



# Despite multiple headwinds, the US economy is proving stubbornly resilient.

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Despite multiple headwinds, including highly unpredictable trade policies and restrictive interest rates, the US economy is proving stubbornly resilient following a flat first quarter, anchored by consumer outlays which rebounded sharply in June. Job growth continues to be healthy, averaging 150,000 in the last quarter, exceeding expectations, and the unemployment rate edged lower to 4.1% in June, remaining within its range of the past year. Weekly claims for initial unemployment benefits, as good a real-time gauge of layoffs as is available, have been steady, suggesting stability in unemployment trends. Business and consumer confidence, which fell to multiple year lows this Spring in reaction to threatened draconian tariff measures and other economic uncertainties, are rebounding. Interest rate sensitive sectors, including housing, real estate and autos continue to be a drag on economic activity.

***Recent surveys signal economists have become less pessimistic that US trade policies would lead to slower growth and higher inflation, at least near-term, and polls show reduced chances of recession which the consensus now pegs at 33%, down from 45% in April forecasts. Expected GDP growth of 2.2% in the second quarter compares with economists' 0.8% expectations in April, and a reported slight decline for all of the first quarter.***

Most important, the tariff-driven inflation surge that economists had widely forecast has not yet materialized. While core consumer prices, which exclude volatile food and energy components, ticked up a bit in June, they remain at their lowest levels in four years, but still above the Federal Reserve's 2% target. We view tariff hikes as likely to have a one-time impact on inflation readings later this year, by as much as 0.7% in the fourth quarter, as measured by the CPI, though their impact will be partially offset by lower energy and shelter cost inflation.

***The longer-term impact of Trump's policies, which besides tariffs include a clampdown on illegal immigration, stepped-up deportations, and provisions in the recently signed tax and spending bill (OBBBA), will all take time to filter into the real economy. So, the cumulative effect on inflation from these policy changes, in addition to the eventual level of tariffs, will remain a wild card until later this year, causing the Fed to remain on the sidelines until then.***

## Rolling Recession

Putting aside the impact of Trump's on-again, off-again tariffs and other headline-grabbing stories of the day, GDP growth figures have remained surprisingly positive. Overall employment remains strong. Corporate profits have generally exceeded expectations and Wall Street earnings estimates have been

trending higher. Inflation has declined dramatically over the past two years and is likely to edge lower once the impact of Trump's tariffs has been absorbed, increasing the probability the Fed will cut rates later this year. In short, there are no signs of an imminent downturn in the overall economy. Yet, throughout the recovery and to this day, many economists continue to forecast a turn to recession. What they have missed, in our view, is that we have in fact experienced a series of sequential contractions across economically sensitive and cyclical sectors of the economy, including housing and autos, tech, freight, and commercial real estate, suggesting we have been in a rolling recession not captured in traditional macroeconomic snapshots. A rolling recession is evident, though, in the economic stress experienced in sectors and regions at different times. Therefore, unless job losses spike and consumer outlays, which account for 70%+ of GDP, experience a sharp downturn, overall economic data may not signal a recession in the traditional sense.

A rolling recession is not the usual, economy-wide contraction defined by the National Bureau of Economic Research (NBER). Instead, it is a scenario where different sectors of the economy contract sequentially, with contraction "rolling" through industries, regions or market segments without a synchronized downturn. Evidence of sector-by sector recession include housing beginning in mid-2022, manufacturing in 2022-2023, tech and white-collar layoffs in late 2022 through mid-2023, freight and transportation in 2023, and commercial real estate and regional banks in 2023-2024. We have also seen labor market segmentation where overall unemployment remained low, but job losses were concentrated in specific sectors. The recovery from COVID-19 saw strong services and hospitality rebounds which masked weaknesses in tech, finance, and logistics. Regional disparities, especially those reliant on tech, housing construction, or commercial real estate, have faced local downturns. San Francisco Bay Area, Austin, and Seattle experienced job losses and falling home prices, while the Sunbelt grew. Consumer resilience masked underlying weakness when personal consumption remained strong due to excess pandemic savings and tight labor markets, delaying a broader recession. However, lower income households increasingly turned to credit to sustain their spending, and credit card delinquencies/auto loan defaults rose sharply in late 2023, signaling consumer stress at that time.

