Economic Summary – Q4 2025

Scott McIntyre, CFA
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2009
scott.mcintyre@hilltopsecurities.com

Greg Warner, CTP
HilltopSecurities Asset Management
Co-Head of Investment Management
Managing Director
512.481.2012
greg.warner@hilltopsecurities.com

Matt Harris, CFA
HilltopSecurities Asset Management
Senior Portfolio Advisor
Senior Vice President
512.340.1845
matt.harris@hilltopsecurities.com

The federal government was shuttered for nearly half of the fourth quarter, delaying traditional economic data releases and forcing analysts to rely on less familiar private sector growth and employment measures. Within these measures, Fed officials focused on deteriorating labor conditions, voting to lower the overnight funds rate in both October and December. This, despite the economy accelerating in the second half of the year while consumer inflation remained frustratingly above the Fed target.

Advances in artificial intelligence and favorable tax treatment should fuel business growth in 2026, while potentially reducing labor demands. The new year brings a change in Fed leadership, along with likely challenges to central bank independence. We expect the FOMC, influenced by the president and a new chairman, will cut rates more aggressively than the December "dot plot" had indicated.

Overview

Investment in A.I. infrastructure was a primary engine of GDP growth in the first six months of 2025, while personal consumption posted its weakest back-to back quarters since late 2022. Consumer spending seemed to improve by late summer/early fall, but confirmation of this apparent rebound was delayed.

On the first day of the last quarter of 2025, all non-essential operations of the federal government were abruptly closed as the nation's increasingly-polarized political parties failed to reach an agreement to fund the new fiscal year. As the days stretched into weeks, economists speculated over the degree of impact on Q4 GDP growth. Near the end of October, the Congressional Budget Office (CBO) reported the shutdown would reduce annualized fourth quarter growth by 1.0 to 2.0 percentage points. Surprisingly, the pain associated with what would become the longest government closure in history never really materialized.

The pain associated with what would become the longest government closure in history never really materialized.

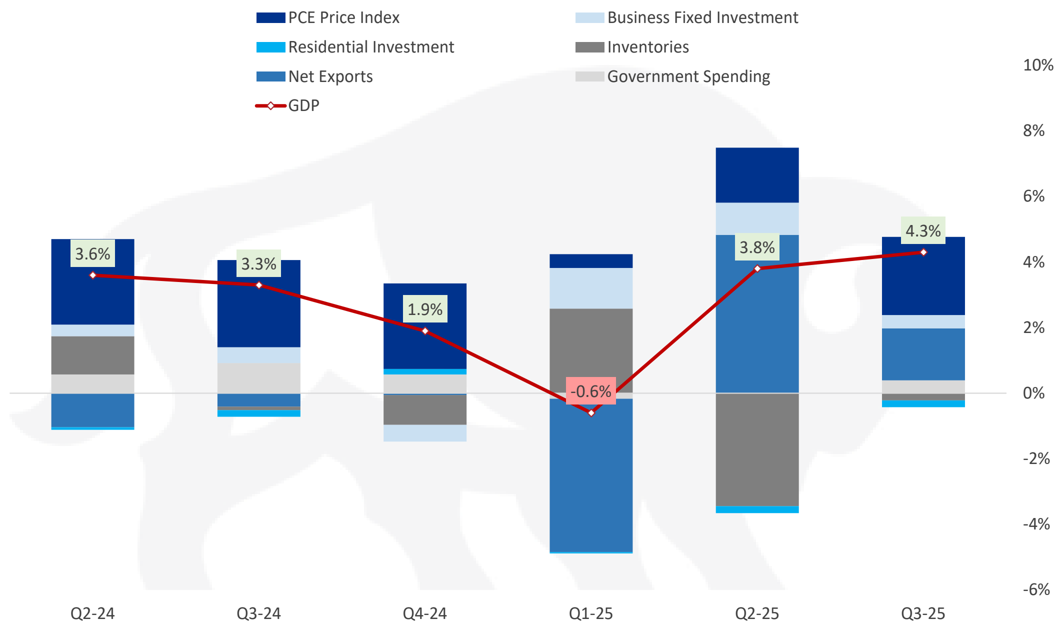
The majority of Americans felt little inconvenience. The hardships were concentrated in isolated pockets. The millions of unpaid federal workers included essential air traffic controllers and TSA agents, contributing to thousands of flight delays and cancelations across the nation, but Americans adjusted. At the same time, SNAP funding expired in November. This was a bigger concern. The idea of low income Americans suddenly having little means to feed themselves probably expedited the uneasy truce that ended the record 43-day shutdown.

