US Daily: Our Fed Views vs. Market Pricing After the Employment Report (Mericle / Marshall / Zu)

- We pushed back the final three rate cuts in our Fed forecast on Friday morning in response to the strong December employment report, which alleviated some of the lingering concerns about recent labor market softening. We now expect two cuts this year in June and December and one more in 2026 (vs. three this year previously) to an unchanged terminal rate of 3.5-3.75%.
- Our baseline forecast remains somewhat more dovish than market pricing mainly because we are more optimistic than many that the underlying inflation trend will continue to fall toward 2%. But it is hard to have great conviction in the timing of cuts because the economic data we expect—a healthy labor market and lower inflation—would make cuts reasonable but not critical, and because it is hard to know how the FOMC will navigate likely tariff increases.
- We have more conviction that market pricing as a statement about the probability-weighted path of the funds rate over the next few years across many possible scenarios is too hawkish, and in particular that the market-implied probability of rate hikes is too high. This reflects both our inflation optimism and our view that the implications of the new administration's policies for interest rates are not as strongly and unambiguously hawkish as widely assumed. We do not expect fiscal or immigration policy changes to boost inflation appreciably, and we find it hard to envision tariffs that raise inflation enough to make a plausible case for hiking that do not also unsettle the equity market, as even much smaller tariffs did in 2019.

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Our Fed Views vs. Market Pricing After the Employment Report

We pushed back the final three rate cuts in our Fed forecast on Friday morning in response to the strong December employment report. We now expect two cuts this year in June and December and one more in 2026, which we have penciled in for June (vs. three this year in March, June, and September previously), to an unchanged terminal rate of 3.5-3.75% (the dark blue line in Exhibit 1).

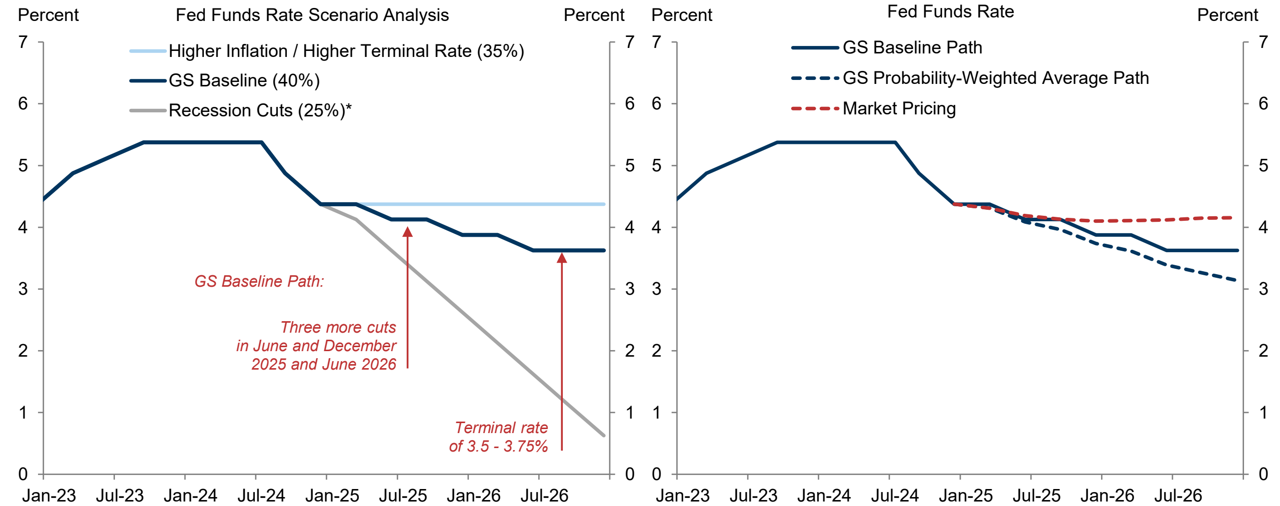
We made the change because the employment report alleviated some of the lingering concerns about recent labor market softening. The unemployment rate fell 15bp to 4.1%, our estimate of trend job growth based on payroll and household employment growth rose to 192k per month, the job-finding rate rebounded, and job openings have now been roughly stable at a healthy level for the last half year.

We still expect year-on-year core PCE inflation to fall almost 0.3pp by the March meeting, which would allow the FOMC to cut if it wants. But the stronger labor market data have taken away any urgency, and we suspect that uncertainty about potential tariff increases will deter the FOMC from cutting for now.

