GDP Slows to 1.5% Despite Stronger Consumer Demand

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

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

The Bureau of Economic Analysis released the first estimate of second-quarter GDP, and the final June inflation report this morning. Economic growth slowed more than expected during the second quarter, while inflation improved. Despite the softer GDP headline, domestic demand remained surprisingly strong, even as the economy continues to navigate elevated inflation, higher rates, ongoing conflict in the Middle East, and tariff uncertainty.

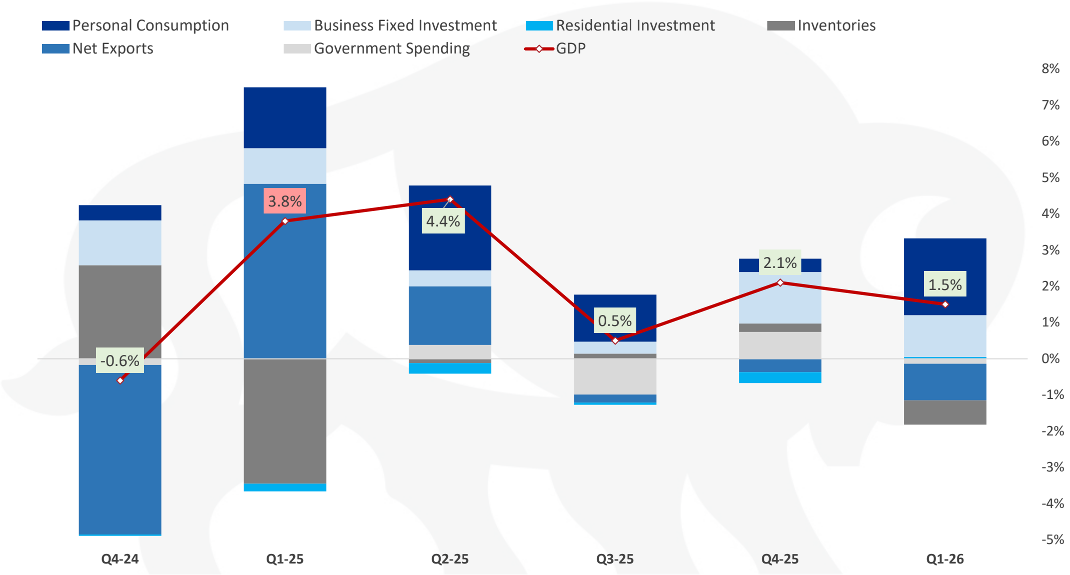
Second-quarter GDP expanded at a 1.5% annualized pace, below the 2.0% estimate forecast and down from 2.1% during the first quarter. But consumer spending, which accounts for roughly two-thirds of economic activity, accelerated sharply, growing at a 3.2% pace after posting just 0.5% growth in the first quarter. Business investment also remained healthy, reflecting continued spending on equipment, technology, and AI infrastructure.

The primary weakness in the GDP report came from trade and inventories. Net exports subtracted just over one percentage point from growth while inventories reduced GDP by an additional 0.7 percentage points. Those categories remain distorted by tariffs as businesses continue adjusting supply chains and import schedules. Combined, trade and inventory effects reduced headline GDP growth by 1.7 percentage points.

The inflation data released alongside GDP was also encouraging. The Personal Consumption Expenditures Price Index, the Federal Reserve's preferred measure of inflation, fell 0.1% in June. On a year-over-year basis, headline inflation slowed to 3.7% from 4.1% in May. Core PCE, which excludes food and energy, increased just 0.1% for the month and eased to 3.3% from 3.4%.

Despite the softer GDP headline, domestic demand remained surprisingly strong, even as the economy continues to navigate elevated inflation, higher rates, ongoing conflict in the Middle East, and tariff uncertainty.

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



Source: Bureau of Economic Analysis

Like the CPI and PPI reports released earlier this month, June's inflation data showed broad improvement. The core reading came in below expectations and marked a step in the right direction for the Fed attempting to return inflation to the Fed's 2% target.

Markets have moved past June's data. Oil prices have risen sharply over the past month as conflict in the Middle East has intensified, and supply concerns have resurfaced. The national average price for unleaded gasoline is up about $0.23 over the past month, while diesel has climbed nearly $0.50. Although June's inflation report was a good sign, investors are now focused on whether higher oil, gas, and diesel prices in July will feed back into broader inflation measures.

Although June's inflation report was a good sign, investors are now focused on whether higher oil, gas, and diesel prices in July will feed back into broader inflation measures.

The long end of the Treasury curve remains elevated. The 30-year Treasury yield briefly moved above 5.2% yesterday, reaching its highest level since 2007. Since the June FOMC meeting, 10-year Treasury yields have risen roughly 25 basis points while long bond yields have increased even more. Some market participants view the move as evidence that investors are demanding greater compensation for inflation risk. Others point to Warsh's efforts to reduce forward guidance and allow markets to determine rates with less assistance from the Federal Reserve. Either way, the bond market has already done some tightening for the Fed.

The market is now turning its attention to September's FOMC meeting. Between now and then, policymakers will receive two employment reports and two CPI reports. While today's data showed inflation moving in the right direction and consumers continuing to spend, uncertainty surrounding developments in the Middle East, energy markets, and tariff policy remains elevated. The futures market is currently pricing roughly a 55% probability of a September rate increase, suggesting investors remain far from convinced that the inflation story is over.

Market Indications as of 9:50 A.M. Central Time

DOW	Up 213 to 51,807 (HIGH: 53,056)
NASDAQ	Up 594 to 25,037 (HIGH: 27,094)
S&P 500	Up 90 to 7,406 (HIGH: 7,610)
1-Yr T-bill	current yield 4.00%; opening yield 4.01%
2-Yr T-note	current yield 4.23%; opening yield 4.27%
3-Yr T-note	current yield 4.29%; opening yield 4.32%
5-Yr T-note	current yield 4.38%; opening yield 4.40%
10-Yr T-note	current yield 4.67%; opening yield 4.67%
30-Yr T-bond	current yield 5.22%; opening yield 5.20%