



Economic Commentary:

Navigating Chaos and Cracks
in the U.S. Economy

June 2025

June 2025

The chaotic implementation of U.S. trade policy has created an environment of uncertainty with repercussions that cascade from the Federal Reserve to the corporate sector and ultimately to the consumer. The continual shifting and extension of policy deadlines only increases the likelihood of a more protracted slowdown of economic activity. Ironically, it is the unpredictable actions of the administration that are keeping monetary policy in a restrictive mode despite repeated calls by the President to lower rates.

Inflation Trends

Reports on inflation during April were in-line or below market expectations. The Consumer Price Index (CPI) and the Core CPI both came in at 0.2% for the month, a tenth below expectations. The year-over-year CPI declined to 2.3% from 2.4% in March, while the year-over-year Core CPI remained at 2.8%. The Fed's preferred measure of inflation, the Core Personal Consumption Expenditure (PCE) index, was +0.1%, as expected, bringing the year-over-year figure down to 2.5% from 2.7%. Declining energy prices and disinflation in services offset the nascent increase on imported goods due to tariffs. Since the "reciprocal" tariffs were only announced at the beginning of April, the full impact of those tariffs is still a few months away.

Consumer Spending & Savings Behavior

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 personal income, on the other hand, increased by 0.7% during the month, fueled by a surge in government transfer payments. Consumers saved their extra income, bringing the savings rate to an 11-month high of 4.9%, up from 3.5% at the end of 2024. Consumers are increasing their savings while scaling back their spending, which is an indication that consumers are sensing a slowing economy and becoming more cautious.

Core durable goods orders in April declined 1.3%. Businesses front-loaded orders prior to the tariffs but have since been slow to make long-term commitments associated with durable goods.

GDP Contraction & Corporate Profitability

The second reading for real GDP in the first quarter continued to show contraction, but there was a slight improvement from the initial estimate of -0.3% to -0.2% annualized. The main driver of the revised reading was an improvement in private inventories due to the surge in imports ahead of the tariffs. On the other hand, real final sales to private domestic purchasers (a measure of the underlying demand for domestically produced goods and services) eased from an initial reading of 3.0% to 2.5% annualized, the slowest rate in nearly two years.

Corporate profits declined 2.9%, the most since 2020, suggesting that businesses are absorbing some of the cost of the tariffs. Businesses still have room to absorb higher costs as profit margins, although down slightly, remain elevated. Going forward, the willingness of businesses to absorb additional costs coupled with the ability to pass some costs through to consumers will impact corporate profitability and the ability and willingness to hire new employees.

Manufacturing & Service Sector Contraction

The ISM Manufacturing Index for May contracted for the third consecutive month to 48.5, the lowest reading since last November. There was a slight improvement in the New Orders sub-index, rising to 47.6 from 47.2, but that still indicates a degree of contraction in New Orders. The Prices Paid sub-index remains elevated as pipeline price pressures reflect the impact of tariffs. The ISM Service Index fell into contractionary territory with a 49.9 reading as a result of lower business demand and a sharp drop in New Orders. This is first time that both ISM indices have been in a contraction mode (below a reading of 50.0) since last June.

U.S. Credit Downgrade

On May 16, Moody's downgraded the U.S. credit rating from Aaa to Aa1, citing concerns about the nation's growing debt and interest costs. This follows a similar downgrade of U.S. debt by S&P in 2011 and Fitch in 2023. A downgrade generally leads to higher borrowing costs as investors demand a higher yield to compensate for increased risk.

Cracks in the Employment Picture

The May Employment report showed an increase of 139,000 in non-farm payrolls, while gains in March and April were revised down by 95,000. The unemployment rate remained at 4.2%, but the labor force contracted by 625,000, bringing the labor force participation rate to its lowest level since December 2023. If the labor force had not contracted, the unemployment rate would have increased to 4.6%. Average hourly earnings were up 0.4% during the month and the year-over-year figure remained at 3.9%. The wage figures remain consistent with the Fed's 2.0% inflation target, assuming 2.0% productivity growth.

The breadth of labor market growth is deteriorating as the diffusion index (a measure of the percentage of industries where employment is growing) dropped to a six-month low of 50.0, down from 60.8 at the end of 2024.

Non-farm payrolls are only growing 1.1% year-over-year, a rate that has historically led to sub-par economic growth unless productivity is exceptionally strong.

The April JOLTS report (Job Openings and Labor Turnover Survey) showed an increase in layoffs, while the quits rate dropped as workers found it harder to get new jobs.

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.



The Fed's Balancing Act on Monetary Policy

The next meeting of the Federal Open Market Committee (FOMC) is June 17 -18. The target range for Fed Funds is expected to remain unchanged between 4.25% and 4.50%. Public speeches by FOMC members over the past few weeks indicate that they are willing to remain patient to understand the impact of tariffs on the economy and inflation measures before making any changes in monetary policy. Monetary policy is currently in a restrictive mode and the longer the Fed waits to lower interest rates, the more slowing the economy is likely to endure.

The recent Beige Book (the summary of commentary on current economic conditions in each of the 12 Federal Reserve districts) indicated that all Fed districts reported elevated uncertainty, leading to cautious behavior by businesses and households. Firms reported delaying hiring decisions, but layoffs were not pervasive. In total, a lower demand for labor was reported.

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 September or October.

If current weak trends of economic activity continue, the Fed will be forced to ease monetary policy by cutting the Fed Funds rate, but the uncertainty about the impact of tariffs mentioned at the outset is keeping the Fed on hold for now. The concern is that the Fed will wait too long to change monetary policy, thus unnecessarily prolonging the economic slowdown. They were guilty of a similar mistake (in the opposite direction) when they were slow to tighten monetary policy in response to accelerating inflation in 2021.

For more information please contact:

John Beuerlein | *Chief Economist, Pohlrad Companies*

Lanie Beck | *Senior Director, Content and Marketing Research*
lbeck@northmarq.com | (918) 494-2690

Northmarq

3500 American Blvd W | Suite 500
Minneapolis, MN 55431
(952) 356-0100
www.northmarq.com