Macro Vision

December 23, 2025

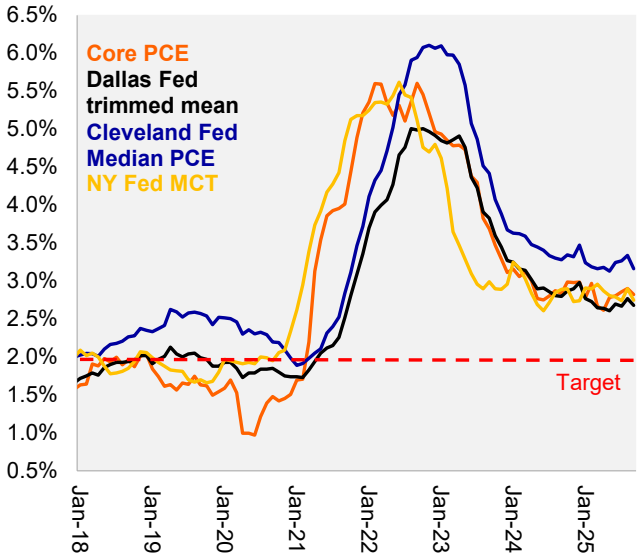
The risk of an irresponsible Fed Chair

- We estimate the Fed's implicit pursued inflation target under its own Taylor Rules specifications. We find that the current FOMC led by Jerome Powell pursued an implicit inflation target around 2% until now, but by cutting rates closer to neutral of 3.0% it will likely allow inflation to be higher, if the economic outlook evolves as we expect.
- As Powell's term as Fed Chair ends by May 2026, we simulate the impact of a potentially irresponsible new Fed Chair pushing rates below neutral levels. For example, if rates go to 2.50%, this would mean that the perceived inflation target could be as high as 4% to 5%, renewing risks of unanchoring inflation expectations.
- Although markets seem to not price much of this risk for now, such a behavioral shift could cause relevant additional pressure on long-term yields through higher term premia and also be a downside pressure for the Dollar.

With Jerome Powell's term as Fed Chair ending in May 2026, we discuss the risks associated with the arrival of a possible irresponsible new Chair, defined as one that brings the policy rate below the neutral rate of 3.0%, without support from macroeconomic fundamentals. Our exercise consists of inverting the Taylor Rule and solving it for the implied inflation target, considering the observed policy rate and our forecasts for inflation and unemployment as given.

For the simulation, we consider our baseline scenario of persistent underlying inflation and resilient activity. We expect that underlying inflation (Core PCE metric) will remain persistent around 2.5-3.0% as has been the case for the past 2 years (see chart). At the same time, economic growth is likely to remain resilient, which leads the labor market to stabilize. Growth is being backed by continued positive fundamentals from an expansionary fiscal policy, loose financial conditions and some boost in investment and productivity from AI. While policy shifts could eventually affect these dynamics, given monetary lags, we treat these assumptions as exogenous to the analysis.

PCE Underlying Inflation 12m



Sources: Haver, Itaú BBA

As a first step, we estimate the Taylor Rule specifications that the Fed cites in its semiannual Monetary Policy Report[1].

