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Rate Cuts Under Pressure: The Risk of Yield Curve Steepening Amid Questions of Fed Independence

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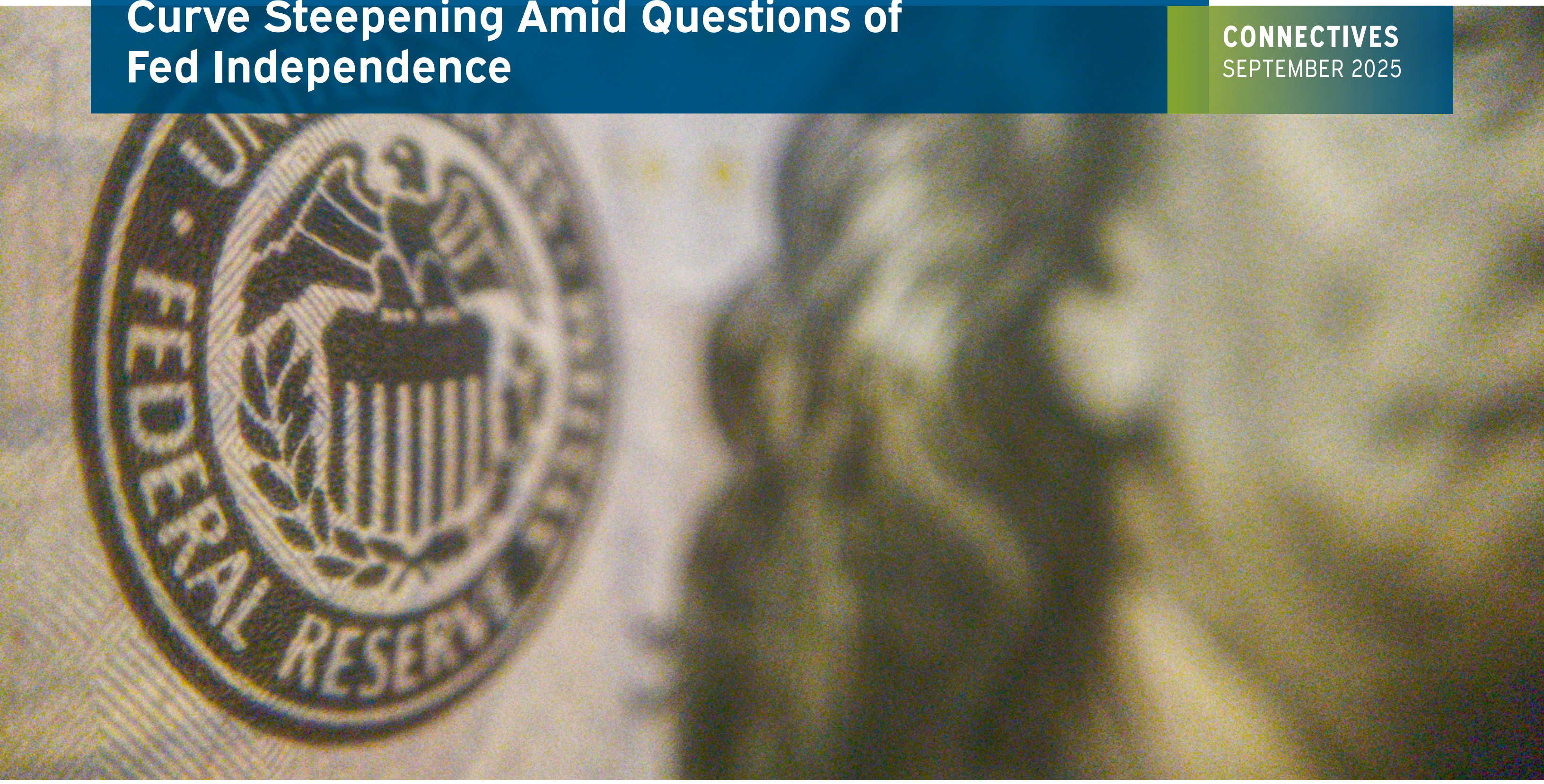

