

A Bifurcated Economy

The hoopla over the astonishing downward revisions to job growth in recent months- and the political tremors that followed - suggests that the labor market is weaker than thought. But that doesn't change our assessment of the broader economy. We already knew that the economy was sprouting fissures, and growth was slowing below its trend rate. However, we continue to believe that it is not on the precipice of a recession, as some alarmists are claiming. To be sure, the unfolding landscape is not very appealing, as slowing growth is being accompanied by faster inflation, a stagflation scenario that evokes harsh memories of the painful 1970s.

But don't compare the current environment with the one that prevailed 50 years ago. Nose-bleed inflation like that seen in the 1970s is not in the cards. Nor are the multiple deep recessions needed to bring inflation under control then likely to happen now. The economy is navigating muddy waters, but it should muddle through barring some external shock that knocks it off the rails. Internally, policy makers know what's at stake; if mistakes are made, they are poised to correct.

Indeed, with inflation and job growth trending in the wrong direction, the chance of a miscalculation looms large. The Fed has a dual mandate of pursuing maximum employment and price stability. Hence, it must make a choice which one to tackle when they are on a conflicting course. On its surface, the case for raising rates would seem to be stronger, as inflation is further away from the Fed's 2 percent target than unemployment, which at 4.2 percent, remains near historical lows. But in a departure from past practices, the usually data-dependent Federal Reserve is likely to downplay this statistical variance, believing that a rate cut would be more appropriate. For one, the tariff-induced rise in inflation is not as steep as feared and it makes sense to wait and see if it fades once the tariff impact plays out. For another, the low unemployment rate masks underlying cracks that are opening in the job market. It is harder to arrest deteriorating labor conditions than it is to bring down inflation. What makes the Fed's decision particularly complex now is that we are living in a bifurcated economy, with some sectors thriving and some struggling. Monetary policy is not equipped to distinguish between the two, and the divide is likely to widen in coming months.

Muted Inflation Impact

The market turmoil, including a 12 percent drop in stock prices, that followed the "Liberation Day" tariff threats on April 2 is now in the rear-view mirror. Stocks have since raced to new highs and bond yields have retraced a brief upward climb. One reason for the turnaround is that the extreme tariff hikes announced on that day did

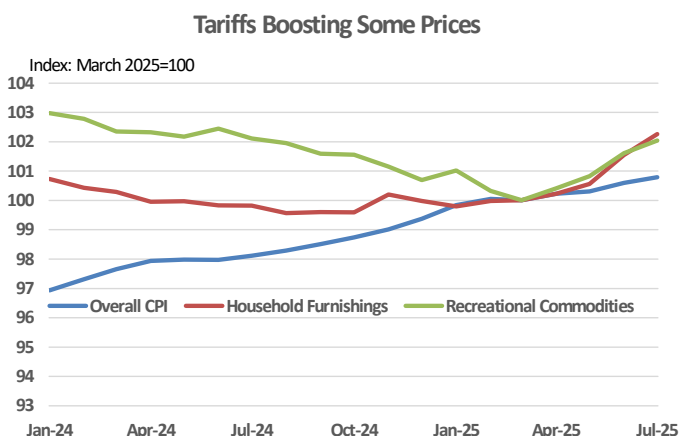
not come to pass. They were either postponed, rescinded or lowered through myriad deals with trading partners. While tariffs are considerably above where they were at the start of the year, they are still far below what President Trump threatened to impose on April 2. Investors heaved a sigh of relief that those extreme increases have been avoided, at least for now.

For another, the inflation impact has so far been much less than feared. Some of the tariffs have seeped through into prices, most notably on imported goods heavily exposed to tariffs, like home furnishings and recreational products (toys and pet products) that come almost entirely from overseas. Those prices have increased much faster than general prices. Overall, core good prices (as opposed to service prices that are less exposed to tariffs) are rising at the fastest pace in two years, increasing 1.1 percent from a year ago. That might not seem like much, but until March they had been deflating for more than two years.

Still, inflation directly linked to tariffs has not increased enough to deter the Fed from cutting rates, if it is inclined to do so. Nor is the rise in overall inflation much of a deterrent. True, it is heading in the wrong direction; but with the overall consumer price index rising 2.7 percent over the past year, and the core CPI that excludes volatile food and energy prices up by 3.1 percent, inflation is not alarmingly hot, particularly when viewed against the 9 percent peak rate reached in the post-pandemic inflation cycle.