The overall effect on the economy was considerably less negative than the dire predictions had suggested. Remarkably, while much of the federal government was shuttered, the equity markets reached fresh record highs as major U.S. tech companies continued to announce A.I. infrastructure plans. The recession drumbeat that accelerated with the "Liberation Day" tariff announcement in April continued to fade, and the near term outlook drew cautiously upbeat.

While much of the federal government was shuttered, the equity markets reached fresh record highs as major U.S. tech companies continued to announce A.I. infrastructure plans.

The temporary closure of the Bureau of Labor Statistics (BLS) and Bureau of Economic Analysis (BEA), among others, made it challenging to gauge current conditions by traditional measures. The advance estimate of third quarter GDP, originally scheduled for release on October 30, was canceled. The preliminary estimate of Q3 2025 GDP was finally released on December 23 with a surprisingly strong +4.3% reading.

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



Source: Bureau of Economic Analysis

Although business investment slowed from the breakneck speed of the first half, improved consumer spending and a surge in net exports picked up the slack.

Although business investment slowed from the breakneck speed of the first half, improved consumer spending and a surge in net exports picked up the slack. For perspective, the Bloomberg economist survey *taken in mid-April*, had shown an average Q3 GDP forecast of just +0.7%.

The 82 economists polled in April clearly overestimated the negative tariff effect, while underestimating the ongoing resilience of American consumers as well as company fears of missing out on the rapidly-evolving A.I. technology gambit.

The 82 economists polled in April clearly overestimated the negative tariff effect, while underestimating the ongoing resilience of American consumers as well as company fears of missing out on the rapidly-evolving A.I. technology gambit.

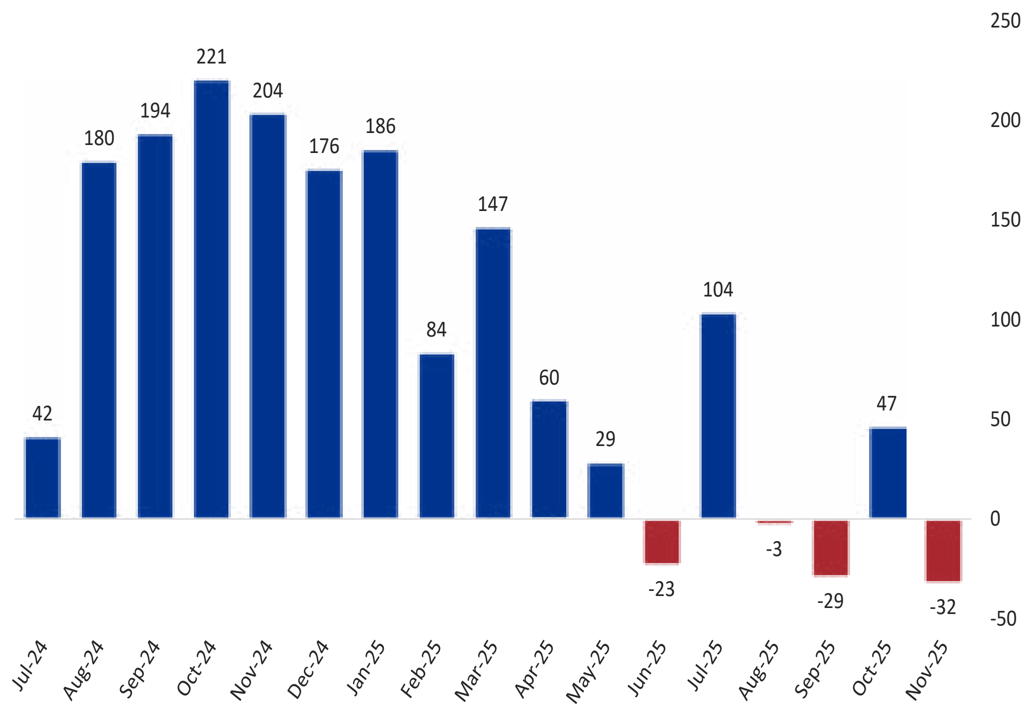
Although Open AI released ChatGPT three years ago, A.I. chatbots only recently exploded onto the public consciousness. ChatGPT, now one of many, tripled its weekly active users to 900 million in 2025 (Demand Sage, Dec. 2025). The early, and hopeful, expectation was that A.I. technology would be a net positive for the labor market; however, one of the troubling economic themes for the third and fourth quarters was rising unemployment.

