July 22, 2025

Dutta's Monetary Thoughts

Gut Check: Three Economies

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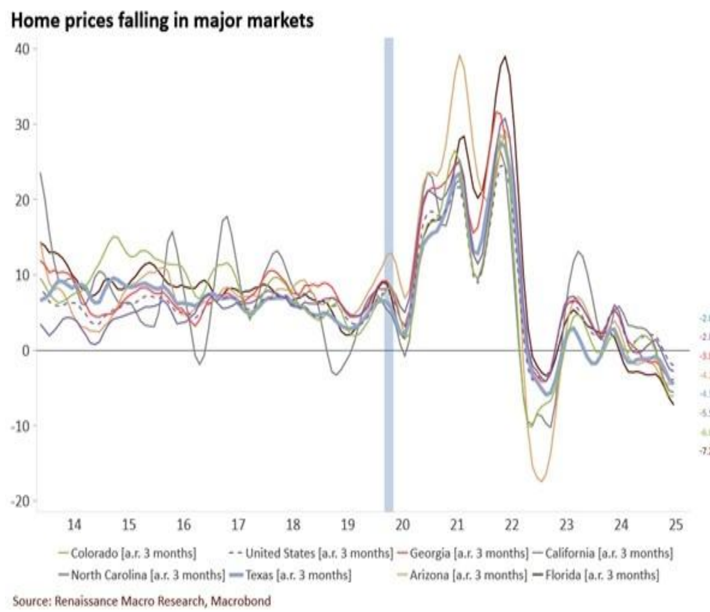
Innocent until proven guilty

Given how strong the financial markets have been, the US economy is innocent until proven guilty. Right now, you have three things going on in the US economy. Let's go through each in some detail from bad to good.

- The US housing market is in recession with weakening construction and declines in prices across major markets.
- The consumer is sluggish; however, with the labor markets showing some resilience there is no sign of a steep drop.
- AI related investment has been significant, is boosting growth, and there is no sign this is letting up anytime soon.

I am inclined to put more weight on housing and the consumer. This leaves me cautious on the economic outlook, especially since housing is unlikely to improve until monetary conditions ease.

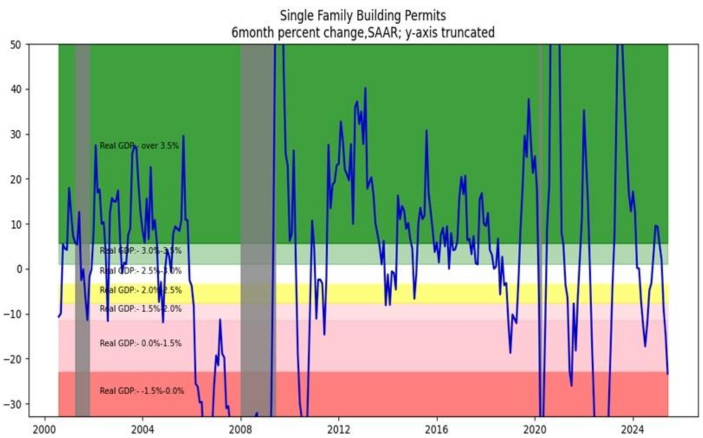


Housing is in recession

Housing activity continues to deteriorate. As inventories rise home prices have been deflating across the country. The truth is many recent buyers assumed they'd be refinancing into lower rates by now. That has not happened and as a result, we're seeing more homeowners put their homes up for sale.

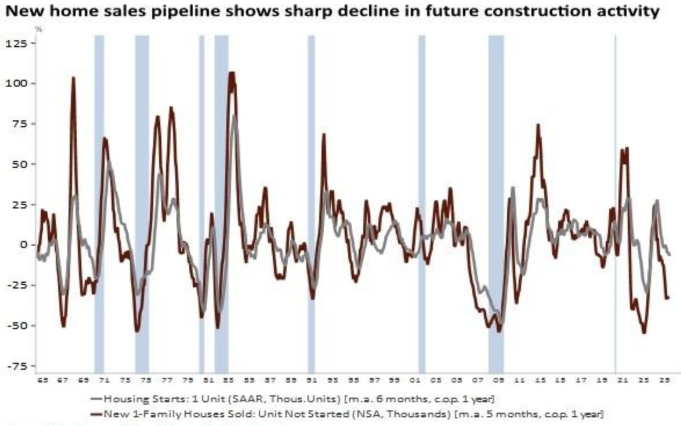
According to Zillow's Home Value Index, prices have declined two percent at an annual rate over the last three months. Importantly, the declines appear to be most pronounced in the regions of the country that have contributed the most to real estate construction in recent years – Florida, Arizona, Texas, and California.

