Yardeni Research

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# Morning Briefing

## The Fed Remains On Hold

*Check out the accompanying chart collection.*

**Executive Summary:** As investors, central bankers, and economists the world over await the US monetary policy decision to emerge from next week's FOMC meeting, William and Ed assess where Fed officials' heads are at. Their recent speeches don't suggest urgency to ease, and neither do recent economic data releases. Inflation and unemployment, as of now, both are tame. But officials face extreme visibility challenges trying to make out what lies up ahead, as Trump's unknown tariff impacts fog their views of near-term GDP growth, unemployment, and inflation. … Central banks around the world are navigating in the dark as well, blinded by the uncertain ramifications for their economies of US policy decisions—monetary, fiscal, and trade related.

**Weekly Webcast.** If you missed Monday's live webcast, you can view a replay *here*.

**Federal Reserve I: Fed Up With Uncertainty.** Speaking in South Korea last week, Federal Reserve Governor Christopher Waller faced a standing-room-only crowd of businesspeople thirsty for answers about US policy. Yet Waller seemed to have far more questions about the direction of the globe's biggest economy than explanations.

Waller said on June 2 that the volatility surrounding President Donald Trump's tariffs "has created *considerable uncertainty* about where trade policy will settle." As corporate chieftains in the US struggle to navigate Trump's Tariff Turmoil (TTT), Waller said "economic policy uncertainty among businesses is very elevated, and this has affected measures of sentiment and confidence for consumers and businesses."

What Waller effectively admitted is that Fed officials face extreme visibility challenges of their own as the second half of 2025 begins, never mind 7,000 miles away. Think of Fed Chair Jerome Powell and the voting members of the Federal Open Market Committee (FOMC) as like airline pilots anticipating thick fog hiding the horizon that will force them to fly by instrument.

At the moment, the navigational aids available to Powell & Co. suggest that the economy is aloft and well. For all the adverse conditions through which the US flew in April and May and the storms and turbulence that lie ahead, the Fed remains on autopilot, as robust employment acts as a sizable tailwind.

This leaves the Fed unlikely to shift course and ease even as Trump and Wall Street clamor for rate cuts. This is especially true of next week's *June 17-18 meeting*. But that's not to say things won't change abruptly as Trump's *30% China tariff*, *25% tax* on autos, *50% levy* on steel and aluminum, *10% across-the-board tariff* and the trajectory of "reciprocal" taxes take their tolls near and far.

Let's look more closely at the Fed officials' views from the monetary cockpit:

(1) *Risks abound.* Waller's bottom line is that "the context for this uncertainty about tariffs is that hard data on the fundamentals of the economy lately has been mostly positive and supportive of the Federal Open Market Committee's economic objectives."

On June 3, Fed Governor *Lisa Cook told* a New York audience that "while the economy remains solid, the economic environment could become highly challenging for monetary policymakers. At our most recent policy meeting last month, I supported the FOMC's decision to leave our policy interest rate unchanged. The current stance of monetary policy is well-positioned to respond to a range of potential developments."

That same day, Atlanta Fed President *Raphael Bostic told* reporters that "there's still a ways to go in terms of the progress that we're going to need to see. I'm not declaring victory on inflation yet." In an *essay* published on June 3, Bostic added that "I continue to believe the best approach for monetary policy is patience. As the economy remains broadly healthy, we have space to wait and see how the heightened uncertainty affects employment and prices. So, I am in no hurry to adjust our policy stance."

(2) *Economy stands its ground.* Perusing recent data and other Fed speeches, it's hard to detect an urgent need for Fed action. Friday's employment report was Exhibit A. Amid intense fears of an abrupt slowdown—including those of Trump himself—the US added an above-expectations *139,000 jobs* in May, while the jobless rate stayed at 4.2%, near historical lows (*Fig. 1* and *Fig. 2*).

The print belied Trump's social media pleas for rate cuts. On June 4, two days before the jobs report, a soft May reading from payroll firm ADP had *Trump posting*: "ADP NUMBER OUT!!! 'Too Late' Powell must now LOWER THE RATE. He is unbelievable!!!"

