



## Fed faces crucial test

Rarely has the US Federal Reserve been as divided as it is ahead of next week's meeting. We examine whether the doves will prevail and interest rates will be cut again, and how the battle for the Fed's independence is shaping the interest rate outlook for 2026.

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### The Fed is divided

Will the US Federal Reserve cut interest rates further? Following the steps taken in September and October, the next course of action is unclear. At the press conference after the October meeting, Fed Chair Powell explained that there were “strongly different views about how to proceed in December” within the Federal Open Market Committee. A further cut at the December meeting is by no means a foregone conclusion – “far from it,” according to Powell.

The minutes of the meeting, which have since been published, confirmed this assessment. This is because “several” participants were of the opinion that a further interest rate cut in December could well be appropriate. “Many” participants, on the other hand, expressed the view that it would probably be appropriate to leave interest rates unchanged for the rest of the year. Since in Fed speak ‘many’ is more than ‘several’, those who tended to favor unchanged interest rates in December predominated among the meeting participants. This is an interesting point, even if not all meeting participants are entitled to vote.

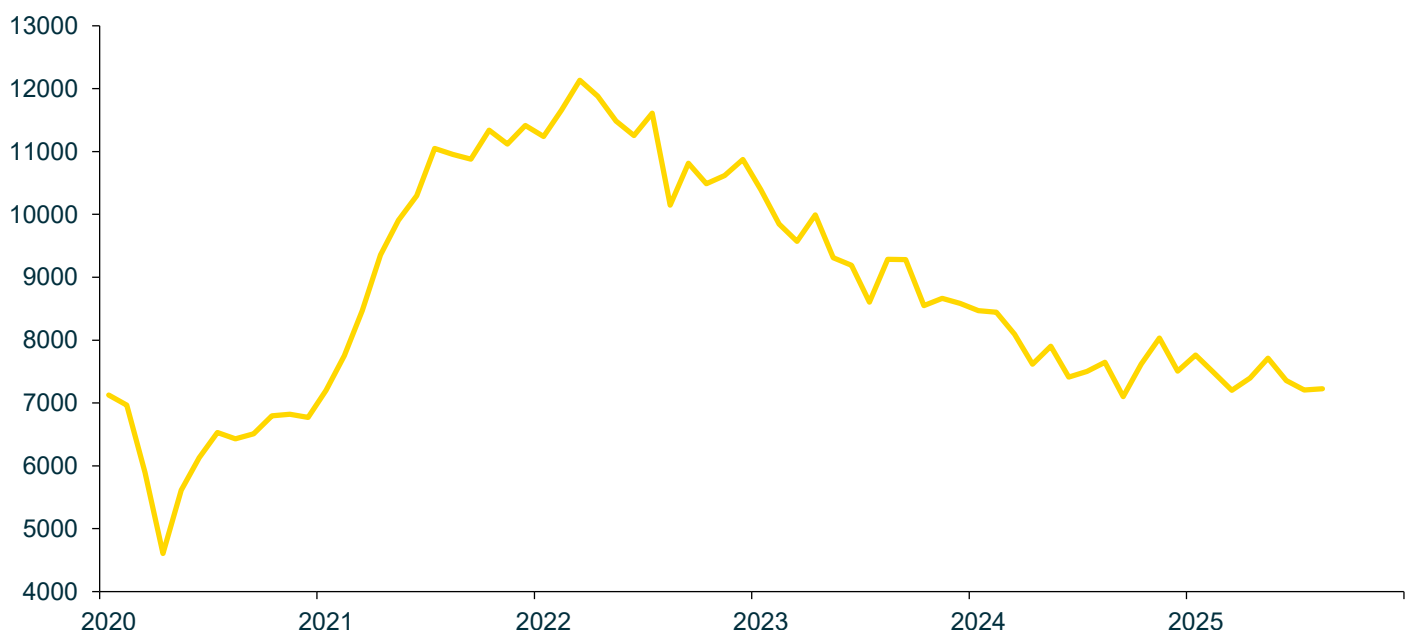
### What are the arguments?

The Fed's decision is so difficult because both the goal of maximum employment and that of price stability are at risk, but the necessary interest rate moves would go in opposite directions. The focus of the discussion is primarily on the labor market. A slowdown is clearly visible here. However, the decisive factor is whether this is due to lower supply of or weaker demand for labor.

