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MONETARY AFFAIRS:

Preview: Fed on Hold, While Assessing the Economic Impact of the War in Iran

by

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Executive Summary

- **Expected Decision**: *We expect the Fed to remain on hold in March.* In line with consensus, we expect the Fed to maintain its target Fed funds range at 3.50% - 3.75% in March. Markets see a near-certain Fed pause with attention focused on how policymakers assess the Iran war's inflation impact and whether Powell signals any possibility of rate cuts later this year.

  On forward guidance, the Fed will remain data-dependent and decide policy meeting by meeting even if the bar to a rate cut is now higher than last year. Regarding *balance sheet policy,* the Fed has resumed Treasury bill purchases—about $165bn since December, for "technical reasons"—expanding its balance sheet and supporting Treasury financing.

- **Policy Discussion**: *Escalating Middle East tensions are pushing oil prices higher and raising inflation risks just as markets expect the Fed to hold rates at 3.50%-3.75% at the March meeting*. Traders assign nearly a 100% probability to a pause. Powell has little reason to change course after resisting political pressure and being de facto cleared of DOJ allegations. With inflation rising again and the economy still relatively resilient, the Fed remains firmly in a pause phase, and markets see little chance of cuts in March or May and even beyond. The war with Iran increases inflation while reducing growth and weakening the labor market. So the right choice for the Fed is wait and see as the fog of uncertainty has increased and the impact of the war depends on how long it lasts and thus how persistent is the rise in energy prices.

  The larger uncertainty now centers on Fed leadership. President Trump has nominated former Fed governor Kevin Warsh to succeed Powell, but the confirmation process has been complicated by the DOJ investigation involving Powell and the subsequent appeal of a court ruling blocking it. If Warsh is confirmed before the June meeting, his view that technological forces such as artificial intelligence are deflationary could support rate cuts, even if there is still only a minority of three at the current time (Waller, Miran and possibly Bowman) supporting a rate cut; so Warsh may not have a majority of the FOMC in favor of rate cuts even when he joins the Fed. Also, elevated oil prices and rising inflation pressures could eliminate the case for near-term easing until the latter part of the year.

  Warsh may want to further reduce the balance sheet of Fed; but this would lead the balance to become below the "ample reserves" regime that most FOMC members support. And going to below "ample reserves" makes liquidity shocks more likely leading to more frequent future emergency liquidity injections that are backdoor forms of QE. Also, unlike what argued by Warsh, reducing the balance sheet doesn't justify a lower Fed Funds rate as in the current regime where excess reserves earn interest the impact of both QE and QT on financial conditions and credit growth is mostly sterilized by the interest rate on excess reserves.

  Meanwhile, the Middle East conflict has already shifted market expectations from two rate cuts this year to barely one. Higher energy prices may be pushing headline inflation toward 3.5% by summer, while the labor market has weakened, with 92,000 jobs lost in February and unemployment rising to 4.4%. The Fed has also resumed Treasury bill purchases—about $165bn since December—expanding its balance sheet and supporting Treasury financing. Yet the effective funds rate remains sticky and long yields continue rising, suggesting monetary conditions have not eased and reinforcing the case for the Fed to maintain its current stance.

- **Changes to Economic Forecasts:** *The Fed's updated SEP is expected to revise growth forecasts downward and inflation projections slightly higher, likely pushing back the timeline for rate cuts to the latter part of 2026 and one more cut in 2027.* The Middle East conflict is lifting energy prices and increasing inflation risks while also weighing on growth and employment, suggesting cuts are more likely delayed than cancelled. As a result, expectations for policy easing have been sharply reduced, with markets now seeing at most one 25bp cut in 2026 and some forecasts pushing the first move to late 2026 or even 2027.

Several broader factors reinforce this cautious outlook. Escalating tensions in the Middle East have pushed oil prices higher, raising the risk of another inflation shock through energy and gasoline costs. But if the oil price shock is temporary the Fed could ignore it as long as inflation expectations remain anchored. At the same time, uncertainty over Fed leadership—given Jerome Powell's term as chair expires in May 2026—is adding another layer of policy uncertainty.

