Viewpoint

Our Thoughts

- Re-Calibrating the Fed, Consumer Demand, and Inflation
- Housing Slump: The Sequel

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Re-Calibrating the Fed, Consumer Demand, and Inflation

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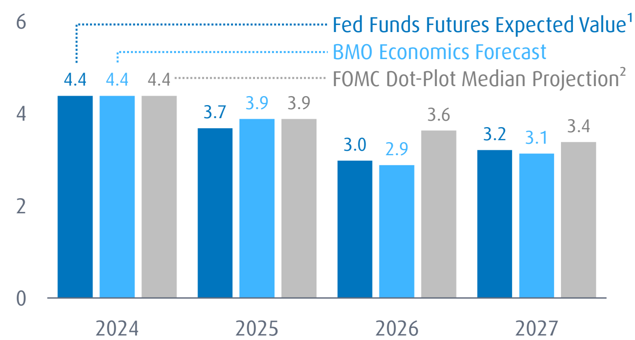
Bond and money markets have been busy re-calibrating their expectations around Fed rate cuts and inflation in recent days. The President's continuing comments on Jay Powell's performance, rumors that he could name the next Fed Chair early, and mounting pressure on the Fed to cut rates aggressively, combined with another week of downbeat economic reports and tame PCE inflation, are having an impact on market expectations. It may be impacting the thinking of some FOMC members too. The Fed's Waller and Bowman both made headlines with their comments that they would consider another rate cut as soon as the July meeting. While we don't believe this is the majority opinion on the FOMC, we still think the first rate cut from the Fed is most likely in September. However, it does suggest a shift in tone, and macroeconomic risks may be brewing. Jay Powell swatted down the need for the Fed to move anytime soon.

Chart 1
Markets Pricing-In More Aggressive Fed Rate Cuts Ahead

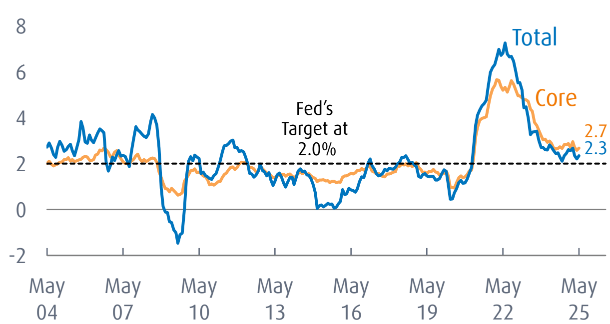
Fed Funds Rate Outlook (year-end)



Sources: BMO Economics, CBOT, Fed [1] as of June 27, 2025; [2] June 2025 meeting

Chart 2
Another Month of Tame Inflation

United States (y/y % chng)
Total and Core PCE: Chain-Type Price Index



Sources: BMO Economics, Haver Analytics, FRB Cleveland/FRED

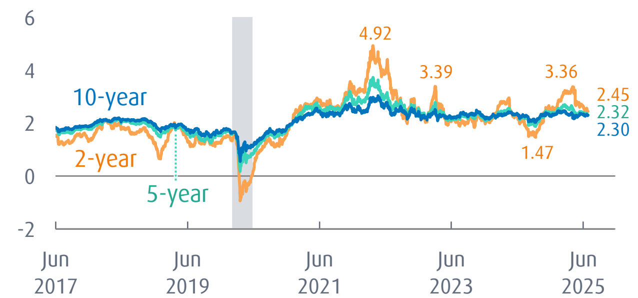
In contrast, **the futures market appears to be raising the odds of more aggressive rate cuts ahead.** Fed funds futures are now placing 88% probability of a quarter-point rate cut from the Fed by September. At the beginning of the week that probability was only around 73%. By the end of 2025, the market sees between 2 and 3 quarter-point cuts with at least five quarter-point rate cuts by the end of 2026. The market appears to be aligning with our current forecast. **We expect a September and December rate cut with a total of six quarter-point rate moves by the end of 2026** (*Chart 1*).

A downward revision to Q1 GDP growth (now -0.5% a.r.) with a sharply lower real consumer spending growth rate of only 0.5%, along with **weaker May personal income and spending** reveal rapidly cooling consumer demand that could keep the inflation shock from tariffs more muted than previously expected**.** Real consumer spending dropped a bigger than expected 3.3% annualized in May even as real personal income excluding transfer payments dropped at a 1.7% annualized pace. **We cut our Q2 real consumer spending estimate** to 1.6% today from 2.1% previously, trimming a tenth of a percentage point off our Q2 GDP growth estimate even as we lifted forecasts for business equipment spending.

