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STONEBRIDGE ECONOMIC OUTLOOK

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Overview

Key U.S. economic statistics showed notable fluctuations during the first half of 2025, which were associated with changes in federal policies and their implementation by the Trump administration. Real gross domestic product (GDP) increased by an annual rate of 3.8 percent in the second quarter after a decrease of 0.6 percent in the first quarter, influenced by the potential for high tariffs and their variable application. Inflation, measured by the Consumer Price Index (CPI), also varied, rising at an annual rate of 1.6 percent in the second quarter following a 3.8 percent increase in the first quarter.

Despite these quarterly swings, the economy on average for the first two quarters of 2025 seemed to be okay, suggesting little need for monetary policy to be more stimulative. For example, according to the Bureau of Economic Analysis (BEA), real GDP grew at an average annual rate of 1.6 percent, which was roughly in line with most estimates of the economy's potential growth rate at full employment. Similarly, the Bureau of Labor Statistics (BLS) reported that the CPI rose by an average annual rate of 2.7 percent over the first two quarters of 2025, matching the pace observed over the four quarters of 2024 and remaining above the Federal Reserve's 2.0 percent target. Finally, the unemployment rate maintained a narrow range of 4.0-4.2 percent, and the average monthly increase in nonfarm payroll jobs was estimated at 129 thousand over the first six months of 2025. Indeed, when the Federal Open Market Committee (FOMC), which is the Federal Reserve's policy committee, met in late July, they assessed the risks to the economy to be slightly tilted toward higher inflation rather than lower employment. Hence, it was no surprise that the FOMC voted to keep its monetary policy stance in place.

More recently, the labor market data has shown signs of stalling. It started with the shockingly sluggish July employment report released by the BLS in early August, which estimated the increase in nonfarm payroll jobs at 73,000, which was much lower than expected. However, the great shock came from the sharp downward revisions to payroll jobs in each of the prior two months. May's initial report of a 144,000 gain in payroll employment was revised down to 19,000, while June's initial 147,000 was revised to 14,000.

This concern about the labor market was reinforced somewhat by the August employment data released early this month showing a gain of only 22,000, as well as revisions to June and July that on balance subtracted another 21,000 jobs from total jobs. Moreover, a few days later, the BLS reported that its preliminary benchmark revisions to the level of nonfarm payroll employment in March 2025 was down a whopping 911,000 than currently shown in the official data. [1] This wave of weaker payroll data seemed to convince the FOMC that the risks to the economy had shifted toward lower employment, inducing the committee to cut its federal funds rate target by 25 basis points at its September policy meeting. The FOMC also implied that they were leaning toward further cuts in the federal funds rate at each of the two remaining policy meetings this year.

Notwithstanding these developments, inflationary pressures persisted. In August, the CPI increased by 2.9 percent year-over-year, up from the 2.7 percent rise in July. The core CPI, excluding food and energy, advanced 3.1 percent compared to the previous year, marking the third consecutive monthly increase. Federal Reserve Chair Powell provided an excellent summary of the dilemma that the two-sided risks of higher inflation and lower employment represent for monetary policymakers. "Two-sided risks mean that there is no risk-free path." [2] The Federal Reserve easing too soon could risk fueling more inflation, forcing the Fed to reverse course later, while maintaining what is considered a restrictive policy for too long might

[1] The preliminary benchmark revisions are calculated only for March 2025 for the major industry sectors. Official establishment survey estimates will not be updated until the publication of the January 2026 Employment Situation news release, which will incorporate the final benchmark revisions.

[2] Chair Jerome H. Powell, Board of Governors of the Federal Reserve Board, *Economic Outlook*, Speech at the Greater Providence Chamber of Commerce 2025 Economic Outlook Luncheon, Warwick, Rhode Island, September 23, 2025.

weaken the labor market "unnecessarily."[3] In either scenario, financial markets could experience corrections owing to a flight away from risk.

