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HSBC Asset Management

Fed cuts on weak employment

Investment Event | 18 September 2025

Front-loaded cuts

The Federal Reserve (Fed) opted to cut the funds rate target range by 25bp to 4.00-4.25%. This was the first move since December last year and in line with market expectations. The reduction was widely supported with the only dissent coming from new Federal Open Market Committee (FOMC) member Stephen I. Miran, who preferred a 50bp cut.

The FOMC's statement noted that "growth of economic activity moderated in the first half of the year. Job gains have slowed" but that the unemployment rate "remains low" and "Inflation has moved up and remains somewhat elevated".

The updated FOMC projections showed limited changes to the economic variables:

- GDP was revised up marginally in 2025 and 2026 and is expected to grow broadly in line with its longer run potential rate over the coming years.
- The unemployment rate was kept unchanged at 4.5% and nudged down marginally in the subsequent years.
- Core Personal Consumption Expenditures (PCE) inflation is still expected to be running at 3.1% at the end of 2025 but moderate more slowly in 2026 before returning close to target in 2027.

Figure 1: FOMC median economic projections

	2025	2026	2027	Longer run*
GDP (% yoy)	**1.6**	**1.8**	**1.9**	**1.8**
June 2025 Fed projection	*1.4*	*1.6*	*1.8*	*1.8*
Unemployment rate (%)	**4.5**	**4.4**	**4.3**	**4.2**
June 2025 Fed projection	*4.5*	*4.5*	*4.4*	*4.2*
Core PCE inflation (%)	**3.1**	**2.6**	**2.1**	**2.0**
June 2025 Fed projection	*3.1*	*2.4*	*2.1*	*2.0*
Fed funds rate (%)	**3.6**	**3.4**	**3.1**	**3.0**
June 2025 Fed projection	*3.9*	*3.6*	*3.4*	*3.0*

*Source: US Federal Reserve, figures refer to Q4 * Longer run figure is headline PCE inflation rather than core PCE*

The more noteworthy change was to the FOMC's expectation for policy, with the median forecast now showing a total of three 25bp cuts this year (including September's move) versus only two in the June projections. The median projection remained for one further rate cut in both 2026 and 2027.

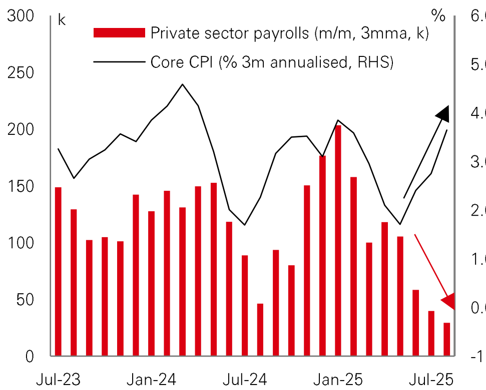
The FOMC's revised path for Fed funds in 2025 is broadly in line with market pricing ahead of the meeting but more hawkish than the three further 25bp cuts the market was pricing for 2026.

Balancing the risks

Chair Powell's comments shed greater light on the FOMC's thinking. He characterised the 25bp reduction in the funds rate as a **"risk management cut"**. Specifically, the Fed has become more concerned about labour market developments.

Chair Powell highlighted that payrolls have slowed significantly, with a good part of that slowdown reflecting "very little growth" in the supply of workers. However, he added that demand for workers has come down more sharply, meaning that **the pace of jobs growth is likely to be below the "breakeven" rate** that is required to maintain stable unemployment.

Figure 2: Stagflation-lite



Source: Macrobond, HSBC AM as of 17 March 2025

The Fed cut by 25bp at its September meeting with its projections hinting at a further 50bp of easing by end-2025

FOMC members have become more concerned about downside risks to employment, which warrant the policy rate being taken to a more neutral level

Fed cuts are an important element supporting risk assets, a further broadening out of market returns, and a softening of the USD, with emerging markets benefitting most

Nonetheless, we need to remain aware of the economic risks. Macro signals point to "stagflation lite" - weaker growth and still-warm inflation.

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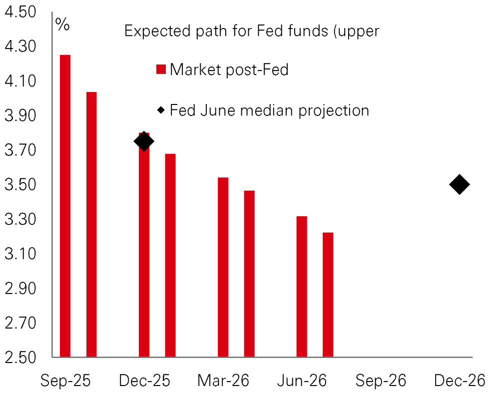
On the inflation front, Chair Powell confirmed that **good price inflation has picked up due to the imposition of tariffs**. Nonetheless, the "passthrough has been slower and smaller" than expected while disinflation has continued in the service sector.

Taken together, **the Fed views the risks to its dual inflation and employment mandates as having become more balanced**; earlier in the year, the upside risks to inflation had been seen as more pronounced. With the downside risks to employment having clearly increased since mid-year, the **FOMC now views it as sensible to reduce the policy rate to a more neutral level** over the coming meetings before slowing the pace of easing in 2026.

Figure 3: Dovish market pricing



Source: Bloomberg, Federal Reserve, HSBC AM as of 17 March 2025

The market reaction to the Fed decision and commentary was limited. **Market expectations for Fed policy were little changed, meaning it still expects a more dovish path for policy than does the median FOMC member in 2026** (Figure 3). At the time of writing, the 10y yield had increased marginally while the S&P500 equity index was down fractionally.

Investment implications

We know from history that Fed easing cycles outside of recessionary events are generally good for risk asset performance. Alongside strong profits data and renewed AI enthusiasm, **the rising likelihood that the Fed would resume cuts this month has boosted investor risk appetite**. This has meant that despite policy uncertainty, many asset classes are trading at year-highs amid low volatility. Double-digit returns are making 2025 a banner year for investors.

In our central scenario we think **Fed cuts are an important element that supports a further broadening out of market returns**. Lower US interest rates provide important breathing space for other global central banks to ease policy, with emerging markets (EMs) benefiting the most. **Fed cuts should also weigh on the US dollar**, again allowing EM central banks to be proactive, and supporting emerging market stocks and local currency bond returns. This is a big reason why EM bonds and stocks have been among the best performing assets in 2025.

Nevertheless, we must be realistic about how much the Fed can ease going forward with inflation proving sticky. The multi-polar world means we are in an economic regime where supply shocks are more important, where growth is more constrained, and inflation is higher and more volatile. As suggested by Chair Powell, **we may be witnessing tactical insurance cuts, rather than a full-blown easing cycle**.

Furthermore, even with rate cuts, **longer-term interest rates in Western markets have been stuck at high levels** given high inflation uncertainty and concerns over government debt sustainability. This means that certain sectors of the economy – notably real estate – that are more geared to long-term interest rates are less likely to benefit from monetary policy easing.

We also need to be aware of the economic risks. **Macro signals point to "stagflation lite" - weaker growth and still-warm inflation**. Investors need to be alert to the risk that "labour market cooling" phase-shifts to "labour market cracking". In this scenario, the Fed cuts more aggressively, but most risk assets are likely to struggle, especially given how much good news is already embedded in market prices.

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Content ID: D054742; Expiry Date: 18.03.2026