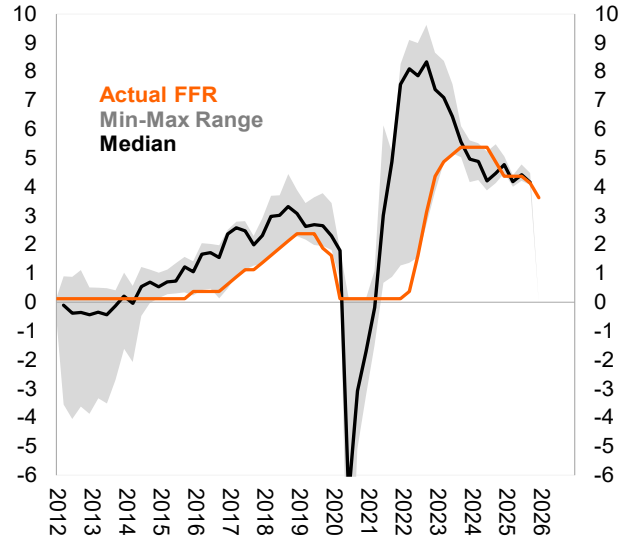
Monetary policy rules

Taylor (1993) rule	$R_t^{T93} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t^{LR}) + (u_t^{LR} - u_t)$
Balanced approach rule	$R_t^{BA} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t^{LR}) + 2(u_t^{LR} - u_t)$
Balanced approach (shortfalls) rule	$R_t^{BAS} = r_t^{LR} + \pi_t + 0.5(\pi_t - \pi_t^{LR}) + 2\,min\,\{(u_t^{LR} - u_t), 0\}$
Adjusted Taylor (1993) rule	$R_t^{T93adj} = max\{R_t^{T93} - Z_t, ELB\}$
First-difference rule	$R_t^{FD} = R_{t-1} + 0.5(\pi_t - \pi_t^{LR}) + (u_t^{LR} - u_t) - (u_{t-4}^{LR} - u_{t-4})$

Based on realized and forecasted data (and the FOMC estimate of the neutral rate, currently at 3.0%), the Taylor Rules suggest the policy rate should remain around 4.0% through the end of 2026, leaving limited room for rate cuts. In other words, the FOMC decision to cut to 3.50-3.75% at this December meeting already brought the fed funds rate below rule-based estimates.

[1] Federal Reserve Board. (2025, June 20). Monetary Policy Report.

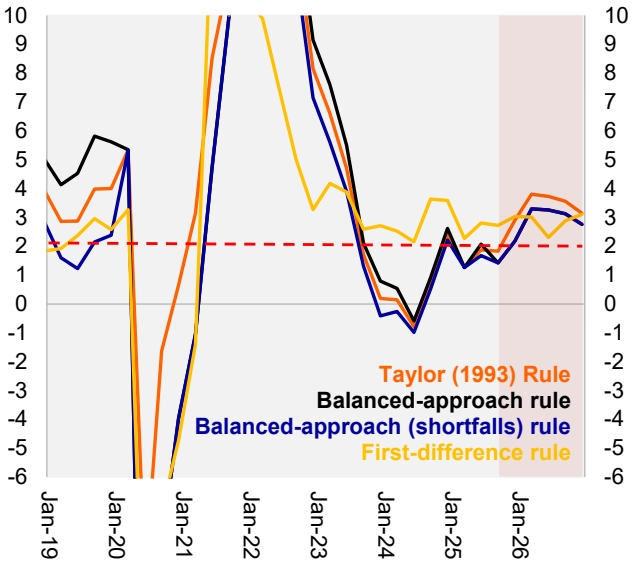
Fed Monetary Policy Rules



Source: Itaú BBA

A second step is to invert the Taylor Rules, solving them for the implied inflation target, based on the realized policy rate and the estimated coefficients. This exercise shows that Powell followed an implicit inflation target of around 2% until recently (see the chart below). Using our forecasts for inflation and the unemployment rate, and assuming the FOMC follows its Dots projection with one additional rate cut next year, the implied inflation target rises to a range around 3.0% next year. This suggests that the Fed will adopt a more dovish stance than rule-based guidance would prescribe by following this policy path, if our scenario proves right, even though the policy rate would remain above the 3.0% neutral level. In other words, according to the traditional Taylor rule specification, pursuing a 2.0% inflation target would not leave much room for easing.

