FED: POWELL'S LEGACY SHOULD ENDURE

The context surrounding the December 9-10 FOMC meeting (BNP Paribas scenario: -25bp), which marks the final meeting of 2025, serves as a prelude to the challenges that the Federal Reserve will face in 2026. The outlook for the dual mandate calls for differing responses, and uncertainty prevails, fuelled by divisions among FOMC members that stand in contrast to the institution's pro-consensus stance. In the coming year, a significant test awaits US monetary policy and its autonomy, particularly with the succession of Chair Jerome Powell. However, the potential for an abrupt shift in US monetary policy should not be overstated. The Fed's decisions are expected to continue to be driven by economic fundamentals.

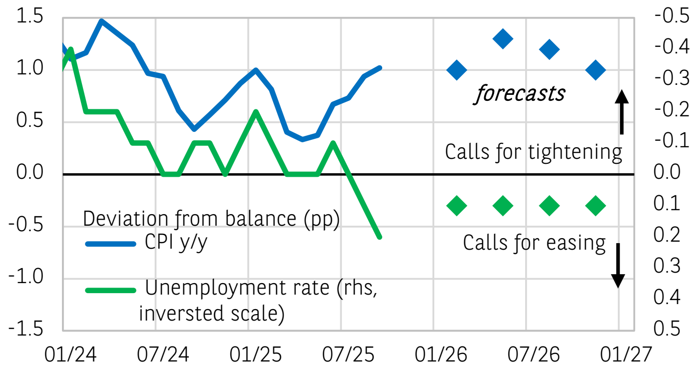
JEROME POWELL'S LEGACY: A DATA-DEPENDENT FED UNTIL THE END

J. Powell's term as Fed chair will end in May 2026. His leadership, which began in 2018, has been centred on maintaining the central bank's non-partisan nature, adopting a data-driven, economically informed and responsive approach to carrying out its duties, while striving for consensus. The December 9-10 FOMC meeting is expected to adhere to this trajectory, continuing the rebalancing of monetary policy that J. Powell indicated in Jackson Hole, prompted by the increased downside risks to employment that became increasingly evident over the summer. As the outlook on this front has not materially changed since then, a further cut (-25bp) is expected at the forthcoming meeting, in line with those made in September and October 2025, bringing the Fed Funds target to 3.5% - 3.75%.

In 2025, there has been a reallocation of risks around the Fed's dual mandate, which supports the case for monetary easing, while the full impact of trade and immigration policies on employment and inflation have likely not yet materialised. The decline in job growth is stark (non-farm payrolls averaged +59k in the six months to September 2025, compared with +133k a year earlier) and has been compounded by a substantial downward revision to total payroll employment from April 2024 to March 2025 (-911k in the preliminary estimate). At the same time, inflation has been rising since April 2025 (+0.7pp to +3.0% y/y in September), although the impact of tariffs appears to be more moderate than initially feared. This is also offset by the disinflationary effect of a less tight labour market. Therefore, the decision to lower the Fed Funds target is based on a solid macroeconomic rationale, even if it also appears timely given the prevailing political pressures. However, the Fed's reaction function is clearly skewed towards employment, with insurance or 'risk management' rate cuts, despite the labour market not being all that far from full employment and inflationary pressures persisting (Chart 1).

Consequently, we anticipate a final rate cut (-25 bp) in late Q1 2026, which would adjust the target range to 3.25% - 3.50%. Looking ahead, sustained growth momentum (around its potential rate) should reduce the likelihood of a further slowdown in employment and, as a result, the case for further easing. J. Powell would then step down as Fed Chair in May 2026, leaving monetary policy well positioned, from the FOMC's perspective, to bring inflation back to target 'without creating undue risks to the maximum employment objective' (J. Williams, New York Fed)[1]. The terminal rate would therefore stand slightly above the FOMC's long-term estimate (+3.0% in the Q3 Summary of Economic Projections). This indicates a moderately restrictive stance in the face of persistent inflation, which would preserve leeway to react swiftly if necessary to a more significant deterioration in the labour market. However, our assessment of the neutral rate (+3.75% in nominal terms, which is the midpoint of our range between 3.25% and 4.25%) makes this an accommodative stance.

FED: CONFLICTING SITUATIONS FOR THE DUAL MANDATE



Note: The curves and dots indicate the deviation (actual or forecast) of inflation from its target and of the unemployment rate from the FOMC estimate of full employment. A result in the upper part of the chart (inflation above target, unemployment rate below full employment) suggests a situation calling for restrictive policy, and vice versa.

CHART 1

SOURCE: BLS, BNP PARIBAS

DIVISIONS WITH NEW SIGNIFICANCE

A troubling development, especially given the mixed and incomplete nature of the economic data that makes it difficult to interpret, is the increasing discord among Fed members. This has manifested in various ways: a fragmentation of rate projections in the Q3 Summary of Economic Projections (SEP), dissenting votes among governors, opposing votes (both for maintaining rates and for a larger cut in November), and disagreements expressed in public speeches. The forthcoming meeting, which will include the rate decision and the SEP, is likely to follow suit. Furthermore, these divisions may deepen and intensify in the event of internal pressure, for example from the incoming Fed chair, to implement further cut rates beyond Q1 2026. This would be detrimental to the consensus-building approach that J. Powell has clearly strengthened. The changing likelihood of a rate cut at the upcoming meeting (Fed Futures market, Chart 2) reflects the reduced predictability of monetary policy in the current context. This situation has been exacerbated by divisions, with the dovish stance of the governors counterbalancing the hawkish stance of the regional Fed presidents. This could ultimately undermine the institution's credibility and lead to more sudden market reactions following decisions that are less thoroughly prepared.

