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Fed set to pause as it balances labor risks and strong demand

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Post-shutdown data normalization justifies a pause while preserving optionality for future easing amid a hiring freeze

Recent data indicate that 2025 growth significantly outpaced initial expectations; this momentum, driven by resilient consumption and sustained AI investment, provides a positive carryover into 2026. The flow of hard data has improved since the December meeting, allowing for a clearer read on recent momentum. The latest GDP estimate showed that growth accelerated in 3Q, with real GDP expanding at a 4.4% annualized pace, driven by strong consumption growth. While overall investment growth decelerated, it remained underpinned by still-rapid gains associated with the ongoing AI-related capex boom. Final sales to private domestic purchasers held at a solid 2.9% pace, pointing to resilient underlying demand (Figure 1). Net exports also appear to be providing a meaningful tailwind despite continued distortions from non-monetary gold trade (excluded from GDP) and unusual swings in pharmaceutical trade likely linked to tariff threats. While 4Q GDP is not yet available, activity appears to have ended the year on firm footing. Real consumption rose by 0.3% m/m in both October and November, suggesting that the government shutdown had limited adverse effects on household spending. Manufacturing activity still looks soft overall, though segments tied to IT equipment production continue to provide some support. The Atlanta Fed's GDPNow model currently points to strong 4Q growth of around 5.4%. The latest estimate of productivity growth (4.9% in 3Q), likely linked to growing AI adoption, is probably a reason behind the recent divergence between resilient output and softer hiring. Taken together, intermeeting data should reinforce the view among most FOMC participants that the economy requires no additional near-term policy support, validating the already signaled pause.

The labor market remains in a "low-hire, low-fire" equilibrium, with limited layoffs offsetting subdued job creation and preventing a sharper rise in unemployment. Following the end of the government shutdown, the BLS released delayed employment reports for October and November in mid-December, shortly after the FOMC meeting. The data showed somewhat stronger-than-expected gains in private payrolls and an increase in the unemployment rate to 4.6%, a move that was largely driven by a notable expansion of the labor force rather than a material deterioration in household employment. The December employment report, published earlier this month, showed nonfarm payrolls rising by 50,000—broadly in line with expectations—alongside a downward revision to the previously reported October losses (Figure 2). The unemployment rate edged back down to 4.4% (from a downwardly revised 4.5% in October), reflecting a rebound in the employment measure of the households survey amid a modest decline in labor force participation. JOLTS data for November continued to signal a steady cooling in labor demand without any significant rise in layoffs. Taken together, official data through the end of 2025 confirm a sharp loss of momentum in the labor market, but still provide limited evidence of a more concerning deterioration, pointing instead to a broadly stagnant environment. This assessment is reinforced by forward-looking indicators. ISM employment subindices showed tentative stabilization in December, with a modest uptick in manufacturing employment and a more notable rebound in services. While this evidence is consistent with a “low-hire, low-fire” equilibrium, the outlook remains vulnerable to a sharper deterioration should job losses accelerate, potentially triggering a sudden rise in the unemployment rate. This risk likely ensures the Fed will keep the door open for a resumption of the rate-cutting cycle later this year.

Even with limited evidence of tariff-related price pass-through so far, upside inflation risks from strong demand are likely to remain central to the Fed’s assessment. Besides, pre-tariff imports frontloading suggests a lagged price pass-through, creating a latent inflation risk the Fed has yet to fully quantify. As with labor market data, the resumption of CPI releases occurred only after the December FOMC meeting. The government shutdown significantly impaired CPI data collection in October and November. Against that backdrop, CPI readings for those months were puzzlingly soft. Headline inflation eased to 2.7% y/y in November, while core inflation fell to 2.6% y/y (both from 3.0% in September). The slowdown was unusually broad-based, including a notable moderation in shelter inflation, with owners’ equivalent rent rising well below its 2025 pace. PCE inflation data for October and November, released last week, painted a more nuanced picture. Total and core PCE inflation increased by 0.21% and 0.16%, respectively, leaving annual inflation rates broadly stable at around 2.8% in both months. The December CPI release showed core inflation rose by a below-consensus 0.2% m/m, led by further easing in services—particularly shelter—while core goods prices remained broadly flat, likely reflecting at least some transitory tariff-related pressures. Overall, intermeeting evidence suggests limited tariff pass-through to consumer prices thus far. This is due in part to offsetting factors such as moderating shelter inflation, which continues to provide a disinflationary tailwind against potential goods-price pressures. Looking ahead, near-term estimates such as the Cleveland Fed’s CPI nowcast suggest that disinflation should continue, albeit at a more gradual pace. We continue to think most at the Fed will prefer to keep conveying a data-dependent approach for future decisions to prevent markets from pricing out inflation risks. This caution is warranted by the continued strength in domestic demand and possible inflationary pressures from tariffs, which could have been masked thus far by import frontloading and the offsetting cooling of shelter inflation.

