Economic Update

SECOND QUARTER 2025
JULY 3, 2025

Quarterly Key Points

- 1Q GDP growth measured -0.5% q/q annualized on a surge in imports ahead of Liberation Day. 2Q GDP growth forecasts vary widely among the estimates we track, ranging from 2.0% to 3.5% q/q annualized.
- Despite all the disruption in equity markets, rates remained remarkably stable during the quarter. The 2-year Treasury decreased 17 bps and the 10-year Treasury increased 2 bps, resulting in a slightly steeper curve. Longer-term real rates and break-even inflation were also remarkably well-behaved.
- The Fed has held rates steady at every policy meeting so far in 2025 and is reluctant to start cutting rates too soon with tariff-driven inflation potentially on the horizon. While monetary policy is at a standstill, Congress has been busy working on the One Big Beautiful Bill Act.
- Inflation progress has resumed, with most measures of inflation showing improvement. Tariff driven inflation does not yet appear in the data. However, it is possible that tariffs may have a delayed impact. Currently, inflation is squarely in the Fed's target range. Short-term inflation expectations retreated to 2.45% at the end of the quarter while long-term inflation expectations have also come back down to ~2.30% recently.
- The labor market steadily improved over the slower start to the year while the impact of government trade policy was front and center within consumer spending and retail sales over the second quarter. Manufacturing and business orders are in contractionary territory once again after a brief rebound in the first quarter. Although it has been trending downward since the fourth quarter of 2024, the ISM Services PMI remains steady.

Our View

- The President's policy changes have been wide reaching, and time is needed still to judge the impact. For now, a heightened level of uncertainty exists. The One Big Beautiful Bill Act and the embedded debt ceiling adjustments overshadow continued focus on the U.S. Government's debt and spending. Immigration and geopolitical tension in the Middle East are additional sources of volatility.
- Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value when yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

2Q2025 – THE VOLATILITY OF VOLATILITY

Nothing stays constant, not even volatility. The second quarter of 2025 began with market volatility in response to the Liberation Day announcement from the White House on April 4. Volatility indices of every flavor spiked from already elevated levels, and equity markets responded by selling off 10%-12% over the following days. By April 8, the S&P 500 was down ~18% from its high point in February. It is no surprise that the President pumped the breaks on the tariff implementation, announcing a 90-day pause on the morning of April 9. The pause calmed the market, which drove the S&P 500 to a new all-time high on June 30. However, the end of the tariff pause is fast approaching on July 9, and another round of volatility might be lurking just around the corner. Additionally, the reconciliation bill, debt ceiling, geopolitical turmoil, immigration reform, and debates around the independence of the Federal Reserve (Fed) are among the plentiful factors that threaten to bring additional volatility.

Despite all the disruption in equity markets, rates markets remained remarkably stable. The 2-year Treasury rallied to a low of 3.61% by the end of April, only 28 basis points (bps) lower than at the end of March. The 10-year Treasury barely moved, rallying only 5 bps. By the end of the second quarter, the 2-year Treasury was back up to 3.72%, a net 17 bps lower on the quarter. The 10-year Treasury ended up 2 bps higher for the quarter at 4.23%, virtually unchanged. Additionally, the 2s vs 10s curve, which has historically been referenced as a recession indicator when negative, is hardly signaling a recession at positive ~50 bps (Figure 1). Longer-term real rates and break-even inflation were also remarkably well-behaved.

FIGURE 1: U.S. TREASURY CURVE STEEPNESS

Source: Bloomberg

As the dust finally settled, the market saw the President's willingness to negotiate. The deadline for the 90-day pause on reciprocal tariffs is near, but there may be continued extensions or additional concessions to be made. Despite only a few trade deals in place, markets do not seem to expect a significant impact from the pause expiring, risking additional volatility from an unexpected outcome. The White House is likely keen to avoid repeating the initial reaction. However, the knock-on effects from trade policy in consumer spending and inflation could delay the Fed from rate cuts in the second half of the year. The Fed remains patient and focused on inflation and the potentially delayed impact of fiscal policy changes on economic stability.

2Q'25 ECONOMIC UPDATE

1Q GDP growth measured -0.5% q/q annualized on a massive 38% surge in imports ahead of Liberation Day. The surge in imports caused net exports (exports minus imports) to be a large drag on measured GDP; however, this is heavily distorted and likely to reverse in the next quarter. Gross private investment increased by a whopping 23.8% q/q annualized driven by a 23.7% increase in fixed investment in equipment. However, personal consumption slipped to only 0.5% q/q annualized.

Growth forecasts for the second quarter vary widely among the estimates we track, ranging from 2.0% to 3.5% q/q annualized, as the distortion in net exports in the first quarter unwinds. Furthermore, economic policy uncertainty has retreated after reaching record levels in April. It is too soon to tease out the ultimate impact that trade policy will have on the economy and the heightened level of uncertainty continues to muddy the near-term outlook. The median recession probability forecast on Bloomberg remains at 37.5%, relatively low. However, we believe the downside tails are likely fatter than the recent past.

