

# GLOBAL PERSPECTIVES

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## SIGNALS FLASH YELLOW AS MARKETS STAY UPBEAT: PERSPECTIVES ON THE EMERGING US SLOWDOWN

- ▶ The US economy is cooling, with labor markets, housing, and consumers all showing signs of fatigue. The Fed is holding interest rates steady for now, but internal dissent signals rising concern over growth.
- ▶ Easier monetary policy — if delivered soon — could help restore momentum, not just through lower rates but by signaling to households and firms that policy is back on their side.
- ▶ Despite the soft data, markets remain calm, credit is readily accessible, and the S&P 500 has made new record highs on hopes that AI-driven capex and fiscal stimulus from the One Big Beautiful Bill Act (OBBBA) will work together with easier monetary policy to reinvigorate the economy.

HIGHLIGHTS

### A BUMPIER ROAD TO A SOFT LANDING?

Even as a growing body of data suggests the US economy is slowing, financial markets remain mostly upbeat. The S&P 500 dipped modestly in early August but has since gone on to post new all-time highs. Credit spreads are tight, volatility is subdued, and the US dollar has weakened — a supportive mix for risk assets. But underneath that calm

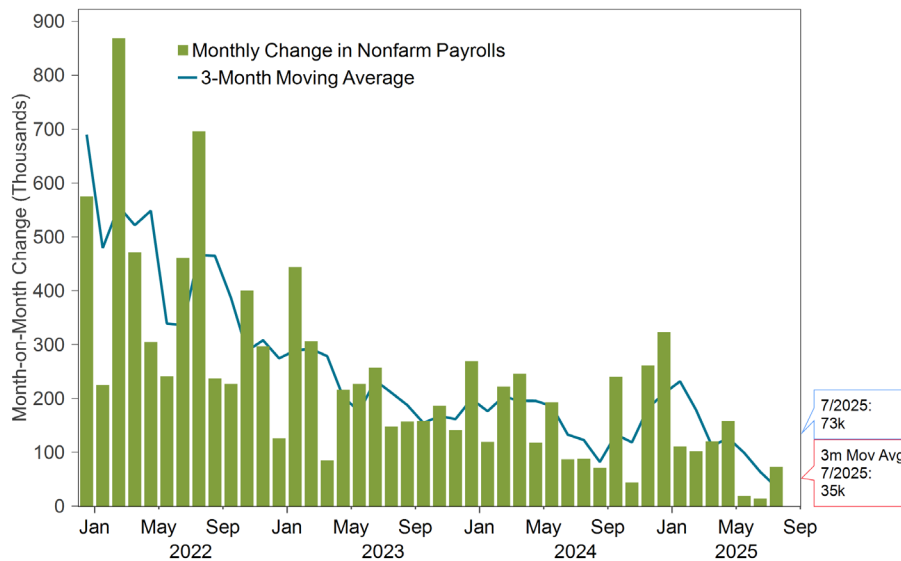
surface, key parts of the economy are showing signs of fatigue. Investors hoping for a soft landing will probably get their wish, but the road there looks bumpier than recent market strength implies.

## LABOR AND HOUSING LOSING STEAM

The clearest evidence of deceleration comes from the labor market. In July, the US economy added just 73,000 jobs, well below consensus expectations, and revisions to prior months erased 258,000 previously reported jobs. That brought the three-month average for job creation down to around 35,000 — a sharp drop from the 170,000 monthly pace in 2024 (**Figure 1**). The unemployment rate ticked up modestly to 4.2%, and hiring has become more narrowly concentrated in healthcare and government.

**FIGURE 1**

**The Labor Market Has Cooled,  
as Reflected in Weaker Job Growth**



Sources: GW&K Investment Management, BLS, and Macrobond.

The July jobs report brought clear evidence that the labor market has cooled, with the three-month average for job creation being only 35,000 compared to a monthly pace of 170,000 in 2024.

