining fast owing in large part to a sharp tightening in immigration policies. Immigration, of both skilled and unskilled workers, has been one of the factors behind U.S. exceptionalism.

Continuing jobless claims are climbing steadily, which is indicative of fewer job openings and new hiring, but not large-scale layoffs yet. Layoff announcements have nevertheless risen, even in sectors less exposed to the trade war like information technology. The Labor Department recently reported that there were approximately 1.5 million fewer hires in the first four months of this year compared to the same period last year. For instance, on Labor Department data, high-school graduates aged 18 to 19 who have not pursued further education are grappling with an unemployment rate of 14.5%. This figure has risen from 13.3% in the year prior, highlighting a growing concern for young job seekers.

The Fed may end up cutting more than twice

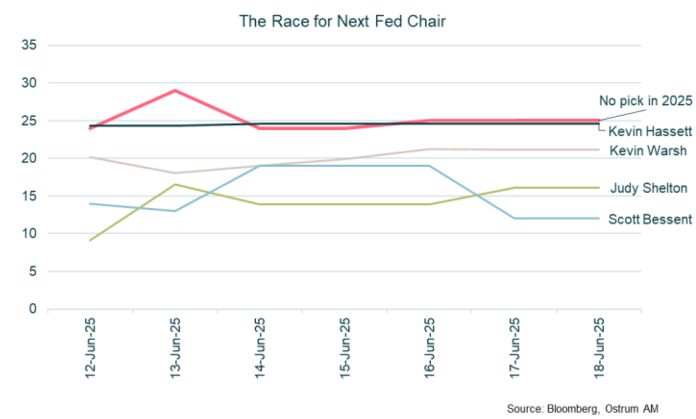
Our outlook for the Fed is thus based on a belief that inflation will rise less than forecast. Tariff rates may settle at a lower level than currently expected. Indeed, Donald Trump suspended reciprocal tariffs within days of the Liberation Day announcement. Market pressure from both bonds and equities and intense lobbying from retailers and manufacturers dependent on imports with no U.S. substitutes (like China's rare earths) have already led to amendments of the tariff policy.

Furthermore, shelter costs will be a significant source of disinflation and other service prices have slowed. Core service inflation has fallen from 4% in January 2025 to less than 3% in May. In addition, the U.S. consumer looks over-extended again. The Fed should pay greater attention to rising delinquency rates on credit cards and auto loans. Delinquency rates are at levels last seen in the great financial crisis. That must raise eyebrows since the unemployment rate is just 4% currently. The moratorium on student debt came to an end last year and delinquency rates rose back to around 8% in the 1st quarter of 2025, which means that many households will have lower credit scores and reduced access to credit. The downside risks to consumer spending may be understated by the Fed at this juncture.

At the end of the day, the labor market will move the needle for the Fed. Revisions to non-farm payrolls (NFP) have been skewed to the downside in recent months. NFP prints under 50k could be the signal for the Fed to bring forward interest rate reductions. Unemployment rate is steady at 4.2% but employment from the household survey was down 696k in May. Furthermore, the hawkishness in the Fed communication is reminiscent of May 2024 when policymakers discussed keeping rates at 5.5% through December 2024. The Fed instead cut rates by 50 bps in September after soft employment data last summer and kept on reducing rates (by 25 bps in the next two meetings) even as the labor market stabilized in the 4th quarter. Like in 2024, there is scope for 100-bp easing in Fed rates to 3.5%.

Succession drama

Since inauguration day in late January, the Federal Reserve has been under intense pressure from Donald Trump. The U.S. President regularly demands, in inflammatory all-caps social media messages, that Fed funds rates be cut immediately from 4.50%. Although the Supreme Court recently ruled that he cannot fire the Fed Chair, President Trump may soon nominate his successor as Jerome Powell's term as Fed President will end in May 2026. Head of National Economic Council Kevin Hassett and Trump's economic advisor Judy Shelton are being considered for the post. Former Fed Governor Kevin Warsh and current Treasury Secretary Scott Bessent also appear to be in contention. Betting markets suggest Kevin Hassett is most likely to be picked. However, betting markets see a 25% chance that President Trump will not announce his pick for the next Chair in 2025. Jerome Powell may have to cope with a shadow Fed chief, who could interfere with the FOMC's policy guidance.



