Fed Watch

# Fed set to hold rates on mounting risks despite recent signs of economic softening

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## It will keep the doors open to further easing later this year, but any major hint of a possible rate cut in the next meetings is unlikely

- **While consumer spending remained robust in Q4, recent data suggests increased consumer and firm caution along with headwinds for the manufacturing sector amid deployed and likely upcoming tariffs.** Real GDP growth slowed to 2.3% in 4Q24, falling short of consensus expectations (2.6%) and marking a deceleration from Q3 (3.1%). The drag on demand came from a 5.7% contraction in private investment, with equipment investment plummeting 9.0%, possibly explained by Q4's temporary disruptions (hurricanes and strikes). However, personal consumption jumped 4.2% buoyed by a 12.1% increase in durable goods spending, which translated to a still-solid 3.0% rise in final sales to private domestic purchasers that suggests that fundamental domestic demand remained healthy by year-end (Figure 1). Yet, early data for 1Q25 has raised concerns about growth sustainability. While the ISM manufacturing index climbed to expansion in January (to 50.9) for the first time since 2022, it slipped to 50.3 in February amid a surging prices paid index and tariff-related price concerns among survey respondents. Indeed, manufacturing output experienced a 0.1% MoM decline in January despite the 0.5% increase in overall industrial production driven by an expected post-strike rebound in aerospace, prompting concerns that the manufacturing recovery signaled by recent survey data may prove to be short-lived. Conversely, the ISM services index dipped slightly to 52.8 in January (from 54.0 in December), but it rose again to 53.5 in February amid a steady rise in the employment index and a broadly stable new orders index, which suggests that the services sector holds as the main supporter of economic growth. However, retail sales fell 0.9% MoM in January, significantly exceeding the expected 0.1% drop, and then inched up 0.2% MoM in February, well below the 0.6% MoM expected rebound. Consumption also fell (-0.3% MoM) in January. The unseasonably cold weather may have contributed to some of the weakness, but increased consumer caution may also be playing a role as reflected by consumer sentiment surveys. The impact of incoming activity data on the economic outlook is highlighted by the Atlanta Fed's GDPNow forecast for 1Q25, which drastically changed from 2.3% SAAR in late February to -2.4% currently. All this means that the main reasoning behind the Fed's likely decision to keep rates unchanged this week could shift from the previous meeting's focus on strong economic data to tariff-related uncertainty.
- **Recent labor market data presents a mixed but generally stable picture, marked by continued job growth and a fluctuating unemployment rate around its steady-state level.** Non-farm payrolls increased by 151,000 in February, following a downward revision of January's gain to 125,000 from 143,000. The 3-month average declined to 200,000 from a nearly 2-year high in January. However, the 6-month average continued to trend upward to 191,000 from 177,000. This upward trend is set to reverse soon though, as strong figures from September, November and December of last year drop off the calculation (Figure 2). Job gains in non-cyclical sectors such as health care (+52,000) and social assistance (+11,000) continued to be the main drivers of job creation. However, cyclical sectors have continued to add support: employment trended up in financial activities

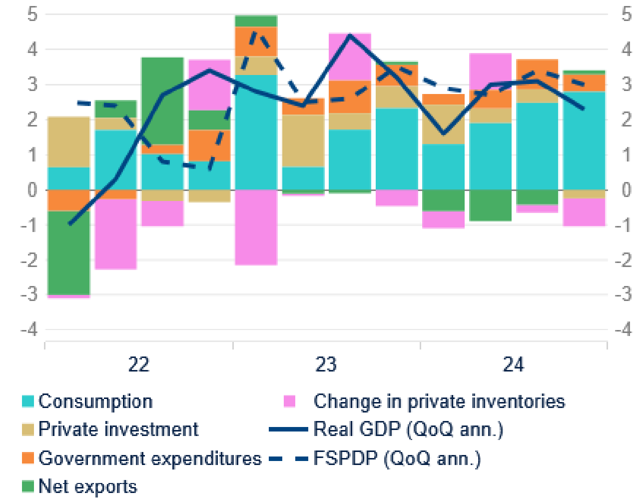
(+21,000) and transportation and warehousing (+18,000). Modest job losses were seen in retail trade (-6,000) and federal government employment (-10,000). The latter reflects the initial batch of mass layoffs of federal workers in the government sector which have accelerated since and, thus, will start to weigh more heavily ahead amid Trump's new Department of Government Efficiency (DOGE) initiative. The unemployment rate decreased from 4.1% in December to 4.0% in January but then rose again to 4.1% in February, thereby reinforcing the idea that the labor market has stabilized. Further evidence of this stabilization comes from the fact that job openings have largely trended sideways for almost a year now. The JOLTS report also showed that the private quits rate rebounded to 2.3% in January, but remains at a level that is consistent with wage growth slowing down to around 3% by year-end, which continues to suggest that any worrying wage-related price pressures in the services sector are unlikely to last. Despite signs of softening from real activity data, the stability in the labor market will likely provide support for the Fed to remain cautious and maintain its current policy stance amid the continued uncertainty around the effects of Trump's policy changes .

