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MARKET SIGHT LINES

Labor Market Firm and Inflation Cooling: When Will the Federal Reserve Cut Rates?

By Michael O'Keeffe, *Chief Investment Officer*

During the pandemic, we, other industry participants, and the Federal Reserve (Fed) discussed "distortions" in the data, like the significant job losses, high inflation, and the quick, deep decline of economic growth and subsequent recovery. These days, we're now talking about data "normalization," seeing various data series finally settle back around levels more consistent with those seen before the pandemic. We see that happening with the labor market and inflation, even as the Fed prepares for its June meeting next week. In this Sight|Lines, we share an update on the labor market and inflation – the two pillars of the Fed's dual mandate – and how these results may influence the Fed policy decision next week and interest rates going forward.

THE TAKEAWAY: NO FED CUT EXPECTED, EVEN WITH A FIRM LABOR MARKET AND COOLER INFLATION

Recent data gives the Fed reason to begin its rate-cut cycle, but investors say no. In summary:

- Job openings are holding up reasonably well, with some metrics settling below pre-pandemic levels, and others showing greater strength compared to that period.
- While a little elevated compared to the very strong labor market right before the pandemic, unemployment remains well below the 10-year pre-pandemic average.
- The Job Openings and Labor Turnover Survey (JOLTS) Quits Rate, which measures worker confidence to leave for another position, has settled to levels consistent with pre-pandemic norms.
- Wage growth remains firm, one potential inflationary force.
- The consumer price index (CPI) cooled in May, and over the last four months, levels are below the Fed's 2% target.
- The producer price index (PPI) was also up 0.1%, but the levels over the last four months were negative, so well below the Fed's 2% target, on average.
- Personal consumption expenditures (PCE) in April also showed inflation cooling.
- Despite a firm job market and cooling inflation, the Fed is expected to keep rates steady.

IN-DEPTH: MARKET PARTICIPANTS SEE NO FED CUT NEXT WEEK, DESPITE THE LABOR MARKET HOLDING FIRM AND INFLATION COOLING

Investors are not expecting a Fed rate cut next week, despite data around the two parts of the Fed's dual mandate – labor and prices – giving them ample reason to do so. Going deeper:

- Job openings are holding up, but were mixed compared to the 10 years before the pandemic:
  - JOLTS job openings were 7.4 million in May, well above the 5.0 million pre-pandemic average.
  - May nonfarm payrolls cooled to 139,000, below the 183,000 pre-pandemic average.
  - ADP payrolls increased by just 37,000 in May, well below the pre-pandemic average of 168,000.
- Unemployment remains well below the 10-year average before the pandemic:
  - May unemployment of 4.2% is well below the pre-pandemic average of 6.2%.
- JOLTS quits, a measure of worker confidence, was 2% in April, in line with the 10-year pre-pandemic average.
- Wage growth remains firm:
  - The May reading was 0.4%, with a year-over-year level of 3.9%, both above the 10-year pre-pandemic levels of 0.2% month over month and 2.4% year over year.
- Various inflation measures are showing inflation cooling, nearing the Fed's 2% target:
  - The CPI was 0.1% in May, averaging an annualized rate of 1.4% over the last four months.
  - Core CPI, which excludes food and energy, had risen 2.0% over those periods.
  - The PPI was 0.1% in May, averaging an annualized rate of -0.1% over the last four months.
  - Core PPI levels (ex-food and energy) were 0.1% and 1.1% over those periods.
  - PCE grew 0.1% in April, with an annualized 2.1% over the last three months.
- The Fed is expected to keep rates steady, even with a firm job market and cooling inflation:
  - Fed funds futures are showing a 100% probability rates will remain unchanged next week.
  - Fed officials continue to reinforce their intention to hold rates steady, given uncertainty around trade, tariffs, fiscal, and regulatory policies. Atlanta Fed President Raphael Bostic recently said:
    - "Given the elevated uncertainty, I continue to believe the best approach for monetary policy is patience. The economy remains broadly healthy, giving us space to wait and see how heightened uncertainty affects employment and prices."

CONCLUSION

During the pandemic, industry participants talked a lot about data "distortions," including the labor market, inflation, and economic expansion. The focus has now shifted to "normalization," with much-watched data finally settling back to levels seen before the pandemic. Two categories – the labor market and inflation – are in keen focus, as they represent measures of the two components of the Fed's dual mandate. And, despite a still-firm labor market and cooling inflation, investors expect the Fed to hold rates steady at its meeting next week. Interest rates are expected to stay higher for longer.

Michael P. O'Keeffe, CFA

Chief Investment Officer

michael.okeeffe@stifel.com

www.stifelinsights.com