Our baseline forecast remains more dovish than market pricing mainly because we are more optimistic than many that the underlying inflation trend will continue to fall toward 2%, and in that scenario we think the FOMC will want to lower the funds rate from a level that it sees as meaningfully restrictive. But it is admittedly hard to have great conviction in the precise timing of cuts because the economic data we expect—a healthy labor market and lower inflation—would make cuts reasonable but not critical, and because it is hard to know how the FOMC will react in the near term to uncertainty about possible tariff increases and later to any one-time effects of tariffs on inflation as they are implemented.

We have more conviction that market pricing as a statement about the probability-weighted path of the funds rate over the next few years across many possible scenarios is too hawkish. The gap between market pricing (the red dotted line on the right of Exhibit 1) and our probability-weighted Fed forecast (the dotted dark blue line on the right of Exhibit 1) is now meaningful.

Exhibit 1: Market Pricing Is Now Meaningfully More Hawkish Than Our Baseline and Especially Our Probability-Weighted Fed Forecast

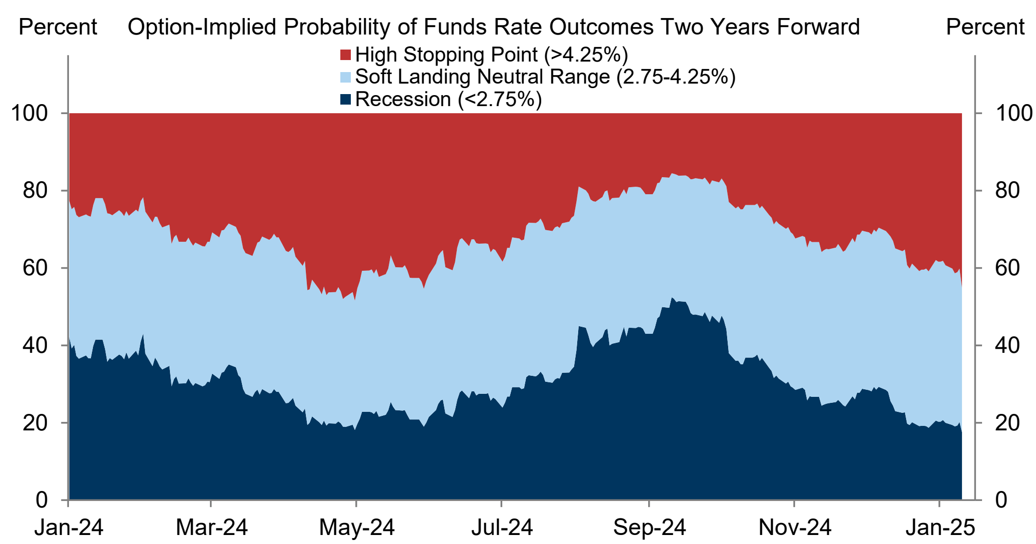


*This is the probability of a recession happening at any point over the horizon shown above. Our 12-month recession probability is 15%.

Source: Goldman Sachs Global Investment Research

Why is market pricing of the funds rate path so high, showing only one cut over the next few years? Exhibit 2 uses options to show what probabilities the market attaches to the funds rate being in various ranges two years forward. As the market greatly reduced the probability weight it attached to levels of the funds rate that likely correspond to recession scenarios, it reallocated that weight to scenarios where the funds rate stays quite high instead of to an intermediate range that the FOMC might plausibly see as neutral and where it would likely want the funds rate to settle in a soft landing.

