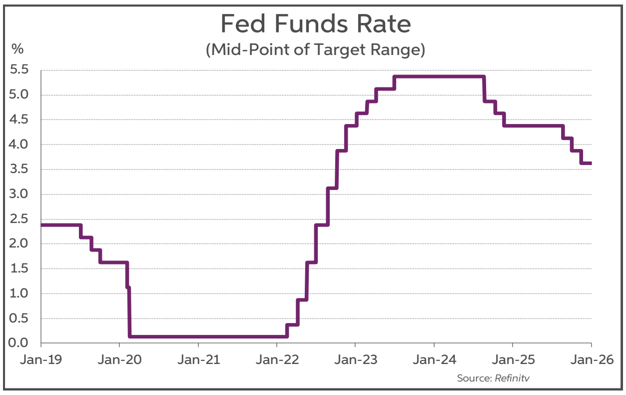
Fed Watch

AIB Treasury Economic Research Unit

29th January 2026

Fed on hold and no sign of any near term easing

The first Federal Reserve Open Market Committee (FOMC) meeting of 2026 saw the central bank leave interest rates unchanged. The target range for the Fed funds rate was maintained at 3.50-3.75%. The decision to leave rates unaltered was very much in line with market expectations. There were two dovish dissenters at the January FOMC (Miran and Waller), who voted for a 25bps rate cut. The most recent rate change from the Fed occurred at its previous meeting in December, when it cut by 25bps. This represented the third 25bps rate cut of the year. So far, in its current easing cycle, which began in September 2024, the Fed has cut rates by a total of 175%.

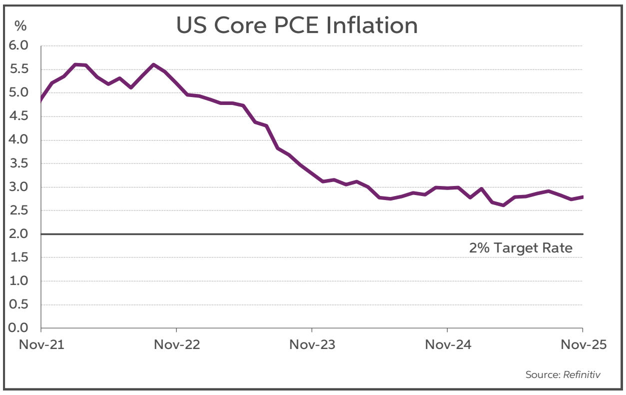


In terms of the January meeting statement, of the amendments that were made, they indicate that the Fed has a more upbeat view of the US economy's performance and outlook than at the time of its December FOMC. It now describes economic activity to be expanding at a "solid pace" compared to "moderate" previously. In terms of the labour market, its assessment is that the unemployment rate has "shown signs of stabilisation" (in December it noted that the rate had "edged up"). It also removed the reference to "downside risks to employment rose in recent months". It continued to state that inflation "remains somewhat elevated".

Similar to the meeting statement, the comments from Chair Powell in the post meeting press conference espoused a more positive assessment of the US economy compared to December. He noted that "economic activity has clearly improved since the last meeting" and he listed off a raft of indicators that suggest the economy has started off 2026 "on a solid footing for growth". In terms of the inflation backdrop, Chair Powell commented that it has "performed, about as expected". He also stated that the Fed thinks that "tariffs are likely to move through and be a one-time price increase". In his assessment of the risks to the Fed's dual mandate, he said that the downside risks to employment and the upside risks to inflation "are probably diminished a bit".

Given that there were no expectations of a rate cut from the Fed this month, one of the **main points of focus was what guidance, if any, would be given regarding the timing and extent of any further rate cuts. In this regard, the Fed provided no new insight**. Chair Powell continued to emphasise that the Fed's interest rate policy setting "is well positioned to address the risks we face on both sides of our dual mandate". He also repeated that the FOMC will continue to make its decisions on a "meeting by meeting" basis and that they "haven't made any decisions about future meetings". Instead, the Fed will let "the data light the way for us".

Its most recent interest rate projections (i.e. dot plot) were published in December. They continued to indicate a gradual pace of policy easing from the Fed over the next 2-3 years. The median projection for 2026 remained for one 25bp rate cut to 3.25-3.50%. For 2027, rates are seen as declining to 3.00-3.25% by year end. **In terms of market expectations, futures contracts are pricing-in a more aggressive pace of rate cuts this year compared to the Fed.** They imply that the market envisages rates being lowered by around 50bps this year, getting down towards 3.2% by the end of the year.



Overall, the main take away from the January FOMC is that while the Fed retains an easing bias, it is not contemplating any near term rate cuts, despite pressure from the White House to do so. The extent of any further easing will be very much data dependent, especially in terms of the labour market. While the Fed upgraded its assessment of labour market conditions, we believe there is the potential for some further softening on the jobs front over the course of this year. Therefore, our view is that 50bps of rate cuts from the Fed over the course of this year is an appropriate expectation.

