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Economic Update

THIRD QUARTER 2025
OCTOBER 3, 2025

Quarterly Key Points

- Sources of uncertainty are not in short supply in 2025. The S&P 500 is at all-time high levels and the investment grade credit index spread levels are at all-time tights. Additionally, measures of interest rate volatility have plummeted since the dramatic Liberation Day spike and interest rate markets have remained remarkably stable.
- 2Q GDP growth measured 3.8% q/q annualized, following two upward revisions, on robust consumption and investment that were stronger than initially estimated. Personal consumption accelerated to 2.5% q/q annualized, up from only 0.6% in 1Q. Growth forecasts for the third quarter range from 1.2% to 2.7% q/q annualized.
- The Fed delivered a 25 bps cut at the September FOMC meeting. In the post meeting press conference, Chair Powell characterized the cut as a "risk management cut," as the downside risk to employment has increased along with inflation risk.
- Inflation has once again started trending in the wrong direction with most measures increasing through late summer. Forecasters and central bankers have been expecting an uptick in inflation as tariffs work their way through the system. So far, this increase has not been as high as expected. The market is currently pricing in a one-time inflation adjustment attributable to tariffs followed by a return to trend.
- The labor market continues to slow, furthering a downward trend in job creation that emerged earlier this year. Despite low consumer confidence readings and elevated uncertainty, the consumer remains resilient. Manufacturing orders have been consistently contractionary for the better part of the past three years, while the ISM Services PMI remains barely expansionary.

Our View

- The economy has tolerated uncertainty amid various potential sources of volatility rather well. Tariffs have not yet translated into an alarming rise in inflation and risk assets continue to perform well, shrugging off any incremental changes. While the Fed eased monetary policy in September, a stagflation scenario is perhaps materializing. Geopolitical tensions and the U.S. Government shutdown are additional sources of uncertainty.
- We continue to recognize the potential for policy changes at home and abroad as sources of volatility, and more time is needed to judge the impact. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment.

3Q 2025 – THE MARKET ADJUSTS TO MULTIPLE SOURCES OF UNCERTAINTY

Sources of uncertainty are not in short supply in 2025. Last quarter, tariffs, the pending reconciliation bill, the debt ceiling, geopolitical turmoil, immigration reform, and Federal Reserve (Fed) independence were among the factors poised to bring additional volatility to financial markets. One quarter later, the S&P 500 is at all-time high levels and the investment grade credit index spread levels are at all-time tights. Additionally, measures of interest rate volatility, such as the ICE BofA MOVE (MOVE) Index, have plummeted since the dramatic Liberation Day spike. The MOVE index has now returned to a level last seen before the Fed started its rate hiking cycle in early 2022. Despite this, potential sources of volatility remain. Although the One Big Beautiful Bill Act passed early in the third quarter which removed debt ceiling concerns for the time being, the U.S. Government is currently shut down because Congress has yet to pass an appropriations bill. Notably, the government shutdown will result in delays of economic data releases, including the employment report for September. With inflation remaining stubbornly above target and labor markets trending weaker, this delay in data is another source of potential volatility. For now, however, the market appears to have adjusted to this new and uncertain landscape.

Meanwhile, interest rate markets have remained remarkably stable. The 2-year Treasury yield fell 11 basis points (bps) during the quarter, winding up at 3.61%, while the 10-year Treasury decreased only 8 bps to 4.15%. Year-to-date, the 2-year is 63 bps lower while the 10-year is 42 bps lower resulting in steepening of just 21 bps. Over the quarter, longer-term real rates and breakeven inflation rates were also well-behaved with 10-year real rates lower by 15 bps and 10-year breakeven inflation wider by 7 bps.

2Q GDP growth measured 3.8% q/q annualized, following two upward revisions, on robust consumption and investment that were stronger than initially estimated. Personal consumption accelerated to 2.5% q/q annualized, up from only 0.6% in 1Q. Measures of spending were considerably stronger compared to the previous quarter with spending on goods measuring 2.2% q/q annualized and spending on services measuring 2.6% q/q annualized. While gross private investment declined by -13.8% q/q, this was largely a reversal of tariff driven front running earlier in the year.

