

## Economic Summary – Q2 2025

The second quarter began amid widespread fears that the so-called “Liberation Day” tariffs would trigger inflation, push the U.S. economy into recession, stall equity markets, and prompt the Federal Reserve to cut interest rates sooner and more aggressively. *Surprisingly, none of this happened.* Instead, most inflation measures actually fell, the economy expanded, and major stock indexes rebounded to new highs.

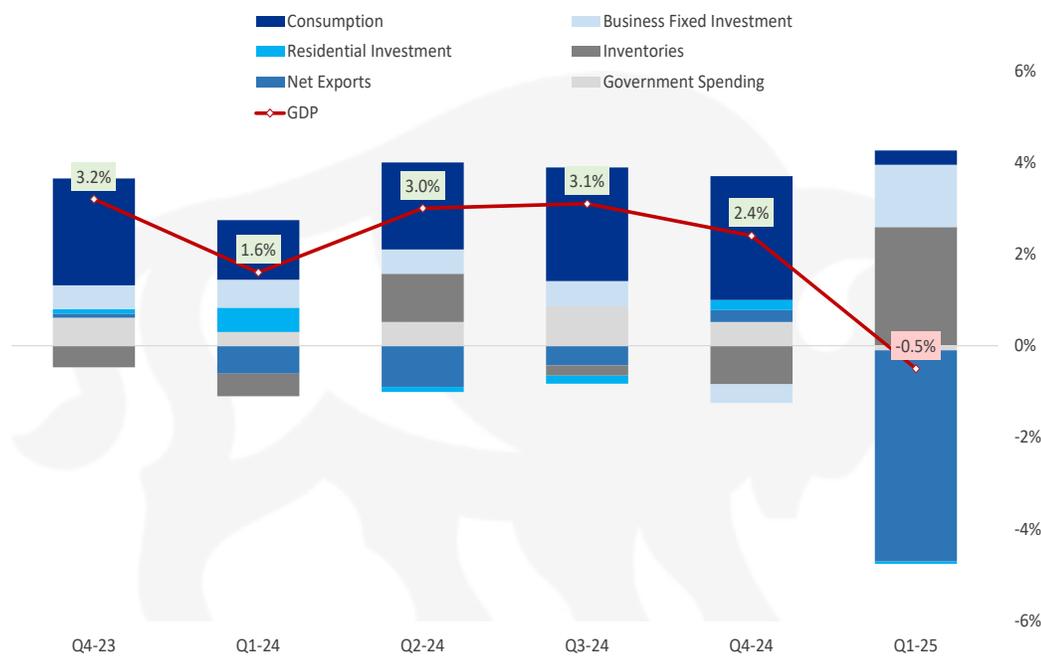
This unexpectedly positive outcome was largely due to a shift in trade policy early in the quarter. Most of the reciprocal tariffs announced on April 2 were postponed until July 9. The notable exception was China, where tariffs on nonexempt Chinese imports were raised to 145%, prompting China to retaliate with a 125% tariff on U.S. goods. This escalation effectively halted most bilateral trade. However, a temporary 90-day agreement followed, reducing U.S. tariffs on Chinese goods to 30% and Chinese tariffs on U.S. goods to 10%, a significant de-escalation, and a sigh of relief.

These adjustments, along with exemptions for essential goods like pharmaceuticals and semiconductors, combined to relax self-imposed restraints on the domestic economy. Still, American businesses faced an average tariff rate of 15.8% in May, the highest in nearly a century (Yale Budget Lab). Many firms accelerated purchases ahead of tariff deadlines, boosting inventories, but uncertainty surrounding trade policy has delayed investment and hiring decisions, which will impact future months.

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### Gross Domestic Product (Quarter-over-Quarter Annualized Percent Change)



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Source: Bureau of Economic Analysis

Recession fears, which were widespread in early April, diminished as the quarter progressed. Although first-quarter GDP contracted by -0.5%, the first negative reading in three years, the decline was driven primarily by a sharp increase in imports (+38%) with minimal export growth (+0.4%). This negative net trade subtracted nearly five percentage points from overall GDP. Inventory accumulation helped offset some of this drag but not nearly enough to keep Q1 GDP positive.

