The Fed and Liquidity Markets: Steady Through the Noise

FEATURING

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Uncertainty driven by the Trump administration's revised trade policy has resulted in heightened volatility in interest rates and risk assets. Recent core readings have shown meaningful progress on services inflation but are likely biased to be higher over the next several quarters as goods prices adjust to implemented tariffs. With inflation still sticky and above target, the Fed will likely wait for more incoming data before returning to rate cuts in the second half of 2025. Away from the policy rate, the Fed will rely on a broad toolkit to address any further dysfunction in the Treasury market. Short duration strategies remain an attractive option for investors seeking to take advantage of high-quality opportunities within corporate and consumer credit while minimizing exposure to interest-rate volatility.

Growth

- While US recession risks have decreased since April 2 ("Liberation Day"), they are still higher than they were on April 1.
- Street estimates call for tariffs to have a -1% to -3% impact on GDP, which would likely be seen in the middle of 2025 or early 2026.
- Fiscal and regulatory initiatives of the Trump administration are likely to offset some negative impacts of tariffs, but their effects won't be felt for several quarters.
- Increased business and consumer uncertainty will likely lead to slowed or delayed capital investment, conservative hiring decisions and tepid consumer spending.
- The labor market remains vulnerable to the considerable uncertainties emanating from trade policy.

Inflation

- The market expects higher inflation over the next year due to tariffs but anticipates lower inflation over the longer term as tariff effects may dampen the economy.
- Recent inflation data has been benign, but the impact of tariffs on goods pricing is expected to become evident in the coming months.
- Cutting rates while inflation remains above target carries the risk of de-anchoring broader inflation expectations.
- A significant drop in oil prices could weigh on the headline Consumer Price Index (CPI) and potentially influence core inflation measures, helping to mitigate some inflationary pressures.

- There is a divergence between market-based and survey-based measures of inflation: market-based measures are more restrained as compared to rising survey-based expectations.

Fed Policy

- Inflation uncertainty will keep the Federal Reserve (Fed) on hold in the first half of 2025, but slowing growth and further softening in the labor market will allow for three 25-basis-point rate cuts by year-end.
- To ensure proper market functioning and liquidity, the Fed has multiple tools at its disposal, including the standing repo facility, the discount window and foreign exchange swap lines, and is prepared to act preemptively.
- The Fed will continue to prioritize monitoring the impact of debt ceiling negotiations and potential increased issuance of cash management bills on liquidity conditions.
- The supplemental leverage ratio may be adjusted to exclude US Treasury (UST) holdings and reserves to enhance banks' ability to intermediate in the markets.

Liquidity Market Outlook/Positioning

- Elevated levels of interest-rate volatility are likely to persist in the near term.
- Liquidity and short duration strategies may be compelling for investors that wish to take advantage of high-quality corporate and consumer credit spreads while minimizing exposure to interest-rate risk.
- The ongoing debt ceiling negotiations and the potential for increased issuance of short-term USTs may impact liquidity conditions, with the Fed closely monitoring these developments.
- We view money market funds and short-duration assets as attractive due to wider spreads on CDs, commercial paper and floating-rate securities.