BNY

SHORT THOUGHTS

iFlow

January 28, 2025

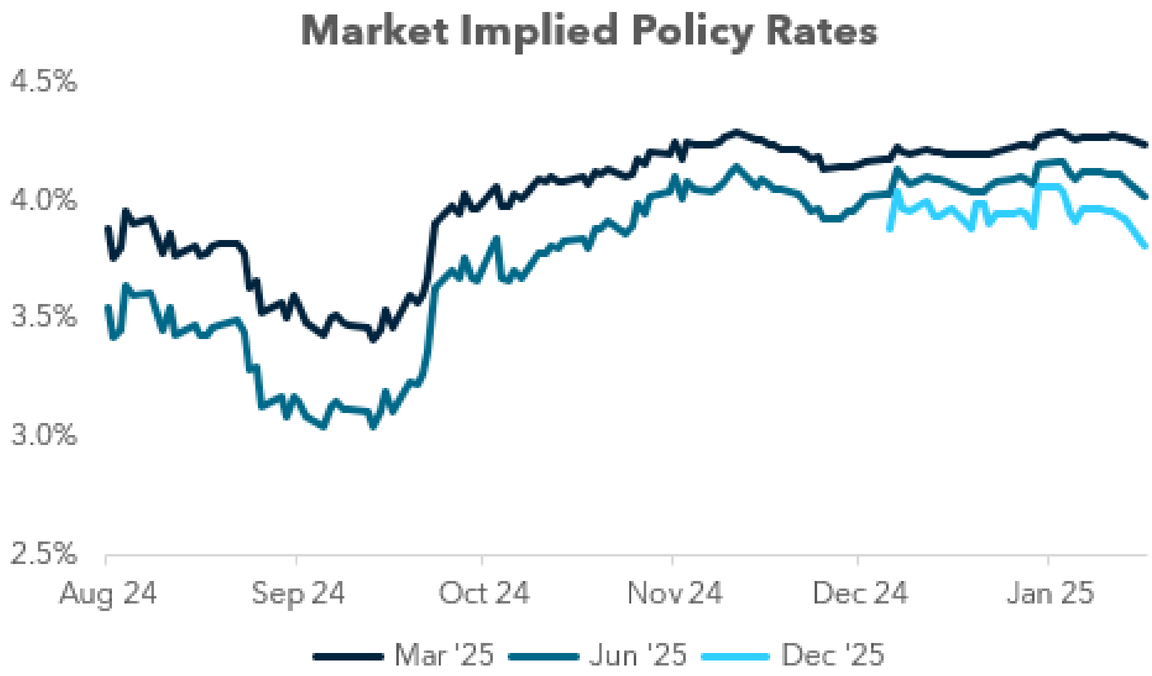
January FOMC Preview – On Hold

- We expect no change in interest rates from the FOMC on Wednesday
- Potential policy developments could weigh on the Fed's inflation and policy outlook
- Expect Chair Powell to defend the central bank’s independence and apolitical nature

The Federal Open Market Committee meets this Wednesday and we – along with virtually the entire Street – don’t expect anything in terms of concrete policy actions at this meeting. This doesn’t mean the meeting, which will only include the policy statement and the post-meeting press conference, won’t be worth paying attention to. On the contrary, with inflation developments over the medium highly uncertain and pressure from the new administration on the Fed to lower rates, how the Chair navigates the presser will be of more than just a passing interest.

Let’s first concentrate on the rates outlook – which since the November election has been remarkably steady. Exhibit #1 below shows the current implied federal funds rate in March, June and December, derived from the swaps market. At 4.23%, the March contract is currently priced for less than one cut. The June contract, however, sees a little more than a full 25bp cut by the end of Q2. Looking all the way out to December this year, market pricing suggests the FOMC’s own forecast for two cuts this year is accurate, as the swaps imply a 3.85% funds rate by the end of the year. Note that the current effective federal funds rate is 4.33%.

