Fed Watch

Fed to stay put as it waits for tariff effects to show up in 2Q data

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With data preceding most tariffs, the Fed will likely signal it has room to maintain its policy stance heading into the June meeting

- **While headline GDP contracted, underlying demand remained solid, with consumption and investment proving resilient.** The US economy contracted at an annualized rate of 0.3% in 1Q25, the first decline since early 2022. This was largely due to a 41.3% surge in imports, as consumers and firms rushed to make purchases ahead of anticipated tariffs, leading net exports to subtract 4.8 pps from GDP growth. Nonetheless, final sales to private domestic purchasers rose by 3.0%, pointing to solid underlying demand (Figure 1). Personal consumption slowed to 1.8%, the weakest pace since 2Q23 amid increased consumer uncertainty, but it does not appear to be collapsing despite depressed consumer sentiment: the University of Michigan's consumer sentiment index fell to 52.2 in April—its lowest since July 2022. March's retail sales report showed broad-based gains, with core retail sales up a healthy 0.5%. The strength of recent consumption data may, however, reflect some transitory factors, including a rebound in spending after the unseasonably severe winter of late 2024 and early 2025, and potentially some front-loading of purchases ahead of tariff implementation. These dynamics may have more than offset the caution implied by sentiment indicators. Nonresidential business investment also contributed to the resilience of private demand, expanding 9.8%, likely driven by early purchases of capital equipment in anticipation of tariffs. Since trade data is typically subject to fewer revisions than consumption and investment data—because it's easier to keep track of trade data as it relies less on broad estimations—1Q25 consumption and investment growth may be revised upward in future releases. While the ISM manufacturing index remained below the 50 threshold in April (at 48.7)—extending a nearly two-year contraction streak that should not in itself raise major concerns—the latest industrial production data showed manufacturing output rose by 5.1% annualized in Q1. Nonetheless, weak new orders warrant caution in drawing optimistic conclusions about the sector's outlook. The sustainability of private demand momentum through 2Q25 remains highly uncertain given the drag on confidence from trade tensions and Trump's policy unpredictability. Still, in the very short term, the strength of real activity data supports the Fed's decision to remain in wait-and-see mode this week.
- **Hiring remains robust across cyclical sectors, and layoffs are limited—even as federal employment shrinks and outlook risks persist.** The labor market remains resilient, with non-farm payrolls rising by 177,000 in April following a downwardly revised but still solid 185,000 in March (Figure 2). The unemployment rate held steady at 4.2%, with limited room for further declines. A sharp drop in southwest border crossings and reports of ramped-up deportations are expected to continue constraining labor force growth—even as prime-age employment has recently increased, limiting the potential for a lower jobless rate. Federal government payrolls declined only modestly—down 4,000 in March and 9,000 in April—amid ongoing DOGE-related cuts. Elsewhere, job growth was broad-based, with cyclical sectors continuing to post strong gains despite tariff uncertainty: transportation & warehousing added 29,000 jobs in April (following 27,000 in

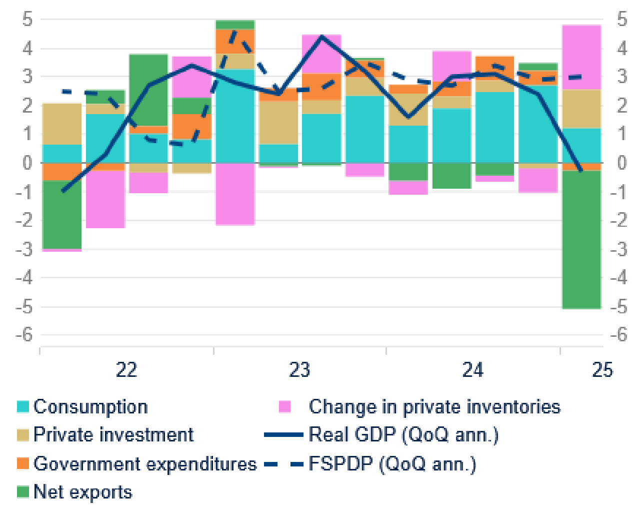
March). Food services employment rose by 16,600, reinforcing the idea that businesses in demand-sensitive sectors are still hiring. Leisure and hospitality added 24,000 new jobs in April and had already posted 38,000 new jobs in March, likely due to weather-related effects. That increase was somewhat at odds with the ISM services index falling to 50.8 in March, but aligns with April's rebound to 51.6—driven in part by the employment index, which rose sharply from 46.2 to 49.0. Further evidence of labor market resilience came from the March JOLTS report: the hiring rate held steady at 3.4%, while the layoff rate edged down to 1.0% (from 1.1%). Taken together, these indicators suggest that firms, facing an uncertain outlook, remain hesitant to either freeze hiring or implement layoffs. This labor market stability will likely be underscored by the Fed as key justification for holding rates steady in the near term.

