June 17, 2025

Dutta’s Monetary Thoughts

Patience won’t be a virtue

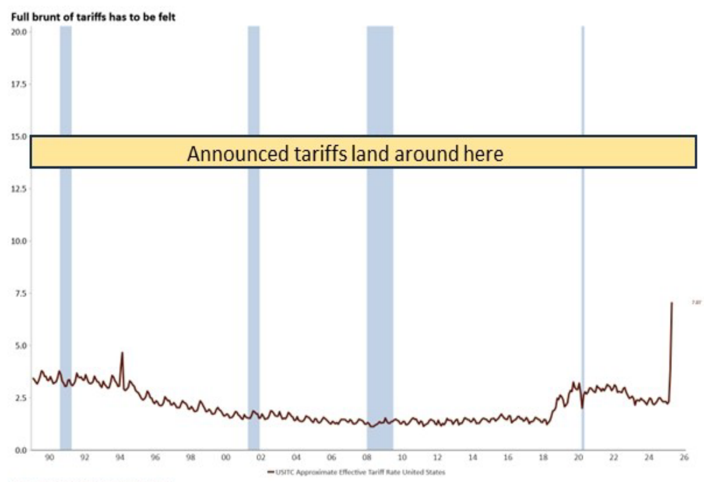
Neil Dutta

Asymmetrical risks to interest rate outlook

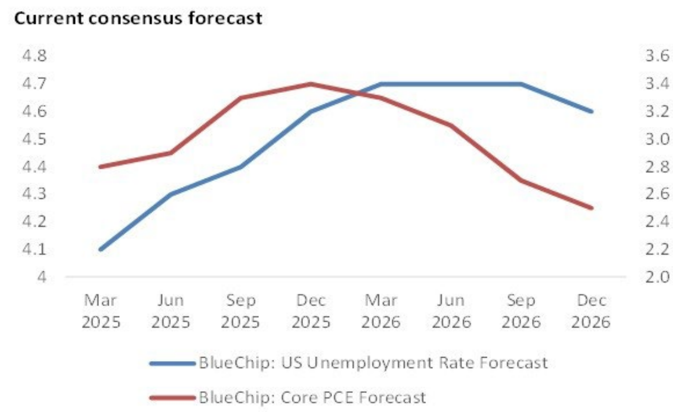
The gap between what I think the Fed “should do” and what they will do continues to widen, exacerbating downside risks to the economic outlook.

At the post-FOMC press conference on May 7th, Chair Powell noted “You know, there should be some increase in inflation. There should be some increase in unemployment. Those call for different responses.” Since then, inflation has been somewhat weaker than expected while unemployment has been advancing. The response in this case seems relatively straightforward; policy should ease somewhat.

The Fed has its reasons for holding off on doing anything. First, there is still upward inflation pressure in front of us from tariffs. As our nearby figure shows, the current effective tariff rate is lower than the announced tariff rate. There is a phase in period as the tariffs are enforced. Tariffs are not yet at “full strength.” Second, tariffs threaten to push up inflation expectations and higher inflation expectations run the risk of pushing up actual consumer price inflation.

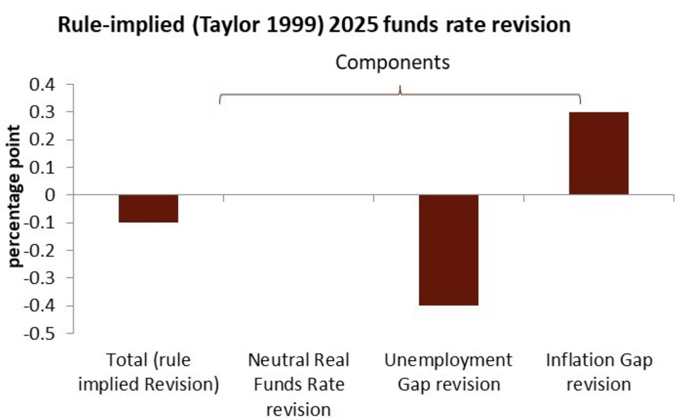


We’re not expecting much out of the Fed’s dots. It’s precisely because they lack clarity on the outlook that they should be reluctant to make big changes. If there is a risk, it’s that they change growth and inflation forecasts without changing the “dots.” Put differently, if they have the same reaction function, (no changes to longer run funds rate or NAIRU) – the consensus changes imply a downward revision to funds rate based on a simple Taylor rule.



