Economic Update

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Commentary

The markets have been awaiting Jerome Powell's speech at the Fed's annual Jackson Hole economic symposium for several weeks now, hoping to get some more clarity on the path of short-term interest rates. Chairman Powell surprised many during his speech on August 22, where he struck a much more dovish tone than he has at his post-Federal Open Market Committee press conferences over the past several months. The stock market loved the new perspective and climbed back to within a whisker of all-time highs. (The S&P 500 is up almost 10% year-to-date.) Treasury rates declined by 10 to 15 basis points across the curve.

Chairman Powell opened his speech by stating that the "balance of risks appears to be shifting." Clearly, the large downward revision to payrolls last month has him worried that the labor market is getting too soft. This is understandable now that three-month average payroll growth is at its lowest level in 15 years (not including the pandemic impacts). In addition, he noted that the labor market is experiencing a tenuous equilibrium, with both labor supply and labor demand falling. He mentioned that if the downside risks to the labor market materialize, the impact could be rapid and non-linear.

Turning to inflation, he made no mention of the much higher than expected producer inflation data from last week. (July's monthly increase was the largest in over three years.) He stated that it is "reasonable" to believe that the tariff impact will be a one-time event and will produce only a temporary lift to inflation. He downplayed the risk of a potential wage-price inflation spiral since the labor market is facing "increasing downside risks."

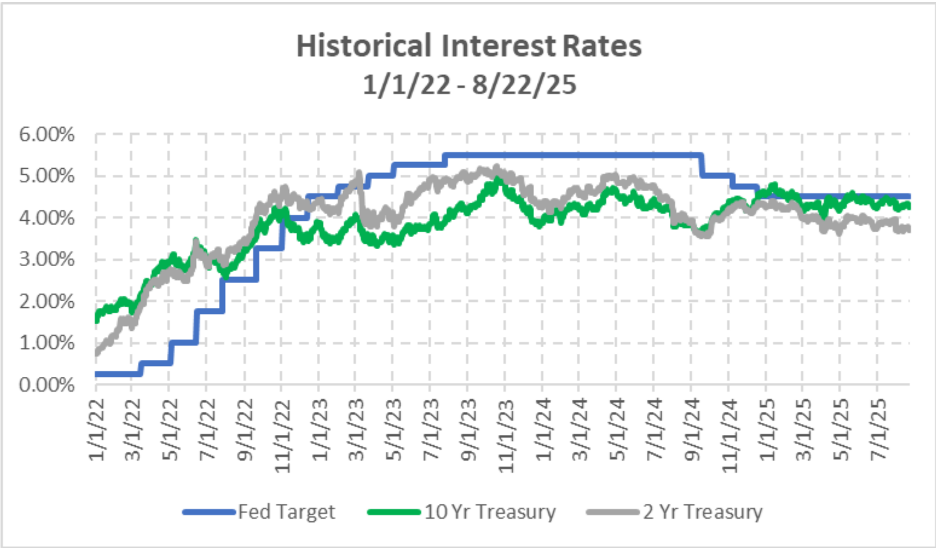
Along with the markets, we were surprised by the much more dovish tone. The Fed got burned the last time that they believed an upward impact to inflation (the pandemic) was temporary (or "transitory," as the Fed liked to say). There aren't many textbooks that would have the Fed cutting rates when we are almost 100 basis points above their target inflation rate. Still, Powell would argue that the fed funds rate is currently restrictive given that it is 150 basis points higher than what the Fed considers the neutral rate.

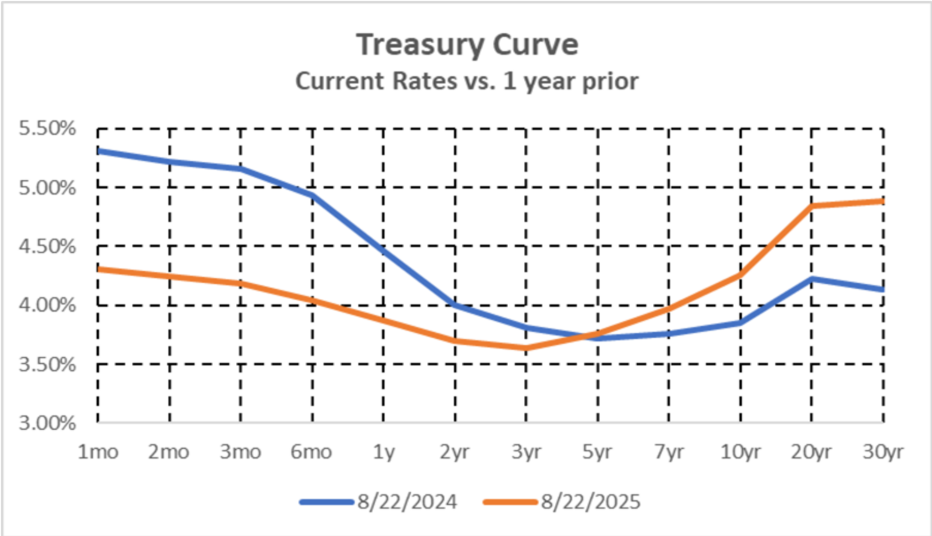
We think that the Fed will be cautious in their movements but will be more willing than we previously believed to take some preemptive steps to avoid an economic downturn. We share the concern that the labor market may be weakening too quickly. We still believe that a large economic downturn is not in the cards, but near-term recession risks are elevated.

