Citi Wealth

Fixed Income *Investment Strategy*

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When in doubt, do nothing: FOMC leaves Fed Funds unchanged at 4.50%

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- The Federal Open Market Committee kept the Fed Funds rate steady in the 4.25-4.50% target range today, now marking six months since the last cut in mid-December 2024. The primary change to the FOMC statement was slightly more upbeat than May's, stating: "*Uncertainty around the economic outlook has diminished but remains elevated".*
- The Federal Reserve publishes its "Summary of Economic Projections" (SEP) every quarter. This month's release signaled another drop in GDP by YE25 to 1.4% from March's 1.7% estimate, and unemployment also moved slightly higher to 4.5% from the previous 4.4%. Core PCE inflation was also revised higher from 2.8% to 3.1%. Overall, this is a somewhat negative set of economic revisions, but less so than some economists had feared.
- The updated "dot plot" (a survey of FOMC members' policy rate forecasts, and part of the SEP), was moderately less bullish than its previous update on March 19th. For the balance of 2025, it still indicates two more 25bp rate cuts to a rate of 4.00%, but then only one cut in 2026 (previously two cuts) down to a rate of 3.75% (**Figure 1**).
- Chairman Powell elaborated on this set of economic revisions at his press conference, saying: "*labor market conditions have remained solid*", but also noted that "*tariff impacts on inflation could be persistent*", and the Fed "*can't assume tariff inflation hit will just be one-time.*" Powell also repeatedly stated the need for a cautious approach on reacting before tariff impacts were fully understood: "*we are well-positioned to wait to learn more about the likely course of the economy before considering any adjustments to our policy stance.*"
- Since the previous March SEP meeting, Treasury yields are unchanged out to about 7 years, while they have risen somewhat from the 10 year point out to 30 years. This "bear-steepening" of the yield curve is likely primarily due to a perception that the Trump Administration's policy priorities are mildly stagflationary as per the Fed's just released economic estimates above. In addition, investors in longer-dated Treasuries may also be starting to demand higher yields to compensate them for the possibility of an increase in net new Treasury issuance in coming years (**Figure 2)**.
- Given continued uncertainty over the inflationary impact of tariffs and the new US budget bill, as well as due to geopolitical risks which might result in higher oil prices, we think balanced portfolios should maintain fixed income duration of about 5 years to benefit from future Fed rate cuts and avoid the risk of potentially higher long-term rates in the future.

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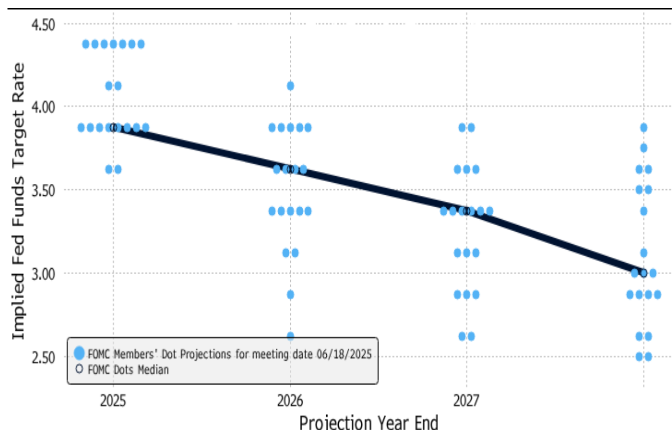
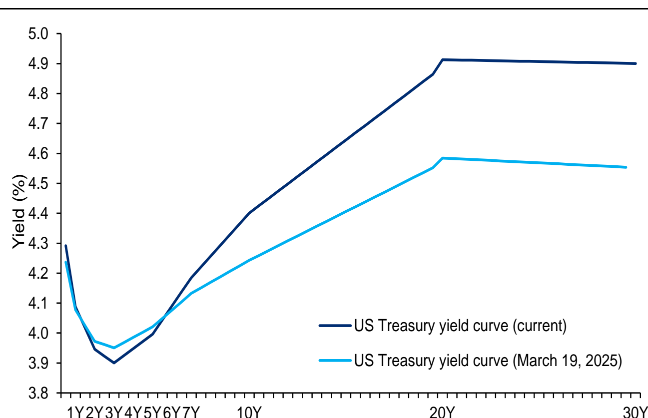
FIGURE 1: Fed participants' projections for midpoint of target range of Federal Funds Rate

FIGURE 2: US Treasury Yield Curve





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Our view:

Throughout months of extreme "tariff regime volatility" following the March FOMC meeting, Chairman Powell and various Fed members stated they would remain in a very cautious holding pattern until the tariff rates were finalized, and the possible effects could be seen in hard economic data. Fast forward to today, and not only is the new tariff structure not finalized, but the Fed also has several new potentially major macro drivers to contend with.

First, Congress is now finalizing the new US budget bill, which is estimated to add trillions to the deficit. Unfortunately, how many trillions is unknown, and various estimates of the additional cost have an extremely wide dispersion. Obviously, a larger annual fiscal deficit is not supportive of lower inflation. Second, the recent hostilities in the Middle East pose inflationary risks as well, particularly if oil supplies are interrupted and oil prices surge.

Further, despite evidence that the economy is slowing even before any major tariff impacts, it's probably not slowing fast enough to induce the Fed to act anytime soon given the Fed's own estimates of rising inflation by year-end. Accordingly, the Fed is likely to maintain the current Fed Funds rate until it sees inflation definitively cooling as the impact of tariffs, the budget, and energy prices becomes clearer. Only a sudden deceleration in economic indicators and/or rise in unemployment beyond the newly published Fed economic estimates is likely to prompt a swifter reaction to cut rates.

We think that fixed income holdings within balanced portfolios should maintain an average duration of around 5 years. Short-to-intermediate term rates will likely decline somewhat once the market perceives the Fed getting closer to cuts, which will likely benefit these intermediate duration bonds. Furthermore, if new government policies shift towards encouraging growth later this year, it is possible that longer-term rates would not move much lower (or may even shift higher) as the market might demand increased term premium due to fears of future inflation uncertainty and increased Treasury bond supply.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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