As prices have come down, we've seen homebuilders begin to rationalize construction to sales activity. So far this year, building permits have declined 34 percent at an annual rate. As our nearby figure shows, the pace of decline seen over the last six months is consistent with weak conditions in the broader economy.

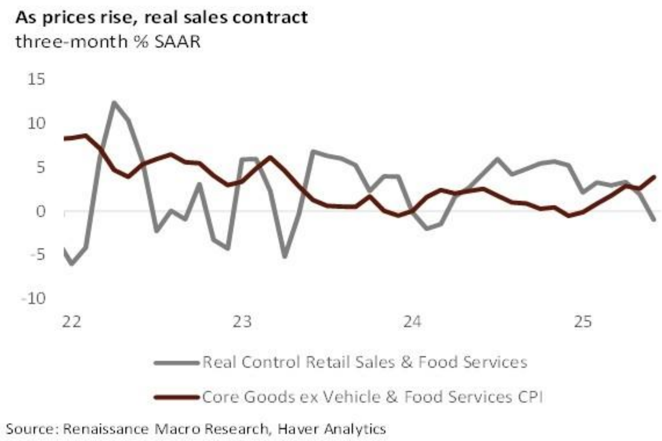


There appears to be no activity in the pipeline for future construction. So far this year, new homes sold but not yet started are down 33.3 percent against the same period last year. That's quite a bit more than the decline in single-family housing starts. Moreover, builders continue to report very weak buyer traffic. At this point, if you aren't selling homes, you aren't starting homes.

