May 2025

Fed Thoughts: The Gambler

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There's a well-worn metaphor describing the unfortunate lot of officials at the Federal Reserve (Fed) being held responsible for the US economy, but not being in control of it. Some say Chair Powell and his colleagues play the hand they are dealt, but that's only half right. Policymakers with an instrument influencing the economy over time play the cards dealt while all along counting the cards that must be left in the deck.

The economic hand the Fed currently holds is favorable in that aggregate demand retains momentum, financial conditions remain easier than when it made the turn toward accommodation, the labor market appears roughly balanced and inflation is sluggishly returning to its 2% goal. Their problem is that the dealer, the President of the United States, seems to have stacked the remaining policy deck to contain only two extremes.

In one, the administration continues to walk back the punitive tariffs announced on April 2, otherwise known as "Liberation Day," settling market jitters and reassuring spenders. In the other, the administration retains enough of those punitive tariffs to contract global trade in such a manner that it leads households and firms to shelter in place.

This piece describes the cards already dealt, the cards remaining in the deck, how the hand is played forward and what might disrupt play.

Monetary Policy Cannot Be Set to Manage Both Potential Outcomes

As for the state of play right now (and never has a more fluid qualifier been given):

- **We think that the upside case for the economy is about 40%.** In that circumstance, the administration continues to walk back its initial tariff announcements in response to the reaction in financial markets and concerns of constituents, and partner governments keep calm and carry on. Spending is shaken but not shocked, and a modest hike to prices from the tariffs that remain are a minor detour on the route to price stability.

- **In the downside outcome, about a 60% chance, we think trade policy and uncertainty about how it will be administered may derail the US's ongoing economic momentum and progress toward price stability.** Spending is hit by the tax on imports that tariffs represent, uncertainty about the resolve of the administration and retaliation by partners, leading firms and households to slash spending plans. Inflation rises immediately from the tax on goods and stays high over time from the sluggish adjustment of other prices to re-equilibrate relative prices, including a possible un-anchoring of expectations.

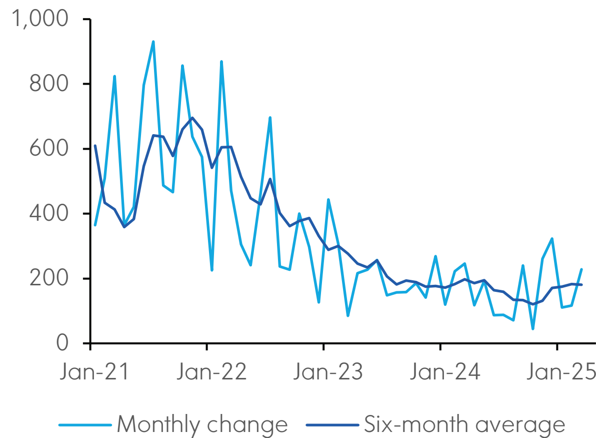
Balancing these unbalanced risks, the Fed will likely opt to go slow, delaying further rate cuts until the first round of price hikes from tariffs show that the inflation risk is contained. This will happen no sooner than the FOMC (Federal Open Market Committee) meetings in June or September, with the forecast rounding when officials have more ways to convey their plans. Further policy accommodation will then be doled out as the economic data warrant and the dealer shows his next cards.

Of course, events may drive the agenda if a market correction becomes disorderly and puts monetary policy into quicker motion. It has happened before, but we don't think the Fed sees it that way, yet. Either way, the Fed will be reactive, either to the slow burn or a quick conflagration.

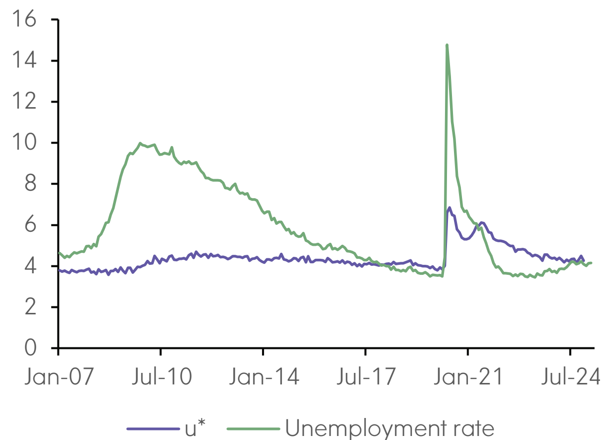
The Cards Dealt

With a tinge of nostalgia, consider the economic data in hand. Payroll gains continue to be robust, holding at the pace of the past one-and-a-half years at or above trend growth. With additions to the labor force slower than the prior few years, this has held the unemployment rate around the level consistent with efficient use of resources.