A 60% drop in net immigration (San Francisco Fed, Nov. 2025) has reportedly pushed the breakeven job growth required to maintain the current unemployment rate down from approximately +155k per month to 32k-82k, depending on the immigration scenario (St Louis Fed, Aug. 2025). The fact that 1.6 million fewer immigrants seeking work didn't push unemployment lower, and +4.3% GDP growth failed to boost company payrolls suggests technology is reducing labor demand. The GDP/jobs disconnect also indicates that recent growth is concentrated in capital-intensive sectors of the economy capable of increasing output with fewer workers.

Employment

The BLS released the August employment report on September 5, while the September report was ultimately delayed until November 20. During those 76 days, investors sought other sources. With few exceptions, this alternate jobs data signaled mounting labor market weakness. ADP reported private-sector payrolls fell by -32k in November, matching September with the largest monthly decline in payrolls since early 2023.

ADP Payrolls Total Change (in thousands)



Source: Automatic Data Processing, Inc / Bloomberg

ADP reported private-sector payrolls fell by -32k in November, matching September with the largest monthly decline in payrolls since early 2023.

Details within the report indicated small businesses with fewer than 50 employees shed -120k jobs in November, the steepest single-month drop since May 2020.

Announced job cuts in the October Challenger, Gray & Christmas report showed more than 153k planned layoffs, a 175% year-over-year increase and *the highest for any October in 20 years*. The most commonly cited reasons given for the layoffs were cost-cutting (32.9%) …*and artificial intelligence* (20.3%). The November report wasn't as dramatic, but another 71k planned job cuts brought the 2025 total to 1.17 million, a 54% year-over-year increase and *the highest since 2020*.

Announced job cuts in the October Challenger, Gray & Christmas report showed more than 153k planned layoffs, a 175% year-over-year increase and the highest for any October in 20 years.

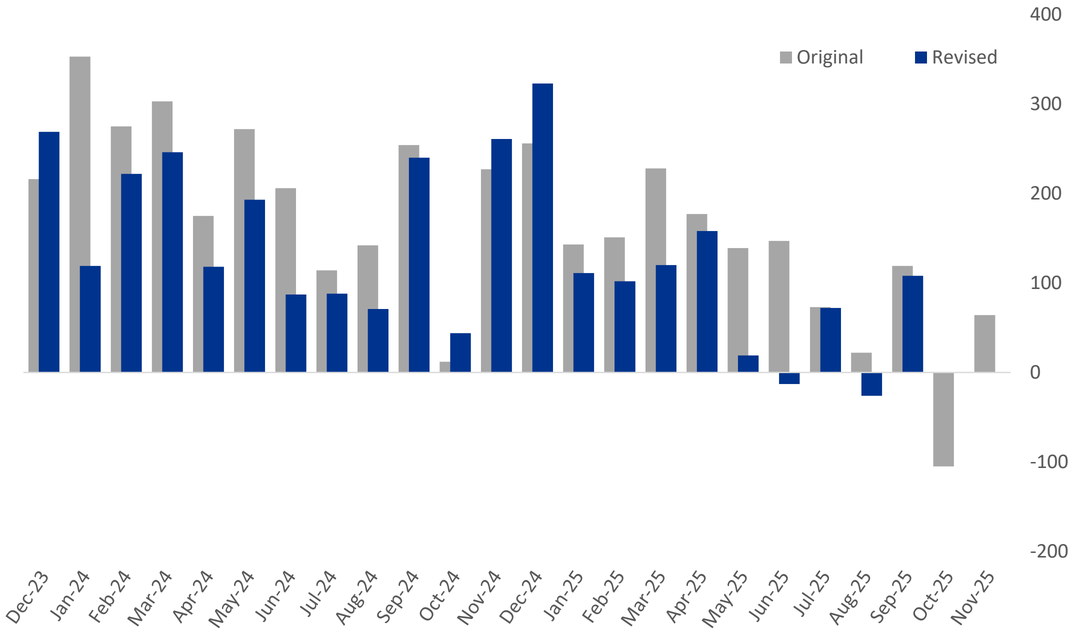
Revelio Labs, considered to be well-correlated with the BLS, reported back-to-back payroll losses for October and November and a total of -50k fewer jobs for the seven-month period ending in November, a sharp decline from the +240k jobs added during the first four months of the year.

