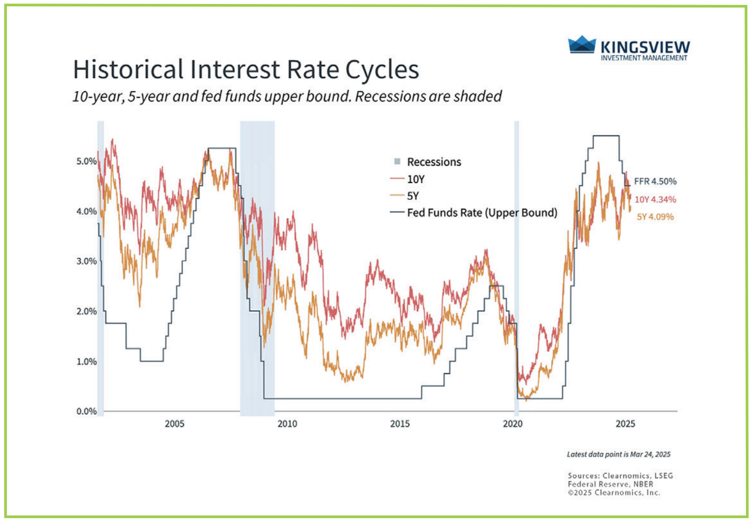
Portfolio Manager Insights

What the Fed's Rate Pause Means for Long-Term Investors

Weekly Investor Commentary | March 26, 2025

Investment Committee

THE FED HAS KEPT RATES UNCHANGED THIS YEAR



Federal Reserve policy has been a key driver of markets over the past few years. It's not surprising to investors that changes in policy direction have resulted in market swings, most notably in 2022 when the Fed began to hike rates, and again last year when investors anticipated Fed rate cuts. So far in 2025, the Fed has kept policy rates unchanged despite investor concerns over tariffs, consumer sentiment, and a possible economic slowdown. Why is the Fed on hold and how does it affect long-term investors?

The Fed's main objective is to achieve its dual mandate set by Congress: maximum employment and stable prices. This translates into keeping both unemployment and inflation low. This is why the Fed increased interest rates in 2022 to combat rising prices, and then began cutting rates last year as inflation pressures eased. At the start of 2024, investors worried that beating inflation would require slowing the economy, a possibility that fortunately did not take place.

However, the Fed now faces greater uncertainty. In its Summary of Economic Projections published after its recent March meeting, it downgraded the outlook for economic growth. These projections suggest that GDP may only grow 1.7% in 2025, a slowdown from 2.5% in 2024 according to the Bureau of Economic Analysis. The last time GDP growth fell below 2% was in 2022 when inflation was running hot.

Expectations of higher inflation and unemployment both contributed to the lowered 2025 guidance. Despite the worsening outlook, the Fed did not change its rate guidance for the next few years. This suggests the Fed is taking a balanced approach to economic risks, despite how the market has reacted over the past month.

According to the Fed's statement and press conference, there are a few reasons for this. Prominently, the primary concern around tariffs is that they could spark higher prices for consumers. While this is never pleasant, it's important to distinguish between one-time price increases on specific goods and persistent inflation. In 2018, for instance, washing machine prices shot higher due to tariffs, but then stabilized. This is different from pressures that raise many or all prices of goods and services across the entire economy, such as when an economy is overheating or when supply chains are disrupted.

This is why the Fed is trying to look past the near-term effects of trade policy, and not overreact to what it often refers to as "transitory" events. Of course, if tariffs are applied more broadly and are longer lasting, inflation could move higher, hurting consumer pocketbooks.