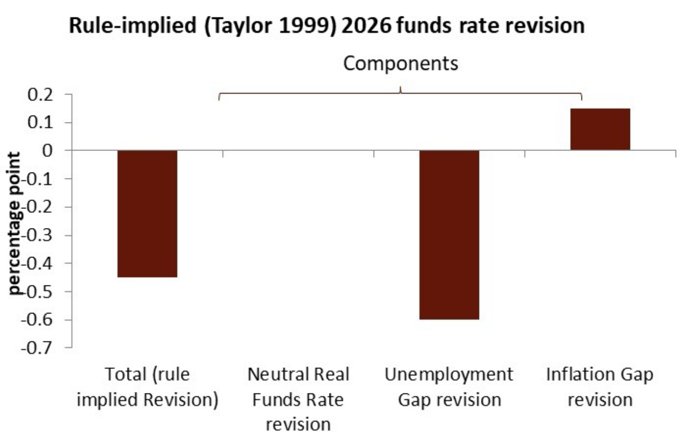
Source: Renaissance Macro Research, Haver Analytics

We update a Taylor Rule based on anticipated changes to the Summary of Economic Projections from March using the latest BlueChip Consensus Forecast. BlueChip has the unemployment rate rising to 4.6 percent and staying there through the end of 2026 and has core PCE rising to 3.4 in Q4 2025 before falling back to 2.5 percent.



Note: Funds rate revision = neutral_real_rate_revision + 0.5*Core_Inflation_revision + 2*Unemployment_gap_revision

If the Fed follows the consensus, in 2025, they revise up U3 by 0.2ppt and core PCE by 0.6ppt. Assuming no changes to longer-run estimate of neutral unemployment or rates, a standard Taylor Rule prescribes a funds rate that is a touch lower than where it is presently.



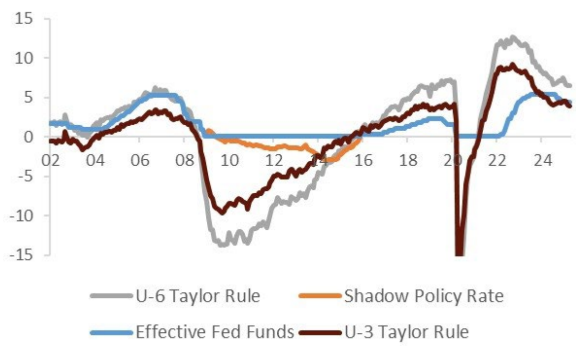
Note: Funds rate revision = neutral_real_rate_revision + 0.5*Core_Inflation_revision + 2*Unemployment_gap_revision

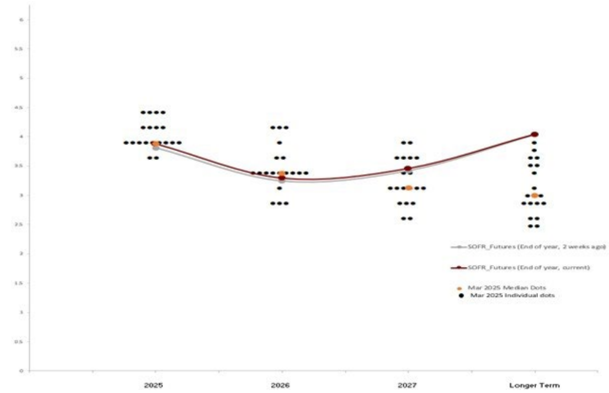
Similarly, in 2026, they would revised up U3 by 0.3ppt and core PCE by 0.3ppt (2.2 to 2.5 percent). Again, a standard Taylor Rule prescribes a downward revision to the funds rate of roughly two quarter-point cuts.