Certainly, employment growth has also slowed because immigration has declined sharply, meaning that fewer people are entering the labor market. However, influential Governor **Waller** and we do not consider this to be the decisive factor. After all, an increasing shortage of labor would have led to a rise in the number of job vacancies and upward pressure on wages. However, neither of these developments has been observed. In fact, the number of job vacancies has fallen rather than risen recently (Chart 1). The same applies to average hourly wages. The slower growth in employment this year is therefore more likely to be due to a decline in demand for labor by companies.

#### Chart 1 - No increase in job openings

job openings, seasonally adjusted monthly figures, in thousand



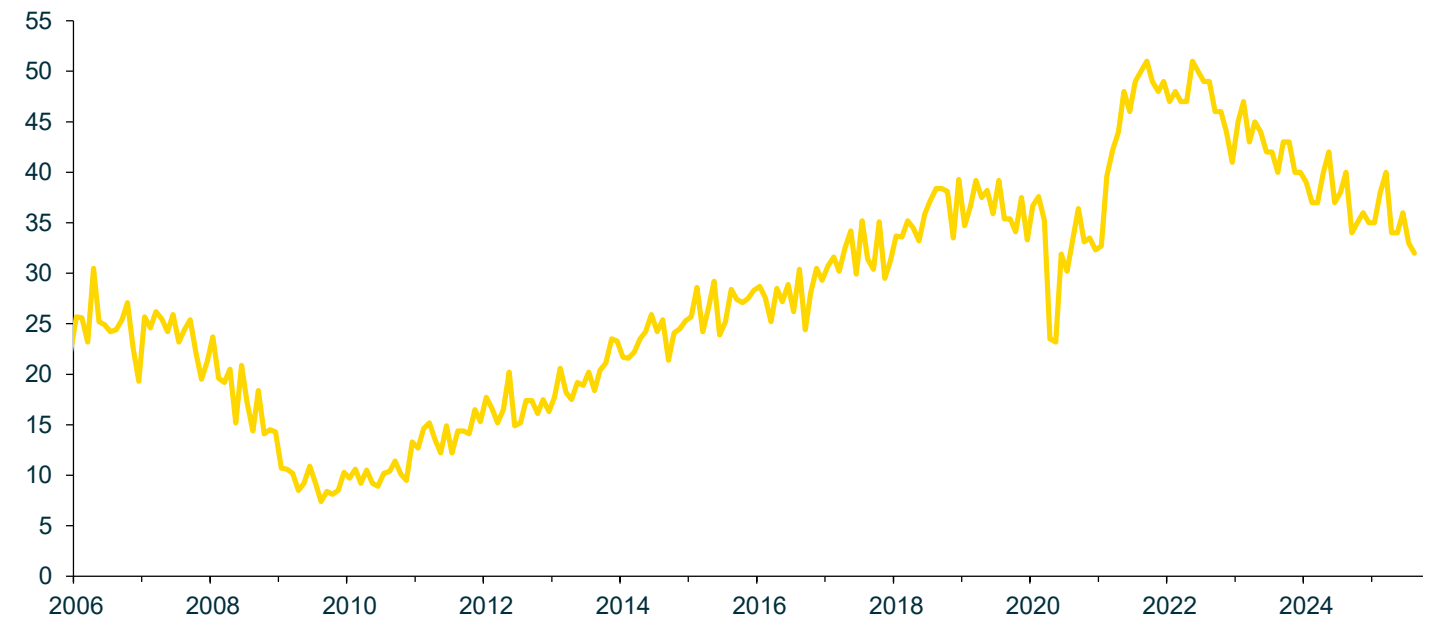
Quelle: BLS, S&P Global, Commerzbank Research



Surveys point in the same direction. Consumers report that it has become more difficult to find a job. Conversely, companies say that it has become easier to fill vacancies. This is evident from a survey conducted by the National Federation of Independent Business NFIB (Chart 2).

### Chart 2 - Fewer small businesses report problems in filling vacancies

NFIB survey, share of companies which report at least one hard to fill job opening, in %



Quelle: NFIB, S&P Global, Commerzbank Research

Many Fed officials are also concerned about the rise in the unemployment rate to 4.4% in recent months. Excluding the peak of the pandemic in 2020/21 as a special situation, it was last higher in February 2017.

