

Special Coverage: The Fed remains on hold amid tariff uncertainty

Key takeaways

- ◆ As expected, the Federal Reserve kept the federal funds rate target range unchanged at 4.25%-4.50%. The FOMC continues to try to balance the recent weaker economic data and the rising risk of recession with concerns surrounding tariffs and the potential for an acceleration in inflation.
- ◆ Even with a likely deterioration in the future growth-inflation trade-off, we continue to expect three 0.25% rate cuts this year, in June, September and December. However, if the May jobs data don't show evidence of softening (in the unemployment rate, net employment growth, or both), then the FOMC may keep policy rates unchanged again in June.
- ◆ For fixed income investors, despite the potential for some near-term tariff inflation, any back up in market rates continues to provide a tactical opportunity. For US equity investors, the widespread use of tariffs and the potential for accelerating inflation continue to dampen the outlook for corporate profits and economic growth in 2025. The sizable downward revision to corporate profits should incorporate any potential slowdown in economic growth and tighter corporate margins if tariffs are enacted and companies choose to assume part of the increased price levels. Until the tariff policy decisions are finalised, it seems US equities may remain volatile and the outlook for corporate profits uncertain. For now, we remain neutral on US equities.



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What happened?

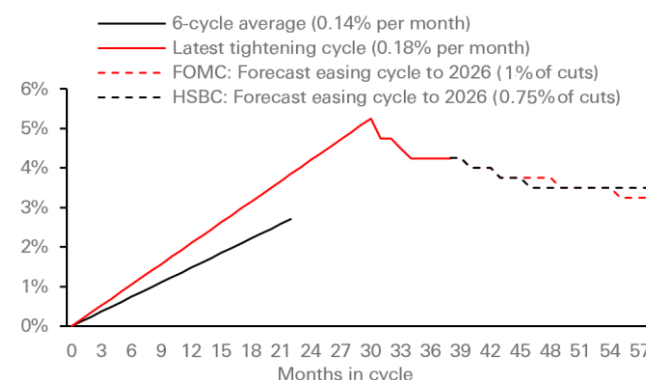
- As expected, the Federal Reserve kept the federal funds rate target range unchanged at 4.25%-4.50%. This marks the third consecutive meeting where the FOMC remained on pause.
- There were no new economic projections delivered at this meeting as the new Summary of Economic Projections (SEP) will be published at the next meeting in June.
- Mr. Powell repeated that "FOMC policy is in a good place, the Fed isn't under pressure to move, and they don't know where trade policy is headed -- but for now 'it's a fairly clear decision for us to wait and see and to watch'". He also stated that "The underlying inflation picture is good."
- Mr. Powell also said that "current policy is modestly, or moderately restrictive" and recognised that current real rates are "still holding down inflationary pressures -- they're not at neutral". He said, "the effect of tariff hikes on the economy remains highly uncertain". Tariffs, if sustained, "are likely to generate a rise in inflation, a slowdown in economic growth and an increase in unemployment". But "the effects on inflation could be short-lived, reflecting a one-time shift in the price level".

Median of the FOMC economic projections from the last Fed meeting: March 2025

Variable %	Median			
	2025	2026	2027	Longer run
Change in real GDP	1.7	1.8	1.8	1.8
December projection	2.1	2.0	1.9	1.8
Unemployment rate	4.4	4.3	4.3	4.2
December projection	4.3	4.3	4.3	4.2
PCE inflation	2.7	2.2	2.0	2.0
December projection	2.5	2.1	2.0	2.0
Core PCE inflation	2.8	2.2	2.0	
December projection	2.5	2.2	2.0	
Memo: Projected appropriate policy path				
Federal funds rate	3.9	3.4	3.1	3.0
December projection	3.9	3.4	3.1	3.0

Source: Federal Reserve, HSBC Global Private Banking and Wealth as at 7 May 2025. Forecasts are subject to change.

Will the most aggressive Fed tightening ever result in aggressive easing as well?



Source: Bloomberg, HSBC Global Private Banking and Wealth as at 7 May 2025. Forecasts are subject to change.

- Regarding inflation, Mr. Powell stated “It’s also possible that the inflationary effects could instead be more persistent. Avoiding that outcome will depend on the size of the tariffs, on how long it takes for them to pass fully into prices and ultimately on keeping longer-term inflation expectations well anchored”. Regarding inflation expectations, “Near-term measures of inflation expectations moved up as reflected in both market and survey-based measures. Survey respondents including consumers, businesses and professional forecasters point to tariffs as the driving factor. Beyond next year or so, however, most measures of longer-term expectations remain consistent with our 2% inflation goal”.
- The “soft data”, which include surveys for consumers and businesses, are much weaker than the “hard” data on the US economy. In 1Q25, the US economy contracted -0.3% q-o-q, SAAR. However, imports had a -5.0% contribution to 1Q25 GDP as companies front-loaded imported goods to avoid tariffs. Final sales to domestic purchasers (GDP less inventories and trade) rose 3.0% in 1Q25 and 2.9% in 4Q24.
- May payrolls rose +177K, which was above consensus and the prior month. The unemployment rate in May remained at 4.2%, still close to the 56-year low of 3.4%. On the inflation side, payrolls provided some relief as average hourly earnings rose only 0.2% in the month and slowed to 3.8% y-o-y.
- The fear of tariffs has resulted in downward earnings revisions. According to FactSet, S&P 500 consensus earnings are now forecast to rise +9.5% in 2025, which is down from +14.8% at the beginning of the year. For 2026, analysts have also cut earnings forecasts due to the fear of tariffs, slower growth, and faster inflation. Consensus 2026 earnings now stand at +11.1%, down from +14.2%. The downward revisions are concerning and have led to a re-pricing of equities.
- We still see risks to inflation due to tariffs and that slower economic growth and a higher unemployment rate are likely to nudge the Fed towards easing soon. We continue to expect three 0.25% rate cuts this year, in June, September and December, followed by no change in policy rates in 2026.

Investment implications

- For fixed income investors, despite the potential for some near-term tariff inflation, any back up in market rates continues to provide a tactical opportunity. While the disinflation process is occurring more slowly than had been forecast, it seems that the Fed is content with inflation heading toward 2%, despite short-term fears of tariffs-inspired inflation. As a result, Fed policy easing should resume soon.
- For US equity investors, the widespread use of tariffs and the potential for accelerating inflation continues to dampen the outlook for corporate profits and economic growth in 2025.
- The sizable downward revision to corporate profits should incorporate any potential slowdown in economic growth and tighter corporate margins if tariffs are enacted and companies choose to assume part of the increased price levels. Until the tariff policy decisions are finalised, it seems US equities may remain volatile and the outlook for corporate profits uncertain.
- Valuations are now much more reasonable, and market sentiment is fairly weak, suggesting that perhaps the worst of this repricing of US equities may be behind us soon.
- It’s important to remember that despite the near-term risks, 2026 forecast for S&P 500 corporate earnings show a sharp acceleration to 11%, providing upside for a market where valuations now seem much more reasonable. Moreover, the Fed is likely to resume easing monetary policy soon, which has historically been quite accretive to earnings and a boost for US equities.

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