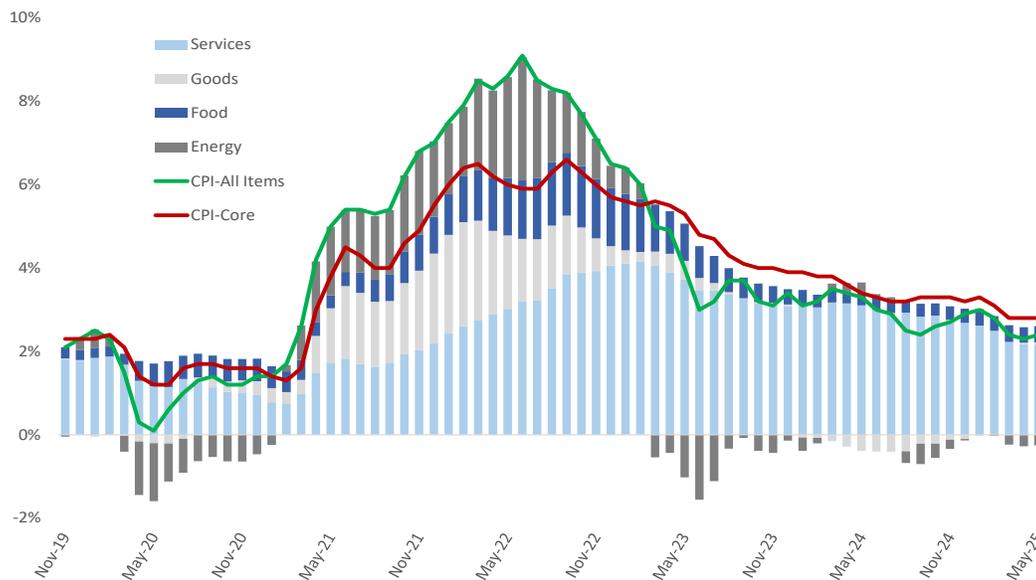
It's hard to draw reasonable conclusions when the headline is so noisy. A more accurate measure of economic growth—*real final sales to private domestic purchasers*—which excludes trade and inventories—rose at a +1.9% annual pace in Q1, down from +2.9% in Q4 2024. However, personal consumption, the largest component of GDP, slowed dramatically from +4.0% to just +0.5%, marking *the weakest quarter for consumer spending* (excluding the 2020 pandemic lockdown) in nearly 14 years.

Second-quarter GDP is expected to rebound as the trade deficit narrows, but consumer spending remains sluggish. While Q1 weakness may have been overstated and Q2 growth may appear deceptively solid, the underlying trend points to a clear deceleration in demand since the start of the year.

This softening of demand has, *so far*, kept a lid on price pressure. Both the Consumer Price Index (CPI) and Producer Price Index (PPI) indicated extremely low inflation measures for May, with overall and core readings rising just +0.1%. For CPI, this marked the fourth consecutive month of results below the median forecast. On a year-over-year basis, overall CPI edged up from +2.3% in April to +2.4% in May, while the core rate held steady at +2.8% for the third straight month, *matching a four-year low*. When annualized over the three-month period from February to May, overall CPI rose at a more modest +1.7% pace, largely due to declining energy prices driven by weakening global and domestic demand.

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### Consumer Price Index (Year-over-Year Percent Change)



Source: Bureau of Labor Statistics

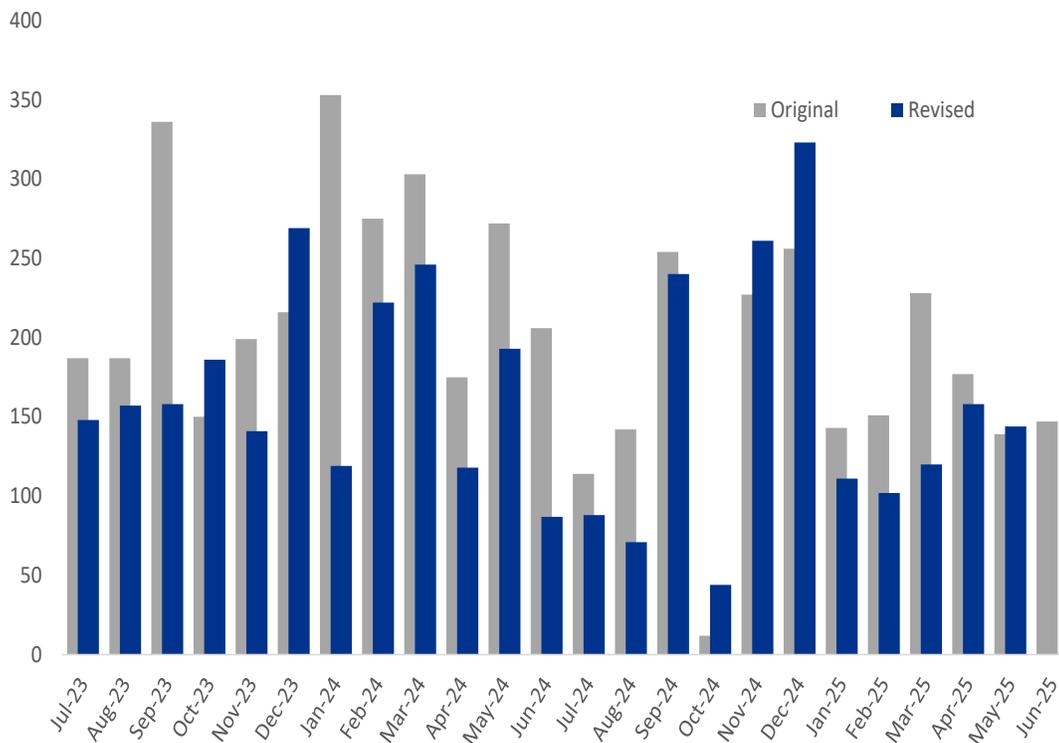
Some of this ongoing moderation in consumer inflation can be attributed to shelter costs as significant increases in available supply paired with depressed demand continue to ease housing costs.

