The Fed's December Dilemma

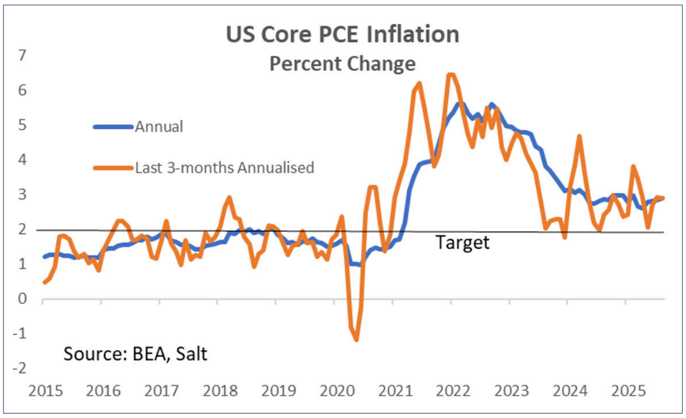
As the US Federal Reserve (the Fed) approaches its last meeting of the year, the outlook for inflation, the labour market and monetary policy are no clearer. This is highlighted by recent speeches from Federal Open Market Committee (FOMC) participants who appear evenly split between a cut and hold at the December 9-10th meeting. Furthermore, the government shutdown and delays to data releases haven't helped matters for a data-dependent Fed either. Market pricing has also vacillated recently between a cut and a hold. Most recent market pricing has the odds of a cut next week at 85%. I think the decision is closer to 50:50.

The critical questions for the FOMC next week are:

- whether lingering inflation risks, including the pass-through from recent tariff increases, still argue for patience; and
- the extent to which softer demand for labour is a function of genuine labour market weakness, or rather a function of supply conditions in the labour market.

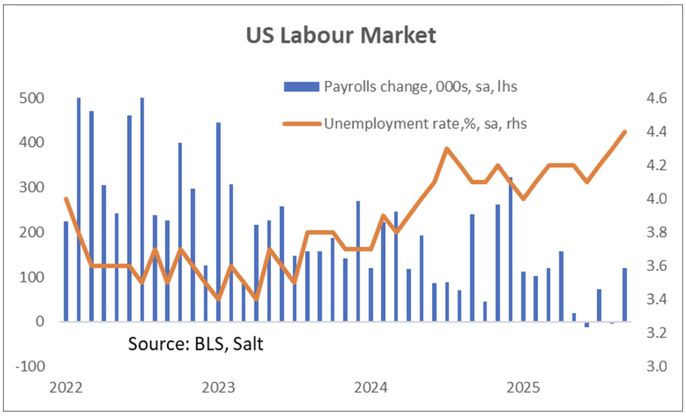
The case for cutting rates: Inflation is softening, the labour market is cooling, and tariff pass-through looks limited

The case for easing begins with the view that the underlying disinflation trend remains intact despite tariff-related noise. Core PCE has continued to drift lower on a sequential basis, and while the tariff measures introduced earlier in the year have added modest upward pressure to certain goods categories, the pass-through has been partial rather than broad-based.

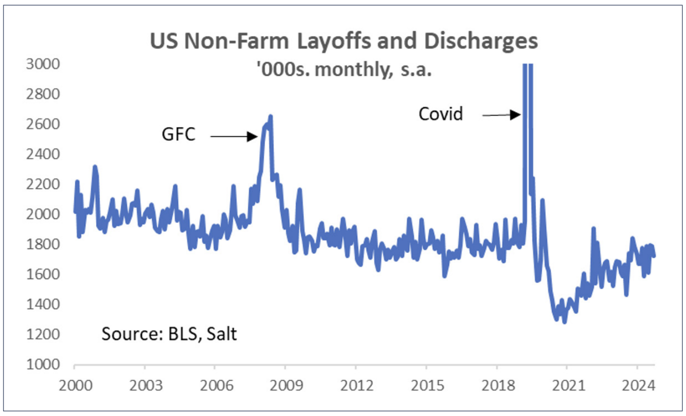


Many firms appear to have absorbed some of the higher import costs through margin compression, and the broader inflation ecosystem, especially in services, has shown greater resistance to tariff spillovers than initially feared. This supports the argument that underlying inflation momentum is still moving toward target.