Meanwhile, total and core PCE inflation came in muted and very close to our forecasts for May, only 0.04 percentage points higher than our estimates (*Chart 2*). Powell admitted that if not for tariff inflation risks, the Fed would probably already be cutting rates. Bond market inflation expectations have been declining steadily since April 9 when the reciprocal tariff relief first surfaced and haven't looked back since (*Chart 3*). This

Chart 3
Bond Market Inflation Expectations Continue to Plunge

United States (% : as of June 27, 2025)
Breakeven Inflation Rate



Sources: BMO Economics, Bloomberg, FRB St. Louis *Shading marks recessions*

week Treasury inflation breakevens continued to drop, especially at the shorter 2-year horizon. The latter has fallen a whopping 91 basis points since April 9.

What is clear, so far, is that the April tariff shock and inflation fears did indeed hold back consumer spending in May, helping to dampen inflation in the second quarter. The question the markets and the Fed have to wrestle with is: will inflation remain contained with recession fears subsiding, and equity markets are at record highs? The interest rate outlook and the cost of financing the national debt will depend on the answer. For now, the market is signaling that softer demand, an improved inflation outlook, and an Administration push point to more Fed rate cuts ahead.

Housing Slump: The Sequel

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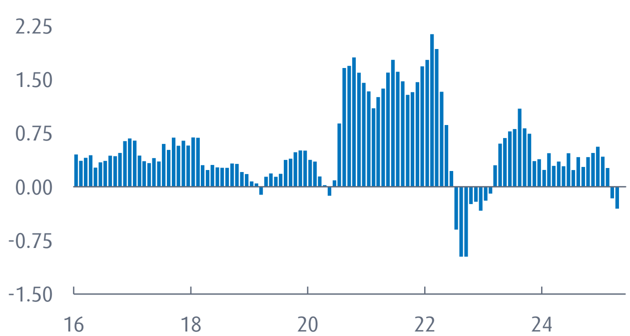
We wrote about the soggy housing market seven weeks ago, but recent data warrant an update. If anything, the market is even softer than we initially thought, with **resale prices buckling under the weight of high mortgage rates**. Both the FHFA and Case-Shiller measures fell in April (seasonally adjusted)—the latter for the second month, led by 1%-plus declines in San Francisco and Los Angeles. Case-Shiller prices are averaged over three months based on sales data that are lagged by a few months, so they measure pricing behavior with a three- to four-month delay. This means that the recent softness likely began early this year, even before the trade war tanked consumer confidence. Indeed, median home prices (NAR) have fallen for five straight months to May (s.a.), by 2.5% in all, while Zillow's measure has fallen three months in a row, albeit modestly.

Chart 1
What Goes Up...

United States (s.a. : m/m % chng)
S&P CoreLogic Case-Shiller Home Price Index — Composite 20



Sources: BMO Economics, Haver Analytics, S&P

With demand in the tank, something needs to give on the affordability front—yet mortgage rates aren't budging. The 30-year rate has been stuck around 6.8%—or two full percentage points above the 20-year average. This leaves prices (and income growth) to do the heavy lifting. **All signs point to further price declines this summer amid rising inventories and slumping sales.** While pending home sales bounced nearly 2% in May, this followed a larger drop in April to near the lowest levels since at least 2001. Poor affordability is the culprit, particularly in the previously booming markets of the South and West.

Conditions aren't much better in the new home market. Single-family sales plunged 14% in May. Available inventory topped half a million units, the highest since 2007, led by a record number in the South. Although national supply of 9.8 months is below the 2009 peak of 12.2, it's still nearly four months higher than the historical norm. This suggests that sagging new home prices haven't hit bottom.

Should home prices fall further, consumer spending could be modestly affected. A WSJ story (June 24) revealed how more homeowners—especially those who bought at peak prices in hot markets—are underwater on their mortgage due to falling home values. While total numbers remain small, they're growing in former boomtowns now seeing steep price declines. In Cape Coral, Florida, 7.8% of owners owe more than their home is worth, while the percentage is 4.2% in Austin, Texas.

Still, barring a recession that drives unemployment higher, **we don't believe that negative equity for some owners will significantly impact spending or trigger a wave of mortgage defaults**. The national delinquency rate at 4.0% in Q1 is still one percentage point below the long-run average, and remains low even in Florida and Texas despite steeper price declines. Most homeowners still have ample equity and should be able to ride out a moderate downturn. Importantly, we don't see a material further drop in prices, so most underwater owners are unlikely to feel pressured to walk away. After a cool summer and fall, home sales should pick up once the Fed gets back in the easing saddle, putting a floor under home values.