By the time the BLS was operational and the (admittedly stale) September employment report was finally released on November 20, the markets were fully braced for bad news. The good news was that the headline numbers were better than expected. The underlying numbers …*not so much.*

By the time the BLS was operational and the (admittedly stale) September employment report was finally released on November 20, the markets were fully braced for bad news. The good news was that the headline numbers were better than expected. The underlying numbers … not so much.

According to the Bureau of Labor Statistics, U.S. companies added +119k payroll jobs in September, more than doubling the median forecast. Prior month revisions subtracted -33k, with the previously-reported +22k August gain turning into a -4k loss.

Non-Farm Payrolls Total Change (in thousands)



Source: Bureau of Labor Statistics

The result was a big month-over-month increase, which *suggested* improvement. However, joblessness worsened, as +470k Americans entered the labor force in September while just +251k found work, nudging the unemployment rate up from 4.3% to 4.4%. One quarter of these unemployed workers, representing 1.9 million Americans, were college graduates, the highest percentage since BLS tracking began in 1992.

The headline unemployment rate rose from 4.4% to 4.6% in November, partly reflecting the absence of an October household survey, but also signaling a wide-spread cooling in labor demand.

The combined October–November jobs report was finally released on December 19. A largely-anticipated decline in federal workers was responsible for a -105k drop in October payrolls, but the November job count climbed by a better-than-expected +64k.

At the same time, the headline unemployment rate rose from 4.4% to 4.6% in November, partly reflecting the absence of an October household survey, but also signaling *a wide-spread cooling in labor demand*.

November unemployment was the highest in over four years, but this common measure only considers people who have actively sought work in the past 30 days. The broader "underemployment rate," which includes Americans working part-time because full-time work wasn't available, as well as those who'd like a job but are not currently searching, jumped from 8.0% to 8.7%.

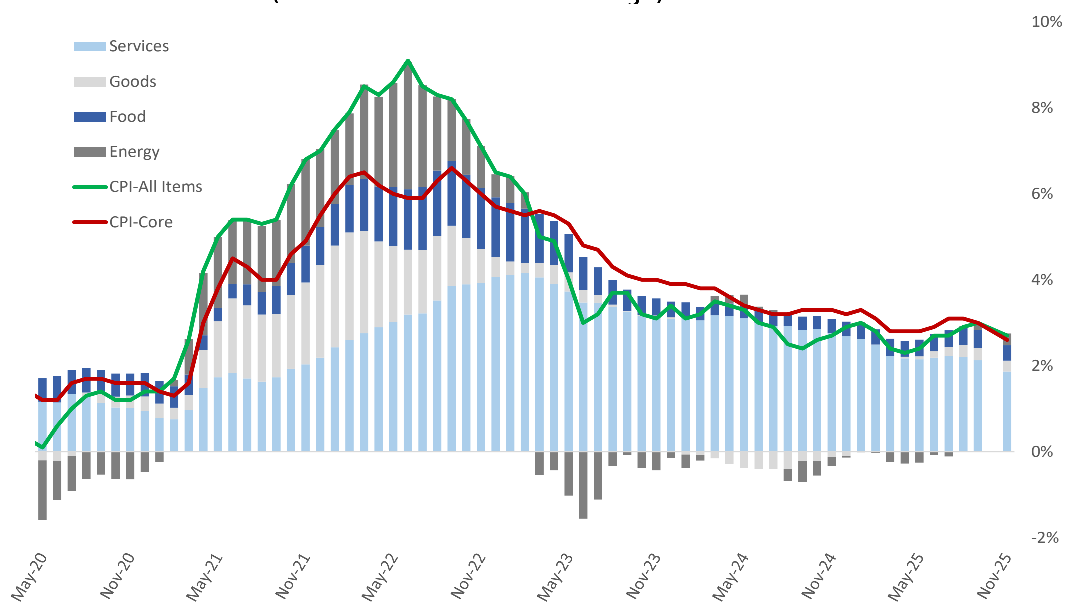
Inflation

The optics of a sharp rise in unemployment, even as the overall economy accelerates, is seen as a problem for the Trump Administration. Unfortunately, Fed officials are reluctant to reduce rates further when inflation remains elevated. The lack of government data didn't preclude Fed officials from a precautionary cut in late October, and the November CPI report, released on the morning of the December FOMC meeting, was accommodative enough to allow another reduction.