Implicit Inflation target derived from Taylor Rules

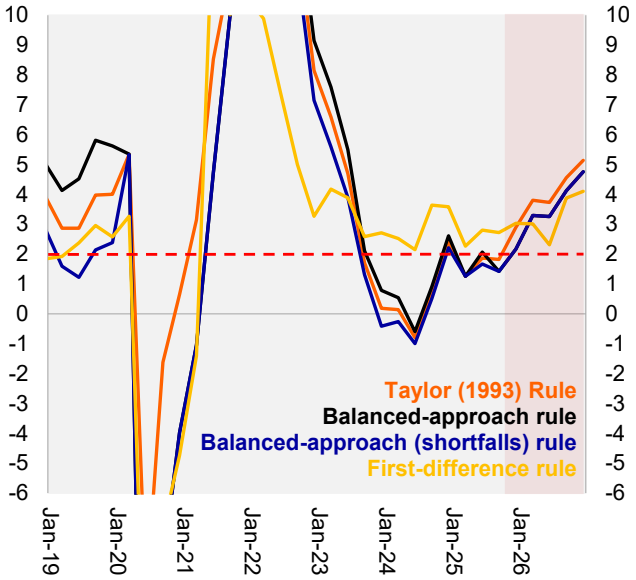


Source: Itaú BBA

A final step is to assume an irresponsible new Fed Chair that cuts the policy rate below neutral to a terminal rate of 2.5% next year, for example, out of synch with the fundamentals.

Under this policy path, the implied inflation target increases to 4.0-5.0%, well above the explicit Fed inflation target of 2.0%. This outcome underscores that a Fed Chair focused solely on reducing rates below neutral would risk triggering a renewed and problematic acceleration in inflation.

Implicit Inflation target derived from Taylor Rules



Source: Itaú BBA

In the matrix below, we consider different scenarios for inflation and the terminal policy rate that result in implied inflation target outputs using the framework described above. The bottom line is that, given a persistent underlying inflation outlook in which Core PCE stays around 2.5-3.0%, the Fed would be pursuing a much higher implied inflation target if it cuts rates further below 3.0%. Core inflation needs to be at the 2% target for the Fed to be able to cut below neutral levels without risking inflation reacceleration.

FFR	Expected Core PCE						
	1.8	2.0	2.3	2.5	2.8	3.0	3.3
1.50	3.9	4.5	5.1	5.8	6.4	7.0	7.6
2.00	2.9	3.5	4.1	4.8	5.4	6.0	6.6
2.50	1.9	2.5	3.1	3.8	4.4	5.0	5.6
2.75	1.4	2.0	2.6	3.3	3.9	4.5	5.1
3.00	0.9	1.5	2.1	2.8	3.4	4.0	4.6
3.25	0.4	1.0	1.6	2.3	2.9	3.5	4.1
3.50	-0.1	0.5	1.1	1.8	2.4	3.0	3.6
3.75	-0.6	0.0	0.6	1.3	1.9	2.5	3.1

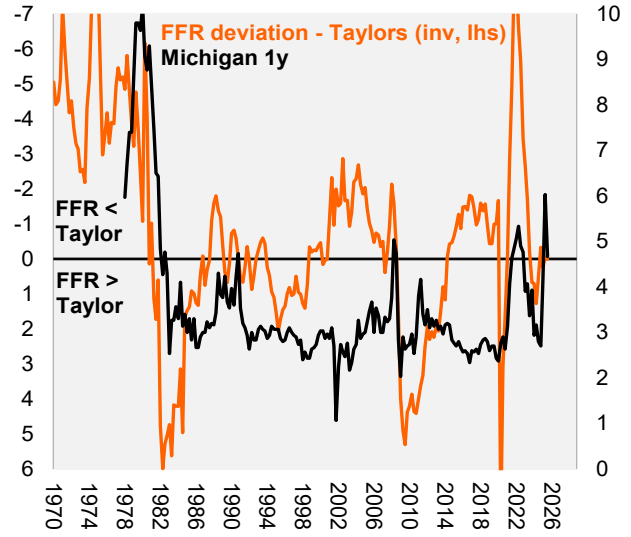
*Avg of Taylor (1993), Inertial (1993), Balanced-approach (shortfalls) and First-difference rules

The major channel through which a higher inflation regime could emerge is the unanchoring of inflation expectations. The chart below shows that the dovish monetary policy stance adopted in the 1970s by Arthur Burns led to a major unanchoring of expectations, ultimately fueling the inflationary cycle in the 1970s and 1980s.

After Paul Volker subsequent sharp policy tightening to above Taylor rules estimates, inflation was controlled and expectations re-anchored, a stability that persisted until the pre-Covid period.

