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MACRO AND MARKET

Interest Rates Unchanged as Fed's Course Remains Unclear

The Fed held rates steady as competing inflation and labor market risks gave most policymakers pause.

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Key Takeaways

- After cutting interest rates three times in 2025, the Fed voted to hold its target rate steady on January 28, though two members dissented.
- The Fed offered few clues regarding future policy moves amid a challenging backdrop of elevated inflation and slowing job growth.
- Given our expectations for solid economic growth and lingering inflation risks in 2026, we don't believe additional easing is a certainty this year.

The Federal Reserve (Fed) shifted gears at its first monetary policy meeting of 2026. After cutting rates at each of its last three meetings, the central bank left the short-term lending rate unchanged. The January 28 decision kept the U.S. short-term interest rate target in a range of 3.5% to 3.75%, the lowest since 2022.

Once again, there was dissension among the policymaking ranks. Two Fed Board members voted to cut rates another quarter-point, while the remaining 10 favored a pause.

This marked the fifth consecutive meeting that concluded with dissenting opinions. We believe this ongoing divergence hurts the Fed’s credibility regarding the future course of monetary policy.

Fed Holds Rates: How Do Other Central Banks Compare in 2026?

The Fed’s latest interest rate announcement aligned U.S. policy with that of other developed markets’ central banks. Earlier this week, the Bank of Canada left its overnight lending rate unchanged.

The European Central Bank has held rates steady since June 2025, while the Bank of England, which eased in December, may cut again in early 2026. Furthermore, the Bank of Japan, which raised rates in December, left rates unchanged in January. Australia’s central bank has been on hold since November.

Inflation vs. Jobs: Which Presents the Bigger Risk for the Fed?

Policymakers continued to consider whether above-target inflation or slowing job growth presents the greatest risk to the U.S. economy. Those worried about inflation believe cutting rates while inflation remains elevated is a risky strategy that could drive prices even higher. Those in favor of additional easing insist that focusing solely on inflation puts the labor market at risk of weakening further.

In December, Fed Board Chair Jerome Powell expressed concerns about the labor market due to the government's methodology for measuring hiring. He noted that federal data may have overstated job creation in 2025 by as many as 60,000 jobs per month. If true, the economy could be shedding jobs rather than adding them.

Powell’s concerns aren’t without merit. As we learned last year, the government overstated the number of jobs created by nearly 1 million for the 12 months ending in March 2025.

However, at his most recent press conference, Powell said, “We still have some tension between employment and inflation, but it’s less than it was.” He noted the unemployment rate appears to be stabilizing, easing to 4.4% in December from 4.5% in November.

Powell also noted that although core inflation remained at an above-target annual rate of 2.8% in November, the upside risks to inflation appear to be moderating. He indicated that much of the recent pressures on goods prices are tariff-related, which he said is “actually good news.” He explained that demand-driven inflation would be more difficult to address than one-time effects from tariffs.

Against this backdrop, he insisted the Fed remains well-positioned to make monetary policy decisions on a meeting-by-meeting basis.

Will Economic Momentum Continue in 2026?

Despite elevated inflation and a weaker jobs market, the U.S. economy has remained surprisingly strong. It expanded at an annualized rate of 4.4% in the third quarter, up from 3.8% in the second quarter. And, as of January 26, the Federal Reserve Bank of Atlanta estimated the fourth-quarter growth rate will reach 5.4%.

Looking ahead, our economic outlook remains optimistic, largely due to these powerful tailwinds likely to unfold:

- A capital spending wave benefiting the artificial intelligence industry, along with non-technology-related sectors.
- A more pro-growth regulatory backdrop.

- A consumer spending boost supported by federal tax refunds.
- The cumulative effects of Fed easing, which should loosen financial conditions and help promote economic growth.

Could Inflation Rise Before Leveling Off?

While easier financial conditions should represent a tailwind for economic growth, they could also create headwinds for consumer prices. In fact, we believe inflation may creep higher through the first half of the year before stabilizing mid-year.

Recent futures market data projected two Fed rate cuts in 2026. However, with economic growth poised to remain healthy and inflationary pressures likely to persist, we're not yet convinced the Fed will ease at all.

But our outlook could change.

While inflation and employment data are key components of the Fed's path forward, they aren't the only factors. We believe the Fed's future course also hinges on who becomes the next Fed chair. Powell's term ends in May, and President Donald Trump appears close to naming a new chair.

Why Diversification Matters After a Fed Pause

As always, we believe maintaining a broadly diversified investment portfolio is a sensible strategy throughout economic and Fed cycles. Our experience suggests that investors who maintain their long-term strategies while remaining mindful of emerging opportunities may improve their risk/reward potential.

Today, as the Fed pauses and the economic outlook remains upbeat, we believe putting cash to work across financial markets may be a prudent policy.

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