

# Oil shock is set to reinforce Fed caution on resuming easing

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## The FOMC will likely stress a wait-and-see approach as it assesses how the outlook evolves before shifting its policy bias

**Intermeeting data showed that economic activity lost momentum late last year, contrary to earlier indications of particularly strong 4Q growth.** Last week's BEA second estimate showed 4Q26 real GDP growth slowed to 0.7% annualized, down from the 1.4% advance estimate, largely reflecting a 16.7% contraction in federal spending that subtracted about 1.2 pp from growth amid the government shutdown. Underlying domestic demand remained relatively solid, with final sales to private domestic purchasers rising 1.9%, supported by continued gains in consumption and business investment ([Figure 1](#)). The latter likely continues to reflect solid demand linked to AI. Shipments of non-defense capital goods excluding aircraft rose 0.9% m/m in December, with categories linked to computing and communications equipment posting strong gains. Early 2026 data also paint an encouraging picture, partly reflecting the post-shutdown rebound. The ISM manufacturing index remained in expansionary territory in January and February—after several years of persistent weakness—while the services index rose to its highest level since mid-2022. That said, consumer activity showed some softness at the start of the year, with retail sales declining amid weather-related disruptions. Still, real disposable income rose 0.7% m/m in January, a tailwind for consumption going forward. Our attention will focus on how the recent oil price surge tied to the war in Iran may shape FOMC participants' outlook for economic activity. As a net energy exporter, the overall growth impact may prove limited, but persistently high fuel prices could erode household purchasing power and weigh on consumer spending over time.

**Mixed labor market signals point to broadly stable but increasingly fragile conditions, likely keeping in focus downside risks to the Fed's employment goal.** January's employment report suggested some renewed strength, with nonfarm payrolls rising by 130,000, largely driven by gains in health care and social assistance, as well as solid increases in construction and professional and business services. The unemployment rate fell to 4.3% despite a rebound in participation to 62.5%, indicating some improvement in labor market conditions. However, the February employment report showed payrolls declining by 92,000, alongside downward revisions totaling 69,000 to the prior two months ([Figure 2](#)). The weakness was broad-based, with job losses across manufacturing, construction, transportation, and leisure sectors, while health care—previously the main driver of hiring—also posted declines. The unemployment rate edged up to 4.4%, reflecting largely stable labor force participation. Other indicators suggest that labor demand continues to cool but without a sharp deterioration.

Job openings fell to 6.5 million in December, the lowest level in five years, while hiring remains subdued even as layoffs stay historically low. Initial unemployment claims have remained broadly stable at around 210,000 in recent weeks, offering little evidence so far of a meaningful rise in layoffs. Taken together, recent employment data continue to support the characterization of the labor market as a “low-hire, low-fire” equilibrium. While this configuration limits near-term increases in unemployment, it leaves the outlook vulnerable to a faster deterioration should hiring weaken further or layoffs begin to rise, potentially triggering a sharper increase in the unemployment rate. This continued risk suggests the Fed will likely seek to convey that it is keeping the door open to resuming rate cuts later this year.

**Inflation data prior to the surge in oil prices suggested that tariff-related price pressures remained contained, although progress toward disinflation continues to be uneven.** In January, headline CPI rose 0.17% m/m, bringing the annual rate down to 2.4%, while core CPI increased 0.3% m/m, lowering the annual rate to 2.5%—its lowest level since early 2021. The softer-than-expected January reading was driven in part by non-core components, particularly lower gasoline prices, although easing shelter inflation and continued softness in core goods prices also contributed to the moderation. Used vehicle prices declined notably and there was still limited evidence of tariff-related pass-through to consumer prices. February data reinforced that picture. Core CPI increased 0.22% m/m, leaving the annual rate unchanged at 2.5%, while headline CPI rose 0.27% m/m, reflecting somewhat firmer food and energy prices. Shelter inflation remained broadly stable, suggesting that the gradual easing in housing-related price pressures continues to support the disinflation process. That said, the Fed’s preferred core PCE price index rose about 0.36% m/m in January, pushing the annual rate back to roughly 3.1%, highlighting a puzzling gap between CPI and PCE core inflation measures since November ([Figure 3](#)). Looking ahead, the recent surge in oil prices could introduce renewed upside risks to inflation. Beyond the direct impact on energy prices, Fed officials will likely convey the need to assess potential second-round effects stemming from higher oil prices following the war in Iran, which could gradually feed into transportation and other services costs. Even so, the continued moderation in shelter and goods prices suggests that underlying inflation pressures remain broadly contained, which would allow the Fed to leave the door open to the possibility of resuming rate cuts later this year.