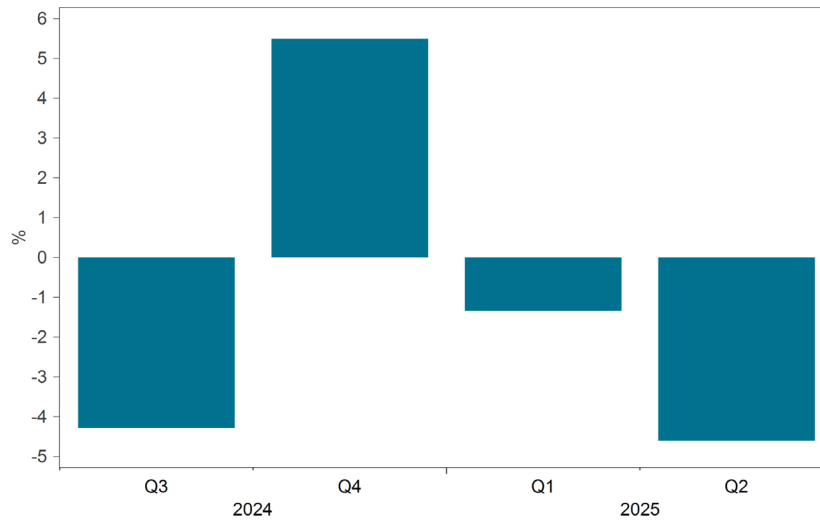
More granular data adds to the concern. The labor force participation rate has edged down, particularly among prime-age workers, and job openings continue to drift lower. While layoffs remain historically low, anecdotal reports of hiring freezes and slower onboarding point to growing employer caution.

Housing is another clear weak spot. Residential fixed investment declined by 4.6% in Q2, following a contraction in Q1 (**Figure 2**). High mortgage rates — still hovering near multi-decade highs — have discouraged buyers, reduced refinancing activity, and slowed new home construction. Permits and housing starts have fallen in recent months, and homebuilder sentiment is very depressed.

Taken together, labor and housing — two traditionally cyclical sectors — are flashing yellow, if not quite red.

FIGURE 2

### Housing Remains a Drag on Growth: US Real Residential Fixed Investment (Annual Rate %)



Sources: GW&K Investment Management, BEA, and Macrobond.

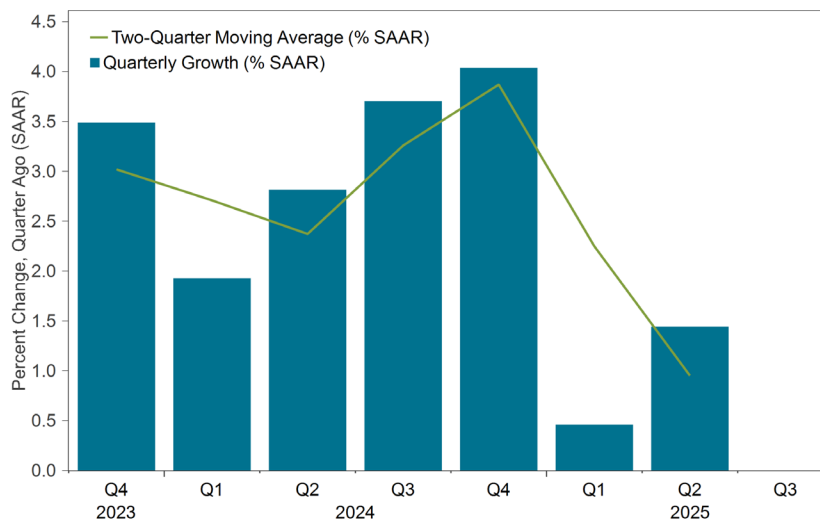
High mortgage rates have depressed housing activity and homebuilder sentiment while contributing to a decline in residential fixed investment in three of the last four quarters.

## CONSUMPTION FLATTENS

For much of the past two years, US consumers helped power the economy through inflation shocks and rate hikes. But recent data show that strength is waning. Real personal consumption expenditures rose at an annualized pace of only 1% in the first half of 2025 (**Figure 3**). Even more notably, spending on services — a category that had held up well — slowed to an anemic 0.5% growth rate in the last six months (**Figure 4**).