Payroll Employment
Thousands of workers



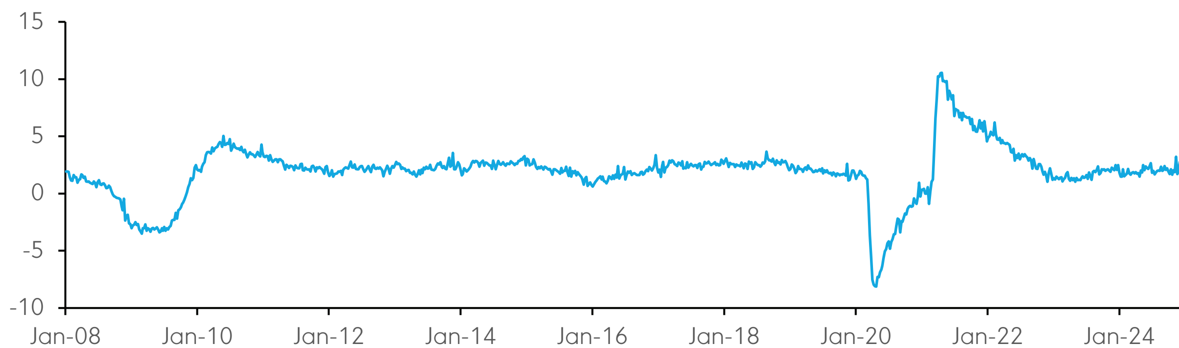
Labor Market Balance
Percent



Source: Bureau of Labor Statistics (payrolls, unemployment and vacancy rates), accessed via FRED with firm analysis, 4/7/25. Natural rate, u* from Pascal Michaillat and Emmanuel Saez, Brookings Papers on Economic Activity, September 2024, and Bureau of Labor Statistics, The Full Employment Rate of Unemployment (FERU), u*, is the rate of unemployment that achieves a socially efficient allocation of labor. Labor-market tightness is defined as the number of job vacancies per jobseeker, v/u. Assuming that the economy moves along a fixed Beveridge curve, the FERU is the geometric average of the unemployment and vacancy rates: $u^*=\sqrt{uv}$.

Readings on spending have been more mixed, with tracking estimates suggesting that first-quarter real Gross Domestic Product (GDP) declined. Some of this, however, owes to shifts in spending in advance of correctly anticipated trade ructions that make much higher imports a notable drag on the arithmetic. When Fed staff roll together weekly readings on economic activity into a composite, the result suggests real GDP will expand about 2.25% over the next four quarters.

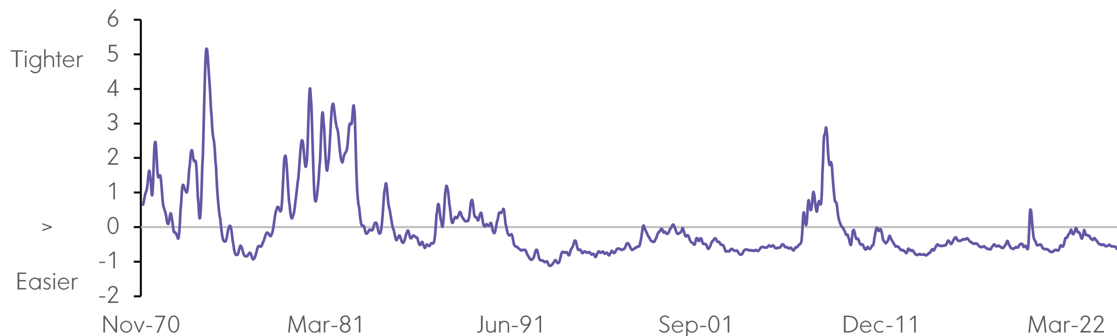
Weekly Economic Index
Index, scaled to the four-quarter GDP growth rate



Source: Lewis, Daniel J., Mertens, Karel and Stock, James H., Weekly Economic Index (Lewis-Mertens-Stock) [WEI], retrieved from FRED, Federal Reserve Bank of St. Louis, 4/10/25.