Potential advocates of unchanged interest rates, on the other hand, tend to point out that inflation has been above target for a long time (Kansas City Fed President Jeffrey Schmid and, similarly, Governor Michael Barr). Boston Fed President Susan Collins sees no urgency for interest rate cuts given the buoyant financial markets. And St. Louis Fed President Alberto Musalem warned that the Fed must be cautious as he sees only limited room for further interest rate cuts before monetary policy becomes too loose.

### Which camps have emerged at the Fed?

In recent weeks, three camps have formed among the twelve voting members of the Federal Open Market Committee (the seven governors from the Federal Reserve Board plus five of the twelve regional Fed presidents). We have grouped them according to our interpretation of their respective statements, with the members of the central board in bold:

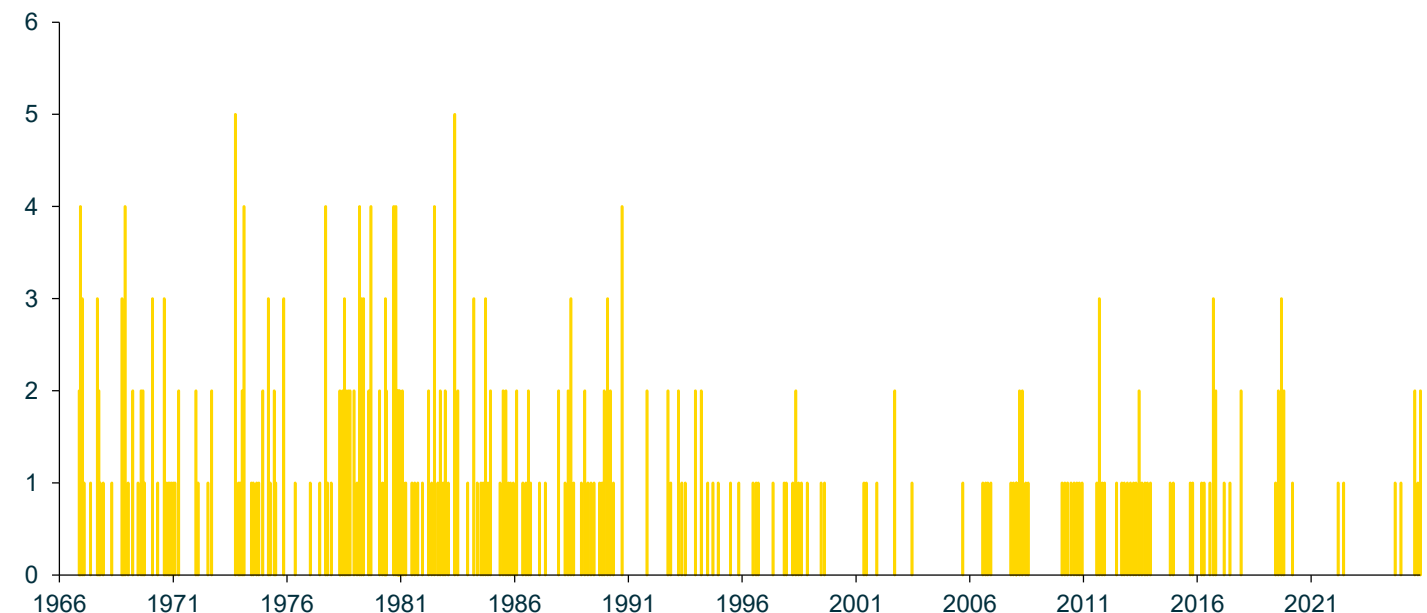
- In favor of rate cut in December: **Waller/Miran/Bowman**/Williams
- Unclear: **Powell/Cook/Jefferson**
- Rather against rate cut: **Barr**/Collins/Schmid/Musalem/Goolsbee

In purely numerical terms, the camp in favor of unchanged interest rates is currently slightly ahead. However, the governors seem to be leaning more toward an interest rate cut, as does the influential president of the New York Fed, John Williams. The decisive factor is likely to be which way Fed Chair Powell leans and how successful he is in persuading other members to follow him. In any case, there could be a historic number of dissenting votes at the December meeting. The last time there were three dissenters from the majority opinion was in 2019, four in 1990, and five in 1983 (Chart 3).<sup>[1]</sup>



### Chart 3 - Many dissents in the turbulent 70s and 80s

Number of dissents in FOMC interest rate decision



Quelle: Fed St. Louis, Commerzbank Research

### Our assessment: When in doubt, the Fed cuts

We expect the Fed to cut key interest rates by 25 basis points next week, albeit perhaps with some reservations. Ultimately, when weighing up the risks, the Fed is likely to give greater weight to the labor market than to inflation. This is because some may assume that a slowdown in the labor market will curb inflation in the medium term. Given the high inflation, this decision would be a delicate one, but Powell has already stated that there are no longer any risk-free paths for monetary policy.

