

MARKET COMMENTARY

A better growth outlook leads the Fed to a pause

Paolo Zanghieri

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- **The January FOMC meeting revealed a more optimistic economic outlook, with the committee highlighting improved activity data and a stabilising labour market.**
- **Chair Powell emphasised sustained economic strength and a stable 4.4% unemployment rate, nothing that inflation remains persistent due the one off impact tariffs, but disinflation is expected in the coming months, and expectations remain anchored.**
- **The Fed is likely to pause further rate cuts until at least June, given diminished risks to inflation and employment.**

The January meeting contained two surprises: Governor Waller joined Governor Miran in dissenting from the decision to keep rates unchanged, instead arguing for a cut; secondly, and most importantly, the FOMC appeared significantly more optimistic about the growth outlook. The press release (included at the end of this commentary) highlighted a strong improvement in the activity data, suggesting the FOMC is less concerned about any further deterioration in the labour market.

During the press conference, Chair Powell emphasised the improvement in economic data since December: “the economy has once again surprised us with its strength”. The unemployment rate has stabilised at 4.4%, and signs of improvement in economic activity should support strong—or at least steady—labour demand in the coming months.

The FOMC expects core PCE inflation to have ended 2025 at 3.0% year-on-year. While this is the same reading as a year earlier, the underlying story is quite different. According to Powell, the persistence in the core rate is largely due to goods, boosted by the (likely one-off) impact of tariffs: the effect on prices appears to have peaked, and disinflation is anticipated in the central months of the year, while inflation elsewhere has trended downwards. Short-term inflation expectations have declined, particularly in financial markets, while long-term expectations have remained near 2%, signalling that the Fed’s credibility as an inflation fighter remains intact.

A significant drop in inflation would be a clear trigger for the Fed to resume the easing that most of the FOMC is committed to, but for now, the Fed is in a favourable position to monitor developments. The policy rate is within the range of neutral estimates (albeit close to the upper bound), and Powell argued that, given the strength of recent activity data, it is difficult to claim that the policy stance is overly restrictive. Upside risks to inflation and downside risks to employment have both diminished since the December meeting, so the Fed is less constrained by the tension between them; furthermore, the lagged effects of earlier cuts should help the labour market stabilise. Of course, Powell stated that the FOMC has made no plans regarding the timing or pace of further cuts, but with the economy growing at a solid rate and unemployment stabilising, we believe a pause in rate cuts is likely. We now expect this to last until at least the June meeting, possibly under a new chair.

As expected, there were many questions on the tension with the Treasury and the impact of political risk on the economy and the status of US government bonds and the dollar. Naturally, Powell refrained from answering most of them, but a few important points emerged. First, he attended the Supreme Court hearing concerning Governor Cook’s case, stating that it is the most important

legal case the Fed has faced in its history, and not attending would have been problematic. Second, he noted there is little evidence of global investors turning away from America and suggested that inflation expectations are a better measure of the credibility of US policy than the price of gold or silver.

Overall, it was a rather uneventful meeting that left markets unimpressed, with Treasury yields and the S&P remaining broadly flat during the press conference.

Available indicators suggest that economic activity has been expanding at a ~~moderate~~ solid pace. Job gains have ~~stowed this year~~ remained low, and the unemployment rate has ~~edged up through September. More recent indicators are consistent with these developments; shown some signs of stabilization.~~ Inflation has moved up since earlier in the year and remains somewhat elevated.

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. Uncertainty about the economic outlook remains elevated. The Committee is attentive to the risks to both sides of its dual mandate ~~and judges that downside risks to employment rose in recent months.~~

In support of its goals ~~and in light of the shift in the balance of risks~~, the Committee decided to ~~lower~~ maintain the target range for the federal funds rate ~~by 1/4 percentage point~~ at 3-1/2 to 3-3/4 percent. In considering the extent and timing of additional adjustments to the target range for the federal funds rate, the Committee will carefully assess incoming data, the evolving outlook, and the balance of risks. The Committee is strongly committed to supporting maximum employment and returning inflation to its 2 percent objective.

In assessing the appropriate stance of monetary policy, the Committee will continue to monitor the implications of incoming information for the economic outlook. The Committee would be prepared to adjust the stance of monetary policy as appropriate if risks emerge that could impede the attainment of the Committee's goals. The Committee's assessments will take into account a wide range of information, including readings on labor market conditions, inflation pressures and inflation expectations, and financial and international developments.

~~The Committee judges that reserve balances have declined to ample levels and will initiate purchases of shorter-term Treasury securities as needed to maintain an ample supply of reserves on an ongoing basis.~~

Voting for the monetary policy action were Jerome H. Powell, Chair; John C. Williams, Vice Chair; Michael S. Barr; Michelle W. Bowman; ~~Susan M. Gollins~~; Lisa D. Cook; ~~Beth M. Hammack~~; Philip N. Jefferson; ~~Alberto G. Musalem~~ Neel Kashkari; Lorie K. Logan; and ~~Christopher J. Waller~~ Anna Paulson. Voting against this action were Stephen I. Miran ~~and Christopher J. Waller~~, who preferred to lower the target range for the federal funds rate by ~~1/24~~ 1/4 percentage point ~~at this meeting~~; and ~~Austan D. Goolsbee and Jeffrey R. Schmid, who preferred no change to the target range for the federal funds rate at this meeting.~~