Against this backdrop, Jerome Powell could choose to take no chance on inflation and maintain the status quo on interest rates for longer than necessary. The Fed's initial misreading of inflation risks from 2021 ("temporary inflation") still haunts the current FOMC. It could help his legacy as the Fed President who finally quell inflation in the face of geopolitical risks repeated supply-chain shocks and tariffs.

Furthermore, Trump's pick will be ordered to cut rates aggressively in 2026. Scott Bessent and Kevin Hassett understand the value of Fed independence and credible monetary authorities. However, the nomination of Judy Shelton, a card carrying MMT believer (Modern Monetary Theory) could disrupt financial markets. The MMT's core belief that federal deficits are a myth and can be financed by money printing indefinitely would prove extremely dangerous in the current context. This would undermine the U.S. dollar and raise risk premia on long-term Treasuries.

Conclusion

The Fed's wait-and-see attitude masks diverging views on the relative importance of upside risks to inflation and downside risks to activity. Seven FOMC participants expect rates to stay unchanged until the end of the year whilst 10 rate-setters expect 2 to 3 rate cuts. It remains to be seen whether tariff hikes, which dent consumer demand, will be inflationary. Labor market conditions are also worsening although the unemployment rate hovers about its long-run average. In our opinion, there is scope for monetary easing beyond just two cuts. However, Jerome Powell's term will end in May 2026. President Trump could announce his replacement in the coming months. In this context, Powell could decide to take no chance on Inflation considering that the next Chair may cut rates aggressively thereafter.

Axel Botte

Market review

The U.S. strikes Iran

Trump ordered strikes on Iran's nuclear sites. The reaction of financial markets remains limited considering the potential consequences of a closure of the Hormuz Strait and the destabilization of the Iranian regime. Rates hover around 4.40% in the United States and 2.50% in Germany. The Swiss National Bank (SNB) is returning to near-zero rates, while the Norwegian central bank has opted for a rate reduction.

Donald Trump decided to hit Iranian nuclear facilities. A battle damage assessment must still be established at this stage. China, which purchases nearly all Iranian oil, has taken a step back, but one cannot rule out support for the Islamic regime. Russia has been relatively quiet on the matter. At this juncture, the rebound in risk assets is surprising given the stakes involved. Even implied volatility has plateaued at 22%.

U.S. economic reports indicate signs of fragility, particularly in the housing sector, which is experiencing another downturn. Housing starts have dipped below the 1.3 million mark. The confidence among builders, as reported by the NAHB survey, reflects a market dominated by sellers for the past few months. The housing market will remain a source of disinflation, likely offsetting the expected impact of tariffs on prices. The Federal Reserve remains cautious and divided on this issue, with employment figures being crucial, especially as new unemployment claims have risen in recent weeks. In the Eurozone, economic activity remains lackluster in France, according to INSEE's survey. However, consumption has shown slight growth after three consecutive years of declining retail sales. In the UK, the latest employment data and persistent inflation are being debated by the Bank of England, which is expected to cut rates in August. Other central banks are taking a more proactive stance. The SNB has reduced its rate to 0% in an effort to combat the strength of the Swiss franc, with limited success thus far. The Norges Bank surprised markets with a rate cut to 4.25%, outpacing the Riksbank and the ECB. Conversely, inflation data would justify a rate hike in Japan, but the Bank of Japan remains enigmatic on this front.