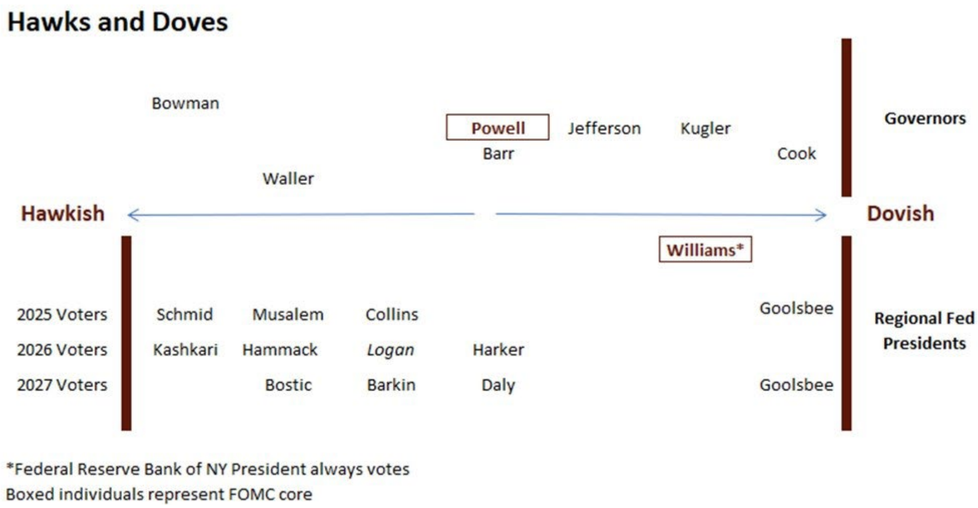
So, the risks seem asymmetrical hawkish relative to the baseline. The Fed is unlikely to mechanically follow the prescription from a standard Taylor rule. So, what's likely is the forecast revisions to inflation and unemployment without the rates changes.

That leaves the Fed somewhat hawkish relative to where they "should be."