New home sales pipeline shows sharp decline in future construction activity

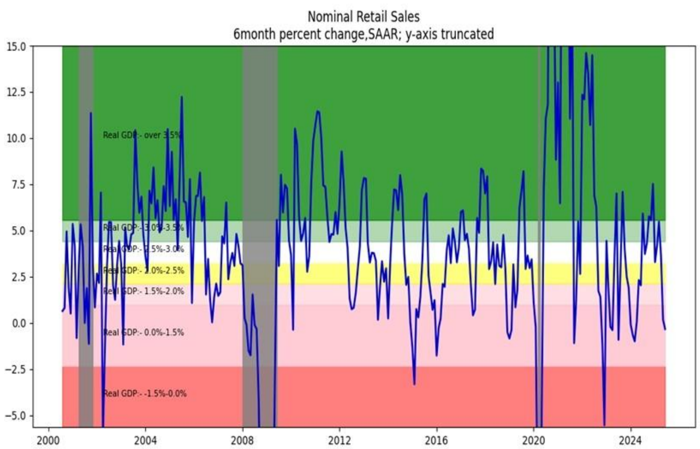


Source: Renaissance Macro Research, Macrobond

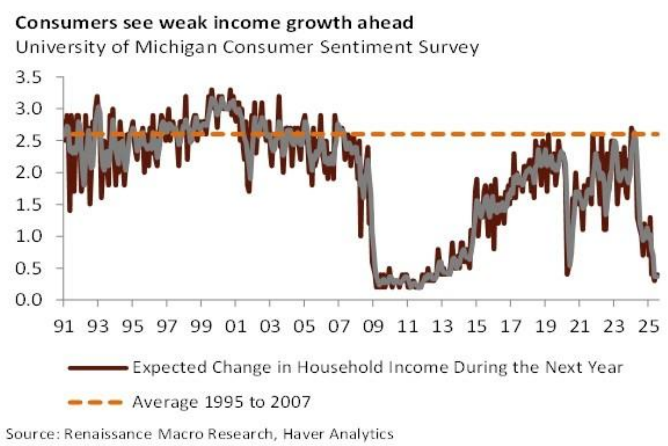


Nominal spending is weak; real consumption is worse

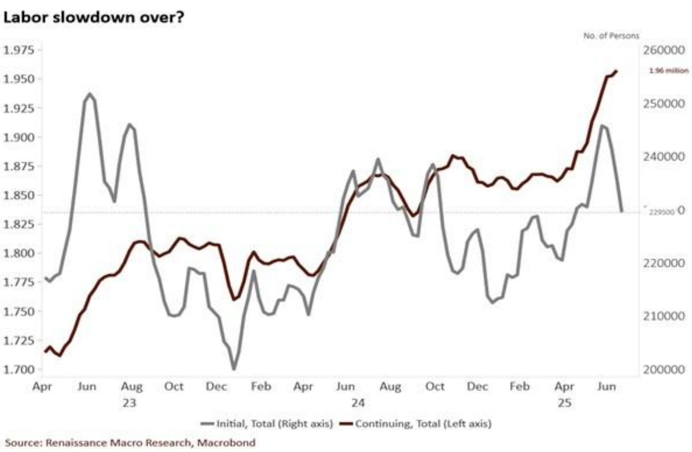
While June's retail sales figures were stronger than expected, it's clear that tariffs are eating away at the volume of goods sold. What goes into price comes out of quantity. Indeed, the Atlanta Fed is now tracking 1.5 percent real PCE in Q2, a 0.2ppt drop from the previous reading. This follows growth of just 0.5 percent in Q1. Average it out and real PCE is tracking just 1.0 percent SAAR in the first half of 2025. That's where things stand.



The broader story is that nominal activity is slowing. Believe it or not, total retail sales have declined so far this year, contracting 0.3% at an annual rate. Excluding gasoline stations, retail sales have been about flat. As our chart shows, when retail sales are this soft, we're in a below potential growth environment. Now, we've been here a couple of times post-COVID. The difference today is that spending on household services is running about half the pace now as it was then.

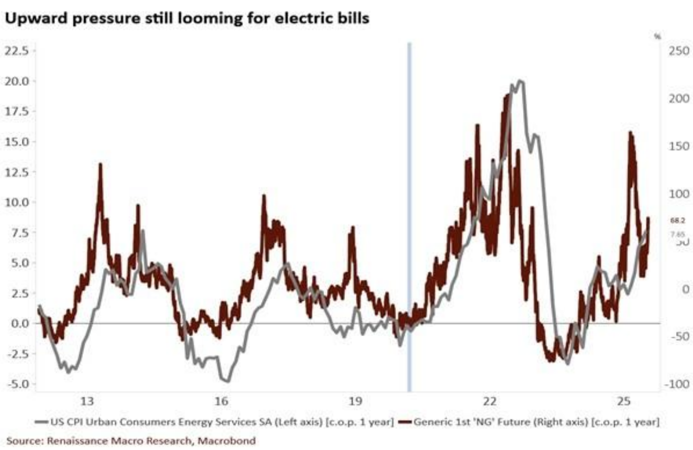


Labor markets remain cool. In June, recall that the growth in the index of aggregate weekly payrolls was zero. Thus, in June at least, consumers were able to eat the rise in prices by dipping into household savings. That cannot continue indefinitely. Moreover, forward-looking measures of wage growth show that there is still some cooling in the pipeline and high-frequency measures of labor demand continue to cool. Finally, while consumer sentiment appears to have stabilized, consumers continue to report very meek income expectations over the next year.

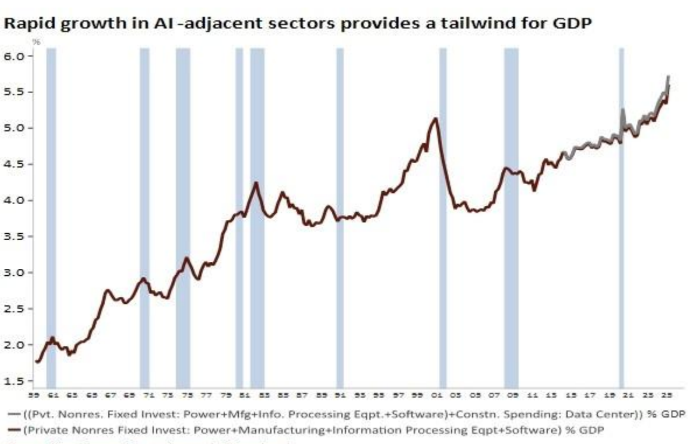


There are two risks to the consumption outlook.

