Interest Rates Focus

14 May 2025

Fed in no hurry to cut; but the path remains for lower Fed funds rate

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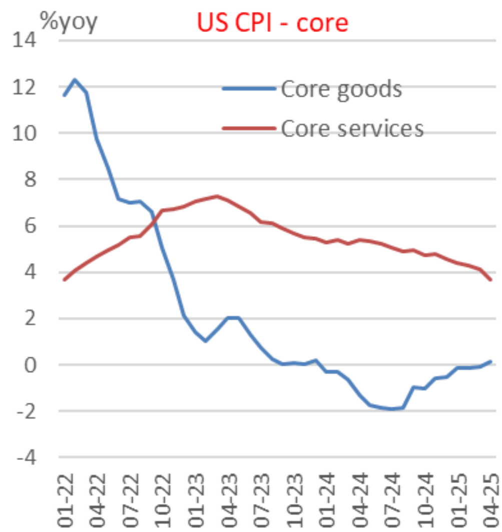
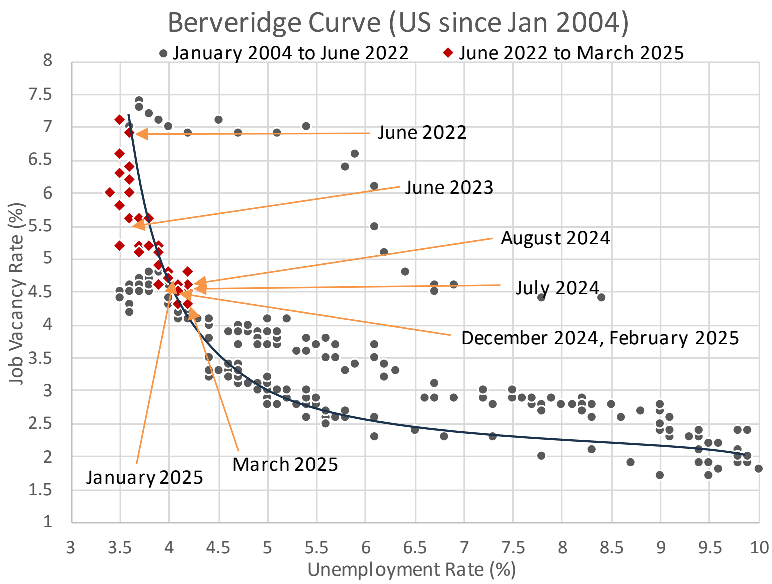
- Market has pared back Fed rate cuts expectation upon favourable development on the trade front, with the recent trade deals seen as reducing the risk of US recession. Meanwhile, April CPI showed the disinflation progress continued in a very gradual manner which drew little market reaction. We have been of the view that triggers for rate cuts will likely need to come from the labour market/growth front; continued cooling in the labour market will justify rates at less restrictive levels as long as there is no strong rebound in inflation. Our house view is for a US slowdown although we do not expect an outright recession in 2025. IMF's 2025 US GDP forecast of 1.8% is more bullish than our forecast of 1.3%. Given the macroeconomic outlook, our base-case remains for three 25bp Fed funds rate cuts this year. However, with the FOMC in no hurry to cut rates while the cooling in the labour market has been a slow process, **we have pushed our expectation for the next Fed funds rate cut to Q3. We now expect one 25bp Fed funds rate cut in Q3 and two 25bp Fed funds rate cuts in Q4**, instead of one 25bp cut each in Q2, Q3 and Q4.



Source: CEIC, OCBC Research

- **April CPI inflation**. April headline CPI rose by 0.2% MoM versus consensus for 0.3%; index of shelter rose by 0.3% MoM accounting for more than half of the all-items monthly increase. The energy index also increased MoM, as increases in natural gas index and electricity index more than offset a decline in gasoline index. On year-on-year basis, headline CPI inflation eased to 2.3% YoY versus 2.4% YoY prior, but core CPI inflation stayed virtually the same, at 2.8% YoY. Disinflation in core services have continued but core goods emerged from months of YoY deflation to a positive 0.13% YoY offsetting the easing in core services inflation. Overall, the CPI report did little to alter the stance of the Fed for now, which is in no hurry to cut rates.

- **The labour market.** We have been of the view that triggers for rate cuts will likely need to come from the labour market/growth front. Recent labour market indicators suggest the labour market is moving in line with gradual cooling. Although April non-farm payroll at 177K was above consensus expectation, the level itself was not strong. Under the household survey, the unemployment rate stayed at a cyclically high level of 4.2% in April and hourly earnings eased to 0.2%MoM. Under the JOLTS report, March JOLTS job openings rate fell further to 4.3% – this is one of the two variables for the Berveridge Curve which the FOMC monitors. The Berveridge Curve, which plots job vacancy rate against unemployment rate, helps explain the timing of the Fed funds rate cuts in 2024. The latest data point was very near our fitted curve, suggesting the labour market is on track to becoming less tight. Importantly, the job-to-unemployment ratio edged further lower to 1.02x, which means any further drop in job openings may have a more material impact on unemployment.



Source: Bloomberg, OCBC Research

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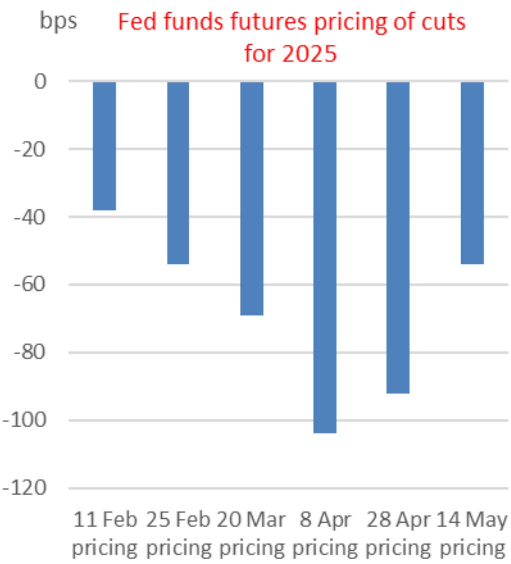
- **Market pricings.** Market has recently pared back rate cuts expectation, to the latest 54bps of cuts for this year, from as much as more than 100bps of cuts priced at some points in April. A rate cut at the June FOMC meeting has been priced out, versus earlier pricing of 41bps of cuts for May and June FOMC meetings combined. The chance of a 25bp cut by July FOMC meeting was last priced at 40%. A rate cut is not fully priced until September FOMC meeting. Polymarket pricing of US recession has fallen from the recent high of 65% in early April to just 38%, reflecting how market fears have shifted. As uncertainty is high on various fronts including trade tensions, and the growth and inflation outlook, market may not be willing to go too much ahead of the curve before the next Fed funds rate cut materialises.

- **UST yields forecasts**. Following from the change of the timing of our expected Fed funds rate cuts and considering the improved market sentiment upon the recent trade development, we have also revised upward mildly our UST yields forecasts. We maintain a downward bias on UST yields on a multi-month horizon.



Source: Bloomberg, OCBC Research

Interest rates forecasts	Q225	Q325	Q425	Q126
FFTR upper	4.50	4.25	3.75	3.50
2Y UST	3.90	3.70	3.50	3.50
10Y UST	4.35	4.15	3.95	3.95

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