ECONOMIC NEWSLETTER

ECONOMIC NEWS - JULY 2025

A Waiting for Godot Economy

The heightened uncertainty and angst among households and businesses over trade and fiscal policies have not abated. Worse, the flare-up of geopolitical tensions in the Middle East has added another layer of turbulence to the economic landscape. Yet the headlines sounding notes of doom and gloom are not being echoed in the real world. The economy continues to display more resilience than expected, and policy makers feel little urgency to act preemptively to stave off a recession. Understandably, some are questioning whether the doomsday worriers are crying wolf and should slink back into the woodwork.

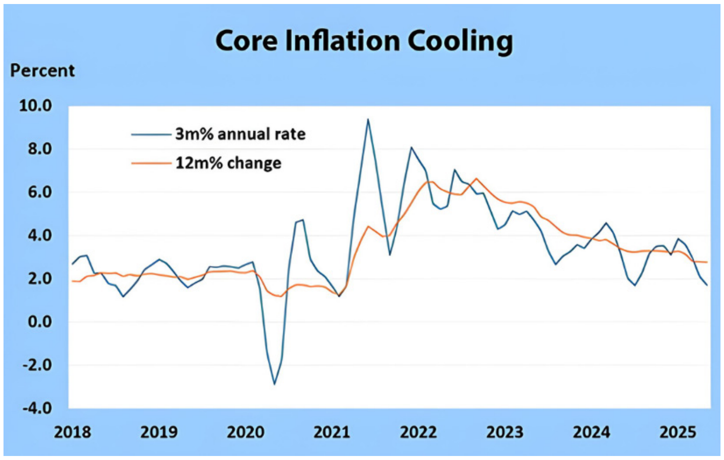
Investors have also been shaken by the volatile news cycle, but here too the behavior of the financial markets has not been overly dramatic. Stock prices have responded – sometimes violently – to each unwelcome tariff announcement or upheaval on the geopolitical front; likewise for the bond market where yields have staged some unusually large daily moves. But on balance, stock prices and yields are not much different from where they stood at the start of the year, and household balance sheets are still in good shape.

So, should we "pack up our troubles" and smile through the turbulence? Granted, it is hard to upend a $31 trillion economic juggernaut. It takes a major shock, such as a pandemic, an oil crisis, or war-time restrictions to dismantle the pillars that undergird the U.S. economy. The visible disrupters now afoot are not potent enough to do the job. But that doesn't mean the economic vessel will avoid the rough waters seen ahead. It may seem like we are in a "Waiting for Godot" economy, where expectations run high but results never appear. Economists describe such an event as more noise than substance. They also know that it is only a matter of time before the noise morphs into substance. The Federal Reserve is diligently trying to prevent that from happening. The challenge is to not overreact to the noise but keep a vigilant eye on changes in the substance.

The Fed Holds Firm

As expected, the Federal Reserve held interest rates unchanged at its latest policy-setting meeting on June 17-18. That disappointed the White House, of course, where calls for rate cuts have rung loud and clear for months to help lower the cost of financing a burgeoning deficit as well as to spur growth. But the Fed has a dual mandate to pursue maximum employment as well as stable prices. After cutting rates by a full percentage point last year, it put a hold on additional cuts in January as the employment side of the mandate has been met, while inflation has remained above its 2 percent target.

By holding rates steady at their elevated levels so far this year, the Fed is placing more emphasis on reducing inflation than worrying about the job market, where the unemployment rate still hovers near historic lows. But inflation has cooled markedly in recent months and by some measures has almost closed the gap with the 2 percent target. Over the past three months, the consumer price index, stripped of volatile food and energy prices, has increased at an annual rate of 1.7 percent.



So what is the Fed waiting for? Simply put, it fears the noise of higher tariffs will morph into the substance of higher inflation. In the updated economic projections presented at the policy meeting, Fed officials expect inflation to rise to 3.1 percent at the end of this year, up from the 2.8 percent projected at the March meeting, before the ramped-up "Liberation Day" tariffs were announced on April 2. To be fair, the Fed also raised its forecast for the unemployment rate, but by a smaller 0.1 percent to 4.5 percent. Hence, the Fed still sees a greater risk of higher inflation than unemployment, justifying its decision not to cut rates for now.

Where's The Beef?

On the surface, critics of the Fed's decision to delay rate cuts have a point. As noted, inflation has cooled considerably in recent months, even though higher tariffs have been in effect since early April. This has raised speculation that the costs of higher tariffs are not being passed on to consumers, but are being "eaten" by companies. To some extent, that is true, particularly among smaller businesses that do not have alternative sources to obtain cheaper supplies than from imports and can't afford to lose sales. Many are closing their doors because of the squeeze on profits from the higher cost of goods.

