At their May meeting, the U.S. Federal Reserve Open Market Committee voted to keep the Fed funds rate unchanged for the third straight time at the range of 4.25-4.50%. There were no dissents.

The formal statement specifically started off acknowledging the swings in net exports that "have affected the data," with little else changed, noting economic activity and labor conditions as "solid," as well as inflation remaining "somewhat elevated." They also noted continued "uncertainty" about the future outlook, and a language update that "the risks of higher unemployment and higher inflation have risen."

For the last few weeks, CME Fed funds futures pointed to no action in May but have continued to waver for rate activity later this year, along with ever-changing market guesses about the risk of U.S. recession. As of this morning, odds of a future rate cut have come in at just under 30% for June, but over 50% for July. By year-end 2025, the highest odds point to three cuts, down to a Fed funds rate of 3.50-3.75%. By year-end 2026, odds are for two further cuts to 3.00-3.25%.

<u>Economy</u>. The first release of Q1-2025 U.S. GDP growth came in at a negative -0.3%—on its face, a sharp deterioration from the prior quarter. However, while some elements of core growth were still positive, some underlying components were sharply distorted by pre-tariff import/export trade factors. Those point to a potential snap-back in Q2 assuming some trade deals are made, and the domestic environment doesn't worsen in the meantime from business and consumer 'wait and see' behavior. However, if weakness does surface, we could reach the technical definition of a recession—two straight quarters of negative growth. The most recent Atlanta Fed GDPNow indicator for Q2-2025 predicts a rebound to 2.2% growth, just above the still-positive estimates from a variety of private economists, led by strength in personal consumption, fixed investment, and government. The main GDPNow model now incorporates the unique 1st quarter data point of strong gold imports to the U.S. from Europe during the period, which overwhelmed exports in the total net export calculation. (Exports of goods/services tend to act as a positive influence on growth, as they include production, which are offset in the calculation by imports, but usually resulting in a much smaller differential.)

<u>Inflation</u>. Headline CPI rose 2.4% over the trailing 12 months ending in March, while core CPI ex-food and energy rose 2.8%. Core PCE for March ran at 2.6%, continuing above the Fed's 2.0% target. Inflation has shown slow improvement over the past few months, but the worry in recent weeks has been the potential impact of higher tariff rates causing another price shock. If similar to prior tariff episodes, chances of a near-term price spike certainly

rise at maximum quoted tariff rates, even if the adjustment is short-lived. Such a rise would further delay a calming in inflation conditions this year and perhaps even into 2026. If the higher inflation impact were taken alone, it could likely pressure the Fed to keep rates higher for longer.

Employment. Labor conditions haven't shown much deterioration in recent months. The unemployment rate has stabilized around 4.2%, with additional impacts from slower immigration this year, which has altered labor market supply/demand dynamics. Job openings have gradually been slowing, with the labor market in better balance, and no signs of noteworthy layoff activity. Due to the Fed's dual mandate, labor has become more of a secondary swing factor lately, with the Fed noting they're more apt to cut rates when signs of deterioration appear, now that they've seen inflation (pre-tariff, anyway) as having stabilized. Based on those criteria, signs of change are not yet apparent, which also explains the Fed bias toward holding steady.

Economic analysis this year has been almost solely focused on the U.S. administration's tariff policy, leaving Fed monetary policy in the background for a change. Economists tend to have a hard time making forecasts that rely on bimodal 'yes' or 'no' outcomes, especially when tied to all-or-nothing political decisions and unclear timing. The potentially high impact of tariffs on economic activity outweighs other macro factors in the areas of growth, inflation, and possibly labor, to the point of being able to tilt the economy into recession, which raises current stakes—recession odds continue to look around 50/50.

The 'Liberation Day' announcements served to sustain already-high levels of pessimism from businesses, consumers, and economists about what the future might bring. Though, the 90-day pause this month has calmed things, with a hope that tariff rates can be lowered as individual trade deals come together over the next few months. If substantive deals are done and uncertainty evaporates, damage could be minimal, and recession fears could fade; conversely, relatively few deals could deepen the economic pain. Trade deals can take a notoriously long time to negotiate, so how long this lasts, absent any further pauses or extensions, may make the difference between recession or no recession. At the same time, such pauses prolong the uncertainty, with both stock and bond markets showing continued high volatility and sensitivity to various announcements. The Fed has stayed out of the fray so far, in terms of making predictions or reacting to sentiment data, despite political pressure to cut rates to juice the economy. The Fed finds itself in a challenging position, as members have noted the overused description of 'uncertainty' that challenges financial conditions, but the hard data has not yet made its way through to warrant a shift in policy. The key question is whether any evidence surfaces in one of the next few meetings. With rates over 4%, they have much more potential dry powder than in recent years. As one FOMC member recently put it, they “would rather be slow and move in the right direction than move quickly in the wrong direction.”

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Sources: CME Group, Federal Reserve Bank, U.S. Bureau of Economic Analysis, U.S. Bureau of Labor Statistics, FocusPoint Solutions calculations.