rithm
May 1, 2025

Satish Mansukhani, Investment Strategist
smansukhani@rithmcap.com

Fed on Wait and Watch with Objectives in Conflict

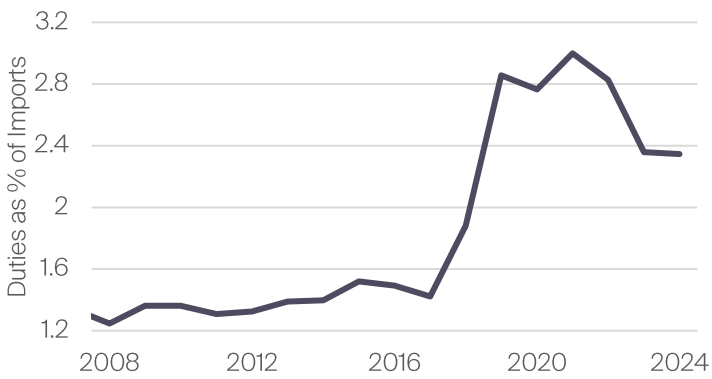
The Federal Open Market Committee (FOMC) concludes its next policy meeting on Wednesday. Policymakers are again widely expected to keep interest rates on hold, signaling they are in no hurry to lower them further. The Fed is tasked with two objectives: price stability and maximum employment. In March, the core PCE price inflation rate slowed to 2.6%, down from 3.0% in February (previously reported at 2.8%.) The unemployment rate that month was 4.2%, which the Fed estimates to be full employment. The Fed lowered rates by one percentage point late last year and, absent new shocks, would likely hold policy steady. However, the massive tariff increases announced on April 2nd complicate the outlook and pose a dilemma for policymakers.

The Conversation

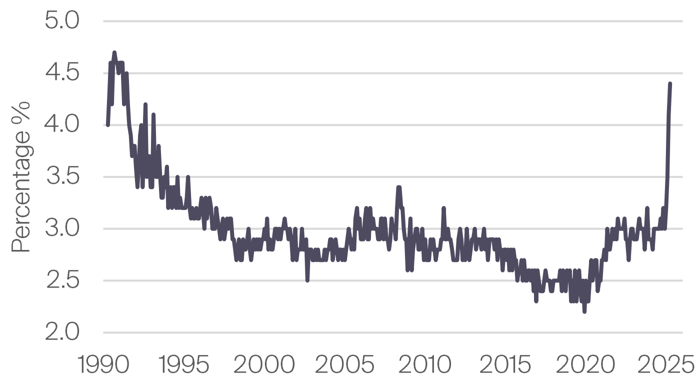
Tariffs are a tax on imports, paid by those who bring goods into the United States. They have generally been small—the average rate was 2.4% in 2024. The April 2nd tariffs, combined with earlier measures, would have pushed the average rate above 25% given 2024 trade patterns. Although many tariff suspensions and adjustments followed for certain products and countries, the remaining 10% minimum tariff, the fentanyl tariffs, and duties on steel and aluminum still represent the largest U.S. tariff hike since the Smoot-Hawley Act of 1930.

Most economists agree that a large tariff increase has two primary effects. First, it depresses output, acting as both a negative supply shock and a negative real-income shock. These effects intensify if other countries retaliate with their own tariffs. Second, it pushes up domestic prices at a time when inflation remains above target. In a recent speech, Chair Powell emphasized the Fed's "obligation ... to keep longer-term inflation expectations well anchored" and prevent a one-time price level surge from becoming a persistent inflation problem. The University of Michigan's medium-term inflation expectation rose to 4.4% in April, suggesting this objective may be at risk.

Average Effective Tariff Rate[1]



Medium-Term Inflation Expectations[1]



The Rithm Take

When the mandates conflict, Chair Powell advises assessing which indicator is furthest from its target and estimating how long it will take to return to goal. However, this assessment remains elusive, and it may take months for data to reflect the post-tariff environment. If tariff-driven price hikes spread broadly across the economy—similar to COVID-related supply shocks—the Fed will likely hold rates steady. If the economy falls into recession and the tariff shock proves a one-time price increase, the Fed may cut rates sharply. A third scenario is a recession accompanied by persistently elevated inflation—a stagflationary outcome reminiscent of the 1970s—posing a true policy dilemma. For now, the Fed's best option is to wait and watch.

1. Sources: Haver Analytics, University of Michigan