Creating Opportunities

Fed Watch

# Fed to remain cautious as probable tariffs cast a shadow on monetary policy easing

Javier Amador / Iván Fernández

**January 27, 2025**

## Recently better inflation data do not outweigh increased risks from strong economic momentum and Trump's policy changes

- **Though strongly influenced by the uncertainty around Trump's policies, the Fed's likely decision to pause rate cuts this week is also explained by recent solid economic data.** The third estimate for 3Q24 real GDP growth was revised up to 3.1% from 2.8% SAAR (final sales to private domestic purchasers inched up to 3.4% from 3.2%) on upward revisions to both personal consumption expenditures and exports, which were only partially offset by the subtracting effect of revised gross private domestic investment and imports. Timelier data showed that growth continued with good momentum in 4Q24 despite October's temporary disruptions (hurricanes and strikes). In December, the control group measure of retail sales (which excludes restaurants, vehicles, gasoline and building materials) increased by a strong 0.7% MoM, wiping out November's 0.1% fall, while industrial production jumped by 0.9% MoM on broad-based strength and a 6.3% rebound in aerospace manufacturing following the end of the strike at Boeing. Survey-based data pointed to a still robust services sector and a manufacturing sector that is probably on its way to recover: the ISM manufacturing index increased to 49.3 from 48.4 in December amid a 2.1-point increase in the new orders index that suggests a promising outlook for this year's output, while the ISM services index rose to 54.1 from 52.1, mitigating half of November's sharp decline. Within the latter, the 6.2-point increase in the prices paid subindex is consistent with late-2024 core inflation stickiness, but the broadly unchanged employment subindex (at 51.4) suggests that any worrying wage-related price pressures in the services sector are unlikely to last. With recent activity data heading in the same direction, the Atlanta Fed's 4Q GDP nowcast stands at a strong 3.0% SAAR. This pile of real activity data supported by the strength of consumption will reinforce a cautious approach among FOMC members.
- **Evidence continues to suggest that the labor market is either at or very close to a healthy equilibrium, which could be at risk in 2H25 amid the potential effects of renewed anti-immigration policies.** Non-farm payrolls scored a larger-than-expected 256,000 gain in December. Following a downwardly revised yet strong 212,000 November's figure, the 3-month average jobs gain stood at a healthy 170,000 (Figure 1), which nevertheless remains below the average pace seen in 1H24 and 2023. The combined 86,000 solid job gains in retail and leisure and hospitality activities suggest that cyclical sectors are recently playing a more important role in explaining the continued strength of the labor market as compared to the recent past, when non-cyclical government and healthcare sectors were the primary sources of job growth. It's important to note though that private ex-healthcare job growth is still running at a slower pace than in the months prior to the pandemic. November's JOLTS data was consistent with the labor market strength depicted by the payrolls data and showed that job openings increased to 8.10 million (from 7.84 million in October). But this strength should not raise worrying concerns around inflation, since the private quits rate continued to fall to its lowest since the onset of the pandemic, which suggests that wage growth has room to a further slowdown (Figure 2). Indeed,

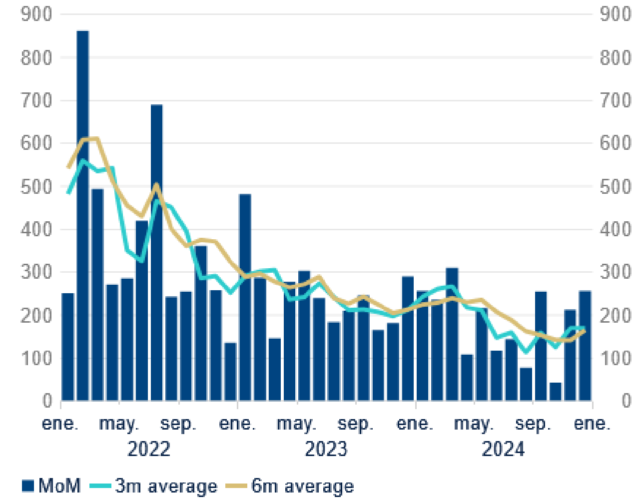
average hourly earnings ticked down slightly to 3.9% YoY in December, from 4.0% despite a 0.1%-point decrease in the unemployment rate, which at 4.1% stands well within the central-tendency FOMC participants' estimated longer-run level (3.9-4.3%). In any case, the wage growth trend warrants close monitoring by the Fed, as Trump's immigration curbs could contribute to broader inflationary pressures in 2H25.