In addition, higher tariffs have so far had less of an impact on inflation than feared. In any case, the tariff issue has lost some of its momentum. First, Trump himself has recently been backpedaling somewhat. He reduced tariffs on foodstuffs because consumer sentiment—and thus the president's popularity—is suffering from inflation. Similarly, the 10% additional tariffs on Canadian goods announced by Trump in October in response to a Canadian commercial have not yet been implemented. Secondly, a recent Supreme Court hearing gave the impression that the court could declare some of the tariffs illegal. Trump would then try to re-establish these tariff barriers on a different legal basis. However, these regulations would restrict him more, and he would no longer be able to impose tariffs on a whim as he has done in the past.

Another argument in favor of an interest rate cut is that the markets are currently pricing this in with a probability of around 90%, and the Fed has not yet given any indication that this is a misjudgment. Above all, there is also political pressure on the Fed to ease monetary policy.

Powell would probably combine an interest rate cut with more hawkish communication. This could be part of an agreement to achieve broader support. It is conceivable that there will be guidance that the bar for further interest rate cuts is now significantly higher.

### What will happen in 2026?

In fact, we expect a slower pace of interest rate cuts in the first months of the new year, as next week's move would be the third in consecutive meetings. Powell's remaining term as Fed chair until mid-May will see three more meetings, at which we expect only one further cut in total. By then, it should become clear that although the US economy has lost momentum, there is no threat of a slump due to the continuing favorable financing conditions. In addition, the effects of tariffs are likely to be reflected more strongly in inflation by then. The Fed should therefore proceed more slowly.

That is likely to change beginning with the June meeting, however, as Powell's successor as Fed chair takes office. Our favorite for this position is economist Kevin Hassett, who currently works in the government as chairman of the National Economic Council. Hassett is considered a close and loyal confidant of Trump. Loyalty is likely to be a decisive criterion for Trump when filling the position, after Powell, whom he appointed, disappointed him by not implementing his calls for massive interest rate cuts. Hassett has frequently criticized the Fed this year, accusing it, among other things, of refusing to implement more substantial interest rate cuts for political reasons.



Ultimately, Trump's second term differs from his first primarily in how he pushes through his political priorities in a more structured way. And especially in such a central position as the Fed chair, Trump will ensure that the course is set correctly from his point of view.

Trump would also gain more leeway if his push to remove Governor Lisa Cook from office is successful. The case is currently before the Supreme Court, which has scheduled a hearing for January 21. If Cook loses her position and Powell resigns as governor after the end of his term as Fed chair (he could theoretically stay on as a governor at the Fed until 2028, as this appointment is independent of his appointment as chair), Trump could appoint two more governors. He recently appointed his advisor Stephen Miran to this body. Together with Christopher Waller and Michelle Bowman, whom he appointed earlier, he would then have replaced five of the seven governors, which would be a considerable contingent in the 12-member Open Market Committee that determines monetary policy.

We therefore fear that the Fed's independence will be undermined, as it was in the 1970s. The Fed is likely to ease monetary policy more than economic data would justify. We expect the Fed to cut its key interest rate at each of its four meetings starting in June, which would push the upper bound of the target range for the Fed Funds Rate down to 2.50%.

This means that doubts about the Fed's independence are likely to grow with each interest rate move in the second half of the year. Longer-term US government bonds should therefore not benefit from the interest rate cuts. On the contrary, we actually expect bond yields to rise in the second half of 2026 due to higher risk premiums. At the same time, the dollar should come under pressure. We forecast an exchange rate of 1.22 against the euro at the end of 2026.

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[1] Theoretically, it is even conceivable that no proposal will receive a majority. However, the Fed's rules do not address this scenario. In this case, either a second vote could be scheduled or the decision could be postponed until the next meeting and interest rates left unchanged. [[back to text](#)]



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