The optics of a sharp rise in unemployment, even as the overall economy accelerates, is seen as a problem for the Trump Administration. Unfortunately, Fed officials are reluctant to reduce rates further when inflation remains elevated.

Because the Bureau of Labor Statistics (BLS) was shuttered during the entire month of October, price data was never collected. As a result, the November report only included year-over-year changes. The annual pace of headline CPI, expected to rise slightly, unexpectedly fell from +3.0% in September to +2.7% in November, matching a five-month low, while core CPI dropped from +3.0% to +2.6%, *the lowest since March 2021*.

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



Source: Bureau of Labor Statistics

The lowest forecast of core CPI in a Bloomberg survey of 62 economists was +2.8%, 0.2 percentage points above the actual number. The primary reason for the apparent cooling of consumer prices was shelter costs. Housing, representing about 35% of the overall CPI and roughly 45% of the core, climbed a puzzling +0.18% from September. It was the lowest two-month change since the pandemic shutdown in April-May 2020 and an abrupt decline from the +0.64% two-month change in the prior report. Although annualized shelter costs have been falling steadily since April 2023, analysts determined the missing October price data resulted in underreporting of prices in November.

Although annualized shelter costs have been falling steadily since April 2023, analysts determined the missing October price data resulted in underreporting of prices in November.

December CPI will likely adjust to reflect slightly higher prices, but the inflation rate will still be much tamer than expected six months ago. This is obviously a positive, unless you expected prices *to fall*, and many Americans did. Affordability (or the lack thereof) has become an issue, and a majority of consumers are unhappy.

The Consumer

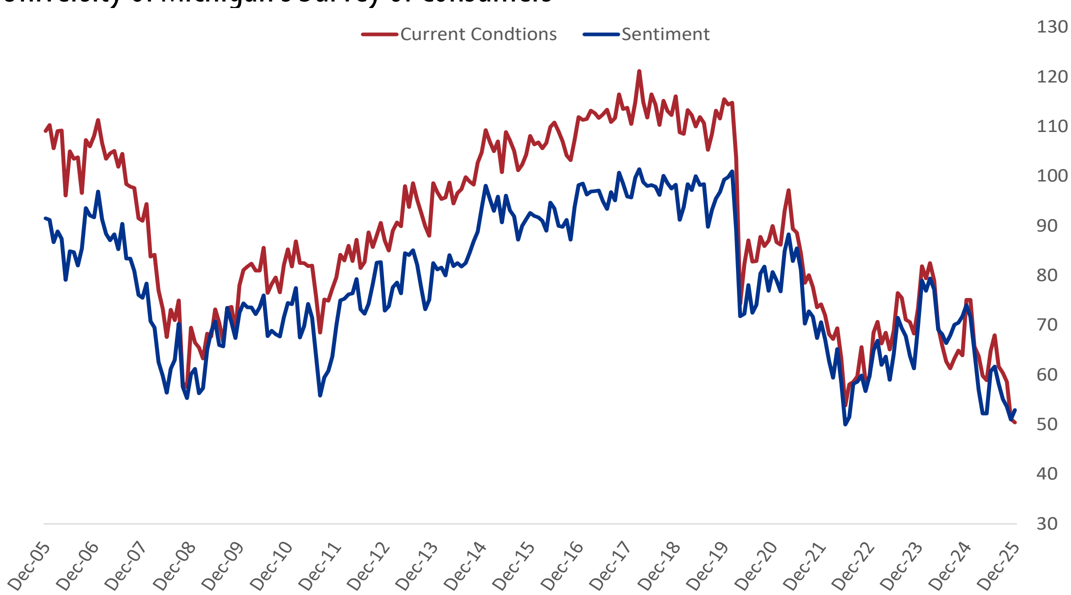
In the December Harris poll, conducted for *The Guardian*, 45% of Americans believe their financial security is getting worse compared to just 20% who believe it's getting better. The same poll reveals 57% of Americans believe the US economy is currently *in recession*, up 11% from a similar poll conducted back in February. This is particularly hard to reconcile with the recently reported +4.3% third quarter GDP growth, but it's consistent with other gloomy consumer polling.

