The FOMC Has Much to Consider

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The Federal Reserve's policy setting Federal Open Market Committee (FOMC) gathers next week to consider the stance of monetary policy. Their task, which by its very nature entails some degree of attempting to predict the future, was already complicated by President Trump's trade and tariff policies and a very uncertain economic environment. This week's string of economic data and geopolitical events did nothing to ease the challenge facing the FOMC.

As we wrote following last Friday's employment report, though job growth remains relatively strong, a few cracks have appeared in the foundation of the labor market. Those cracks grew a bit this week as initial jobless claims held at 248k, the highest level of claims since last October's hurricanes caused a spike in filings. The four-week moving average rose to its highest level since August 2023. Even more concerning, the level of continuing claims climbed to 1.96 million, the highest since late 2021 and topping all estimates in Bloomberg's survey. Looking at a six-month moving average, the upward trajectory of both initial and continuing claims for unemployment benefits is clear.

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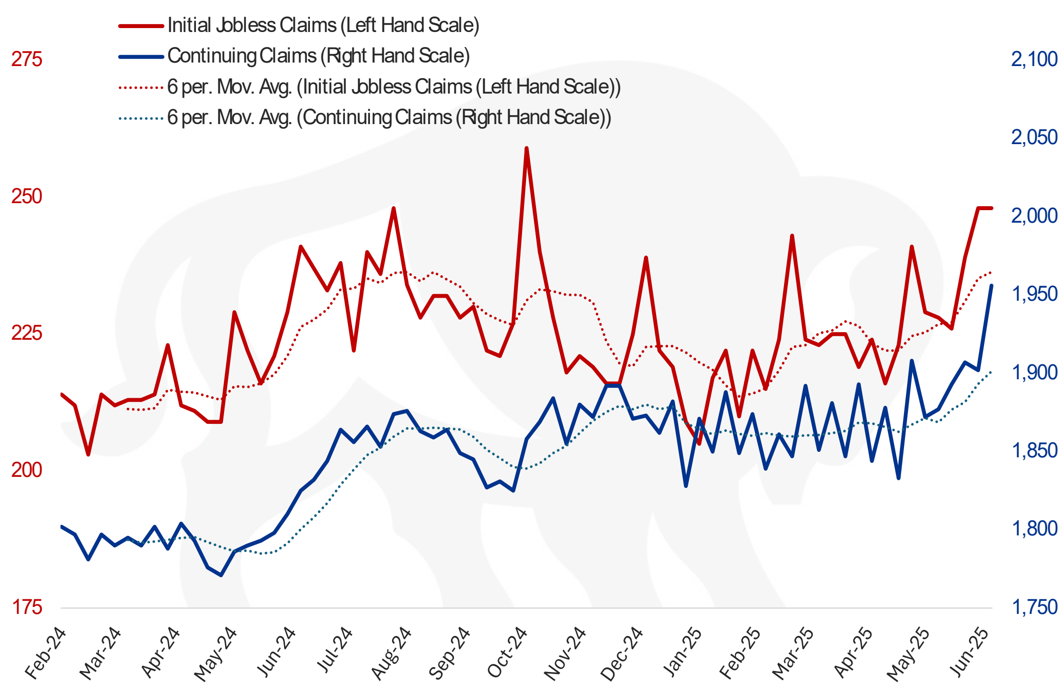
Claims for Unemployment Benefits (in thousands)



Source: Bureau of Labor Statistics

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The recent downtrend of inflation is clear as well. This week, both the consumer and producer price indices came in below expectations. That runs counter to the prevailing narrative which calls for tariffs to send inflation higher. One must look closely to find evidence of tariff induced inflation at the consumer level. In May, it can be seen in higher prices for toys and appliances. But lower prices in areas not tariff affected are offsetting the few spots where tariffs are pushing up prices.

That doesn't mean higher prices aren't coming, but it's a complicated process. For one, many companies built up their inventories in the months before tariffs were imposed. That means they have a supply of goods on hand that can be sold before they must factor in tariff costs. In addition, with many of the most outlandish tariff rates on pause and some goods exempted for one reason or another, the full impact has yet to be realized. Also, tariffs are applied at the wholesale price to the importer, not the retail price to the consumer. For example, a 10% tariff on a pair of Nike shoes that cost $30 to manufacture adds only $3 to the cost. Even if that $3 is fully passed through to the consumer, that $100 pair of shoes is now just 3% higher at $103. Sure, those shoes are more expensive, but as long as any price increases are modest and limited to a narrow scope of goods, the _overall_ rate of inflation may not rise that much.

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That brings us to another point. Just because a company incurs higher costs or wants to pass along higher prices doesn't mean they can. It's a competitive world and consumers have choices. Maybe instead of the $103 Nike shoes we buy the $90 Puma's instead, or just wear our old shoes a bit longer. Consumers can and will change their spending habits. Faced with higher prices on some items consumers will curtail their spending on others. We're already seeing evidence of that as well. Airfares declined in May as demand for travel has faltered.

Further complicating the inflation picture is Israel's attack on Iran which has stoked fears of a wider war in the Middle East. Falling energy prices have been one factor restraining inflation in recent months. With oil prices spiking, energy costs seem likely to add to inflationary pressures in the months ahead.

With the tariff situation unresolved, with consumers, markets and FOMC participants still fearful of future inflation from tariffs, and now the added uncertainty surrounding energy costs, the FOMC will most assuredly not cut rates at next week's meeting. We expect them to reiterate their message of patience, noting that they will remain data dependent and will await further clarity before they act.

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One final note… Something doesn't seem right with the bond market. Normally, an event such as Israel attacking Iran would trigger a flight-to-safety rally in US Treasuries. We are not seeing that today. Stocks are falling in a typical risk-off reaction, gold is higher, but the bond rally is absent. In fact, yields all across the Treasury curve are higher today and that is both interesting and a bit concerning. It's just another indication of the uncertain environment and shifting world order.

Market Indications as of 2:32 P.M. Central Time

DOW	Down -812 to 42,156 (HIGH: 45,014)
NASDAQ	Down -254 to 19,408 (HIGH: 20,174)
S&P 500	Down -64 to 5,981 (HIGH: 6,144)
1-Yr T-bill	current yield 4.08%; opening yield 4.04%
2-Yr T-note	current yield 3.95%; opening yield 3.87%
3-Yr T-note	current yield 3.91%; opening yield 3.83%
5-Yr T-note	current yield 4.01%; opening yield 3.92%
10-Yr T-note	current yield 4.41%; opening yield 4.36%
30-Yr T-bond	current yield 4.91%; opening yield 4.81%