In the current cycle, inflation has remained for five years above target, partly driven by an overly loose policy stance following the Covid shock. This has elevated inflation expectations and revived the tail risk of them becoming unanchored once again. The fear would be a repetition of the policy mistakes from the 1970s.

FFR deviation - Taylor Rule and Inflation Expectations

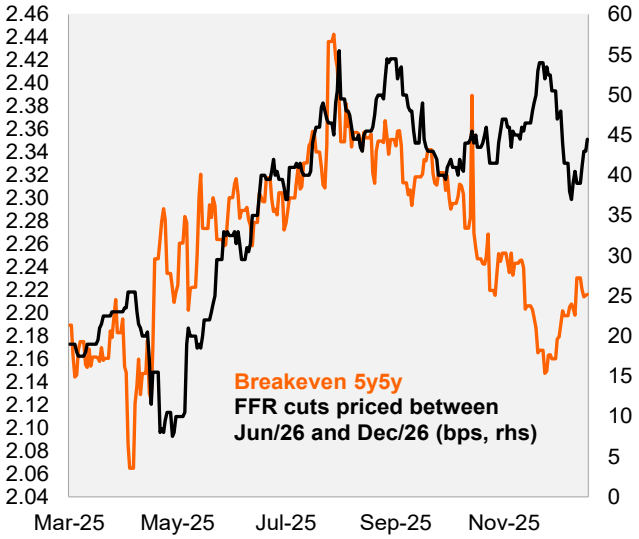


Source: BBG and Itaú BBA

In this context, several factors could either exacerbate or mitigate the risk of unanchored inflation expectations. Additional fiscal stimulus ahead of midterm elections, reaccelerating inflation and higher neutral rates could contribute to a sharper inflation unanchoring of expectations and higher term premia, particularly if perceived as signs of policy mismanagement. Institutional risks, such as perceived weakening of Fed independence, also warrant close attention. On the other hand, a weaker growth outlook, a benign disinflation process, lower commodity prices or stronger internal opposition within members of the FOMC to an overly accommodative policy could help mitigate these risks.

For now, markets appear to assign limited probability to an irresponsible Fed scenario. The pricing of Fed Funds rate cuts in the second half of next year has ranged from 1 to 2 cuts, while breakeven inflation indicators have been stable and even declined more recently.

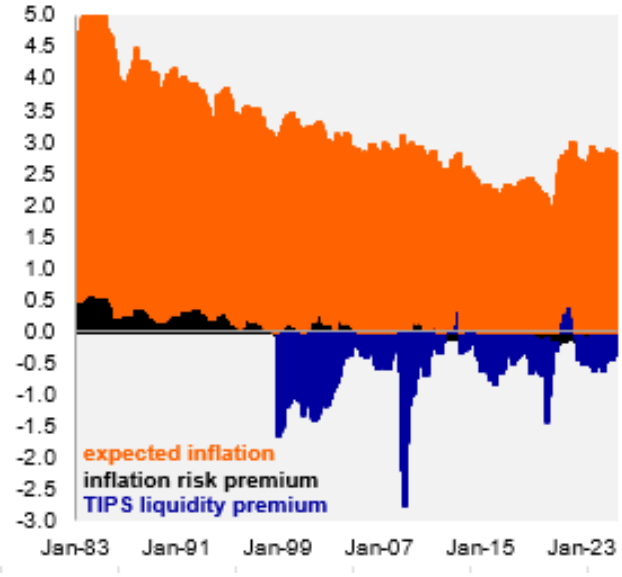
Fed cuts pricing in 2H26 and Breakeven inflation