FIGURE 3

### Consumers Pull Back: US Real Personal Consumption (% SAAR, Quarterly)

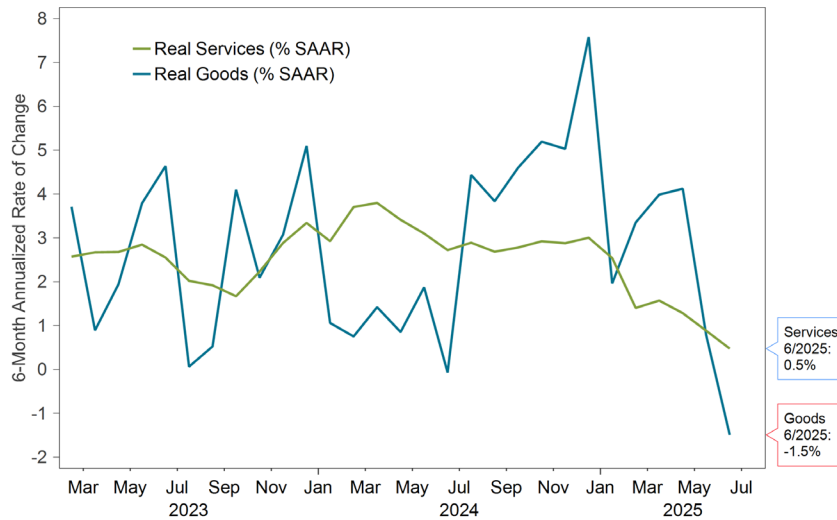


Sources: GW&K Investment Management, BEA, and Macrobond.

Growth in real consumer spending slowed to an average annual rate of about 1% in the first half of 2025, down sharply from its 3%+ pace in 2024.

FIGURE 4

### Real Services Spending in 2025 Has Been Slowing Along With Goods Spending



Sources: GW&K Investment Management and Macrobond.

Real services spending has been less volatile than goods spending but has slowed to an anemic 0.5% annual rate over the six months through June.

Households appear to be pulling back on discretionary purchases. Travel, dining out, and recreation categories have shown weakness, and real retail sales have disappointed. With pandemic-era savings now largely exhausted for most income groups, and with credit card rates near 20%, many families are choosing to delay or reduce spending.

That's not to say the consumer is collapsing. Incomes are still rising, albeit more slowly, and inflation has moderated from its 2022 – 2023 highs. But the slowdown in real consumption, especially in services, is a notable shift in behavior. In the past, such patterns often preceded or coincided with downturns.

### MIXED CONDITIONS MASK UNDERLYING RISK

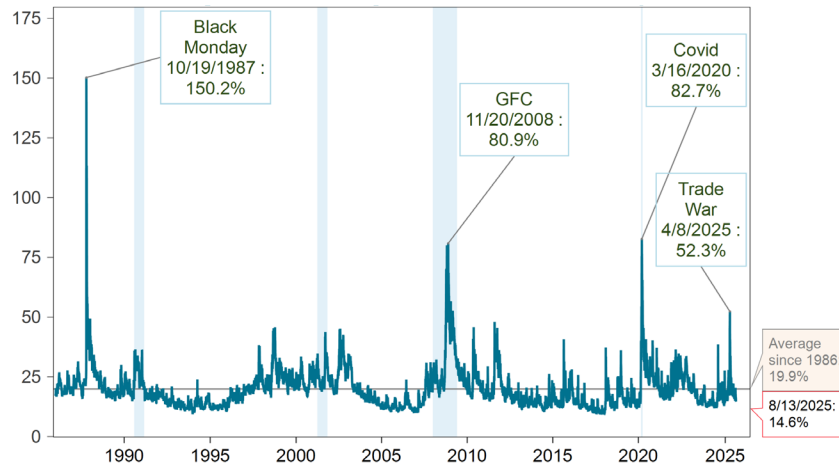
The contrast between softening fundamentals and calm markets is striking. The Chicago Board Options Exchange's CBOE Volatility Index (VIX), a common measure of expected stock market volatility, returned to below its historical average after an extraordinary bout of volatility around Liberation Day in April (**Figure 5**). Credit markets are not signaling distress: investment-grade and high-yield spreads remain tight, and corporate borrowing remains accessible (**Figure 6**). Meanwhile, the US dollar has weakened significantly in 2025, which tends to support exports and boost earnings for multinationals (**Figure 7**).

Equity markets have taken little note of rising macro uncertainty. After reaching new highs in July, the S&P 500 declined modestly in early August. Yet the index has since posted new record highs, buoyed by enthusiasm over AI and expectations for fresh monetary and fiscal stimulus that will boost growth.

The divergence between weak data and strong asset prices could resolve in either direction. Market optimism may prove prescient if economic conditions stabilize or improve. But if labor or consumer weakness deepens, equity valuations could come under pressure.

