

From Rate Cuts to Rate Hikes

The U.S. Federal Reserve (the “Fed”) Open Market Committee will meet once again in two weeks, where Chairman Warsh will take the helm for the first time. While the Fed has kept rates steady throughout 2026, there is far from a consensus among the group. The last meeting in April 2026 witnessed the largest number of dissenters in 30 years. As the war in Iran continues into its fourth month, sentiment around the Fed’s next move, and when a move will be made, have changed significantly. The market has completely turned face on its short-term interest rate expectations, moving from expectations of two cuts in 2026, to now penciling in a hike by the end of year. In this week’s “Three on Thursday,” we take a look at market rate expectations, inflation and money supply. For more insights, view the table and two charts below.

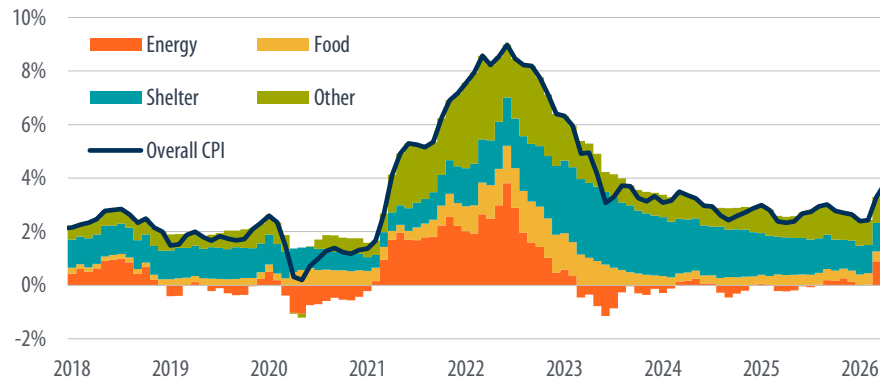
Market Implied Probabilities for Federal Funds

FOMC Meeting Dates	Federal Funds Range (bps)								Implied Meeting Outcome
	300-325	325-350	350-375	375-400	400-425	425-450	450-475	475-500	
6/17/2026	0.0%	1.6%	98.4%	0.0%	0.0%	0.0%	0.0%	0.0%	Stay
7/29/2026	0.0%	1.4%	90.2%	8.4%	0.0%	0.0%	0.0%	0.0%	Stay
9/16/2026	0.0%	1.1%	72.2%	25.0%	1.7%	0.0%	0.0%	0.0%	Stay
10/28/2026	0.0%	0.9%	59.6%	33.4%	5.8%	0.3%	0.0%	0.0%	Stay
12/9/2026	0.0%	0.6%	41.0%	41.6%	14.5%	2.1%	0.1%	0.0%	Hike
1/27/2027	0.0%	0.5%	33.6%	41.5%	19.5%	4.3%	0.5%	0.0%	Stay
3/17/2027	0.0%	0.4%	24.7%	39.4%	25.5%	8.4%	1.5%	0.1%	Stay
4/28/2027	0.0%	0.3%	21.0%	37.2%	27.6%	11.0%	2.5%	0.3%	Stay
6/9/2027	0.0%	0.3%	20.4%	36.7%	27.8%	11.5%	2.8%	0.4%	Stay
7/28/2027	0.0%	0.3%	20.2%	36.5%	27.9%	11.7%	2.9%	0.4%	Stay
9/15/2027	0.0%	3.3%	22.7%	35.2%	25.5%	10.3%	2.5%	0.4%	Stay
10/27/2027	0.0%	2.8%	19.6%	33.2%	27.0%	12.8%	3.8%	0.7%	Stay
12/8/2027	1.9%	14.1%	28.8%	29.1%	17.4%	6.7%	1.7%	0.3%	Stay

Source: CME Group, First Trust Advisors. Probabilities implied by 30-Day Fed Funds futures pricing data. Estimates as of 6/3/2026. Orange highlighted cell represents projected federal funds rate at that meeting.

The CME FedWatch Tool is one of the most widely followed gauges of market expectations for Federal Reserve policy. Using pricing from 30-Day Federal Funds futures contracts traded on the Chicago Mercantile Exchange, it calculates the implied probability of Federal Funds interest rate changes at upcoming Federal Open Market Committee (FOMC) meetings. As of yesterday, markets were pricing in at least one rate hike by year-end, with rates expected to remain at that higher level throughout 2027. That marks a dramatic shift from the beginning of the year when investors were expecting the Fed to deliver two rate cuts.

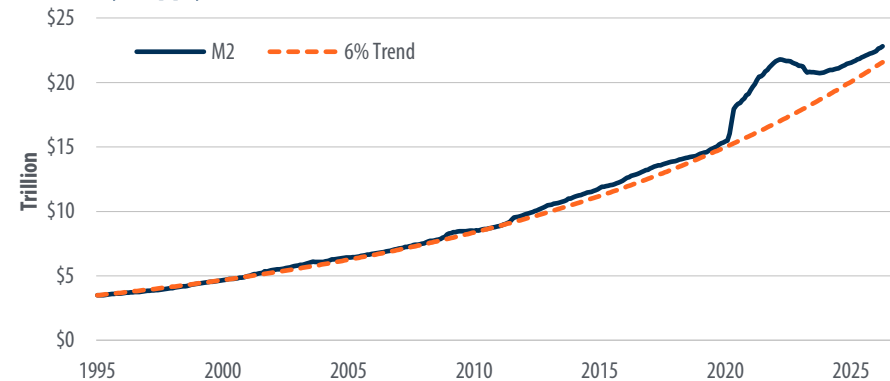
Contributions to Year-Over-Year Percentage Change in CPI



Source: Bureau of Labor Statistics, First Trust Advisors. Monthly data from 1/2018- 4/2026.

Part of the Fed’s dual mandate is to ensure stable prices in the U.S. economy – which it defines as keeping overall inflation at about a 2.0% target. While inflation was slowly trending towards this target to start the year, the war in Iran and subsequent closure of the Strait of Hormuz pushed fuel oil prices 54% higher, causing the Consumer Price Index (CPI) to rise sharply over the past two months. The good news is that prices for other goods and services in the CPI have remained subdued. Although prolonged increases in energy prices can spill over into other areas of the economy, history tells us that persistent inflation stems from monetary conditions rather than supply disruptions.

M2 Money Supply vs. Past Decades’ 6% Trend Growth



Source: Federal Reserve Board, First Trust Advisors. Monthly Data 1/1995-4/2026.

As Milton Friedman famously observed, inflation is ultimately the result of “too much money chasing too few goods.” Higher energy prices can temporarily push the CPI higher, but they do not create sustained inflation by themselves. When consumers spend more at the gas pump, they have less to spend elsewhere. In that sense, higher energy prices reshuffle spending across the economy; they do not determine the overall inflation tide. That is driven primarily by the money supply. In 2020 and 2021, the money supply surged by more than 40%, helping fuel the inflation that followed. Today, money supply growth remains well below its historical average of roughly 6%, suggesting inflation should return to a more moderate path once the current conflict subsides.

This report was prepared by First Trust Advisors L.P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.