FROM THE OFFICE OF THE CIO

The Fed's Decision: A Pause, Not a Pivot

By Richard Anderson, CFA, Senior Portfolio Strategist

Key takeaways

- **The Fed paused, but the tightening cycle is not over.** October's decision gives policymakers more time to assess September's rate hike rather than signaling a shift toward easier policy.
- **Inflation remains the Fed's primary concern.** Price pressures are still too high, but stable economic and labor market conditions give policymakers flexibility to move gradually.
- **The source of inflation matters.** Energy, tariffs, and infrastructure-related pressures cannot be directly solved with higher rates, arguing against an aggressive series of hikes that would primarily weaken demand elsewhere.
- **We expect less tightening than markets.** Our base case calls for 50 basis points of additional tightening, with 25 basis point hikes in December and March separated by time to assess their impact.
- **Inflation expectations are the key risk to our outlook.** Temporary price shocks become more concerning if they change consumer and business behavior. Evidence that inflation expectations are becoming unanchored would support a more aggressive Fed response.

The Federal Reserve held rates steady on Wednesday, October 28, pausing after September's first rate hike of the cycle. The Federal Open Market Committee (FOMC), the Fed's rate-setting arm, maintained the federal funds rate at 3.75%–4.00%, a decision that was widely expected. Fed funds futures placed the probability of an October hike below 15% in the week leading up to the meeting. Even hotter-than-expected inflation data did little to change expectations for an October pause.

The October vote revealed more than the decision to hold rates steady. September's rate hike was unanimous, as is often the case with the first policy move under new Fed leadership. That consensus did not carry over into October, with two voters dissenting in favor of a 25 basis point hike. This vote demonstrates that policymakers face an increasingly difficult tradeoff, as inflation remains elevated while the broader economy and labor market remain stable.

The Fed's statement offered little additional guidance. Consistent with Chair Kevin Warsh's approach since taking the helm, the release was concise and direct. That brevity appears deliberate. The Fed wants to preserve flexibility rather than commit to a predefined path for rates.

Warsh's balancing act

Warsh used his press conference to reinforce that a pause should not be mistaken for an end to the inflation fight. He acknowledged that inflation remains too high, while characterizing the labor market as balanced and the broader economy as being in a good place. His message was hawkish, but he deliberately avoided committing to the timing or size of the next move. By withholding guidance, the Fed keeps its options open while maintaining its focus on inflation.

A key question was straightforward: If inflation justified September's hike and has moved higher since then, why not hike again? Warsh affirmed that monetary policy takes time to work its way through the system to borrowing costs, spending, and investment. Policymakers want time to assess September's hike before raising rates again.

Warsh also announced a change to how the Fed will review its broader policy strategy. Beginning in 2027, one FOMC meeting each year will be dedicated to monetary policy strategy, increasing to two meetings in 2028. These sessions will not include a policy vote or statement, giving policymakers dedicated time to debate the Fed's framework without the pressure of making an immediate rate decision.

> *"At each policy meeting, my colleagues and I assess the economy by looking out the window — it's what we call 'interrogating reality' — to gauge what's really going on. It is not a task that has grown easier."*
>
> *Kevin Warsh*

Muted market response

Markets largely looked through the widely expected pause. Long-term Treasury yields rose, short-term yields declined, major U.S. equity indexes advanced, and the U.S. dollar weakened. Expectations for December remained largely unchanged, with futures continuing to price more than an 80% probability of a hike. The reaction reinforced the broader message: Investors viewed October as a pause in the tightening cycle, not its conclusion.

Our view

The Fed still has work to do, but we believe it will do less than markets expect. Inflation remains above the Fed's 2% target and is likely to remain elevated heading into December as higher diesel and energy costs work their way into consumer prices.

But the source of that inflation matters. Much of the latest inflation pressure is coming from forces that higher interest rates cannot directly fix. Energy costs, tariffs, and AI-related investment pressures are contributing to higher prices. At the same time, inflation pressures tied to labor and housing remain more subdued. Higher rates cannot produce more oil, remove tariffs, or expand power generation. They can only weaken demand elsewhere in the economy.

That is why we continue to expect a shorter and shallower hiking cycle than markets anticipate. Following September's hike, Warsh said the Fed had "removed a dose of accommodation." We believe those words were carefully chosen. That language suggests the Fed wants to reverse some of its 2025 cuts without slowing the economy more than necessary.

Our base case remains 50 basis points of additional tightening, most likely through 25 basis point hikes in December and March. That would largely unwind the insurance cuts delivered under former Chair Jerome Powell while giving policymakers time between moves to judge how the economy is absorbing higher rates.

What would change our view?

The biggest risk to our outlook is not simply whether inflation rises, but why it rises and how households and businesses respond.

The Middle East remains the clearest wild card. A renewed escalation involving Iran could push energy prices materially higher, while de-escalation could relieve some of the pressure. The more likely outcome is prolonged volatility with energy prices responding to geopolitical headlines but remaining above pre-conflict levels.

The greater risk is that repeated price shocks begin to change behavior. The U.S. is not experiencing a wage-price spiral, but businesses and households have now lived through several years in which one price shock has followed another. Companies may become quicker to pass on higher costs to customers, while consumers may become more willing to buy today if they believe prices will be higher tomorrow.

That is the line the Fed cannot afford to cross. Inflation expectations have remained anchored so far. If expectations become unanchored, temporary price shocks could become more persistent as consumers buy sooner and businesses raise prices more aggressively. Evidence of that shift would make us more hawkish on the path for rates.

Bottom line

The Fed is tightening with caution rather than the conviction it displayed in 2022. Inflation remains too high, but today's economy does not call for the rapid succession of rate increases used to confront the much broader inflation problem of four years ago.

We continue to expect another 25 basis point hike in December, followed by a pause as policymakers assess the impact of higher borrowing costs. This strategy favors a more deliberate hike-pause-hike approach. The message from October was therefore less dovish than the decision to hold rates might suggest. The Fed has not finished tightening, but it is giving each move more time to work.

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