Support to aggregate comes from fiscal policy, which stills posts deep deficits, the remaining savings of households and state and local governments that had been pocketed from large federal transfers during the Pandemic, and accommodative financial conditions. True, the sharp correction in equity markets in recent weeks ate significantly into wealth, but that only reversed recent gains, not the longer-term run-up. Also, higher long-term interest rates trace a round-trip, putting levels mostly back to where they were before the election. Fed officials tend to smooth through and aggregate this information, as in the Federal Reserve Bank of Chicago's index showing financial conditions extending a run into accommodative territory since the Fed pivoted toward ease.

Federal Reserve Bank of Chicago National Financial Conditions

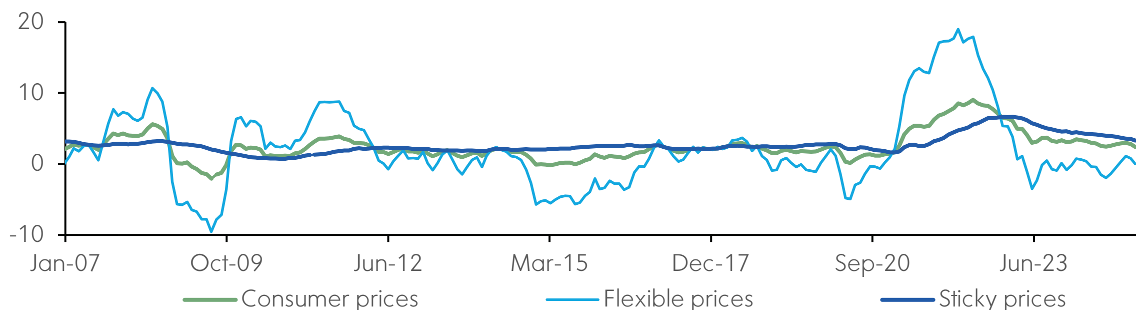


Source: Federal Reserve Bank of Chicago, accessed 4/13/25. Weighted averages of 105 weekly indicators of risk, credit, and leverage in the financial system, with each expressed relative to its sample average and scaled by its sample standard deviation. Zero represents average financial conditions and positive and negative values are, respectively, tighter and looser.

Meanwhile, the Fed made durable progress in returning to price stability, evident in the arithmetic of the consumer prices index. About 70% of the household consumption basket are items with sticky prices, which are resistant to change (mostly services). The rest, mostly goods, have flexible prices, which can quickly adjust to market fluctuations. The latter had shot up on Pandemic shortages and then mostly moved sideways. For the past four years, sticky prices increased sluggishly but persistently to correct the relative price misalignment. Having made up a lot of the lost ground, sticky-price inflation is now slowing by roughly 10% each month, declining in the same grudging manner as it increased. If the labor market remains roughly in balance, so as not to put pressure on costs, an extension of this trend would get the Fed where it wants. En route, the Fed planned modest cuts in the nominal policy rate to reduce its restrictiveness in real terms.

Consumer Prices and the Flexible and Sticky Components

Twelve-month change, percent



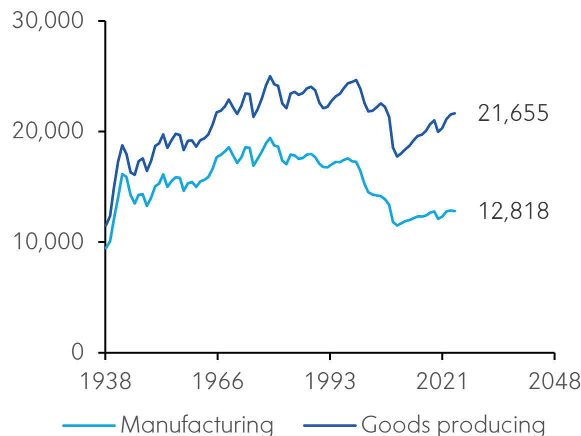
Source: Bureaus of Labor Statistics (consumer prices) and Federal Reserve Bank of Atlanta (flexible and sticky prices). Retrieved from FRED, and firm analysis, 4/14/25. The flexible component represents the 30% of the household consumption basket in which prices adjust quickly and frequently. Sticky prices represent the other 70% of the basket in which prices adjust sluggishly.

