US Economic Update 26 August 2025

US Fed – September cut but still see gradual easing

- We expect the first Fed rate cut (of 25bps) will now be in September, as the Fed sees rising downside labour market risks and as it manages political risks.
- Our broader outlook is little changed. We still expect a total 50bps of cuts by the end of this year, and a further 75bps in 2026. This would leave the target range at 3.00-3.25% - around what the Fed considers neutral.
- The challenges facing the Fed have not changed - with elevated inflation and (expected) rising unemployment to push the Fed in opposite directions.
- We still expect a gradual easing cycle as the Fed manages the risk of second-round inflation effects from tariffs and navigates considerable political pressure. Uncertainty around the forecast profile is wider than normal.

Changing risks lead to a Sept cut

Following the July employment report, which indicated there has been a major weakening in jobs growth, markets now price a September cut as highly likely. Even before these labour market data, there were two dissents at the July FOMC meeting (both calling for a rate cut) and subsequent Fed commentary indicates more members are now open to a September meeting rate cut.

A September cut had been a clear risk to our earlier October and December forecasts, and following Fed Chair Powell's Jackson Hole speech it is now the central case.

Previously Powell had indicated that the 'main [labour market] number' to look at was the unemployment rate. However, in July it stayed in the same range it has been in for a year. With changes in immigration policies affecting labour supply, the unemployment rate (and other slack variables) provides a better read on how the Fed is tracking against its full employment mandate and whether output is moving below potential (which might lower inflation risks).

At last week's Jackson Hole speech, while Powell maintained the view that the weakening in jobs growth is being accompanied by weaker labour supply (due to a 'sharp fall off in immigration') he sees this dynamic as leading to a risk of higher layoffs and unemployment.

Powell also reinforced his previous comments that a reasonable base case was that tariffs would only have a one-off impact on prices. He argued that, given that the labour market 'is not particularly tight' and facing downside risks, the risk of adverse wage-price dynamics was not high.

Powell's comment that "…with policy in restrictive territory, the baseline outlook and the shifting balance of risks may warrant adjusting our policy stance" opens the way to a September cut. At the June meeting, the majority of Fed members thought the Fed would cut rates by 50bps this year so a September rate cut does not represent a major shift. While some members may prefer to wait a little further for more information (e.g. to confirm that the unemployment rate is rising as expected), a move in September versus one in October has few implications for the economy, but would acknowledge the shifting assessment of the balance of risks and guard against reputational damage in the event unemployment starts to rise.

Beyond September

While the FOMC may view that the balance of risks has evolved, the unemployment rate does remain low. It is not clear that an output gap in the economy (or labour market) has opened up yet. Inflation remains elevated and is likely to push higher and remain above target through 2026.

Whether there are more permanent impacts on inflation from tariffs remains uncertain – while Powell leaned more into the view that tariffs would only lead to a one-time adjustment to prices, he indicated that it remains '…a risk to be assessed and managed'.

While 50bps of cuts this year could be justified on a changing risk assessment and likely balances the risk of hawkish and dovish dissents in a divided committee, further adjustments beyond this would require more obvious spare capacity in the labour market. Activity data so far for Q3 is holding up, also reducing the pressure for a series of consecutive cuts this year.

As we expect the unemployment rate to rise – peaking in early 2026 at around 4.5% – we expect Fed rate cuts to continue into 2026. With inflation expected to remain above target, but to moderate over 2026, this points to a gradual easing cycle of -25bp per quarter as the Fed continues to balance the risks to both sides of its mandate.

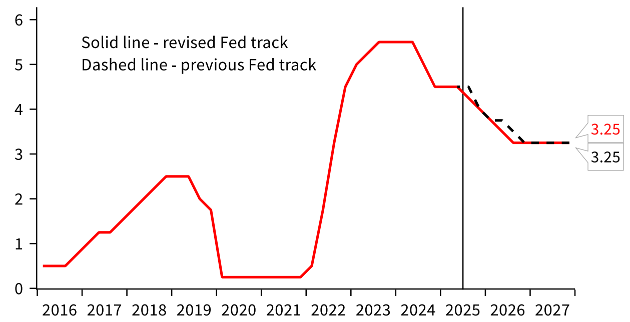
This is slightly faster paster of easing than we had previously assumed (which had rate cuts in 2026 more back ended). However, recent developments highlight the sensitivity of the Fed to labour market weakness. An unemployment rate above its long-term level will argue against keeping policy at restrictive levels.

Moreover, membership of the FOMC is likely to become more dovish given that President Trump will prioritise this in any appointments. This is already evident in departing Governor Kugler's proposed temporary replacement (Stephen Miran). There will also be a new Fed Chair from May, and Powell may also resign from the committee at that time. President Trump has also announced he will remove

Governor Cook, although Cook has indicated she will challenge Trump's decision.

We still see the trough for rates is a target range of 3.00 to 3.25%; around the FOMC's (median) view of its nominal neutral level. The unemployment rate should start to decline later in 2026 but is not expected to be so far from neutral that the Fed needs to be more aggressive, given that inflation is unlikely to dip below target.

Fed funds rate (top of target range, end quarter %)



Source: National Australia Bank, Macrobond

Risks

Major policy shifts have occurred in the US this year – including trade, immigration and a major budget bill. While growth in the economy slowed in H1 and is expected to remain weak in H2 before improving in 2026, the full economic impact of these changes remains highly uncertain. This includes for inflation and labour market indicators and so, by implication, makes the uncertainty bands around any Fed forecast wider than normal.

For the September meeting we think that a strong labour market report for August would be necessary to see the Fed hold policy unchanged. Conversely, Powell's Jackson Hole comment that the Fed will move carefully argues against the chance of a 50bp cut, unless the August employment report produces another major (downside) change in labour market perceptions.

Our baseline forecast sees a gradual rise in the unemployment rate over the rest of this year and into 2026. Given the Fed's sensitivity to labour market weakness it is possible evidence of a weakening labour market could see the Fed deliver a series of consecutive cuts.

On the other hand, we expect the FOMC will require the data to make a positive case for further easing as we move into 2026. With still material inflation risks and early Q3 partial activity data on the positive side, further resilience in the data could see the Fed on hold sooner than we expect if the balance of risks swings back towards inflation.

Signs that tariffs will have more persistent impacts on inflation (as opposed to our forecast assumption of one-off price level shift) could also bring an earlier than expected pause. We also assume that changes in immigration (and possibly net outwards migration) will have a neutral impact on inflation as it affects both supply and demand; however, with some sectors of the economy more reliant on migrants then it is possible there will be some net inflationary impact.

To sum up, the risk around our revised Fed track are skewed towards more cuts in the near term but for the Fed to pause at a higher level of the fed funds rate. An FOMC more inclined to tolerate some inflation risk in service of their full employment mandate also reduces the risks they will be required to play catch up with fast or deeper cuts later.

The political backdrop also represents a major asterisk. Our forecasts assume that the FOMC continues to operate within a normal policy and analytical framework – it may lean dovish but will ultimately set policy with reference to meeting its inflation/full employment mandate with a conventional view of how policy affects the economy and how policy should respond to changing conditions. If new appointments cause the Fed to move in another direction (e.g. they are motivated to get Treasury borrowing costs down) then this is different scenario which could have far reaching consequences for financial markets and the economy.

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