Monetary metrics

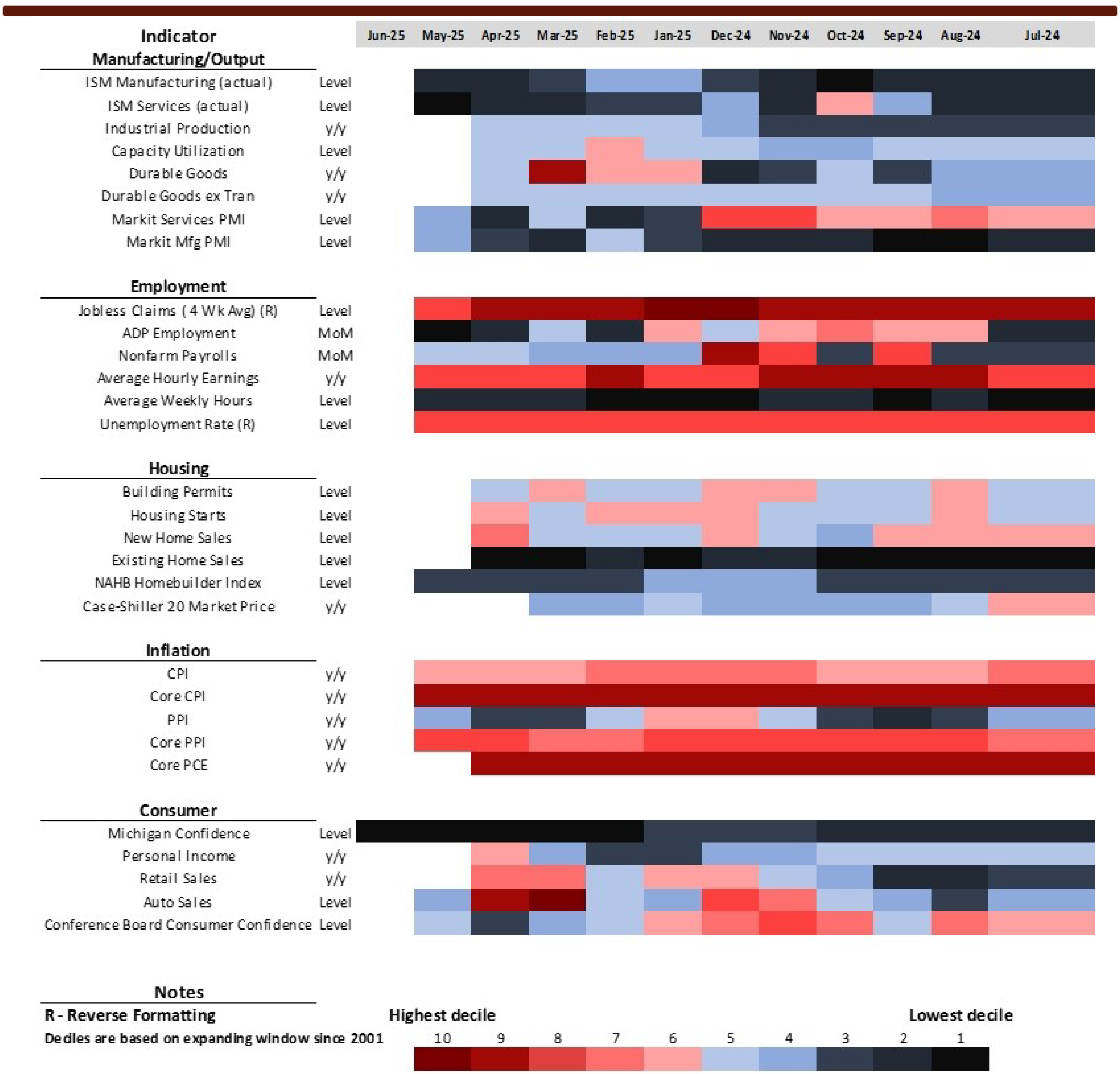




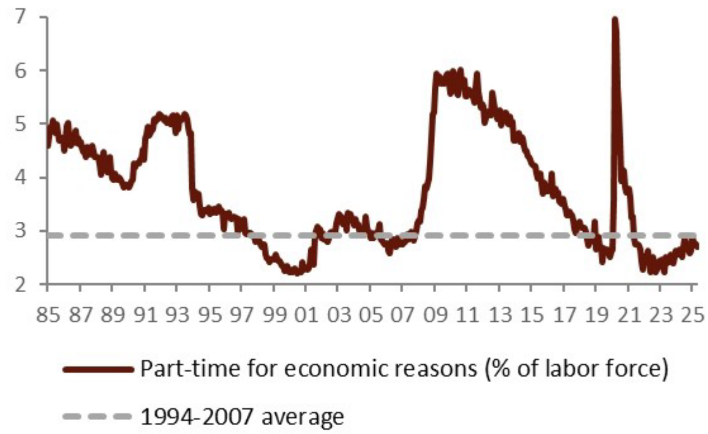


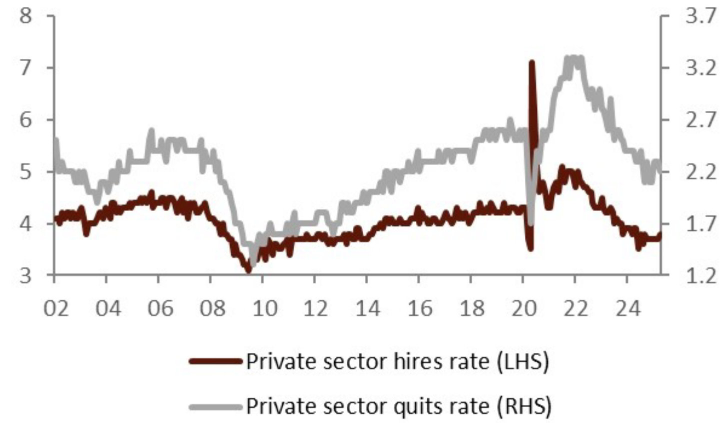
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
December projection	2.1	2	1.9	1.8	1.8–2.2	1.9–2.1	1.8–2.0	1.7–2.0
Unemployment rate	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3
December projection	4.3	4.3	4.3	4.2	4.2–4.5	4.1–4.4	4.0–4.4	3.9–4.3
PCE inflation	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0
December projection	2.5	2.1	2.0	2.0	2.3–2.6	2.0–2.2	2.0	2.0
Core PCE inflation	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1	
December projection	2.5	2.2	2.0		2.5–2.7	2.0–2.3	2.0	
Projected policy path								
Fed funds rate	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6
December projection	3.9	3.4	3.1	3.0	3.6–4.1	3.1–3.6	2.9–3.6	2.8–3.6