Bifurcated Consumer

Much attention is being paid to the impact of tariffs on



inflation. That's understandable as the outcome will have a big influence on policy decisions, interest rates and overall financial conditions. The bigger the inflation impact, the bigger the ramifications for all the above. But assessing the impact of tariffs solely through the usual aggregate statistics, like the consumer price index, unemployment, etc., obscures the diverse impact they have on different segments of the economy.

One of the most underrecognized trends since the Covid pandemic is the increased bifurcation of the U.S. economy. High income households have thrived, thanks mainly to surging stock and home prices that have greatly enhanced the net worth of this cohort. Conversely, lower income households have fared less well, particularly after the generous pandemic related stimulus payments ran out. This cohort has relied primarily on income growth, which has notched decent gains early in the pandemic recovery amid labor shortages but has since tapered off as the economy has slowed. Indeed, recent data show that wage gains of lower-paid workers are not keeping pace with that of higher earners.

Importantly, lower income households are likely to be more affected by the impact of tariffs because they spend a disproportionate share of their income on the most affected goods. What's more, they have less of a savings cushion to withstand the hit to incomes that the tariffs on these goods impart. Conversely, wealthier households spend a larger share of their incomes on services and, hence, are less exposed to the tariff impact. They can finance their discretionary spending out of wealth gains and their larger savings cushions. While a small fraction of the population, high-income households account for more than 50 percent of total spending. That means, of course, that economic growth is more dependent on the drivers of wealth - the stock market and house prices. That's a positive influence when stock prices and housing values are rising, but a big risk if, and when, they sputter.

Bifurcated Businesses

Likewise, tariffs are widening the gap between large and small businesses. Large companies are far better equipped to withstand the impact. For one, they have more pricing power and can pass more of the tariffs on to customers. For another, they have the muscle and buying power to renegotiate contracts with suppliers and, if necessary, to move their orders to countries with lower tariffs. Moreover, like wealthier households, they have more of a cushion to absorb the tariffs if they choose not to raise prices. Indeed, throughout the trade wars, profits of larger corporations in the S&P 500 index have remained at healthy levels, something that has underpinned the sturdy gain in stock prices.

Just the opposite is the case with small businesses, which operate with thinner profit margins, have less pricing power and less muscle to renegotiate contracts with foreign manufacturers. What's more, they have less clout in the credit markets. Whereas large businesses can access lower-cost funds in the bond market, small businesses are more reliant on bank lending, where borrowing costs are higher, and credit standards are tightening. That's not surprising as the slowing economy and higher input costs related to tariffs are taking a bite out of earnings of mom-and-pop establishments. A proxy of this trend can be seen in proprietor's income, which has turned decisively weaker over the past three months.

Keep in mind that small businesses contribute more to job growth than large corporations. Hence, the squeeze on earnings has

a disproportionate impact on hiring. According to ADP, the payroll processing firm, small businesses with 1-49 employees have reduced worker headcount in two of the past three months even as payrolls overall has increased. Odds are, the huge downward revision in payrolls in May and June, which clipped 253 thousand jobs from their original estimates, were concentrated among smaller firms, as they tend to respond later to the Labor Department's survey of business than do the larger companies. The downward revisions incorporated those late responses.

Less Trade Uncertainty is Promising Sign

We suspect that low-income households and small businesses will continue to feel the most pressure from tariffs in coming months, opening a larger gap with upper income and large corporations. A bifurcated economy is clearly not desirable, as it sustains and intensifies inequality and encourages social unrest. But it doesn't mean that a recession is inevitable. The slowdown in economic activity in recent months is due at least in part to uncertainty over trade policy. Many businesses put investment and hiring plans on hold until they get a clearer sense of what the tariff landscape will look like. Trade deals are still being negotiated but a blueprint with most trading partners is on the table, and fewer surprises should be forthcoming. The reduction in uncertainty alone will enable planning decisions to go forward and set the stage for a pickup in activity.

