SMITH AFFILIATED CAPITAL
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INVESTMENT COMMENTARY

The Waiting for Godot Economy – But the Clock is Ticking

Tariffs: More Noise Than Lasting Inflation

Uncertainty among households and businesses over trade, fiscal policy, and geopolitical tensions has lingered deep into midyear. The flare-up in the Middle East injected fresh volatility, though those risks have receded for now. Despite the steady drumbeat of alarming headlines, hard data continue to portray an economy that is gradually decelerating rather than collapsing outright. Policymakers, citing persistent inflation and the risk of premature action, have so far resisted preemptive rate cuts. Yet in our assessment, this cautious stance increasingly misjudges the evidence: the balance of risks now argues that the Federal Reserve will be compelled to begin easing policy in the second half of 2025 as a return to normalization via modest cuts, not a full cycle shift.

Markets have weathered a barrage of tariff threats, political brinkmanship, and global disruptions without a decisive break. Equity indexes have recently set fresh record highs, reflecting optimism that policy will not remain restrictive indefinitely. Meanwhile, household balance sheets remain broadly healthy, though cracks are emerging in discretionary spending and employment trends. It is difficult to derail a $31 trillion economic juggernaut without a severe shock, but a combination of slowing demand, tighter policy, and prolonged uncertainty is steadily tightening conditions. This is the essence of what feels like a "Waiting for Godot" economy—where expectations of a growth resurgence persist, but the underlying data increasingly show erosion beneath the surface. The critical question is not whether the Fed will cut rates, but precisely when—and by how much.

Much of the current policy debate has focused on tariffs. The 90-day pause on reciprocal tariffs is expiring in July. The White House claims progress on multiple trade agreements, but in reality, few trading partners have secured meaningful deals. Even if deadlines are extended again, tariffs have already lifted the effective rate above 15%, the highest since the 1930s. This escalation is not a marginal policy shift; it represents a structural headwind to consumption and corporate margins that will continue to weigh on sentiment well into next year.

So far, the most direct impact has been to raise substantial revenue for the Treasury, partially offsetting deficit spending tied to the administration's expansive fiscal agenda. However, tariffs function as a tax on consumption, and while some passthrough to consumers is inevitable, the inflation impulse has proven smaller than many policymakers feared. Recent high-frequency price data indicate decelerating core inflation, and firms are increasingly reluctant to test pricing power as discretionary demand cools.

Importantly, the disinflationary side effects—slowing sales, squeezing margins, and dampening hiring—are becoming harder to ignore. While year-over-year core PCE inflation remains above the Fed's 2% target, the three-month annualized rate has dropped below 2%, and the headline measure is running closer to 1%. In our view, if tariffs fail to ignite a sustained price spike, the rationale for maintaining highly restrictive policy grows weaker. The risk is no longer just inflation; it is that demand erosion begins to outweigh any residual price pressures.

Labor Market Cracks Emerging

Labor market resilience has underpinned the Fed's caution for most of 2024 and early 2025. Employment data have appeared steady even as growth slowed. But a range of indicators now point to softening momentum. Businesses have become increasingly reluctant to hire, and layoffs are no longer offset by strong job creation. Initial claims for unemployment benefits have been trending higher, and surveys show rising anxiety over job security among households.

This cycle has produced a unique dynamic: firms neither hiring nor firing aggressively. While this approach has kept the unemployment rate deceptively low, it is unlikely to persist indefinitely. With immigration curtailed and labor force growth slowing, even modest declines in hiring can translate into a faster rise in joblessness. The June personal income and spending report underscored this shift, showing the first decline in personal income in years and a modest pullback in overall consumption—signals that household finances are under mounting pressure.

In addition, younger workers and recent college graduates are struggling to secure employment as AI-driven automation reshapes entry-level and clerical roles. These developments are eroding the foundations of consumer spending. In our assessment, these labor market cracks are not consistent with a policy stance that remains highly restrictive into 2026. If anything, they point to a brewing risk that the Fed may overstay its tightening cycle and inflict unnecessary damage on employment.

Demand Destruction Is Overtaking Price Pressures

While policymakers have emphasized tariffs' potential to boost prices, they have paid far less attention to their dampening effect on demand. Tariffs are effectively a consumption tax whose burden intensifies as real income growth decelerates. Even in sectors where companies can pass through some costs, households are trimming discretionary purchases and delaying larger commitments. The June data confirm that this drag is already taking hold: services spending fell, and wage growth continued to moderate alongside diminished hiring.

We expect the erosion of purchasing power to deepen in the second half of 2025, amplifying disinflationary forces and eventually outweighing any near-term boost to prices. Some policymakers—most notably Governors Waller and Bowman—have already signaled readiness to act if labor market deterioration continues. The Fed's dual mandate requires balancing price stability with maximum employment. In our assessment, the risk of over-tightening now exceeds the risk of cutting too soon.

The Fed's Dilemma: Avoiding a Stagflation Trap

The scenario the Fed most fears—a stagflationary combination of rising inflation and slowing growth—remains a theoretical possibility if tariff escalation continues or external shocks flare again. But to date, the evidence does not point decisively in that direction. While the core PCE remains elevated on a year-over-year basis, the recent trend is well below 2%. More importantly, wage gains are moderating, and consumption is losing momentum. The softness in discretionary spending and the steady climb in jobless claims suggest that the economy is more vulnerable to policy overreach than many assume.

