

Fed's December policy decision: turning point towards neutrality

Fed's rate cut could be last before an extended pause

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Fed funds rate cut to lowest level in nearly three years

The Federal Open Market Committee (FOMC) concluded its December meeting with a widely anticipated 25-basis point (bp) cut in the federal funds rate to 3.50–3.75%. This marks the third rate cut in 2025 and brings the federal funds rate to its lowest level in nearly three years. The Federal Reserve (Fed)'s move appears to be the final step in a front-loaded adjustment process back towards neutral, rather than the beginning of an extended easing cycle.

Beyond the headline rate cut, the Fed addressed liquidity conditions, noting that reserve balances have declined from previously "abundant" levels to what it now terms "ample". To maintain this status—particularly ahead of the usual mid-April tax-season dip—the Fed committed to reserve-management purchases of shorter-term Treasuries.

A more divided Fed

The December vote revealed growing divergence within the FOMC compared to October. Nine members supported the 25-bp cut, while three dissented—two favoured no change (Schmid, Goolsbee) and one advocated a deeper 50 bp cut (Miran). This compares to October's 10–2 split. There was also evidence of greater resistance among other members to further cuts with policy now deemed to be within the realm of neutral. With the federal funds rate now within the Fed's estimated neutral range, any additional accommodation would be true easing rather than normalisation. In that context, it is natural for opinions within the FOMC to diverge further. Discovering neutral is not a one-off decision but an iterative, data-driven process.

Notable revisions to growth expectations

The Fed's Summary of Economic Projections (SEP) introduced notable revisions. Growth expectations for 2026 were upgraded from 1.8% to 2.3%. This upward adjustment raises the hurdle for additional easing unless incoming data deteriorates meaningfully. Core PCE inflation was revised slightly lower, yet the median projection does not foresee the Fed's 2% target being achieved until 2028. The median policy path remains unchanged, pointing to one more cut in 2026 and no hikes, reinforcing the narrative of limited easing and data dependence.

Chair Jerome Powell reiterated that "there are no risk-free paths" in policy, echoing his September message. The Fed continues to stress that uncertainty remains elevated and that it must weigh risks to both inflation and employment.

Fed continues to navigate a challenging trade-off

The Fed continues to navigate a challenging trade-off between above-target inflation and a softening labour market. Unemployment has edged higher, and recent government shutdown-related delays have created gaps in official data, complicating the Fed's ability to assess real-time conditions. Still, the Fed observes signs of a gradually cooling labour market and rising downside risks to employment. Tariffs have kept goods-price inflation elevated, even as services inflation continues to disinflate. This divergence complicates judgements about how restrictive policy should be.

Market and economic impact

Markets pricing in more easing than the SEP, dollar/yen reaction limited

It is worth noting that the markets are pricing in more easing than the SEP, expecting approximately one additional cut, concentrated between April and June 2026. The Fed funds futures imply a steeper decline in mid-2026 than the median dot plot, reflecting expectations of softer labour data and potential FOMC rotation effects in May 2026. The reaction by dollar/yen to the Fed's decision was modest; we believe the main driver of the pair is Bank of Japan-related developments, and the currency market did not appear to interpret the Fed's decision as particularly dovish.

Maintaining ample reserves heightens sensitivity to liquidity fluctuations

Looking ahead, we believe that the maintenance of ample reserves increases sensitivity to liquidity swings. With reserves positioned near the kink of the demand curve, short-term rates react more sharply to reserve drains—such as those around the April tax season. This dynamic underpins the Fed's decision to pre-announce bill purchases to stabilise reserves.

Productivity messaging supports short-run disinflation but risks contributing to market mispricing

Recent labour-productivity gains (output per hour) cited by Powell primarily reflect capital deepening rather than structural total factor productivity (TFP) improvements. If investors interpret these gains as structural, they risk assuming a high-growth/low-rate equilibrium that is internally inconsistent.

Future policy path: growth, neutral rate and inflation dynamics

Growth upgrade raises the bar for easing.

The Fed's upward revision to 2026 growth (from 1.8% to 2.3%) makes additional rate cuts less likely. Unless the economy deviates meaningfully from this stronger outlook, the Fed's baseline scenario—one more cut in 2026 and no hikes—remains intact.

Productivity and the neutral rate often misunderstood

Short-run productivity gains can dampen inflation, but sustained improvements in TFP push the neutral rate (r*) higher. Powell acknowledged this explicitly: a genuine supply-side acceleration would lift the equilibrium real rate, contradicting current market pricing that assumes structurally higher growth alongside structurally lower real rates.

Most probable path: extended pause near neutral, with two-way optionality

If the Fed were to ease further, it would require clear evidence of labour-market deterioration. Conversely, while much less likely at the current juncture, tightening could occur if tariff-driven inflation proves more persistent or if productivity gains fail to stabilise unit labour costs.

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