FOMC Overview: Steady Amid Cautious Optimism

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Rate unchanged: 4.25% to 4.5%:
In the latest FOMC meeting, the Federal Reserve ("Fed") Chairman, Jerome Powell, emphasized that while the economy has shown "significant progress", premature rate cuts could jeopardize hard-won gains against inflation. Noting an increase of economic uncertainty as a result of Trump's tariffs, Powell is of the view that inflation could remain elevated as these costs could be passed on to consumers in the near term.

This decision reflects a deliberate pause to assess the impact of prior tightening and navigate uncertainties in the near future. Projections from the Summary of Economic Projections (SEP) suggest a gradual easing ahead, with the median federal funds rate expected to decline to 3.9% by the end of 2025 and 3.4% by 2026, unchanged from December's estimates.

Slowdown in balance sheet reduction:
In the latest FOMC meeting, the Fed pushes forth with their reduction of securities from their balance sheet plan, albeit removing the following guidance from the previous FOMC meeting. The monthly cap on Treasury redemptions was reduced from $25 billion to $5 billion, while the cap on agency mortgage-backed securities will remain unchanged starting from the beginning in April 2025.

By reducing the runoff of Treasuries, the Fed retains more reserves within the system, thereby enhancing overall market liquidity without fully halting quantitative tightening and maintaining a gradual path toward normalising its $7 trillion portfolio. The decision reflects lessons learned from past episodes of market volatility, prioritizing flexibility as global economic headwinds mount.

Notably, Christopher Waller, a member of the Fed, voted against this action in the first FOMC meeting of 2025. However, his stance changed to vote in unison with the other 11 members during the subsequent FOMC meeting.

Economic Performance

Economic Strength and Labour Market Resilience:
Powell struck an optimistic tone on the economy, noting that activity remains "strong overall," buoyed by a robust labor market. Nonfarm payrolls have averaged 150,000 jobs per month over the past three months, with the latest unemployment rate at 4.2%, hovering near historic lows. Moderate wage growth continues to outpace inflation (Exhibit 1), sustaining an increase in household spending even as higher borrowing costs weighed on sectors like housing and manufacturing (Exhibit 2 and 3). However, the Fed's updated projections hint at caution: The median unemployment rate is expected to rise modestly to 4.4% by end-2025, reflecting expectations of a gradual cooling in hiring demand.

Sources: Reuters, Federal Reserve, Trading Economics

Economic Performance

Exhibit 1: Wage growth vs Inflation

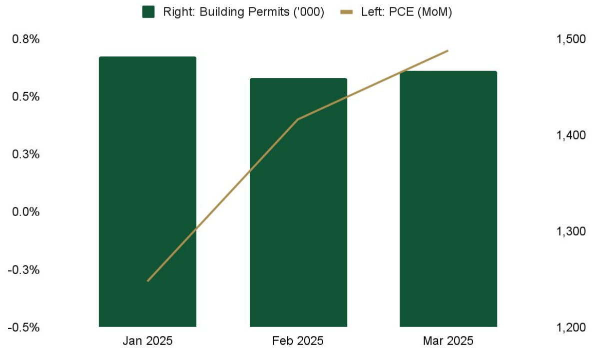

Exhibit 2: Household spending against Personal Consumption Expenditure

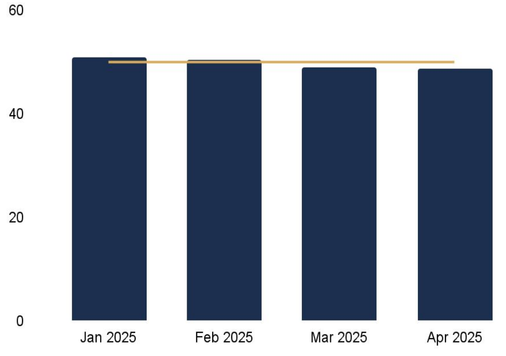

Exhibit 3: ISM Manufacturing PMI (line denotes 50)

Higher Inflation Expectation from 2.5% to 2.7%: Inflation has "eased significantly over the past two years," Powell noted, with headline PCE falling to 2.3% and core PCE (excluding volatile food and energy) to 2.6% on a YoY basis for April 2025. Yet prices remain "somewhat elevated" relative to the Fed's 2% target, driven by persistent service-sector inflation and supply-chain disruptions linked to recent tariffs. The SEP's median inflation projections were revised upward, with total PCE now expected to reach 2.7% in 2025 (up from December's 2.5%) before declining to 2.2% in 2026.