While US GDP has remained resilient, the labor market is showing signs of stress.[1] August's weaker employment report and sharp downward revisions to May and June as well as a significant downward revision of total jobs added between March 2024 and March 2025 point to a potential turning point in the cycle.[2]

This labor market softening comes as tariff-related cost pressures keep inflation risks elevated, creating a difficult policy backdrop.[3] It appears that companies have largely been absorbing the cost of tariffs so far or planned for them by purchasing inventory ahead of the US announcement in early April 2025.[4] However, questions linger about who will ultimately pay the cost of tariffs going forward. If companies continue to absorb the cost, it could impact profit margins and ultimately the stock market, as well as further weigh on the labor market and overall economic growth.[5] If instead they are passed on to consumers, that could hurt spending and also the broader economy.[6] The most likely path will probably be some combination of the two. Despite recent comments by the Federal Reserve (The Fed) that tariff-related inflation may just cause a one-time bump in prices, the fact remains that inflation is still above the Fed's target.[7]

The Fed is tasked with navigating the dual challenges of maximum employment and price stability, yet the trade-offs have become increasingly complex. Specifically,

[1] Source: Bureau of Labor Statistics (BLS) as of September 11, 2025.

[2] Source: Financial Times, H. Kim, "The US Job Market is Getting (Slowly) Worse," September 7, 2025.

[3] Source: Wall Street Journal, J. Lahart, "US Added 911,000 Fewer Jobs in the Year Ended in March 2025," September 7, 2025.

[4] Source: Wall Street Journal, J. Whalen et al., "Trump's Tariffs Being Picked Up by Corporate America," July 24, 2025.

[5] Ibid.

[6] Source: Liberty Street Economics FRBNY, J. Abel et al., "Are Businesses Absorbing the Tariffs of Passing Them Through," Jun 4, 2025.

[7] Source: Federal Reserve, Chair Jerome Powell, "Monetary Policy and the Fed's Framework Review," Speech at Jackson Hole Meeting August 22, 2025.

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cutting rates too aggressively to support the labor market could reignite inflationary pressures, while keeping policy too tight to combat inflation risks accelerating job losses and weakening consumer demand. In this environment, policy missteps carry high stakes, and maintaining credibility will be critical to anchoring expectations.[8]

To this last point, a growing concern is the challenge to Federal Reserve independence potentially posed by the Trump administration.[9] Pressure on Chair Powell to lower policy rates and/or resign from his position, uncertainty over the next Fed chair, and the prospect of additional board appointments amidst a push to remove Federal Reserve Governor Cook[10], has heightened the risks of partisanship shaping policy decisions.

When a central bank is perceived as lacking independence, it undermines the credibility of the institution, making it difficult to anchor inflation expectations and maintain market confidence. If investors perceive that rate decisions are subject to political interference, they may demand higher yields on government bonds, increasing borrowing costs and destabilizing financial markets.[11]

To date, while markets have seen bouts of volatility surrounding the rumors of potentially removing Chair Powell and Governor Cook from the Federal Open Market Committee, they have largely been more reactive to the incoming economic data. The interest rate futures curve over the last few months details this dynamic.[12]

[8] Source: Federal Reserve, Chair Jerome Powell, "Monetary Policy and the Fed's Framework Review," Speech at Jackson Hole Meeting August 22, 2025.

[9] Source: Wall Street Journal, A. Blinder, " The Assault on the Fed's Independence Should Concern Everyone," September 10, 2025.

[10] Source: Wall Street Journal, Editorial Board, "Fed's Independence Goes to Court," September 10, 2025. President Trump's attempt to fire Federal Reserve Governor Lisa Cook in August 2025, citing alleged mortgage fraud, marked the first such removal attempt in the Fed's 112-year history and triggered a legal battle over whether a president has the authority to oust a Fed governor "for cause."

[11] Source: Federal Reserve History, M. Bryn, "The Great Inflation 1965 – 1982." In the 1970s, the Fed, under pressure from the executive branch, kept rates too low for too long, which allowed inflation to spiral and eroded public trust in the central bank's ability to manage price stability. The resulting stagflation was costly and required sharp, painful rate hikes in the early 1980s to restore credibility. This period serves as a cautionary tale about the dangers of compromising central bank independence.