(3) *Trump pounds the table*. Of course, if Trump's instrument flying skills were better, he might've known that APD has been an unreliable barometer. The official payrolls gain reported by the Bureau of Labor Statistics (BLS) was reminder enough of that—139,000 versus ADP's *37,000 increase in May* (*Fig. 3*). That followed another misleading signal in April, when *ADP reported 60,000* versus BLS's *177,000 gain*.

Last Friday's employment data are unlikely to alter views that Fed Governor Adriana Kugler expressed a day earlier in New York. Kugler stressed that, all things considered, she's more worried about turbulence on the inflation front than a sharp slowdown. The impact of the tariffs on producer and consumer prices, she said, will be "*the first-order effect*."

Kugler noted that "*down the road*, when prices go up, consumers and businesses will react, and demand will come down, and that's when you expect maybe to have a bigger effect in terms of a slowdown in economic activity and employment." The tariff factor, she made clear, supports her view that it's best to stand pat on rates to assess the magnitude of the inflationary fallout.

"Disinflation has slowed," Kugler said, "and we are already seeing the effects of higher tariffs, which I expect will continue to raise inflation over 2025. I see greater upside risks to inflation at this juncture and potential downside risks to employment and output growth down the road."

**Federal Reserve II: Inflation Risks Top Downturn Risks.** Research from Fed staff, Kugler cautioned, shows that the pass-through of tariffs into prices can be "relatively quick" and that if "elevated tariffs persist, even just in the short run, larger effects may be coming soon."

Also on Thursday, Philadelphia Fed President *Patrick Harker argued* that the central bank's wait-and-see approach is still the right one. "Even in a time of uncertainty, we remain as certain and deliberate as ever in our approach," Harker said in Philadelphia, adding that he's comfortable with recent decisions to "keep the Fed's policy interest rate steady."

Speaking on June 5, Kansas City Fed President Jeff Schmid seemed to have a similar flight plan in mind. "While the tariffs are likely to push up prices, the extent of the increase is not certain, and likely will not be fully apparent for some time," *Schmid said* in Kansas City. "Likewise, the extent of the drag on growth and employment is also unclear."

(1) *Tariff effects galore.* Of course, the gauge that might be most telling is how the FOMC's

post-meeting Summary of Economic Projections for June differs from the March version.

Back in March, it's doubtful that any Fed officials had Trump imposing a *145% tariff* on China on their Bingo card. Even today's 30% is higher than many of the levies in the 1930 *Smoot-Hawley Tariff Act*, which deepened the Great Depression.

On March 19, when Trump's China tariff was still around 10%, *FOMC meeting participants' median projections* for real GDP growth were 1.7% in 2025, down from *2.1%* expected on December 18, and 1.8% in 2026, down from 2.0% in December (*Fig. 4*). Yet their unemployment forecasts remained low, barely budging from their December meeting to their March one: In March, the median expectations for the unemployment rate were 4.4% in 2025 and 4.3% in 2026; in December, they were 4.3% for 2025, 2026, and 2027 (*Fig. 5*).

Moreover, inflation has proven to be more subdued than the Fed had expected in March: The Personal Consumption Expenditures (PCE) price index increased at a *2.1% y/y rate in April*, below the FOMC meeting participants' March median forecast of 2.7% and December median forecast of 2.5% (*Fig. 6*). The Fed targets a 2.0% y/y inflation rate—so April's reading was close to ideal.

(2) *Inflation worries overdone*. Looking to June, upside risks to inflation are indeed possible as tariff effects filter into finished prices. Yet fears of an inflation surge aren't backed by recent Fed bank surveys. Take the Cleveland Fed's Inflation *Nowcasting* model, which suggests an unalarming 2.4% y/y CPI increase.

Even so, Wall Street is bracing simultaneously for upside surprises in inflation and downside risks to growth. The level of economic uncertainty ginned up by TTT over the last three months has been even worse than that created by Covid-19 during the Trump 1.0 era, said Gita Gopinath, the International Monetary Fund's first deputy managing director. In a *Financial Times* interview last week, *Gopinath said*: "This time the challenge is going to be greater for them compared to the pandemic. During Covid, central banks were moving in the same direction … easing monetary policy very quickly."