The labour market reinforces this assessment. Job openings have normalised, unemployment has edged higher, and wage growth has cooled towards levels consistent with stable inflation. The Fed's own analysis suggests that labour-market-driven inflation pressures, which are far more persistent than tariff effects, have eased meaningfully. With employment indicators softening and tariff effects appearing contained, the burden of proof begins to shift toward ensuring policy is not too restrictive.



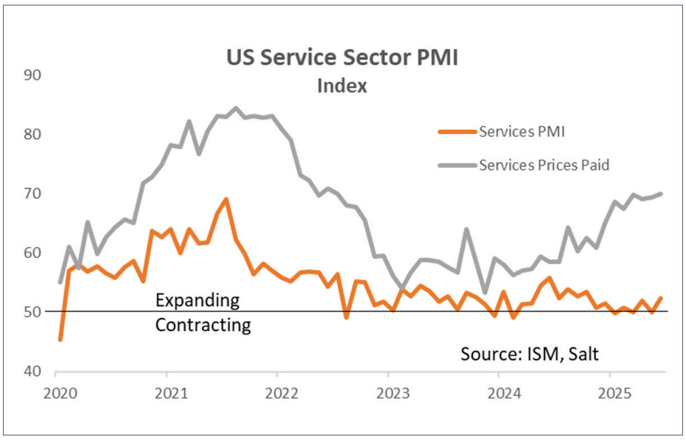
standards, and wage growth, though easing, remains above levels fully compatible with 2% services inflation.



Moreover, as inflation declines, real rates are rising automatically, and the elevated level of long-end yields means financial conditions remain tight. A modest rate cut would help offset that tightening and ensure that a cooling labour market is not amplified unnecessarily by the lagged pass-through of tariffs. In this framing, tariffs have been a manageable irritant, not a structural inflation threat, and therefore should not prevent the Fed from recalibrating policy.

The case for holding rates steady: Tariff pass-through adds inflation risk, and labour demand may be stronger than it appears

The case for patience rests on concern that neither inflation nor the labour market has reached a point where easing is risk-free. Services inflation remains somewhat sticky, and policymakers may want greater certainty that recent improvements are durable. Latest service sector ISM prices paid reading is at 70, a level not seen since the pandemic.



Tariff effects are also incomplete. It appears firms have absorbed cost increases initially and may yet pass them on when demand conditions allow. The Fed may therefore prefer to wait to judge whether tariff-related pressures broaden as we move into 2026.

Labour-market conditions add a second reason for caution. While job growth has slowed, unemployment remains low, layoffs are low, quits are still high by pre-pandemic

We have long argued that reduced labour-force growth, rather than weakening labour demand has been responsible for the recent slowing in payrolls growth. The Trump administration's stricter immigration policies have slowed labour-supply expansion, especially in sectors reliant on foreign-born workers. If labour supply is constrained, lower payroll gains may mask ongoing demand strength and leave upward wage pressure more persistent than headline indicators imply.

In this environment, cutting rates risks providing stimulus into what is effectively still a tight labour market. It could amplify the inflationary impact of tariff pass-through if businesses seize on better demand conditions to restore margins. Maintaining the current stance preserves credibility, keeps pressure on inflation expectations, and gives the Fed additional time to ensure inflation is converging sustainably toward target before easing.

Dissent in the ranks?

Ultimately the decision will come down to the Fed's collective judgement on asymmetric risks - protecting the labour market if policy is now too tight, versus protecting price stability if disinflation is incomplete. Tough call.

As I look down the list of current Fed voting members, the number who have recently spoken in favour of a cut is around the same number who have spoken in favour of a hold. It is quite conceivable that the ultimate decision comes down to the Chairman's casting vote. It is also quite conceivable that there will be a few official dissenters to the decision, and quite possibly in different directions.

If they do cut, I wouldn't take this as a sign that market pricing of four more cuts this cycle is right. We may just be at a point in the process where the labour market argument wins the day. That doesn't mean that stronger inflation pressures can't remerge in early 2026 and stymie the market, and the FOMC's appetite for further cuts.

Final comment: Watch the dots!

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