MARKET COMMENTARY

The Fed worries about stagflation and does not change course. QT slows down.

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• The FOMC kept its expected path for the policy rate unchanged but was vocal in flagging the risk the new administration policies pose to an overall strong economy.

• Short-term projections for inflation were revised up, while long-term ones were slightly down, under the assumption that the impact of tariffs will be transitory and just delay disinflation. Yet, growth forecasts were marked down throughout the horizon.

• The pace of QT will halve from April to allow the financial sector to adapt more smoothly and in line with what happened in the past balance sheet reduction episode. The debate on the debt ceiling played no role in the decision.

In the March meeting, the Fed chose to wait and see how the uncertainty shock hitting the US economy and the looming tariff increase would unfold. Its preferred path for the Fed funds rate was unchanged with respect to December, with two cuts this year and two for 2026, but both the macro forecast and the balance of risks around it underline deep concern.

The press release acknowledged the good state of the economy, as indicated by labor market data. The assessment of the balance of risks was removed (Powell deemed it no longer necessary in the Q&A session) and replaced by a nod to high policy-related uncertainty. Moreover, starting next month, the pace of the runoff on the stock of Treasuries will be halved, while that of MBS will be kept constant.

Recent indicators suggest that economic activity has continued to expand at a solid pace. ~~Since earlier~~The unemployment rate has stabilized at a low level in ~~the year,~~ recent months, and labor market conditions ~~have generally eased, and the unemployment rate has moved up but remains low.~~remain solid. Inflation ~~has made progress toward the Committee's 2 percent objective but~~ remains somewhat elevated.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. ~~The Committee judges that~~Uncertainty around the ~~risks to achieving its employment and inflation goals are roughly in balance. The~~ economic outloc ~~is uncertain, and the~~has increased. The Committee is attentive to the risks to both sides c its dual mandate.

In support of its goals, the Committee decided to ~~lower~~maintain the target range for the federal funds rate ~~by 1/4 percentage point to~~at 4-1/4 to 4-1/2 percent. 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 Committee will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities. Beginning in April, the Committee will slow the pace of decline of its securities holdings by reducing the monthly redemption cap on Treasury securities from $25 billion to $5 billion. The Committee will maintain the monthly redemption cap on agency debt and agency mortgage-backed securities at $35 billion. The Committee is strongly committed to supporting maximum employment and returning inflation to its 2 percent objective.

The economic projections were consistent with a sizeable, short-run increase in inflation, which would then subside. What the FOMC flags, however, is a more durable and negative impact on growth and the unemployment rate. The most interesting part of the projections was the large shift in the balance of risks, towards extremely high concern about the possible stagflationary impact of tariffs (chart at the bottom right).

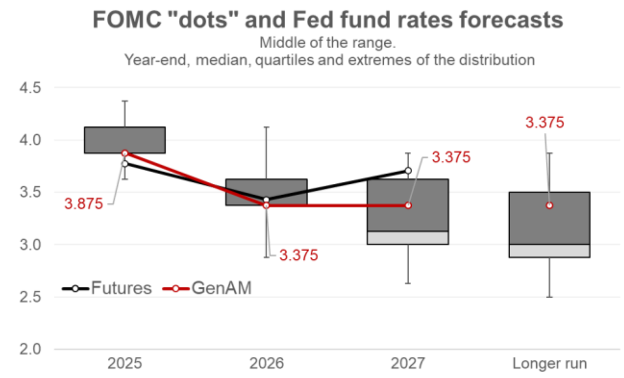
In the press conference, Powell reiterated the view that hard data remain solid, while soft ones have clearly deteriorated. The economy created 200k jobs per month on average in the last three months, with low and stable unemployment. The labor market is in a 'no hire no fire' situation, meaning that an uptick in layoffs may trigger a sudden sharp increase in the unemployment rate. Wage growth, still strong, is not a cause of concern for inflation. Consumption remains solid; in the past, gloomy surveys often did not lead to a material weakening in actual purchases, Powell pointed out, but this time it may be different. Risks of a recession have increased but remain rather low.

The FOMC expects core PCE to tick up to 2.8% year-on-year in February. Powell flagged that while short-term expectations have increased, with tariffs being a driving factor, longer-term ones remain anchored. The FOMC base case is a temporary increase in inflation that will delay, but not suppress, the gradual process of disinflation. But it is hard to have a clear view, given the noisy behaviour of some series, such as the sharp increase in core goods inflation before most of the tariffs are implemented.

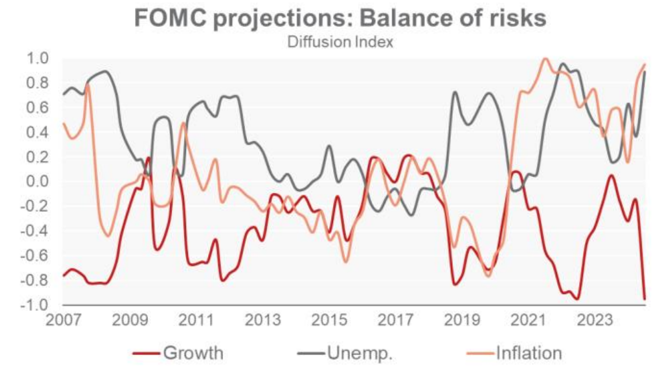
Powell conceded that there was some inertia in the updating of the forecasts and rate projections, as uncertainty prevented high-confidence predictions ("What would you write down?" he replied to a journalist). Overall, the FOMC deems that the Fed is in a good place to adapt policy to incoming news. Powell stated twice that the committee is in no hurry to move from what remains a restrictive stance.

The decision to halve the size of the redemption cap was taken after observing the TGE flows but was in no way motivated by worries about the debt ceiling. Consistent with what happened in the past QT, the desire was to allow for a very smooth transition. Reserves remain abundant, but some parts of the financial system (he explicitly quoted money market funds) are responding to the balance sheet rundown. No changes were made to the pace of shrinking in MBS holdings, in line with the intention to rebalance the composition of the balance sheet towards Treasuries. Powell was careful to underline that a slower QT has no implication for the conduct of monetary policy and is not meant to deliver any hidden signal.

Despite the Fed's worries about growth, market reaction was positive, with the S&P up 1.2% and the 10-year yield down 4bps to 4.26%.



Source:Federal Reserve Board, Datastream,GenAM estimates



Source:Federal Reserve Board, GenAM

	2025	2026	2027	Longer run
GDP growth (Q4/Q4 ann.)	1.7	1.8	1.8	1.8
Sep. projections	*2.1*	*2.0*	*1.9*	*1.8*
Unemployment rate	4.4	4.3	4.3	4.2
Dec. projections	*4.3*	*4.3*	*4.2*	*4.2*
PCE infl. (Q4/Q4 ann.)	2.7	2.2	2.0	2.0
Dec. projections	*2.5*	*2.1*	*2.0*	*2.0*
Core PCE infl. (Q4/Q4 ann.)	2.8	2.1	2.0	-
Dec. projections	*2.5*	*2.2*	*2.0*	-
Federal funds rate	3.9	3.4	3.1	3.0
Dec. projections	*3.9*	*3.4*	*3.1*	*3.0*