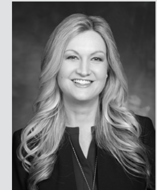
March 17, 2025

Amid Elevated Inflation and Fiscal Policy Uncertainty, the Federal Reserve Remains on Hold



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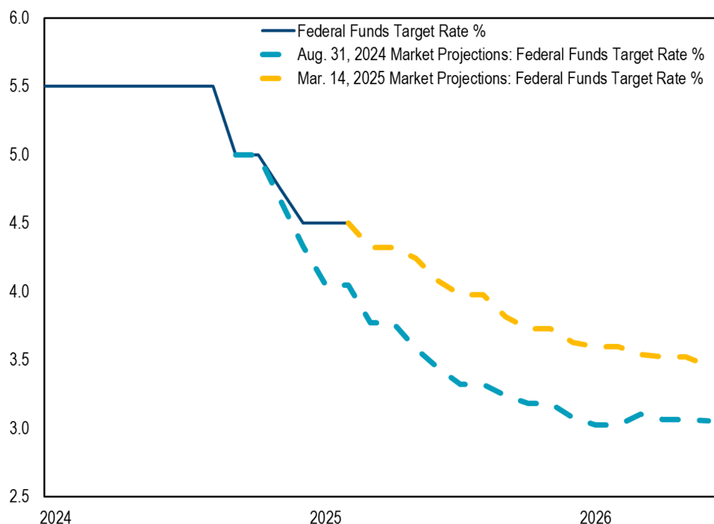
Given the ample uncertainty surrounding the U.S. economy, as well as the unknown directional momentum of inflation, Federal Reserve (Fed) officials moved to the sidelines. Holding rates steady at the start of the year, policy makers indicated a need for patience as the data evolves and the Committee is better able to assess the realized impact of fiscal policy initiatives coming down the pipeline, including international tariffs.

Since the January 28-29 Federal Open Market Committee (FOMC) meeting, however, fears and unease have only increased. Amid a plethora of adjustments and policy initiatives in Washington, D.C. wreaking havoc on markets, fears of a potential downturn – or even an outright domestic recession – have grown, prompting some investors to increase bets of further Fed policy relief sooner than later. Nevertheless, at this juncture, with the Committee still struggling to balance a need to provide support to a potentially cooling labor market while reining in price pressures, the Fed is likely to hold on any further rate accommodation.

Rather than double down with additional rate reductions, which were originally initiated to combat fears of employment weakness that failed to come to fruition, the Committee is presumably better suited to maintain its "*wait and see*" approach, at least for now. After all, much of the unfavorable reactions from consumers, businesses, and investors have been in anticipation of a potentially negative impact from executive order initiatives, as opposed to a response to a realized fallout in economic activity. Furthermore, while downside risks to growth remain, at least some market conditions as well as fiscal policy components – equally – threaten upside inflationary pressures, complicating the pathway for Fed members.



Source: Bloomberg/Bureau of Economic Analysis/Federal Reserve Board

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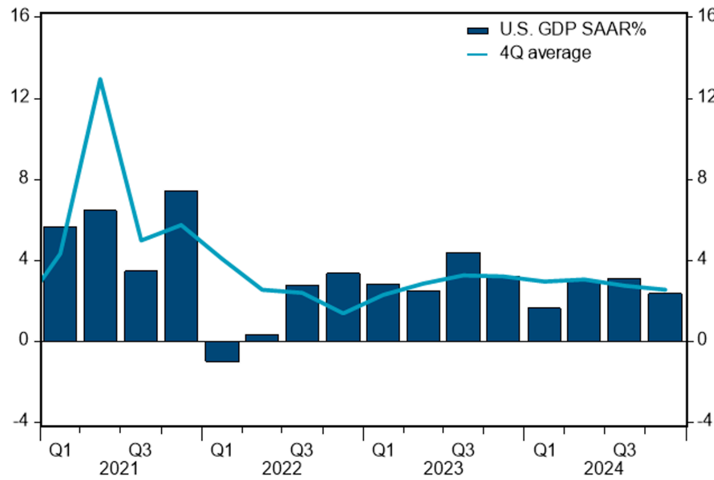
Thus, while the market remains optimistic the Committee will be willing and able to eventually eke out at least three additional rate cuts by year-end, policy is likely to remain steady in the near term, with the federal funds target range firmly fixed at 4.25-4.50%. Of course, the accompanying communication at next week's policy meeting could tip the Committee's hand in terms of primary concerns, a policy lean, and/or expected timeline for any future adjustments in rates.