- **Data continued to ease inflation concerns, but increased risks stemming from above-trend GDP growth and Trump's policies will likely prompt the Fed to maintain a cautious approach.** Both November's CPI and PPI data released ahead of last month's FOMC meeting signaled that core PCE inflation would score a much weaker pace in November. It did. Following the above-target-consistent gains in September and October (~0.3% MoM), core PCE prices rose by 0.11% MoM in November, which left unchanged the 12-month rate at 2.8% but drove the 3-month annualized rate down to 2.5% from 2.8%. This development will likely repeat this month. While headline CPI inflation jumped to 2.9% YoY (0.4% MoM) in December from 2.7% in November amid a 4.4% MoM jump in gasoline prices, core CPI prices increased by a more modest 0.23% MoM, and edged down to 3.2% YoY, after staying unchanged at 3.3% YoY for three straight months. Shelter inflation stickiness seems to linger despite November's encouraging figures, with both owner's equivalent rent and rent up 0.3% MoM each in December (vs 0.23 and 0.21% MoM in November), but will likely not raise major concerns among Fed officials since housing services disinflation in the pipeline gives ample room for further cooling as rental turnovers and renewals are set to keep balancing better with market rents (Figure 3). The CPI data, coupled with a weaker-than-expected increase in producer prices eclipsed only by a sharp increase in airfares, will likely be reflected in a muted rise in core PCE inflation for the second consecutive month in December. The actual data will be released next Friday but will likely be already considered during this week's FOMC meeting. While these developments will be welcomed, a rate cut is still off the cards this week amid the increased uncertainty around the inflationary effects of Trump's migration and (upcoming) trade policies.
- **Further easing of at most 50 bps before year-end is still on the table, but the Fed could stay on the sidelines for longer until it knows if Trump follows through on his plans to impose tariffs.** Uncertainty appears to have peaked exactly a week before Trump's inauguration, when the 10-year Treasury yield hit 4.8%, its highest since October 2023, and 120 bps above the 3.6% mid-September low from last year. The inverted hump at the short-end of the curve suggests the market still expects the Fed to deliver a bit more easing before entering a prolonged pause in the rate-cutting cycle later this year (Figure 4). Although it stepped back in the last few days, the 10-year term premium rose to a 68bp decade-high pre-election day as concerns about inflation risks and fiscal sustainability continued to mount. Futures-implied chances of a 25bp rate cut in March fell from 50 to 30% over the past month, but further easing of at most 50 bps by year-end is still on the table. Markets seem to share the view that "upside risks to the inflation outlook [have] increased," but also that the likely one-off nature of a tariff-driven inflation shock is unlikely to de-anchor inflation expectations. More permanent effects on prices would come from a massive hit to immigration, but market participants and analysts (us included) do not appear to be pricing in such a scenario now (see here for more on the recent evolution of US interest rates).
- **We expect the Fed to hold rates steady this week; our focus will be on any signals pointing to a more long-lasting pause and thus, a likely delay of the rate cut cycle we currently expect.** Both the updated dot-plot and Powell signaled in December that the Fed was taking a "more cautious" approach to rate cuts this year amid increased inflation uncertainty. The meeting minutes reinforced such a signal by showing that both the Fed staff and a number of FOMC participants began to incorporate "preliminary placeholder assumptions" around Trump 2.0, leading them to take "a gradual approach as [they move] toward a neutral policy stance." The risk has grown that the Fed could keep rates on hold for more than one meeting as the nature and purpose of the upcoming tariffs is still unknown (i.e., magnitude, their temporary or permanent nature, used mostly as a negotiating tool?). The key will be to understand whether a view like that of Bowman, who "could have

supported taking no action at the December meeting," dominates among FOMC members over the opinion shared more recently by Waller, who "believe[s] more cuts will be appropriate."

