Weekly Economic Commentary

March 21, 2025

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Although the calendar was chock-full with economic data, the Federal Reserve took center stage this week, with traders parsing the meaning of the latest policy meeting. To be sure, the decision to leave the main policy rate unchanged at 4.25-4.50 percent came as no surprise, as that was the consensus expectation heading into the meeting. The focus of attention was how Fed officials were thinking about the whirlwind of tariff announcements coming out of the administration, particularly how they would influence growth and inflation forecasts of the 19 members of the Federal Open Market Committee. Those forecasts were presented in the Summary of Economic Projections (SEP), which is released every quarter. Unlike the expected decision to keep rates unchanged, the SEP as well as the comments by Fed Chair Powell at the post-meeting press conference were newsworthy enough to upend market expectations.

Initially, the markets reacted positively to the meeting, as the median forecast of the members kept intact the two rate reductions projected in the previous quarterly forecast, made in December. Under the hood, however, the details of the vote revealed a less certain path to rate reductions. Most notably, the number of officials that expected none or 1 rate cuts this year leaped to 8 from 4 in December. What's more, only 4 members projected more than 2 rate cuts, compared to 5 in December. Hence, while the median forecast, anchored by 9 members, still expected 2 rate cuts, the average forecast tilted to fewer reductions, a somewhat more hawkish outlook than indicated in December. While Chair Powell supported that forecast in the subsequent press conference, the main takeaway from his comments were twofold.

Federal Reserve Economic and Interest Rate Projections

Variable	Median[1] 2025	2026	2027
Change in real GDP	1.7	1.8	1.8
December projection	2.1	2.0	1.9
Unemployment rate	4.4	4.3	4.3
December projection	4.3	4.3	4.3
PCE inflation	2.7	2.2	2.0
December projection	2.5	2.1	2.0
Core PCE inflation[4]	2.8	2.2	2.0
December projection	2.5	2.2	2.0
Memo: Projected appropriate policy path			
Federal funds rate	3.9	3.4	3.1
December projection	3.9	3.4	3.1

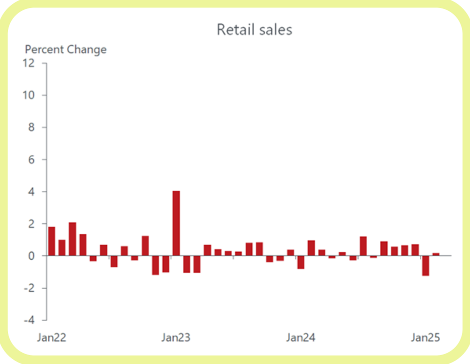
First is that the on-again, off-again tariff announcements have greatly increased uncertainty, suggesting that the projections by the FOMC should be taken with a grain of salt. No one knows what will ultimately come out of the White House and, hence, it is almost impossible to gauge what their prospective economic impact would be. Second is the recognition that some tariffs are certainly coming, and they will probably cause more inflation than otherwise. Conversely, they will also have a dampening effect on growth, as higher prices discourage consumer spending, leading to weaker business hiring and investment. Those contrasting outcomes are revealed in the SEP as core PCE inflation was revised sharply higher – to 2.8 percent this year from the 2.5 percent projected in December. Meanwhile, GDP growth was revised lower, to 1.7 percent from 2.1 percent.

However, Powell also stressed that the inflationary impact of higher tariffs was expected to be "transitory", a one-time lift to the price level, not a recurring influence that would increase the inflation rate. That too is reflected in the SEP, as the inflation rate in 2026 and 2027 is expected to retreat to the pace projected in December. The use of the term "transitory" was taken with some trepidation, as Powell admitted that the term was used early in the post-pandemic era when prices took off and turned out to be more sustainable than temporary, prompting the aggressive rate hikes that followed. Hence, Powell perceives the transitory impact of higher tariffs on inflation to be conditional this time. One reason it again could morph into something more sustainable would be if the tariffs caused inflationary expectations to become unanchored.

Powell and his colleagues at the Fed firmly believe that a sustained increase in inflationary expectations could become a self-fulfilling prophecy. When consumers expect higher prices in the future, they pull forward purchases, spurring higher prices if supply is not sufficient to meet the sudden increase in demand. This, in turn, creates a feedback loop, as retailers increase orders to refill depleted inventories, which wholesalers or producers down the supply chain scramble to keep up with. Higher prices reinforce the feedback loop by encouraging workers to demand higher wages, raising labor costs that employers strive to cover by raising prices again. Of course, in an economy with excess capacity, this is not usually a problem as the slack in the labor force and in factories can readily absorb the increased demand. But that's not the case when the economy is near full employment and the supply chain is being stressed, as is the case now. Importantly, a headline-grabbing warning sign was sounded by the University of Michigan last week, as it's survey of households revealed a sharp jump in both short-and long-term inflationary expectations.