(3) *Asia on the frontlines*. The Bank of Japan, for example, is in rate-hike mode. Other monetary authorities that are easing are doing so cautiously as they struggle to assess the inflationary fallout from the trade war. One such official was in the Seoul audience that Waller addressed last week: Bank of Korea (BOK) Governor Rhee Chang-yong.

A week earlier, on May 28, Rhee's monetary policy board cut its seven-day repurchase rate *by 25 basis points to 2.5%* (*Fig. 7*). That same day, the BOK nearly halved its 2025 GDP forecast to 0.8% from its earlier projection in February. As Rhee put it on May 28: "Since growth momentum has weakened more significantly than initially expected, we believe there's a possibility rates will be cut more than we thought going forward."

Days later, Rhee explained how the policy chaos emanating from Washington has been reducing the BOK's economic visibility in real time. *Rhee noted* that uncertainty over what Trump does with reciprocal tariffs next month (Korea risks a *25% levy*) is proving just as disorienting as sectoral tariffs. Asia's fourth-biggest economy is highly sensitive to input costs for its exports of semiconductors, steel, aluminum, and cars. As of now, each is subject to separate Trump duties.

Making matters worse for BOK officials is that no one can say where Trump's China tariffs are heading. Or, for that matter, where US Treasury yields are bound for. As Rhee told Waller and the rest of the audience on June 2, risk aversion among foreign investors suddenly growing weary of US assets is increasing volatility in Korea's government bond market.

**Federal Reserve III: The World's Central Bank.** There's still considerable PTSD in Asia from US yield spikes of the past. Namely, the 1997-98 Asian financial crisis, an episode that bore the Fed's fingerprints. To be sure, the epic collapse of economies in Thailand, Indonesia, and Korea was caused by too much overseas debt, extreme overinvestment, and crony capitalism. But it was the Fed's *1994-95* tightening cycle that pushed developing Asia over the edge.

Under then-Chairman Alan Greenspan, the Fed *doubled* short-term rates to 6% in 12 months. The tightening cycle arguably contributed to the bankruptcy of *Orange County, California*, the *Mexican peso crisis*, and the demise of Wall Street securities giant *Kidder, Peabody & Co*. The dollar's multi-year rise made currency pegs impossible to maintain. First, Bangkok devalued, then Jakarta and *Seoul* followed suit.

Consider the following:

(1) *The global perspective*. The internationalization of US rate decisions over the last 30 years has made Fed watching a global game. The Fed has 12 districts; but from the respect of its impact reach, it's as if Latin America were the 13th, East Asia the 14th, Eastern Europe the 15th, and the BRICS—Brazil, Russia, India, China, and South Africa—collectively the 16th. In 2013, mere talk that the Fed might step away from its post-2008-

crisis quantitative easing, the so-called "*taper tantrum*," slammed Brazil, India, Indonesia, South Africa, Turkey, and other *emerging nations*.

As such, worries that Trump might pivot back to trying to fire Powell are decidedly global worries. Such a step could further upend confidence in the dollar, damage trust in the US financial system, and send long-term Treasury yields skyrocketing. *Elisabet Kopelman* at SEB Research has said the fact that the dollar has fallen in recent months along with stocks while long-term interest rates are "decoupling" from shorter maturities sends "new warnings that the market no longer has the same confidence in the US" (*Fig. 8*).

(2) *Powell's job security*. Many took solace in a *May 22 Supreme Court ruling* signaling that the Fed chair is legally protected from a president angling to fire him or her. Still, *Phil Suttle* at Suttle Economics speaks for many when he says "the chances of the Trump administration accepting this ruling and moving on are very low."

Washington's fiscal trajectory could be its own challenge for the Fed, if long-dated Treasury yields were to spike. The same goes for central bank officials from Seoul to Frankfurt. Yet the bottom line is that the Powell Fed seems comfortable with its wait-and-see approach on rate cuts. And the Fed is finding that the balance of data is validating this disposition.

