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Comfort with Current Economic Conditions Spurs Fed Divergence

Key takeaways

- The Fed left rates unchanged at its June meeting, intending to be patient while the effects of the tariffs work their way into economic and inflation data. Chair Jerome Powell reiterated his comfort with current economic conditions, but the governors seem to have diverging opinions.
- The decline in the Institute of Supply Management's Services PMI index to 49.9 is worrying, since a reading below 50 suggest that services may be contracting.
- Consumer confidence is growing and could rebound back further in a few short months if wages continue to grow, oil prices fall and tariffs don't detract as much from growth as initially feared.
- 139,000 nonfarm payroll jobs (NFP) were added in June, the unemployment rate held steady at 4.2%, but the pace of job growth continues to slow.

Recap

Markets remained well behaved in June despite a sharp increase in geopolitical risks. Several US large-cap equity indexes ended the month near all-time highs, corporate bond spreads narrowed and 10-year Treasury yields fell modestly. Economic growth remained solid but uneven, and inflation declined more than expected. Tariffs showed up in the news again, but major impacts to growth and inflation have yet to show in the data. At its June meeting, a data-dependent Fed maintained the federal funds rate in the same 4.25 to 4.50% range that has prevailed since December 2024. The budget resolution also made its way through the Senate.

The Fed left rates unchanged at its June meeting while continuing its quantitative tightening policy through balance sheet reduction. Policymakers' comments and the meeting minutes make it clear that the Fed intends to be patient while tariffs work their way into economic and inflation data. In the press conference following the meeting, chair Jerome Powell acknowledged that while inflation could rise in the short term due to tariffs, the long-term impact on consumer prices remains uncertain.

Later in the month, in his annual Humphrey-Hawkins testimony to Congress, Powell reiterated his comfort with current economic conditions. However, there does seem to be a growing divergence in opinion among the governors. Caution surrounding downside risks due to trade tensions and slowing global growth remain. In public speeches, governors Michelle Bowman and Christopher Waller advocated for cutting rates as soon as the July meeting.

The summary of economic conditions (dot plot) released after the June meeting showed that the committee lowered their expectations for growth while raising their expectations for inflation. The median growth projection fell from 2.1% to 1.4%. Core PCE inflation, the Fed's favored metric, is projected to rise to 3.1% from 2.8%. The new plot continues to suggest two 25-basis-point (bps) cuts in 2025. While the number of projected cuts is unchanged from the prior meeting, the number of participants expecting no change this year rose from four to seven.

Economic growth remains reasonably strong. GDPNow, the Atlanta Fed's real time GDP estimation, suggests second-quarter growth of 3.4%. With two-thirds of the quarter's economic data released, reasonable quarter-over-quarter growth seems assured. However, the economy shows signs of growing weakness. For instance, May retail sales declined by 0.9%—the largest decrease in four months. A decline in motor vehicle sales largely drove the decrease. On a brighter note, the portion of retail sales that are direct inputs to the GDP calculation, called the retail control group, rose a respectable 0.4%. More worrisome is the decline in the Institute of Supply Management's Services PMI index to 49.9. A reading below 50 suggest that services, estimated to be 70% of the economy, may have finally begun to contract. At 46.4, the forward-looking new orders segment of the survey implies significant weakness to come.

Wealth effects from the renewed rally in equities may act to improve consumer confidence and buoy services spending. Consumer confidence could also rebound back to where it was a few short months ago if:

- Wage growth remains consistent
- Oil prices fall due to a reduction in prices in the Middle East
- Tariffs don't detract as much from growth as initially feared
- The new budget extends or increases the 2017 tax cuts

Against this backdrop, the 10-year Treasury yield fell 17 bps on the month, and one- to 10-year investment-grade (IG) corporate credit spreads narrowed four bps on the month. The ICE BofA/Merrill Lynch 1–10 Year US Corporate Index returned 1.32% for the month and 7.83% for the trailing one year. Credit spreads in all sectors narrowed over the month. Leisure and autos performed best, while retail, media and consumer goods lagged somewhat. Lower quality again outperformed higher quality.

The US economy added 139,000 nonfarm payroll jobs (NFP) in June, while the unemployment rate held steady at 4.2%. However, the pace of job growth continues to slow. Over the last three months, NFP growth averaged 135,000 jobs versus the six-month average of 157,000. The four-week moving average of new claims for unemployment insurance might signal even more reason to worry. The average has risen from 212,000 in January to 245,000. While claims are still low, the rise has occurred quickly. Continuing claims are also elevated as jobs have become more difficult to find. Private surveys, like the ADP employment report, suggest far slower employment growth. The 37,000 jobs in this survey were the fewest jobs added since March 2023, and that number is very near the low end of growth for non-recessionary periods.

Looking ahead

Markets and the economy remain in wait-and-see mode as the final shape of tariffs and their ultimate effect on the economy become clearer. Changes are also happening from the downsizing of the federal workforce, the expiration of foreign work visas and the decline in immigration. All these may have significant negative impacts on the employment side of the Fed's dual mandate. The budget reconciliation and its effect on individual and corporate tax rates, particularly if support for the extension of the tax cuts appears to wane, is likely to increase volatility. The outcome rests largely on the willingness of the consumer to consume. We suspect that the third quarter will begin to provide answers. In the meantime, IG balance sheets are still solid, and attractive all-in yields continue to provide a hedge against uncertainty.

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