Except, that was then. As for now, tariffs are a direct tax soon to be imposed on imported goods, reminiscent of the Pandemic shock. The hard lesson of dismissing the interplay of goods and sticky prices at that time as being transitory lingers at the Fed. How it responds going forward depends on the run of cards.

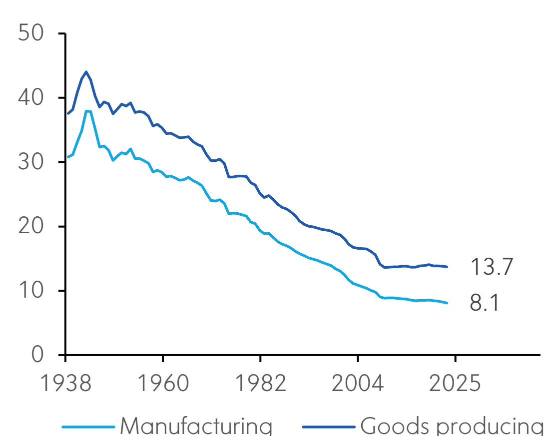
The Dealer's Deck

Over his public life, President Trump never hid his suspicion of US trading partners and his desire to return manufacturing to the US. After the election, most investors read this to mean the White House would advance a plan to use national leverage to pry open foreign markets, benefiting us and them through an increased volume of trade. The actions on April 2 disabused many of this notion. A 10% duty was levied on all economies. On top of that, reciprocal tariffs were placed on 90 countries, which globally cover 65% of GDP and almost 80% of the population. The design, scale and scope of tariffs strongly signaled the intent to compress global trade. The road the President mapped was, by his own admission, likely to involve dislocations at first and, we think investors suspected, lower output in the aggregate and profits in many industries in the long run.

Payroll Employment in Manufacturing and Goods-Producing Industries
Thousands of workers



Share of Total Payroll Employment
Percent



Source: Bureau of Labor Statistics, accessed from FRED, 4/7/25.

While the announcement didn't offer many off-ramps along the route to lower trade volumes, the President somewhat reversed course after the subsequent market sell-off but raised other tariffs based on retaliation from a few trading partners. Nor do we believe that the President completely controls his destiny. The administration is making a gamble on the political economy. Typically, a democratically elected government attempts to shift resources toward a favored sector through subsidies to a concentrated group. In the current experiment, the purchasers of imports are being taxed by tariff duties that will be seen transparently in consumer prices to benefit the smaller pool of potential manufacturing workers, quite small in fact. Manufacturing has declined secularly since World War II, with its share of the US labor force now shrunken to 8%.

The political arithmetic of hurting a lot immediately to help a few over time is problematic, unless voters get the tariff proceeds or other policies gain significant traction in stimulating the economy. Political backlash may cut the experiment short, putting a self-fulfilling cycle of failure into motion in which no one invests to enable the shift in production, and so there is no shift in production.

Relative to Election Day 2024, we think tariffs will likely wind up higher for everyone, though not as high as first feared on April 2, and likely tilt to shoulder some Chinese businesses out of US trade. We also think none of this will be settled or will settle down soon. We think:

- Tariffs will likely be higher, posing a drag on domestic activity as households pay the duty tax and some foreign governments retaliate to constrict our exports.
- Supply chains will likely be disrupted as firms reroute production to cheaper sites, but some business models outright fail.
- The tariff hike will likely boost goods prices that may ripple through other prices.
- Uncertainty about the trade regime will likely raise the option value of waiting, and subsequently, cutting investment.

The needle on the recession meter maps directly into the time it takes trade policy to settle down and where it settles down. Of course, the setting on the gauge also depends on how the Fed plays its hand, given the cards it expects to be dealt actually arrive.

Playing the Fed Hand Forward

The FOMC canonical playbook provides the advice that the imposition of tariffs should be treated as an adverse supply shock. If inflation expectations are well anchored, the appropriate policy is to follow the existing plan for the nominal policy rate. Some overage of the inflation goal is balanced by a shortfall from the full employment goal, and the lower real policy rate in the interim (because of the rise in inflation) tempers the hit to aggregate demand.

Because the FOMC's expected adjustments to the nominal policy rate are modest and depend on the demonstrated persistence of lower inflation, the Fed has scope on the timing. This suggests that officials following the playbook are likely to wait until first-round effects on prices of the Trump Administration's policies show through and pull the trigger only if inflation expectations are reasonably contained in June or September.