Overall, GDP grew at a 1.6% annualized rate during the first half of the year, considerably lower than previous years. However, incoming data suggests underlying momentum is stronger than anticipated. Growth forecasts for the third quarter range from 1.2% to 2.7% q/q annualized. The median recession probability forecast on Bloomberg is relatively low at only 33%. We believe more time is needed to determine the ultimate impact of shifting policies on the economy and the heightened level of uncertainty continues to cloud the outlook. However, the downside tails are likely fatter than in the recent past.

THE FED SHIFTS MONETARY POLICY, DELIVERS A CUT

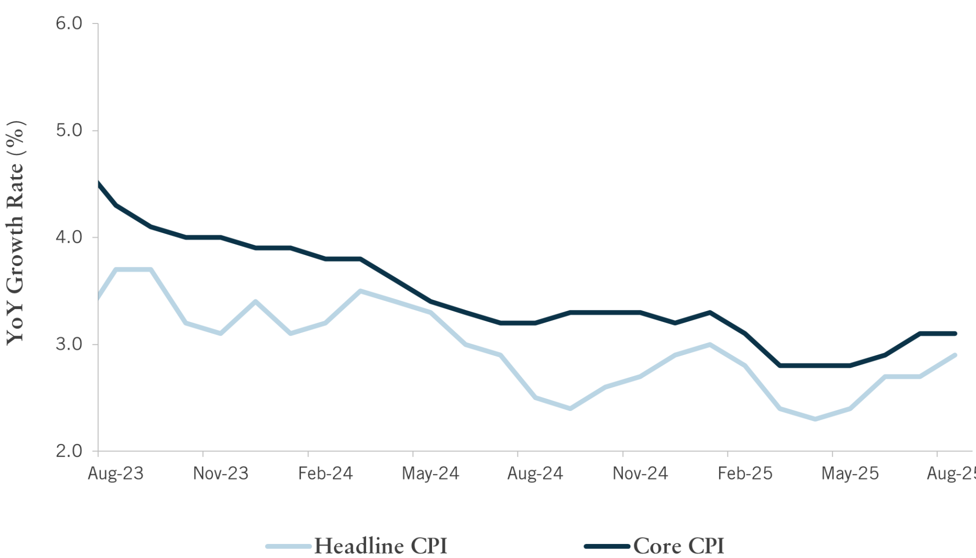
In the face of sticky inflation and a slowing labor market, the Fed kept rates unchanged throughout the summer. In a repeat of summer 2024, the Fed stayed on hold at its July meeting, just days before the release of core PCE and a dismal employment report. Notably, there were two dissenting votes at the July meeting for the first time since 1993. Nevertheless, Fed Chair Powell's press conference message leaned hawkish in tone despite mounting pressure to lower interest rates. Shortly thereafter, however, Chair Powell delivered the keynote speech at the Jackson Hole Economic Symposium in August, suggesting that "the shifting balance of risks may warrant adjusting our policy stance," signaling a dovish turn. The August employment report reinforced the need for a change in monetary policy and the Fed delivered a 25 bps cut at the September FOMC meeting. In the post meeting press conference, Chair Powell characterized the cut as a "risk management cut," as the downside risk to employment has increased along with inflation risk. He also acknowledged the tenuous position the Fed is facing with the potential for stagflation which would bring difficult decisions regarding the dual mandate of price stability and full employment.

Additionally, the Fed completed a five-year review of their Statement on Longer-Run Goals and Monetary Policy Strategy in August. In its last review five years ago, the Fed moved to flexible average inflation targeting which allowed inflation to run above or below the 2% target with the goal of reaching an average 2% rate over an unspecified time horizon. The updated framework targets 2% inflation more directly in place of the previous flexible inflation average. The change is expected to help address the difficulty in communicating policy with deviations from the average.