Historically, the negative relationship between uncertainty and hiring is strongest for small businesses, so the more clarity there is on the trade front, the more likely these firms will stop laying off workers. The key question is whether the consumer demand will hold up in the face of higher tariff-induced prices and growing job insecurity. So far, households have become more selective in their buying habits but have not zipped up their wallets. Expectations of higher prices coming down the pike may even inject a short-term boost to consumption, as consumers accelerate back-to-school purchases to beat tariffs. It's possible that will enable the Fed to wait a bit longer before cutting rates to keep inflationary expectations in check. But while people really hate inflation, there's no question that they hate job losses even more. The next move, whether in September or later in the year, will be a rate cut to stave off a recession.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

	<u>July</u>	<u>June</u>	<u>May</u>	<u>April</u>	<u>March</u>	<u>February</u>	<u>January</u>	<u>12-Month Range</u>	
								<u>High</u>	<u>Low</u>
Prime Rate	7.50	7.50	7.50	7.50	7.50	7.50	7.50	8.50	7.50
3-Month Treasury Bill Rate	4.25	4.23	4.25	4.21	4.20	4.22	4.21	5.20	4.20
5-Year Treasury Note Rate	3.95	3.96	4.02	3.91	4.04	4.28	4.43	4.43	3.50
10-Year Treasury Note Rate	4.39	4.38	4.42	4.28	4.28	4.45	4.63	4.63	3.72
30-Year Treasury Bond Rate	4.92	4.89	4.90	4.71	4.60	4.68	4.85	4.92	4.04
Tax-Exempt Bond Yield	5.27	5.24	5.22	5.18	4.30	4.20	4.19	5.27	3.83
Corporate Bond Yield (AAA)	5.45	5.46	5.54	5.45	5.29	5.32	5.46	5.54	4.68
Conventional 30-Year Mortgage Rate	6.72	6.82	6.82	6.73	6.65	6.84	6.96	6.96	6.18
Dow Jones Industrial average	44500	42753	41864	39876	42092	44209	43524	44500	39876
S&P 500 Index	6297	6080	5811	5370	5684	6039	5980	6297	5370
Dividend Yield (S&P)	1.23	1.28	1.32	1.43	1.34	1.24	1.26	1.43	1.23
P/E Ratio (S&P)	26.9	26.3	25.1	23.8	24.0	25.5	27.2	27.2	23.8
Dollar Exchange Rate (vs. Major Currencies)	120.5	121.0	122.7	124.5	126.5	128.1	129.0	129.0	120.5

* Monthly Averages

Economic Indicators

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								<u>High</u>	<u>Low</u>
Housing Starts (Thousands of Units)	1428	1358	1282	1398	1355	1490	1358	1514	1265
New Home Sales (Thousands of Units)		627	623	705	660	642	662	726	623
New Home Prices (Thousands of Dollars)		402	423	413	413	415	431	431	398
Retail Sales (% Change Year Ago)	3.9	4.4	3.4	5.0	5.1	3.9	4.6	5.10	2
Industrial Production (% Change Year Ago)	1.4	0.8	0.7	1.3	1.1	1.2	1.4	1.4	-0.9
Operating Rate (% of Capacity)	77.5	77.7	77.5	77.6	77.7	78.2	77.7	78.2	76.8
Inventory Sales Ratio (Months)		0.38	1.39	1.38	1.38	1.39	1.40	1.41	0.38
Real Gross Domestic Product (Annual % Change)		3.0			-0.5			3.1	-0.5
Unemployment Rate (Percent)	4.2	4.1	4.2	4.2	4.2	4.1	4.0	4.2	4.0
Payroll Employment (Change in Thousands)	73	14	19	158	120	102	111	323	14
Hourly Earnings (% Change Year Ago)	3.9	3.8	3.8	3.8	3.9	4.0	4.0	4.2	3.6
Personal Income (% Change Year Ago)		4.7	4.6	5.4	4.7	4.6	4.3	5.4	4.3
Savings Rate (Percent of Disposable Income)		4.3	4.5	5	4.4	4.4	4.2	5	3.5
Consumer Credit (Change in Blns. Of Dollars)		7.4	5.1	16.4	6.6	-1.3	9.0	17.6	-110.3
Consumer Prices (% Change Year Ago)	2.7	2.7	2.4	2.3	2.4	2.8	3.0	3.0	2.3
CPI Less Food & Energy (% Change Year Ago)	3.1	2.9	2.8	2.8	2.8	3.1	3.3	3.3	2.8
Wholesale Prices (% Change Year Ago)	3.3	2.4	2.8	2.5	3.3	3.4	3.7	3.7	2.1

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