VIEWPOINT

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Economic Commentary:

Rate Cuts on the Horizon

September 2025

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Economic data and an interim speech by the Fed chair have moved the probability of an imminent interest rate cut by the Federal Open Market Committee (FOMC) to 100%. Although inflation remains elevated, weakening in the labor market will likely mitigate the inflationary impact of tariffs since consumer spending will slow as unemployment increases.

Inflation Challenges Persist

The headline Consumer Price Index (CPI) for July was +0.2% for the month (in line with expectations) and remained at 2.7% year-over-year. Since peaking at 9.1% in the summer of 2022, little progress has been made during the past 12 months. Last year at this time, July 2024, the year-over-year CPI was 2.9%. Drawing more attention was July's Core CPI which rose at the fastest monthly pace since January (+0.3%), driven by stronger inflation in services. The year-over-year Core CPI rose to 3.1% in July from 2.9% in June. Notably, tariffs were not a substantive source of Core CPI price pressures during the month. Latent price pressures were indicated by July's core Producer Price Index (PPI) which showed the sharpest monthly increase since March 2022 and is now at 3.7% year-over-year. Producer prices typically lead consumer prices.

The Fed's preferred inflation index, the Core Personal Consumption Expenditure Index (Core PCE), confirmed the readings from the CPI and PPI with pricing pressures more evident from services than from goods. The Core PCE rose 0.3%, as expected, bringing the year-over-year reading to 2.9% from 2.8% in June. In short, price stability (one of the two Fed mandates) is proving more challenging to achieve, providing some basis for members of the FOMC who want to be more deliberate in making any interest rate policy changes.

> *Markets are now pricing in 100% probability of a September rate cut along with two more cuts by the January 28, 2026 meeting."*

John Beuerlein
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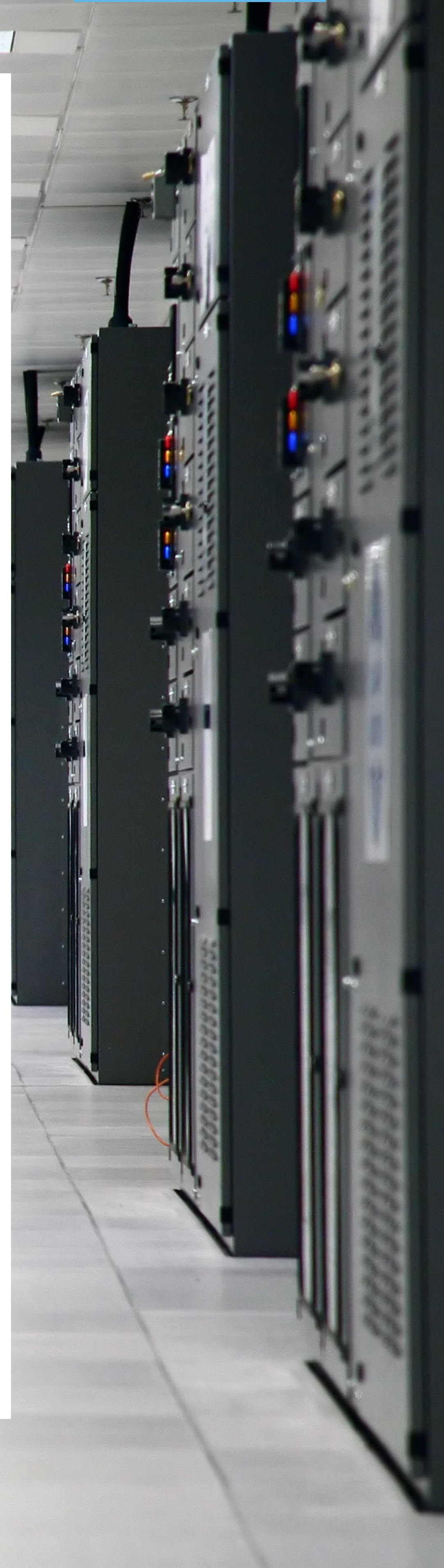

Consumer Spending Slows as Disposable Incomes Shrink

The U.S. consumer has been supported by steady wages and salaries; however, continued elevated inflation pressures are reducing real (inflation adjusted) disposable incomes which will slow real consumer spending. In July, real disposable income increased 0.2%, but that followed a 0.7% decline in May and a flat June. Over the last three months, real disposable personal income is running at a -1.8% annualized rate. Real personal consumption expenditures (spending) were up 0.3% in July, and up only a +1.0% annualized rate for the last three months. The softening labor market will create headwinds for spending with the saving rate now at a low 4.4%.