1 John C. Williams, Navigating Unpredictable Terrain (Speech), Federal Reserve Bank of New York, 21 November 2025

WHAT LIES AHEAD: WILL A LOYALIST AT THE HELM OF THE FED STEER MONETARY POLICY AWAY FROM DATA-DRIVEN DECISIONS?

The identity of J. Powell's successor is expected to be revealed early next year. President Trump has indicated that his selection has already been made. The nominee will need to be confirmed by the Senate first of all and appointed to the board in February. K. Hassett, the current director of the National Economic Council (NEC), is the frontrunner: the website Polymarket gives him a 78% chance of being selected. Since his return to the White House, Donald Trump's public statements and actions have demonstrated his intention to align monetary policy with his administration's agenda, with the appointment of a 'loyalist' figure at its helm. However, this appointee will have to consider the potential for negative reactions from the markets, especially the bond markets, and will therefore need to be well received by them, which points to a conventional choice.

The US president has made no secret of his wish to see a substantial decrease in the Fed's policy rate. The primary goal is to alleviate the interest burden on indebted economic agents, with the federal government being the most significant among them. Additionally, companies that are investing in AI through extensive borrowing are also a target. The aim is also to bolster the residential real estate market through the knock-on effect on mortgage rates. Ultimately, a weaker US dollar, made possible by lower interest rates, would enhance the competitiveness of US companies.

The implementation of rate cuts to serve this agenda, without being warranted by economic conditions around the dual mandate, may be endorsed by a politically biased FOMC chair wielding his influence. However, rate decisions are the outcome of a committee vote, and it is unlikely that the new Chair will garner the necessary majorities for this undertaking. This serves as a safeguard against political takeover and suggests the continuation of framework-driven monetary policy. Another protective element is embedded in the structure of the Fed and its schedule. Nevertheless, it is important to acknowledge the associated risks. Theoretically, no other governor's position is expected to become vacant before September 2027 (P. Jefferson). However, J. Powell's choice regarding his potential continuation on the board after the expiry of his term as chair (his term as governor runs until 2028) remains undecided. The Fed is also awaiting the Supreme Court (SCOTUS) ruling in Trump v. Cook[2], which will have far-reaching consequences.

Beyond its independence, the effectiveness of monetary policy depends on its credibility. The data can be interpreted in different ways, but decisions cannot entirely dismiss them. Neither the Fed nor the administration has any interest in seeing inflation expectations rise, while a relative loss of market confidence could be even more evident in long-term yields – which are already facing a degree of scepticism about public debt dynamics – as well as in stock market valuations. For example, the 10-year yield, which is the benchmark and which Treasury Secretary S. Bessent would like to see fall, is comprised of two elements: a breakeven rate (associated with inflation expectations) and a real rate (Chart 3). Should the Fed adopt a more lenient approach to inflation, the outcome could be doubly detrimental: the breakeven rate would increase, while rate cuts would not necessarily translate to long-term rates. Ultimately, a somewhat dovish approach with regard to fundamentals seems acceptable, and even relatively advantageous given its potential to boost economic growth and asset valuations.

IMPLIED PROBABILITY OF A CUT OF AT LEAST 25 BASIS POINTS AT THE DECEMBER FOMC MEETING

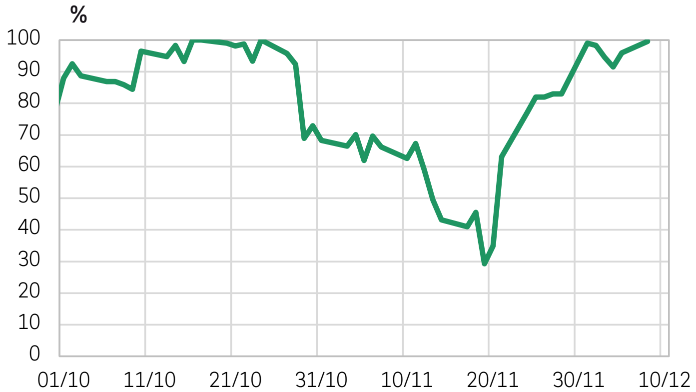


CHART 2 SOURCE: BLOOMBERG, BNP PARIBAS

10-YEAR YIELD (TREASURY NOMINAL COUPON) - BREAKDOWN

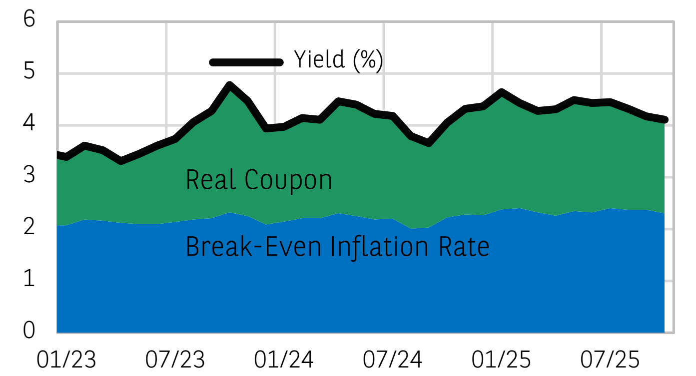


CHART 3 SOURCE: U.S. TREASURY, BNP PARIBAS

Conversely, a clear deviation from the objective of price stability would be unsustainable, counterproductive in relation to the goals being pursued, and generally at odds with the intentions of the current FOMC members. The Fed will probably have to continue enduring the challenges, which are an opportunity for it to bolster its resilience and prominence.

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2 A ruling in favour of the administration would enshrine extensive discretionary power for the President of the United States regarding the composition of the Fed's Board. Conversely, the SCOTUS's overturning of the Governor's dismissal would serve as a positive signal for the operational independence of the central bank.