Key Picture: US Federal Reserve Forecasts – 2025-2028

	2026*f*		2027*f*		2028*f*		Longer Run	
	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report	March Report	Dec. Report
GDP *(real growth, y-o-y)*	2.1	2.3	2.0	2.0	1.9	1.9	1.8	1.8
Unemployment rate *(%)*	4.6	4.4	4.3	4.2	4.2	4.2	4.2	4.2
PCE Inflation *(%, y-o-y)*	3.0	2.4	2.2	2.1	2.0	2.0	2.0	2.0
Core PCE Inflat. *(%, y-o-y)*	2.7	2.5	2.2	2.1	2.0	2.0	-	-
Federal Funds Rate *(%)*	3.375	3.375	3.125	3.125	3.125	3.125	3.0	3.0

Source: Federal Reserve '*Summary of Economic Projections*' *December* 2025. *Note:* 1. GDP reading for Q4-2025; 2. Unemployment rate as of February 2025; 3. PCE and core PCE inflation as of February 2025; 4. Projections reflect the median of FOMC projection

Analysis

- **EXPECTED DECISION**: *On Mach 18, we expect the US Federal Reserve's FOMC to keep its Fed funds range at 3.50% - 3.75%.* In January, Powell and nine members supported the move, while Miran and Waller pushed for a 25 bp cut. This marked Miran's fourth straight dissent before his January departure.

  Regarding *forward guidance*, the Fed will continue to be data-dependent regarding further policy changes with decisions being made meeting by meeting. The markets assign more than a 99% probability to a hold. The main focus will be how policymakers assess the economic impact of the Iran war, which has pushed energy prices higher and increased inflation risks. The Fed's updated projections and Chair Jerome Powell's press conference will be closely watched for signals on whether rate cuts remain possible this year.

  Regarding *balance sheet policies*, the Fed in May last year decided to slow down the pace of QT from June. The Committee will continue reduce the size of its balance sheet made of Treasury securities, agency debt, and agency mortgage-backed securities holdings. Starting in April, the Committee slowed 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. But in December 2025 the Fed has resumed Treasury bill purchases—about $165bn so far – to manage market liquidity.

- **POLICY DISCUSSION**: *The escalating Middle East tensions are pushing oil prices higher and raising inflation risks, while uncertainty over Fed leadership, given Jerome Powell's term expires in May 2026, adds further policy uncertainty.* The key question for the Federal Reserve at this meeting is not whether it will cut rates: the Fed will not cut. Markets overwhelmingly expect the FOMC keep the federal funds rate unchanged at 3.50%-3.75%. Traders are assigning almost a 100% probability to the continuation of a pause. Chair Jerome Powell has little reason to change course now. After resisting political pressure for months and recently being cleared of allegations that triggered a DOJ investigation, Powell is unlikely to make any policy move that could be interpreted as yielding to external pressure. The Fed has already delivered several cuts in late 2025 and is now in a pause phase as inflation has edged higher again while the economy remains relatively resilient.

Markets broadly understand this dynamic. A March cut is essentially off the table, and a May cut is also unlikely, particularly since it may be Powell's final meeting as Fed chair. However, the tone of the meeting is likely to reveal growing divisions within the committee. Miran and Waller – as well as possibly Bowman – may dissent again and vote this week for a rate cut; while many other hawkish FOMC members will find fodder for their view that rates should not be cut based on the rise in inflation that the oil shock will cause. Minutes from the January meeting showed that while some policymakers had previously supported rate cuts, others are now increasingly concerned that renewed inflation pressures could even justify keeping policy tighter for longer. With inflation above target and rising, the Fed will prioritize preserving its inflation credibility, making rate cuts harder to justify.

The bigger uncertainty now centers on the leadership transition at the Fed. President Trump has nominated former Fed governor Kevin Warsh to succeed Powell, but the confirmation process has become complicated. A Justice Department investigation involving Powell initially clouded the political environment, and although a judge blocked the probe, the DOJ has appealed. As a result, Thom Tillis, the senator overseeing Warsh's confirmation, has suggested pausing the process until there is greater clarity.

