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Rates Steady as Fed Revises Growth, Inflation Outlooks

Central bank policymakers preach patience, leaving interest rates unchanged despite growing headwinds from tariffs and other Trump administration priorities.

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Key Takeaways

The Fed once again left interest rates unchanged, but policymakers lowered their growth outlook and lifted their inflation forecast for the year.
While Fed Chair Powell touted the economy's resilience, he indicated uncertainties about tariffs and other policies are creating challenges.
We believe maintaining equity and fixed-income diversification may help manage the challenges of a slowing economy and heightened volatility.

The Federal Reserve (Fed) remained on pause, holding the target short-term lending rate steady on March 19. Compared with other developed markets, U.S. policy rates remain among the highest at a range of 4.25% to 4.5%.

Additionally, amid mixed economic data and tariff policy uncertainty, Fed officials revised their growth and inflation forecasts for 2025. The Fed's outlook for annual growth dropped from 2.1% to 1.7%, and its inflation forecast rose from 2.5% to 2.7%. Officials did not change their projection for a

year-end federal funds rate of 3.9%, implying they expect to cut rates twice this year.

The Fed also announced it will slow the pace of its balance sheet cuts until Congress addresses the federal government's debt ceiling. Officials still want to reduce the size of the Fed's balance sheet, but they don't want to risk a market disruption amid a potential debt ceiling standoff.

The Fed's outlook reflects the central bank's wait-and-see approach as President Donald Trump's second administration takes shape. We expect uncertainty to prevail and market volatility to remain elevated as Trump's policy priorities unfold. In our view, the economy will likely slow, highlighting the importance of broad portfolio diversification.

Fed Preaches Patience in Policy Outlook

Unlike its peers in the eurozone, U.K., Canada and Australia, which have continued cutting rates this year, the Fed has been on hold since December. Fed Board Chair Jerome Powell said the Fed remains committed to reaching target inflation and fostering full employment, but rates aren't on a preset course. In his post-policy meeting news conference, he indicated the Fed isn't in a hurry to adjust monetary policy, believing officials can wait for greater clarity.

Additionally, Powell touted the economy as strong, the job market as solid and uncertainty as "unusually elevated." He attributed the uncertainty to tariffs, which he also noted would likely have a transitory effect on inflation. He acknowledged recent drops in consumer and business sentiment, but he also noted such data historically have not been reliable predictors of consumption growth.

Powell noted that developments in the Trump administration's trade, immigration, fiscal and regulatory policies will affect the economy. However, he also emphasized the Fed is focused on separating the signal from the noise as the outlook evolves.

The Fed still believes the risks to the central bank's dual goals of promoting stable prices and maximum employment are balanced. Nevertheless, Powell

suggested meaningful movements in either metric would trigger a policy change.

Our Forecast Points to Slowdown, Rate Cuts

The Fed continues to navigate a complex landscape. So far, the nation's economic growth has remained relatively healthy, and inflation has moderated. But we believe headwinds are mounting and will ultimately take a toll on growth.

For example, we're increasingly convinced the combination of government spending cuts and tariffs will trigger economic pains. New tariffs may weaken consumer demand, while government efficiency initiatives could lead to rising unemployment. Whether the economy slips into recession or stalls, we believe an economic downshift will emerge.

Later in the year, however, the impacts of deregulation and onshoring, along with renewed market optimism, may start to surface, fueling better economic momentum.

Economy Due for a Detox

Our economic outlook partly aligns with that of Treasury Secretary Scott Bessent, who recently stated a "detox period" is inevitable. "The market and the economy have just become hooked, and we've become addicted to this government spending, and there's going to be a detox period," Bessent said in response to concerns about potential economic weakness.[1]

He later clarified that detoxing doesn't necessarily mean a recession is inevitable. Bessent noted that the administration's goal is to make a smooth transition from "unsustainable" levels of federal government spending to a more private-sector-fueled economy.

Despite prevailing concerns about upcoming economic weakness, recently released data have been mixed. For example, in February:

- U.S. manufacturing expanded to its highest level since June 2022.

- Retail sales moved back into positive territory but below forecasts after dropping in January.
- Monthly housing starts jumped more than 11% compared with January.
- Job growth increased from January but fell short of expectations.
- The unemployment rate inched up to 4.1% from 4% in January.

Meanwhile, according to the Atlanta Fed, the economy may have already downshifted. The latest gross domestic product (GDP) forecast from the Atlanta Fed points to a first-quarter GDP contraction. The Atlanta Fed's GDP forecast is a running estimate based on available quarter-to-date data and can shift notably as new metrics emerge.

Inflation Is Unlikely to Deter Fed Policy

Annual measures of inflation eased in February, with the core Consumer Price Index (excludes food and energy prices) falling to its lowest level in nearly four years. Nevertheless, along with economic worries, inflation fears persist largely due to tariff and global trade policies.

We still believe inflation will continue to moderate slowly. Of course, tariffs may create bumps in the road, but we expect them to smooth out over time. We believe the slowing economy will outweigh temporary pricing pressures, prompting the Fed to resume its rate-cut program by summer.

Keeping Diversification at the Forefront as Uncertainty Reigns

Recent worries about the economy, tariffs and government spending cuts have bolstered equity market volatility. The S&P 500® Index closed in correction territory on March 13 — a move Treasury Secretary Bessent characterized as "healthy."

Meanwhile, the credit markets have remained relatively steady. We view this calmness as an opportunity to adjust fixed-income risk exposure ahead of our forecasted economic slowdown.

Overall, we believe broad portfolio diversification remains appropriate for all market environments. But it's particularly appealing amid heightened uncertainty and volatility.

As the economy and financial markets adjust to the Trump administration's agenda, volatility is likely to ease. Until then, staying diversified across high-quality stocks to capture upside potential and high-quality bonds to foster risk management may help manage market fluctuations.

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