Fed projections still anticipate two rate cuts in 2025, and Chair Powell's recent Congressional testimony struck a notably more moderate tone. While some have interpreted this shift as a reaction to political criticism, it more likely reflects a growing recognition that the data are shifting faster than policymakers expected earlier this year. Indeed, the combination of moderating inflation and weakening employment is precisely the environment that warrants a pivot to easier policy.

Timing and Magnitude of Rate Cuts

There are four policy meetings left this year—July, September, October, and December. While consensus holds that the Fed will remain on hold in July to gather more evidence, the probability of a pivot later in the year has increased. The June data have already softened expectations for consumption and hiring. Should these trends deepen into late summer, a September or October move appears increasingly likely.

What would trigger an earlier or more aggressive move? A material downside surprise in employment or consumption, or further evidence that inflation continues to fade. Recall that last September the Fed implemented a 50-basis-point "catch-up" cut when cracks widened faster than anticipated. A similar scenario is plausible if labor market weakness accelerates, and core inflation remains subdued.

Why We Expect Cuts in the Second Half

Our base case remains that the Fed will deliver the first reduction in September or October, followed by another cut before year-end. The combination of softening demand, moderating inflation, and labor market strain is inconsistent with a prolonged hold. The Fed's own Summary of Economic Projections points to additional easing in 2026 as inflation stabilizes near target. From our perspective, the argument for waiting much longer is becoming harder to justify. Even if tariffs temporarily lift headline inflation, the underlying momentum points to a more disinflationary environment as demand softens.

Importantly, the Fed's credibility does not depend on maintaining higher rates indefinitely. Its credibility depends on adjusting policy in response to the data. As the evidence accumulates that core inflation is subsiding and employment is softening, the rationale for persistent restraint erodes. We believe policymakers increasingly recognize that delaying action risks a deeper slowdown that could be more challenging to reverse.

Investor Implications

For investors, the message is clear: while headline risks—tariff brinkmanship, geopolitical uncertainty, and political volatility—will continue to generate near-term swings in markets, the underlying trajectory of policy is shifting toward support. Bond yields have already stabilized as expectations for rate cuts have firmed, and equities have responded to the prospect that the Fed will not remain restrictive indefinitely.

We continue to expect at least two cuts before year-end, with additional easing likely in 2026 as the lagged effects of past tightening filter through the economy. The risk of policy error—over-tightening into a softening environment—has increased materially. The Fed appears increasingly aware of this risk, as recent moderation in official commentary signals.

Looking Ahead

The "Waiting for Godot" economy may soon see the long-anticipated policy response begin to materialize. Patience remains warranted, but the clock is ticking. The Fed is likely to act before year-end to prevent demand erosion from hardening into a self-reinforcing downturn. While meaningful risks remain—especially around escalating trade policy and the possibility of renewed geopolitical shocks—the fundamental backdrop increasingly argues for a measured transition toward accommodation. For investors and policymakers alike, the imperative is to recognize that the data—not the headlines—will ultimately dictate the appropriate course.

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U.S. Treasury Market				Total Return (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
6 Mo Bill	5.33	4.23	4.25	1.01	4.89
2 Year Note	4.76	3.885	3.72	1.12	5.47
5 Year Note	4.38	3.95	3.80	1.72	6.47
10 Year Note	4.40	4.21	4.23	1.04	5.40
30 Year Note	4.56	4.57	4.78	-2.08	0.05

Municipal Bonds	Yield (%)			Total Return (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
Barclays General Obligation Index	3.55	3.64	3.71	0.00	1.27
Barclays New York Bond Index	3.70	3.89	4.01	-0.23	0.52
Barclays California Bond Index	3.52	3.67	3.79	-0.14	1.03
Barclays Revenue Index	3.80	3.95	4.07	-0.20	1.00

Equities	Levels			Total Return (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
S&P 500	5,460	5,882	6,205	10.94	15.14
DJIA	39,119	42,544	44,095	5.46	14.72
Nikkei (Tokyo) US $ Terms	39,583	39,895	40,487	13.81	4.29

Commodities	US $			Percent Change (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
Gold Comex Spot ($ per oz)	2,327	2,625	3,303	5.75	41.96
CRB Future Com. Pr. Index*	290	297	297	-3.89	2.34
W. Tx Int. Crude ($ per bbl.)	82	72	65	-8.91	-20.15

Currencies	Levels			Percent Change (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
Yen	160.88	149.96	144.03	-3.95	-10.47
Sterling	1.26	1.2918	1.3732	6.30	8.60
Euro	1.07	1.0816	1.1787	8.98	10.03

Global Bond Markets**	Levels			US $ Terms (%)	
	6/28/2024	12/31/2024	6/30/2025	2nd Qtr	1Yr
German 10 year	2.50	2.74	2.61	10.65	11.16
Japanese 10 Year	1.05	1.49	1.43	5.00	1.83
UK 10 Year	4.17	4.67	4.49	9.12	11.72
Barclays US Emerging Market	7.17	6.53	6.32	2.54	10.58