By the numbers

As indicated in Table 1, the overall performance of the U.S. economy in the latter half of 2025 is projected to closely mirror that of the first half. Quarterly real GDP growth rates are expected to remain uneven, though less volatile than those observed in the initial two quarters. It is important to note that the bulk of the fluctuations in GDP growth rate in the first half resulted from significant changes in imports, which subtracted 4.7 percentage points in the first quarter and subsequently contributed 5.0 percentage points in the second quarter. Such pronounced fluctuations are not expected to repeat in the second half of the year.

Consequently, real consumer spending will be the key to GDP growth in the third and fourth quarters, reflecting more typical patterns. In the first half of this year, real personal consumption expenditures (PCE) contribution to real GDP growth was somewhat uneven as well, adding 0.5 of a percentage point in the first quarter and 1.7 percentage points in the second. Nevertheless, the average contribution was 1.1 percentage points, half the contribution of 2.3 percentage points for all of 2024.

Recent data suggests that consumer spending has rebounded from the sluggishness of the first half. According to the BEA, real PCE registered solid gains in each of the first two months of the third quarter, increasing at an annual rate of 3.0 percent versus an average gain of 1.6 percent in the first half of 2025. Indeed, the Federal Reserve Bank of Atlanta's GDPNow model estimates third-quarter real PCE growth at 3.4 percent. The GDPNow model should be viewed as providing a running estimate of GDP and its components prior to its release "based on available economic data for the current measured quarter."[4] Accordingly, I have raised my estimate of real PCE growth in the third quarter to 2.5 percent, resulting in real GDP growth being revised upward to 2.7 percent as well. The reason for my estimate of real PCE falling short of the recent GDPNow estimate is that real disposable income for the first two months of the third quarter is on track to increase a mere 0.2 percent at an annual rate.

Apparently, the wealth effect from the record high stock market and stellar house prices has encouraged the growth in spending to outpace income growth. As a result, the personal saving rate fell to 4.6 percent in August from 5.0 percent in June and the recent high of 5.7 percent in April. The implication is that if the stock market continues to hit new highs and house prices do not collapse, spending growth may continue to outpace income growth. My concern is that the stock market corrects, house prices stagnate, and real disposable income stubbles further owing to further weakness in payroll job growth.

One consideration that may have limited the downside to consumer spending is that over a fifth of the population now receives a Social Security benefit, including retirement, disability, and supplemental security income. For this reason, it is difficult to anticipate a recession without a sharp decline in employment. On the other hand, the preliminary benchmark revision to the establishment survey data in March 2025 cut nearly one million payroll jobs from payrolls, which will not be deducted from the official data until January 2026. Weaker payroll growth should cause weaker personal income growth over the remainder of the year, even before adjusting for inflation.

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[3] Ibid.

[4] GDPNow, Federal Reserve Bank of Atlanta, Center for Quantitative Economic Research, September 26, 2025.

Table 1
U.S. Economic Forecast

	Annual	2025 Quarterly				Annual	
	2024	**Q1**	**Q2**	**Q3*f***	**Q4*f***	**2025*f***	**2026*f***
Real Gross Domestic Product	**2.4**	**-0.6**	**3.8**	**2.7**	**1.0**	**1.7**	0.6
Civilian Unemployment Rate	4.2	4.1	4.2	**4.3**	**4.5**	**4.5**	**5.4**
GDP Chain-Type Price Index	2.4	**3.6**	**2.1**	**2.4**	2.8	2.7	2.2
Consumer Price Index, All	2.7	3.8	**1.6**	2.9	2.9	2.8	2.4
Consumer Price Index, Core	3.3	3.5	2.1	3.3	3.5	3.1	2.7
Price of WTI crude oil ($/bbl)	71.0	71.4	64.	66.1	**64.0**	**64.0**	**65.0**
Trade-Weighted Dollar	126.0	127.9	122.8	121.0	119.0	119.0	120.0
S&P 500 Operating Earnings	233.4	57.5	**64.0**	**65.0**	**63.0**	**249.2**	230.0
Percent vs. Year Ago	9.3	5.9	**9.7**	**9.9**	**2.9**	**6.8**	-7.7
91-Day Treasury Bill Rate*n*	4.6	4.3	4.3	4.3	**4.0**	**4.0**	**3.0**
10-Year Treasury Note Yield*n*	4.2	4.4	4.2	4.3	**4.2**	**4.2**	**3.8**
30-Year Mortgage Rate	6.6	6.8	6.8	6.7	**6.8**	**6.8**	**6.8**
Bank Prime Rate	7.6	7.3	7.3	7.3	**7.0**	**7.0**	**6.0**