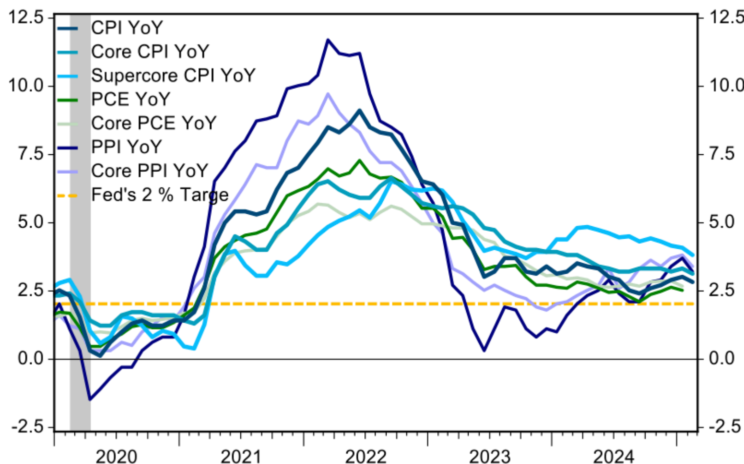
ANTICIPATED LANGUAGE AND WORDING ADJUSTMENTS:

- According to the January FOMC statement, economic activity continues to expand at a "*solid pace*," a positive assessment most likely reiterated in the March statement. The latest read on GDP shows U.S. activity grew at a 2.3% pace October to December. While there was a slight reduction from 3.1% in Q3, the annual pace of growth was a positive rate of 2.8% for 2024 following a 2.9% increase the year prior. Furthermore, looking forward, as spending remains volatile and may slow somewhat further in the early months of 2025, even a reduction in momentum nearer 2% would be sufficient to signal ongoing support to broader economic activity above 2% GDP in 2025.



Source: Bureau of Economic Analysis/Haver Analytics

- Maintaining a positive read of "*solid*" labor market conditions, officials noted the unemployment rate "stabilized at a low level" in the January statement. The latest February employment report indicated a rise of 151,000 new payrolls. While falling somewhat short of expectations, it also marked a two-month high, bringing the total number of new jobs created since the start of the year to 276,000. Household employment, meanwhile, dipped roughly 590,000, while the labor force declined 385,000, resulting in a rise in the unemployment rate from 4.0% to 4.1%. Despite minimal month-to-month volatility, however, the longer-run average of the U.S. joblessness remains at an impressive 3.8% since the start of 2022. While some officials may argue in favor of a more dovish assessment, emphasizing the risks of further deterioration in hiring, given much



Source: BLS, BLS/H, BEA/Haver

GLOSSARY

CPI – Consumer Price Index

EOP – End of Period

FOMC – Federal Open Market Committee

GDP – Gross Domestic Product

PPI – Producer Price Index

QT – Quantitative Tightening

SAAR – Seasonally Adjusted Average Rate

SEP – Summary of Economic Projections

YoY – Year over Year

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of the recent decline may prove weather-related or "*transitory*" in nature, the statement is likely to repeat January's wording.

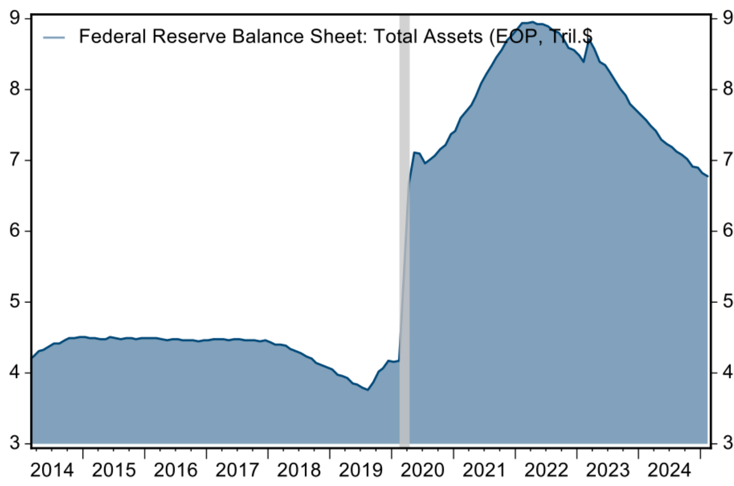
- Acknowledging the still-elevated level of inflation, in the January FOMC statement, the Committee removed language noting "*progress*" toward the Committee's 2% objective. The latest inflation reports, however, indicated a somewhat improved read on price pressures, with the Producer Price Index and Consumer Price Index cooling more than expected in February, following a welcome decline in the January Personal Consumption Expenditures. Of course, nominally still elevated nearer 3%, after several months of acceleration, a minimal one-month reduction does little to quell fears of *further* upside price risks or instill confidence in reestablishing a sustained disinflationary trend. While likely unnecessary to tweak the January language in a more hawkish direction emphasizing further limited improvement, the Fed is likely to repeat the January characterization once again excluding the notion of "*progress*."

- Facing a delicate balance of supporting the U.S. labor market and reining in price pressures back to a rate of 2% over the longer run, in January, the Fed judged the risks to achieving its dual mandate to be roughly "in balance." In fact, after reaching a peak of 5.50% by July 2023, many officials concede the more recent reduction of policy by "just" 100 basis points (bps) from September through December has already moved the rates needle relatively closer to neutral territory. While policy itself remains somewhat restrictive, the opposing market forces (downside risk to unemployment versus upside risk to inflation) appear to be equally influencing – and complicating – the Fed's next policy move. As such, the March FOMC statement will expectedly reiterate a still-balanced view of the risk profile.