Key Risks

Uncertain energy price may affect price level: These adjustments reflect heightened uncertainty around energy prices. In Jan and Feb 2025, average electricity prices were reported at ~13 cents per kWh, significantly higher than previous years. Geopolitical tensions such as the protracted war in Ukraine, global trade tariffs and the lagged effects of restrictive monetary policy, continued to weigh in on the economy. For instance, higher interest rate begun to weigh on business investment and consumer spending, but the full impact on the whole economy may take several quarters to materialise. While long-term inflation expectations remain anchored at 2%, Powell warned that "the path to price stability is likely to be bumpy," necessitating a patient approach.

Uncertain policy: A recurring theme in the Fed's deliberations was the "unusual uncertainty" stemming from policy changes under the new administration that includes overhauls to trade agreements, immigration rules, fiscal stimulus and financial regulation. Additionally, concerns with the Trump's administration undermining Powell's legitimacy could complicate short-term economic outlook, clouding forecasts for growth, labor supply and productivity. For instance, tariffs on imported goods have exacerbated supply-chain bottlenecks, while proposed immigration restrictions threaten to tighten labor markets further. Powell

Sources: Trading Economics, FOMC, U.S. Energy Information Administration

Key Risks

emphasized that the Fed cannot "pre-judge" the outcomes of these policies but must remain agile, adjusting its stance as data evolves. This uncertainty reinforces the case for a data-dependent Fed, wary of overreacting to transient shocks while staying attuned to structural shifts.

Market Implications

Financial markets and commentators interpreted the latest Fed's stance as hawkish, with the S&P500 index closing ~5% lower for Q1 2025 and bond yields edging lower. The 10-year Treasury yield settled at 4.25%, reflecting bets on slower economic growth and eventual rate cuts. However, the spread between the U.S. 2 Year/10 Year widened to 51 bps, painting another narrative of stronger economic growth and speculation of rising inflation at the horizon. The Fed's decision to slow QT further bolstered risk assets, easing fears of a liquidity crunch.

We believe that financial markets are entering a new phase where traditional risk-on/risk-off strategies are less effective. With central banks limited by persistent inflation, there is less room for strong policy support during periods of volatility. With IMF revising its forecasts for major economies, US and Canadian GDP forecasts may face downward revisions in the coming months amid weakening economic data, while rising US Treasury yields and widening credit spreads are increasing refinancing risks for highly leveraged firms. Investors now need to adjust their portfolios to reflect stickier inflation, tighter liquidity and greater downside risks. In this environment, high-quality defensive assets are likely to perform better.

Risk averse investors can seek safe haven in inflation-protected securities (TIPS) that is a viable hedge against lingering price volatility. Investors who are speculating that the Feds might stick to their forecast of 2 interest rate cuts by a full percentage point at the end of the year may consider short-medium duration bonds and benefit from capital appreciation as rates decline.

Conclusion: Patience as Guiding Principle

The latest FOMC meeting underscored the Fed's delicate balancing act. On one hand, the economy continues to display remarkable resilience through strong job growth and easing inflation. On the other hand, policymakers face a fog of uncertainty from stubborn price pressures to untested fiscal policies, demanding vigilance on their end. Powell's mantra of "patience is not passivity" captures the Fed's stance: prepared to pivot if the labor market weakens or inflation reaccelerates, but resolved to avoid premature moves that could destabilize progress. The policy uncertainty and the fluctuating economic performances create volatility in the market and hardship to forecast long-term rates. The Fed adjusting its inflation expectations also implies the economy is uncertain. In this sense, investors should brace for volatility, leaning into high-quality bonds and sectors insulated from policy shocks. The road to a soft landing remains narrow, but the Fed's deliberate pragmatism offers a steady hand on the wheel.

Sources: CNBC

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