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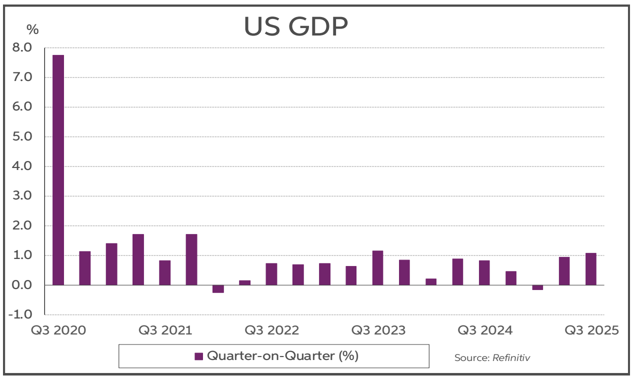
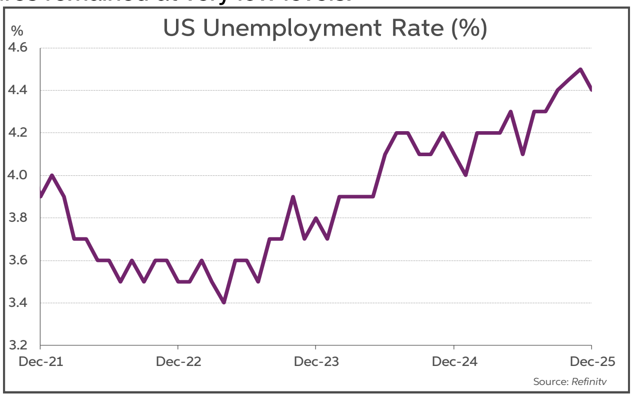
US economy gains momentum but remains fragile



Having contracted by 0.2% in the first quarter, the US economy regained momentum as 2025 progressed. GDP rebounded sharply, expanding by 0.9% in Q2 and by 1.1% in Q3, led in part, by an acceleration in consumer spending. Personal consumption rose by a modest 0.2% at the start of the year, but increased by 0.6% in Q2, and by 0.9% in Q3. Fixed investment has been the main driver of growth though, rising by 3.0% in the first three quarters of 2025, amid a surge in AI-related expenditure. However, very sharp swings in imports have created significant volatility in the data. Goods imports surged by 11% q/q in Q1 before falling by 7.8% in Q2 and by a further 1.7% in Q3. Exports have also been lumpy, essentially stagnating in Q1, contracting in Q2, only to grow by 2.3% in Q3. Meanwhile, government spending was a drag on growth in the first half of the year, but rose by 0.5% in Q3, due to an uptick in defence expenditure.

Meantime, the data for Q4 have also been volatile and somewhat contradictory. The services PMI averaged 53.8 in Q4, down slightly from 54.8 in Q3, but still consistent with a solid pace of expansion in the sector. The non-manufacturing ISM also printed firmly in expansion mode, albeit it improved throughout the quarter. Elsewhere, the manufacturing PMI averaged 52.2 in Q4, up from 51.6 in Q3. In contrast though, the manufacturing ISM was in contraction mode and deteriorated throughout Q4. In terms of the available hard data, retail sales have maintained solid momentum in Q4. Both the headline and control group (a key core sales metric) measures have expanded by 0.3% and 0.5% per month on average in Q4, compared to 0.4% and 0.3% per month in Q3. Industrial production increased by a modest 0.2% in Q4, following a 0.6% rise in Q3. **The limited available survey data in 2026 have been mixed.** The manufacturing and services PMIs were little changed, meaning they stayed in expansion territory in January. Elsewhere, the Michigan consumer sentiment indicator improved marginally, although the Conference Board metric deteriorated in January. Overall, both measures remained at very low levels.



Regarding the labour market, conditions have softened. Payrolls fell for the first time since December 2020 in June, and contracted twice more in the second half of the year. Overall, the pace of payroll expansion slowed to 49k per month in 2025, compared to 168k during 2024. Meanwhile, the unemployment rate ended the year at 4.4%, up from 4.0% last January. Despite this though, average earnings growth has held relatively steady. It stood at +3.8% y/y in December, a touch below the +3.9% y/y rate seen throughout Q1.

At the same time, inflation remains elevated but it has slowed in recent months. Some tariff related price pressures appear to have contributed to stickiness in inflation, with core-CPI stuck between 2.8-3.1% between February to October. However, it fell to 2.6% in November/December, its lowest level since March 2021. Similarly, CPI accelerated throughout the summer months, peaking at 3.0% in September, before falling to 2.7% in the final two months of the year. Meanwhile, core-PCE has printed in a narrow 2.7-2.9% range between May-November, having troughed at 2.6% in April. Looking ahead, the Fed sees core-PCE averaging 2.5% in Q4 2026 and 2.1% in Q4 2027.

In summary, US economic conditions deteriorated at the start of 2025 but regained some momentum as the year progressed. High levels of uncertainty, especially regarding US trade policy, weighed on activity and contributed to sticky inflation. At the same time, the government shutdown made assessing the economy more difficult, due to its economic impact and because it curtailed data collection. Overall though, it is clear that conditions in the labour market have weakened and inflation remains a concern. Thus, with both elements of the Fed's dual mandate in tension, the central bank's policy decisions have become more divisive. Meanwhile, although AI-related investment is boosting US growth at present, there is also some concern that it may be creating a bubble in financial markets. As a result, the US economy appears more fragile, albeit recent growth projections for the economy have been revised higher. The IMF is now forecasting US GDP rose by 2.1% in 2025 (up from +2.0%) and will increase by 2.4% (compared to 2.1%) in 2026.