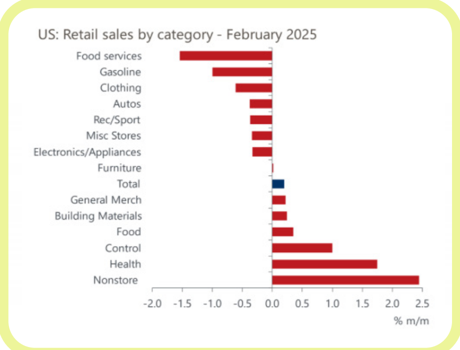
From our lens, the bar for the Fed to cut rates has increased, as inflation – despite an encouraging cooling shown in the February CPI report – remains well above its 2 percent target. What's more, we expect the personal consumption deflator for the month, scheduled for release next week, will not be as friendly as was depicted in the CPI report. And with the February employment report showing a solid increase in payrolls, the Fed can focus more on the inflation side of its dual mandate of pursuing maximum employment and price stability. Simply put, it would not take much of an upside surprise on the inflation front to keep the Fed on the sidelines for the rest of the year.

However, it would be a mistake to ignore the downside risks facing the economy, which could prompt the Fed to cut rates sooner rather than later. Make no mistake, the economy isn't in or flirting with a recession. But that doesn't mean the Fed can be complacent. True, the main engine of growth – the job market, wages and incomes – continues to forge ahead and keep the economy afloat. But pockets of weakness are showing up, and not all of it is in the soft data, which has been portraying far more weakness than the hard data. But the hard data too are starting to show cracks that bear watching. Case in point is the retail sales report released this week, providing a glimpse of consumer spending that accounts for roughly 70 percent of GDP.



Sales in February did increase by 0.2 percent, arresting the setback that occurred in January. But the January decline was revised sharply lower, with the revised number showing an outsize 1.2 percent decline, the weakest reading since 2021. The setback that month was largely caused by bad weather and an unusually long flu season, and expectations were for a strong rebound in February. The 0.2 percent increase hardly qualifies as strong, as the consensus was looking for a gain at least three times as much. Granted, the sluggish gain was held back by a 1 percent decline in sales at gasoline stations, reflecting the fall in prices at the pump. Another drag came from a 0.4 percent decline in auto sales, which is at odds with the increase in unit sales reported by auto manufacturers. None of the major sales categories notched solid gains, except for e-commerce which staged a respectable 2.4 percent increase. But that merely reverses a similar decline in January.

To be sure, the retail report tracks sales mainly for goods, whereas the largest share of consumer spending is for services. However, the one service sector included in the retail sales report was disappointing, namely sales at restaurant and bars. Sales there fell 1.5 percent, following two months of weak readings. If this indicates that discretionary spending is starting to buckle, it may be a sign that middle and upper-income households, whose spending drove the economy last year, may be pulling back. We will get more clarity next week when details on service spending will be provided in the personal income and spending report. As it is, the source data in the retail sales report together with the spending plunge in January suggest that GDP growth is slowing to almost stall speed in the first quarter. That could change if spending in March rebounds strongly. But if it doesn't, the Fed's antenna may well start to tune in more to the growth side of its dual mandate and worry less about the inflation side.



Key Financial Indicators

Interest Rates	March 21	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.29%	4.30%	4.31%	5.37%
6-month Treasury bill	4.23	4.25	4.34	5.30
2-year Treasury note	3.96	4.03	4.20	4.60
5-year Treasury note	4.01	4.10	4.28	4.20
10-year Treasury note	4.25	4.32	4.43	4.21
30-year Treasury bond	4.59	4.62	4.68	4.39
30-year fixed mortgage rate	6.67	6.65	6.85	6.87
15-year fixed mortgage rate	5.83	5.80	6.04	6.21
Stock Market				
Dow Jones Industrial Index	41985.35	41488.19	43428.00	39475.90
S&P 500	5667.56	5638.94	6013.10	5234.18
NASDAQ	17784.05	17754.09	19524.01	16379.46
Commodities				
Gold ($ per troy ounce)	3026.50	2993.60	2949.70	2165.00
Oil ($ per barrel) - Crude Futures (WTI)	68.28	67.20	70.24	80.82

Key Economic Indicators

	Latest Month/Quarter	Previous Month/Quarter	Two-Months/ Quarters Ago	Average-Past 6 Months or Quarters
Retail Sales (February) - % change	0.2	-1.2	0.7	0.3
Housing Starts (February) - 000s	1501	1350	1526	1397
Building Permis (February) - 000s	1456	1473	1482	1458
Industrial Production (February) - % change	0.7	0.3	1.1	0.2
Capacity Utilization (Percent) - all industries	78.2	77.7	77.6	77.5
Existing Home Sales (February) -mlns of units	4.26	4.09	4.29	4.12

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