

Fiscal Fire, Monetary Ice (for Now)

With a robust U.S. economy, above-target inflation, and continued tariff uncertainty, the FOMC kept its key interest rate at 4.25–4.50%.

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Topic

Market Events

Key takeaways

- At the headline level, the U.S. economy appears robust, although we view the second-quarter growth rebound as largely a reflection of volatility from trade-policy shocks.
- While progress has been made in reducing tariff-related uncertainty, the key question remaining is how much of the cost of tariffs will be passed on to consumers.
- Barring a labor market shock or concern over Fed independence, we expect possibly one rate cut later this year.

Today, the Federal Open Market Committee kept the federal funds rate stable—“on ice”—at 4.25–4.50%. U.S. fiscal policy has remained loose, and passage of the One Big Beautiful Bill Act looks to be adding fuel to the fire. The act is estimated to contribute up to 1% to U.S. economic growth in its first year, with the marginal contribution decreasing over time. At the headline level, the U.S. economy appears robust: Unemployment remains stable, real earnings continue to grow, and corporate earnings have proven resilient.

Digging deeper, though, there are areas of concern. Inflation, in particular, remains above the Federal Reserve’s (Fed’s) 2.0% target, with the headline [Consumer Price Index](#) rising to 2.7% year over year in June. Also, while the second-quarter growth data released today shows that net U.S. exports turned from negative in the first quarter to positive in the second, private inventories show the opposite. From our perspective, the sharp growth rebound is less a sign of economic strength than a reflection of volatility from trade-policy shocks.

Also beneath the surface, two key U.S. labor market trends are emerging. First, corporations remain hesitant to reduce headcount following the post-COVID labor shortages, which continues to exert upward pressure on wages. Second, immigration policies are increasingly influencing labor statistics. On the inflation front, shelter price inflation has been moderating, but this is being offset by rising prices for goods—especially in sectors most affected by tariffs, like household goods—and an acceleration in sticky prices. On the corporate side, the Business Activity sub-index of the [Institute for Supply Management Services Purchasing Managers’ Index](#) rebounded to 55, suggesting a reacceleration toward pre-April levels. The services sector remains a relative bright spot while manufacturing continues to struggle. With ongoing tariff uncertainty and declining trade flows between the U.S. and China, further economic slowing cannot be ruled out.

The administration has made incremental progress in reducing tariff-related uncertainty, with key agreements reached with the European Union, Japan, and the U.K. and a continued pause in escalation with China. However, the details matter. With a headline 15% tariff rate and additional sector-specific levies, the key question is how much of this cost will be passed on to

consumers. In the first quarter of 2025, annualized U.S. import tariffs represented 15% of nonfinancial corporate after-tax profits—a significant burden.

Barring a major labor market shock or renewed concerns over Fed independence, we expect the central bank to maintain a “wait and see” stance with possibly one rate cut later this year. The interest rate market currently anticipates a federal funds rate reduction to around 3.9% by year-end 2025. Much will depend on how the trade-off between inflation and growth evolves. If growth weakens further, the Fed may be inclined to cut rates to support the economy. However, if growth remains resilient, it will be difficult to justify easing with inflation still elevated.

In terms of market positioning, we expect equity performance to remain dispersed. We favor a barbell strategy: overweighting relatively tariff-insensitive sectors, growth equities (especially those benefiting from the artificial intelligence theme), and emerging markets given expectations of continued dollar weakness. Our outlook on high-quality bonds remains neutral, with a preference for shorter maturities at this stage.

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