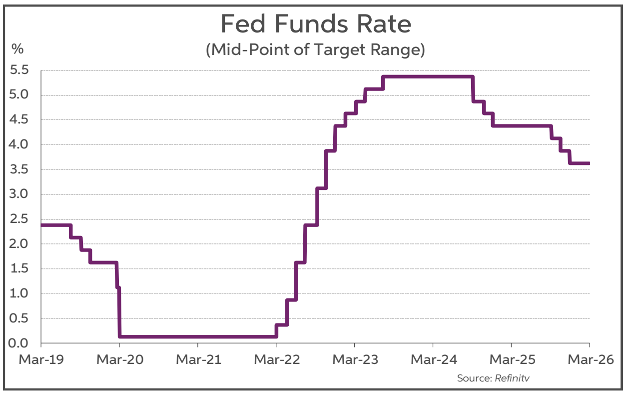
Fed Watch

AIB Treasury Economic Research Unit

19th March 2026

Fed waiting to see the economic impact of Middle East war

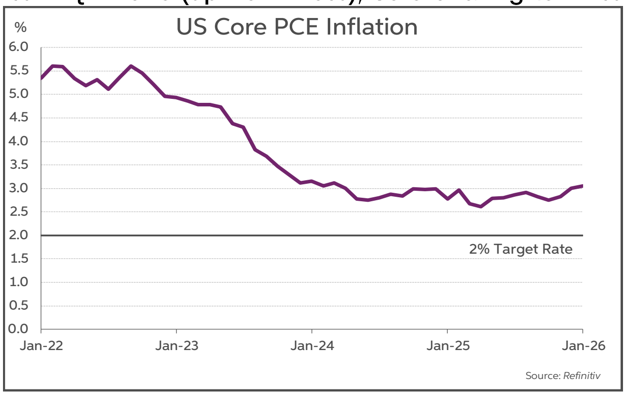
The second Federal Reserve Open Market Committee (FOMC) meeting of 2026 saw the central bank leave interest rates unchanged. The target range for the Fed funds rate was maintained at 3.50-3.75%. The decision to leave rates unaltered was very much in line with market expectations. There was one dovish dissenter at the March FOMC, with former Trump White House official, Governor Miran, once again voting for a 25bps rate cut. The most recent rate change from the Fed occurred at its meeting in December, when it cut rates by 25bps. So far, in its current easing cycle, which began in September 2024, the Fed has lowered the policy rate by a total of 1.75%.



Meanwhile, the March meeting statement was little changed compared to the January edition. Indeed, the only material amendment of note was in relation to the Fed's assessment of the unemployment rate, which is now described as being "little changed" in recent months, compared to its previous assessment, which was that it was showing "signs of stabilisation". At the same time, the FOMC continued to acknowledge that job gains "remained low", and that inflation is still "somewhat elevated". Regarding the conflict in the Middle East, the Fed stated that the implications for the US economy are "uncertain".

The Summary of Economic Projections released in tandem with the March FOMC meeting, were also little changed compared to the previous update, which was provided in December. Most notably, the median projection for the Fed funds target range in the interest rate dotplot, remains for just one rate cut this year, and for another rate cut in 2027. Furthermore, the long-run policy rate projection was unchanged from December also, at 3.00-3.25%. **Meanwhile, the updated macro forecasts indicate that the Fed expects growth and inflation to be slightly stronger than previously anticipated.** The Fed is now pencilling in GDP growth of 2.4% y/y (was 2.3%) in the final quarter of this year. For Q4 2027 and Q4 2028, the Fed is forecasting GDP to increase by 2.3% (was 2.0%) and 2.1% (was 1.9%), respectively. It has also lifted the estimate of long-term growth to 2.0% from 1.8% previously. In terms of inflation, core-PCE is now expected to average 2.7% in Q4 2026 (up from 2.5%), before falling to 2.2% next year (was 2.1%) and to 2.0% in 2028 (unchanged).

At the post-meeting press conference, Chair Powell refused to offer any forward guidance on the future path of policy. Instead, he emphasised the uncertainty regarding the economic outlook. He once again characterised the US economy as being "solid" at present. Importantly, when asked if the Fed would consider hiking rates if oil prices remained elevated, he replied, "We're prepared to do what needs to be done" - suggesting the Fed will raise rates if they deem it necessary. Chair Powell also noted that near-term inflation expectations had risen in recent weeks, likely reflecting the substantial increase in oil prices. However, his overarching message was that it was too early to tell how the conflict will impact the US economy.



Overall, the Fed has kicked to touch. It is waiting to see what impact the war in the Middle East has on the US economy, with particular focus on if higher energy prices "leak into" core inflation. This suggests a willingness to look through a temporary rise in headline inflation from higher energy costs, as long as the second round price effects are contained. Furthermore, the updated interest rate dotplot indicates that the median view on the FOMC is for policy easing this year and next. **Despite this though, market rate expectations hardened markedly in the aftermath of the Fed meeting.** The market now sees only a 40% chance of a rate cut this year. In our view the market has gone too far, although there are now clear upside risks to US inflation due to the war. However, we still expect the Fed to resume rate cuts this year, albeit the timeline for policy easing has likely been pushed-out. However, the duration of the Middle East conflict will determine, when and if, the Fed can cut rates.