INFLATION PROGRESS STALLS ONCE AGAIN

Inflation has once again started trending in the wrong direction with most measures increasing through late summer (Figure 1). After reaching a low point of 2.3% y/y in April, headline CPI slowly increased to 2.9% y/y in August. Meanwhile, core CPI increased to 3.1% y/y in August after bottoming out at 2.8% y/y last spring. We believe month-over-month and rolling 3-month numbers provide a stronger signal of trajectory than year-over-year measurements. With that in mind, headline CPI increased by 0.4% m/m in August while core CPI increased by 0.3% m/m. Both measures previously bottomed out at 0.1% m/m in May. On a rolling 3-month average basis, both headline CPI and core CPI accelerated to 0.2%-0.3% m/m over the past several months from a low of 0.1% m/m in May, implying an annualized run rate of approximately 2.5%-3.5%.

FIGURE 1: HEADLINE CPI VS. CORE CPI



Source: Bloomberg

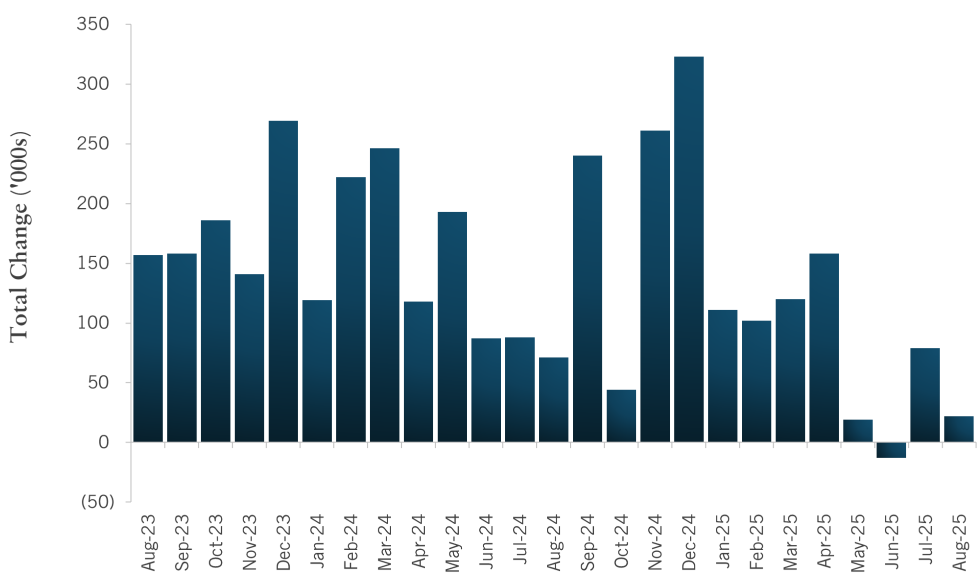
PCE inflation shows a similar pattern. Headline PCE increased to 2.7% y/y in August while core PCE accelerated to 2.9% y/y. Measured month-over-month, headline PCE rose 0.2% in July and 0.3% in August while core PCE registered 0.2% increases in both months. On a rolling 3-month average basis, both headline PCE and core PCE have averaged 0.2% m/m since June implying ~2.5% y/y annualized run rate. Headline PPI and core PPI increased by 0.7% m/m in July before falling by -0.1% m/m in August. On a year-over-year basis, core PPI is 2.8% in August while headline PPI is 2.6%. On a rolling three-month basis, both headline PPI and core PPI measured 0.2% m/m in August.

Forecasters and central bankers have been expecting an uptick in inflation as tariffs work their way through the system. So far, this increase has not been as high as expected. The market is currently pricing in a one-time inflation adjustment attributable to tariffs followed by a return to trend. Short-term inflation expectations, represented by the 2-year breakeven inflation rate, have increased slightly to 2.63% after falling to a low of 2.41% in mid-June. Meanwhile, long-term inflation expectations have come back down with 5-year breakeven and 10-year breakeven registering 2.45% and 2.37%, respectively. Importantly, the 5-year, 5-year forward breakeven rate remains well anchored at ~2.30%.