- **Despite softer price data in March, tariffs and rising expectations suggest the Fed will tread cautiously on any dovish turn.** March inflation data showed signs of moderation, with core CPI rising 0.06% MoM, driven mainly by declines in hotel prices and airline fares. The Fed's preferred PCE inflation measure also rose only slightly—by 0.03%—pushing the annual core inflation rate down to 2.6% from 3.0%. The three- and six-month annualized rates eased to 3.5% and 3.0%, from 4.3% and 3.4% respectively (Figure 3). However, these more benign readings followed three consecutive above-target months and do not capture the early-April implementation of broad-based global tariffs. This suggests that a single favorable inflation print is unlikely to prompt a dovish turn from the Fed, especially given that core prices will accelerate in the coming months as tariff effects begin to filter into official data. The inflation outlook is further complicated by the continued rise in survey-based inflation expectations. According to the latest University of Michigan survey, both one-year and five-year inflation expectations rose significantly in April—to 6.5%, the highest since 1981, and 4.4%, respectively. Another worrying signal comes from the ISM manufacturing prices paid index, which has increased by nearly 20 basis points since November to 69.8. The services sector initially appeared less affected by tariff-related pressures, with the ISM services prices paid index dropping by 1.7 points in March to 60.9, but it rose to 65.1 in April. In short, while the latest hard inflation data suggest some easing, positive inflation data precede tariffs. The broader backdrop of tariff risks and rising survey-based inflation expectations is likely to keep the Fed cautious. A single month's improvement is not enough to confirm a sustainable path back to 2%, and thus the Fed is likely to maintain its current policy stance for now.
- **Treasury yields and widening spreads reflect investor uncertainty, while Fed officials emphasize caution amid persistent inflation threats.** Treasury yields were highly volatile during the intermeeting period. A brief flight to safety pushed the 10-year yield down to 3.86% immediately after Trump's "Liberation Day" announcement, but a quick bond sell-off sent it surging to 4.5% soon after. This volatility drove the Trump administration to announce a 90-day pause to global reciprocal tariffs. Since then, the 10-year yield has hovered near 4.3%, but inflation risks and continued threats to the Fed's independence are likely to prevent long-term yields from declining much. The increase in the term premium shows that investors are demanding greater compensation for long-term risk, which has prevented long-term Treasury yields from falling in tandem with recently easing market-based inflation expectations—a development that could offset some of the concerns arising from survey-based inflation expectations—and lower market-implied rate projections. Though still near historical lows, corporate bond spreads have widened amid a worsening business outlook, and some broad financial stress indicators have shown mild upticks, reflecting growing uncertainty and sensitivity to policy shocks (see here for more on the recent evolution of US interest rates). The minutes of the March FOMC meeting showed that participants maintained a cautious tone as inflation will likely "be boosted this year by the effects of higher tariffs." While signs of economic weakness are still not evident in hard data, many participants noted that contacts were pausing hiring decisions and delaying capital spending due to policy uncertainty and declining business sentiment. These downside risks likely explain why markets are pricing in a ~70% chance of at least three rate cuts by year-end (Figure 4).

- **With economic activity still solid and tariffs set to push up inflation, the Fed is expected to extend its pause while awaiting greater clarity.** Amid mixed economic data and the delayed effects of recently imposed tariffs, we expect the Fed to keep the policy rate unchanged this week at its 4.25–4.50% target range. While March inflation data was more favorable, concerns about tariff-driven price pressures persist. The Fed is likely to maintain its data-dependent stance and signal it is in "no hurry" to adjust policy until there is greater clarity on the effects of renewed trade measures. Consumers have continued to spend despite weak sentiment, likely supported by still-healthy household balance sheets and a stabilized labor market. If this puzzling behavior continues into 2Q25, it could reinforce the Fed’s decision to extend its pause, indicating that recession fears may be overstated. For now, our view is that a major shift in the Fed’s tone is unlikely. Our attention will remain focused on any signals of a possible change in outlook heading into the June meeting.