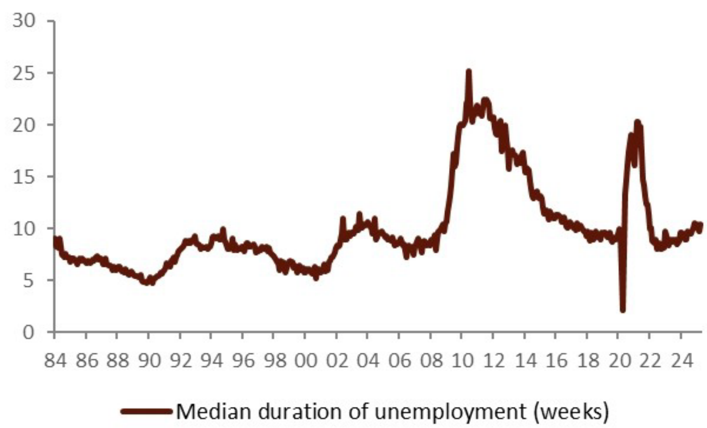
High frequency data heat-map

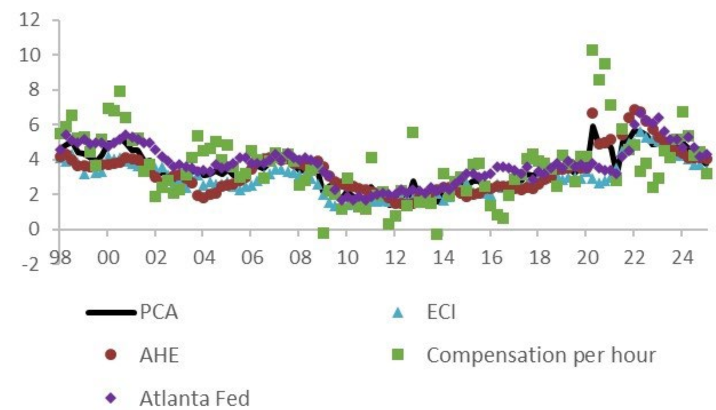


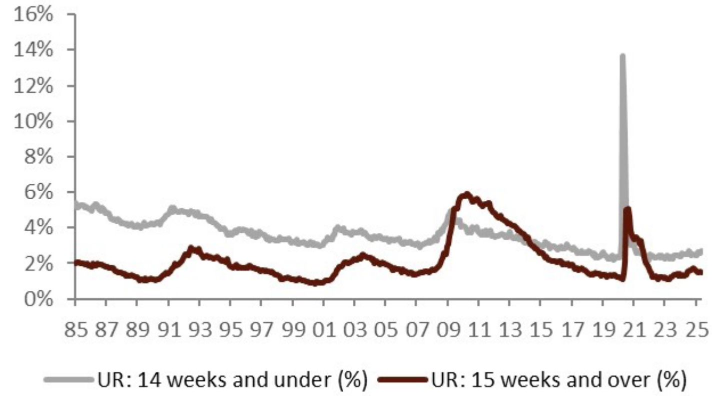
Labor market indicators

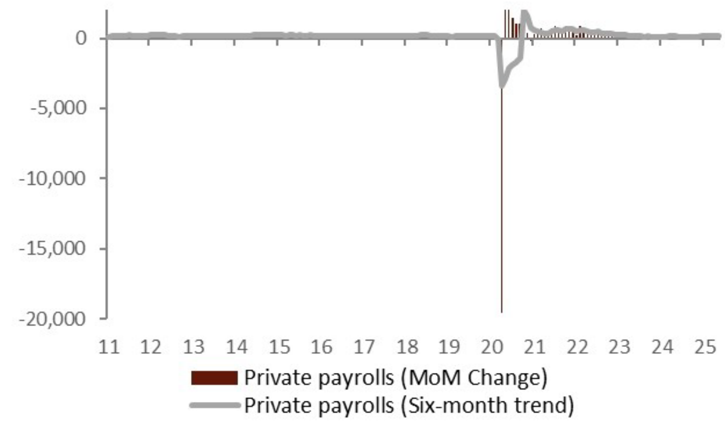




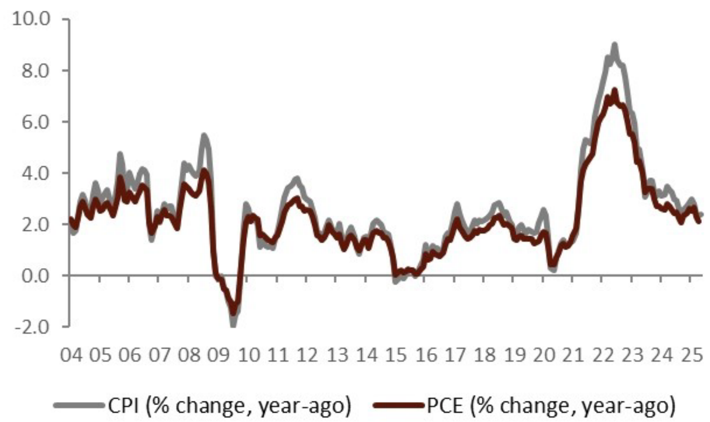


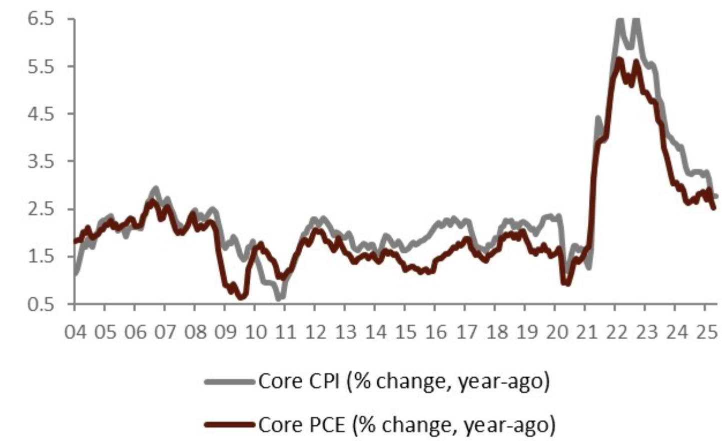


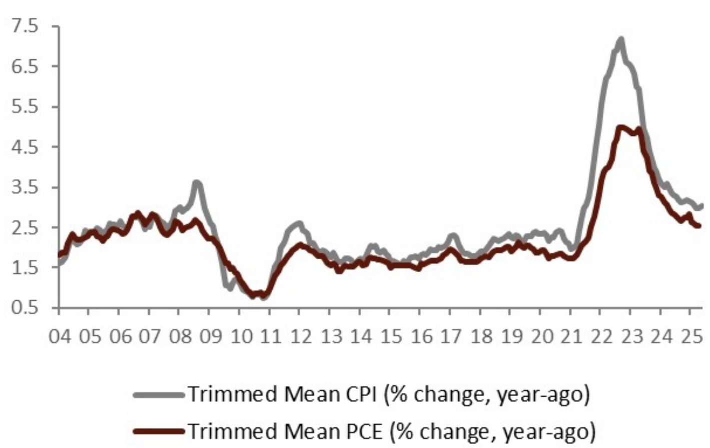


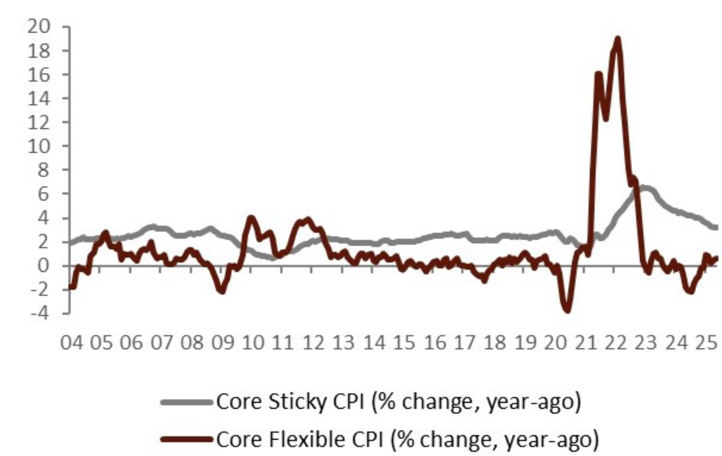