Should the economy continue to experience these rolling recessions, as we expect, the implications for policymakers and investors are quite distinct from those we have historically experienced in a synchronized downturn, suggesting more targeted approaches. For example, for monetary policy, the Fed will need to balance inflation control with supporting weakening sectors. A one-size-fits-all interest rate policy may risk overtightening for some sectors while under-addressing overheating in others as is the current situation for housing and commercial real estate. For fiscal policy, traditional stimulus (e.g., broad tax cuts or stimulus checks) may be inefficient or unnecessary while focused fiscal support for hard-hit industries and regional aid for depressed metros would be desirable. For example, infrastructure and industrial policy might serve dual purposes of long-term competitiveness and short-term support to ailing manufacturing.

***For equity investors, paying greater attention to sector rotation as rolling recessions will create opportunities to add to sound long-term investments during periods when they are out of favor. Avoiding excessive concentration in favored sectors or industries will add value. For bond investors, credit spreads may widen unevenly so that lower quality bonds or industrials may weaken while investment grade issues may experience greater demand.***

## **Takeaways From Recent Economic Data**

## Consumption

Since the second quarter began, consumer spending, which accounts for 70% of GDP, has picked up, driven by resilient income and credit conditions. While tariff worries remain, consumers are still spending, perhaps less boldly. June retail sales surged 0.6% from May, well above expectations, following two months of lagging outlays. Core sales, which exclude autos and fuel, also rose 0.6%. These gains span auto dealers, home improvement, apparel, and restaurants/bars. High-frequency and payment data show stabilization and even growth. Bank of America reported 4% growth in overall second quarter spending on travel, entertainment, and services. JP Morgan/Citigroup both noted multi percent increases in card spending and volumes. JP Morgan's consumer-card revenue climbed about 7% year-over-year. During Q2 earnings calls, bank CEOs have described consumers as doing fine, citing strong spending and stable credit health, with JP Morgan emphasizing low delinquency rates. The Atlanta Fed's GDPNow Q2 growth estimate is currently 2.6%, driven in part by consumer spending momentum. Consumer surveys offer mixed signals: McKinsey and Deloitte note sentiment remains cautious, but Deloitte spotted the first uptick in discretionary spending intentions in nine months in May-June.

***The June retail sales data may be sending mixed signals. Some analysts view the June sales as front-loading, anticipating tariffs or school-season demand. Tariffs and inflation pressures continue to weigh on sentiment surveys, so while spending remains resilient, discretionary choices may be more selective. And as the performance of retail stocks diverges, discount chains are outperforming while furniture/electronics retailers are underperforming, highlighting a shift toward value purchases.***

## Jobs

The Fed is closely monitoring wage growth which has moderated slightly but still exceeds 4% annually, signaling tight labor conditions. The current rate of wage gains, well above the rate of inflation, is underpinning consumption. The NFIB Small Business Survey reports employers are having difficulty filling positions, although the severity of doing so has eased somewhat. The "quality of labor" remains a top concern. Finally, weekly jobless claims remain historically low, hovering around 220,000 to 240,000 in recent weeks, consistent with a healthy job market. Continuing claims have ticked up slightly year-over-year but remain modest, suggesting laid-off workers are generally able to find jobs. Low jobless claims indicate that layoffs are not widespread, and employers are generally holding onto workers.

## Housing Starts

Both housing starts and permits rebounded in June, but the details of the reports showed it was another month of weak homebuilding. The modest rebound for both comes after activity declined in May to the slowest pace since the COVID shutdowns. The 4.6% increase in starts was due entirely due to a 30.0% jump in the volatile multi-family category, which offset the 4.6% decline for single-family starts. The fact that more houses were completed than were started in the month reveals just how weak housing has been. Single family starts are down 10.0% in the last year while construction permits are down 8.4%. High interest rates, elevated prices, and lack of inventory have depressed the housing sector, which represents about 5.0% of GDP.

## Inflation

Consumer inflation in June, as measured by the CPI, remains above the Fed's 2.0% target with the headline rate creeping up as expected to 2.7% and the core reading at 2.9%, the largest gain in core in

five months. These increases come amid higher costs for some goods, suggesting tariffs were only beginning to have an impact on inflation figures in June, keeping the Federal Reserve on hold until later this year, longer than many had expected. Somewhat softer demand is limiting price increases for services like airline fares and lodging, keeping underlying inflation muted for now. That trend, if sustained, could ease concerns of a broad-based rise in price pressures from tariffs. Nevertheless, we expect the tariff-induced rise in inflation to become more evident in the July-August reports, as in June businesses were still selling merchandise accumulated before Trump announced sweeping import duties in early April. Recall that when in 2018 Trump slapped tariffs on washing machines it took several months for the duties on those goods to show up in the inflation data.