CONSUMERS AND BUSINESSES HOLD THEIR GROUND DESPITE SLOWING LABOR MARKETS

The labor market continues to slow, furthering a downward trend in job creation that emerged earlier this year. As previously noted, the September employment report was delayed due to the U.S. Government shutdown. June nonfarm payrolls saw -13k jobs added, marking the first negative job creation since December 2020 (Figure 2). July and August were not much better, adding 79k and 22k jobs respectively, dragging the 3-month average down to only 29k jobs. The monthly average so far this year has been ~75k per month whereas the monthly average was 168k per month in 2024 and 216k per month in 2023. Despite slower job creation, the unemployment rate increased only slightly to 4.3% in August after previously being range bound between 4.0% and 4.2% since May 2024.

FIGURE 2: NONFARM PAYROLLS



Source: Bloomberg

Despite low consumer confidence readings and elevated uncertainty, the consumer remains resilient. Adjusted retail sales growth has seen broad-based increases with consistent upward revisions. June, July, and August measured 1.0% m/m, 0.6% m/m, and 0.6% m/m, respectively. Retail sales ex-autos followed suit, rising by 0.9% m/m in June, 0.4% m/m in July, and 0.7% m/m in August. In similar fashion, nominal personal consumption increased by 0.5% m/m in both June and July and 0.6% m/m in August; core personal consumption gained 0.3% m/m in June and 0.4% m/m in both July and August. Measured year-over-year, nominal personal consumption growth consistently has been 5.0%-5.6% while core personal consumption growth has been between 2.5%-3.2%. More recently, nominal personal consumption growth increased to 5.6% y/y in August and core personal consumption growth jumped to 2.7% y/y. Personal income growth measured 0.4% m/m in both July and August translating into 4.9% y/y and 5.1% y/y, respectively. Month-over-month real hourly income growth has generally been positive, with occasional flat to negative readings. The personal savings rate, measured as a percentage of disposable income, is headed lower after peaking last spring at 5.7%, measuring 4.8% in July and 4.6% in August.

Manufacturing orders have been consistently contractionary for the better part of the past three years, only briefly breaking into expansionary territory for a few months at the start of 2025. Since February, the ISM Manufacturing PMI has measured between 48-49, most recently registering 48.0 in July, 48.7 in August, and 49.1 in September. Business new orders followed a similar pattern, peaking in January, with June and July measuring 46.4 and 47.1, respectively, before increasing to 51.4 in August. Most recently, business new orders slid back to 48.9 in September. The downturn in early summer could potentially reflect a pullback after front-running the onset of tariffs earlier in the year. The ISM Services PMI remains expansionary, yet at a slightly lower level than at the beginning of the year. After registering 49.9, 50.8, and 50.1 in May, June, and July, respectively, the index jumped back up to 52.0 in August before turning lower to 50.0 in September. Industrial production has been on an upward trajectory in 2025, climbing all the way to 104.2 in June, before staying strong at 103.8 in July and 103.9 in August. Capacity utilization has also been steady at 77.4% in both July and August.

30-year fixed mortgage rates, as measured by Freddie Mac, fell to ~6.3% at the end of the quarter. Existing home sales have measured approximately 4.0 million units in every month since February. New home sales volumes spiked to 800,000 units annualized in August after bouncing between 600,000-700,000 units annualized over the previous several years. Existing home supply has slowly drifted upwards and now measures ~4.5 months. The supply of new homes dropped sharply to 7.4 months of supply in August coinciding with the dramatic increase in new home sales during the same month; however, this still remains above pre-pandemic levels. Home price appreciation continues to stall out, with the S&P Cotality Case-Shiller home price index posting month-over-month declines for the past five months. The 20-city composite registered seasonally adjusted decreases of -0.2% m/m in June and -0.1% m/m in July, resulting in the year-over-year basis slipping to 1.8% y/y in July.

LOOKING AHEAD

The economy has tolerated uncertainty amid various potential sources of volatility rather well. Tariffs have not yet translated into an alarming rise in inflation and risk assets continue to perform well, shrugging off any incremental changes. While the Fed eased monetary policy in September, a stagflation scenario is perhaps materializing. Geopolitical tensions and the U.S. Government shutdown are additional sources of uncertainty.

We continue to recognize the potential for policy changes at home and abroad as sources of volatility, and more time is needed to judge the impact. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value when yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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