If Warsh is confirmed by the June meeting, the policy outlook could shift. Warsh has argued that technological forces, particularly the expansion of artificial intelligence, could exert deflationary pressure on the economy, potentially giving him justification to support rate cuts. But if he pushes for an early rate cut, he may not have a majority of the FOMC in favor of it as so far only Waller, Miran and possibly Bowman are in favor of early cuts. And the likely rise in the inflation rate following the war with Iran will push further out any rate cut to a timing not earlier than the fall of 2026, even if the oil shock may slow down growth and weaken the labor market. In that stagflationary outcome the Fed would be in a difficult spot as rising inflation would argue for staying on hold while a weaker growth and employment outlook could justify rate cuts. On net, the current Fed – even with the addition of Warsh this year – will want to wait and see how the war and other factors affect its dual mandate.

Another question concerns Fed leadership if Powell's term as chair ends in May before Warsh is confirmed. Powell could technically remain on the Board, but precedent suggests otherwise: Janet Yellen (and previous Fed Chairs) left the Board when her chairmanship ended. If Powell follows that path while Warsh's approval remains unresolved, the Fed could face a period of unusual leadership uncertainty.

Events in the Middle East have also shifted expectations for Fed monetary policy. Markets have moved from pricing in two rate cuts this year to barely one (recently even less than a full 25bps one), while a rate hold at the March 18 meeting now appears almost certain. The conflict in Iran and disruptions in the Strait of Hormuz have pushed oil prices higher, lifting U.S. gasoline prices above $3.60 per gallon and potentially toward $4.00 or above if the war last long. Higher energy costs are likely to feed into transportation, airline fares, and other sectors such as food, fertilizers, and plastics, potentially pushing headline inflation close to 3.5% by summer, well above the Fed's 2% target.

The growth outlook is less clear. While business surveys suggest solid activity, the labor market has weakened, with the economy losing 92,000 jobs in February and unemployment rising to 4.4%. Rising geopolitical uncertainty may further weigh on hiring and broader economic activity; certainly the war with Iran will reduce growth this year by at least 0.2% in a baseline scenario where the war doesn't lasrt more than two months.

The Fed's renewed T-bill purchases since mid-December, about $165bn, have expanded its balance sheet and pushed bank reserves back above $3tn. It supports Treasury financing amid large deficits, and resembles a softer form of quantitative easing even as long-term yields continue rising due to fiscal and inflation risks. Yet the effective federal funds rate has remained stubbornly high at around 3.64%, just 1bp below the rate paid on reserves, suggesting that liquidity injections have not eased money-market conditions as expected.

This stickiness stems partly from earlier repo market tightness, when reserves dipped below $3tn, which pushed the effective rate higher within the Fed's target range. Whether the Fed will address this unusual persistence is unclear, though it raises questions about market functioning and could warrant attention at the press conference. More broadly, the Fed is now facing higher nominal yields, rising real yields, and widening inflation breakevens, a combination that argues against rate cuts. In this environment, maintaining current policy appears most likely, with 10-year Treasury yields potentially rising toward the 4.3%-4.5% range before easing later.

- **CHANGES TO ECONOMIC FORECASTS:** *The meeting will include an updated Summary of Economic Projections, which is widely expected to revise growth forecasts downward while nudging inflation projections higher.* Such revisions would likely push back the timeline for rate cuts that markets had anticipated earlier. The Middle East conflict is likely to push inflation higher but also weigh on U.S. growth and employment. As a result, the Fed's rate cuts are more likely to be delayed rather than cancelled, unlike in 2022, when a combination of demand and supply shocks drove inflation sharply higher and forced the Fed to raise rates. The expectations for policy easing in 2026 have already been scaled back sharply. At the end of 2025, investors were betting on several rate cuts during the year. Now many forecasts suggest only one modest 25-basis-point cut, or in some scenarios no cuts at all until 2027. A growing consensus among analysts is that the first reduction may not come until the Fed's September 2026 meeting, as policymakers wait for clearer evidence that inflation is returning sustainably toward target.

  Several broader forces are shaping this cautious outlook. The escalation of conflict in the Middle East has pushed oil prices higher, raising the risk of a new inflationary shock through energy and gasoline prices. At the same time, uncertainty surrounding leadership at the central bank is adding another layer of complexity, as Jerome Powell's term as Fed chair is set to expire in May 2026.