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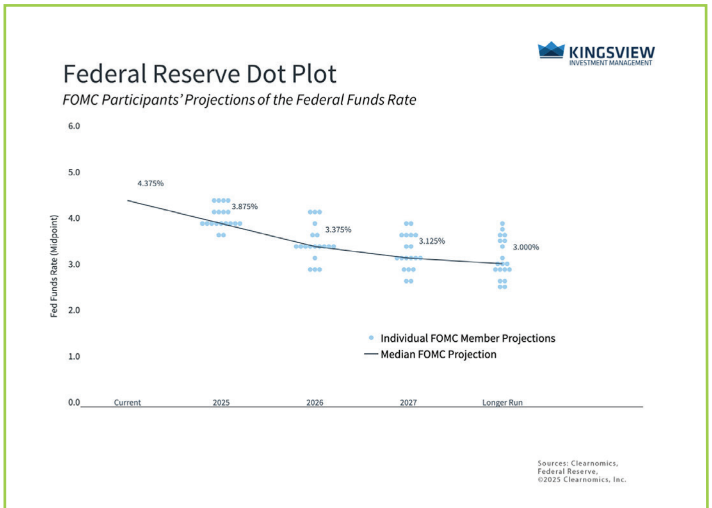
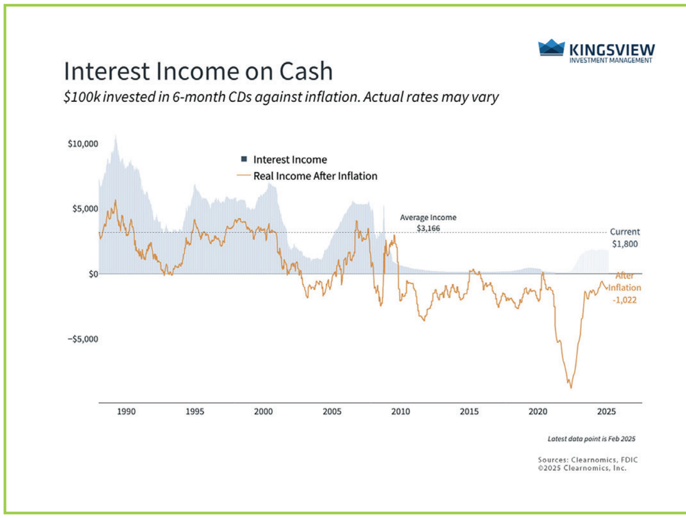
The three most-followed inflation gauges currently remain above the Fed's official long-run inflation target of 2.0%. This difference is one reason financial markets have been far more reactionary than the Fed in recent weeks.

THE FED STILL EXPECTS TO CUT RATES TWICE THIS YEAR



CASH MAY FEEL SAFE, BUT IT CAN BE COUNTER-PRODUCTIVE



Another important reason for a balanced approach by the Fed is the underlying strength in various parts of the economy. Fed Chair Jerome Powell highlighted low unemployment, rising wages, and significant job openings as important indicators of economic health. He also emphasized that how consumers feel and how much they spend don't always align. This is true today with consumer confidence near its lows even as retail sales remain relatively steady.

Chair Powell also highlighted that the data can be hard to interpret. For instance, consumers and businesses might buy more ahead of expected tariffs, not less, if they expect prices to rise in the future. This can be counterintuitive and cloud the numbers. He also emphasized that while higher grocery bills are a real challenge for everyday Americans, they are backward-looking as an inflation indicator.

What can we expect from the Fed going forward? While the Fed kept rates unchanged at its March meeting, it still expects to cut twice in 2025. Similarly, market-based forecasts expect the Fed to cut rates two or three more times in 2025, reflecting confidence that inflation will make some progress this year, despite the tariff uncertainty.

It's important to put these expectations in perspective, since they can change quickly. For example, entering 2024, investors anticipated seven to eight Fed rate cuts in the wake of slowing inflation before adjusting to zero rate cuts. In the end, three cuts were implemented. Even the Fed's own rate forecasts from its Summary of Economic Projections can change meaningfully each quarter.

Additionally, although the Fed did not cut rates in March, it did announce that it will slow the roll-off of assets on its balance sheet. In simple terms, the Fed will provide more support to the economy, which may effectively lower interest rates. This means that the Fed will buy more Treasury securities than it has been

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when its bond holdings mature. Many economists have been speculating on when the Fed would end its "quantitative tightening" program, the name by which this policy is known.

Given that the actual path of rates is hard to predict, it's important to not focus on any individual Fed decision. Instead, the overall path of rates is what matters for long-term investors and their portfolios.

Historically, falling policy rates have helped to support markets and the economy by making it easier for businesses and consumers to borrow, boosting economic activity. The exact number of rate cuts may change the timing, but not the overall trajectory of Fed policy.

As long as interest rates remain elevated, some investors may seek the perceived safety of cash. This is a natural reaction to market swings and worrying headlines. However, holding an inappropriate level of cash can be counterproductive. History shows that markets often recover when investors least expect it, and not benefiting from portfolio growth can derail financial plans.

Despite their appeal over the past few years, many traditional cash vehicles also offer inadequate yields once inflation is taken into consideration. This is because higher prices can quietly erode the purchasing power of cash, even if it may not feel that way based on account balances alone. As the accompanying chart shows, interest income on cash is often still negative after adjusting for inflation, based on nationwide averages.

While some vehicles may provide greater yields, cash is not a long-term solution to income generation or portfolio growth. So, while there continues to be market uncertainty amid recession fears, tariff risks, and the Fed on hold, it's important to maintain a long-term perspective. Market volatility is a normal part of investing, but there will likely also be greater clarity in the coming months as the situation unfolds.

The bottom line? The Fed is maintaining a balanced view despite economic and market concerns. Long-term investors should try to maintain a broader perspective as well. History shows that not reacting to short-term headlines is the best way to achieve financial goals.

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