The Fed: Navigating a Stagflationary Scenario

Amid uncertainty around tariffs and their impact on U.S. growth and inflation, the Federal Reserve held its key interest rate at 4.25–4.50%. We explain what may lie ahead.

Authors	Date	Topic
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Key takeaways

- Given continued concerns around tariffs and their possible impact on U.S. growth and inflation, the Fed held the federal funds rate at 4.25–4.50% at its May meeting.
- We believe the next likely window for the Fed to lower rates won't be until September of this year or possibly later.
- With the ongoing tariff uncertainty and trade flows between the U.S. and China dropping sharply, the probability of a recession later this year has increased.

Today, the Federal Open Market Committee announced another pause in its key interest rate, the federal funds rate, keeping it at 4.25–4.50%. Given continued worries around tariffs and how they could affect U.S. growth and inflation, the Federal Reserve (Fed) is following a widely expected, "wait and see" approach on rates. We believe the next likely window for the Fed to lower rates won't be until September or possibly later. The Fed itself expects to make only two rate cuts this year versus the market's expectation of three.

U.S. inflation has trended down lately, although consumer and corporate price expectations have risen sharply. Fully aware of this situation, the Fed doesn't want higher short-term expectations to derail inflation's longer-term downward trend. Food and energy prices will likely help headline inflation come down further, although the uncertainty around tariffs as well as a weaker U.S. dollar could potentially push inflation from its current 2.4% rate toward 3.0%.

Labor market data remain fairly robust, and real wages continue to support the U.S. consumer. However, elevated interest rates and a slowing U.S. economy have led to some spending fatigue. While the latest gross domestic product figures showed a decline, they were heavily affected by imports ahead of tariff announcements. Forward-looking U.S. growth indicators point to markedly weaker real growth (growth adjusted for inflation/deflation)—down from 2.5–3.0% in 2024 to below 1.0% this year. With ongoing tariff uncertainty and trade flows between the U.S. and China dropping sharply, the probability of a recession later this year has increased.

The interest rate market currently expects the Fed will cut rates to around 3.6% by the end of 2025. A lot will depend on how the inflation-versus-growth trade-off develops. Growth is likely to continue weakening, and the Fed would ideally want to cut rates to support growth—though over the shorter term, higher prices could make that tricky.

We expect equity market performance to remain volatile and continue to favor cheaper parts of the U.S. equity market, international equities, and emerging market equities given better valuations, more fiscal and monetary stimulus still to come, and higher valuations of a number of U.S. large caps. Our outlook for higher-quality bonds remains favorable given still-attractive overall yields.