The first is the upside risk – I'm wrong about the labor market. Initial unemployment claims have declined sharply in recent weeks, as an example. Perhaps conditions start to perk up and income growth accelerates. Labor markets usually don't turn on a dime, but it's a risk I'm open to.



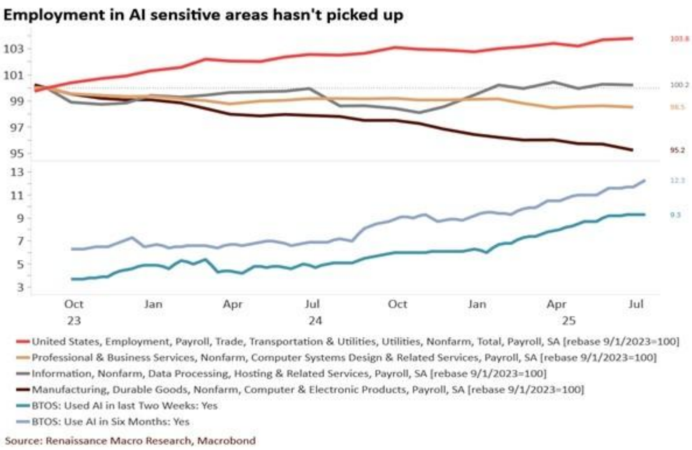
Second, household energy prices are climbing. [Perhaps AI demands] are taxing the US electrical grid. At any rate, heating oil and natural gas prices imply upward pressure on utility bills this summer. The risk here is not inflation so much as it is a shock to disposable incomes, further depressing real spending.



AI is booming

Tech related spending continues to provide a meaningful lift to GDP growth. I think a reasonable approximation is about 0.5ppt to GDP growth on average per quarter.

We provide a simple illustration of this. I define AI-adjacent as the following: information processing equipment investment, software, power facilities construction, manufacturing structures, and data center construction. Tally this up and we are looking at roughly six percent of US GDP, more than what we saw in the late-90s. It's been growing by about ten percent per year for the last two years. So, that's a 0.6ppt tailwind to GDP growth. This is an important driver of the macroeconomy and an even more important driver of the equity market.



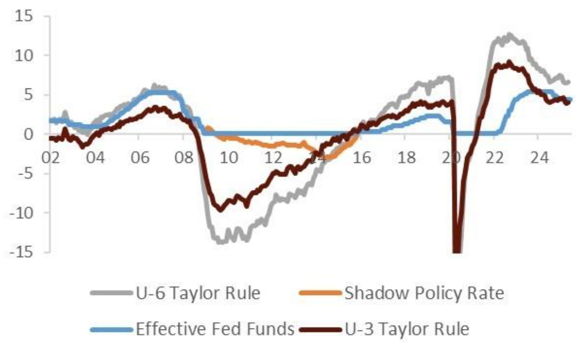
Now, unlike the 1990s, employment in the tech sector is not really taking off, at least not uniformly. According to weekly data from the Census, firms continue to report increase AI usage with more firms planning to use AI in the months ahead. According to the Business Trends and Outlook Survey (BTOS), 12.3 percent of the firms surveyed will use AI in six months, continuing a steady upward march. However, during this period we have seen employment in computer design and data processing / hosting services generally decline. The one area that has been strong has been utilities employment – the energy demands for AI run deep.

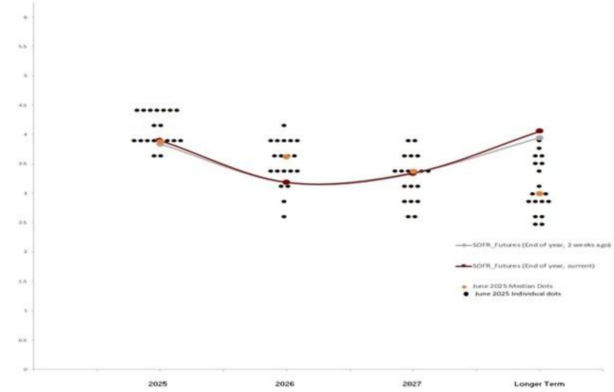
The risk with any major capex boom associated with a tech innovation is a bust. There will be a point that adoption becomes saturated, spending outpaces demand for it, and the need for additional investment spending will dry up. At any rate, it is hard to see tech related business investment add as much to GDP growth in 2026-2027 as it is right now.

