

A Whiff of Stagflation Complicates Fed Policy

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From a technical standpoint we are not in a recession. But that hasn't stopped many from sounding the recessionary alarm. Heightened uncertainty goes hand in hand with fears of the unknown, and those fears can cause changes in behavior. It's quite possible to talk ourselves into a recession, just as expecting higher inflation can be a self-fulfilling prophecy. At the center of this tension is the Federal Reserve, trying to distinguish signal from noise in a landscape muddled by tariffs, market swings, and diverging economic indicators. It's the job of the Federal Reserve to bring clarity and calm to the discussion so that it can identify and respond to underlying forces rather than subjective influences that it cannot control.

Despite the gloomy public mood, economic fundamentals haven't collapsed. Growth has slowed but remains positive. Consumers are more cautious, yet real incomes are still rising, which supports spending. The January inflation spike that rattled markets reversed somewhat in February, but inflation—particularly the Fed's preferred PCE gauge—remains above target. The Fed has responded prudently by maintaining rates, aware that premature easing could re-ignite inflation. At the same time, high policy uncertainty—particularly around tariffs—is broadening the range of possible outcomes, complicating rate decisions and increasing the odds of a policy misstep.

The Wealth Effect: A Double-Edged Sword

Historically, the stock market has been an unreliable predictor of recessions. But its impact on consumption today is more direct with equities representing a record share of household wealth – much of it in retirement plans. Last year, stock gains helped offset softening wage growth, sustaining consumption and the wealth effect. As equity ownership has broadened, the line between market sentiment and economic reality has blurred. According to the recent University of Michigan and the Conference Board surveys, household sentiment is down and inflationary expectations are rising. The same mechanism that fueled consumption to the upside could reverse, especially with signs of slower job and income growth already emerging. That's why recent market declines — amid inflation surprises and geopolitical risk—bear watching. They not only affect wealth but also confidence, which in turn influences spending and hiring decisions.

Meanwhile, the disinflation trend has stalled since late last year, and odds are inflation will move up rather than down over the remainder of the year. A lot depends on how the shape-shifting nature of Trump's tariff threats play out. The currently proposed basket of levies could lift the inflation rate towards 3 percent by mid-year, further challenging the Fed's credibility and flexibility.

Stagflation Risks: Elevated, but Not Entrenched

Stagflation – a rare combination of sluggish growth and high inflation – remains a fear, not a base case. The economy's main growth driver, consumer spending, has downshifted in January and February and, depending on trade and inventory swings – two volatile components – could drag the growth rate in Q1 GDP down to a virtual standstill, if not into negative territory for the period. But it is not uncommon for GDP to decline for a quarter during expansions, and we believe that the current growth setback will be temporary. For one, the slump was frontloaded into January, which carries the heaviest statistical weight for the quarter, reflecting the effects of harsh weather, rampant wildfires and the pulling forward of some spending into December due to tariff threats. The weaker rebound in February, while concerning, was due partly to the later timing of tax refunds and an unusually sharp drop off in election-related spending by nonprofits. But income growth is holding up, outpacing inflation, and as noted household balance sheets are healthy. Barring a massive wealth-destruction from a collapse in stock prices, we believe consumer spending should recover in the second quarter and provide modest support for the broader economy over the rest of the year.

Fed Outlook: No Rush, But Eyes Open

The Fed left rates unchanged at its March meeting and reiterated its expectation for two rate cuts this year. Its updated economic projections showed a modest increase in both inflation and unemployment forecasts for 2025, but not enough to signal stagflation. More importantly, neither trend is expected to persist, as both inflation and unemployment are projected to decline next year. However, inflation is expected to decline more, closing in on the 2 percent target, which keeps alive two more rate cuts the Fed intends to make this year.

We agree that the Fed is right to be patient, as the current and projected unemployment rate remains near historically low levels and well below the level seen in past recessions. And with inflation still above target, the Fed unsurprisingly feels it is necessary to keep its policy rate steady at a modestly restrictive level. At this juncture, the Fed sees the risk of higher tariff-induced inflation as a one-off and greater than the risk of a recession, a reasonable assumption but it also assumes inflation expectations remain anchored. If businesses pass on cost increases and workers demand higher wages, the Fed's margin for error narrows. That dynamic makes communication and data responsiveness more important than ever.

It's too early to know if inflationary expectations have become unanchored, as the latest surge revealed in surveys by the University of Michigan and Conference Board is only for one month and has not been validated by other indicators, including market-based measures in the bond market.

Therefore, the Fed must remain vigilant about shifting risks. If inflation surprises persist or expectations rise, rate cuts could be delayed—or, conversely, if demand deteriorates faster than expected, the Fed may need to act sooner.