FIGURE 5

## The Fear Is Gone: VIX Volatility Index Is Back Below Average Following Its Liberation Day Spike

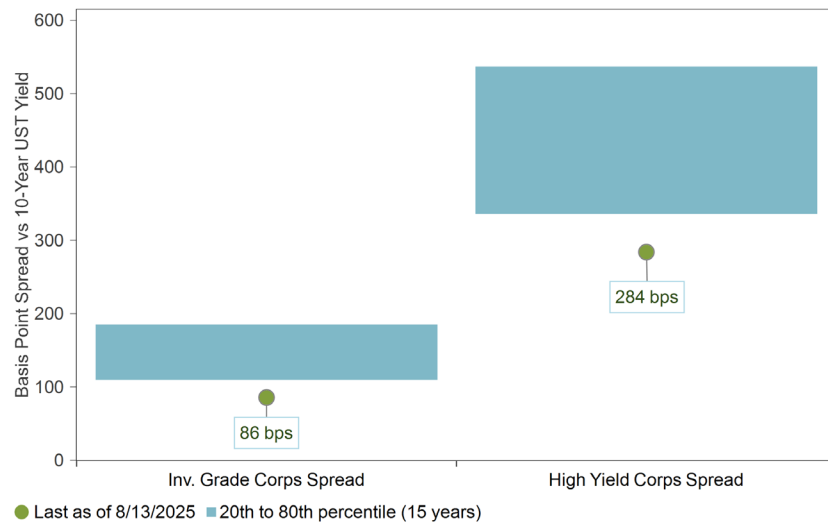


Sources: GW&K Investment Management, Bloomberg, CBOE, and Macrobond.  
Note: Shaded areas denote NBER recession periods.

Following one of the largest surges of the VIX volatility index since its inception, recent volatility has been running below its long-term historical average of 19.9%.

FIGURE 6

## Corporate Credit Spreads Are Very Tight Compared to the Last 15 Years

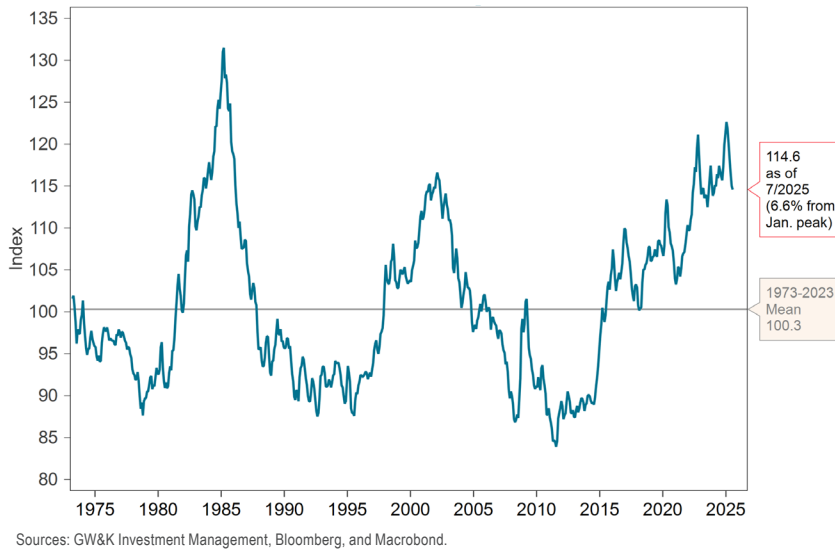


Sources: GW&K Investment Management, Bloomberg, and Macrobond.

Investment-grade and high-yield bond spreads over US Treasuries remain historically tight, reflecting favorable borrowing conditions for corporations.

FIGURE 7

### The US Dollar Is Off Its Peak But Remains Strong: The US Real Trade-Weighted Dollar Index



While remaining historically strong, the US dollar has weakened significantly in 2025. Recent dollar weakness should help support exports and boost earnings for multinationals.