Typically, decreased demand would coincide with labor market deterioration, but employment conditions have held up surprisingly well. After holding steady at 4.2% for three months, the unemployment rate was expected to rise to 4.3% in June. Following the first negative ADP payroll report in two years, some analysts, including *Bloomberg Economics*, warned of a potential increase to 4.4%. Instead, the unemployment rate unexpectedly declined to 4.1%.

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While part of the decline in unemployment was due to a shrinking labor force, it's hard to make an argument for weakness with the jobless rate within half a percentage point of a six-decade low. The June employment report also showed +147k jobs were added to nonfarm payrolls, topping forecasts for the fourth consecutive month. After revisions, average monthly payroll growth for the quarter was more than adequate at +150k. The labor market might eventually tank, but it *hasn't yet*. And it might not.

### Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

While the labor force participation rate remains historically low at 62.4%, the rate for prime-age workers (ages 25–54) reached 84.3% in June—near a record high. This suggests a tight labor market, and demographic trends point to even fewer available workers in the years ahead. The number of Americans aged 65 and older has increased from 40 million to nearly 53 million over the past decade. By 2035, this group is projected to reach 77 million, surpassing the number of children under 18 for the first time in U.S. history.

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Retiring baby boomers already outnumber new entrants to the labor force by a wide margin. While advances in artificial intelligence may help offset some of the labor shortfall, *the more pressing challenge is likely to be a shortage of qualified workers*. This emphasizes the need for expanded job training programs and a sensible immigration policy.

For now, most hard data on employment and inflation remain within acceptable bounds. However, soft data—particularly the business sentiment surveys—suggest potential weakness ahead.

The Conference Board's Measure of CEO Confidence fell by 26 points in the second quarter, marking the largest quarterly decline in the survey's 50-year history. Among the 133 CEOs surveyed, 82% reported that economic conditions had worsened over the past six months (up from 11% in the prior quarter), while only 2% believed conditions had improved. Looking ahead, 64% expect further deterioration, and 83% anticipate a recession within the next 12 to 18 months.

Similarly, the National Association of Manufacturers' second-quarter survey showed that over half of respondents reported a more pessimistic growth outlook, nearly 80% had experienced increased costs due to tariffs and 36% indicated they were delaying or canceling business investments. More than one-third had either halted hiring or expected to reduce headcount in the coming months, and only 55% expressed a positive business outlook—*the lowest level since the early stages of the pandemic in summer 2020*. The top concerns were trade uncertainty (77%) and rising material costs (66%).

In a concrete sign that tariffs are already weighing on business activity, FedEx warned in late June that its second-quarter profits would fall short of expectations due to "sharply deteriorated" shipments between the U.S. and China. For the first time in 13 years, FedEx declined to provide forward guidance, citing "uncertain global demand."

The Federal Open Market Committee (FOMC) met in June and voted to maintain the overnight funds target at 4.25% to 4.50% for the fourth consecutive meeting. While soft data and forward-looking indicators might have justified a rate cut, the Fed officials opted for caution given the economy's relative strength and the unpredictable trade environment.

President Trump expressed growing frustration with the Fed's patience, questioning Chairman Powell's competence and threatening to nominate a more accommodative replacement well before Powell's term ends in May 2026. On the morning of the FOMC meeting, Bill Pulte, head of the Federal Housing Finance Agency and a Trump appointee, publicly demanded that Powell either cut rates immediately or resign. Following the meeting, Trump called for an aggressive 200 to 300 basis point reduction. *Powell has yet to waver.*

When the Fed cuts rates, it lowers the *overnight* lending rate. Historically, *longer-term* interest rates have been driven by inflation expectations. More recently, however, factors such as large federal budget deficits, rising national debt, and trade-related uncertainty

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have exerted upward pressure on long-term yields. As the debt burden grows, investors may demand higher returns to compensate for the increasing—albeit still remote—risk of default. In this context, cutting short-term rates prematurely could push long-term rates higher and damage the Fed’s credibility.