THIS MONTH

Fixed Income Outlook

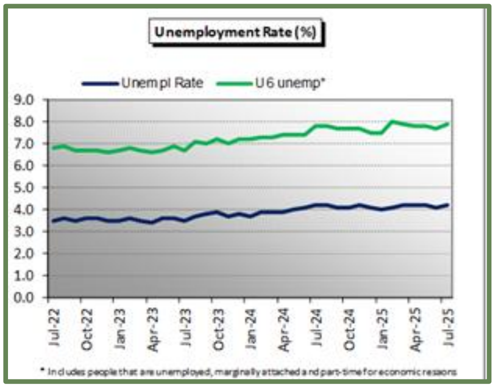
Treasury rates moved significantly lower in early August after the much weaker than expected labor market data. Rates declined by 10-20 basis points across most of the curve. Rates retraced some of that movement after some higher inflation data but shifted back lower after Chairman Powell's speech on August 22. The markets have priced in an 81% chance of a rate cut at the September meeting and another cut in December. At this point, the bar is high for the Fed not to cut in September. We agree with market pricing at these levels.





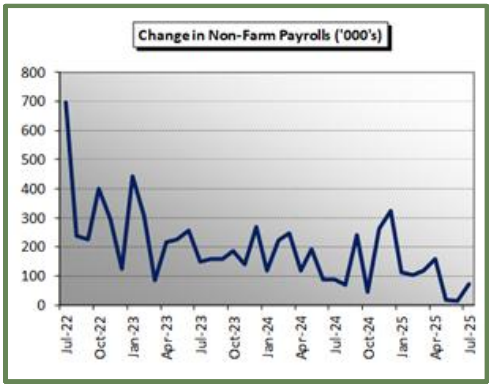
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Unchanged

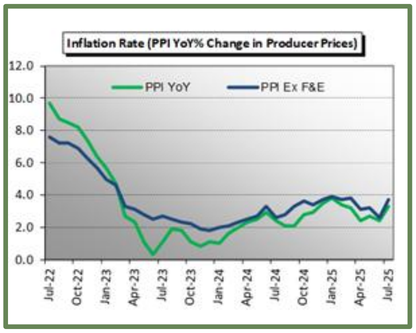
As expected, the unemployment rate in July remained unchanged from the prior month at 4.2%. The underlying details of the report were weak. For the third consecutive month, the labor market shrank and the labor force participation ratio contracted. Labor supply and demand appear to be both contracting.



Large Negative Revision to Payrolls

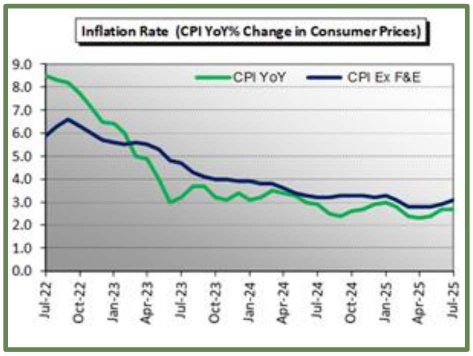
Payroll growth for July came in lower than expected at 73,000 versus the expected 105,000. The bigger story was the large negative revision for the previous two months. Payrolls were revised downwards by 258,000. Three-month average payroll growth is now at its lowest level in 15 years (excluding the pandemic).

Inflation Readings
(Data source: Bloomberg)



Producer Prices Jump Higher

Producer prices in July were much higher than expected. Prices rose by .9% on a month-over-month basis and 3.3% on a year-over -year basis versus expectations of .2% and 2.5%, respectively. It was the largest monthly increase in over three years.

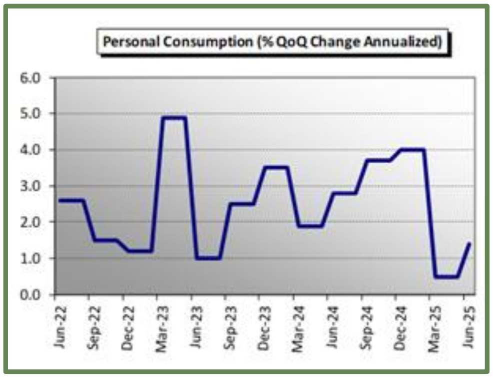


Consumer Inflation as Expected

Consumer inflation in July rose by 2.7% on a year-over-year basis, which was unchanged from the prior month. Core inflation rose by 3.1%, the most in six months. Goods prices rose at a relatively tame pace, indicating that the tariff pass-through to consumers is still low.

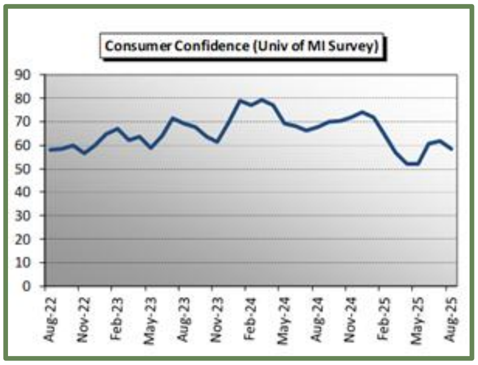
Consumer Readings

(Data source: Bloomberg)



Consumer Spending Subdued

Consumer spending in Q2 improved from the previous quarter but remains sluggish. Spending was 1.4% in Q2 versus .5% in Q1. The pace for the first half of 2025 is the lowest in consecutive quarters since the start of the pandemic.



Consumer Confidence Declines

Consumer confidence decreased for the first time in four months in the preliminary August report. Inflation expectations bounced higher from the previous month. Consumers continue to express concerns about future employment and inflation.