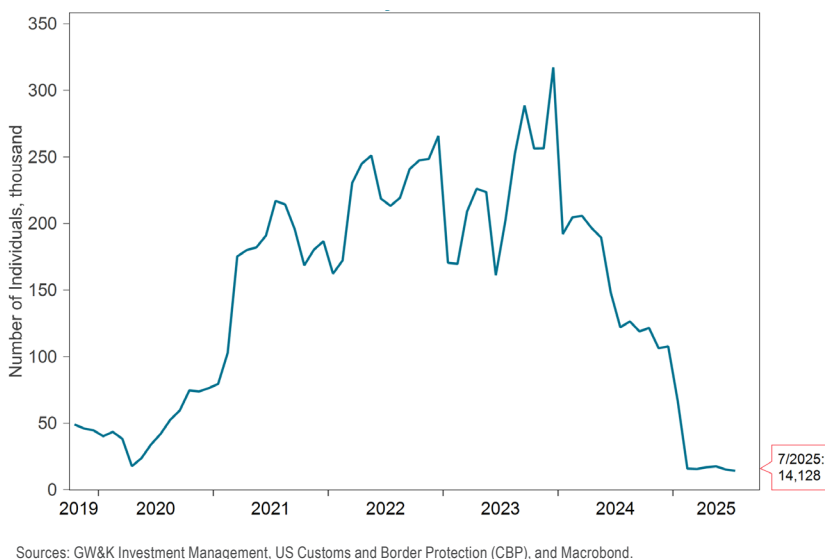
## DIVERGING FORCES: IMMIGRATION, AI, FISCAL STIMULUS, AND THE FED

One reason for the current complexity is the unusual mix of headwinds and tailwinds shaping the outlook.

On the downside, restrictive immigration and deportation policies have slowed labor force growth (**Figure 8**). Economists at Goldman Sachs estimated earlier this year that such measures may have lowered the US economy's potential growth rate by 0.3 to 0.4 percentage points.<sup>1</sup> Labor shortages have already been reported in agriculture, construction, and parts of the service sector. These shortages limit the economy's ability to grow without triggering wage inflation — and make it harder to judge whether the current slowdown reflects weak demand or tight supply.

FIGURE 8

### Illegal Immigration Has Collapsed: US CBP Monthly Border Encounters



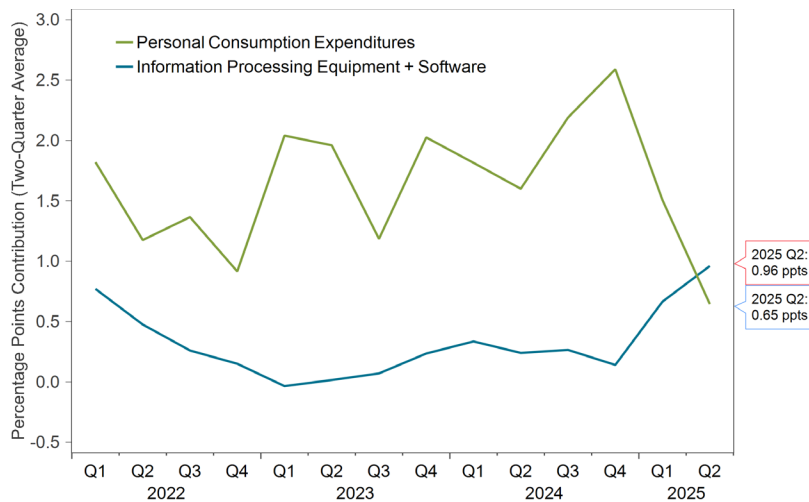
A collapse in illegal immigration in 2025 is contributing to a slowdown in labor force growth that could limit the economy's capacity to grow without triggering inflation.

<sup>1</sup> "How will declining immigration impact the US economy," *Goldman Sachs Research*, February 20, 2025.

On the upside, investment in artificial intelligence infrastructure continues to surge. In the first half of 2025, business spending on software and information processing equipment contributed more to GDP growth than consumer spending (**Figure 9**). Big Tech firms are investing tens of billions of dollars in data centers, AI model training, and related hardware. That capex boom has helped prop up both headline GDP and equity valuations, even as other sectors stall.

FIGURE 9

### AI Spending Has Surged: Two-Quarter Average Contribution to GDP Growth



Spending on information processing equipment and software has contributed more to US GDP growth in 2025 than consumer spending, even though consumer spending is 11x larger than AI-related spending.

Fiscal policy may also provide a tailwind. The OBBBA, signed into law in July, is expected to add meaningful stimulus in late 2025 and into 2026. It preserves expiring tax cuts for households, expands deductions for business investment and R&D, and introduces targeted relief measures for specific income groups. While its effects are just beginning to show, the law could amplify private sector spending in coming quarters — especially if paired with an eventual shift toward easier monetary policy.

