Economic Update

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JULY 2025

Commentary

The markets continue to cheer the tamer path for tariffs than what was unveiled in early April. With the tail risk of an all-out tariff war seemingly averted, the stock market has soared to all-time highs. Equities (based on the S&P 500 Index) were up 2.7% in July and have gained 7.8% year-to-date. Economic data continues to show a cooling economy with some cracks but one that does not appear headed for a drastic near-term downturn.

Second quarter gross domestic product (GDP) data was released this week, with the headline growth data exceeding expectations largely due to international trading flows. Given all the volatility in net trade and inventories caused by the tariffs, we believe that it is best to focus on final sales to domestic purchasers (which is GDP excluding inventories and trade) to get a better handle on the underlying economy. This number came in at just 1.1%, which was a decrease from 1.5% in the prior quarter and the slowest pace since the end of 2022. Consumer spending did pick up from Q1 but grew at just 1% in the first half of this year versus the 3% pace in 2024.

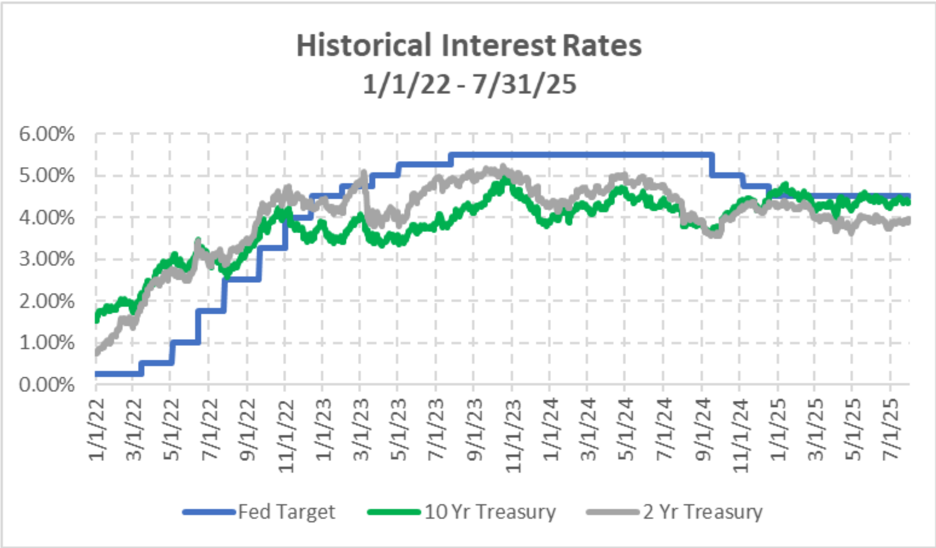
Indications of a slowing economy caused many to believe that the Fed would guide the markets for a rate cut at its next meeting in September. Instead, Chairman Powell provided no such clarity. He stated that the fed funds rate is “modestly restrictive” at current levels but cautioned that inflation is still above their target. Indeed, the Fed’s preferred inflation measure, core Personal Consumption Expenditures, has barely moved over the past year and stands at 2.6% versus the Fed’s 2% target. For the first time in three decades, there was more than one dissent at the Federal Open Market Committee (FOMC) meeting. Fed Governors Michelle Bowman and Christopher Waller both voted for a rate cut. While somewhat significant, the dissenting votes may have been more of auditioning to become the next Fed Chair. President Trump has made his disdain for Powell well-known as well as his strong wish for lower interest rates.

We continue to believe that the economy is getting close to stall speed. Labor market data has held up reasonably well but has shifted from job creation mode to an uneasy balance of lower labor supply and lower labor demand. With stalled inflation progress, it is difficult for the Fed to make a preemptive move lower in rates. They just can’t be as aggressive pushing rates down as the market wants. This increases the odds of a harsher landing.

THIS MONTH

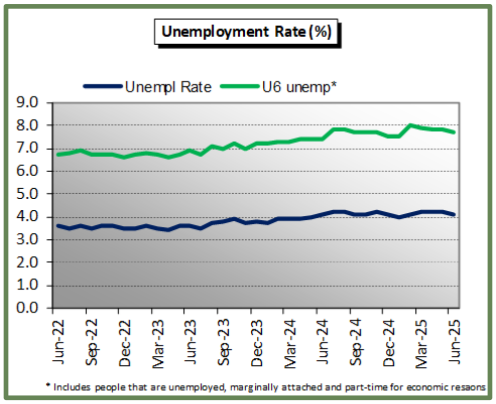
Fixed Income Outlook

Treasury rates moved higher during the month of July largely due to the more hawkish than expected FOMC meeting. The market is pricing in a 40% chance of a rate cut at the September 17 meeting and 1.5 cuts through the end of the year. We see greater than 50% odds that the Fed cuts in September. By most estimates, a 25 basis point cut would still leave the fed funds rate modestly restrictive and send a message that the Fed acknowledges the risk of slowing growth.



