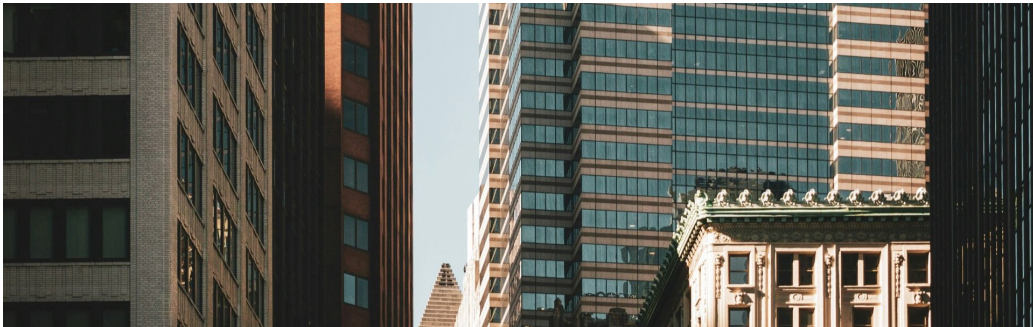
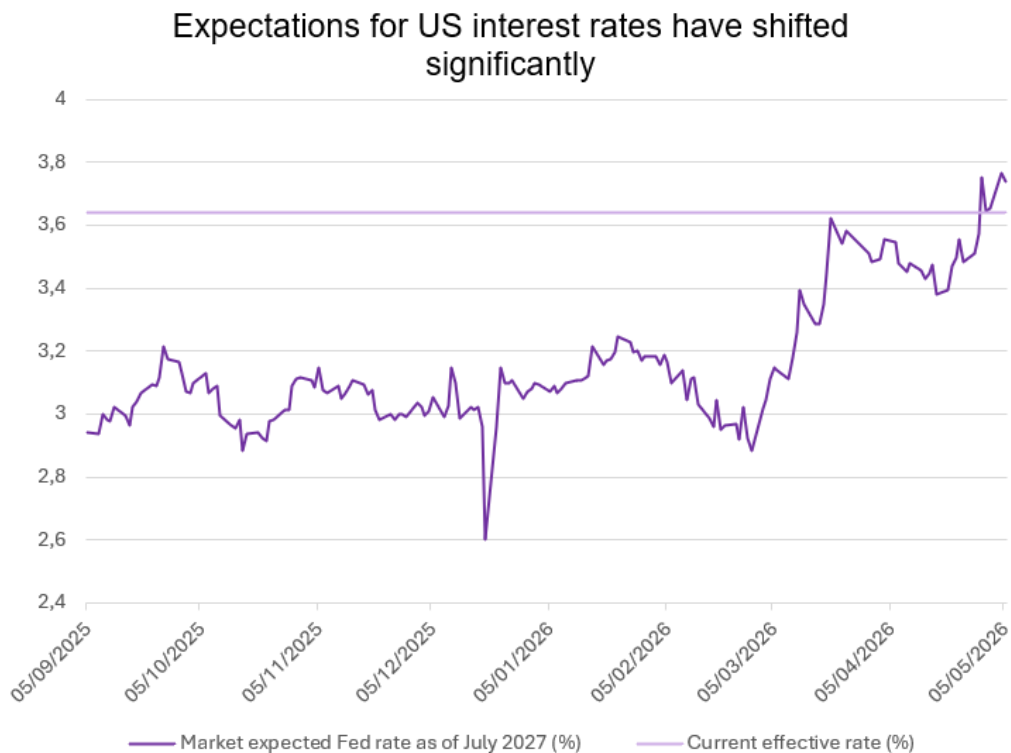


May 11, 2026

# The market closes the door on Fed rate cuts



*Expectations for monetary policy easing by the US Federal Reserve (Fed) have shifted significantly since the start of the year. The conflict in the Middle East, and the sharp rise in global energy prices that followed, has pushed inflation expectations higher and forced markets to reassess the likely path for interest rates.*



Source: Bloomberg, BIL

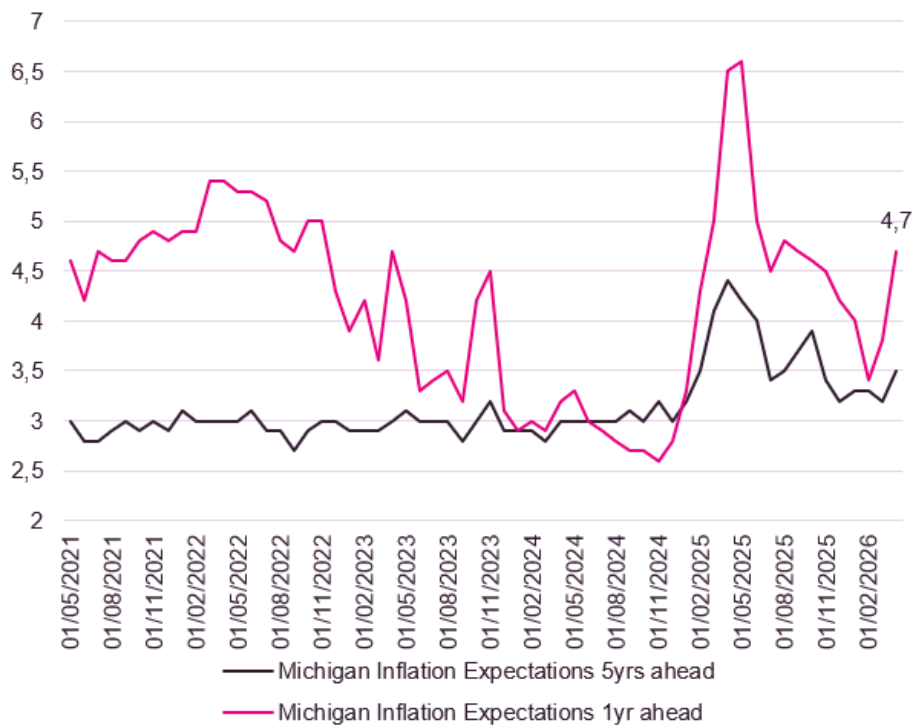
Before the conflict began, market participants expected the US central bank to lower interest rates by a total of 50 basis points in 2026, which would have brought the funds benchmark rate to 3% - 3.25%. Since then, however, markets have sharply pared back those expectations. Traders now see little chance of easing this year, with some even beginning to price the risk of further tightening in 2027.