For policymakers at the Federal Reserve, the potential for an AI-fueled and fiscally supported economic growth recovery creates a dilemma. Why ease prematurely if growth may soon be poised to exceed the economy's natural speed limit? Core inflation has remained elevated, running around 2.8% year-on-year in recent months — still above the Fed's 2% target.

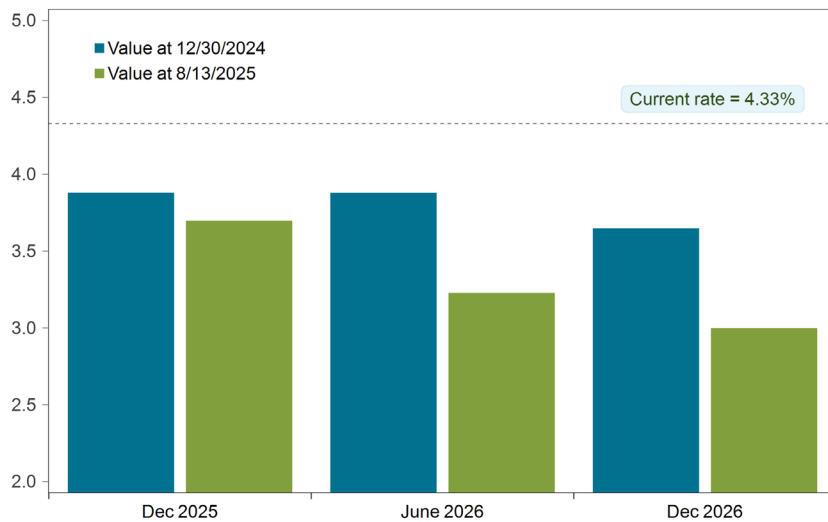
That said, growth is clearly slowing, and some officials, like Fed Governors Christopher Waller and Michelle Bowman, have argued that interest rates are now too restrictive. The Fed held rates steady again in July, with dissent from both Waller and Bowman in favor of an immediate cut.

Given the weak July jobs report published after the Fed's most recent meeting, Fed funds futures are now signaling near-total confidence in a September rate cut, and markets now expect the policy rate to fall to around 3% by the end of next year (**Figure 10**). But the Federal Reserve itself appears more cautious. Chair Powell has stressed that tariff-related inflation, though possibly short-lived, could persist. For now, the Fed seems content to let the data guide its hand — even as markets get ahead of the curve.



FIGURE 10

## Higher for Not Much Longer: Evolution of Fed Funds Futures



Sources: GW&amp;K Investment Management and Macrobond.

Reflecting this year's economic slowdown, fed funds futures have stepped up bets that there will be significant Fed easing in late 2025 and through 2026.

Well-timed rate cuts by the Fed could serve as both financial and psychological catalysts for boosting the economy. Beyond reducing borrowing costs, easier monetary policy often lifts consumer sentiment and business confidence — key ingredients for renewed spending and hiring. Home buyers priced out by rising mortgage rates may return to the market, and businesses that had paused capital expenditures could greenlight projects again. Even modest declines in rates tend to ease financial stress and signal policy support, encouraging households and firms to re-engage after months of caution.

## CONCLUSION: NOT ALARM — BUT ATTENTION

The US economy is not in recession, but it is no longer in cruise control. The loss of momentum in job creation, housing, and consumption is real, even if headline GDP and AI-driven capex obscure that trend. Financial conditions remain easy, and despite a modest dip in early August, the equity market rally has continued largely unabated.

For investors, this is not yet a moment of alarm — but it is a moment to pay attention. If AI investment continues to surge and inflation drifts lower, the economy could pull off a soft landing. But if labor market weakness deepens or consumption slips further, the Fed may find itself behind the curve. With yields still high versus the past two decades, bonds would then get a chance to play their stabilizing role in investor portfolios.<sup>2</sup>

Markets have placed their bet on resilience. The payoff may come if the Fed's next moves help unlock pent-up demand in housing, consumer spending, and business investment outside Silicon Valley.

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<sup>2</sup> See William Sterling, "Weathering the Storm: Why Fixed Income Still Matters in Turbulent Markets," GW&K Global Perspectives, May 2025.



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