Other considerations come into the frame about the first move, because the playbook covers small shocks, not a once-in-a-century policy intervention. Other pages of the playbook matter, too. Policymakers will likely reasonably fear outsized reactions in both prices and aggregate demand to tariff hikes, the former threatening to un-anchor inflation expectations, and the latter veering into recession territory. At the same time, an abrupt repricing of global assets markets may worsen balance sheets and creditworthiness and impede aggregate demand.

In the past three business cycles, recession fears dominated, and the Fed moved quickly and aggressively around the downturn. However, reacting to what the administration may do would wrong-foot them if the administration backtracks more than expected. Moreover, given the traffic on social media, Fed officials might also fear that early action appears politically motivated. This time, we think officials will likely opt to wait to clean up the mess, to the extent there is one.

Thereafter, lessons about inflation dynamics around the pandemic will resonate. Tariffs are mostly a one-shot and large impetus to flexible prices. The Fed has two unappealing choices.

- For one, it can hold the overall price level to its one-time ramp-up from the tariff by restraining aggregate demand so that flexible prices fall back somewhat to offset the subsequent catch-up in sticky prices.
- For another, it can be more accommodative and allow sticky prices to rise to reach the desired relative price at unchanged, higher flexible prices. This implies a longer stretch of increased inflation, which could strain the anchor to inflation expectations.

The second option looks like bringing Team-Transitory out of retirement after its policy mistake during the Pandemic, which is why we expect the Fed to plan on a shallow path of policy ease.

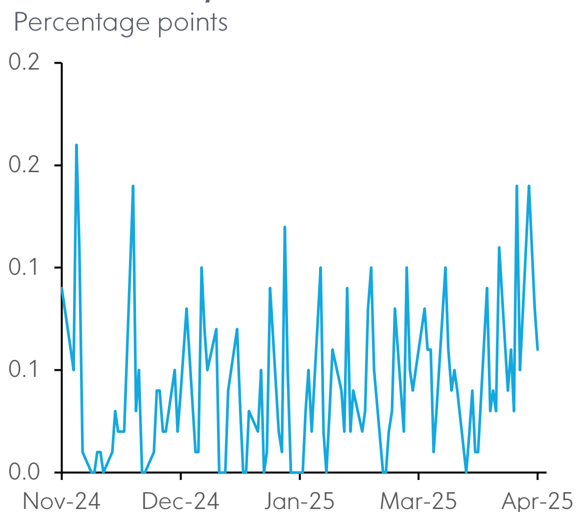
A reactive Fed planning on limited policy accommodation raises the odds that a bad outcome on trade becomes worse, adding to recession risks. Financial markets may force the Fed into motion sooner, either by a sharper decline in capital values that significantly tightens financial conditions or a disruption to operations, which brings the Fed's responsibility for financial stability into play.

All Bets Are Off

On-and-off-again tariffs have put investors on a wild ride in financial markets, with outsized and sometimes opposite-signed swings in equity prices and long-term interest rates from day to day. Beyond the succession of the White House's executive orders, market mechanisms may have steepened the incline of price adjustment. This raises the question whether the Fed, driven by its responsibility for financial stability, steps in to restore order. This is especially significant if strains appear in the first link of the monetary policy transmission mechanism and where the Fed is a fiscal agent, the Treasury market. The obvious precedent was in March 2020 as the Pandemic gloom darkened, but such concerns likely altered the trajectory of monetary policy other times, such as in 1998 and 2008.

Ten-Year Constant Maturity Treasury Yield
Percent

Absolute Value of the Daily Change in the 10-Year Treasury Yield
Percentage points



Source: Federal Reserve, H.15, and firm analysis. Accessed 4/13/25. Gaps in the Ten-Year Constant Maturity Treasury Yield chart represent holidays.

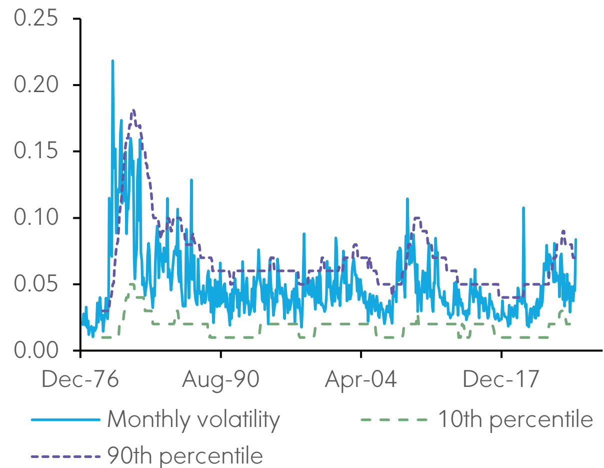
Across the Federal Reserve System, at the Board of Governors and the 12 Reserve Banks, there's exactly one trading room. Most Fed officials view market swings from a physical and mental distance, and three considerations suggest to us that the hurdle for them to "break-the-glass" and act other than solely for macroeconomic considerations is high.