Since the December FOMC meeting, financial markets have increasingly aligned with the view that the Fed will keep rates unchanged in the near term. Treasury yields were largely range-bound over the holiday season, with more recent increases driven mainly by geopolitical headlines related to US-Europe tensions around Greenland rather than domestic developments. Markets reacted with little concern to Powell’s remarks regarding the DOJ investigation into the Fed’s headquarters renovation, suggesting low confidence in the case’s escalation and success. Still, concerns about Fed independence—particularly surrounding future leadership—could gradually exert further upward pressure on long-term inflation expectations

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(Figure 3), even if near-term market pricing remains relatively stable. Expectations that the Fed will remain on hold while Powell stays on as Chair until May appear to be limiting further curve steepening. Futures-implied paths now embed a pause likely to extend for at least three consecutive meetings (Figure 4), with markets assigning roughly a 75% probability to no more than two rate cuts before year-end (see here for more on the recent evolution of interest rates). The minutes from last month's meeting characterized the December rate cut as a "finely balanced" decision, with some participants noting that they could have supported keeping rates unchanged. Despite differing views on the degree of remaining policy restrictiveness, most participants agreed that further easing toward neutrality may eventually be warranted to avoid a significant deterioration in the labor market. Importantly, the minutes also pointed to a growing consensus that tariffs are unlikely to generate persistent inflation pressures.

The Fed is set to pause its easing cycle this week, keeping the policy rate unchanged at 3.50-3.75%. The case for a pause will be anchored primarily in upside inflation risks stemming from stronger-than-expected growth toward the end of 2025, which has reduced the need for additional near-term policy support. Resilient domestic demand, continued momentum in consumption, and relatively elevated goods inflation—even amid limited tariff pass-through—are likely to dominate arguments for caution against moving too quickly toward further easing. That said, the pause is unlikely to be accompanied by a markedly hawkish tone. The labor market remains in a fragile "low-hire, low-fire" equilibrium, leaving the outlook vulnerable to a rapid deterioration should job losses accelerate and translate quickly into a higher unemployment rate. As a result, the Fed is likely to avoid signaling that the easing cycle has definitively ended, instead emphasizing optionality and data dependence. This should translate into guidance that keeps the door open to further easing later this year.

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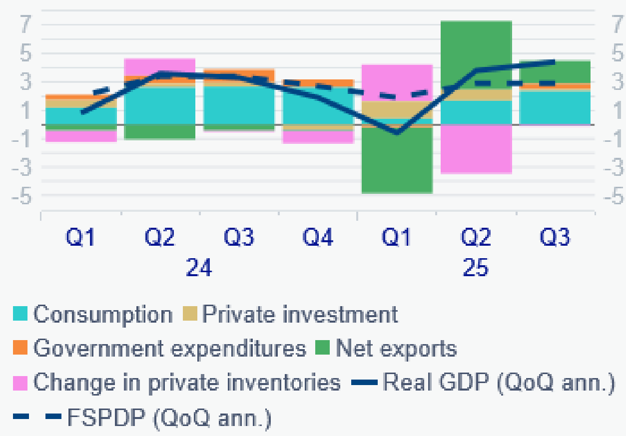
Growth accelerated in 3Q, with real GDP expanding at a 4.3% annualized pace

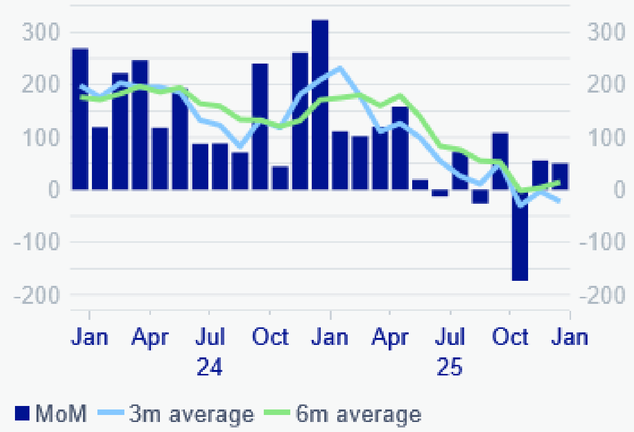
FIGURE 1. REAL GDP GROWTH (%)



Source: BBVA Research / BEA

Nonfarm payrolls rose by 50,000 in Dec amid a downward revision to October losses

FIGURE 2. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

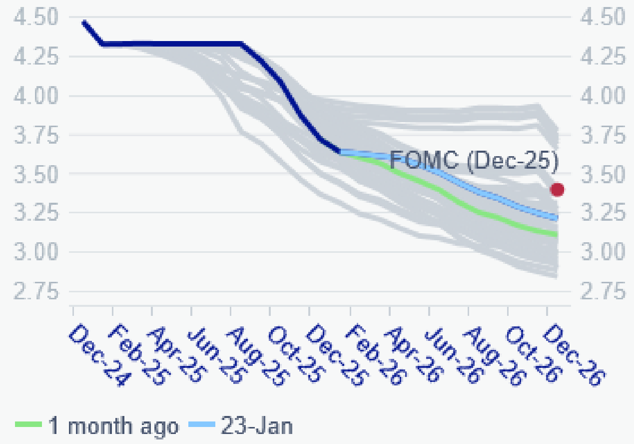
Concerns about Fed independence could exert further pressure on inflation expectations

FIGURE 3. BREAKEVEN INFLATION RATES IN TREASURY YIELDS (%)

Source: BBVA Research / Treasury Dept.

Markets now assign roughly a 75% probability to no more than two rate cuts before 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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