Exhibit #1: Remarkably Stable Rate Expectations

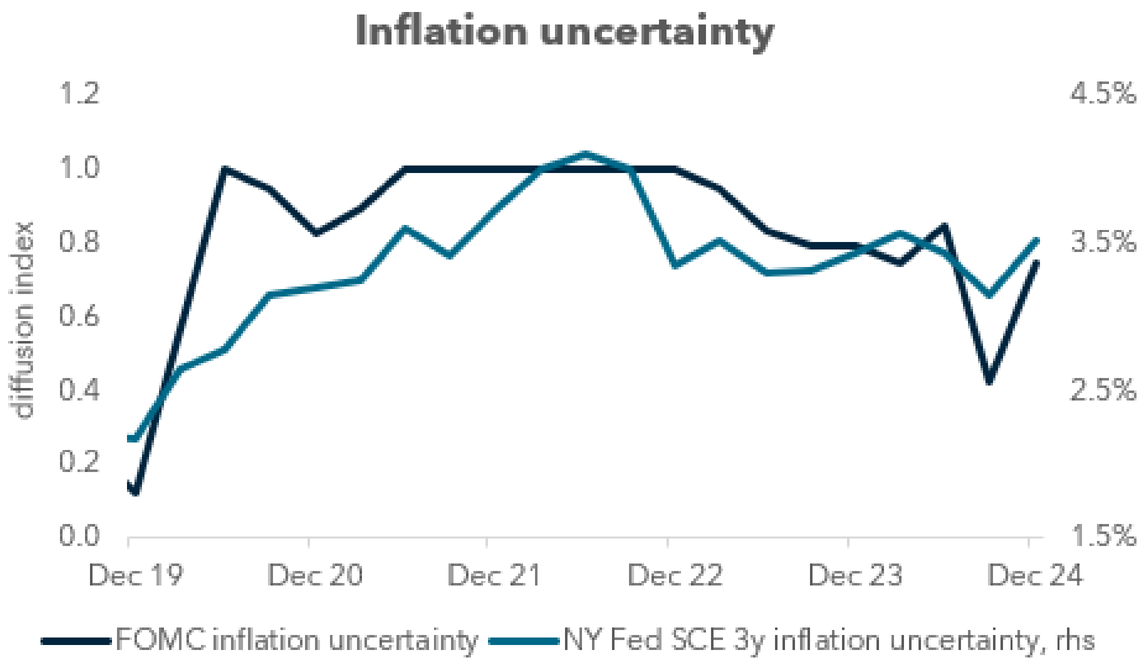


Source: BNY Markets, Bloomberg

Needless to say, developments in the inflation data over the next several months will be key to the rates outlook. The trouble is that the inflation outlook is highly uncertain. Numerous forces could conspire to keep the pressure on inflation in the next several months. Tariffs, immigration policy, as well as the energy and commodity price outlook are all question marks going forward.

Exhibit #2 below shows two measures of inflation uncertainty. The first is a diffusion index which summarizes FOMC members' certainty derived from the quarterly Summaries of Economic Projections. Note that it's been highly elevated since the pandemic, and after a brief turn lower last September has risen again. The second measure we plot comes from the New York Fed's monthly Survey of Consumer Expectations and shows inflation uncertainty among participants for 3-year ahead inflation expectations. It too has turned higher in recent months.

Exhibit #2: Inflation Uncertainty Still High and Reaccelerating



Source: BNY Markets, Federal Reserve Board of Governors, Federal Reserve Bank of New York

---

This suggests a very cautious tone will be forthcoming from the FOMC, and we expect Chair Powell to reflect that ambiguity in his post-meeting comments. We fully expect questions at the press conference to focus on potential sources of inflation uncertainty, and to what extent potential policy moves from the new administration currently feed into the Fed's thinking on inflation. Powell has been consistent in stating that until policies are actually enacted, the Fed doesn't typically form policy views or inflation forecasts in anticipation of those policies.

However, the minutes from the December 2024 meeting indicate that (emphasis ours):

"All participants judged that uncertainty about the scope, timing, and economic effects of potential changes in policies affecting foreign trade and immigration was elevated. Reflecting that uncertainty, ***participants took varied approaches in accounting for these effects.*** *A number of participants indicated that they incorporated placeholder assumptions to one degree or another into their projections. Other participants indicated that they did not incorporate such assumptions, and a few participants did not indicate whether they incorporated such assumptions."*

In other words, different members took different approaches to incorporating potential policy changes – a feature that we think will still be at work for the January meeting.