In the December Harris poll, conducted for The Guardian, 45% of Americans believe their financial security is getting worse compared to just 20% who believe it's getting better.

A December CBS News poll showed 7 of 10 Americans are struggling to pay for food, housing and health care, validating the claim that affordability is a widespread issue and reiterating the notion of a k-shaped recovery.

The University of Michigan's monthly survey of U.S. consumers was abysmal in November and improved only slightly in December, with the Index of Consumer Sentiment hovering *near the lowest in survey history.*

University of Michigan's Survey of Consumers



Source: University of Michigan

The current conditions sub-index did reach an all-time low in November and continued to a fresh low in December. On a similar note, the Conference Board's consumer confidence measure fell for the fifth straight month, with the 89.1 December reading well below the 109.5 mark from a year earlier.

Overall confidence may be waning, but the top 10% of U.S. earners feel fine, continuing to drive nearly half of national spending.

Overall confidence may be waning, but the top 10% of U.S. earners feel fine, continuing to drive nearly half of national spending.

October retail sales, delayed a month, appeared tepid, coming in just below the median forecast at +0.1%, but eight of 13 categories posted increases. A huge -1.6% drop in vehicle sales, reflecting the September expiration of the federal EV tax credit, extracted 0.3 percentage points from the headline. The other major category weighing to the downside was gasoline station sales as lower pump prices reduced receipts.

Control group sales, which exclude sales at auto dealerships and gas stations, as well as food service establishments and building materials stores, and are used in calculating GDP, rose +0.8%, well above the +0.4% forecast. Thus, the weak headline masked a quite respectable core sales gain which suggests third quarter momentum carried forward into the fourth quarter.

On October 30, with limited economic information, the FOMC cut a precautionary quarter-point. Then on December 17, the committee voted to lower the overnight target rate (for the third straight meeting) . . . by another quarter point to a new range of 3.50% to 3.75%; now down 175 basis points from just 15 months earlier.

The Fed

On October 30, with limited economic information, the FOMC cut a precautionary quarter point. Then on December 17, the committee voted to lower the overnight target rate (for the third straight meeting) . . . by another quarter point to a new range of 3.50% to 3.75%; *now down 175 basis points from just 15 months earlier.*

The December move was fully expected by the morning of the meeting. It was surprising that just two committee members voted to hold steady, although the updated dot plot indicated four of the seven non-voting regional Fed presidents also favored no change. A third dissent was for a larger 50 bp reduction.

Fed Chairman Jerome Powell's term expires in May and speculation on who will replace him has continued to evolve. When the quarter began, it looked as though White House National Economic Council Director Kevin Hassett would fill the vacancy, but that trial ballon has since deflated, opening the door for former Fed governor Kevin Warsh and more recently, current Fed Governor Chris Waller.

Trump's decision on a new Chairman, subject to congressional approval, is now expected to be announced in January. In early December, the Fed Board of Governors voted unanimously to reappoint all of its remaining regional bank presidents for another five-year term. The somewhat unexpected announcement came about 11 weeks before the February 28, 2026 term expiration date and appears to be a referendum on the Fed's intent to maintain its independence despite pressure from White House officials.

The yield curve steepened dramatically during the quarter as rate cuts dragged short yields lower, while longer yields moved higher as investors weighed inflation expectations, the implications of soaring national debt and future Fed integrity.

The new Fed Chairman and composition of the FOMC is expected to have a considerable market impact in 2026.

The Financial Markets

The yield curve steepened dramatically during the quarter as rate cuts dragged short yields lower, while longer yields moved higher as investors weighed inflation expectations, the implications of soaring national debt and future Fed integrity.

All three major indexes advanced for the third straight quarter, finishing the year near record highs. For all of 2025, the Dow was up +12.7%, the Nasdaq +19.8%, and the S&P 500 +16%. Remarkably, all of the gains occurred after the April tariff announcement.

Q4 Interest Rates

		Fed Funds	3 mo. T-bill	12 mo. T-bill	2 yr. T-note	5 yr. T-note	10 yr. T-note
Last	9/30/2025	4.00-4.25%	3.95%	3.63%	3.61%	3.74%	4.15%
High			3.96%	3.71%	3.63%	3.79%	4.19%
Low			3.56%	3.47%	3.42%	3.55%	3.95%
End	12/31/2025	3.50-3.75%	3.64%	3.48%	3.48%	3.73%	4.17%

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

Economic and Interest Rate Outlook

Trump's reciprocal tariffs were widely-expected to slow growth and spark inflation. Neither really happened.