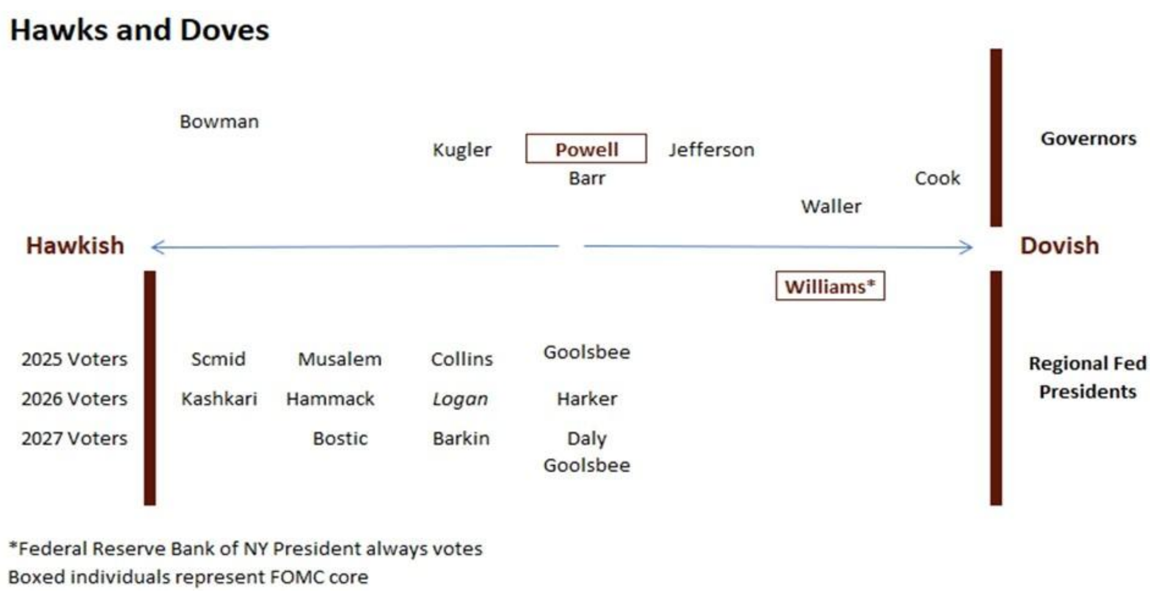
Cross currents

These are three important cross-currents. One interesting thought is that AI might be booming so much so that it is crowding out consumers through higher energy costs, but minimal employment benefit. At any rate, for the US economy, I am inclined to put more weight on housing and the consumer than technology primarily because I think the risk is elevated that weakness in these areas ultimately bleeds into employment in a way that tech strength hasn't.