"*Some participants observed that, with the target range for the federal funds rate having been lowered a total of 100 basis points with this meeting's decision, the policy rate was now significantly closer to its neutral value than when the Committee commenced policy easing in September.*"

– December 17-18 FOMC Meeting Minutes

- Beginning in June 2022, the Fed initiated a campaign to reduce its then $8.9 trillion balance sheet in a process of Quantitative Tightening (QT). As of January, the Committee reaffirmed its intention to "continue reducing its holdings of Treasury securities and agency debt and agency mortgage backed securities (MBS)" at a current pace of up to $25 billion in Treasuries and up to $35 billion in MBS in each calendar month. According to the January FOMC meeting minutes,



Source: Federal Reserve Board/Haver Analytic

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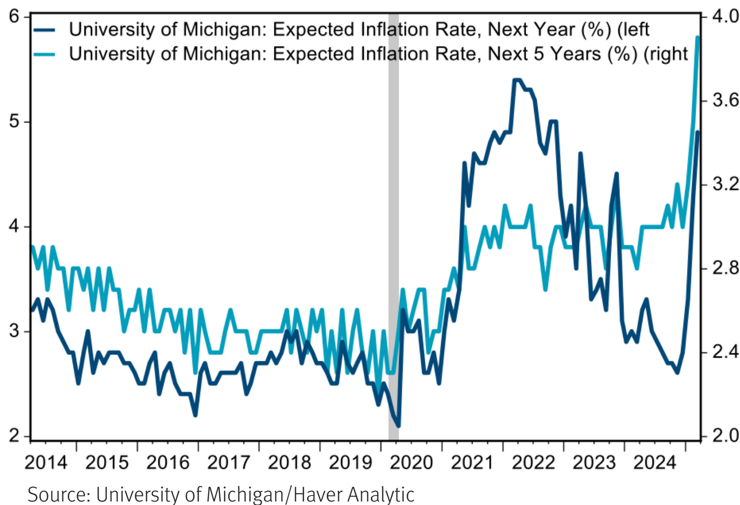
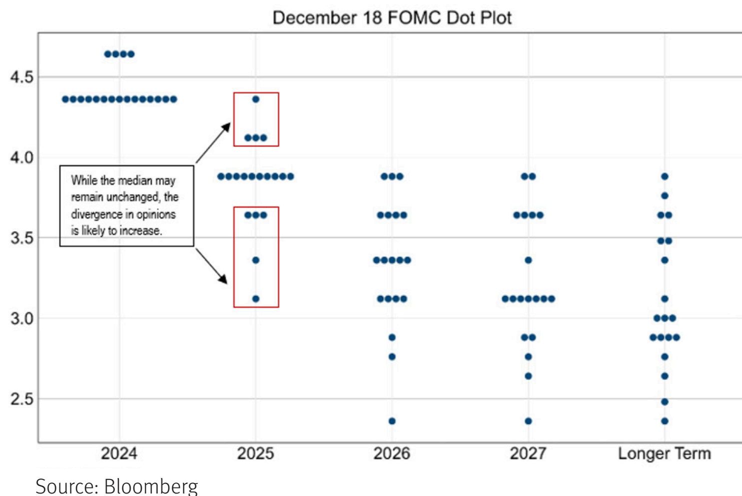
however, there was a growing concern over "*debt ceiling dynamics*" and as a result, some participants noted "*it may be appropriate to consider pausing or slowing balance sheet runoff.*" As such, the March statement may indicate a lower cap on monthly reductions – or at least a desire to reduce the cap in the coming months – potentially paving the way for an end to QT as early as the second half of the year.

- The Committee continues to consider a range of information in determining the appropriate pathway for policy including "*readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.*" However, again, according to the January FOMC meeting minutes, a number of policy officials pointed to the latest fiscal policy agenda as a specific course of uncertainty. According to the minutes, several fiscal policies have "*the potential to hinder the disinflation process, including the effects of potential changes in trade and immigration policy, as well as strong consumer demand,*" particularly as a number of businesses indicated they "*would attempt to pass on to consumers higher input costs arising from potential tariffs.*" Therefore, the March FOMC statement could take the opportunity to explicitly identify additional factors, including specific fiscal policies, being considered in determining the timing and extent of any additional policy adjustments needed.



Source: University of Michigan/Haver Analytic

- Finally, the latest Summary of Economic Projections (SEP) in December showed a material downward revision to the Committee's expectations for additional rate cuts, reducing the median forecast from four to two reductions in 2025. Given the rising concerns of potentially deteriorating growth coupled with growing fears of upside price risks, the median forecast for an additional 50 bps in policy relief will expectedly remain. The diversion of opinions around said forecast, however, is likely to widen among policymakers. Additionally, the SEP



Source: Bloomberg

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is likely to reiterate a forecast for stubbornly elevated inflation beyond the Fed's 2% forecast into 2027, as well as a lower prediction of unemployment near 4.3-4.4% and a slightly reduced growth rate, potentially falling below 2% in the near term.

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