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Weekly Commentary

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Paige Wilhelm

Senior Vice President

Senior Portfolio Manager

Federated Investment Counseling

Might the Fed follow inflation's holding pattern?

We likely will have to wait for future historians to uncover exactly what was behind the Federal Reserve's mid-September rate cut. Chair Powell cited the weakening labor market; others point to political pressure. While recent measures of employment certainly have softened, was it weak enough to merit a move considering inflation has not retreated completely? Congress tasks the Fed with supporting both full employment and price stability, but the latter remains higher than its target of 2%. In fact, the Personal Consumption Expenditures Index (PCE), hardly budged last month. Year-over-year, it grew 2.7% in August, compared to 2.6% in July. Core PCE, which strips out volatile elements like food and gasoline, stayed at an elevated 2.9%. Of particular concern is that goods prices pulled back slightly. But that side of the inflation equation is likely to heat up if, as expected, businesses pass tariff-related costs onto consumers in the coming months. That could leave policymakers in a world of hurt.

Indeed, what if the labor market improves before the Fed's October FOMC meeting? That's a distinct possibility, as fewer people applied for unemployment pay in the week ended September 19, with jobless claims falling to 218,000. Combined with a significant upward revision of second quarter gross domestic product from 3.3% to 3.8%, the Fed might want to hold rates steady. That would fly in the face of market expectations that the reduction of the federal funds target range it issued in mid-September heralded the start of another string of rate cuts. This week's nonfarm payrolls report will be as critical as it gets.

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