Monetary metrics

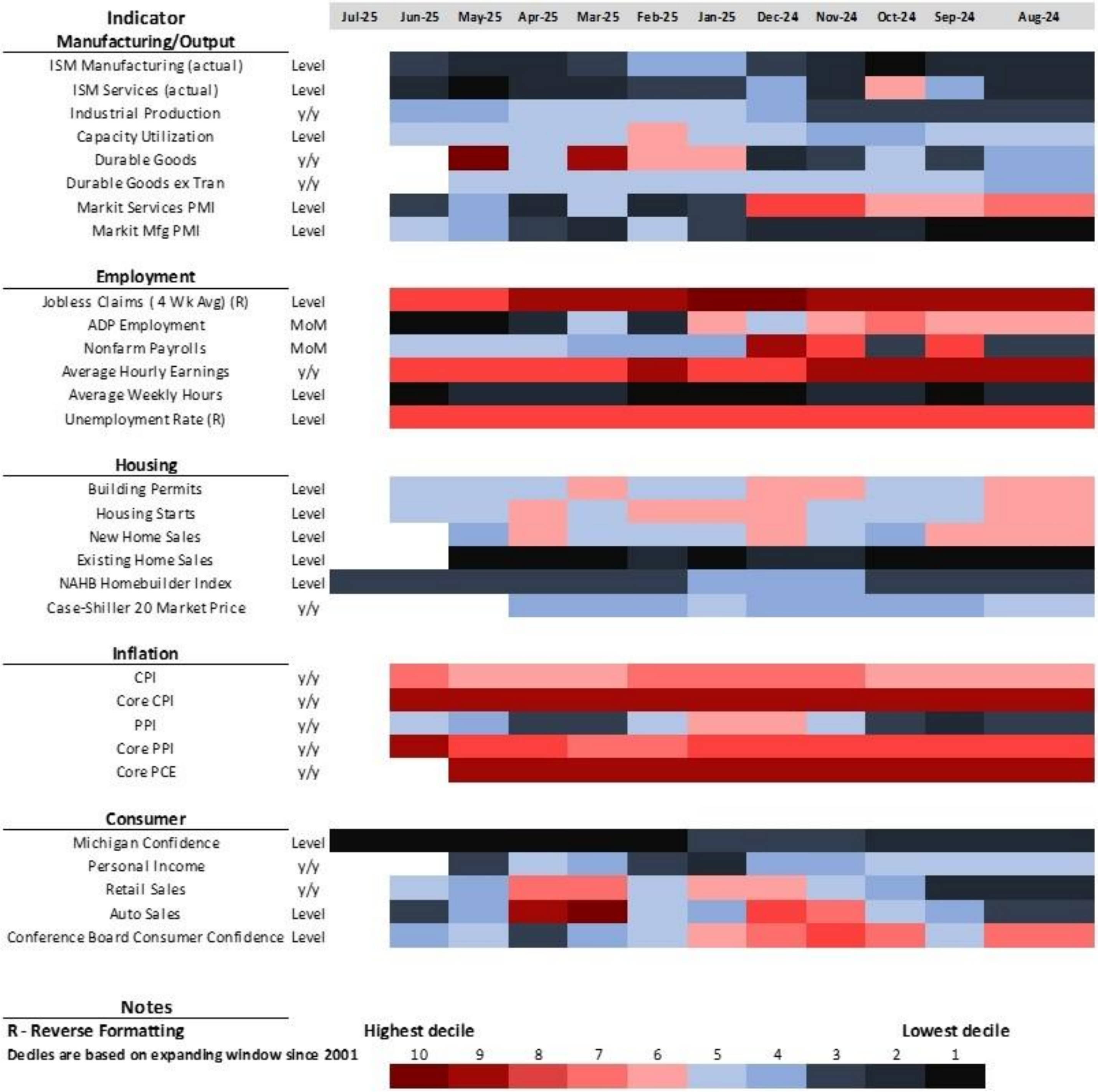




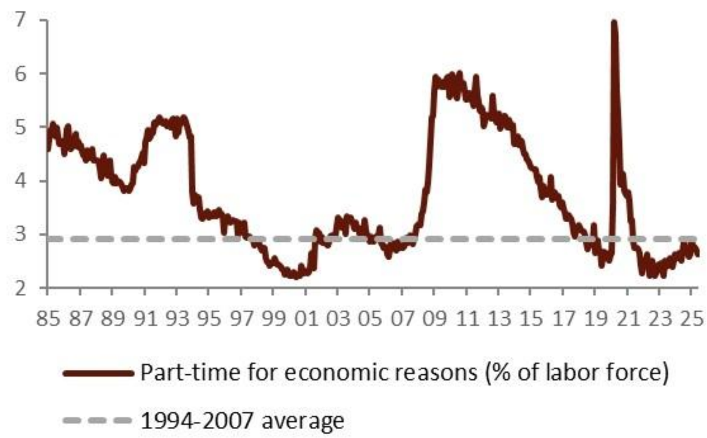


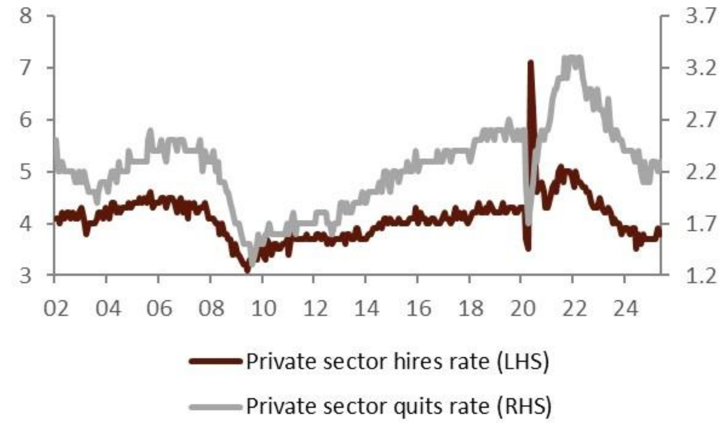
FOMC Forecasts	Median				Central Tendency			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.4	1.6	1.8	1.8	1.2–1.5	1.5–1.8	1.7–2.0	1.7–2.0
March projection	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0
Unemployment rate	4.5	4.5	4.4	4.2	4.4–4.5	4.3–4.6	4.2–4.6	4.0–4.3
March projection	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3
PCE inflation	3.0	2.4	2.1	2.0	2.8–3.2	2.3–2.6	2.0–2.2	2.0