Until recently, the Fed’s credibility under Chairman Powell was viewed very positively, particularly in terms of how financial markets responded to his messaging. Despite ongoing economic uncertainty, the passage of an unpopular funding bill, multiple escalating military conflicts, and a downgrade of the U.S. sovereign debt rating by Moody’s, equity markets managed to recover all losses tied to President Trump’s “Liberation Day” tariff announcement. At least part of this market resilience should be attributed to Powell’s steady leadership, which had appeared to guide the economy toward a soft landing—until the trade war intervened.

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Global investor sentiment told a different story. In the first half of 2025, the U.S. dollar index fell nearly 11%, its worst first-half performance since 1973 as baffling trade policy, persistent inflation expectations, and ballooning government debt unnerved foreign investors. Meanwhile, gold posted its strongest first-half gain in 46 years, as investors sought safety amid uncertainty and central banks diversified away from dollar-denominated assets.

U.S. corporate profits declined from a record \$205 billion in Q4 2024 to \$118 billion in Q1 2025. Yet equity markets shrugged off the earnings slump. The Dow rose nearly +5% for the quarter, rebounding +17% from April lows. The S&P 500 gained +10.6%, up almost +25% from its April trough, while the NASDAQ surged +17.8% for the quarter, a stunning +33.4% rebound from early April. Much of this rally was likely driven by expectations that the business-friendly, debt-heavy “Big Beautiful Bill” would pass—which it ultimately did.

Although the Fed held the overnight rate steady, Treasury yields declined across most maturities during another volatile quarter for bonds. The exception was the long end of the curve, where yields on 10- to 30-year maturities moved higher, reflecting investor concerns over the growing national debt. This segment of the yield curve will increasingly serve as a barometer of the nation’s fiscal credibility. At present, the long-term outlook remains troubling.

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## Q2 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
<b>Last</b>	3/31/2025	4.25-4.50%	4.29%	4.03%	3.88%	3.95%	4.20%
<b>High</b>			4.38%	4.15%	4.05%	4.17%	4.60%
<b>Low</b>			4.23%	3.83%	3.60%	3.71%	3.99%
<b>End</b>	6/30/2025	4.25-4.50%	4.29%	3.97%	3.71%	3.80%	4.23%

Source: Federal Reserve, U.S. Department of the Treasury

## Economic and Interest Rate Outlook

Worries that the U.S. economy would collapse by summer as prices spiked were clearly overblown, but it's far too early to breathe easy. With just two countries reaching trade agreements within the 90-day negotiation period, the Administration has promised a series of letters detailing what each trade partner will be required to "pay" to do business with the United States. According to the President, no further negotiations will occur after August 1. . . . unless he changes his mind.

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How these tariff costs are passed along will determine whether it's corporate profits that get dinged or consumer pocketbooks. Regardless, the outcome is unlikely to match the dire forecasts made three months ago. A more pressing concern is the erosion of trust, which may lead to the formation of global trade partnerships that exclude the United States. Early signs of this shift are evident: Chinese exports to the U.S. fell -35% in May, even as China's overall exports rose +5%. Over time, other nations are likely to prioritize more stable and cost-effective trade relationships.

This transition could have serious long-term consequences, including upward pressure on domestic inflation and challenges in financing U.S. Treasury debt. With an estimated \$25 trillion in new Treasury issuance expected over the next decade, the U.S. may be inadvertently undermining its funding capacity.

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In the short term, lower interest rates would help reduce debt servicing costs, though caution from the Federal Reserve is warranted. The recently passed funding bill is expected to stimulate growth, potentially increasing inflationary pressures—especially when combined with reciprocal tariffs likely to take effect on August 1.

From the Fed's perspective, some inflation is inevitable. The extent of the price increases are unknowable. *There's no manual for what's unfolding.*

The June dot plot indicates two quarter-point rate cuts in 2025, followed by single cuts in 2026 and 2027. This conservative outlook suggests Fed officials are concerned that tariff-driven inflation could become embedded but expect the economy to avoid recession. Bond futures currently align with this forecast, pricing in two rate cuts in the second half of the year.

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Still, these projections are subject to change. The past five years have made it painfully clear that financial forecasts are comforting in the moment, but ultimately worthless. The rules of Trump's tariff plan are continually shifting, which keeps extreme uncertainty intact. While the third quarter begins on a more optimistic note, underlying risks persist. Volatility should be expected.

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