- **February's CPI inflation data presented a mixed bag of positive moderation signs but also persistent concerns; a strong dovish pivot at this week's FOMC meeting is highly improbable despite softer activity data.** Headline CPI increased 0.2% MoM in February (down from January's 0.5%) on softer food and energy inflation. Core CPI also slowed to 0.2% MoM (from 0.4% in January). Both rents and owner's equivalent rents increased by a sticky 0.3% MoM pace, which nonetheless continued to gradually push the 12-month rate down to 4.3% (from 4.4% in January and from an 8.2% peak back in March 2023), and should not raise major concerns among Fed officials since housing services disinflation in the pipeline gives ample room for further cooling as rental turnovers and renewals are set to keep balancing better with market rents. However, price increases across most of the major subindexes except new vehicles (-0.1%) and airline fares (-4.0%) will likely be reflected in a not-so-encouraging core PCE inflation report for February. The most recent PCE inflation data showed that a 2.6% YoY gain in January (0.3% MoM) remains uncomfortably above the Fed's target, especially considering that both 3- and 6-month annualized measures have been flat-trending since September of last year (Figure 3). This makes it very unlikely to prompt any rate cut hint from this week's FOMC meeting, i.e., a rate cut is off the cards, even more so amid the increased uncertainty around the inflationary effects of Trump's policies.
- **Do lower Treasury yields signal that markets expect the Fed to eventually shift its focus back to growth risks despite increased uncertainty around Trump's trade and immigration policies?** January's FOMC meeting minutes showed that FOMC participants had not closed the door to the possibility of resuming the rate-cutting cycle later this year if they see "additional evidence of continued disinflation," but they also signaled a potential longer-than-expected pause of the rate-cutting cycle, with "a majority of participants" observing that "the current high degree of uncertainty" made it appropriate for them to take a "careful" approach in considering further rate cuts, particularly as they face factors that have the "potential to hinder the disinflation process." This was a strongly shared opinion among financial markets for some time, but they now seem to be less certain of a scenario in which the Fed keeps rates at their current level (4.25-4.50%) for the whole year amid a potential economic slowdown in the following quarters. The 10-year Treasury yield has fallen to 4.3% from its 4.8% peak a week before Trump's inauguration (Figure 4), and the futures market implied odds of no rate cuts during the whole year dropped from 30% to 2% in the same period (see here for more on the recent evolution of US interest rates). For the time being, the futures market has almost fully priced in the Fed will remain on the sidelines this week and considers that will also be the case by the May meeting (75% chances of such an outcome).
- **We expect the Fed to keep rates on hold this week; the FOMC will likely continue to signal that additional rate cuts in the short term are unlikely as uncertainty remains high.** Powell will likely continue to convey that the Fed "do[es] not need to be in a hurry, and [is] well positioned to wait for greater clarity," but

the implementation of tariffs during the intermeeting period (on Chinese imports since early February and on steel and aluminum this week) will likely compel the Fed to begin to acknowledge in the policy statement the inflationary risk from such policy decisions. However, the Fed will most likely continue to reiterate that “uncertainty around the [policy] changes and their likely effects remains high.” The updated SEP will likely include an upward revision to December’s 2.4% median PCE inflation projection if we assume that more FOMC participants have incorporated “placeholder assumptions” regarding the inflationary effects of Trump’s policy changes. In contrast, the 2.1% projected GDP growth rate for this year could be adjusted down amid recent weaker-than-expected data. But the net impact of these revisions on the dot-plot is less clear, especially considering the continued stability of the labor market. We continue to think that further disinflation in the pipeline in the services sector, particularly in housing services inflation, will drive the Fed to continue to keep the doors open to a resumption of the rate-cutting cycle later this year, but any major hint of a possible rate cut in the next meetings is unlikely in our view. Besides, the kind of attention paid to inflation over the past couple of years will likely take a significant turn soon as the effects of Trump's new policies begin to impact prices. The effect of tariffs on imported goods, even if a one-off, will very likely prevent core inflation from resuming its downward path, and the focus going forward will be on whether these price increases trigger second-round effects. This, along with the possibility of more permanent effects from immigration policy, could complicate the return of inflation to the 2% target for quite some time. All in all, we do not expect either the statement or Powell to hint at a possible rate cut soon amid heightened downside risks to growth and instead expect both to convey that amid lingering uncertainty the Fed remains comfortable in its current wait-and-see mode and is in “no hurry” to resume the rate cut cycle.