But the main reason tariffs haven't had their expected impact yet is because factories and retailers stockpiled goods before tariffs took effect. Hence, companies are selling merchandise at pre-tariff prices from inventory and are holding the line until their stock runs out. As inventories are replenished with goods carrying the higher tariffs, the pressure to raise prices will grow. Just how much of a price increase occurs will depend on how tariffs are absorbed along the distribution line. Some research indicates that one-third will be absorbed by factories, one-third by sellers and one-third by consumers.

But most of the actual pass-through is yet to occur; with inventories still being drawn down, the price impact from the replenished stock will not be visible until later this summer or the fall. That's the primary reason the Fed remains in a wait-and-see mindset. As Fed Chair Powell noted in his post-meeting press conference: "Ultimately the cost of the tariff has to be paid, and some of it will fall on the end consumer. We know that's coming, and we just want to see a little bit of that before we make judgments prematurely."

In other words, if not for the looming inflation threat from tariffs, the Fed would probably be more inclined to cut rates sooner than it now expects. Indeed, one Fed governor – Christopher Waller – said right after the policy meeting that a rate cut should take place as early as July. His justification for such an early move is that he believes any price increase would be a one-off event and not cause a sustained increase in the inflation trend.

Conflicting Views

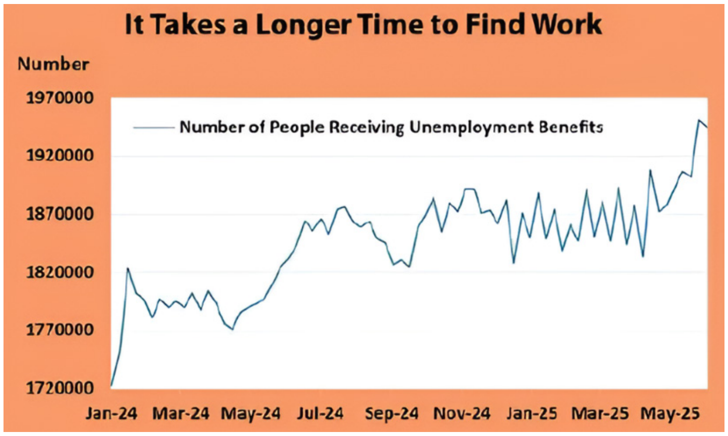
Waller's view is not shared by the other policy makers, but mostly because of timing, not direction as rate cuts are still on the table this year, according to the projections of the 19 members of the Fed's policy-setting committee. The median projection at the June gathering is for two reductions, the same as was the case at the March meeting. Hence, the central bank believes that the inflation retreat in recent months still has legs, and the tariff impact will only temporarily arrest the trend. But that median projection masks a fractured consensus, as 7 of the members expect no cuts this year, and 2 expect only one cut. When asked at the press conference, Powell suggested in so many words that these projections should be taken with a grain of salt, as no one knows what the inflationary impact of tariffs will be, only that it is coming and the Fed will wait-and-see how persistent it is.

The worst-case scenario facing the Fed is if inflation picks up and growth slows, a stagflationary trend that is the central bank's biggest nightmare. Then it would have to choose which side of its mandate it should more actively pursue: lean against fighting inflation or shoring up employment. The former would mean keeping rates at their elevated levels, risking more pain to the economy. The latter requires rate cuts sooner rather than later, risking even higher inflation. Indeed, the Fed's projections are for both unemployment and inflation to pick up in coming months, so a stagflationary trend is clearly on the Fed's radar.

However, neither projected rise in unemployment or inflation is alarming and, importantly, the Fed does expect inflation to retreat in 2026, underscoring the planned rate cuts put forth in the Summary of Economic Projections for later this year and in 2026. There is a good chance that the Fed will view the balance of risks facing the economy differently later in the year, shifting its focus away from inflation and towards preventing an unwelcome pickup in unemployment.

Tariffs' Dual Impact

There are four Fed meetings left this year – in July, September, October, and December. What would prompt the Fed to cut rates as early as July, as Waller suggested? Clearly, the urgency to do so that soon is not compelling. The central bank looks at a full body of data to assess the economy's performance, but it keeps a laser eye on the job market. By the time you read this, a fresh employment report for June will be out and it will likely reveal a continued slowdown in job growth seen so far this year. But unless there is a sudden surge in unemployment, it is not likely to move the Fed's compass as slower job growth fully aligns with expectations. For one, the broader economy, paced by consumer spending, is cooling, and businesses are pulling back on hiring. But they are also not firing workers, worried that it would be difficult to rehire them if sales turn out to be stronger than expected.



That's a key reason the unemployment rate has remained as low as it has. For another, a major source of labor force growth in recent years has come from foreign-born workers, and immigration has been severely restricted this year. Hence, with a reduced labor force, fewer workers need to be hired to keep a steady unemployment rate.

