At the January meeting, the U.S. Federal Reserve Open Market Committee voted to keep the Fed funds rate unchanged at the range of 3.50-3.75%. There were two dissents, from members Miran and Waller, who wanted to lower rates by a quarter-percent.

The formal statement wording changed slightly from December, with economic activity expanding at a "solid" (from the earlier "moderate") pace, as job gains have "remained low" (from "slowed this year"), and the unemployment rate showing "some signs of stabilization." Perhaps significantly, the prior comment that "downside risks to employment rose in recent months" was removed.

Since year-end, CME Fed funds futures have shown high confidence about today's no change, with probabilities having solidified even further over the last few weeks. For all of 2026, the highest odds now call for rate cuts only in June and December, which would bring the year-end level down to 3.00-3.25%. Markets also assume no rate changes until Dec. 2027, where rising odds of a quarter-percent rate hike have crept in (although sometimes far-out changes can be a quirk of futures market pricing). Policy at a 3% Fed funds level is deemed to be near the theoretical 'neutral rate,' where monetary conditions are considered neither loose nor tight. But, of course, a lot can happen between now and then to deviate from such an ideal path. Odds have aligned with comments from FOMC members over the past month, alluding to "little need" for near-term easing, and a "gradual" path with cuts perhaps being necessary only "later" in the year. Interestingly, FOMC members continue to disagree on whether current policy is actually "restrictive" or not. Such disagreement among members implies that rates could be near their correct place.

<u>Economy</u>. The Atlanta Fed GDPNow indicator for Q4-2025 is currently running at an exceptionally high 5.4%, led by consumer spending, net exports, and inventories (the latter two tend to self-correct quarter-to-quarter, making their durability less reliable), and residential construction remains a negative contributor. The Blue Chip estimate of human economists remains around 1%, while other mainstream estimates have been hovering in the 2-3% range for both Q4 and Q1-2026—just above long-term trend. Decent GDP growth doesn't point to a falloff that raises recession fears, or one that needs more Fed stimulus, including positive fiscal impulses from last year's tax bill. All else equal, that would serve to signal policy remaining contained.

<u>Inflation</u>. In the December 2025 CPI report, trailing 12-month headline and core (ex-food and energy) prices rose 2.7% and 2.6%, respectively. Core PCE for November, running late, came in at a 12-month pace of 2.8%, still almost a percent above the Fed's 2% target. While inflation is still running high, it hasn't radically worsened as tariff policies haven't

proved as damaging as feared, and could go lower if the Supreme Court ends up ruling against their emergency use. There are still hopes that shelter inflation normalizes lower in coming quarters, based on estimates from private sources and the delayed index inclusion of data. At the same time, a weaker dollar pushes up import prices, which can make the inflation-fighting task even more difficult. For the public, the perception of inflation and higher price levels after the pandemic have driven a political push toward affordability fixes. Government action could alter some items at the margin, but aren't likely to drop consumer prices outright and reverse damage already done over the past six years. In short, official inflation rates remain above policy guidelines, resulting in a likely bias for rates kept steady (or even higher, if the Taylor Rule was looked to as a guide) rather than downward, all else aside.

Employment. The unemployment rate in December fell back to 4.4%, considered a healthy level. Payroll growth has slowed, and job openings have settled down at a lower range. While immigration changes have altered the labor force size (and underlying calculations), employers appear to be reluctant to let workers go, but also aren't actively hiring. AI continues to be talked about as a longer-term factor in labor markets, on the opposing sides of concern about worker displacement but also cost savings for employers. Corporate usage of AI continues to increase based on some surveys, but it doesn't appear to have advanced to the point where human jobs are being supplanted more quickly by computers and robots, other than perhaps in some specific tech functions. This is a multi-year phenomenon, though, where impacts remain unclear, especially with the cross-currents affecting the Fed in labor, growth, and inflation.

As it stands, the expected pace of Fed cuts in 2026 has flattened out to just a couple. This is absent any downward shifts in the labor market, which is the most likely catalyst now for cutting faster and more dramatically, perhaps even to below the neutral rate if conditions worsened. Otherwise, a base case of a decent growth environment in 2026, with still-high but still-improving inflation, points to gradual action.

As a recession doesn't appear imminent, an environment of rate cuts (as opposed to hikes) has historically been positive for risk assets like equities and real estate. It can be a positive for bonds as well, although the Fed only controls short-term U.S. Treasury rates. On the longer-term end of the curve, the 10-year U.S. Treasury yield of 4.25% still looks to be in an appropriate place, based on long-term GDP growth assumptions (around 2% trend) plus inflation expectations (around 2.0-2.5%). However, that doesn't account for the periodic worries about Federal deficit and debt levels, as well as sometimes inconsistent U.S. policies, which can prompt markets to require an added term premium. (As an example, such worries have surfaced in the Japanese bond market over the past few weeks.) But, so far, concerns in the U.S. have been contained. This all points to higher chances of a positively-sloped yield curve, which is normal and represents a healthy overall environment.

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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.