Source: BBG and Itaú BBA

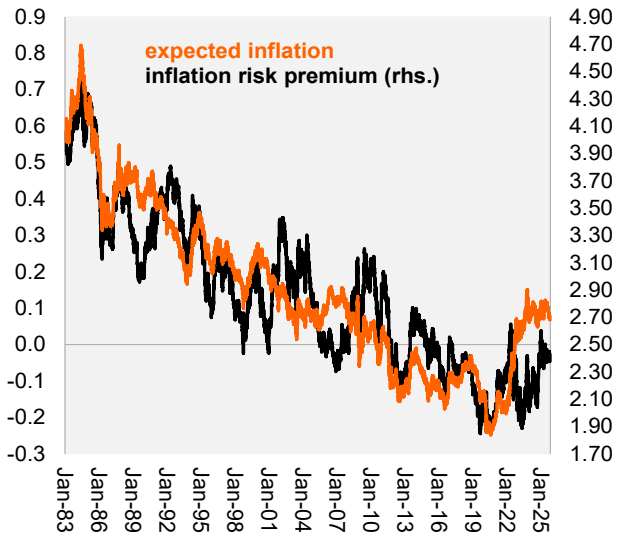
This dynamic is also evident in the DKW model decomposition[2] of TIPS yields, that shows that breakeven inflation has not increased much due to a still low inflation risk premium and a negative liquidity premium. Meanwhile, pure inflation expectations have edged higher, indicating that market participants perceive some risk of inflation persistence, though not yet a broad-based repricing of inflation risk.

DKW Decomposition of 10y Inflation Breakeven



Source: D'Amico et al. and Itaú BBA

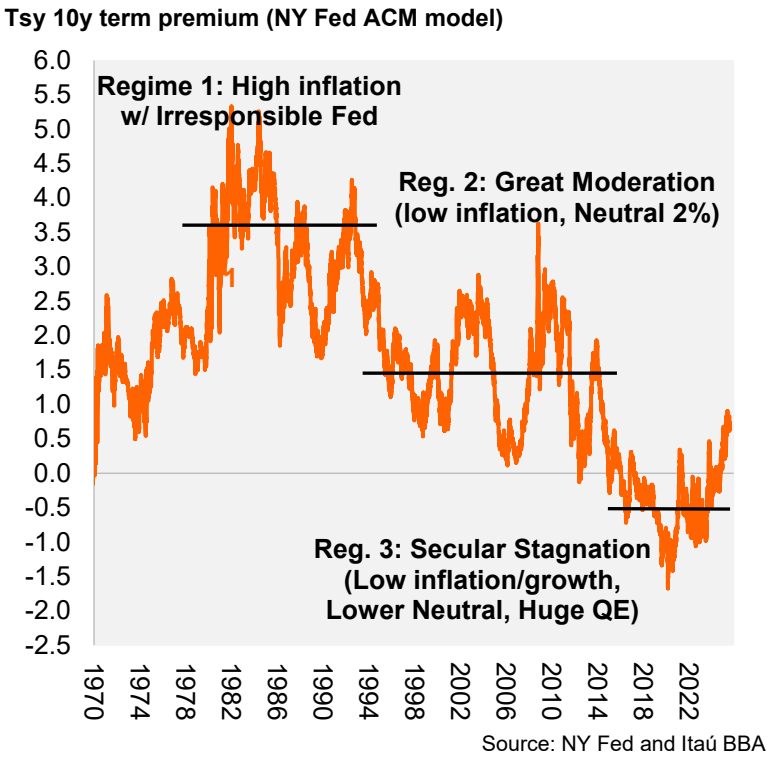
DKW Decomposition of 10y Inflation Breakeven



Source: D'Amico et al. and Itaú BBA

If the chance of an irresponsible Fed really increases, markets would likely demand higher risk premium, pressuring long term yields. During the high inflation and perceived policy leniency era, term premia were at a much higher level and only declined with the onset of the Great Moderation in late-1990s. If we decompose long-term yields, as the table below shows, a more lenient Fed that targets inflation at 2.5% or higher, with real rates around 1.5% and positive term premiums could drive long-term yields to 4.5-5.0% or potentially above.

[2] Federal Reserve Board. (2019, May 21). TIPS from TIPS: Update and discussions. FEDS Notes.