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly estimates for real GDP and all measures of inflation are annual rates of change from the previous quarter. The quarterly estimates for the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

***n**—The 3-month and 10-year Treasury yields are at "constant maturities," which are interpolated by the U.S. Treasury from the daily yield curve for Treasury securities. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market that are obtained by the Federal Reserve Bank of New York.*

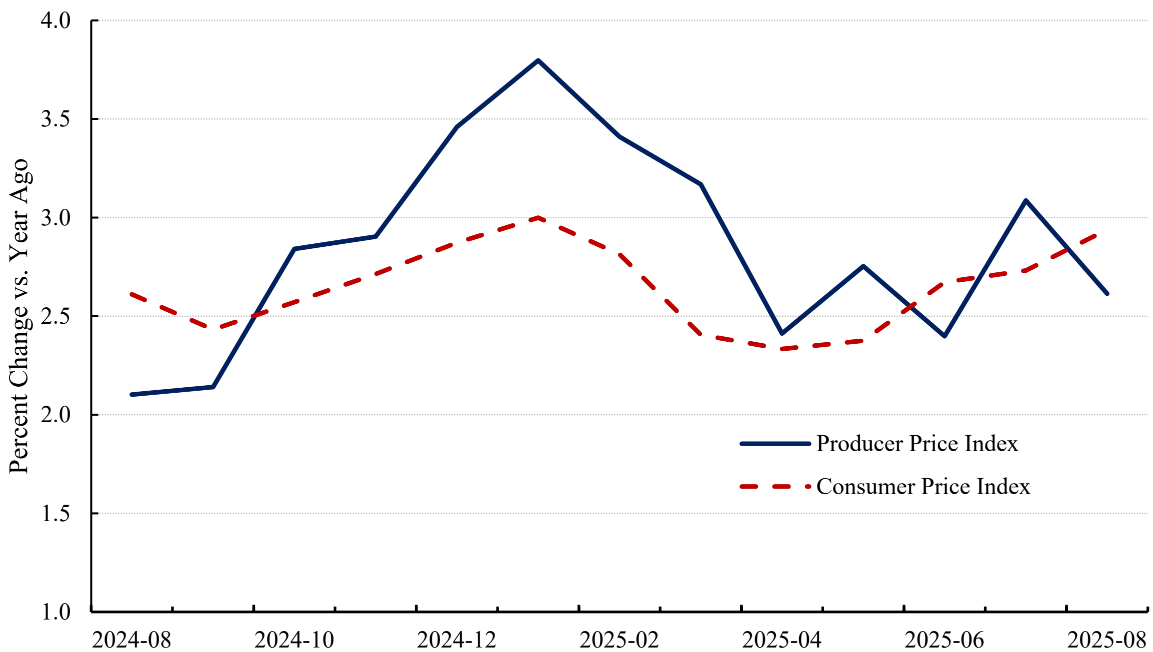
***f**—forecast: data points in bold type reflect a major change from the previous forecast.*

Consumer price inflation, measured by the percentage change in the CPI, is expected to remain elevated at a level close to 3.0 percent in the second half of 2025. As Chair Powell noted, "tariff increases will likely take some time to work their way through supply chains." Hence, even if higher tariffs represent a "one-time" increase, that does not mean "all at once."[5] The implication is that it will take time for the tariff effect to be fully captured in consumer prices. I agree, which is the primary reason I expect the CPI to increase 2.9 percent at an annual rate in the second half.

