

Fed set to hold rates steady in Powell's final meeting as Chair

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Stronger-than-expected March consumption and employment may tilt the Fed's tone slightly more hawkish

While the third estimate of 4Q25 GDP confirmed a weaker end to last year than initially thought, US consumers continued to hold up well heading into 2026. Real GDP growth was revised down to 0.5% annualized, from the 0.7% second estimate, reflecting a softer contribution from investment. With final sales to private domestic purchasers only marginally revised to 1.8% from 1.9%, the underlying picture remained little changed, with 4Q weakness largely reflecting a bigger drag from the government shutdown. Recent data suggest consumption has held up well despite the energy shock. Retail sales rose 1.7% m/m in March, largely driven by gasoline, but sales excluding gasoline increased by 0.6% m/m. Investment has also remained supported by the AI buildout, with core capital goods orders rising 0.8% m/m and extending their run of gains to nearly a year, led by computers and related products. The Atlanta Fed's GDPNow model points to 1Q26 growth of around 1.2% annualized, with contributions of roughly 0.9 pp from both consumption and nonresidential investment, partly offset by a drag from net exports and residential investment. On the supply side, industrial output fell 0.5% m/m in March due to declines in mining and utilities, but manufacturing output expanded at a 3.0% annualized rate in 1Q. While oil prices have moderated following the temporary U.S.-Iran ceasefire, the continued uncertainty around the conflict is likely to keep weighing on confidence in the growth outlook. As a net energy exporter, the overall impact on U.S. growth may be limited, but persistently elevated fuel prices could erode purchasing power and weigh on consumption over time. For now, strong consumption supports extending the pause.

Labor market signals remain mixed and volatile, pointing to broadly stable yet still fragile conditions, keeping downside risks to the employment goal in focus. Following a downwardly revised decline of 133,000 in February, nonfarm payrolls rebounded by 178,000 in March, with much of the increase reflecting temporary factors. The 91,000 gain in health care was partly driven by the end of sector strikes, while gains in leisure and hospitality (+44,000) and construction (+26,000) were likely supported by the unwinding of unusually cold weather that had weighed on February data. But at the same time, manufacturing, trade, transportation and utilities, and professional and business services posted a combined gain of around 50,000 jobs, reversing the previous month's decline and bringing total gains in 1Q26 to 78,000—the first quarterly increase since 1Q23. By contrast, continued declines in information and financial services—particularly in the former, which has not posted a positive gain since December 2024—likely reflect faster adoption of AI in these sectors. Despite the March rebound, the

three-month average increase remained modest at 68,000 ([Figure 1](#)). The unemployment rate edged down to 4.3% (from 4.4%), driven by declines in both the labor force and household employment, pointing to lower participation rather than stronger job creation. March's rebound also contrasts with soft signals elsewhere: employment subindexes from both the manufacturing and services ISM declined, with the latter falling to its lowest level since December 2022, while initial jobless claims edged up to 214,000 from 208,000 in the week ending April 17. Overall, employment data continue to suggest a "low-hire, low-fire" equilibrium. While this should contain near-term increases in unemployment, it leaves the outlook vulnerable to a faster deterioration if hiring slows further or layoffs rise—particularly if higher gas prices weigh more heavily on real disposable income and consumer demand. Against this backdrop, the Fed is likely to maintain optionality and keep the door open to eventually resume rate cuts. Yet, even recent remarks by one of the more dovish members, Governor Waller, suggest somewhat less concern about recent labor market softening. He noted that the labor market is "vulnerable to weakness" and that "head-snapping volatility" complicates assessment relative to the Fed's employment goal. He also sees a "possibility that even several months of negative payrolls may not signal a recession as they often have in the past." Overall, labor market concerns may have eased somewhat over the intermeeting period.

As widely expected, headline inflation picked up in March driven by the sharp 21.2% m/m rise in gasoline prices derived from the Middle East energy shock. Headline CPI increased by 0.9% m/m (3.3% y/y, up from 2.4% in February). Core inflation remained relatively contained, with core CPI rising 0.2% m/m (2.6% y/y, up 0.1 pp from February). Goods inflation edged up to 1.2% y/y (from 1.0% in February), reflecting a combined 1.4 pp contribution from household furnishings, apparel, and recreation commodities, likely driven by the ongoing pass-through of tariffs, which more than offset the decline in used vehicle prices (-0.4% m/m). Services inflation eased slightly, to 0.2% m/m from 0.3% in February, with shelter prices rising 0.3% m/m. However, other measures of underlying inflation continue to point to still persistent pressures. The Fed's preferred core PCE deflator—which continues to diverge from its historical negative spread to the CPI measure ([Figure 2](#))—remained elevated through February, suggesting still uncomfortable disinflation progress. In particular, the 0.37% m/m increase in the core PCE deflator pushed the three-month annualized measure up to 4.4% (from 3.6% in January), a notable development that is unlikely to go unnoticed by the Fed and will likely keep most participants leaning cautiously hawkish ([Figure 3](#)). While most participants are likely to view the recent pickup in inflation as a largely one-off shock, Fed officials will likely emphasize the need to assess potential second-round effects from higher oil prices, particularly as they feed into transportation and other services costs as the Strait of Hormuz remains closed. Even so, the gradual progress in services disinflation suggests that underlying demand-driven inflation pressures remain relatively contained, allowing the Fed to keep the door open to eventually resuming rate cuts.

