

A Fine Balance

The Federal Open Market Committee (FOMC) dropped its key interest rate by 0.25% to 3.50–3.75%. Going into 2026, we see signs that fiscal stimulus will be more meaningful in addressing the current weakening labor market.

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Topic

Market Events

Key takeaways

- **Outlook on rates:** This was the third rate cut for 2025; we expect no further cuts until the second half of 2026.
- **Labor and inflation:** Inflation has remained sticky, while the labor market has continued to deteriorate.
- **Market implications:** Bonds are fairly to expensively priced; equities seem to have entered a new phase of expectations for artificial intelligence (AI).

Today, the FOMC announced another 0.25% cut, reducing its key interest rate (the federal funds rate) to 3.50–3.75%. The committee, along with market participants, continues to face challenges from the U.S. government shutdown, with various agencies trying to catch up on the data publishing schedule. As a result, it had to make this decision using stale data and balancing risks. The FOMC also commented on balance sheet management, announcing Treasury bill purchases to begin again in 2026, which are expected to maintain ample reserves.

Today also saw a new set of dots added to the Federal Reserve's (Fed's) dot plot. Dispersion among the FOMC on where the terminal rate lies is revealing. As 2026 begins, we believe the makeup of the board's voting members will come into greater focus and that, while the market is relatively optimistic (pricing in two more rate cuts by the end of 2026), we expect cuts will come after June, with the FOMC on pause starting in January.

Inflation has remained sticky, with the headline rate at 3%, which is higher than the 2% target. This is stale data from September, and survey measures indicate a pick-up in headline inflation. We're now seeing the impact of tariffs on prices. Crucially, the first quarter of 2026 should see some tailwinds on the year-over-year figures for inflation to the downside, which could offset some cost pressures from tariffs. When inflation is accompanied by strong growth, it's not an inherent negative for markets; indeed, available U.S. growth data has continued to paint a rosy picture.

The paradox remains. With a deteriorating labor market accompanied by better growth, the FOMC must balance its dual mandate and how it communicates its views. Over the long term, we believe the Fed will tolerate inflation above 2%—if growth remains resilient—acknowledging the risks of overly precise inflation targeting, but the labor market is a greater political challenge. Labor markets have experienced a structural shift this year, driven by a combination of demographics and migration. We believe fiscal stimulus would be a more impactful tool to address these challenges.

Bond markets have remained fairly to expensively priced, with U.S. 10-year yields around 400–410 basis points (bps; 100 bps equal 1%). Tight corporate spreads make new positions less attractive. Equities have been fascinating, with the AI theme clearly evolving into a new phase. Commodities offer an opportunity for adding alternative exposure, aside from precious metals but across industrials and parts of the energy complex. This may be especially true should U.S. growth run hotter and inflation expectations start to re-rate amid a “run it hot” Fed narrative, post June 2026.

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