However, the "no hiring, no firing" strategy is not sustainable over the long term. It means that jobless workers are staying longer on the unemployment lines, something that can be seen in the steady climb in the number of jobseekers collecting unemployment benefits. This trend eventually seeps into the mindset of employed workers, stoking heightened anxiety over job security and discouraging discretionary spending.

Keep in mind too that most attention regarding tariffs has centered on their inflationary impact. But higher tariffs also have a negative impact on demand, as they are essentially a tax on sales. It may be unclear how high the tax will be until we know how much of the tariffs will be passed on to consumers. But as Powell noted, some passthrough is coming. With wages poised to slow along with cooling job growth, it will take a toll on household purchasing power. Simply put, the demand destruction from tariffs will soon outweigh the inflation impact, which should level off as we head into 2026. The Fed is heeding the noise of the inflation threat now, but some policymakers are already seeing the substance starting to crumble. Look for that minority view to expand later this year and form a consensus that decides to start cutting rates.

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KEY FINANCIAL AND ECONOMIC INDICATORS

FINANCIAL INDICATORS*

	May	April	March	February	January	December	November	12-Month Range High	12-Month Range Low
Prime Rate	7.50	7.50	7.50	7.50	7.50	7.65	7.81	8.50	7.50
3-Month Treasury Bill Rate	4.25	4.21	4.20	4.22	4.21	4.27	4.42	5.24	4.20
5-Year Treasury Note Rate	4.02	3.91	4.04	4.28	4.43	4.25	4.23	4.43	3.50
10-Year Treasury Note Rate	4.42	4.28	4.28	4.45	4.63	4.39	4.36	4.63	3.72
30-Year Treasury Bond Rate	4.90	4.71	4.60	4.68	4.85	4.58	4.54	4.90	4.04
Tax-Exempt Bond Yield	5.22	5.18	4.30	4.20	4.19	4.04	4.14	5.22	3.83
Corporate Bond Yield (AAA)	5.54	5.45	5.29	5.32	5.46	5.20	5.14	5.54	4.68
Conventional 30-Year Mortgage Rate	6.82	6.73	6.65	6.84	6.96	6.72	6.81	6.96	6.18
Dow Jones Industrial average	41864	39876	42092	44209	43524	43656	43717	44209	38904
S&P 500 Index	5811	5370	5684	6039	5980	6011	5930	6039	5370
Dividend Yield (S&P)	1.32	1.43	1.34	1.24	1.26	1.24	1.23	1.43	1.23
P/E Ratio (S&P)	25.1	23.8	24.0	25.5	27.2	26.5	27.0	27.2	23.8
Dollar Exchange Rate (vs. Major Currencies)	122.7	124.5	126.5	128.1	129.0	127.8	126.5	129.0	122.1

* Monthly Averages

ECONOMIC INDICATORS

	May	April	March	February	January	December	November	12-Month Range High	12-Month Range Low
Housing Starts (Thousands of Units)	1256	1392	1355	1490	1358	1514	1295	1514	1256
New Home Sales (Thousands of Units)		743	670	653	662	718	676	743	623
New Home Prices (Thousands of Dollars)		407	404	412	431	423	398	431	398
Retail Sales (% Change Year Ago)	3.3	5.0	5.1	3.9	4.6	4.6	3.9	5.10	2
Industrial Production (% Change Year Ago)	0.6	1.4	1.2	1.2	1.4	0.4	-0.9	1.4	-0.9
Operating Rate (% of Capacity)	77.4	77.7	77.8	78.2	77.7	77.6	76.8	78.2	76.8
Inventory Sales Ratio (Months)		1.38	1.38	1.39	1.40	1.39	1.40	1.41	1.38
Real Gross Domestic Product (Annual % Change)			-0.2			2.5		3.1	-0.2
Unemployment Rate (Percent)	4.2	4.2	4.2	4.1	4.0	4.1	4.2	4.3	4.0
Payroll Employment (Change in Thousands)	139	147	120	102	111	323	261	323	44
Hourly Earnings (% Change Year Ago)	3.9	3.9	3.9	4.0	4.0	4.0	4.2	4.2	3.6
Personal Income (% Change Year Ago)		5.5	4.8	4.7	4.3	5.2	5.1	5.5	4.3
Savings Rate (Percent of Disposable Income)		4.9	4.3	4.4	4.1	3.5	3.9	4.9	3.5
Consumer Credit (Change in Blns. Of Dollars)		17.8	-3.4	-0.9	9.0	-110.3	-5.9	17.8	-110.3
Consumer Prices (% Change Year Ago)	2.4	2.3	2.4	2.8	3.0	2.9	2.7	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)	2.8	2.8	2.8	3.1	3.3	3.2	3.3	3.3	2.8
Wholesale Prices (% Change Year Ago)	2.6	2.5	3.3	3.4	3.7	3.4	2.9	3.7	2.1