## Real GDP growth slowed to 2.3% in 4Q24, marking a deceleration from Q3 (3.1%)

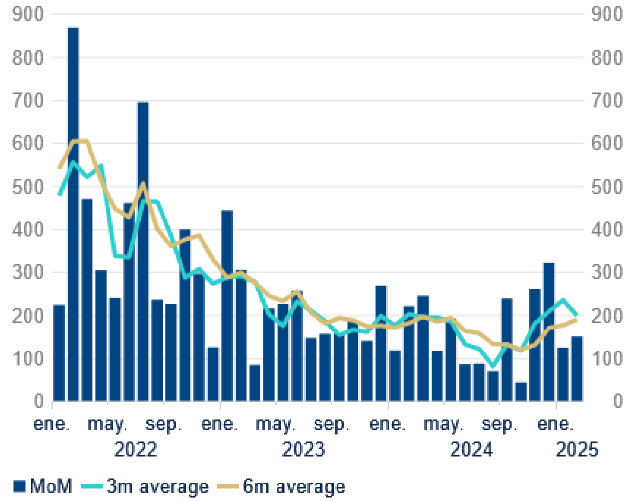
Figure 1. **REAL GDP GROWTH** (%)




Source: BBVA Research / BEA

## The stability in the labor market will likely provide support for the Fed to remain cautious

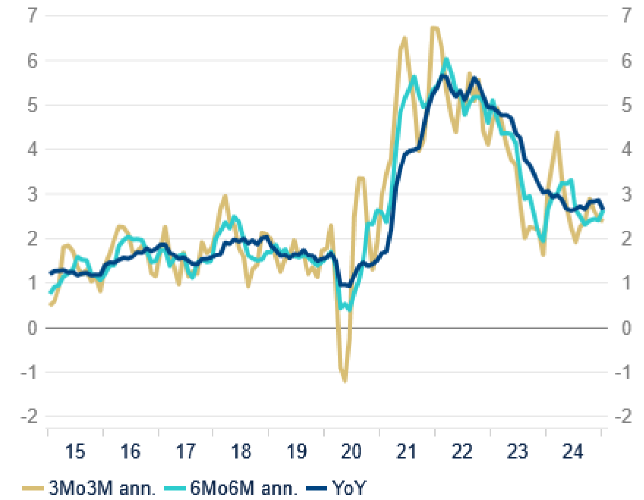
Figure 2. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)




Source: BBVA Research / BLS

## Both 3- and 6-month annualized measures have been flat-trending since September of last year

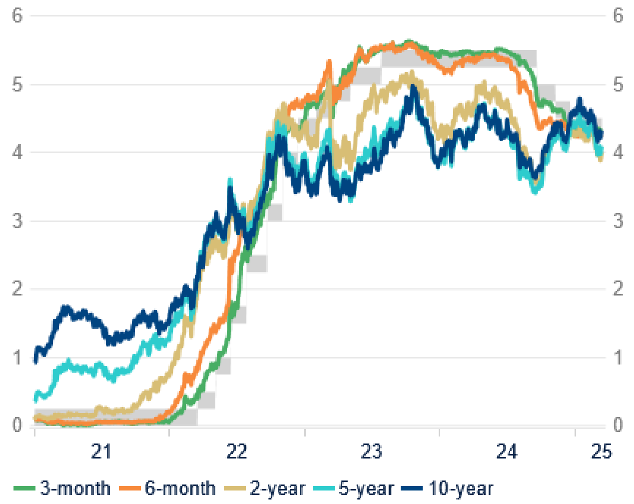
Figure 3. **CORE PCE INFLATION** (%)




Source: BBVA Research / BEA

## The 10-year Treasury yield has fallen to 4.3% from its 4.8% peak a week before Trump's inauguration

Figure 4. **TREASURY YIELDS** (%)




The gray area indicates the fed funds rate target range
Source: BBVA Research / Fed / Treasury Dept.

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