Interestingly, not all analysts agree that inflation is increasing. Chart 1 shows that the year-over-year percent change in the Producer Price Index (PPI) decreased to 2.6 percent in August from 3.5 percent in December 2024 (solid blue line). Some market participants point to this downward movement in the PPI as evidence that inflation may be moderating, suggesting that changes in the PPI can lead or correspond to changes in the CPI. While the two indices show some correlation over longer periods, differences in their concepts and definitions can result in significant divergence at times. This may be one of those times.

One distinction between the PPI and CPI involves imports: the PPI covers goods and services sold by domestic producers to households, thereby excluding imports, while the CPI covers all goods and services purchased by consumers regardless of their origin of production, including imports.[6] Given the current environment of high tariffs, the exclusion of imports in the PPI may help explain why the PPI declined 0.1 percent in August, while the CPI increased 0.4 percent in the same month. It may also help explain why PPI inflation decelerated so far this year, while CPI inflation has not. Another distinction between the two indices is that the PPI excludes taxes, since they do not represent producer revenue, while sales and other taxes paid by consumers are part of household expenditure and are included in the CPI.

Chart 1
Producer Price Index and Consumer Price Index



Source: Bureau of Labor Statistics.

[5] Ibid.
[6] U.S. Bureau of Labor Statistics, **Economic New Release: Technical Notes**, Last Modified Date: September 10, 2025.

Nevertheless, if employment weakens, then any near-term acceleration in inflation most likely will be dismissed as temporary by the Federal Reserve's FOMC. That said, given the "unusual and challenging developments" in the labor market highlighted by Chair Powell, identifying weakness in the labor market may not be as straight forward as the recent reports of stagnant payroll employment alone might suggest. [7] After all, there are two surveys in the monthly employment report, the household survey and the establishment survey. The former is used to derive the unemployment rate, while the latter is used to estimate the level of nonfarm payroll employment. According to Federal Reserve Chair Powell, the "there has been a marked slowing in both the supply of and demand for workers." The challenge facing the FOMC regarding monetary policy is how to interpret sluggish payroll job gains due to a lack of supply if labor demand is still enough to keep the unemployment rate well below 5 percent.

I contend that evidence of a more stagnant labor market in the form of a slightly higher unemployment rate may not surface until late in the fourth quarter. In this regard, the unemployment rate was 4.3 percent in August, which is up from 4.2 percent in July and above the average rate for the first half of the year. This slight uptick, combined with disappointing payroll jobs recently, apparently was enough to push the FOMC to lower its federal funds rate target 25 basis points at its September meeting.

In addition, I expect the unemployment rate to increase further over the next four months and real PCE growth to slow markedly in the final quarter of 2025. The combination of slower growth and weaker employment is expected to justify further cuts in the federal funds rate target by the FOMC, but probably only one more cut of 25 basis points this year. My best guess is that the cut is made at the December FOMC meeting rather than at the October meeting. Moreover, the fourth quarter may be a precursor to what is likely to transpire in the first half of 2026, including slow growth, little or no employment gains, and less inflation, all of which will tilt the risk of the economy to the downside and promote further cuts in the federal funds rate target by the FOMC.

Regarding economic data from government agencies going forward, the truth may be more in the revised data than in the initial reports given the lack of resources in the various agencies to collect and analyze the data. One way to counter this is to report the data less often rather than report incomplete data more frequently. In this regard, President Trump's nominee for Commissioner of Labor Statistics floated the idea of suspending the monthly jobs report in favor of quarterly reports from the Bureau of Labor Statistics until its methods can be improved to limit subsequent revisions. The sad truth is that less frequent reports will not eliminate revisions but only make them less frequent.

Most recessions in the United States are not immediately recognized at their onset. It is typically after data revisions that recessionary conditions become clear. The National Bureau of Economic Research, which determines business cycle timing, often announces the official start date for a recession retrospectively. In many instances, the announcement occurs when the recession is nearly over.

Stay tuned!

[7] Chair Jerome H. Powell, Board of Governors of the Federal Reserve Board, *Economic Outlook*, Speech at the Greater Providence Chamber of Commerce 2025 Economic Outlook Luncheon, Warwick, Rhode Island, September 23, 2025.

Important Disclosure Information

All information herein is as of September 30, 2025, unless otherwise indicated.

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