First, Treasury yields have been volatile, with one-tenth of the trading days since last November posting changes of more than 10 basis points (bps). But its level traced a round trip, with the 10-year yield now about where it was just before the 2024 election. Fed officials are unlikely to sound the alarm bell over a market treading water, on net.

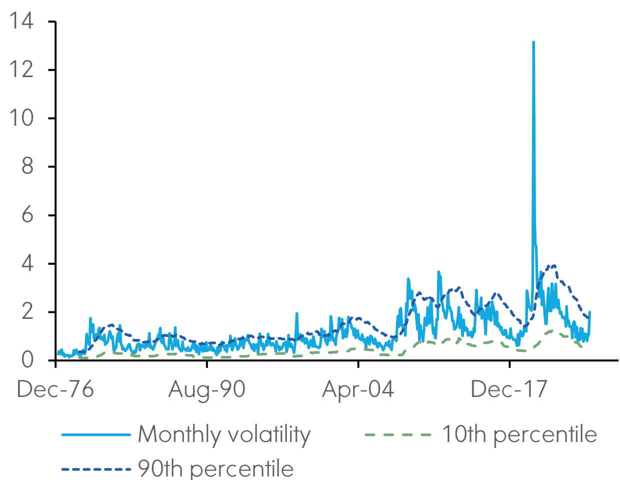
Second, Fed officials likely put recent moves in a longer-term perspective, of the sort offered in the "Absolute Value of the Daily Change in the 10-Year Treasury Yield" chart. Fed staff mostly deal with market readings as processed by the Treasury—the constant-maturity yields across the term structure as published daily in the Fed's H.15 "Selected Interest Rates" statistical report. The upper panel shows the monthly absolute value of daily changes in the 10-year yield since 1976 (That is, we look at the daily changes in yields disregarding the sign of the changes.). They also examine the 10th and 90th percentiles of those outcomes as calculated in a three-year trailing window. The 10th and 90th percentiles isolate the cutoffs points for extreme, but rare, observations. President Trump does not hold a candle to prior Fed Chair Paul Volcker in creating volatility in Treasury yields. Bond prices and yields move inversely. When yields were high while the Fed was strenuously fighting inflation with a high policy rate, bond prices were low. The daily percent changes in price were also low. Volcker's pivot in October 1979 toward inflation fighting put volatility on a different plateau. Recent readings are not far above the longer-term mean. They are only just above the upper confidence bound and well below the outliers that previously prompted the Fed to resort to emergency measures.

Of course, the Volcker plateau owed to a one-way trip in longer-term yields to catch up with a fed funds rate peaking at almost 20%. Given the inverse relationship between yields and prices, the volatility of prices was not as high, shown in the lower panel using a proxy for the price of the 10-year note. The secular downtrend

Absolute Value of the Daily Change in the 10-Year Treasury Yield
Percentage points



Absolute Value of the Daily Change in a 10-Year Treasury Price Proxy
Percent

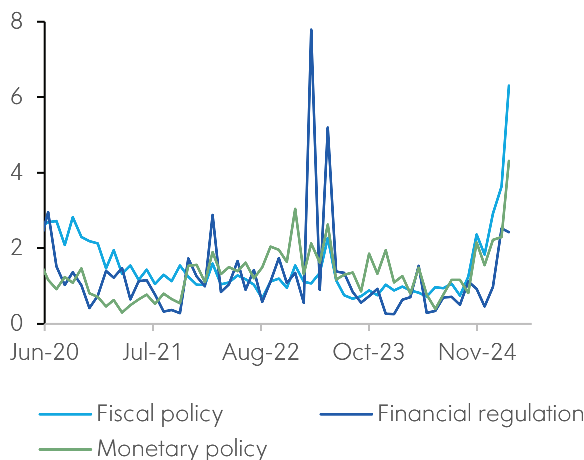


Source: Federal Reserve, H.15, and firm analysis, 4/14/25. The solid line in the upper panel gives the monthly average of the absolute value of the daily change in the 10-year yield (that is, disregarding the sign). The dashed lines give the 10th and 90th percentiles of those outcomes over a trailing three-year window. The bottom panel uses the consol approximation to the price of the 10-year (the reciprocal of its yield) and calculates the absolute value of daily price changes (in percent) and the percentiles of the distribution as above.