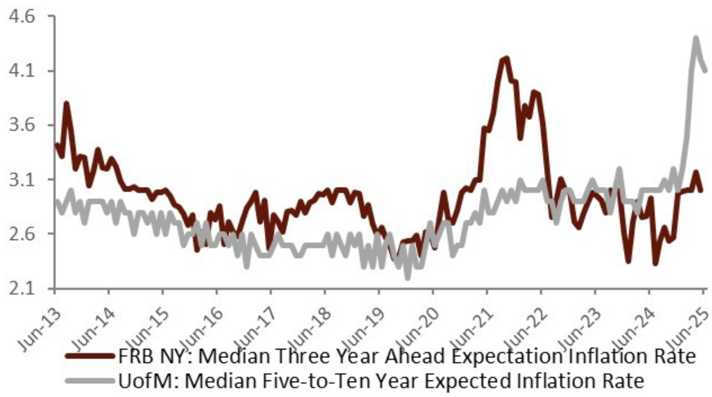
Inflation indicators







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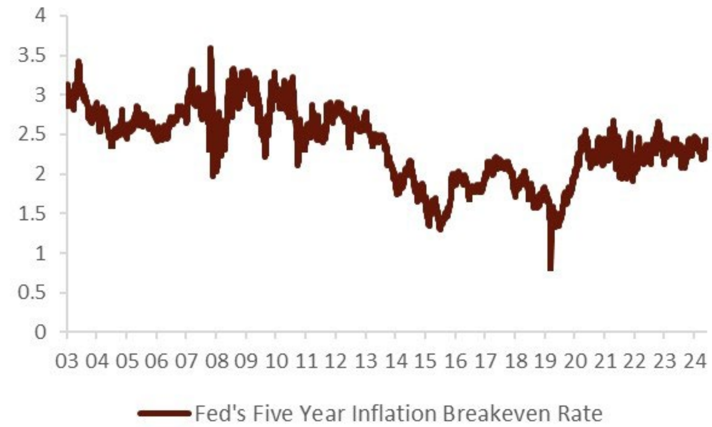
FRB NY: Median Three Year Ahead Expectation Inflation Rate
UofM: Median Five-to-Ten Year Expected Inflation Rate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Fed's Five Year Inflation Breakeven Rate

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