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The U.S. economy has shifted noticeably since the spring. After contracting in the first quarter, growth briefly rebounded, but the underlying picture has become more mixed. The labor market has continued to soften, inflation pressures have shown signs of re-accelerating, and both consumer and business sentiment have eased further. Together, these developments suggest that while the economy remains fundamentally resilient, the balance of risks has tilted more negative heading into the fall.

We entered 2025 with the economy stumbling in Q1: real GDP slid -0.5% annualized, dragged down by large imports front-loaded ahead of the tariffs. In Q2, the picture was reversed: GDP bounced back at a +3.3% annualized rate, led by stronger consumer spending and a sharp drop in imports (since imports subtract from GDP). Still, over the first half of the year, growth averaged a subdued 1.4%, and second-half growth estimates are broadly in line with this pace, implying full-year GDP in 2025 is likely to come in below 2%.

The labor market is cooling, though the unemployment rate remains within healthy territory. Job growth slowed sharply in August, with only ~22,000 new jobs added, while unemployment edged up to 4.3%. Average hourly earnings rose 3.7% year-over-year, a step down from July's 3.9%, but still slightly ahead of headline inflation.

This cooling has prompted the Federal Reserve to make its first rate cut this year. On September 17th, the Fed lowered its federal funds target range by 25 basis points to 4.00% - 4.25%. The Fed framed the move as "risk-management" in response to rising downside risks, particularly in the labor market, while reiterating their commitment to lowering inflation to 2%.

Inflation has begun to firm again from its spring lows. Headline CPI rose 2.9% year-over-year in August, up from a trough of 2.3% earlier this year. Core CPI, which excludes food and energy, stands at 3.1%, edging higher after bottoming at 2.8% in the spring. The PCE index has followed the same trend as CPI, rising 2.7% year-over-year in August, with the core measure up 2.9%. Tariffs are contributing to renewed goods price pressures, off-setting some of the easing seen in services categories, and these effects are expected to build through the second half of the year. In its September statement, the Fed acknowledged that inflation remains elevated and warned that risks of re-acceleration persist.

Treasury yields have shifted notably throughout the year, reflecting persistent inflation concerns and tariff-related risks. Despite the Fed's cut, both the 10-year and 30-year yields moved higher in its aftermath. The yield curve has steepened, which is typically viewed as a healthy sign and is an improvement from a year ago, but in this case the move likely reflects investor skepticism that inflation can return to target quickly. Bond markets are effectively signaling that policy should not be eased too aggressively while inflation remains near 3%. Mortgage rates also ticked up following the cut, undercutting the Fed's aim of making borrowing more affordable.

Sentiment has weakened over the summer. The University of Michigan's preliminary September survey showed consumer sentiment falling to 55.4, down from 70.1 a year ago and among the lowest readings since 2022. On the business side, ISM surveys show a more mixed picture: the Manufacturing PMI stayed in contraction territory at 48.7 in August, but the Services PMI held in expansion territory at 52.0, though at a slower pace than earlier in the year. Taken together the data point to a more cautious environment, with some firms pausing investment and hiring in response to higher costs, tariff uncertainty, and uneven demand.

Overall, the economy is slowing while inflation remains near 3%. This combination of modest growth and persistent price pressures points to a more challenging environment where households and businesses gain limited ground in real terms. The risk is not an immediate recession, but rather a period of sub-trend growth with inflation still elevated, leaving consumers and firms feeling squeezed. The path forward is still open for a soft-landing, but the margin for error has narrowed considerably.

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