The Fed's preferred inflation gauge, the Personal Consumption Expenditures index (PCE) remains above its 2.0% target. Both headline (+2.3%) and core (+2.7%) PCE indicate persistent inflation. As tariffs, particularly those on apparel and furnishings, work their way through the system amidst a growing economy, headline PCE is expected to rise toward 3.0% later this year.

The Fed, acting cautiously, will remain on hold over the near term, until officials are able to assess whether tariffs will have a longer-term impact on prices. Consequently, absent an unlikely sharp downturn in the economy, the Fed will keep rates higher longer than expected previously, particularly if Trump kicks the tariffs can further into late 2025 or beyond.

Meanwhile, one-year inflation swaps have recently jumped to around 3.07%, signaling financial markets are anticipating a noticeable tariff-driven boost in inflation in the near-term. Consumer expectations, as shown in University of Michigan and New York Fed surveys, show year-ahead inflation expected near 3.0-3.2%, aligning closely with the swap market. Longer-term financial market expectations put inflation at 2.4% and Cleveland Fed's model peg 10-year inflation at 2.33%, gradually easing back toward the Fed's 2.0% target.

## **Forward-Looking Economic Indicators**

**ISM Manufacturing Index.** Activity in the manufacturing sector, which accounts for 11.4% of GDP, continued to decline last month, but by less than the consensus expected. June was the fourth consecutive month when the index has been below 50. (Recall readings below 50 signal contraction; readings above 50 signal expansion.) The major measures of activity declined, contributing to a reading of 49. The new orders index fell to 46.4, but the production index rose to 50.3 from 45.4 in May. The employment index fell to 45.0 from 46.8 in May, and the supplier deliveries index fell to 54.2 from 56.1. A measure of prices paid for raw materials showed slightly faster inflation, ticking up to 69.7, near the highest level since 2022.

The ISM Manufacturing Index had been below 50 for all of 2023 and 2025. June's weak reading, and signals of contraction over the past four consecutive months were largely due to uncertainty over trade policy and, more recently, conflict in the Middle East. Half of the eighteen major industries reported growth in June compared with six that reported contraction, and three that reported no change. Order books were already weak coming into this year and the added business uncertainty from on-again, off-again tariffs has put many customer orders on pause until predictability returns.

**ISM Non-Manufacturing Index.** The Index rose to 50.8 in June, exceeding the consensus. (Recall readings below 50 signal contraction; readings above 50 signal expansion.) New orders and business activity were responsible for the expansion reading. Services account for over 70% of the US economy. Uncertainty over trade policy, high interest rates and tensions in the Middle East are delaying activity

and investment. Service companies, once hamstrung by the difficulty of finding qualified help, are now taking a cautious approach with their hiring efforts, as reflected by a drop in the hiring index which fell to 47.2 in June, the third month of contraction in four months. The highest reading of any category was the prices paid index, which fell to 67.5 in June, the third contraction in four months. ***Though inflation pressures remain, the M2 measure of money supply is barely up when compared with three years ago, supporting the view we are likely to have lower inflation and slower growth in the year ahead.***

## Jobless Claims

The latest initial jobless claims data show a decline in the week ending July 12 to 221,000, down 7,000 from 228,000 the prior week, below the expected consensus of 234,000. This marks the fifth consecutive weekly drop in initial claims, and the lowest level since April, suggesting stronger than expected labor market resilience. Continuing claims rose slightly to 1.96 million for the week ended July 5. The four-week moving average of continuing claims, our preferred measure, remained elevated at 1.95 million, the highest reading since November 2021. These figures tell us that while new layoffs are well contained, some workers are taking longer to find new jobs, signaling a slight easing in labor market tightness.

## Outlook

Near term, we expect on-again, off-again tariffs and high real interest rates to linger, contributing to below-trend growth for a couple of quarters. However, improving consumer confidence as tariff uncertainties wane, fiscal stimulus from OBBBA, the anticipation of Fed rate cuts, and massive business investment to develop AI, estimated at \$250 billion over the next year, will allow the US to avoid a traditional recession, setting the stage for a broader economic expansion in 2026. The June reading of our firm's proprietary Economic Model, drawn from publicly available data and designed to signal a change in the direction of the overall US economy six to nine months in advance of an inflection point, remained above-trend, pointing to continued expansion ahead.