THE FED REMAINS MEASURED; GOVERNMENT SPENDING IN FOCUS

After delivering 100 bps of interest rate cuts last fall, the Fed has held rates steady at every policy meeting so far in 2025. The message from the Fed's May and June meetings was one of patience in the face of uncertainty. The post-meeting press conferences with Fed Chair Powell are more informative than the official FOMC policy statements, which showed little change. At both meetings in the second quarter, Powell stressed that the economy remains on solid footing. Unemployment remains low and has been stable while job growth has slowed but remains healthy. Inflation has come down considerably but stubbornly remains above the Fed's 2.0% policy objective. The Fed is reluctant to start cutting rates too soon with tariff-driven inflation potentially on the horizon. Chair Powell has stated that the central bank is inclined to look through to long-term inflation expectations that remain very stable. Among potential paths, tariff related inflation could be a one-time adjustment, after which the long-term trend in inflation rates will resume. For now, the Fed can afford to be patient because the economy is still performing reasonably well.

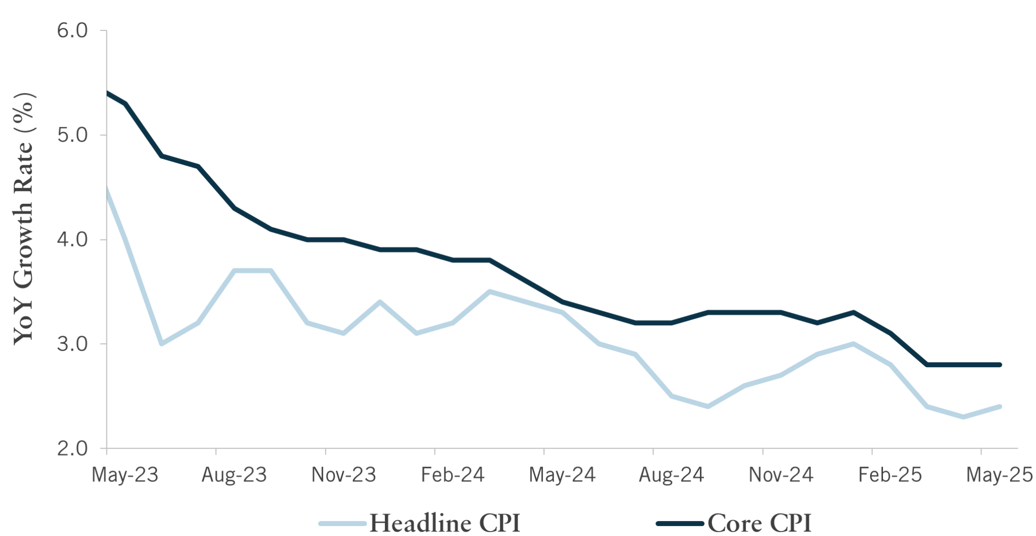
While monetary policy is at a standstill, Congress has been busy working on the One Big Beautiful Bill Act that extends and expands the 2017 Tax Cuts and Jobs Act (TCJA), increases the statutory debt limit (debt ceiling), repeals several clean energy and environmental initiatives, increases defense spending, and cuts spending from various other programs. Overall, the bill will lead to a $2.4 trillion primary deficit despite cutting $1.3 trillion in spending. The TCJA alone is projected to decrease tax revenue by $4.5 trillion over the next decade. However, revenue from new tariffs could offset a considerable portion of that.

In May, the U.S. Government was downgraded by Moody's from Aaa to Aa1 citing levels of outstanding debt. Notably, the One Big Beautiful Bill Act will increase the debt ceiling by another $4 trillion, once again extending the timeline for Congress to address the level of outstanding U.S. Government debt. Moody's is the third rating agency to downgrade the U.S. from the highest notch, following S&P in 2011 and Fitch in 2023. The market took the downgrade in stride, with no significant impact.

INFLATION TRENDING LOWER

Inflation progress has resumed, with most measures of inflation showing improvement. Headline CPI increased by only 2.3% y/y in April and 2.4% y/y May while core CPI increased by only 2.8% y/y in both months (Figure 2).

FIGURE 2: HEADLINE CPI VS. CORE CPI



Source: Bloomberg

As previously highlighted, we believe month-over-month numbers and rolling 3-month numbers provide a stronger signal of trajectory than year-over-year measurements. With that in mind, headline CPI declined -0.1% m/m in March, and rose just 0.2% and 0.1% m/m in April and May, respectively. Core CPI was also muted, increasing by only 0.1%, 0.2%, and 0.1% m/m in March, April, and May, respectively. On a rolling 3-month average basis, both headline CPI and core CPI have increased by only 0.1%-0.2% recently, implying an annualized run rate of ~1.5% to 2.5%. Tariff driven inflation does not yet appear in the data. However, it is possible that tariffs may have a delayed impact. Currently, inflation is squarely in the Fed's target range.