Recap

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Indications of stronger growth and a move toward price stability are ***good news*** *for the economy.*

	Good News	Bad News
United States ▪ Fed Chair Powell defends "Wait-and-See" stance, despite pushback from White House ▪ Pres. Trump narrows candidate list for next Fed Chair ▪ S&P 500 touches a record high amid trade deal hopes	**Wages & Salaries** +0.4% (May) **Existing Home Sales** +0.8% to 4.03 mln a.r. (May)—but lowest May sales since 2009 **Pending Home Sales** +1.8% (May) **S&P CoreLogic Case-Shiller Home Price Index** -0.3%; **FHFA House Price Index** -0.4% (Apr.) **Core Durable Goods Orders** +1.7% (May)	**Real Personal Spending** -0.3% (May) **Core PCE Deflator** +0.2% (May)—above expected **Real GDP** -0.5% a.r. (Q1)—revised lower, particularly for consumer spending on services **Goods Trade Deficit** widened to $96.6 bln (May A)—exports fell 5.2% **Current Account Deficit** $450.2 bln (Q1)—record **Continuing Claims** +37k to a 43-mth high of 1974k (June 21 week) **Conference Board Consumer Confidence Index** -5.4 pts to 93.0 (June) **New Home Sales** -13.7% to a 7-mth low of 623,000 a.r. (May)
Canada ▪ President Trump unexpectedly ends trade talks with Canada over Digital Services Tax ▪ Q2 GDP on track for a modest contraction as activity slipped in April and, likely, May	**Consumer Prices** steady at 1.7% y/y (May)—but **Trim and Median** still high at +3.0% y/y	**Real GDP** -0.1% (Apr.)—and StatCan estimates May also slipped 0.1% **Manufacturing Sales** -1.3%; **Wholesale Trade** -0.4% (May A) **Job Vacancy Rate** -0.1 pts to 2.8% (Apr.)
China ▪ Beijing confirms trade deal framework with Washington		**Industrial Profits** -9.1% y/y (May)
Japan ▪ BoJ gets some relief on cooler Tokyo inflation	**Composite PMI** +1.2 pts to 51.4 (June P) **Tokyo Core CPI** slowed to +3.1% y/y (June) **Jobless Rate** unch at 2.5% (May)	**Retail Sales** -0.2% (May)
Europe ▪ NATO ups defense spending to 5% of GDP; Spain not on board ▪ Chancellor Merz says trade talks made "*far too complicated*" by Brussels	**Germany—ifo Business Climate** +0.9 pts to 88.4 (June) **France—Consumer Spending** +0.2% (May) **France—Consumer Prices** +0.8% y/y (June P) **France—Consumer Confidence** unch at 88 (June) **U.K.—Composite PMI** +0.4 pts to 50.7 (June P)	**Euro Area—Composite PMI** unch at 50.2 (June P)—stuck just above 50 **Euro Area—Economic Confidence** -0.8 pts to 94.0 (June) **Germany—Gfk Consumer Confidence** -0.3 pts to -20.3 (July) **Italy—Consumer Confidence** -0.4 pts to 96.1 (June)
Other ▪ Banxico cuts rates 50 bps ▪ RBA likely to trim rates in July ▪ U.S. bombs Iran's nuclear facilities ▪ Israel-Iran arrive at a ceasefire	**Australia—Trimmed Mean CPI** cooled to +2.4% y/y (May)—lowest since late 2021 **Australia—Composite PMI** +0.7 pts to 3-mth high of 51.2 (June P)	

