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Review: The Fed Keeps Rates Unchanged, and For Now Remains in “Wait and See and Watch” Mode

by

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Executive Summary

- **Decision Made**: *The Fed hold US interest rates steady.* The FOMC unanimously kept the Fed funds rate steady at 4.25%–4.50%, citing rising stagflation risks. The statement also acknowledged recent market volatility as a factor in its policy deliberations. Regarding its *balance sheet policies*, the FOMC slowed its "quantitative tightening", reducing monthly Treasury roll-offs to $5 billion, down from $25 billion in March. The $35 billion cap on mortgage-backed securities remained unchanged. In terms of *forward guidance*, the Fed made it clear that for the time being it remains in "wait and see" mode, awaiting how the tariffs discussion evolves.
- **Policy Discussion**: *Fed Chair Jerome Powell said the central bank is well-positioned to observe how uncertainty around Trump's tariff policies unfolds and sees no urgency to act.* The Fed's dual mandate—price stability and full employment—has become harder to manage, with the latest statement warning of increased risks of both higher inflation and rising unemployment, signaling potential stagflation.

  Powell noted that interest rates remain "moderately restrictive" and appropriate for current conditions. He said it's too soon to prioritize one side of the mandate and that the Fed will wait for clearer data before making adjustments. The Fed cautioned that sustained tariffs could delay progress toward its goals by at least a year and may lead to persistently high inflation, instead of being a price-level adjustment.

  Markets have recovered somewhat on signs of progress in trade talks, but business surveys continue to highlight concerns over supply disruptions and rising input costs. Powell reiterated that political pressure—including Trump's calls for rate cuts—has no impact on the Fed's decisions, which are guided solely by economic data and risks.

  He also rejected the idea of preemptive rate cuts, noting that inflation remains above target and that the path forward depends on further data. Market expectations reflected no rate cut in May, less than a 30% chance in June, and the first likely move in July, with three total cuts anticipated this year.

  The Fed also continued its five-year review of monetary policy strategy, focusing on inflation behavior and long-term planning. Public engagement events and research initiatives are ongoing, with final conclusions expected by late summer.

Key Picture: US Federal Reserve Forecasts – 2025-2027

	2025*f*			2026*f*		2027*f*		Longer Run	
	Latest Reading	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report
GDP *(real growth, y-o-y)*	2.0	1.7	2.1	1.8	2.0	1.8	1.9	1.8	1.8
Unemployment rate *(%, y-o-y)*	4.2	4.4	4.3	4.3	4.3	4.3	4.3	4.2	4.2
PCE Inflation *(%, y-o-y)*	2.3	2.7	2.5	2.2	2.1	2.0	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	2.6	2.8	2.5	2.2	2.2	2.0	2.0	-	-
Federal Funds Rate *(%)*	4.327	3.9	3.9	3.4	3.4	3.1	3.1	3.0	3.0

Source: Federal Reserve '*Summary of Economic Projections*' December 2024 and March 2025. *Note:* 1. GDP reading for Q1-2025; 2. Unemployment rate as of April 2025; 3. PCE and core PCE inflation as of March 2025; 4. Projections reflect the median of FOMC forecasts

Analysis

- **DECISION MADE**: *On May 7, the US Federal Reserve's FOMC held its Fed funds range unchanged at 4.25% - 4.50% in a unanimous decision.* The decision came as it warns of stagflation risks. The statement highlighted recent market volatility and indicated that it is being taken into account in policy decisions.

  Regarding *forward guidance*, the Fed continues to be data-dependent with decisions being made meeting by meeting. However, the Fed also stated: "*In considering the extent and timing of additional adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks".* The FOMC May statement also stated that: "*The Committee is attentive to the risks to both sides of its dual mandate and judges that the risks of higher unemployment and higher inflation have risen*." During the press conference, Powell made it clear that the Fed for the time being remains in "wait and see and watch" mode, awaiting how the tariffs discussion evolves, as monetary policy is in a good place considering that – at present – the economy is broadly in balance.

  Fed rate expectations remain volatile. Ahead of the meeting, markets priced in no cut this week and less than a 30% chance in June, with the first likely move in July and three cuts expected in total for the year. According to the March dot plot, officials still anticipate a half-point rate cut by 2025, despite uncertainty around Trump's tariffs and fiscal policies.

  Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June. The Committee plans to further decrease its Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in April, the Committee will slow the reduction of its securities holdings by lowering the monthly Treasury redemption cap from $25 billion to $5 billion, while keeping the agency debt and mortgage-backed securities cap at $35 billion.