Trump's reciprocal tariffs were widely-expected to slow growth and spark inflation. *Neither really happened.* The main reason why inflation forecasts fell short and growth forecasts far exceeded is that the import duties actually implemented were well below those threatened in the April announcement. The Administration had boasted tariff revenue would top a trillion for the year. Although the exact amount collected is debatable, and final numbers have yet to be tabulated for all of 2025, Politico estimates the full year at just over $260 billion, an annual increase of $170 billion.

With the tariff campaign having achieved marginal success, the Administration is unlikely to abandon bragging rights associated with the revenue stream in 2026. If the Supreme Court were to declare the reciprocal tariffs unconstitutional in January, other measures would be aggressively pursued by the Trump administration. *The tariff story isn't over.*

President Trump had expected a manufacturing boom would fuel growth in 2025 - that hasn't been the case as manufacturing payrolls have declined every month since the April announcement. Instead, it's been furious business investment in A.I. infrastructure and resilient consumer spending, driven in part by the continued stock market rise.

Tech spending slowed in the second half, but the commitment to future business investment is enormous, tax incentives are highly favorable, and a weak dollar will help exports. As a result, stock market forecasts are overwhelmingly positive.

Tech spending slowed in the second half, but the commitment to future business investment is enormous, tax incentives are highly favorable, and a weak dollar will help exports. As a result, stock market forecasts are overwhelmingly positive. The average expected gain in the S&P 500 next year, according to a year end Bloomberg survey, is +9%. All 21 forecasters in the survey believe the stock market will continue its rally for a fourth straight year.

If equity market health mirrored the nation as a whole, the 2026 outlook would be much more positive, *but it doesn't.* According to the Federal Reserve, the wealthiest 10% of U.S. households own nearly 90% of all U.S. stocks, with the top 1% owning roughly half. The A.I. boom suggests early rewards will accrue to those owning equity shares.

According to the Federal Reserve, the *bottom* 50% of U.S. households - *typically not homeowners or stockholders* - account for just 2%-3% of U.S. total wealth. These households represent individual consumers with increasingly limited resources. Their dwindling capacity to spend will directly affect six of the "Magnificent Seven" as Amazon, Alphabet, Apple, Meta, Tesla and Nvidia are all reliant on an eager and growing customer base.

Stock market vulnerability is likely to increase Trump Administration calls for aggressive rate cuts in 2026.

Stock market vulnerability is likely to increase Trump Administration calls for aggressive rate cuts in 2026. Having reduced the overnight target by a combined 175 basis points over a 15-month period, Fed policy is now less restrictive and closer to neutral. *Exactly what constitutes neutral is the question.*

The December "dot plot" shows a single 25 bp rate cut in 2026 and another in 2027, while the futures market suggests less patience, with two 25 bp reductions during the first three quarters of 2026.

Assuming Powell declines to continue as a Fed governor after his chairmanship ends in May, four of the seven governors would presumably favor more aggressive cuts. A seven-vote majority would still be required, but President Trump has an established track record of getting what he wants. The idea that the FOMC members will hold their ground amid unrelenting pressure may be farfetched.

Job loss creates headlines, and during an election year, will demand a response.

If December core consumer inflation (as expected) creeps back toward +3.0%, still well above target, and GDP (as expected) finishes the fourth quarter near +3.0%, the Fed playbook would *normally* signal a pause. However, the committee's main focus is on unemployment, which just reached a four-year high. Labor market conditions could soften further in the coming months as companies respond to the uncertain outlook. Job loss creates headlines, and during an election year, will demand a response.

The President will appoint a new Fed Chairman in the coming weeks. The main selection criteria is that this person will advocate strongly for lower interest rates. Once named, he will immediately be front/center and vocal in supporting the president's wishes.

As the new year begins, the range of possible economic outcomes has never been wider. Cautious optimism is laced with asterisks.

As the new year begins, *the range of possible economic outcomes has never been wider.* Cautious optimism is laced with asterisks. A rate cut in January is highly unlikely but cut(s) should be back in play by the March meeting, whether warranted or not.