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Federal Reserve Monitor | North America

January FOMC: A dovish hold

The Fed delivered a dovish hold and shifted toward a more inflation-driven path for further rate cuts.

Key Takeaways

- The Fed delivered a dovish hold: policy is "well positioned". The committee likely expects to reduce policy rates after inflation is decelerating.
- The economy looks solid, there were "some signs" of stabilization in the labor market & the Fed was confident that tariff-induced inflation would be transitory.
- Further rate cuts are likely inflation-based. Evidence of disinflation is likely to come later in 2026. We retain our outlook for cuts in June and September.
- Little to no evidence of disinflation would mean no cuts in 2026. This would happen if the economy realizes our animal spirits upside scenario.

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In justifying the decision to stay on hold in January, Chair Powell pointed to incoming economic data, which was stronger than expected, "some signs" of stabilization in the labor market, and continued confidence that tariff-induced inflation would be transitory. He said that downside risk to employment had likely diminished — which was the original reasoning behind the risk-management rate cuts — but also said upside risk to inflation had declined. The broad consensus at this meeting was to remain on hold and most FOMC members see the current policy stance as appropriate to stabilize the labor market and guide inflation lower.

We interpret Powell's comments as indicating the Fed still has an easing bias and, as a result, just executed a "dovish hold." He said that the current funds rate target was at the upper end of the plausible range of estimates for neutral and that the policy rate was appropriately set to help guide inflation lower. On net, that suggests the Fed still sees the monetary policy stance as imparting some restriction or at the very least not boosting the economy. He was noncommittal about whether further cuts would come because of labor market softness or inflation moving lower, but the Fed's forecast and our interpretation of the press conference is that the Committee likely expects to reduce policy rates only after it sees evidence that inflation is decelerating. Powell said this would likely become clear in the second half of the year.

We expected greater unanimity on the outlook going into the meeting, and we got it. Powell said the outlook for the economy was stronger than when the Committee met in December. The FOMC did not bring new forecasts for the January meeting, but it sounded like the forecast had been upgraded. He said the economy had "solid" momentum entering 2026 and pointed to resilient consumer spending, expanding business investment, expectations for a fiscal boost, favorable financial conditions, and ongoing AI-related capex spending. The only weak spot Powell identified was housing, where he said activity was still weak.

What would bring no rate cuts in 2026?

Lower risks to both sides of the dual mandate suggest patience. When asked about the future path for the fed funds rate, he provided the standard answer that decisions are "meeting by meeting", but he also hinted that the Fed is no rush: "Haven't made any decisions about future meetings **but** the economy is growing at a solid pace, the unemployment rate is broadly stable and inflation remains somewhat elevated".

What would bring rate cuts? In our view, and assuming the outlook evolves as we and the Fed expect, further rate cuts are likely inflation-based. Since evidence of disinflation is likely to show up later in the year, we retain our outlook for rate cuts in June and September.

What would bring no rate cuts in 2026? Little to no evidence of disinflation. We think this could happen if the economy realizes our animal spirits upside scenario, where the fiscal stimulus is larger-than-expected and the policy backdrop produces a stronger — and early

— acceleration in demand. We think an early upswing in activity is needed since tariff pressures are likely to subside after 1Q 26 and strong demand side pressures would be needed to prevent inflation from decelerating. If that happens, and we don't see a material deceleration in monthly inflation prints, then we think the Fed would remain on hold instead of normalizing its policy stance further.

AI, productivity, and the labor market.

On productivity, Powell has been generally optimistic during recent meetings about the productivity backdrop, and recent economic data are likely to reinforce that view. That said, he implied that productivity was running above fundamentals and refrained from saying the economy was receiving a strong AI-related boost to activity at present. He pointed to solid growth in activity alongside a sharp slowdown in hiring as the likely explanation. If the economy remains solid as the Fed appears to expect, Powell said it should bring some labor demand with it. This would dampen productivity (versus its recent readings).

In our view, volatility in trade and inventory data likely play a role here as well. After surging in 1Q 25, imports have retraced sharply, leading to strong contributions from net trade to growth. We think the give-back in imports will fade in the coming quarters, and that may also soften productivity growth. Still, productivity growth is running 1.9% on a four quarter average, which isn't a bad reading overall.

Data quality?

On data quality, judging from his more optimistic view of the labor market and inflation, it looks like Chair Powell and the rest of the Committee took signal from the recent, noisier data. In terms of data distortions, Powell mentioned that "we are getting to a place where they are not longer material, they are still there, but it is a tweak here and there."

Exhibit 1: January statement changes from December

Available indicators suggest that economic activity has been expanding at a moderate solid pace. Job gains have slowed this year remained low, and the unemployment rate has edged up through September. More recent indicators are consistent with these developments: shown some signs of stabilization. Inflation has moved up since earlier in the year and remains somewhat elevated.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. Uncertainty about the economic outlook remains elevated. The Committee is attentive to the risks to both sides of its dual mandate and judges that downside risks to employment rose in recent months.

In support of its goals and in light of the shift in the balance of risks, the Committee decided to lower maintain the target range for the federal funds rate by 1/4 percentage point to 3-1/2 to 3-3/4 percent. In considering the extent and timing of additional adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee is strongly committed to supporting maximum employment and returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

The Committee judges that reserve balances have declined to ample levels and will initiate purchases of shorter-term Treasury securities as needed to maintain an ample supply of reserves on an ongoing basis.

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; Susan M. Collins; Lisa D. Cook; Beth M. Hammack; Philip N. Jefferson; Alberto G. Musalem; Neel Kashkari; Lorie K. Logan; and Christopher J. Waller; Anna Paulson. Voting against this action were Stephen I. Miran and Christopher J. Waller, who preferred to lower the target range for the federal funds rate by 1/24 percentage point at this meeting; and Austan D. Goolsbee and Jeffrey R. Schmid, who preferred no change to the target range for the federal funds rate at this meeting.

Source: Federal Reserve Board, Morgan Stanley Research

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