

# The Fed Holds, Watching the Growth/Inflation Trade-Off

The Federal Reserve (Fed) once again held rates steady against a mixed backdrop of elevated inflation, a weaker labor market, and stable growth (for now). Amid rising geopolitical risk, time will tell how U.S. fundamentals are affected.

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## Key takeaways

- **Inflation remains stubborn**, with rising energy costs expected to offset cooler core components, including housing—at least in the near term.
- **Markets again price in fewer rate cuts**, with only one cut now expected for 2026 and no sooner than December.
- **Loose fiscal policy**, combined with potentially looser monetary policy, supports consumers but doesn't make the fight against inflation any easier.

## Federal funds rate stays at 3.50–3.75%

Today, the Federal Open Market Committee announced it has kept interest rates unchanged, holding the federal funds rate at 3.50–3.75%. While the bigger macroeconomic picture will likely be affected by rising geopolitical risks, it's too early to know the degree to which this will impact U.S. fundamentals and the central bank's reaction function. Job market data have weakened, as has the official gross domestic product data for the fourth quarter, but overall economic growth seems to be less affected—for now, at least. Inflation numbers have been broadly in line with expectations, but more time is needed to get inflation back to target. With the increased likelihood of more fiscal spending to cushion the consumer from higher energy prices, the Fed is likely to stay data dependent and keep rates on hold. Market consensus has repriced already with only one rate cut expected this year, down from three rate cuts priced in just last month, and materially higher yields are on offer at the front of the yield curve. Tariff-related uncertainty continues to loom in the background; investigations are being carried out under Section 301 of the Trade Act of 1974, and public hearings are expected to end just before Kevin Warsh takes office as chair in May.

## Inflation remains elevated

Core inflation rose slightly to 3.1% in January, based on the Fed's preferred consumption-based inflation measure. This was broadly in line with expectations but shows that, even before the geopolitical escalation, U.S. inflation has been difficult to bring back to target. With ample economic growth, loose fiscal policy, and potentially looser monetary policy, prices are struggling to come down further. The recent sharp rise in energy costs is likely to offset progress made in shelter and core goods inflation, at least in the short term. Historically, the Fed tended to view volatile energy prices and impacts on the consumer more like a tax with a short

time horizon—hence the focus on core inflation. Overall inflation expectations have increased lately but remain well below 2022 levels. We believe it would take a longer period of elevated commodity prices to influence inflation expectations more meaningfully.

## Fiscal policy cushions consumers

Fiscal spending remains robust and might actually accelerate as part of the affordability drive ahead of mid-term elections across the U.S. This should provide some cushion for the U.S. consumer, despite higher energy prices.

Our narrative of “run-it-hotter” U.S. fiscal policy is likely to persist. In this market environment, we believe high-quality bonds that are less exposed to interest rate volatility through attractive carry remain a good choice. The U.S. dollar is likely to remain relatively well supported through geopolitical turmoil, which, under usual circumstances, could have a dampening effect on inflation.

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