Some comments from the Federal Open Market Committee (FOMC) support this. At its latest meeting, the committee voted to keep rates on hold at 3.5%–3.75% for a third consecutive meeting, though the group appeared more divided on what guidance should be given on future moves. Three policymakers supported leaving rates unchanged but opposed language in the statement suggesting a potential bias toward lowering borrowing costs at upcoming meetings. Fed Chair Jerome Powell also struck a more hawkish tone, indicating that the Fed's "easing bias" might come to an end as soon as the June meeting. In response, benchmark 10-year Treasury yields have risen to around 4.33% from 3.94% before the war began, while rate-sensitive 2-year yields have increased to around 3.84% from 3.37%, reflecting market participants digesting the reality of "higher-for-longer" interest rates.

### **Inflation has become the main risk**

The primary driver behind this repricing has been the resurgence of inflation risk linked to the conflict in the Middle East. Despite the US' relatively strong position as a net energy exporter, soaring global energy costs have started to feed into consumer prices in the US. Household budgets are coming under pressure, with the average price for fuel around \$4.50 a gallon, a four-year high. This is clearly a concern for consumers, whose inflation expectations have risen significantly since the conflict began.

## US Consumer Inflation Expectations (%)



Source: Bloomberg, BIL

Companies are also beginning to signal renewed pricing pressure. An increasing number of firms have referenced price increases, or the likelihood of them, in recent earnings releases. With the last inflation surge still fresh in memory, businesses could act quicker this time to protect margins by passing higher input costs on to consumers.

Despite higher fuel prices, US consumers have continued to spend. In fact, US retail sales rose to a one-year high in March, largely driven by a 15.5% jump in gas station receipts, as costs were pushed higher. Even excluding fuel, spending remained broadly firm, supported in part by larger than usual tax refunds received this year, which provided a temporary boost to household cash flows.

However, it is also worth noting that higher interest rates generally act as a brake on stock markets, which could reduce spending among the wealthiest households, who are sensitive to fluctuations in share prices.

The key question is how long consumers can continue to absorb higher prices if energy costs remain elevated and if the "Wealth Effect" is in jeopardy. Even if the conflict was resolved in the near future, allowing oil prices to stabilise around pre-conflict levels, inflation concerns are unlikely to dissipate quickly, given that price pressures were already building before the conflict began.

## Growth holding up

At the same time, relatively robust economic growth and a resilient labour market have shifted the policy focus away from providing stimulus and toward managing inflation risks. Labour market data for March surprised strongly to the upside, suggesting employment is stabilising even without rate cuts. Economic growth also regained momentum in the first quarter, supported by increased investment in artificial intelligence and a rebound in government spending following last year's shutdown.

This resilience has somewhat narrowed the Fed's room for manoeuvre. Strong employment, solid investment activity and continued consumer spending make it difficult for policymakers to look through the current inflation shock. Without clear evidence of labour market deterioration, rate cuts are hard to justify, even if geopolitical risks fade or energy prices stabilise.

## A shift towards higher-for-longer

As a result, expectations for US monetary policy have moved decisively toward a higher for longer outcome. What began the year as a debate over the timing and extent of rate cuts has evolved into a discussion about how long the Fed can remain on hold, and whether further tightening might yet be required should inflation pressures persist.

While persistent cost pressures may eventually weigh on demand and shift risks toward a growth slowdown, the near term balance continues to favor policy restraint over easing. Markets have therefore been forced to adjust not only to fewer expected rate cuts, but to the possibility that none at all may materialize, with some even beginning to consider renewed tightening.

This delicate balancing act comes at a moment of significant change within the Federal Reserve itself. April's meeting marked Jerome Powell's final one as chair, with Kevin Warsh set to assume the role in mid May. While Warsh is widely expected to take a more dovish approach to monetary policy, Powell's decision to remain on the Board for "a period of time" implies a shifting internal balance, including the departure of persistent dissenter Stephen Miran, who has argued for aggressive rate cuts.

Against this backdrop, the Fed's likely course is one of caution. For now, resilient growth keeps policy on hold. But the longer elevated costs weigh on confidence and demand, the greater the risk that today's inflation challenge gives way to a potential growth slowdown.

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