In the financial markets, the flight to safety towards Treasuries is no longer prevalent—even in the face of a nuclear crisis. This paradox reminds us that the Fed's status quo and the fiscal outlook are considerable counterforces. The U.S. 10-year yield has risen back above 4.40% by week's end, ahead of a busy week for bond issuance. The increase in oil prices priced in for the next 3-6 months has supported linkers. The 2-year inflation swap in the Eurozone has climbed back above 1.8%, while its U.S. counterpart is trading at 2.82%. Bund volatility has lessened over the past weeks. The ECB's messaging suggests an additional rate cut before reaching a floor that will spill over into longer maturities. The Bund appears well-valued at 2.50%. As for sovereign spreads, profit-taking on peripheral debts does not negate the theme of convergence towards France or Belgium, both of which are facing public finance challenges. Credit remains dull, which is a welcome relief. Euro IG spreads are stable at 86 bps. The high yield market, which is more richly valued, has widened by 15 bps over the week, following a retracement of the crossover from 287 bps on June 11 to 310 bps. U.S. equity markets are reclaiming their highs, driven by technology, while the Nikkei and Kospi are outperforming Europe.

Axel Botte

Main market indicators

G4 Government Bonds	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Bunds 2y	1.86 %	+2	+10	-22
EUR Bunds 10y	2.52%	0	-4	+16
EUR Bunds 2s10s	67 bp	-2	-14	+38
USD Treasuries 2y	3.9 %	-7	-9	-34
USD Treasuries 10y	4.37 %	-8	-15	-20
USD Treasuries 2s10s	47 bp	-1	-5	+14
GBP Gilt 10y	4.53 %	-1	-16	-4
JPY JGB 10y	1.42 %	-2	-12	+31
€ Sovereign Spreads (10y)	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
France	74 bp	+3	+4	-9
Italy	98 bp	+6	-3	-17
Spain	70 bp	+8	+7	+0
Inflation Break-evens (10y)	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
EUR OATi	201 bp	+2	+0	-
USD TIPS	234 bp	+3	0	+0
GBP Gilt Index-Linked	317 bp	+1	-8	-35
EUR Credit Indices	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
EUR Corporate Credit OAS	97 bp	+0	-4	-5
EUR Agencies OAS	51 bp	+0	+1	-11
EUR Securitized - Covered OAS	48 bp	+0	+0	-8
EUR Pan-European High Yield OAS	332 bp	+8	-3	+14
EUR/USD CDS Indices 5y	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
iTraxx IG	60 bp	+4	-1	+2
iTraxx Crossover	308 bp	+17	-7	-5
CDX IG	57 bp	+2	-3	+7
CDX High Yield	351 bp	+13	-20	+39
Emerging Markets	23-Jun-25	-1wk (bp)	-1m (bp)	YTD (bp)
JPM EMBI Global Div. Spread	326 bp	+5	+1	+1
Currencies	23-Jun-25	-1wk (%)	-1m (%)	YTD (%)
EUR/USD	$1.146	-1.04	+0.89	+10.76
GBP/USD	$1.338	-1.71	-1.2	+6.84
USD/JPY	¥147.71	-2.4	-3.49	+6.54
Commodity Futures	23-Jun-25	-1wk ($)	-1m ($)	YTD ($)
Crude Brent	$77.6	$4.4	$13.4	$4.7
Gold	$3 377.9	-$21.6	$20.4	$753.5
Equity Market Indices	23-Jun-25	-1wk (%)	-1m (%)	YTD (%)
S&P 500	5 968	-1.28	2.84	1.47
EuroStoxx 50	5 213	-2.37	-2.13	6.47
CAC 40	7 535	-2.68	-2.58	2.09
Nikkei 225	38 354	0.11	3.21	-3.86
Shanghai Composite	3 382	-0.21	0.99	0.89
VIX - Implied Volatility Index	21.64	3.94	-2.92	24.73

Source: Bloomberg, Ostrum Asset Management

Additional notes

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