At the January meeting, the U.S. Federal Reserve Open Market Committee voted to keep the Fed funds rate steady at the current range of 4.25-4.50%. There were no dissents.

The formal statement was changed a bit, in removing the negative comment about labor conditions easing, instead "remaining solid." Inflation was downgraded from "made progress" to "remains somewhat elevated."

CME Fed funds futures have been pointing to fewer assumed policy moves in 2025. Odds of a half-dozen or more rate cuts a few quarters ago have shrunk to just one cut by June, and two by December, to a year-end level of 3.75-4.00%. Futures market probabilities for next year have been rolled out, with expectations of 3.75-4.00% by June 2026 and 3.50-3.75% by December 2026, which implies one additional cut, with the Fed continuing to creep along easing slowly until their long-term neutral rate target is reached. If a recession creeps up in the meantime, further cuts are likely, although not priced in. In recent public comments, several FOMC members voiced their satisfaction with current policy rate levels, with perhaps fewer cuts now needed. There also seems to be begrudging acceptance that the long-term neutral rate might end up higher than previously assumed (as of December, the FOMC member median was 3.0%, although the range of opinions was 2.4-3.9%).

Economy. The Atlanta Fed GDPNow estimate fell from 3.2% last week to 2.3% this morning (from a revision down in net exports and inventories), showing a still-strong economic growth pace for Q4-2024. The consensus among economists is a continued solid growth pace for 2025, in the mid-2's, eventually tapering off toward long-term trend levels of ~2% in coming years. Recent robustness has been led by personal consumption, mostly on the higher-income consumer side, with holiday spending over the last few months appearing decent. Confidence about the future had been lackluster over the past few years, especially for smaller businesses, though the 2024 election and policy promises prompted an uptick in mood for some, driven by hopes of a pro-business climate, continued low taxes, and eased regulatory burdens. The above-trend growth environment continues to restrain the Fed from needing to prop the economy up through rate cuts, if looked at alone.

Inflation. For December, headline CPI rose 2.9% over the trailing 12 months, while core CPI ex-food and energy was up 3.2%. Core PCE for November came in at 2.8%, still running higher than the 2.0% FOMC target. Inflation frustration continues, with minor euphoria each month when data shows either a tick down a notch or at least not worse, and dismay if it doesn't. As has been the case for the last few years, getting inflation rates back toward target still looks to be a few quarters out on the horizon. The problem remains shelter prices, which rose 4.6% in 2024, although real-time data indicate some improvement, as rents and home prices are measured less frequently. (Pressure elsewhere has also eased, as December CPI 'all items less shelter' rose only 1.9% in 2024.) FOMC members have mentioned being satisfied with the pace of improvement, although several have shared concerns about potential impacts on inflation from the new administration's tariff and immigration policies. Signs so far point to tariffs that could be more targeted in their final form, and not as broad-sweeping as first feared, but this remains an open question. As a side note, any upward inflation pressures from tariffs could be in the form of one-time price adjustments, rather than a continued headwind. There are also worries that dramatically slowing immigration and/or mass deportations run the risk of shrinking workforce supply, creating mismatch-driven wage increases that could prove more persistent. All else equal, inflation pressures would still tilt toward a more hawkish policy stance.

Employment. Signs of some labor market deterioration in mid-2024 drove the Fed to cut rates by -1.00% last fall, including the jumbo September cut. Conditions have stabilized since then, as Fed officials have noted less uneasiness with labor during their public comments recently, coupled with the December unemployment rate declining back to a low 4.1%, strong payrolls, and a balance in job openings. So, while the Fed shifted from a hyper-focus on inflation toward labor, prompting easing, it's no longer as urgent. As noted, immigration is still a wildcard, in terms of worker-job mismatches and labor costs, although that's the opposite of a layoff-fueled recession-like labor downturn that typically prompts easier policy.

In short, today's conditions point to balance. Despite Chair Powell referring to rates in December several times as "meaningfully restrictive," the Fed does not appear eager to cut rates quickly and juice an economy already growing at an above-average rate, with labor conditions more stable. However, it still appears they'd prefer the ending policy interest rate for this cycle to be lower. Inflation remains an issue, at least in terms of how a 'last mile' 2.5-3.0% pace is more difficult to solve but is far less a problem than high-single-digit inflation of just a few years ago. The latter episode effectively packed a normal decade's worth of inflation into just a few years. That became the higher 'price level' effect many consumers think of as 'inflation' (although they're two different things) and seemed to play a big role in last year's pre-election dissatisfaction, and the heightened sensitivity to possible inflation triggers looking ahead, seen by the higher expected pace in consumer confidence surveys.

The overall environment remains decent, by any of the measures noted. In fact, the economy has moved backward a bit (in a positive way), as some indicators look more mid-cycle than late-cycle. Those on eternal recession watch look for the usual red flags like elevated debt, widening credit spreads, falling corporate profits, or spiking oil prices—none of which appear to be on the horizon. Long-term interest rates, which tend to be out of the Fed's control, have stabilized a bit after a sharp rise earlier in January. These have been tied to the same factors of strong growth and sticky inflation, but also larger government bond supply from fiscal deficits, and the re-emergence of a 'term premium' demanded by bond markets to compensate for more uncertain policy. Sharp rises in yields have historically been disruptive to stocks (as they have in recent weeks), but a moderate rise toward market-clearing levels has tended to be absorbed by markets eventually, if conditions stay generally positive. The assumed 'fair value' for the 10-year U.S. Treasury note has often fallen somewhere around the nominal GDP growth rate (the normally-quoted real growth rate plus expected inflation), putting current levels roughly in line with what one should expect. Many investors are still not used to bonds providing reasonable yields, after 15 years of distorted minimal levels, but also allows more room for normal yield fluctuation that was more common pre-2008. Normalcy is a nice luxury.

Ryan M. Long, CFA

Director of Investments
FocusPoint Solutions, Inc.

Sources: CME Group, Federal Reserve Bank, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, FocusPoint Solutions calculations.