



Carson Francis
Financial Strategist

Caught Between Mandates: The Fed's 2026 Balancing Act

From middle to late 2024, the direction of future monetary policy has been fairly known, in the sense that the direction was towards lower, short-term policy rates. To kick off 2026, the Federal Open Market Committee (FOMC) decided to hold rates steady following three rate cuts in the latter half of 2025 at the September, October, and December meetings. For financial institutions, particularly those whose bottom-line performance is dictated by interest income and interest expense, the Federal Reserve's next move carries significant implications on the balance sheet, which will inevitably feed into earnings.

The Federal Reserve has an explicitly stated dual mandate: maximize employment and maintain steady price levels. Fulfilling this mandate is a lot easier said than done, as the two components of it are contradictory. Achieving strong employment typically requires economic growth, while keeping prices stable calls for restraint. Adding to the complexity, Jerome Powell's term as Fed Chair expires this year, as Kevin Warsh, the Trump Administration's nominee, is set to take his place.

Outside of competing objectives and new leadership, the central bank faces a variety of challenges in 2026. Labor market health sits at the top of the Fed's agenda but getting a clear read has become increasingly difficult. Technological shifts, particularly in artificial intelligence, along with tariff effects have muddied the picture in what's already a stagnant environment often described as "low hiring, low firing." Look only at hiring and you might conclude that a recession is inevitable or that one has already arrived. The economy added just 584,000 jobs last year, as well as a slight uptick in the unemployment rate, marking the weakest year for job creation outside the COVID-19 pandemic era since 2009. Still, the broader economy proved resilient. According to the December 2025 Summary of Economic Projections (SEP), real GDP growth for 2025 was expected to be 1.7% for the year, barely missing the 1.8% long-run trend by a single tenth of a percent.

Business uncertainty was a key driver of the "low-hire, low-fire" economy in 2025 and is expected to continue into 2026. The primary source of this uncertainty is shifting trade policy, particularly the Trump Administration's reciprocal tariffs designed to level the playing field in international markets. The tariffs have not gone unchallenged. In a 7-4 decision, the Federal Circuit ruled that the president exceeded his authority under the International Emergency Economic Powers Act of 1977. The administration appealed to the Supreme Court, which agreed to take up the case. A ruling on the constitutionality of current trade policy is pending, and the outcome, whatever it may be, will carry significant implications for the labor market.

Just as GDP showed resilience, inflation proved stubborn. Price pressures remained sticky throughout 2025, and while estimates for 2026 suggest some easing, inflation is expected to stay elevated. As of the December 2025 Summary of Economic Projections, PCE inflation was projected at 2.4% for 2026, suggesting that further progress toward the 2.0% long-run target is still needed should those projections hold. Much of the path forward depends on shelter costs, which comprise roughly one-third of CPI and have yet to fully reflect softening rental markets.

Since 2020, the Case-Shiller U.S. National Home Price Index has climbed more than 50%, driven by a structural housing supply shortage and a surge in credit availability that magnified demand for existing units. This appreciation has exerted considerable upward pressure on both the Consumer Price Index and the Federal Reserve's preferred inflation gauge, Personal Consumption Expenditures (PCE). Looking ahead into 2026 and beyond, forecasters anticipate some equanimity in housing cost growth, offering potential relief to inflation readings. Should employment uncertainty and decelerating wage growth translate into reduced consumer spending, the resulting pullback in housing demand could offer further relief on the inflation front, though at the cost of weaker economic output.

(Continued)

The Federal Reserve faces a familiar tension. On one side, PCE inflation is projected to remain above the 2.0% long-run target. On the other, the labor market is showing signs of strain, as business uncertainty and rapid technological change continue to complicate the path forward for employment. With Powell's term expiring, a new Fed Chair incoming, and a trade decision looming, the central bank faces not only economic uncertainty but institutional transition as well. Caught between mandates, the Fed's balancing act is far from over.

This uncertainty puts a lot of pressure on financial institutions, particularly community financial institutions, where the bulk of the bottom line consists of money earned via net interest income. When the Federal Reserve's path is unclear, the range of possible outcomes widens, and that range of uncertainty is the definition of interest rate risk. Consider the scenarios: If inflation remains sticky and rates stay elevated longer than expected, funding costs could continue to compress margins. If labor market deterioration accelerates and the Fed responds with cuts, institutions need to understand how quickly their balance sheet is repriced, particularly on the asset side. A Supreme Court ruling on tariffs or a change in direction from the Federal Reserve under new leadership could reshape interest rate expectations overnight. In an environment with many potential catalysts, having clear visibility into your balance sheet's rate sensitivity isn't just a defensive measure, it's a competitive advantage. In an environment where multiple rate scenarios remain in play, proactive interest rate risk management will allow institutions to act decisively when the path forward becomes clearer.

The Baker Group is one of the nation's largest independently owned securities firms specializing in investment portfolio management for community financial institutions.

Since 1979, we've helped our clients improve decision-making, manage interest rate risk, and maximize investment portfolio performance. Our proven approach of total resource integration utilizes software and products developed by Baker's Software Solutions combined with the firm's investment experience and advice. For more information, contact **Carson Francis at The Baker Group: 800.937.2257.***

**The Baker Group LP is the sole authorized distributor for the products and services developed and provided by The Baker Group Software Solutions, Inc.*

Carson Francis
Financial Strategist
The Baker Group LP

INTENDED FOR USE BY INSTITUTIONAL INVESTORS ONLY. Any data provided herein is for informational purposes only and is intended solely for the private use of the reader. Although information contained herein is believed to be from reliable sources, The Baker Group LP does not guarantee its completeness or accuracy. Opinions constitute our judgment and are subject to change without notice. The instruments and strategies discussed here may fluctuate in price or value and may not be suitable for all investors; any doubt should be discussed with a Baker representative. Past performance is not indicative of future results. Changes in rates may have an adverse effect on the value of investments. This material is not intended as an offer or solicitation for the purchase or sale of any financial instruments.