Fed Watch

Fed cuts rates by 25 bps but signals a more hawkish pace going forward

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The updated economic projections show the Fed has begun a new phase of monetary policy amid next year's inflation challenges

- **The Fed cut the policy rate by 25 bps to a 4.25-4.50%, but signaled that the rate-cut cycle will likely take longer than previously thought amid next year's inflationary challenges.** The decision was not unanimous[1] and the only change to the policy statement, which included "the extent and timing" of "additional adjustments," at a first glance suggested a growing consensus among FOMC participants that the pace of future interest rate cuts was likely to slow down going forward. But the SEP and Powell more than confirmed this message. He explicitly explained that this change "signals that [they] are at or near a point in which it will be appropriate to slow the pace of further adjustments." The remarkable strength of economic activity and the disappointing inflation data from recent months, as well as the uncertainty around the actual level of the neutral rate, are likely behind the Fed's renewed cautious approach. However, with "the story of why inflation should be coming down [...] still intact," the main reason behind today's hawkish shift is likely the growing concern among several FOMC participants around the potential inflationary impact of Trump's proposed trade, fiscal, and immigration policies. Indeed, Powell explained that "some people did take a very preliminary step and start to incorporate highly conditional estimates of economic effects of policies into their forecast at this meeting," which contrasts with Powell's previous compelling opinion around the Trump 2.0 scenario: "we don't guess, we don't speculate, and we don't assume." He continued to stress that the FOMC will take its time and will "make a very careful assessment, but only when [they've] actually seen what the policies are and how they're implemented." Nevertheless, the 10bp increase in the 10-year Treasury yield to 4.5% following the meeting indicates that the market had not fully anticipated the Fed's more hawkish tone.
- **The updated SEP points to a slower pace of monetary policy easing next year amid higher inflation uncertainty: "when the path is uncertain you go a little bit slower."** The new median core PCE projection for end-2025 now shows that the Fed expects it to slow down to 2.5%, up from the 2.2% September's projection, and 0.3 pp down from an upwardly revised 2.8% end-2024 projection (Table 1). Core PCE inflation is now expected to come down to target by 2027, but is still expected to come down close to target (2.2%) by the end of 2026. Consequently, the new median fed funds rate projection now points to only 50bp worth of rate cuts next year (down from 100 bps), with four participants penciling in one or no additional cuts (Figure 1). The policy rate projection was also raised by 50 bps (to 3.4%) by year-end 2026 and is now expected to come close to neutral by the end of 2027 (3.1%, up from 2.9% in September) and to neutral (revised up to 3.0% from 2.9%) after the three-year forecast horizon. Both GDP and unemployment rate (UR) projections for 2025 were left largely unchanged: GDP is now expected to grow 2.1% in 4Q25 (slightly up from 2.0% before) and the UR is now projected to end 2025 at 4.3% (slightly down from 4.4% in September). Projections for both GDP and the

[1] Beth Hammack (Cleveland Fed) preferred to maintain the target range for the federal funds rate at 4.50-4.75%.

UR for 2027 were left unchanged at 2.0% and 4.3%, respectively. The main changes for these projections were for 2024: 4Q24 growth was revised up by 0.5 pp to 2.5% and the UR was revised down by 0.2 pp to 4.2%.

- **A “new phase in the process” of easing means the Fed is likely to gear policy to a more hawkish path as it is now thinking about the effects of likely upcoming policy changes.** We continue to think that there are good chances that the Fed cuts rates by 50 bps next year (to a 3.75- 4.00% range), but since both the wording of the statement and Powell hinted the Fed will likely skip cuts in coming meetings[2], we now think that the Fed will skip cutting rates in the first meeting of next year and cut the fed funds rate by 25 bps in March and June, instead of twice in 1Q25 as we previously thought. Although the Fed is not ready to signal that a long pause in the easing cycle is forthcoming, it is acknowledging the increased uncertainty and a more cautious approach in response to it (i.e., it is getting ready to skip rate cuts in coming meetings). The Fed is also signaling that it is not likely that the FOMC would look through the effects of tariffs on inflation in a backdrop of a strong economy and a less restrictive policy. Today’s hawkish shift suggests that the Fed raised the bar for future cuts. Thus, if tariffs are implemented, and given that the Fed is already pointing at skipping cutting rates in the first meeting of next year, the risk is that it further delays (until 2026?) the 50bp worth of rate cuts now forecasted for next year.