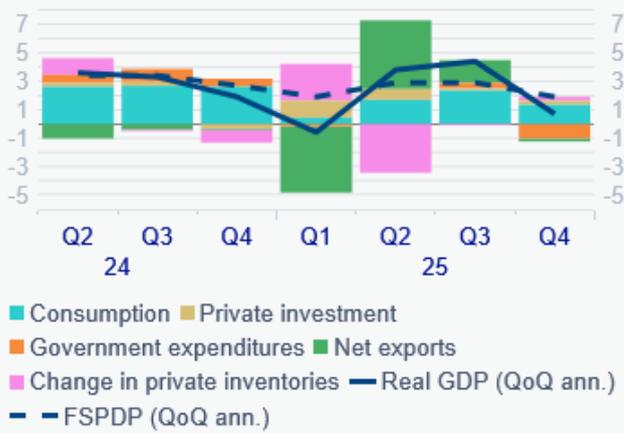
**Financial markets have recently shifted to reflect increased geopolitical risks and greater uncertainty around the inflation outlook amid soaring oil prices.** Treasury yields declined through late February following January’s softer-than-expected CPI print, which pushed the 10-year yield down to around 3.94%, its lowest level since April of last year, partly reflecting lower implied inflation expectations and a compression in the term premium that led to a downward shift in the yield curve (see [here](#) for more on the evolution of interest rates prior to the war). More recently, however, yields have rebounded amid the escalation of the conflict between the U.S. and Iran and the associated surge in oil prices. The increase in yields appears to reflect higher global risk premia and rising inflation expectations (notably, 5y5y forward inflation expectations have actually declined, suggesting that markets are not concerned about medium-term inflation), alongside somewhat firmer expected real yields and a modest increase in the term premium. Notably, this risk-off episode has not produced the typical flight to safe-haven assets: while the dollar has appreciated to its highest level since May, Treasury

yields have moved higher rather than lower, suggesting markets are placing greater weight on the potential inflationary implications of sustained energy price increases. At the same time, the futures-implied policy path now points to limited room for additional rate cuts this year ([Figure 4](#)). This new environment is likely to reinforce the concerns already voiced by more hawkish FOMC participants. The minutes from the January meeting revealed growing unease among several policymakers regarding the inflation outlook. While most participants agreed that the labor market had stabilized and that moderating shelter inflation and stronger productivity could help keep inflation on a downward path, many warned that further progress could prove slower and more uneven than expected. Some participants also noted that they could have supported a more two-sided description of the policy outlook, acknowledging the possibility that policy rates might need to rise again if inflation remains persistently above target. Taken together, these developments reinforce the view that the Fed is likely to maintain a cautious stance while monitoring evolving inflation risks.

**The FOMC is set to keep the policy rate unchanged at 3.50%-3.75% this week and to keep conveying a cautious, data-dependent approach in light of renewed risks.** Prior to the recent surge in oil prices, our baseline assumed the Fed would remain on hold until midyear before resuming the easing cycle in the second half of 2026. Recent geopolitical developments have further reduced the likelihood of an earlier rate cut. But while we expect the Fed to rule out near-term easing, we expect it to maintain an easing bias and signal that, if the conflict proves short-lived, it can largely look through the oil-driven inflationary supply shock. Market pricing already reflects greater uncertainty around the inflation outlook, reducing the need for the Fed to emphasize upside inflation risks as strongly as in previous meetings. Even so, policymakers are likely to maintain a cautious, data-dependent stance. Such caution remains warranted given strong domestic demand, the potential for tariff-related price pressures to emerge as import front-loading fades and shelter disinflation normalizes, and the risk of second-round effects from higher oil prices following the Iran conflict. Against this backdrop, we do not expect a meaningful change in the median policy rate projection in the SEP, even if inflation forecasts move somewhat higher. A broadly unchanged median rate projection in the dot plot would suggest that the Fed prefers to wait and see how the outlook evolves before making any significant shift in its policy bias.

4Q26 GDP growth slowed to 0.7% annualized, down from the 1.4% advance estimate

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



Source: BBVA Research / BEA

Feb jobs report showed payrolls declining by 92k, with downward revisions to prior months

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



Source: BBVA Research / BLS

Data highlights a puzzling gap between CPI and PCE core inflation measures since November

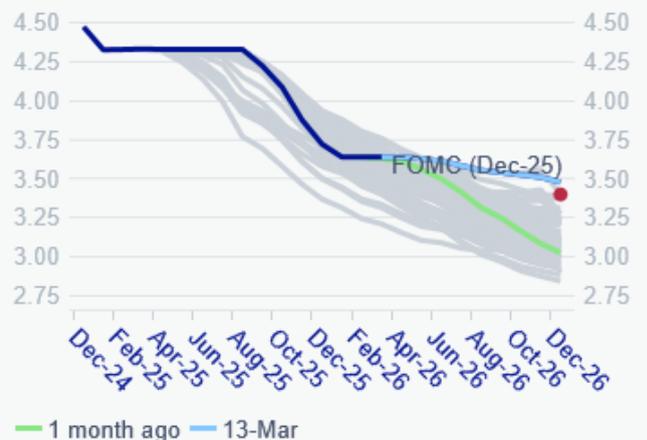
**FIGURE 3. CORE INFLATION (%)**



Source: BBVA Research / BLS / BEA

The futures-implied policy path now points to limited room for additional rate cuts this year

**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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