Economic Forecast Summary for June 27, 2025

		2025				2026				Annual		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	2024	2025	2026
UNITED STATES												
Real GDP	(q/q % chng : a.r.)	-0.5	1.6 ↓	1.5 ↑	1.2	1.6	1.6	1.8	1.7	2.8	1.5	1.5
Consumer Price Index	(y/y % chng)	2.7	2.5	3.4	3.4	3.1	3.2	2.7	2.6	3.0	3.0	2.9
Unemployment Rate	(percent)	4.1	4.2	4.5	4.7	4.8	4.8	4.8	4.8	4.0	4.4	4.8
Housing Starts	(mlns : a.r.)	1.40	1.32	1.35	1.38	1.40	1.41	1.41	1.42	1.37	1.36	1.41
Current Account Balance	($trlns : a.r.)	-1.80	-1.14 ↓	-1.14 ↓	-1.15 ↓	-1.15	-1.16	-1.16	-1.17	-1.19	-1.31 ↓	-1.16 ↓
Interest Rates	(average for the quarter : %)											
Fed Funds Target Rate		4.38	4.38	4.29	4.04	3.79	3.54	3.29	3.04	5.15	4.27	3.42
3-month Treasury Bill		4.34	4.35 ↓	4.35 ↓	4.05 ↓	3.85	3.55	3.30	3.00	5.18	4.30	3.45
10-year Note		4.45	4.35	4.35	4.25 ↓	4.20	4.10	4.05	4.00	4.21	4.35	4.10
EXCHANGE RATES	(average for the quarter)											
C$/US$		1.43	1.38	1.36	1.35	1.35	1.34	1.34	1.33	1.37	1.38	1.34
¥/US$		152	144	144	142	142	141	141	140	151	146	141
US$/Euro		1.05	1.13	1.16	1.17	1.18	1.18	1.19	1.20	1.08	1.13	1.19
US$/£		1.26	1.33	1.36	1.37	1.37	1.38	1.38	1.39	1.28	1.33	1.38
CANADA												
Real GDP	(q/q % chng : a.r.)	2.2	-0.5	-0.5	1.0	2.1	1.7	1.8	2.1	1.6	1.3	1.3
Consumer Price Index	(y/y % chng)	2.3	1.9	1.9	1.8	1.6	2.0	2.0	2.3	2.4	2.0	2.0
Unemployment Rate	(percent)	6.6	7.0	7.6	7.7	7.7	7.5	7.4	7.2	6.4	7.3	7.5
Housing Starts	(000s : a.r.)	223	260	228	228	225	225	225	225	245	235	225
Current Account Balance	($blns : a.r.)	-8.5	-46.0	-46.9	-50.6	-51.0	-50.5	-49.8	-48.8	-14.1	-38.0	-50.0
Interest Rates	(average for the quarter : %)											
Overnight Rate		2.92	2.75	2.50	2.25	2.00	2.00	2.00	2.00	4.48	2.60	2.00
3-month Treasury Bill		2.85	2.65	2.50	2.25	2.00	1.95	1.95	1.95	4.37	2.55	1.95
10-year Bond		3.12	3.20	3.30	3.25	3.25	3.20	3.15	3.15	3.34	3.20	3.20 ↑
Canada-U.S. Interest Rate Spreads	(average for the quarter : bps)											
90-day		-149	-173 ↑	-186 ↑	-182 ↑	-182	-163	-136	-108	-53	-172 ↑	-147 ↑
10-year		-133	-115 ↑	-104 ↑	-100 ↑	-96	-92	-88	-87	-87	-113 ↑	-91 ↑

Blocked areas mark BMO Capital Markets forecasts; up and down arrows (↑↓) indicate forecast changes; spreads may differ due to rounding

Key for Next Week

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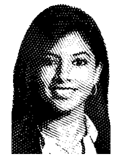

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ISM Manufacturing PMI

Tuesday, 10:00 am

June (e)	**48.7**
Consensus	*48.8*
May	48.5

The **ISM Manufacturing Index** looks to edge up 0.2 pts to 48.7 in June, but that's still in the contraction zone. New orders likely climbed for the third straight month lifting overall production, but factories continue to face major headwinds. Meanwhile, prices paid for materials are expected to stay elevated and may even climb above 70 for the first time since June 2022. Despite the general economy holding up, the manufacturing sector continues to struggle amid downbeat sentiment and elevated rates. — P.T.

Nonfarm Payrolls

Thursday, 8:30 am

June (e)	**+120,000**
Consensus	*+113,000*
May	+139,000

Unemployment Rate

June (e)	**4.3%**
Consensus	*4.3%*
May	4.2%

Average Hourly Earnings

June (e)	**+0.3%**	**+3.8% y/y**
Consensus	*+0.3%*	*+3.8% y/y*
May	+0.4%	+3.9% y/y

Nonfarm payroll growth is forecast to moderate a touch to 120k in June from 139k in May as economic uncertainty remains elevated, weighing on employers' labor demand. Even so, the labor market has performed better than expected since the April 2 tariff shock and for the most part employment and earnings growth remain relatively resilient. With that said, we continue to see signs of softening around the edges. The 4-week average of initial jobless claims moved up gradually in June from 235k at the end of May to 245k as of June 20 and remains well-above its 12-month average of 228k. Continuing claims spiked to 1,974k during the week of June 13, its highest level in nearly four years. The **unemployment rate** is expected to move modestly above its full-employment level to 4.3% in June, a tenth higher than in May. Average hourly earnings growth is forecast to increase a solid 0.3% with year-on-year earnings growth slipping a bit to 3.8% from 3.9%. Average hours worked are expected to remain at 34.3 hours, unchanged from May. Demand for new labor continues to soften as seen in the continuing claims data, but layoffs remain muted as employers and the Fed remain firmly in wait-and-see mode. — S.A.