in yields because of Volcker's success in reining in inflation implies that price volatility has inclined upward since, with notable increases when the Fed lingered at the zero lower bound of its policy rate. Price volatility is currently elevated somewhat, but probably not so much as to worry Fed officials.

Third, financial prices are supposed to respond to news, and there has been a lot of news as of late. The Fed might be concerned about excess volatility, but that's hard to identify in an environment of elevated fundamental volatility. To see this, consider the "Policy Uncertainty Counted by News Citations" chart. Information relevant to longer-term asset prices has been abundant and changeable. "Explaining the Volatility of the 10-Year Treasury Yield" regresses the monthly volatility of the 10-year note yield since 1985, plotted previously, against those measures of policy uncertainty, along with the level of yields and a dummy for the Pandemic panic. About three-quarters of this uncertainty measure is accounted for fundamentals, on average. And given the coefficients estimated, the ratcheting higher of fundamental uncertainty predicts much of the recent volatility.

Policy Uncertainty Counted by News Citations
By Selected Categories, Index, 1985-2010=1



Explaining the Volatility of the 10-Year Treasury Yield
As proxied by the monthly average of daily absolute changes January 1985 to December 2024

	Semi-elasticity	t-statistic		
Control variables				
Constant	0.623	13.93	R^2	0.71
Level of the yield	-0.186	-28.43	Degrees of freedom	474
Pandemic dummy	1.350	4.10		
Policy uncertainty indexes*				
Monetary policy	0.127	3.95		
Fiscal policy	0.095	3.17		
Financial regulation	0.054	3.54		

*Scaled to equal 1.

Source: Economic Policy Uncertainty, "Baker-Bloom-Davis Monetary Policy Uncertainty (MPU) Indices for the United States," accessed 4/13/25 and firm analysis. The Pandemic dummy controls for the outsized move in March 2020. The left hand side values are in logarithms to ensure predicted values are not negative. As a result, the coefficients are semi-elasticities giving the percent change in volatility to a one unit change in right hand side values.

The longer-term perspective of Fed officials inclines them to believe that financial markets can weather most storms. We think the Fed is in a reactive mode from balancing extreme risks in the economic outlook and being concerned about the optics of independence. The inertia in response to economic events applies to its response to financial market dislocations as well.

In Closing

How does the Fed come out of this unbloodied? A reactive monetary authority will not satisfy the political class, especially those who want to shift blame for dislocations triggered by trade policy. A slow response to market jitters and faltering economic indicators will draw the White House's ire during the process of finding Chair Powell's replacement as his term draws to a close. That will be another hand dealt from a stacked deck testing norms on central bank independence.

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Vincent is the firm's Chief Economist and Macro Strategist. In this role, he is responsible for developing views on the global economy and making relative value recommendations across global bond markets, currencies and sectors.

Previously, Vincent served as the Chief US Economist and a managing director at Morgan Stanley. For the prior four years, he was a resident scholar at the American Enterprise Institute (AEI). Vincent also spent 24 years at the Federal Reserve, holding several roles including Director of the Division of Monetary Affairs and Secretary and Economist of the Federal Open Market Committee (FOMC). His responsibilities at the Federal Reserve included directing research and analysis of monetary policy strategies and the conduct of policy through open market operations, discount window lending and reserve requirements. Prior to these roles, he was the principal liaison with the domestic desk at the Federal Reserve Bank of New York and was responsible for preparing a document outlining policy alternatives for each FOMC meeting. He was Deputy Director in the Division of International Finance and Associate Economist of the FOMC and spent five years at the Federal Reserve Bank of New York in both the domestic and international research departments.

His academic publications primarily concern the conduct of policy and issues related to the monetary transmission mechanism as well as an analysis of alternative auction techniques and Treasury debt management. After an undergraduate training at Fordham University, he received graduate degrees in economics at Columbia University.

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