- **POLICY DISCUSSION:** *According to Powell, the Fed is well-positioned to observe how uncertainty around Trump's tariffs unfolds, emphasizing there's no need to rush.* Balancing the Fed's dual mandate—full employment and price stability—has become more challenging amid President Trump's tariff measures. The latest statement warned that "risks of higher unemployment and higher inflation have risen"—a combination that signals potential stagflation. Powell said it's too soon to determine which part of the Fed's dual mandate—employment or price stability—should take priority. He noted that interest rates are "moderately restrictive" and well-positioned as the Fed waits for more clarity on Trump's tariff policies.

  In the post-meeting statement, Powell warned that sustained tariff hikes could slow economic growth, raise unemployment, and push inflation higher—potentially with lasting effects, raising concerns of a stagflation-like scenario not seen since the early 1980s. While some price increases may be temporary, he cautioned that inflationary pressures could persist. Should those goals come into conflict, policymakers will weigh how far the economy is from each and the time needed to close those gaps. For now, the Fed sees no need to shift its stance until there is more clarity.

  Signs of progress in trade talks and a softer tone from the administration have helped markets rebound from the steep sell-off triggered by Trump's April 2 "liberation day" announcement. Still, business surveys reveal lingering concerns over supply disruptions and rising costs due to tariffs.

  During the press conference, Powell warned that if Trump's tariffs remain at current levels, they could delay progress toward the Fed's goals of stable prices and full employment for at least a year. He noted increased risks of higher inflation and unemployment, adding that uncertainty around the scale and duration of tariffs makes it difficult to predict the policy response. As a result, interest rates may stay higher for longer than previously expected. He added that, Trump's calls for lower interest rates have no impact on the Fed's decisions.

Fed rate expectations remain volatile. Powell dismissed the idea of cutting rates pre-emptively, citing inflation still above target and the potential for further increases. "We actually don't know what the right responses to the data will be until we see more data," he said. Ahead of the meeting, markets priced in no cut this week and less than a 30% chance in June, with the first likely move in July and three cuts expected in total for the year.

The Committee also continued its five-year review of monetary policy, focusing on inflation trends and future strategy. This includes public outreach and research events, with findings expected by late summer.

- **ECONOMIC ASSESSMENT:** *Ultimately, the outlook hinges on how the tariff situation unfolds.* After growing 2.5% last year, GDP contracted by 0.3% in the Q1, driven by weaker consumer and government spending and a pre-tariff import surge. However, underlying demand—measured by private domestic final purchases (PDFP, which excludes net exports, inventory investment, and government spending) rose by a solid 3%, matching last year's pace. Consumer spending slowed, but business investment rebounded. A rebound is expected in Q2 if imports don't increase as much as in Q1. The FOMC acknowledged that "swings in net exports have affected the data" but maintained its view that the economy is expanding at a solid pace.

  Job growth has remained strong despite Trump's push to shrink the federal workforce. In April, nonfarm payrolls rose by 177,000 and unemployment stayed at 4.2%, giving the Fed some flexibility amid concerns of a potential slowdown. Wage growth is moderating but still outpaces inflation, suggesting the labor market is near full employment and not a source of inflationary pressure.

  Inflation is easing toward the 2% target, though tariffs are expected to cause a one-off price spike. Trump has urged rate cuts as inflation softens. The Fed's preferred inflation measure stands at 2.3% headline and 2.6% core. Short-term inflation expectations have edged up, largely due to tariff concerns, though long-term expectations remain anchored near the 2% goal.

- **OUR TAKE:** *We don't expect immediate action.* We don't expect the Fed to cut rates in June either, and we look for a first potential rate cut in September and possibly in December (with less cuts than the market is currently pricing in). But the situation may evolve in unpredictable manner, warranting a different response.

- **MARKET REACTION AND IMPLICATIONS:** *Markets slipped following the Fed's post-meeting statement highlighting increased risks of both higher inflation and unemployment*. *In the fixed-income space, the UST yields slipped across the curve,* down an average of 2.5 to 3 basis points, after an earlier drop of over 7 basis points. 10-year Treasury yield dips by 2.5 bps to 4.27% as Chair Powell signals no urgency for policy moves. The 2-year UST fell to around 3.79% after the decision was announced. *In the currency space, dollar held slightly firmer against major currencies* like the yen and euro, following the Federal Reserve's decision to leave interest rates unchanged, as expected by markets. The Dollar Index approached near 99.7 now it trades around 99.5. EUR/USD fell and trades around 1.132. *In the equity space, stocks dip after Fed flags inflation risk but mostly recovered.* After the decision was announced, the S&P 500 fell 0.4%, the Nasdaq dropped 0.9%, and the Dow pared earlier gains, rising just 0.1%.

Analyst Certification*: We, Brunello Rosa and Nato Balavadze, hereby certify that all the views expressed in this report reflect our personal opinion, which has not been influenced by considerations of Rosa & Roubini Associates' business, nor by personal or client relationships. We also certify that no part of my compensation was, is or will be, directly or indirectly, related to the views expressed in this report.*