ISM Services PMI

Thursday, 10:00 am

June (e)	**51.7**
Consensus	*50.5*
May	49.9

The **ISM Services Index** looks to claw its way back above the 50-mark in June, suggesting a moderate expansion for the sector. While business activity and new orders likely climbed, we'll be looking to see if the employment sub-index stayed above 50 for the second straight month. Meanwhile, prices paid for materials and labor likely held close to a two-year high amid lingering inflationary pressures. That will keep the Fed on the sidelines for a while longer. — P.T.

North American Calendar — June 30–July 4

	Monday June 30	Tuesday July 1	Wednesday July 2	Thursday July 3	Friday July 4
United States	Fed Speakers: Atlanta's Bostic (10:00 am); Chicago's Goolsbee (1:00 pm) 11:30 am 13- & 26-week bill auctions $150 bln	**9:45 am S&P Global Manufacturing PMI (June F)** **10:00 am ISM Manufacturing PMI** **June (e) 48.7** *Consensus 48.8* May 48.5 **10:00 am Construction Spending** **May (e) -0.1%** *Consensus unch* Apr. -0.4% **10:00 am Job Openings & Labor Turnover Survey** **May (e) 7,320k (-71k)** Apr. 7,391k (+191k) **Autodata Total Vehicle Sales[D]** **June (e) 15.5 mln a.r.** *Consensus 15.5 mln a.r.* May 15.7 mln a.r. **9:30 am Fed Chair Powell participates in policy panel at the ECB Forum (Sintra, Portugal)** 11:00 am 4-, 8- & 17-week bill auction announcements 11:30 am 6-week bill auction $50 bln	**7:00 am MBA Mortgage Applications 30-year FRM** **June 27** June 20 +1.1% 6.88% **7:30 am Challenger Layoff Report** **June** May +47.0% y/y **8:15 am ADP National Employment Report** **June (e) +110,000** May +37,000 11:30 am 17-week bill auction	**8:30 am Nonfarm Payrolls** **June (e) +120,000** *Consensus +113,000* May +139,000 **8:30 am Unemployment Rate** **June (e) 4.3%** *Consensus 4.3%* May 4.2% **8:30 am Average Hourly Earnings** **June (e) +0.3% +3.8% y/y** *Consensus +0.3% +3.8% y/y* May +0.4% +3.9% y/y **8:30 am Initial Claims** **June 28 (e) 242k (+6k)** June 21 236k (-10k) **8:30 am Continuing Claims** **June 21** June 14 1,974k (+37k) **8:30 am Goods & Services Trade Deficit** **May (e) $69.6 bln** Apr. $61.6 bln **9:45 am S&P Global Services/ Composite PMI (June F)** **10:00 am Factory Orders** **May (e) +8.0%** Apr. -3.8% **10:00 am ISM Services PMI** **June (e) 51.7** *Consensus 50.5* May 49.9 Fed Speaker: Atlanta's Bostic (11:00 am) 11:00 am 6-, 13-, 26- & 52-week bill, 3-, 10[R]-year note, 30[R]-year bond auction announcements 11:30 am 4- & 8-week bill auctions	**Independence Day (markets closed)**
Canada	10:30 am 3-, 6- & 12-month bill auction $23.0 bln (new cash $0.8 bln) 11:15 am Cash management bond buybacks $0.5 bln 12:00 pm 1-month bill auction $2.5 bln	**Canada Day (markets closed)**	**9:30 am S&P Global Mfg. PMI** **June** May 46.1 **Auto Sales[D]** **June** May +7.9% y/y 12:00 pm 10-year bond auction $5.25 bln	**8:30 am Merchandise Trade Balance** **May (e) -$4.0 bln** *Consensus -$6.0 bln* Apr. -$7.1 bln	**9:30 am S&P Global Services PMI** **June** May 45.6

[C] = consensus; [D] = date approximate; [R] = reopening

Upcoming FOMC Policy Meetings: July 29-30, Sep. 16-17, Oct. 28-29

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