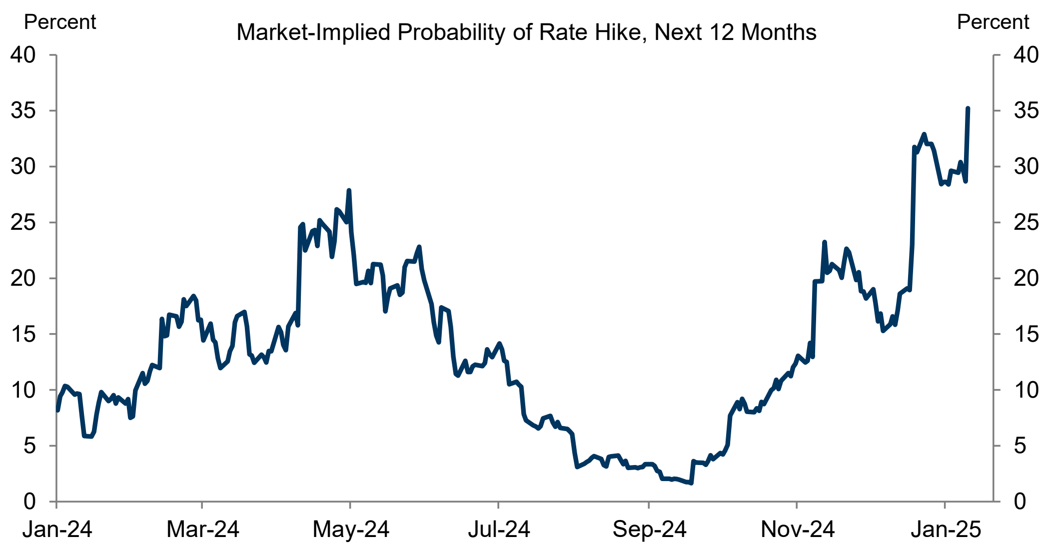
Exhibit 2: As the Bond Market Has Come to See Less Probability of Recession, the Weight Once Attached to That Scenario Has Shifted to Scenarios Where the Funds Rate Stays Quite High



Source: Goldman Sachs Global Investment Research

In particular, over the last several months the implied probability of rate hikes over the next year has risen sharply (Exhibit 3). There is a risk premium in these numbers that means the 35% implied probability shown in the chart should not be taken exactly at face value, but we see this as much too high. And while the starting level of the funds rate has fallen since the election, a hike from any of those starting levels would be a significant development and not meaningfully less so from today's policy rate.

Exhibit 3: The Market-Implied Probability of a Rate Hike Over the Next Year Has Risen Sharply Since the November Elections and Is Now Much Too High, in Our View



Source: Goldman Sachs Global Investment Research

Much of our disagreement with market pricing likely arises from differing views about the impact of policy changes under the second Trump administration on inflation, GDP, and monetary policy. A survey of investors that we conducted after the election suggests that investors expect roughly the same changes to fiscal, immigration, and trade policy as we do. The disagreement is instead about the impact that these policy changes will have on the economy and interest rates. While many investors appear to see the implications for interest rates as strongly and unambiguously hawkish, we do not.

The tax cuts and other fiscal policy changes that we and most investors expect would leave the budget deficit little changed, and their impact on GDP would be offset and likely modestly outweighed initially by the hit from tariffs and lower immigration. While we are forecasting moderately above-consensus GDP growth in 2025 and a small further decline in the unemployment rate this year, standard estimates of the slope of the Phillips curve imply that this is worth only a few basis points on inflation.

Tighter immigration policy is also unlikely to have a large effect on inflation now that the labor market is back in a normal balance. Most of the decline in immigration flows has actually already happened, we expect immigration to end up only moderately below the pre-pandemic rate, and the net effect of immigration on inflation is modest because immigrants add to both supply and demand.

Tariffs could have more noticeable effects on inflation, but the tariffs we expect would raise prices by just 0.3%, these would be one-time effects, they would come on top of a falling underlying trend and likely cause inflation to fall by less rather than rise, and they should be fairly easy to spot in the category-level details, so that it would be clear that the underlying inflation trend excluding tariffs is still falling. While tariffs could easily delay rate cuts, we are quite skeptical that Fed officials would want to hike in response to a one-time tariff effect on inflation, especially from a starting point they see as restrictive.

More extreme tariff scenarios than we include in our baseline, such as a universal 10% tariff, would raise consumer prices more substantially. But we find it hard to envision tariffs that raise inflation enough to make a plausible case for hiking that do not also unsettle the equity market, as even tariffs less than one-fifth as large as the proposed universal tariff did in 2019, and hit GDP growth quite hard. The lessons of that 2019 experience, when the FOMC ended up cutting rather than hiking, should be taken seriously.

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Disclosure Appendix

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We, Jan Hatzius, Alec Phillips, David Mericle, Ronnie Walker, Manuel Abecasis, Elsie Peng and Jessica Rindels, hereby certify that all of the views expressed in this report accurately reflect our personal views, which have not been influenced by considerations of the firm's business or client relationships.

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