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U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **Trust The Process**

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The summer has kicked off with some excitement about central banks starting their cutting cycles, but the Federal Reserve is not among them. While other advanced economies can justify easier policy on the basis of slower inflation and growth worries, the resilience of the U.S. economy is holding rates higher for longer. Hiring continues while layoffs have been limited, and wage gains are outpacing inflation. Consumption and investment are settling into steady, sustainable paces. The Fed's ability to be patient is a luxury afforded by a positive economic context.

If benign inflation reports multiply, we believe the Fed will be on track for a first cut in September. However, the margin for error has eroded; another surprise from the data could push easing further off into the future. We, and the Fed's decision makers, are taking the data one month at a time, with hope for the soft landing still intact.

Following are our thoughts on recent data and developments.

Key Economic Indicators

	2024				2025				Q4 to Q4 change			Annual change		
	24:1a	24:2f	24:3f	24:4f	25:1f	25:2f	25:3f	25:4f	2023a	2024f	2025f	2023a	2024f	2025f
Real Gross Domestic Product (% change, SAAR)	1.6	2.2	1.7	1.3	1.4	1.5	1.5	1.6	3.1	1.7	1.5	2.5	2.5	1.5
Consumer Price Index (% change, annualized)	3.8	3.5	2.9	2.6	2.5	2.4	2.3	2.2	3.2	3.2	2.3	4.1	3.3	2.6
Civilian Unemployment Rate (%, average)	3.8	3.9	4.0	4.1	4.1	4.2	4.2	4.2				3.6*	4.0*	4.2*
Federal Funds Rate	5.38	5.38	5.34	5.08	4.85	4.56	4.16	3.66				5.05*	5.29*	4.31*
2-yr. Treasury Note	4.48	4.90	4.70	4.35	4.00	3.80	3.70	3.61				4.58*	4.61*	3.78*
10-yr. Treasury Note	4.16	4.45	4.20	4.10	4.10	4.00	4.00	4.00				3.96*	4.23*	4.03*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The employment report for May offered something for everyone. Payroll gains of 272,000 show good demand for labor. However, a decline in employment reported by the household survey brought the unemployment rate up one tenth to 4.0%, its highest level in over two years. Wage gains ticked up to 4.1% year over year, arresting a recent decline and providing a cautionary omen for service price disinflation.
    - In past cycles, the divergence between the establishment and household surveys has been a leading indicator of a broader labor market decline. However, the steadier gains seen in the establishment survey seem to be more accurate and are corroborated by other public and private labor market indicators.

  - Job openings in April fell by over 300,000 to 8.1 million, the lowest reading since a surge in 2021. The ratio of openings to unemployed workers stands at 1.2, the same proportion seen in the healthy pre-pandemic era. The labor market is relaxing through fewer openings and slower hiring, but not mass layoffs—a best-case outcome that seemed too good to be true when the Fed's tightening cycle began.

- Inflation as measured by the consumer price index (CPI) showed welcome relief in May. Lower energy costs and flat food prices led to an unchanged trend on the month, bringing the year-over-year measure down one tenth to 3.3%. Excluding food and energy, core CPI improved two tenths to 3.4% over the past 12 months, a three-year low. Disinflation was widespread, with monthly declines in prices for categories like apparel, new vehicles, vehicle insurance and airfare. Rent and owners' equivalent rent remain the leading sources of inflationary pressure.
  - The Fed's preferred measure, the deflator on personal consumption expenditures, measured 2.7% year over year in April, or 2.8% on a core basis. Inflation remains focused in the services and shelter categories, with core services excluding housing weighing in at 3.4%.

- At its June meeting, the Federal Open Market Committee did not change policy, in line with expectations. The quarterly Summary of Economic Projections showed opinions on the committee vary from zero to two cuts by the end of the year, with conservative expectations for core inflation to merely hold steady through December.
  - As of June, the Fed's taper of balance sheet reductions is underway, with declines in U.S. Treasury holdings now capped at $25 billion per month. In the first two years of quantitative tightening, the Fed's securities portfolio value has run down by over $1.6 trillion, without consequence; slowing the pace of the process after a rapid decline is an appropriately cautious adjustment.

- The Fed's efforts to cool the economy through tighter financial conditions have not borne fruit. The risk rally that started last fall has not abated, with equity indices continuing to climb to all-time highs. Volatility has shifted to fixed income markets, with the yield on the 10-year Treasury more likely to reflect immediate market sentiment. Spreads on corporate bonds are holding at very narrow levels. Spreads on new mortgages are contracting slightly but remain historically elevated amid rate volatility. However, higher mortgage rates are not depressing home values amid constrained supply.

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