



DEVELOPMENTS IN FINANCIAL MARKETS AND OPEN MARKET OPERATIONS

No point-in-time-safe data on System Open Market Account holdings was available on or before the cutoff for this meeting. Accordingly, the desk was unable to report total SOMA size, its composition across security types, or any change relative to a prior release. This limitation applies to the SOMA securities portfolio specifically; it should be noted that this section covers SOMA holdings only and does not extend to repo or reverse-repo operation results, for which no point-in-time-safe data source currently exists. Members were advised to treat the open market operations record for this period as incomplete rather than as evidence of no activity.

STAFF REVIEW OF THE ECONOMIC SITUATION

The staff reported that economic activity remained slow or weak across most of the country. According to the Beige Book, activity was described as slow or weak in the Boston, Chicago, Philadelphia, Kansas City, and St. Louis Districts, mixed in Atlanta, Minneapolis, and Richmond, and showing further signs of rebounding in New York. Manufacturing was weak or down in most reports but showed signs of stabilizing or rebounding in several Districts. Retail sales picked up in late December and early January but were generally weak for the period overall, with aggressive promotions and unusually large discounting cited as having reduced profit margins. Auto sales slowed in December after very strong October and November results but remained relatively strong. Construction and real estate activity continued to soften in most Districts, with commercial real estate weakening and housing holding up overall apart from further weakness in higher-priced homes. Drilling activity contracted rapidly in response to lower energy prices, and the airline industry continued to suffer from weak demand and soaring security costs.

On the labor side, the staff noted that markets remained soft, with numerous reports of shrinking wage and benefit packages and, in the Cleveland District, employers invoking 'economic duress' clauses to renegotiate union contracts. The unemployment rate stood at 5.8 percent, above the estimated natural rate of 5.07 percent, and initial jobless claims were elevated at 405,000. The Chicago Fed National Activity Index registered -0.05, consistent with growth slightly below trend. On prices, core PCE inflation was running at 1.16 percent on a year-over-year basis, well below the 2 percent objective, and most Districts reported declining prices for goods and services. The notable exceptions were sharply rising prices for security, health care, and all types of insurance. Many Districts reported that contacts expected a recovery to begin by mid-year or earlier, though the timing and strength were uncertain, and several Districts said that uncertainty had led some businesses to budget conservatively for the first quarter.

STAFF REVIEW OF THE FINANCIAL SITUATION



The staff characterized financial conditions as generally orderly. The financial stress index stood at a low 0.168, and the VIX at 21.88 indicated moderate rather than elevated volatility. The Baa corporate spread was 2.87, elevated enough to reflect some borrowing-cost pressure but short of levels associated with acute credit distress; the Beige Book's report that financial institutions saw only a 'slight softening' of conditions in late November and December was broadly consistent with this reading. The Treasury yield curve was steeply positive, with the 10-year/2-year spread at 1.98, offering no signal of imminent recession. The 3-month T-bill was 7 basis points below the current 1.75 percent funds rate, a small front-end inversion suggesting markets anticipated steady rates with at most a marginal downward tilt rather than aggressive easing.

STAFF ECONOMIC OUTLOOK

The staff outlook drew on the forward-looking quantities available. The neutral real rate used in the policy engine was estimated at 3.708, a relatively high figure that, combined with the current unemployment gap, drove the Taylor rule to prescribe +75 basis points. The staff cautioned that this reading sat awkwardly against a backdrop of below-target inflation and widely reported price declines, and the alternative rules leaned the other way: the Balanced Approach rule and the ELB-adjusted rule each pointed to -50 basis points, while the First-Difference rule prescribed -75. Reference rules were judged reliable for this meeting, so the divergence across them was treated as a genuine spread of signals rather than noise.

Momentum terms shaped the projected path. Inflation momentum was essentially flat at 0.005, implying no near-term buildup of price pressure and little cost to easing on the inflation side. Unemployment momentum was positive at 0.25, indicating that labor-market slack was still building rather than resolving. Taken together, these quantities implied that conditions were more likely to soften modestly than to firm sharply in the near term, and that the current 1.75 percent stance was slightly tight relative to the balance of the rules. The deterministic loss-minimizing recommendation was a modest -25 basis points, a figure that eased toward the soft data and rising unemployment momentum without committing to the larger cuts implied by the more aggressive rules, and one broadly consistent with the small easing tilt visible in the front-end market pricing.