## Equity Investment Policy

US equities, bolstered by sound fundamentals, better-than-feared economic data, expectations of future interest rate cuts, and rising Wall Street S&P500 earnings estimates, continued their month's long climb, making fresh new highs in recent days. The stock market's impressive 25%+ rise from its April low continues to be led by mega cap tech stocks, which account for about 31% of the S&P 500, an extraordinary level of concentration by historical measures. Nevertheless, we find few of the usual markers associated with a general market top. For example, there is no evidence that *sentiment* is euphoric beyond a handful of tech shares. *Equity inflows* are accelerating but are well shy of prior extremes. While *mergers and acquisition* activity in the first half of this year was up 15%, deal volume is 9% lower than a year ago. There are early signs that *IPO* activity is returning but there are no indications it will turn frothy, at least near term. *Real interest rates* remain restrictive. *Earnings revisions* have turned higher. Analysts' estimates of corporate profits bottomed out in the last quarter. *New high data*, while still narrow, continues to edge up as new 1-month highs have persistently expanded since the April low. There have been no durable signs of a shift within the market towards *defensive leadership*. And high-yield and investment grade *credit spreads* remain tight by past standards. BAA spreads are at an all-time low.

Interestingly, in recent weeks we have once again seen the beginnings of a broadening-out in market

leadership which has, in the past, not been sustained as economic uncertainties drove investors back to mega cap growth stocks with assured earnings growth prospects.

While the indicators noted above show the stock market is on solid footing and are supportive of further general market advances, it is worth noting that 41% of stock market's 25%+ recovery since the April low, is attributable to the performance of a handful of heavily weighted, mega cap tech stocks including Microsoft (+35%), Nvidia (+75%), Broadcom (+70%), and Meta (+67%). Nvidia alone has a 7.4% weighting in the S&P500. A risk in today's market, where only 13% of the S&P500 cohort made new highs in the first half of the year, comes from its 31.6% concentration in the tech sector and another 9.6% in communications where, in the past, sentiment-driven corrections, which investors should never rule out, have been severe. For example, during the bursting of the dotcom bubble in 2000-2001, widely-owned tech stocks such as Cisco Systems (-86%), Intel (-82%), Oracle (-84%), Qualcomm (-85%), Amazon (-90%), and Yahoo (-96%) experienced far greater declines than the S&P which fell 49%, while the tech-heavy NASDAQ fell nearly 80%.

***Unique to this cycle, so-called meme stocks have been propelled higher by retail traders chasing momentum, driving prices of these stocks sharply higher absent fundamental reasons, underscoring how social media and gamified trading apps are fueling speculation and creating distortions in a remote corner of the market.***

From a valuation standpoint, stocks are richly valued by investors at 23x times forward earnings as measured by the S&P500, a cap weighted index. The S&P500 equal weight index, which is more representative of the average stock's valuation, while not cheap, is more reasonably priced at 18x forward earnings, not far above its average multiple, leaving room for further broad stock market gains. We see earnings momentum, positive operating leverage and cash tax savings, as underappreciated tailwinds for equities. With earnings rising into next year and the Fed closer to lowering rates, valuations can remain supported around current levels.

***A positive breakthrough in the current trade standoffs with China or the EU, or a more accommodative than expected Fed, could fuel further equity gains, while a deterioration in the outlook for the economy, a spike in the inflation numbers this fall, or slowing corporate profit growth could trigger a 10%+ correction given current elevated equity valuations.***

There has been no change in equity investment policy. Client portfolios remain fully invested within portfolio guidelines, well-diversified, balanced between *growth* and *value* investments, after we tactically added to the *growth* component this Spring. Our investment platform includes allocations to small cap domestic equities, as well as investments abroad in developed and emerging markets. By blending *growth* and *value* investments in a single portfolio, a style unique to Front-Barnett management, we seek to smooth portfolio returns over a market cycle.

## **Fixed Income Investment Policy**

Bond yields have been locked in a narrow trading range in recent months with the yield on benchmark 10-year US Treasury obligations currently close to 4.4%, after having been as high as 4.6% on April 11 and as low as 4.2% on July 25. The outlook for shorter term rates will depend on Fed policy which we expect to turn more accommodative this fall/winter, leading to lower short term rates. Longer-term yields, driven by prospects for inflation, are likely to remain sticky, near current levels where 30-year US Treasury bonds yield 4.93%, until there is greater clarity on the outlook for inflation. We continue to maintain a conservative duration target of 2.75 years in the laddered, high-quality corporate bond

portfolios we actively manage.

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Conference Board's Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. ISM Manufacturing Index: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the US economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. ISM Non-Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives. S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US. S&P 500 Growth Index: The S&P 500 Growth Index is a stock index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. S&P 500 Value Index: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a "style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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