■ Bill Adams ■ Waran Bhahirethan

May 7, 2025

Fed Signals No Pre-Emptive Change to Rates in Reaction to Tariffs; Comerica Continues to Forecast Rate Cuts in Second Half of 2025

- **The Fed held interest rates unchanged at its May decision as expected.**
- **Their monetary policy statement said risks to both inflation and unemployment have risen.**
- **Otherwise, the Fed's outlook is little changed from March. They won't update the Dot Plot until June.**
- **The Fed is signaling they don't plan to change rates pre-emptively because of tariffs. Instead, they plan to "wait and see" how tariffs affect inflation and the job market and then react.**
- **Comerica is maintaining our forecast for the Fed to cut their policy rate three quarters of a percent in the second half of 2025 as consumers spend more cautiously and tariffs snarl the goods side of the economy.**

As universally expected, the Federal Open Market Committee (FOMC) held the federal funds target unchanged at the May 7 decision at a range of 4.25% to 4.50%. The decision was unanimous. The Fed updated their assessment of the economic outlook to acknowledge the flurry of tariff changes in April. Where the March statement read, "The Committee is attentive to the risks to both sides of its dual mandate," the May statement reads, "The Committee is attentive to the risks to both sides of its dual mandate **and judges that the risks of higher unemployment and higher inflation have risen**" (our emphasis on the change).

In the post-decision press conference, Chair Powell signaled that the Fed doesn't plan to change rates pre-emptively to account for higher tariffs' effects on the economy. He said, "We can move quickly when that's appropriate. But we think right now the appropriate thing to do is to wait and see how things evolve." The Fed's reading of recent economic data was little changed from March. They attributed the first quarter's decline in real GDP to surging imports, but otherwise read the backward-looking flow of economic statistics as describing an economy that is in decent shape: "Although swings in net exports have affected the data, recent indicators suggest that economic activity has continued to expand at a solid pace. The unemployment rate has stabilized at a low level in recent months, and labor market conditions remain solid." The April jobs report was reassuringly normal, with 177,000 nonfarm payroll jobs added and the unemployment rate holding at 4.2%.

In contrast to the job market, which they see as largely consistent with full employment, the Fed is still a little unhappy with recent inflation data. The May statement acknowledged that "Inflation remains somewhat elevated." Inflation surged to the highest in over 40 years in 2022. It has improved since then but is still holding stubbornly above the Fed's 2% target. The most recent report on the Fed's preferred measure of inflation, the personal consumption expenditures price index, showed a 2.3% annual increase in March, with the core index excluding food and energy rising a bit more, up 2.6%. Inflation is set to accelerate in the second quarter of 2025 as businesses start to pass the cost of higher tariffs on to consumers.

In contrast to backward-looking hard data, forward-looking indicators of the job market and economy are softening. Job openings fell in March to near the lowest since early 2021, and businesses are reporting more

■ Bill Adams ■ Waran Bhahirethan

cautious hiring plans in surveys. Meanwhile, consumers are freaked out, both by expectations of another round of inflation and by fears of higher unemployment. Economists are inclined to take jittery consumer surveys with a grain of salt after consumers screamed bloody murder about the economy in 2022 and 2023 while splurging on vacations, the Eras Tour, Barbenheimer, and other discretionary experiences. But lately there are signs that consumers are beginning to act on their bad vibes. Consumer spending on hotels and airport foot traffic softened in April. Also, a number of public companies in consumer-facing industries have pulled earnings guidance in recent weeks, a sign their order books could be weakening.

The wildcard is that tariff policies continue to change rapidly, and with them, the economic outlook. If the government quickly announces wins on trade negotiations and lowers effective tariff rates, consumer and business sentiment could rebound, economic growth could regain traction, and inflation concerns could recede. On the other hand, if tariffs hold at current levels for an extended period, or rise further, another painful round of inflation could follow, with a retrenchment of consumer spending and higher unemployment.

Near-term, the overhang of tariff uncertainty is restraining businesses' plans for capital expenditures and hiring. Also, there is a risk that businesses run short on inventories in the next few months if they delay purchases on a gamble that an imminent trade deal will lower tariff rates. Shortages could start to snarl the goods-using parts of the economy, like manufacturing and construction, in the summer or fall.

In short, faced by decent backward-looking data but high uncertainty, the Fed held rates steady in May and waited for clarity on tariffs. Comerica's forecast assumes a partial rollback of tariffs in the next month or two. Even so, the more cautious behavior of businesses and consumers so far in 2025 is expected to soften the economy, causing the Fed to lower rates in the second half of the year. Comerica forecasts for the Fed to reduce the federal funds target a quarter percentage point each at the July, September, and December decisions. The outlook for interest rate cuts as well as expectations for tax cuts in 2026 creates a path for the economy to muddle through 2025's anxiety and avoid a recession, although likely registering slower growth than in 2023 or 2024.

It should be noted that the Fed sees a higher bar to cut interest rates with inflation rising than during a conventional economic slowdown when inflation cools. Chair Powell stated at the May press conference that the Fed's "obligation is to keep longer-term inflation expectations well-anchored, and to prevent a one-time increase in the price level from becoming an ongoing inflation problem." If the Fed sees evidence that rising inflation expectations are affecting longer-run economic decision-making—such as faster wage growth at the same time that the unemployment rate rises—they could cut rates less than in Comerica's forecast, even if that means a stretch of higher unemployment and weaker economic growth.