

# The Fed is set to uphold its “wait-and-see” stance

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**Uncertainty over the policy outlook remains elevated as the effects of tariffs on inflation and the labor market are yet to be felt**

**Data since the May FOMC meeting indicate that real activity remains generally firm, supporting the Fed’s decision to hold rates steady.** While retail sales rose just 0.1% in April, this modest increase still signaled consumption resilience, coming after a sharp 1.7% gain in March likely driven by tariff front-running. In addition, the April PCE report showed a 0.4% rise in services spending and a 0.8% increase in nominal incomes. The latter helps explain why consumption has not faltered, despite widespread sour sentiment. The University of Michigan consumer sentiment index fell in May to its lowest level in decades outside the pandemic. However, it rebounded substantially in June according to the preliminary report, likely reflecting easing concerns over tariffs ([Figure 1](#)), which so far have not significantly fed into inflation ([Figure 2](#)). Manufacturing output declined 0.4% in April, led by a 1.9% drop in motor vehicle production as earlier front-loading effects faded. However, aerospace and parts manufacturing rose by 1.1%, and fabricated metal products gained 1.0%. The ISM manufacturing index dipped to 48.5 in May, driven by inventory drawdowns, but both the production and new orders components improved—likely signaling firmer domestic demand. A gloomier picture emerged from the ISM services index, which fell below 50 in May for the first time since June 2022. This continued its decline from the October 2024 peak of 55.8, driven by sharp drops in new orders and business activity, underscoring broader economic uncertainty tied to tariffs. April’s trade data showed a 16.3% plunge in imports and a 3.0% rise in exports, reflecting the anticipated end of tariff-related stockpiling. This swing in net exports is now the primary driver behind the Atlanta Fed’s current 3.8% GDPNow forecast for 2Q25. Overall, the data continue to justify the Fed’s wait-and-see stance as the second quarter progresses.

**Labor market conditions continue to reflect resilience and stability, though some signs of softening are gradually emerging beneath the surface.** April’s JOLTS report pointed to a still-healthy labor market at the start of 2Q25. Job openings rose to 7.39 million, lifting the openings rate back to 4.4%, while the Beveridge curve continued to track its pre-pandemic dynamics. The hiring rate increased to 3.8%, while layoffs remained low at 1.1%, and the quits rate edged down to 2.2%. Non-farm payrolls increased by 139,000 in May ([Figure 3](#)), with gains concentrated in healthcare, social assistance, and leisure & hospitality. However, jobs in manufacturing, retail, and temporary help services declined modestly, indicating limited but visible effects from tariffs. Moreover, payroll figures for the previous two months were revised down by a combined 95,000. The unemployment rate held at 4.2%, while both the participation

rate and the employment-to-population ratio edged lower—likely reflecting difficulties in matching workers to open positions amid intensified anti-immigration measures. Indeed, continuing claims for unemployment insurance rose by 54,000 to 1.956 million in the week ending May 31, the highest level since November 2021 ([Figure 4](#)). Nevertheless, average hourly earnings rose 0.4% in May, keeping the annual rate at 3.9%—a pace still likely to be seen by the Fed as inconsistent with long-term price stability. Further moderation in wage growth, which we view as likely, would bolster confidence in the disinflation process. Finally, ISM employment components showed modest improvement in May. The manufacturing employment index ticked up but remained in contraction, while the services employment sub-index returned to expansion after two months below 50. In sum, while some signs of softening are emerging, intermeeting data will likely reinforce the view among FOMC members that labor demand, while likely to soften, still remains generally solid despite tariff-related uncertainty.

**Inflation data have remained broadly benign, with little indication to date that tariffs are significantly passing through to consumer prices.** Core CPI inflation rose by just 0.13% MoM in May, below expectations, leaving the annual rate unchanged at 2.8%. While some tariff-related pressures were evident in categories such as toys and major appliances, these were offset by declines in both used and new car prices. As a result, core goods prices were flat overall, while services inflation remained moderate amid a further decline in airfares and a muted increase in medical care services. Indeed, the CPI data suggest that core PCE inflation is likely on track for a third consecutive target-consistent monthly gain in May. The April report had already shown subdued core PCE inflation (0.12% m/m), with the annual rate falling to 2.5%. This likely explains why survey-based inflation expectations appear to have peaked. Although both ISM surveys reported still-elevated “prices paid” indices in May—particularly in services—actual pass-through to consumer prices remains limited so far. The University of Michigan’s June survey showed a sharp drop in one-year inflation expectations to 5.1% (from 6.6%) and a modest decline in five-year expectations to 4.1%. Though still elevated, these moves suggest households are becoming less alarmed about inflation risks amid scarce evidence (yet?) of broad-based price pressures. With lingering uncertainty over where tariffs will ultimately settle, the latest inflation figures justify a cautious approach by the Fed, allowing it to wait to see how the effect of tariffs on inflation and growth unfolds. A further pickup in core prices remains quite possible as cost pressures feed through, but current trends suggest the process is evolving gradually rather than disruptively.