PCE inflation shows a similar pattern. Headline PCE fell to 2.2% y/y and 2.3% in April and May, respectively while core PCE measured only 2.6% y/y in April and 2.7% in May. Measured month-over-month, both headline PCE and core PCE have averaged 0.1% over the three-month period ending in May. Headline PPI fell by -0.2% in April before increasing by only 0.1% in May. Core PPI did the exact same thing. On a rolling three-month basis, headline PPI has been negative at -0.1% while core PPI has been only 0.1%. On a year-over-year basis, core PPI registered 3.0% in May while headline PPI is down to 2.6%.

Short-term inflation expectations, represented by the 2-year breakeven inflation rate, retreated to 2.45% at the end of the quarter after catapulting to almost 3.50% following Liberation Day. Meanwhile, long-term inflation expectations have also come back down with 5-year breakeven and 10-year breakeven rates registering ~2.30% recently. Importantly, the 5-year, 5-year forward breakeven rate remains well anchored at ~2.30%.

LABOR MARKETS & THE CONSUMER HOLD GROUND WHILE BUSINESSES ADJUST TO TRADE POLICY

The labor market steadily improved over the slower start to the year with an uptick in job creation. June non-farm payrolls added 147k jobs following 158k and 144k in April and May. The monthly average so far this year has been ~130k per month whereas the monthly average in 2024 was 195k per month and the monthly average in 2023 was 255k per month. The unemployment rate remains rangebound between 4.0% to 4.2%.

Personal income growth has been trending higher since the beginning of the year, only recently turning lower in May, measuring 0.7% m/m and 5.3% y/y in April and -0.4% m/m and 4.5% y/y in May. The personal savings rate, measured as a percentage of disposable income, has increased nicely since bottoming out at 3.5% at the end of last year. April measured 4.9% while May measured 4.5%. Consumer revolving credit has also decreased, consistent with increased uncertainty, waning consumer confidence, slowing job growth, the expectation of increased unemployment, and elevated inflation expectations.

The impact of government trade policy was front and center within consumer spending and retail sales over the second quarter. Adjusted retail sales growth has followed a pattern consistent with tariff front running. March increased by a whopping 1.5% m/m before contracting by -0.1% m/m in April and -0.9% m/m in May. Retail sales ex-autos followed a similar trend, rising by 0.6% m/m in March before registering 0.0% m/m and -0.3% m/m in April and May, respectively. Measured year-over-year, nominal personal consumption growth consistently has been 5.3%-5.5% while core personal consumption growth has been between 2.8%-3.2%. More recently, nominal personal consumption growth slipped to 4.5% y/y whereas core personal consumption growth fell to only 2.2% y/y marking the lowest readings in over a year.

Manufacturing and business orders are in contractionary territory once again after a brief rebound in the first quarter. March ISM Manufacturing PMI measured 49 followed by 48.7, 48.5, and 49.0 in April, May, and June, respectively. Business new orders followed a similar pattern, measuring 55.1 in January before turning contractionary every month since. April measured 47.2 while May and June registered 47.6 and 46.4, respectively. Although it has been trending downward since the fourth quarter of 2024, the ISM Services PMI remains steady. After the index fell to 50.8 in March, services measured 51.6, 49.9, and 50.8 in April, May, and June. Industrial production has been between 102 and 104 since early 2022, most recently registering 103.6 in May. Since reaching a post-covid peak of 81% in 2022, capacity utilization has remained near its low point of 76.8% in November, most recently measuring 77.4% in May.

30-year fixed mortgage rates, as measured by Freddie Mac, continued to hover around 6.8% to 6.9% during the quarter. Existing home sales measured 4.0 million units in May, consistent with the range in recent history. New home sales have bounced around 600-700 thousand units annualized over the same time, most recently measuring 623,000 in May. Existing home supply has slowly drifted upwards, now measuring ~4.5 months. The supply of new homes remains elevated at ~10 months of supply, well above pre-pandemic levels. Home price appreciation has finally stalled out, with the S&P Case Shiller home price index posting month-over-month depreciation for the past two months. The 20-city composite registered seasonally adjusted decreases of -0.2% m/m and -0.3% m/m in March and April resulting in the year-over-year basis slipping to 3.4% y/y in April.

LOOKING AHEAD

The President's policy changes have been wide reaching, and time is needed still to judge the impact. For now, a heightened level of uncertainty exists. Liberation Day removed any doubts about the President's intention to reshape global trade. The One Big Beautiful Bill Act and the embedded debt ceiling adjustments overshadow continued focus on the U.S. Government's debt and spending. Immigration and geopolitical tensions in the Middle East are additional sources of volatility. Meanwhile, monetary policy is biased to ease later this year as the broader economy sends slowing signals.

Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value when yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.