PARTICIPANTS' VIEWS ON CURRENT CONDITIONS AND THE ECONOMIC OUTLOOK

In their initial predictive assessments, all five participants converged on holding the funds rate at 1.75 percent, though they arrived there from distinct vantage points. The participant most focused on inflation observed that core PCE at 1.16 percent was well below target and that the Beige Book documented widespread price declines, shrinking wage and benefit packages, and 'economic duress' contract renegotiations, all of which confirmed that current inflation risk was muted rather than



elevated. For this participant the case against a hike was clear, but so too was a reluctance to ease: with policy already accommodative at 1.75 percent and many Districts expecting recovery by mid-year, cutting further into an anticipated rebound risked fueling inflation once demand recovered.

The participant weighting labor conditions most heavily emphasized real slack -- unemployment at 5.8 percent against a 5.07 percent natural rate, elevated claims at 405,000, and soft labor markets in the Beige Book -- and noted that below-target inflation left ample room to support employment. Even so, this participant judged that the distinction between a labor market that was weak but stabilizing and one that was actively deteriorating was decisive: with policy not currently restrictive and tentative rebound signs appearing, patience was preferable to spending limited policy space now, while retaining readiness to cut should claims resume climbing or the mid-year recovery fail to materialize. The participant attentive to financial stability pointed to the low stress index of 0.168, moderate VIX, and steeply positive yield curve as evidence of orderly, non-crisis conditions; while the Baa spread of 2.87 reflected genuine borrowing-cost stress, it was not accompanied by systemic dislocation, and a cut into calm markets risked signaling an alarm participants did not feel. The market-focused participant read the near-zero T-bill spread and steep curve as evidence that markets had already priced the trough at 1.75 percent, and the data-dependent participant summarized the balance as an economy that was weak but bottoming, where the data were internally consistent in giving room to ease but no urgency to do so.

When the discussion turned to the deterministic framework's recommendation of -25 basis points, participants engaged directly with the divergence between that figure and their predictive holds. Several took the gap as informative in itself: it suggested that the current 1.75 percent stance was slightly tight relative to conditions rather than badly misaligned. The inflation-focused participant acknowledged that with core PCE this far below target and inflation momentum flat at 0.005, the usual hawkish caution against easing simply did not bind, and that a measured quarter-point trim was defensible even by that participant's lights -- restrained enough to avoid the aggressive -50 to -75 cuts implied by the Balanced Approach, ELB-adjusted, and First-Difference rules, which were judged to overshoot given expected mid-year recovery.

The labor-focused participant found that the framework's -25 better matched the accommodation warranted by rising unemployment momentum of 0.25, conceding that the predictive hold had understated the labor risk, while agreeing that low financial stress and recovery signals made a larger cut premature. The financial-stability participant framed a modest cut as insurance -- large enough to cushion softening financial institutions and weakening commercial real estate before spreads widened further, small enough not to unsettle orderly markets -- and cited the small T-bill inversion as



reinforcing the case for capping the magnitude. Both the data-dependent and market-focused participants moved to endorse: the former reading the numbers literally as below-target inflation plus labor slack justifying a modest insurance cut, and the latter noting that the roughly quarter-move of easing implied by the -7 basis point T-bill spread aligned almost exactly with the framework's output, enough to acknowledge slack without fighting the priced-in recovery.

Across both the predictive and optimal-framework discussions, participants were broadly of the view that the Taylor rule's +75 prescription should be discounted, resting as it did on a high neutral rate estimate of 3.708 that appeared to overstate equilibrium given below-trend activity, a CFNAI of -0.05, and widespread disinflation. The dominant theme was that the risk facing the Committee was one of persistent softness rather than overheating, and that a small, measured easing step was the more prudent correction than either a hold or a lurch.

COMMITTEE POLICY ACTIONS

In the predictive vote on the appropriate policy action, all five participants supported holding the target funds rate at 1.75 percent, a unanimous outcome of 5 to 0. When the Committee subsequently considered the deterministic framework's recommendation of a 25 basis point reduction, all five members endorsed the recommendation as-is; there were no members declining and none supporting the direction while dissenting on magnitude or timing. The optimal-side tally was therefore 5 endorse, 0 decline, 0 partial, with the inflation-focused, labor-focused, financial-stability, data-dependent, and market-focused participants each endorsing the -25 basis point recommendation.