The US economy contracted at an annualized rate of 0.3% in 1Q25, the first decline since early 2022

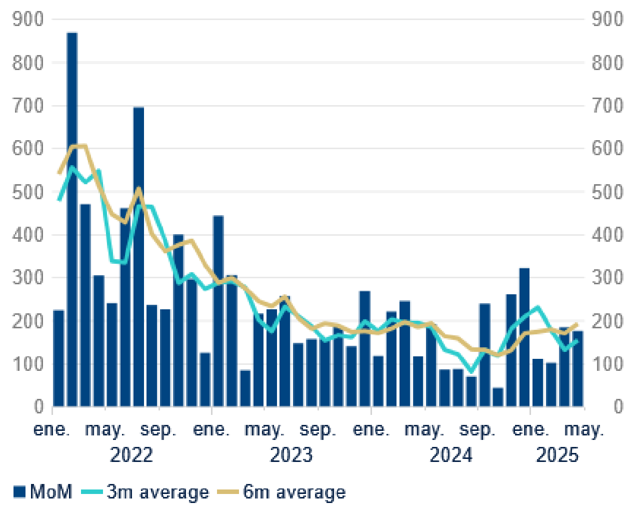
Figure 1. **REAL GDP GROWTH** (%)



Source: BBVA Research / BEA

The labor market remains resilient, with non-farm payrolls rising by 177,000 in April

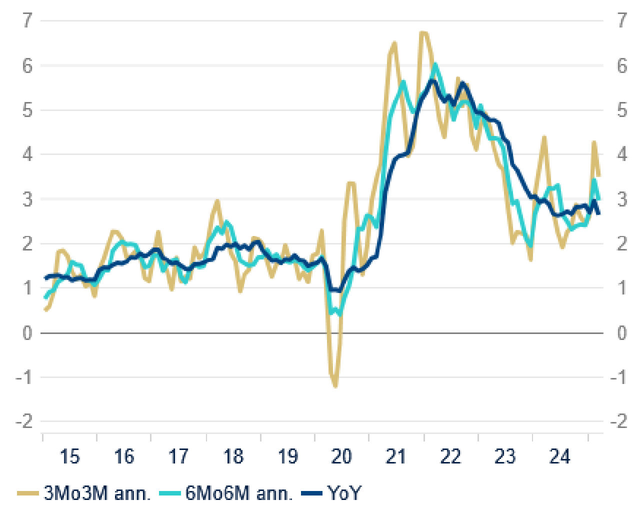
Figure 2. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)



Source: BBVA Research / BLS

The Fed's preferred PCE inflation measure rose only slightly, pushing core inflation down to 2.6%

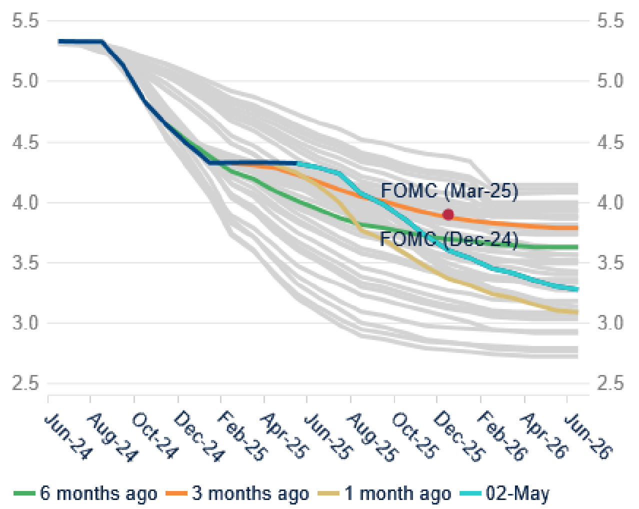
Figure 3. **CORE PCE INFLATION** (%)



Source: BBVA Research / BEA

Markets are pricing in a ~70% chance of at least three rate cuts by year-end

Figure 4. **FUTURES-IMPLIED FED FUNDS RATE** (%)



The gray lines indicate weekly implied rate paths over the past year
Source: BBVA Research / CME / Fed

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