MACRO AND MARKET

Fed Leaves Interest Rates Unchanged Amid Ongoing Uncertainties

A complex backdrop of higher inflation, rising gas prices, the Iran conflict and a resilient U.S. economy keeps the Fed’s rate policy pause in place.

By Charles Tan

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Key Takeaways

The Fed left its short-term interest rate target unchanged at its third consecutive monetary policy meeting, the last under Jerome Powell's leadership.

Despite challenges from higher energy prices, the U.S. economy remains resilient, largely due to fiscal and monetary policy and energy independence.

As we navigate the complex backdrop and await Fed policy clarity, we continue to find opportunities among U.S. and non-U.S. fixed-income securities.

The Federal Reserve (Fed) kept its interest rate target unchanged on April 29 at a range of 3.5% to 3.75%, where it's been since December. This was the final meeting of Jerome Powell's eight-year tenure as Fed chair, with Kevin Warsh poised to take over next month. Powell noted that he would keep his position on the seven-member Fed board, which expires in 2028, for a "to-be-determined" period.

At his post-meeting press conference, Powell cited a recent uptick in inflation and uncertainty stemming from the Iran conflict as drivers of the Fed's continued pause. He also noted that the U.S. economy continues to expand at a solid pace.

Fed Keeps Rate-Cut Bias in Statement

At the March meeting, most Fed officials penciled in slightly lower interest rates by the end of 2026. Since then, some policymakers have suggested that inflation risks could extend the pause in interest rates beyond year-end. Nevertheless, in the latest Fed statement, officials left in place language suggesting an easing bias, despite objections from four members — the most dissents since 1992.

Three officials agreed to the rate decision but opposed the language suggesting a rate cut is more likely than a rate hike. A fourth member favored an interest rate cut.

This backdrop suggests Warsh will inherit an increasingly divided Fed as he seeks to usher in a new era. He is likely to introduce a range of reforms to the Fed's balance sheet and forward guidance framework and provide new inflation measurement metrics.

Regarding the Fed's dual mandate of promoting price stability and full employment, Warsh believes price stability should dominate. In his view, full employment depends on sustained price stability, and without it, the Fed fails in its other responsibilities. He also believes productivity gains from artificial intelligence (AI) should bolster growth without triggering high inflation.

U.S. Economy on Track for Continued Growth

Despite the uncertainties surrounding the Iran conflict, we believe the U.S. economy will grow this year. Many Asian and European countries that depend on Middle Eastern energy are struggling with supply disruptions that threaten their economic growth. Meanwhile, energy independence is helping to mitigate the oil supply shock in the U.S., which, combined with other factors, should minimize the economic fallout.

Core Inflation Pressures Should Subside

While the U.S. has an abundant supply of oil, it has been unable to escape the worldwide impact of higher global oil prices. Higher fuel prices have contributed to rising headline inflation, which climbed from 2.4% (annualized) in February to 3.3% in March. However, assuming the military conflict in Iran isn't prolonged, we expect oil prices to moderate over time.

Core inflation, which excludes energy prices and is a key driver of Fed policy, has increased slightly, from 2.5% in February to 2.6% in March.[1] We expect lower effective tariff rates to help keep core inflation relatively contained, though it likely will remain above the Fed's 2% target.

Consumer-Related Data Remain Stable

The labor market, which, along with inflation, shapes the Fed's interest rate policy, appears to have stabilized. In a low-hire/low-fire jobs environment, the unemployment rate eased slightly from 4.4% in February to 4.3% in March. Additionally, nonfarm payrolls rebounded in March to erase February's job losses.

Furthermore, overall consumer spending remains healthy, with retail sales climbing across most categories in March. However, middle- and lower-income consumers continue to face pressures from the cumulative effects of higher prices over recent years.

Fiscal, Monetary Support Aids Economy

We also expect other factors to support and promote economic growth in 2026, including:

- Tax cuts, federal deregulation and pro-growth fiscal policies outlined in last year's One Big Beautiful Bill Act
- A continuation and expansion of the technology capital spending surge
- The cumulative effects of last year's Fed rate cuts, which totaled 1.75 percentage points
- Better clarity surrounding global trade policy

While our outlook generally remains upbeat, we can't overlook the greatest risk to continued economic growth: stagflation.

An expanded military conflict in the Middle East could further aggravate the region's already damaged energy infrastructure. A prolonged energy shortage could severely damage the global economy and trigger a slow-growth/high-inflation environment in the U.S.

What the Current Interest Rate Environment Means for Markets

We believe high-quality bond yields remain attractive in today's interest rate environment. We expect the benchmark 10-year Treasury yield to remain in a range of 4% to 4.5% through year-end.

Additionally, last year's Fed rate cuts and pro-growth fiscal policies have supported credit fundamentals, fueling opportunities among select high-quality corporate bonds. We also expect corporate mergers and acquisitions activity to increase this year, lifting risk in some sectors and highlighting opportunities in others.

Outside the U.S., we favor government bonds in the U.K. and New Zealand. Weaker growth versus the U.S. and mispriced monetary policy are driving opportunities in these markets.

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

Author

Charles Tan
Chief Investment Officer
Global Fixed Income

[1] As measured by the core Consumer Price Index.

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