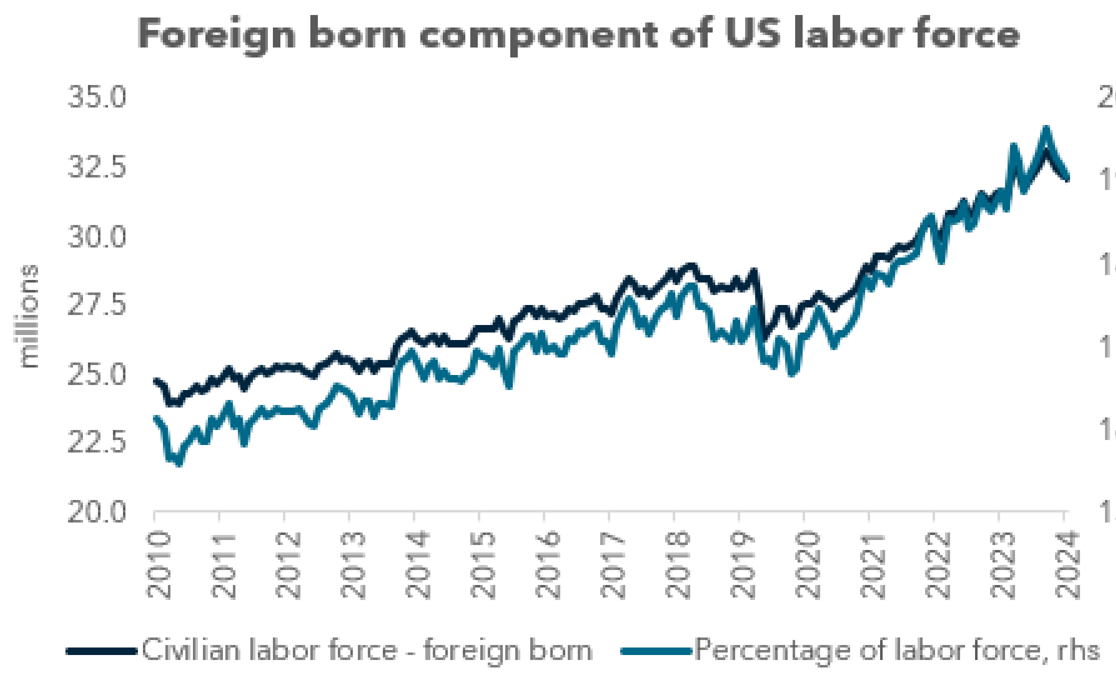
Turning to these potential policy changes which will impact the inflation view, tariffs and immigration policy are key. In the short week since the inauguration, markets have been whipsawed on tariff policy, with proposals and mentions coming out of the White House on an almost daily basis. We still have very little clarity on what the tariff regime will actually be when all is said and done. On the other hand, there is an argument that any consumer price increases that are to come from higher import costs due to tariffs are not inherently part of the inflation-generating process. Instead, they would represent (likely) one-off changes in relative prices and a price level adjustment, rather than an ongoing inflationary mechanism that would need monetary policy to clamp down upon. The Fed could very likely look through price increases of this type.

Immigration policy is a separate matter. Removing millions of workers from the economy is likely to spur labor shortages and wage inflation, although the numbers in question are still unknown. The civilian labor force measures around 170 million people, of which BLS estimates 32 million are foreign born, or 19%. This percentage of foreign-born members of the labor force has accelerated since the pandemic, up from 17% in 2019, or a little over 28 million. Exhibit #3 illustrates these developments.

The Peterson Institute of International Economics estimates that the deportation of 1.3m unauthorized immigrants (equivalent to the Eisenhower-era deportations in the 1950s) would add over 0.5% to inflation 2026-27. If the number of deportations is assumed to be closer to the 8.3m unauthorized immigrants – an estimate of the total number in the workforce – then the inflation hit could be to add a further 3.5% to inflation in the next few years.

No wonder inflation uncertainty is so high, and therefore it should not be a surprise to see the FOMC rather ambiguous on the inflation outlook – and by extension the rates outlook – over the next several months.

Exhibit #3: Size of Foreign-born Workforce Has Grown



Source: BNY Markets, Bureau of Labor Statistics

Finally, but not unimportantly, while no one in the markets really expects a rate cut at this meeting, President Trump has indicated that he wants lower rates, telling the crowd assembled at the World Economic Forum in Davos that he would "demand that interest rates drop immediately." Assuming rates don't drop on Wednesday, this could set up a potentially fraught relationship between the Fed and the administration, something we wrote about soon after the election (see here).

Perhaps Powell will go as far as not to rule out a rate cut in March, at the next FOMC, leaving the door open. However, we expect the press conference to feature heavy questioning regarding the relationship between the central bank and the executive branch. We expect the Chair to reiterate the Fed's independence, its data-driven approach to policy, and its apolitical operating principles. Whether or not this preempts criticism from the administration will bear watching.

Please direct questions or comments to: iFlow@bny.com

Disclaimer & Disclosures

JOHN VELIS

AMERICAS MACRO STRATEGIST

CONTACT JOHN

Can't see the email? View online

This message was sent from an unmonitored email box. Please do not reply to this message.

.