



Economic Commentary:

Cracks in Spending,
Employment and Growth

July 2025

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Economic reports issued in June indicated no significant changes in the trends seen since the beginning of the year: slowing economic activity, subdued inflationary pressures, cautious consumer spending and narrowly based job gains. Consequently, the Federal Reserve kept monetary policy on hold for the fourth consecutive meeting since the last rate cut in December. News on tariffs took a backseat to the debate over the mega tax and spending bill that was finally signed on July 4.

Inflation Tame for Now

Both the Headline and Core CPI (Consumer Price Index) readings were +0.1% for the month of May. On a year-over-year basis, the Headline CPI is 2.4% and the Core CPI is 2.8%. The Fed's preferred measure of inflation, Core PCE (Personal Consumption Expenditures), was +0.2% in May, up from 0.1% in April, bringing the year-over-year reading to 2.7%. Price data have been tame, but that is principally because businesses are still working off the bloated inventory that they built up prior to the tariff announcements. Since the "reciprocal" tariffs were only announced at the beginning of April, the full impact of those tariffs is still a few months away. The unknown that concerns the Fed is the extent of the price hikes ahead, and how sustainable they will be.

Consumer Spending and Credit Strain

After a strong month of spending by consumers during March, when Personal Consumption Expenditures (PCE) rose 0.7% in anticipation of the tariffs, April saw spending increase by only 0.2%, or 0.1% on an inflation adjusted basis. Retail sales (representing about 40% of PCE) showed consumers pulling back from areas affected by tariffs.

Real disposable income in May was -0.4% while Real Personal Consumption Expenditures were -0.1%. With incomes falling faster than spending, the savings rate declined to 4.5% from 4.9% in April. Softer spending on discretionary items was evident as consumers are pushing back on tariff-related price increases. Consumer surveys indicate spending intentions for major purchases are being rolled back. This slowdown in consumer spending that is evident through the first half of the year is a significant concern for the growth outlook in the economy.

Growing consumer strain is apparent as credit card balances have fallen at an annual rate of 6.9% over the last six months – behavior last seen during the pandemic and the Great Financial Crisis (GFC). Delinquencies on credit cards have risen above 12% for the first time since GFC. According to a recent survey by the New York Federal Reserve, one in eight credit card holders do not believe they will be able to make a minimum payment over the next three months. The Buy Now Pay Later (BNPL) option for consumers is being increasingly used and, importantly, its usage is now being incorporated in the calculation of FICO scores, thus potentially impacting access to credit for those overusing BNPL.

GDP Revisions Lead to Weaker Start in 2025

The final reading on real GDP in the first quarter of 2025 was revised down to a -0.5% annual rate from the previous estimate of -0.2%. Weaker consumer spending in the first quarter was the most significant revision. The original estimate for consumer spending was +1.8% (annualized), but the final number was only 0.5%. When this revised data for the first quarter are combined with what has been reported for the first two months of the second quarter, the average pace of spending in the first half of 2025 is 1.0%, down from the 3.1% pace for all of 2024.

Manufacturing and Services Giving Mixed Signals

The ISM Manufacturing Index for June rose to 49.0 from 48.5 but remains in contraction (a reading below 50) for the fourth consecutive month. Weak readings from the sub-indices related to New Orders, Order Backlogs and Employment suggest that additional weakness in manufacturing is likely. The ISM Services Index moved back into expansion with a 50.8 reading from 49.9 in May. Nevertheless, service providers note that uncertainty about the economy is slowing consumers' desires to spend, and consequently, hiring has slowed and the employment sub-index fell into contraction.



Labor Market Showing Cracks Beneath the Surface

The June Employment report showed an increase of 147,000 in non-farm payrolls, and gains in April and May were revised up by 16,000. Although the June gains were well above the market expectation of 106,000, it is important to note that 131,600 (89.5%) of the gain came from health/social services and state/local government. These sectors are not highly correlated with economic activity, and thus their employment gains aren't necessarily reflective of economic strength. Private sector employment gains were only 74,000, the weakest gain in eight months.

- The unemployment rate declined to 4.1% from 4.2%, but, as in May, the number fell because the labor force contracted by 130,000, even though the civilian population increased by 200,000.
- The labor force participation rate is down to 62.3%, the lowest since December 2022.
- The average weekly hours for all private sector workers declined 0.1 to 34.2 hours, an indication that employers are reducing hours in response to softer economic conditions.
- 23.3% of unemployed workers have been looking for work for more than 26 weeks, up from 20.4% in May and the second highest level over the last three years.

There are cracks developing in the employment picture that are feeding into slower economic growth. For now, however, the overall employment picture is strong enough to give the Fed more time to keep policy on hold as it monitors the impact of tariffs.

Federal Reserve Holding Steady Amid Uncertainty

The Federal Open Market Committee (FOMC) met on June 17 - 18 and held the target range for Fed Funds steady between 4.25% and 4.50%, as expected. In the statement after the meeting, the FOMC said that uncertainty about the economic outlook has “diminished but remains elevated.” Of particular note, estimates for year-end inflation rose from 2.8% to 3.1%, and growth estimates were lowered from 1.7% to 1.4%.

Chair Jerome Powell has stated that the Fed likely would have cut interest rates by now if not for the economic uncertainty created by President Trump’s tariffs. While the Fed is worried about potential inflation from tariffs, tariffs are effectively taxes that will be paid by corporations (resulting in lower earnings) or by consumers (reducing disposable income). In either case, the impact of tariffs will slow economic activity.

Markets are currently pricing in one or two interest rate cuts by the end of the year with the first cut likely to occur in October.

Finally, with the passage of the tax and spending bill, the non-partisan Congressional Budget Office (CBO) baseline projections indicate Federal deficits above 5% each year for the coming decade. This estimate does not include the potential impact of a recession. At some point, the Fed’s mandates for low inflation and full employment may need to include consideration of the level of short-term interest rates in order to finance the growing debt. Historically, as the lines between fiscal policy and monetary policy become blurred, long-term economic growth is negatively impacted.

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