



## **DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS**

No System Open Market Account holdings data was available on or before the point-in-time-safe cutoff for this meeting, and consequently the Committee had no current figure for the total size, composition, or change from the prior release of the SOMA portfolio to review. Members were advised that this section reflects SOMA holdings data only; results of repurchase and reverse-repurchase operations are not covered, as no point-in-time-safe data source for those operations currently exists. In the absence of the underlying data, no characterization of portfolio developments could be made.

## **STAFF REVIEW OF THE ECONOMIC SITUATION**

The staff reported that economic growth slowed further in December, with most Federal Reserve Districts describing a continued deceleration from the previous survey. One District reported an outright decline in activity, and another indicated that growth held at the same slow rate as before, while two Districts noted that solid growth showed some signs of softening. All Districts reported weaker manufacturing activity. Holiday retail sales were described as lackluster nearly everywhere despite early and heavy discounting, automobile sales slowed substantially, and dealer inventories built up sizably. Residential construction cooled in most Districts, and commercial real estate activity also showed signs of slowing. The Chicago Fed National Activity Index stood at -0.66, consistent with below-trend growth. The unemployment rate was 4.0%, well below the estimated natural rate of 5.09%, but labor markets eased somewhat over the survey period: layoffs were announced across a wide variety of industries in most Districts, though contacts generally expected laid-off workers to be reabsorbed given pent-up demand elsewhere. Initial jobless claims were 343,000.

On the price side, the staff noted that inflation remained subdued. Core PCE inflation was 1.38% on a year-over-year basis, below the 2.0% reference point. The Beige Book indicated that prices for most manufactured goods were flat to down despite higher energy and other input costs, and that consumer product prices were constrained by heavy holiday discounting. Wage pressures were reported as similar to or slightly less intense than in the prior survey. Banks reported no deterioration in credit quality but described keeping a watchful eye over their loans. The current federal funds rate was 6.0%.

## **STAFF REVIEW OF THE FINANCIAL SITUATION**

Financial conditions presented a mixed but broadly moderate picture. The financial stress index registered 0.2427, elevated relative to calmer periods but not at acute levels, and the VIX stood at 22.03, indicating market anxiety that was somewhat above normal without signaling panic. The Baa corporate spread was 2.61, reflecting some degree of credit-cost stress that bore watching but had not widened to alarming levels. The 10-year/2-year Treasury yield curve spread was positive at 0.52, so the



curve was not inverted. The most striking signal came from the front end: the 3-month Treasury bill yielded 0.86 below the current 6.0% funds rate, indicating that market participants had already priced in substantial near-term easing. Taken together, the data suggested policy that was restrictive relative to where markets expected it to move, with credit conditions moderate but showing early signs of caution.

### STAFF ECONOMIC OUTLOOK

The staff outlook drew on the estimated neutral rate and the momentum measures underlying the reference rules. With the neutral rate ( $r^*$ ) estimated near 3.886 and the current funds rate at 6.0%, policy was assessed as meaningfully restrictive, particularly given that inflation was running below the 2.0% reference point. Inflation momentum was modest at 0.12 and unemployment momentum was slightly negative at -0.05, implying that price pressures were not building and that the labor market's direction of travel had begun to shift, even as the level of unemployment remained low.

The reference rules showed notable dispersion, reflecting the tension between the still-tight labor market and the visible deceleration in activity. The Taylor rule prescribed no change (0 bps), balancing sub-target inflation against a wide unemployment gap relative to the natural rate. The Balanced Approach and ELB-adjusted rules each pointed to +75 bps, driven heavily by the low level of unemployment. The First-Difference rule, which responds to changes in conditions rather than levels, prescribed -25 bps, consistent with the negative activity index and softening momentum. The framework's loss-minimizing recommendation, with the reference rules judged reliable, was -25 bps -- a measured easing that acknowledged the slowdown while respecting contained inflation and the absence of any financial rupture. The projection implied that a modest reduction would begin to normalize an overly restrictive stance without overreacting to a deceleration that, though broad-based, had not yet produced acute stress.

### PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants independently favored a 50 basis point reduction, arriving at that conclusion from distinct analytical vantage points. Participants generally judged that inflation posed no constraint on easing: core PCE at 1.38% was well below the 2.0% reference point, and the Beige Book corroborated limited price pressures, with manufactured goods flat to down and consumer prices held down by heavy holiday discounting. Against this backdrop, several participants characterized the current 6.0% funds rate as clearly restrictive, and pointed to the 3-month Treasury bill yielding 0.86 below the funds rate as evidence that markets had already priced in substantial easing.



The member most attentive to inflation risk noted that his usual caution against cutting was muted, since there was no inflation overshoot to defend against and wage pressures were described as similar to or slightly less intense than before. He initially leaned toward the more cautious end of a 25-to-50 basis point range given still-tight labor markets at 4.0% unemployment, well below the 5.09% natural rate, but was persuaded in the second round that the breadth of the deceleration -- one District in outright decline, weaker manufacturing everywhere, the activity index at -0.66 -- outweighed the risk of reigniting inflation from a single move. The participant focused on employment weighted the widespread layoff announcements heavily, treating them as a leading warning even though contacts expected reabsorption, and argued that the direction of travel mattered more than the low level of unemployment. The participant attentive to financial stability emphasized that his framework favored acting ahead of disorderly conditions rather than reacting after them, citing the VIX at 22, the Baa spread at 2.61, and banks' reported watchfulness over loans as signs of emerging caution. The centrist read the data at face value and judged the breadth and speed of the slowdown to favor the decisive reading, while the participant weighting market signals most heavily regarded the -0.86 bill spread as consistent with an expectation of 50 basis points or more. Both the dove and the market-focused member considered whether a larger 75 basis point move might be warranted, but each stepped back given that credit stress was only moderate and the yield curve, positive at 0.52, was not deeply inverted.

When the discussion turned to the framework's loss-minimizing recommendation of -25 basis points, participants engaged closely with the dispersion among the reference rules. There was broad agreement that the level-based rules -- the Balanced Approach and ELB-adjusted rules at +75 basis points -- rested on stale slack, leaning too heavily on the low unemployment level while ignoring the clear turn in activity. Participants generally found the First-Difference rule at -25 basis points most persuasive, since it responded to changing momentum rather than levels, and noted that the modest momentum readings (inflation at 0.12, unemployment at -0.05) argued for a measured cut rather than a large one. The neutral rate estimate near 3.886 reinforced the judgment that policy at 6.0% was meaningfully restrictive with room to ease.

A genuine difference emerged between the framework's measured call and the participants' more aggressive predictive votes. The inflation-focused member, the financial-stability member, and the centrist each endorsed -25 basis points as the disciplined, defensible move: it acknowledged softening data, respected contained inflation, avoided the growth rules' overshoot, and -- as the financial-stability member stressed -- eased without signaling panic that could itself destabilize markets. The centrist observed that no financial rupture had appeared to justify a larger move, and that the positive 10-2 spread meant no deep-recession alarm was flashing. The employment-focused member and the market-focused member, by contrast, treated -25 basis points as directionally correct



but too timid. The former argued that rising claims and weak manufacturing warranted front-loading to protect jobs before deterioration deepened, while the latter maintained that the -0.86 bill spread aggregated a forward-looking market read that the backward-looking momentum coefficients understated. No participant argued for holding, and no inflation risk was raised that would justify restraint at only -25 basis points; the disagreement was one of magnitude and preemption, not direction.

### COMMITTEE POLICY ACTIONS

In the predictive round, all five members voted for a 50 basis point reduction in the target federal funds rate, a unanimous tally of {-50: 5}. On the separate question of whether to endorse the deterministic framework's -25 basis point recommendation, the Committee did not reach full agreement: three members -- the inflation-focused member, the financial-stability member, and the centrist -- endorsed the recommendation as-is, while two members -- the employment-focused member and the market-focused member -- registered partial agreement, supporting the direction of easing but judging the magnitude insufficient. No member declined the recommendation outright, yielding a final optimal-side tally of three endorse, zero decline, and two partial.