## Calendars

**US: Tues:** NFIB Business Optimism 95.9. **Wed:** Headline & Core CPI 0.2%m/m, 2.5%y/y & 0.3%m/m, 2.9%y/y; Federal Budget Balance -$325.3b; MBA Mortgage Applications. (Source: FX Street)

**Global: Tues:** Italy Industrial Output -0.1%; UK Claimant Change 4.5k; UK ILO Unemployment Rate 4.6%. **Wed:** Lane. (Source: FX Street)

## Strategy Indicators

**S&P 500/400/600 Forward Earnings** (*link*): During the June 6 week, forward earnings rose for two of these three indexes. MidCap's was the sole decliner, but is under review due to potential data errors in the consensus. LargeCap's forward earnings rose for a fifth time in six weeks, MidCap's dropped for the sixth time in nine weeks, and SmallCap's rose for a third time in nine weeks. LargeCap's forward earnings rose 0.2% w/w to its first record high since the April 4 week. MidCap's fell 1.0% w/w to 4.0% below its record high, also during the April 4 week. SmallCap's rose 0.2% w/w to 14.4% below its June 2022 record. LargeCap's forward earnings is up 23.7% from its 54-week low during the week of February 1, 2023; MidCap's is just 4.8% above its 55-week low during the week of March 10, 2023; but SmallCap's has lagged considerably and is up just 0.3% from a 42-month low during the May 23 week. These three indexes' forward earnings downtrend from mid-2022 to early 2023 was relatively modest compared to their deep double-digit percentage declines during the Great Virus Crisis and the Great Financial Crisis. Here are the latest consensus earnings growth rates for 2024, 2025, and 2026: LargeCap (9.7%, 8.4%, 13.9%), MidCap (0.4, 0.3, 20.3), and SmallCap (-10.2, 2.4, 18.7).

**S&P 500/400/600 Valuation** (*link*): Valuations rose w/w during the June 6 week for all three of these indexes, to levels that remain below their 11- to 13-week highs during the May 16 week. LargeCap's forward P/E rose 0.3pt w/w to a 14-week high of 21.5. It's now 0.8pts below its 43-month high of 22.3 during the December 6 week and 4.5pts above the seven-month low of 17.0 during the October 27, 2023 week. That compares to a 30-month low of 15.1 at the end of September 2022 and an 11-year low of 11.1 during March 2020. MidCap's forward P/E rose 0.5pt w/w to 15.9. It's now 1.2pts below its 40-month high of 17.1 during the November 29 week and 3.7pts above the 12-month low of 12.2 in October 2023. That compares to a record high of 22.9 in June 2020 when forward earnings was depressed, and an 11-year low of 10.7 in March 2020. SmallCap's forward P/E rose 0.3pt w/w to 15.0. It's 2.1pts above its 17-month low of 12.9 during the April 4 week and 4.4pts above its 14-year low of 10.6 in September 2022, but remains 2.1pts below its 41-month high of 17.1 during the November 29 week. That compares to a record high of 26.7 in early June 2020 when forward earnings was depressed, and a record low of 10.2 in November 2009 during the Great Financial Crisis. The forward P/Es for the SMidCaps have been mostly below LargeCap's since August 2018. MidCap's P/E is at 26% discount to LargeCap's P/E, not much above its 25-year-low 29% discount during the July 5, 2024 week. That compares to a 19% discount during the March 2, 2023 week, which matched its best reading since October 14, 2021. SmallCap's P/E is now at a 30% discount to LargeCap's P/E, up from a nine-month-low 31% discount during the May 30 week. That compares to a 23% discount during the November 29 week, which was its best reading since the March 2, 2023 week. It's now 4ppts above its 24-year-low 34% discount during the July 5, 2024 week. SmallCap's P/E is at a 6% discount to MidCap's, up from a 20-year low 10% discount in late 2021. Prior to that, from 2003 to 2018, SmallCap's P/E had been mostly above MidCap's, and both were above LargeCap's.

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