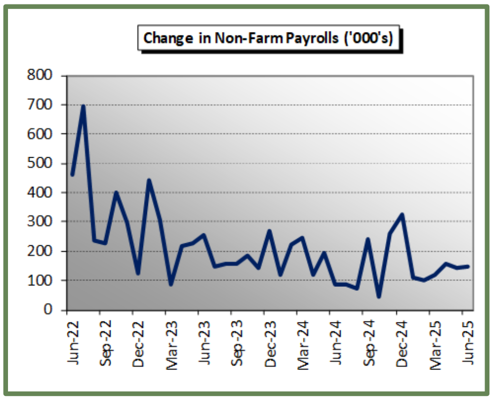
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Declines

The unemployment rate in June unexpectedly fell to 4.1% from 4.2% the prior month. The market was expecting the rate to increase to 4.3%. The underlying details of the report were weak. For the second consecutive month, the labor market shrank and the labor force participation ratio contracted.

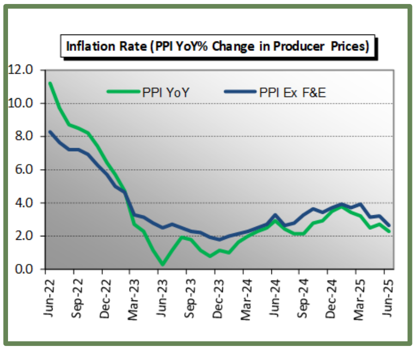


Payroll Growth Stronger than Expected

Payroll growth in June exceeded consensus expectations. Payrolls increased by a net 147,000 jobs versus an estimated 106,000 gain. Private sector job growth was weaker than expected due to the cancellation of federal contracts in the education and health sectors. The Department of Government Efficiency job cuts should start showing up in the data over the next several months, which should push the payrolls number lower.

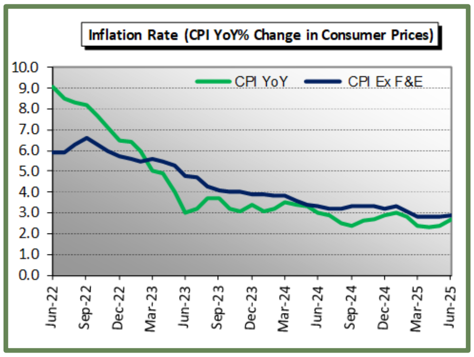
Inflation Readings

(Data source: Bloomberg)



Producer Prices Moderate

Producer prices in June were unchanged on a month-over-month basis and fell to 2.3% from 2.6% on a year-over-year basis. Both were lower than expected. The lower than expected reading was mainly due to a large decline in travel service prices.

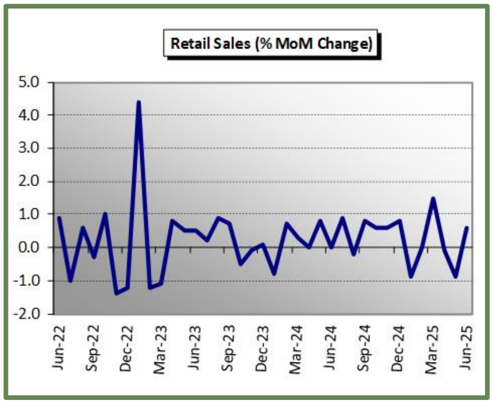


Consumer Inflation Slower than Expected

Consumer inflation in June was lower than expected for the fifth consecutive month. Month-over-month inflation data for headline inflation met expectations, but core inflation was lower than expected. The impact of tariffs are beginning to hit goods prices as toy prices increased the most since 2021 and appliance prices increased by the largest amount in almost five years. This was offset by a decline in new and used car prices.

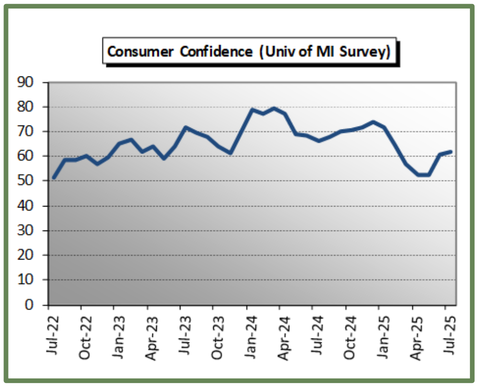
Consumer Readings

(Data source: Bloomberg)



Retail Sales Rebound

Retail sales in June increased by more than expected after experiencing declines the previous two months. 10 of the 13 categories posted an increase. The report has tempered some of the concern of a continued retrenchment in consumer spending.



Consumer Confidence Rises

Consumer confidence increased in the preliminary July report and stands at the highest level since February. Inflation expectations experienced a significant decline from the prior month.