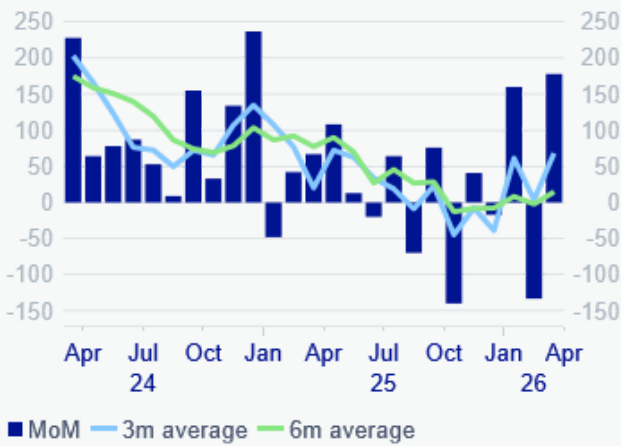
Financial markets have partly unwound earlier concerns about possible rate hikes as geopolitical tensions have eased from their March peak. By late March, futures market pricing implied roughly a 45% probability of at least a rate hike before year-end, but that likelihood has since fallen to near zero. The extension of the U.S.-Iran ceasefire from last week has helped stabilize long-term Treasury yields, keeping them within a relatively narrow range

around after the earlier surge. A more durable de-escalation could support a near-term rally in Treasuries, particularly as the recent decline in volatility ([Figure 4](#)) points to orderly market functioning and limited signs of stress (see [here](#) for more on the evolution of interest rates). At the same time, the March FOMC minutes highlighted a greater emphasis on upside inflation risks, with most participants noting that progress toward disinflation could be slower and more uneven than previously expected. While some flagged the possibility that persistent inflation could warrant further tightening, the Committee maintained an easing bias, with many participants still expecting that rate cuts could resume over time, particularly if the labor market weakens. Overall, the minutes reinforced a cautious, data-dependent stance, with policymakers stressing the need to remain nimble amid elevated uncertainty. More recently, communication around the potential leadership transition at the Fed has added another layer of uncertainty. In his confirmation hearing, Warsh signaled support for a policy framework more focused on interest rates and expressed a preference for lower rates over time, partly reflecting optimism about the supply-side effects of AI. He also questioned the Fed's reliance on core PCE as its primary inflation gauge and reiterated his views on balance sheet normalization and communication strategy.

The FOMC is set to keep the policy rate unchanged at 3.50%-3.75% this week and still convey a cautious, data-dependent approach in light of lingering risks. While the Fed approaches this meeting in a somewhat more benign geopolitical environment, still-sticky core PCE inflation, alongside March's upside surprises in retail sales and nonfarm payrolls, may push the Committee toward a somewhat more hawkish tone at the margin. That said, we expect the Fed to avoid signaling that the next move will be a rate hike. This week's meeting will also mark Powell's final scheduled decision as Chair, with attention likely to focus on whether he signals any intention to remain on the Board after his term ends. This comes as the expected leadership transition appears less contentious than previously thought, following the Department of Justice's decision to drop its investigation into the Fed's renovation project and recent remarks from Senator Tillis indicating his willingness to support Warsh's nomination.

Mixed and volatile labor market data point to broadly stable but still fragile conditions

FIGURE 1. CHANGE IN NONFARM PAYROLL EMPLOYMENT (THOUSANDS)



Source: BBVA Research / BLS

Core PCE inflation continues to diverge from its historically negative spread to core CPI

FIGURE 2. CORE INFLATION (%)



Source: BBVA Research / BLS / BEA

The Feb increase in core PCE inflation pushed the three-month annualized rate to 4.4%

FIGURE 3. CORE PCE INFLATION (%)



Source: BBVA Research / BEA

The recent volatility decline points to orderly market functioning and limited signs of stress

FIGURE 4. ICE BOFAML MOVE INDEX (INDEX POINTS)



The shaded areas indicate the ranges within one and two standard deviations from the mean
Source: BBVA Research / ICE BofAML

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