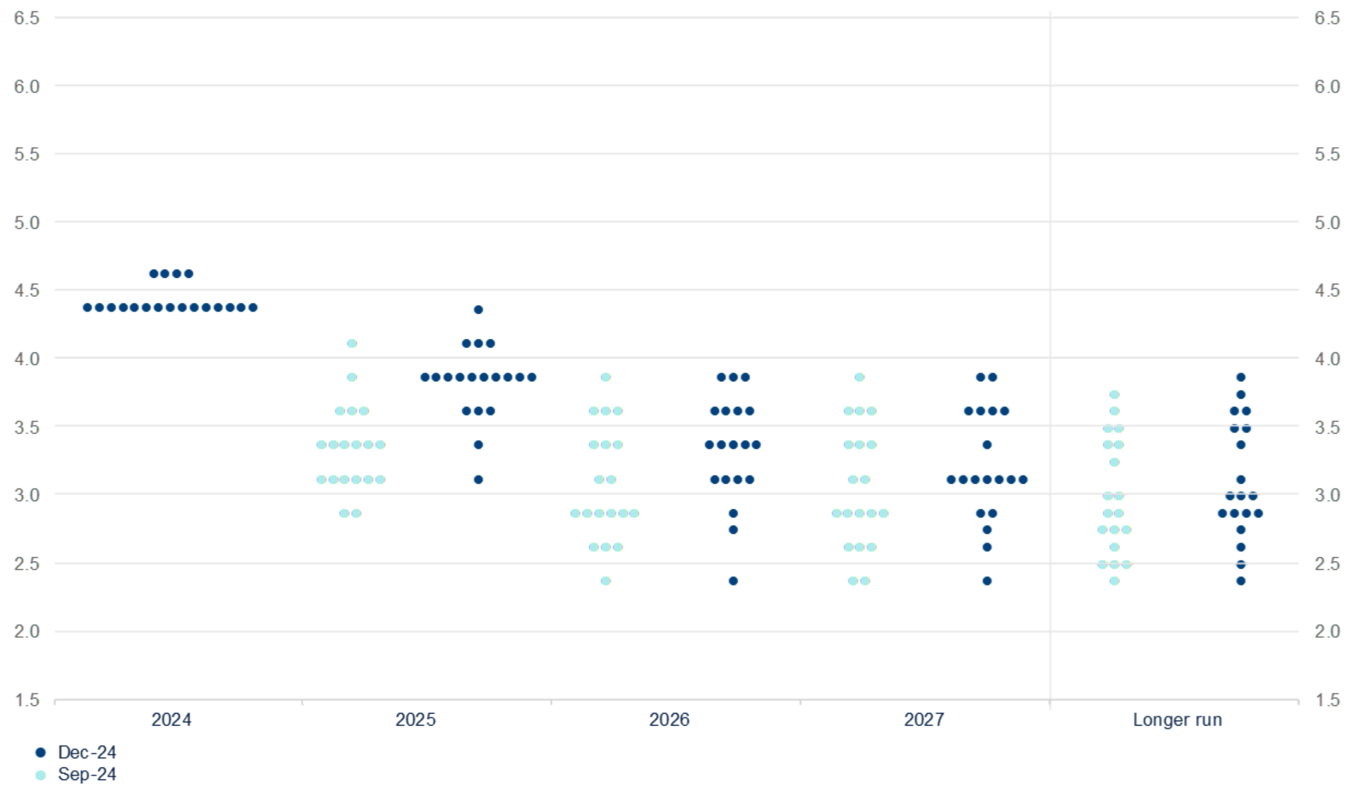
[2] “We are at a point where it is appropriate to slow the pace of cuts.”

The updated SEP points to a slower pace of monetary policy easing next year amid higher inflation uncertainty: “when the path is uncertain you go a little bit slower.”

Table 1. **FOMC PARTICIPANTS’ SUMMARY OF ECONOMIC PROJECTIONS** (DECEMBER 2024, %)

Variable	Median					Central tendency					Range				
	2024	2025	2026	2027	LR	2024	2025	2026	2027	LR	2024	2025	2026	2027	LR
Change in real GDP	2.5	2.1	2.0	1.9	1.8	2.4-2.5	1.8-2.2	1.9-2.1	1.8-2.0	1.7-2.0	2.3-2.7	1.6-2.5	1.4-2.5	1.5-2.5	1.7-2.5
Sep-24	2.0	2.0	2.0	2.0	1.8	1.9-2.1	1.8-2.2	1.9-2.3	1.8-2.1	1.7-2.0	1.8-2.6	1.3-2.5	1.7-2.5	1.7-2.5	1.7-2.5
Unemployment rate	4.2	4.3	4.3	4.3	4.2	4.2	4.2-4.5	4.1-4.4	4.0-4.4	3.9-4.3	4.2-4.2	4.2-4.5	3.9-4.6	3.8-4.5	3.5-4.5
Sep-24	4.4	4.4	4.3	4.2	4.2	4.3-4.4	4.2-4.5	4.0-4.4	4.0-4.4	3.9-4.3	4.2-4.5	4.2-4.7	3.9-4.5	3.8-4.5	3.5-4.5
PCE inflation	2.4	2.5	2.1	2.0	2.0	2.4-2.5	2.3-2.6	2.0-2.2	2.0	2.0	2.4-2.7	2.1-2.9	2.0-2.6	2.0-2.4	2.0
Sep-24	2.3	2.1	2.0	2.0	2.0	2.2-2.4	2.1-2.2	2.0	2.0	2.0	2.1-2.7	2.1-2.4	2.0-2.2	2.0-2.1	2.0
Core PCE inflation	2.8	2.5	2.2	2.0		2.8-2.9	2.5-2.7	2.0-2.3	2.0		2.8-2.9	2.1-3.2	2.0-2.7	2.0-2.6	
Sep-24	2.6	2.2	2.0	2.0		2.6-2.7	2.1-2.3	2.0	2.0		2.4-2.9	2.1-2.5	2.0-2.2	2.0-2.2	
Federal funds rate	4.4	3.9	3.4	3.1	3.0	4.4-4.6	3.6-4.1	3.1-3.6	2.9-3.6	2.8-3.6	4.4-4.6	3.1-4.4	2.4-3.9	2.4-3.9	2.4-3.9
Sep-24	4.4	3.4	2.9	2.9	2.9	4.4-4.6	3.1-3.6	2.6-3.6	2.6-3.6	2.5-3.5	4.1-4.9	2.9-4.1	2.4-3.9	2.4-3.9	2.4-3.8

Figure 1. **FOMC PARTICIPANTS’ PROJECTED APPROPRIATE FEDERAL FUNDS RATE** (%)



Source: BBVA Research / Fed

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