

MARKET SIGHT LINES



What if the Fed Disappoints? Consider the Market Implications

By Michael O'Keeffe, *Chief Investment Officer*



We recently published a series on artificial intelligence (AI) – [the job market impact](#), [investment considerations](#), [healthcare applications](#), and [AI in the digital realm](#) – and how it is playing a key role in our [long-term investment themes](#). In 2025, AI has been a tailwind in an environment where investors are worried about a slowdown and the impact of tariffs on inflation. Despite these worries, the stock market has generally moved higher since the April lows. And in this environment, the Federal Reserve elected to cut its benchmark funds rate 0.25% in September, signaling the possibility of more. In this Sight|Lines, we review this Fed policy action against data on inflation, the labor market, and the economy, considering what may happen if the Fed cuts less quickly, or less deeply, than investors expect.

THE TAKEAWAY: WITH MIXED ECONOMIC DATA, THE FED'S PATH IS UNCERTAIN

The economy and markets appear resilient, but mixed inflation and job market data means that any Fed policy shifts from here are uncertain. In summary:

- Strong second quarter GDP and positive year-to-date equity returns signal resilience.
- Inflation has cooled, but not yet to the Fed's 2% target.
- Job market data is mixed, reflecting a solid labor market that is softening some.
- The Fed made a "risk management" cut in September, signaling the possibility of more.
- The Fed's Summary of Economic Projections reflected a wide range of views among Fed officials, with median projections roughly in line with expectations.
- Some investors and Fed officials are focused on possible negative forces, like the potential inflation impact of tariffs and a slowing economy.
- In the end, Fed funds futures are reflecting two cuts this year and another two next year.
- Given lofty stock market valuations, an unexpected slowdown in Fed rate cuts could trigger increased equity market volatility and weakness from these levels.

IN-DEPTH: THE ECONOMY AND MARKETS HAVE BEEN RESILIENT, BUT WITH MIXED INFLATION AND LABOR DATA, THE FED'S POLICY PATH FROM HERE IS UNCERTAIN

The economy and markets appear resilient in 2025, but inflation remains above the Fed's 2% target and job market data is mixed, so from here Fed policy shifts are uncertain. Going deeper:

- A strong stock market and a robust second quarter GDP result are signaling resilience:
 - Second quarter GDP grew at a 3.8% rate, with consumers a strong contributor.
 - The S&P 500 is up 14.8% year to date through September.
- While inflation has cooled, key measures have not reached the Fed's 2% target. For the last six months:
 - Consumer Price Index (CPI) grew at an annualized rate of 2.3%, with core CPI posting a 2.7% rate.
 - Producer Price Index (PPI) grew at an annualized rate of 1.1%, with core PPI posting a 1.9% rate.
 - Personal Consumption Expenditures (PCE) grew at an annualized rate of 2.2%, with core PCE posting a 2.5% rate.
- Mixed data shows a softening but still solid job market:
 - The unemployment rate of 4.3% reflects close to full employment.
 - The JOLTS report shows 7.2 million job openings, well above pre-pandemic levels.
 - But nonfarm payrolls have cooled significantly.
- The Fed made a 0.25% "risk management" cut in September, with the Summary of Economic Projections (SEP) showing a wide range of views:
 - Officials described the inflation and job market risks as more in balance, with the latter in focus.
 - 2025 GDP projections among Fed officials ranged from 1.3%-2.0%, with the median at 1.6%.
 - Year-end 2025 unemployment estimates ranged from 4.2%-4.6%, with the median at 4.5%.
 - The most hawkish official expects two quarter-point hikes by year-end, while the most dovish is projecting five cuts; this reflects a wide range of views.
- Some investors and Fed officials are focused on possible negative forces:
 - The median SEP inflation estimate at year-end 2026 is 2.6%; the market breakeven rate is 2.7%.
 - The median SEP GDP projection for 2026 GDP is 1.8%, with the consensus forecast at 1.8%.
- Despite these wide-ranging views from Fed officials, fed funds futures are reflecting more cuts:
 - This implies investors are expecting two cuts this year and another two next year.
- As these forces come together, lofty stock market valuations, if met with an unexpected slowdown in Fed rate cuts, could shake investor confidence and trigger increased equity volatility and market weakness.

CONCLUSION

Our series on AI ([the job market impact](#), [investment considerations](#), [healthcare applications](#), and [AI in the digital realm](#)) captures how AI has been a tailwind in the current environment where investors are worried about a slowdown and the impact of tariffs on inflation. Even with a strong stock market since the April lows, the Fed cut its funds rate in September, signaling more. But the Fed is data-dependent, and investors should prepare for the possibility that the Fed won't cut rates as quickly, or as deeply, as expected. This is one of a number of factors that may trigger increased market volatility and a possible market decline.

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