[12] Source: Wall Street Journal, M. Grossman, "Fed Upheaval Sows New Uncertainty About Path of Rates," August 30, 2025.

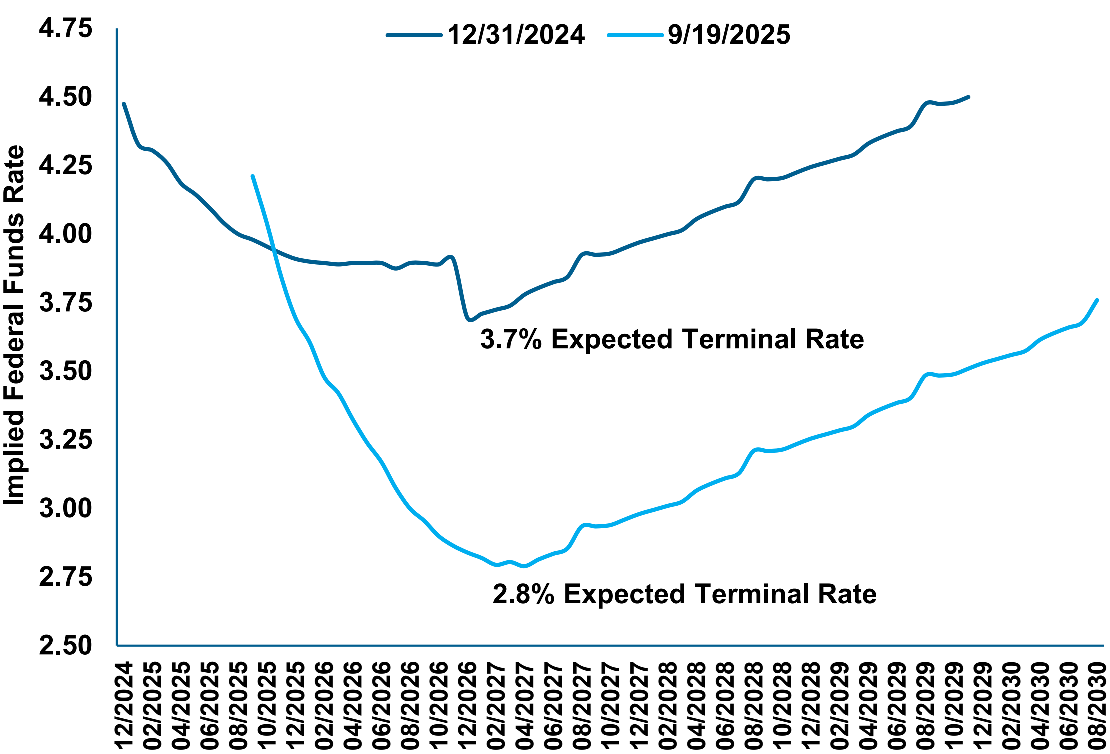

FIGURE 1

Federal Funds Futures Contracts Curve (Implied Policy Rates at Specific Month)

Source: Bloomberg.

Indeed, at the beginning of the year, policy rates were expected to be cut to just under 4.0%. Now, markets are suggesting an additional 1.25% of policy easing to a level of roughly 2.75% will be needed over the next year.[13]

The Federal Reserve finds itself in a difficult position, facing a combination of weak employment data, elevated inflation, and uncertainty around trade policy. While softening labor markets might typically justify rate cuts, doing so amid persistent inflation and political pressure could undermine confidence in the Fed's commitment to price stability. If investors also begin to question the Fed's independence or suspect it is responding to political pressures rather than economic fundamentals, longer-term yields could rise even as the Fed cuts short-term rates, leading to a counter-productive steepening of the yield curve. Such a dynamic would tighten financial conditions and weaken the intended stimulus, complicating the Fed's policy transmission and credibility.

[13] Source: Chicago Mercantile Exchange as of September 11, 2025.

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