Source: NY Fed and Itaú BBA

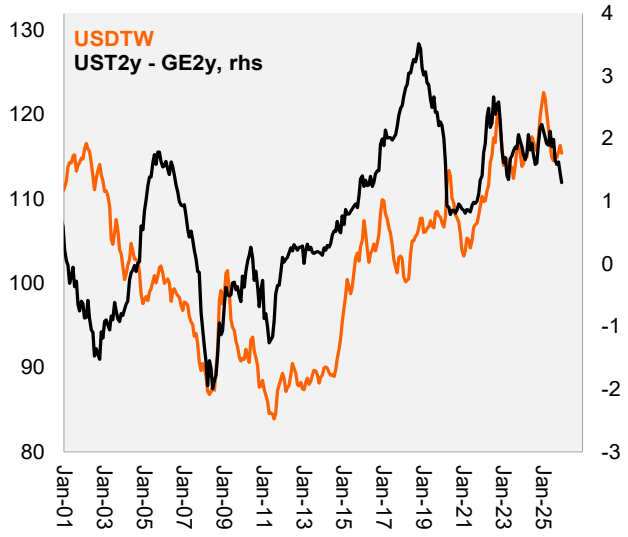
US 10y yield decomposition				
	Irresponsible Fed 70/80s	Great Moderation	Secular Stagnation	Today
Total	**10.50%**	**5.00%**	**2.00%**	**4.20%**
Real FFR	2.00%	1.50%	0.50%	1.50%
Avg Inflation	5.00%	2.00%	2.00%	2.20%
Term Premium	3.50%	1.50%	-0.50%	0.50%

Source: Itaú BBA

Finally, we believe that this discussion would also weigh on the dollar. Based on the framework described in our previous Macro Vision report[3], the Dollar could depreciate an additional 4-5% in the case of a more lenient Fed that pushes rates below neutral. This would be driven not only by narrower interest rate differentials (as the chart below shows), but also by a deterioration in perception of US institutional credibility from policy mismanagement.

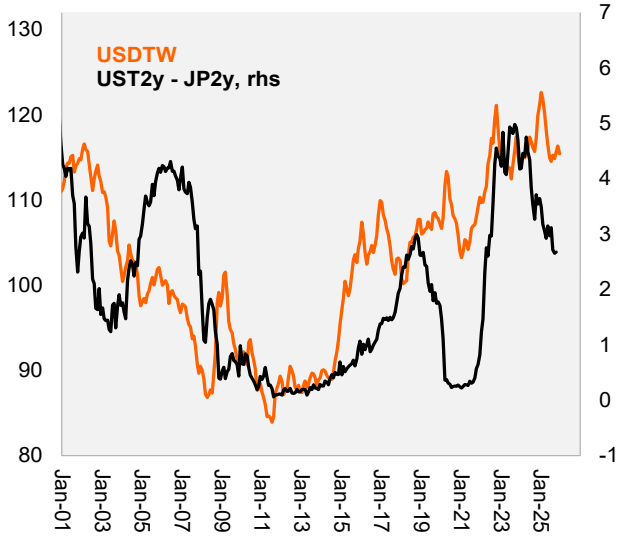
[3] Itaú BBA. (2024, June 4). Macro Vision: Strong Dollar scenario likely to persist and could intensify.

USD vs Rates Differential (US - GE)



Sources: BBG, Itaú

USD vs Rates Differential (US - JP)



Sources: BBG, Itaú

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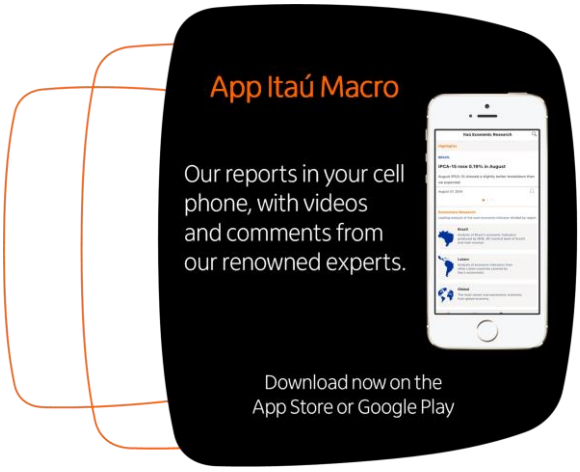

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