The second estimate of real GDP growth in the second quarter was revised up 0.3% to 3.3% from the first estimate. The increase primarily reflected a decrease in imports, which are a subtraction in the calculation of GDP, and an increase in consumer spending. Looking at the first six months of 2025, real GDP is up 1.4% (annualized) and consumer spending is up 1.0% (annualized). The biggest support for the economy in the first half of 2025 came from business equipment investment in AI-related technology. Outside of this investment, business equipment spending has been essentially flat because of policy uncertainty. Corporate profits in the second quarter were up 1.7% quarter-over-quarter, partially reversing the 2.3% decline in the first quarter. Recession odds have decreased but remain higher than normal as the current low level of growth makes the economy more susceptible to extraneous shocks that may occur.

Manufacturing Struggles Amid Mixed Signals

The ISM Manufacturing Index for August was 48.7 – the sixth consecutive month below the neutral rate of 50 – while the subindices were mixed.

- New orders moved above the 50 level for the first time since January, but production dropped to a three-month low at 47.8
- Employment posted the second weakest reading of the past 12 months at 43.8 and overall, only seven of 18 industries were in expansion
- The ISM Services Index for August was 52.0 versus 50.1 in July
- New orders came in at 56.0, the best reading since October
- The employment subindex was 46.5, its third month in a row below 50
- Demand for data centers is one area providing support while rising tariff costs are keeping the prices-paid index elevated at 69.2.

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Labor Market Weakens with Rising Unemployment

The Employment report for August provided further confirmation of the weakening labor environment. Non-farm payrolls increased by only 22,000, (private payrolls +38,000, government payrolls -16,000) well below expectations. June payrolls were revised further to show a 13,000 decline (the initial reading on June payrolls was +147,000). The three-month average employment gain is down to 29,333, below the estimated number of jobs needed to keep the unemployment rate steady.

Full-time employment from the Household Survey declined by 357,000 after a 440,000 decline in July. Over the past four months, full-time employment has declined by 983,000 while part-time workers have increased by 510,000. The increasing number of full-time job losses has negative implications for consumer spending.

The unemployment rate rose to 4.3% from 4.2% due to an increase in the labor force of 436,000, but only an increase in the number of employed of 288,000, while the unemployed increased 148,000. The labor force participation rate increased to 62.3% from 62.2%. In short, labor demand decreased while supply increased, despite immigration outflows.

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Fed Faces Tough Choices as Rate Cuts Near

The next meeting of the FOMC is September 16 – 17, at which they are expected to cut the Federal Funds rate from the current 4.25% - 4.50% range. Chair Powell's speech at Jackson Hole on August 22 opened the door to the possibility of a change in monetary policy at the September meeting by stating that "the downside risks to employment are rising." The August Employment report has removed any doubts about the weakness in the labor market, thus justifying an interest rate cut. The Employment report followed the September 3 release of the Fed's Beige Book which reported on economic conditions in the 12 Federal Reserve districts in the prior six weeks. Here is a key passage from the Beige Book:

"Seven Districts noted that firms were hesitant to hire workers because of weaker demand or uncertainty. Moreover, contacts in two Districts reported an increase in layoffs, while contacts in multiple Districts reported reducing headcounts through attrition—encouraged, at times, by return-to office policies and facilitated, at times, by greater automation, including new AI tools. In turn, most Districts mentioned an increase in the number of people looking for jobs."

Clearly, most of the focus is on the labor market (the second of the Fed's two mandates). But markets are also expecting a further increase in year-over-year inflation readings over the remainder of the year due to the tariffs and low comparative monthly inflation readings in the fall of 2024. Any unexpected substantive and persistent increase in inflation readings would put the Fed in the unenviable position of determining which of their mandates to prioritize – price stability or maximum employment.

Markets are now pricing in 100% probability of a September rate cut along with two more cuts by the January 28, 2026 meeting. Even with an interest rate cut, interest rates will still be above the perceived neutral rate of interest which is 3.0% - 3.25%. In other words, interest rate policy will still be considered restrictive. It must also be remembered that monetary policy affects the economy with a lag. Therefore, any cut in interest rates should not be viewed as an immediate panacea for a slowing economy.

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