**Treasury yields and rate expectations have aligned more closely with the Fed’s cautious stance, reversing earlier bets on swift easing.** The FOMC’s decision to hold rates steady in May, along with Powell’s emphasis on a “wait-and-see” approach, prompted a notable repricing in short-term yields: the 2-year Treasury yield rose from 3.6% in late April to around 4.0% by the end of May, while long-term yields remained elevated. The 10-year yield has hovered near 4.4% since early 2025, and the 30-year yield climbed to its highest level since October 2023—likely driven not by growth optimism, but by rising term premia linked to fiscal concerns and diminished foreign demand for U.S. Treasuries. Despite elevated yields, market volatility has generally stabilized since the “Liberation Day” spike, and market-based inflation expectations have remained well anchored. Professional forecasters left short-term rate expectations largely unchanged in May—broadly consistent with two rate cuts. Implied policy rate expectations in fed

funds futures shifted significantly upward, now pricing in a 70% probability of no more than two rate cuts by year-end, compared to just 5% in late April (see [here](#) for more on the recent evolution of US interest rates). The minutes of the May FOMC meeting carried a slightly hawkish tone. “Almost all” participants highlighted the risk of persistent inflation, with “many” citing reports from firms planning to pass tariff-related cost increases on to consumers. Overall, with no clear signs of systemic financial stress or accelerating inflation pass-through, markets appear to have accepted that the Fed is in no hurry to restart easing, even as more recent Fed communications have revealed a more nuanced divergence of views. Some officials, such as Governor Waller, have signaled openness to rate cuts later this year. Others, however, have emphasized the need for patience, voicing concerns that tariff-related price increases could prove sticky.

**The Fed is set to hold rates at 4.25-4.50%, but the updated SEP will likely reflect lingering risks to inflation and emerging risks to unemployment.** While hard data have generally held up, the continued lack of clear evidence of tariff-driven inflation pressures is likely to keep the Fed cautious on the inflation outlook, amid concerns about persistence. Chair Powell will likely reiterate his message that the Fed is in “no hurry” to adjust policy. Markets will pay close attention to the updated Summary of Economic Projections (SEP). In March, the SEP revisions reflected a modestly higher inflation outlook (core PCE at 2.8% for Q4, up from 2.5%), a slightly higher unemployment rate (4.4%, up 0.1 percentage points), and weaker GDP growth (1.7% Q4/Q4, down from 2.1%). Given recent developments, we expect the Fed to revise its unemployment and growth projections further in the same direction and to possibly raise its inflation forecast slightly. If confirmed, this could nudge the median interest rate projection higher as well. Back in March, the median dot plot still pointed to two rate cuts in 2024. However, 8 of 19 participants projected either only one cut (four members, up from three in December) or none at all (also four, up from one in December). If a couple of members were to shift from projecting two cuts to just one, the median dot would move to a single rate cut—aligning with our recently revised fed funds rate forecasts ([see](#)). While signals on how the Fed now assesses the evolution of risks to its goals will draw significant attention, all eyes will be on the dot plot to see whether a majority still favors at least one rate cut this year.

Consumption has not faltered despite widespread sour sentiment. The UoM consumer sentiment index rebounded in June as tariffs have so far not significantly fed into inflation

**FIGURE 1. UoM CONSUMER SENTIMENT INDEX (PRELIMINARY, FEB.-1966=100)**



Source: BBVA Research / University of Michigan

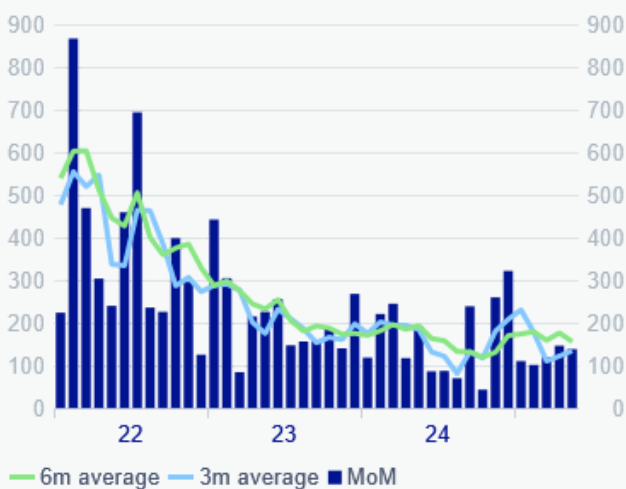
**FIGURE 2. CORE INFLATION (%)**



Source: BBVA Research / BLS / BEA

Non-farm payrolls increased by 139,000 and the unemployment rate held at 4.2%, but continuing claims for unemployment insurance rose by 54,000 to 1.956 million, the highest level since November 2021

**FIGURE 3. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)**



Source: BBVA Research / BLS

**FIGURE 4. CONTINUING JOBLESS CLAIMS (MILLIONS)**



Source: BBVA Research / Labor Dept.

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