Labor Market: Strength on the Surface, Softness Underneath

Firm judgements about what the administration will do on the tariff front is difficult to make, as President Trump has changed course several times – increasing then rescinding or delaying the timing of levies, adjusting the contents of the goods involved, and moving around the trading partners that would be targeted. So far, the main result of the shape-shifting nature of tariff threats has been a surge in uncertainty and a slide in household and business sentiment.

The job market remains a pillar of strength, at least on the surface. February's 150,000 payroll gain is consistent with stable unemployment. However, tighter immigration policy is restricting labor supply, artificially keeping the jobless rate low. More telling is what's happening beneath the surface: hiring is slowing, job seekers are taking longer to find employment, and voluntary quits have fallen to levels seen in past two recessions. This suggests that worker bargaining strength is weakening and wages will not be a source of upward inflation pressure. These are early signs of a cooling labor market, which may eventually reduce inflationary pressures—particularly on wages. This weakening in labor dynamics supports the case for rate cuts later in the year. However, because employment is a lagging indicator, the Fed risks responding

too late, keeping rates high based on outdated data while the real economy deteriorates. A delayed response could lead to deeper cuts in 2026.

Tariff Uncertainty Clouds the Outlook

The wild card remains fiscal and trade policy—especially tariffs. The Trump administration’s shifting stance has increased economic uncertainty. Changes to tariff timing, product coverage, and target countries have left businesses and markets guessing. So far, these threats have primarily dented sentiment, not real activity. But that could change quickly if levies are enacted more broadly or persist longer than expected.

The Fed’s assumption—that tariffs create a one-time price adjustment—is at risk if trade policy becomes an ongoing source of inflation. Moreover, if policy volatility depresses investment or accelerates deglobalization, it could reduce productivity and potential growth, raising the inflation floor. In that scenario, the Fed’s 2% inflation target would be harder to hit—and rate policy would remain tight for longer than markets anticipate.

Conclusion: A Delicate Balancing Act

The economy is in a delicate phase: not in crisis, but not convincingly strong either. Softening consumption, high inflation, and growing policy uncertainty are complicating the Fed’s task. For now, the Fed’s wait-and-see approach is appropriate. But it must remain agile, prepared to pivot quickly if inflation fades or growth falters more than expected.

Markets are signaling that cuts are coming, and we believe the Fed will ultimately follow that path—though likely later than investors would prefer. The risk is not that the Fed moves too soon, but that it waits too long. If it does, the economy may require steeper cuts in 2026 to regain momentum.

Ultimately, the whiff of stagflation is just that—a whiff. But it’s enough to raise the stakes for policy and markets. With no room for complacency, clarity in communication and flexibility in execution will be key to navigating the second half of 2025.

RATES AND TOTAL RETURNS QUARTERLY AND ANNUAL COMPARISON

U.S. Treasury Market				Total Return (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
6 Mo Bill	5.32	4.27	4.23	1.04	5.21
2 Year Note	4.62	4.243	3.89	1.59	5.20
5 Year Note	4.21	4.383	3.95	3.00	5.05
10 Year Note	4.20	4.57	4.21	3.99	3.93
30 Year Note	4.34	4.78	4.57	4.28	-0.11

Municipal Bonds	Yield (%)			Total Return (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
Barclays General Obligation Index	3.29	3.53	3.64	-0.29	0.97
Barclays New York Bond Index	3.50	3.74	3.89	-0.60	0.98
Barclays California Bond Index	3.28	3.5	3.67	-0.48	0.96
Barclays Revenue Index	3.59	3.84	3.95	-0.22	1.27

Equities	Levels			Total Return (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
S&P 500	5254.35	5881.63	5611.85	-4.28	8.23
DJIA	39807.37	42544.22	42001.76	-0.87	7.40
Nikkei (Tokyo) US \$ Terms	40168.07	39894.54	35617.56	-5.59	-9.29

Commodities	US \$			Percent Change (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
Gold Comex Spot (\$ per oz)	2229.87	2624.5	3123.57	19.02	40.08
CRB Future Com. Pr. Index*	290.29	296.72	309.3	4.24	6.55
W. Tx Int. Crude (\$ per bbl.)	83.17	71.72	71.48	-0.33	-14.06

Currencies	Levels			Percent Change (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
Yen	151.38	157.2	149.96	-4.61	-0.94
Sterling	1.26	1.2516	1.2918	3.21	2.33
Euro	1.08	1.0354	1.0816	4.46	0.25

Global Bond Markets**	Levels			US \$ Terms (%)	
	3/31/2024	12/31/2024	3/31/2025	1st Qtr	1Yr
German 10 year	2.30	2.36	2.74	2.47	-0.07
Japanese 10 Year	0.71	1.09	1.49	2.17	-3.51
UK 10 Year	3.93	4.56	4.67	3.87	1.76
Barclays US Emerging Market	7.04	6.71	6.53	2.34	7.43

Source: Bloomberg Financial Data

*Thomson Reuters/Jefferies CRB Commodity Excess Return Index

** Global Bonds Represented by Bloomberg Barclays Indices

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