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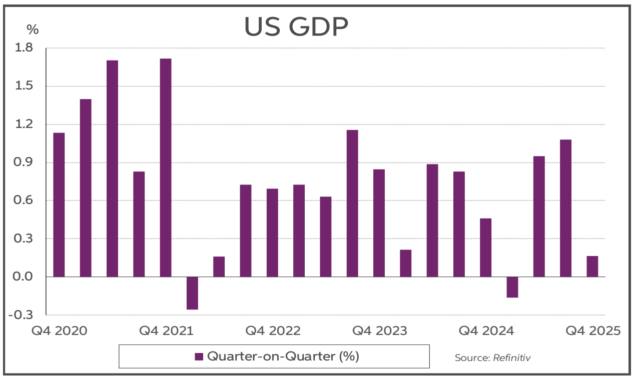
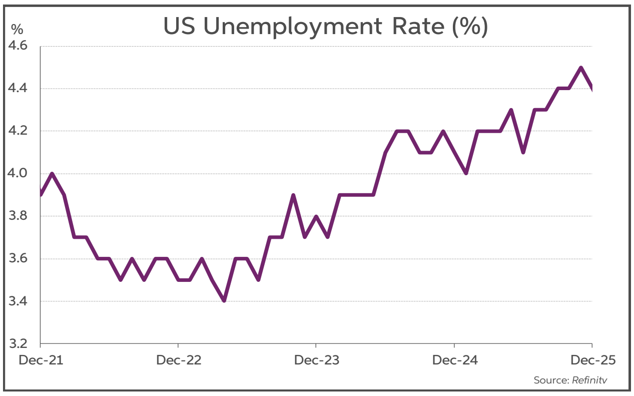
US economy gains momentum but remains fragile

On the face of it, the US economy continued to perform robustly last year, with GDP rising by 2.2% in 2025, down from 2.8% and 2.9%, in 2024 and 2023. However, the headline growth figure masks significant volatility in the underlying data. In particular, shifting US trade policy and the longest government shutdown on record had a major impact on the quarterly GDP growth rates, which ranged from –0.2% to +1.1%. Overall though, US growth was driven by an increase in personal consumption and investment last year. Consumption rose by 2.5%, contributing 1.7 percentage points (p.p.) to GDP in 2025. Meantime, investment jumped by 2.7%, amid a significant ramp up in spending on AI-related infrastructure, boosting growth by 0.5 p.p.. Government expenditure added a further 0.2 p.p. to the total. However, net trade clipped 0.2 p.p. from growth, as imports (up 2.7%) outpaced exports (up 1.5%) last year.



Meantime, the survey data available for Q1 have been relatively solid. Both the manufacturing and services PMIs remained comfortably in expansion mode in the first two months of the year, albeit they did move slightly lower in February. Similarly, the manufacturing and non-manufacturing ISMs were above the key 50 mark in January and February. Indeed, the manufacturing ISM registered its first month of expansion since January 2025 at the start of the year. However, it is worth noting that consumer sentiment remained moribund. Both the Conference Board and Michigan measures of consumer confidence have stayed at very weak levels throughout the opening months of 2026. **The limited available hard data for 2026 have also been encouraging.** Although, headline retail sales contracted by 0.2% in January, following a strong final quarter of 2025, the control group measure, a key underlying sales metric, expanded by 0.3% in the month. Furthermore, industrial production has continued to rise, with output up by 0.7% m/m in January and by 0.2% m/m in February. In year-on-year terms, industrial production was up by 1.4% during the midpoint of Q1.



Regarding the labour market, conditions have softened. Payrolls fell for the first time since end-2020 last June, and contracted three more times in the second half of 2025. Overall, the pace of payroll expansion slowed to just 12k per month in 2025, compared to 168k during 2024. Furthermore, payrolls have remained volatile at the start of 2026, rising by 126k in January before falling by 92k in February. Meanwhile, the unemployment rate is currently at 4.4%, up from 4.0% last January. Despite this though, average earnings growth has held relatively steady. It stood at +3.8% y/y in February, just a touch below the +3.9% y/y rate seen throughout Q4 2025.

At the same time, inflation remains elevated, albeit it has eased in recent months. Both the headline and core rates of CPI inflation declined to 2.4% and 2.5%, respectively, in January, and they stayed at that level in February also. In contrast though, core-PCE inflation has been trending higher in recent months. Having troughed at 2.6% in April, it printed in a narrow 2.7-2.9% range between May-November. However, it rose to 3.0% in December, and again to 3.1% in January, its highest level since March 2024. Looking ahead, the Fed sees core–PCE averaging 2.5% in Q4 2026 and 2.1% in Q4 2027.

In summary, headline figures suggest the US economy remains solid, yet the underlying details indicate it has become more fragile. It is clear that conditions in the labour market have weakened and inflation remains a concern. High levels of uncertainty, especially regarding US trade policy, have weighed on activity and contributed to sticky inflation. Meanwhile, AI-related investment has boosted US growth recently, but there are also some concerns that it may be creating a bubble in financial markets. With both elements of the Fed's dual mandate in tension, the central bank's policy decisions have become more divisive. As a result, the US economy appears more fragile, albeit recent growth projections for the economy have been revised higher. The IMF is now expects US GDP to rise by 2.4% this year and by 2.0% in 2027. However, it should be noted that these forecasts were made before the conflict with Iran started, which poses an added downside risk to the US economic outlook.

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