- **MACROECONOMIC ANALYSIS:** *US economic growth slowed sharply at the end of 2025.* In Q4, GDP was revised down to 0.7%, well below the initial 1.4% estimate and far weaker than the 3.8–4.4% growth seen earlier in the year. The slowdown was largely driven by a 16.7% drop in federal government spending during the shutdown, which cut about 1.16 percentage points from growth.

  Consumer spending also moderated, rising 2% compared with 3.5% in the previous quarter. Business investment remained relatively solid at 2.2%, partly reflecting continued spending on artificial intelligence, though it was slower than the 3.2% pace seen in the third quarter. For the full year, the U.S. economy grew 2.1%, slightly below the previous estimate of 2.2%.

  At the same time, the labor market has weakened. Employers cut about 92,000 jobs last month, and hiring in 2025 averaged fewer than 10,000 jobs per month, the weakest pace outside recession periods since 2002.

  Inflation, however, remained stable at 2.4% in February, with core inflation at 2.5%, both in line with expectations. Economists note that these figures reflect conditions before the recent surge in energy prices linked to the Iran war, which is expected to push inflation higher in the coming months.

- **MARKET IMPLICATIONS***: Markets are likely to remain volatility and will look for clarity from Powell's press conference*. Investors balanced the risk of prolonged supply disruptions through the Strait of Hormuz against occasional signs of de-escalation. Concerns over private credit stress and trade policy uncertainty also pressured markets. US Treasuries posted losses as rising geopolitical risks, especially uncertainty around the Middle East conflict and its impact on energy markets, combined with firm inflation data to push yields higher across most maturities. To put things into context, *in the fixed-income space,* this morning Treasury yields fell in Asian trading as markets shifted focus to the Fed's response to the Middle East crisis. As of March 17, and at the time of writing, the 2*y UST* trades around 3.67% (+20 bps y-t-d). The *10y UST* edged down by 5 bps to 4.20% since the last meeting (+3 bps y-t-d). *In the currency space*, dollar rises broadly as investors weigh Middle East risks. As of March 17, and since the last meeting in January, the *dollar index* edged up by 4.2% to around 99 (+2.1% y-t-d). *EUR/USD* fell by 3.8% to around 1.15 since January meeting (-2.1% y-t-d). *In the equity space,* US stocks fell for a third straight week as the Middle East conflict and volatile oil markets weighed on sentiment. As of March 17, at the time of writing, S&P 500 trades around 6717, falling by 3.7% since the last meeting (-2.1% y-t-d).

APPENDIX (Macro Background): *GDP growth slows reflecting downward revisions to exports, consumer spending among others. I*n Q4, the US economy decelerated to an annualized 0.7% (*c*: 1.4%; *p:* 4.4%), the weakest performance since a contraction in Q1 2025. Consumer spending also decelerated (2.0% vs 3.5% in Q3). Government spending shrank (-5.8% vs 2.2%). Fixed investment increased (1.6% vs 0.8%). Exports contracted (-3.3% vs. 9.6%), while imports contracted by less (-1.1% vs. -4.4%). The economy grew 2.0% y-o-y in Q4 2025, higher than previous estimate of 2.2%.

Composite PMI dropped to the lowest in ten months. In February, *the S&P Global US Composite PMI* declined to 51.9 (*p:* 53). The *Services PMI* also fell to 51.7 (*p:* 52.7). The *Manufacturing* PMI decreased to 51.6 (*p:* 52.4).

The US unemployment rate inched closer to November's four-year high. In February, *the unemployment rate* edged down to 4.4% (*c:* 4.3%; *p:* 4.3%). NFP contracted by 92K (*c:* 59K; *p:* 126K). Wage growth increased by 4.6% in January (*p:* 4.4%). The U-6 unemployment rate, which includes those marginally attached to the labour force and those working part-time for economic reasons, eased to 7.8% (*p:* 8.1%).

Inflation was stable in February. In January, the *personal consumption expenditures* (*PCE*) – the Fed's preferred inflation gauge – eased to 2.8% y-o-y (*c:* 2.9%; *p*: 2.9%). The *core-PCE* – which excludes volatile energy and food prices – rose to 3.1% y-o-y (*c:* 3.1%; *p:* 3.0%). In February, headline and core inflation rate stood at 2.4% y-o-y (*c:* 2.4%) and 2.5% y-o-y (*c:* 2.5%) respectively.