**The 3-month average nonfarm payrolls gain stood at a healthy 170,000 in December**

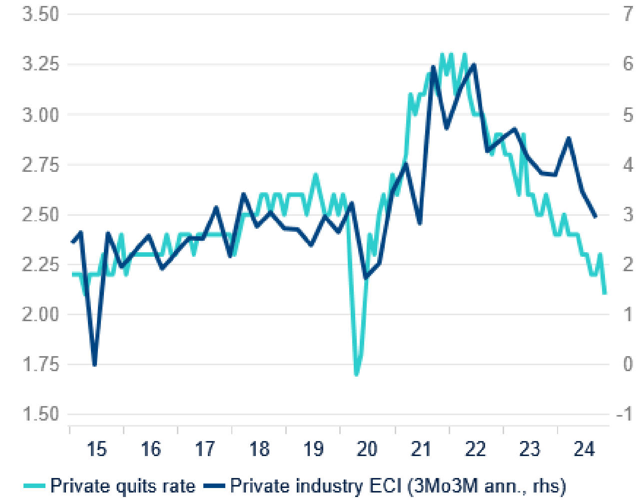
Figure 1. **CHANGE IN NONFARM PAYROLL EMPLOYMENT** (THOUSANDS)




Source: BBVA Research / BLS

**The private quits rate suggests wage growth has ample room to a further slowdown**

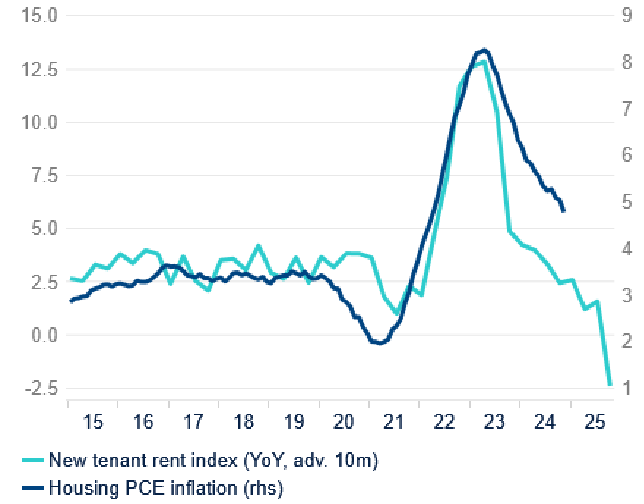
Figure 2. **PRIVATE QUITS RATE AND PRIVATE INDUSTRY EMPLOYMENT COST INDEX** (%)




Source: BBVA Research / BLS

**Rental turnovers and renewals are set to keep balancing better with market rents this year**

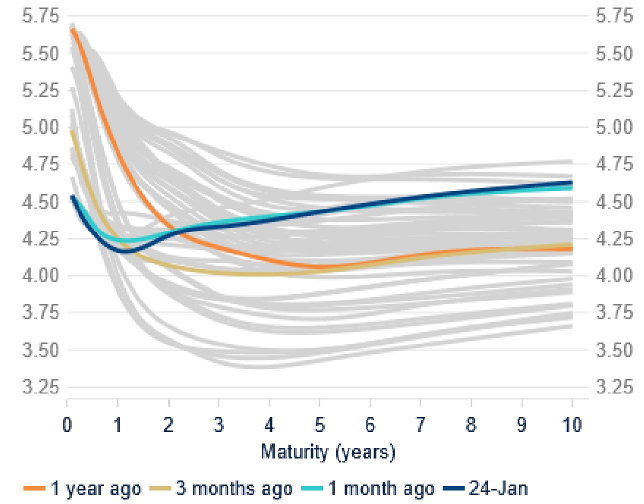
Figure 3. **NEW TENANT RENT INDEX AND HOUSING PCE INFLATION** (%)




Source: BBVA Research / BEA / BLS

**Markets still expect a bit more easing before a prolonged pause in the rate-cutting cycle**

Figure 4. **TREASURY YIELD CURVE** (%)




The gray lines indicate weekly curves over the past year.
Source: BBVA Research / Treasury Dept

BBVA Research

Creating Opportunities

## DISCLAIMER

The present document does not constitute an "Investment Recommendation", as defined in Regulation (EU) No 596/2014 of the European Parliament and of the Council of 16 April 2014 on market abuse ("MAR"). In particular, this document does not constitute "Investment Research" nor "Marketing Material", for the purposes of article 36 of the Regulation (EU) 2017/565 of 25 April 2016 supplementing Directive 2014/65/EU of the European Parliament and of the Council as regards organisational requirements and operating conditions for investment firms and defined terms for the purposes of that Directive (MIFID II).

Readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data or opinions regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.



ENQUIRIES TO:
BBVA Research: Paseo de la Reforma 510, Colonia Juárez, C.P. 06600 Mexico City, Mexico.
Tel.: +52 55 5621 3434
www.bbvaresearch.com