March projection	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0
Core PCE inflation	3.1	2.4	2.1		2.9–3.4	2.3–2.7	2.0–2.2	
March projection	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1	
Projected policy path								
Fed funds rate	3.9	3.6	3.4	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6
March projection	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6

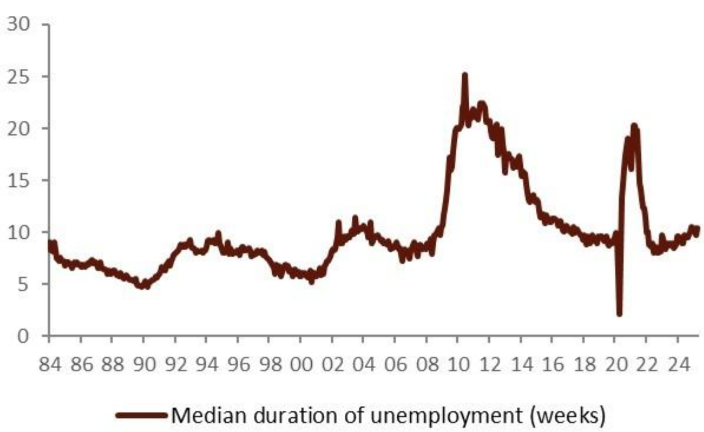
High frequency data heat-map

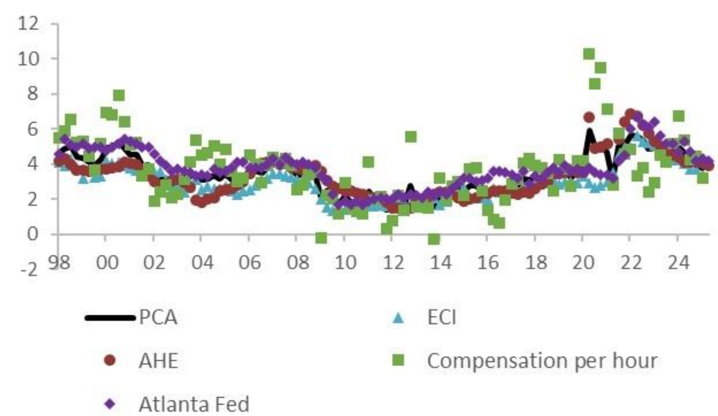


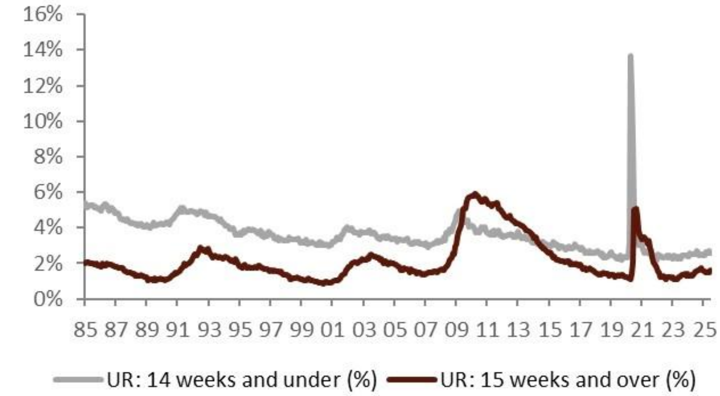
Labor market indicators

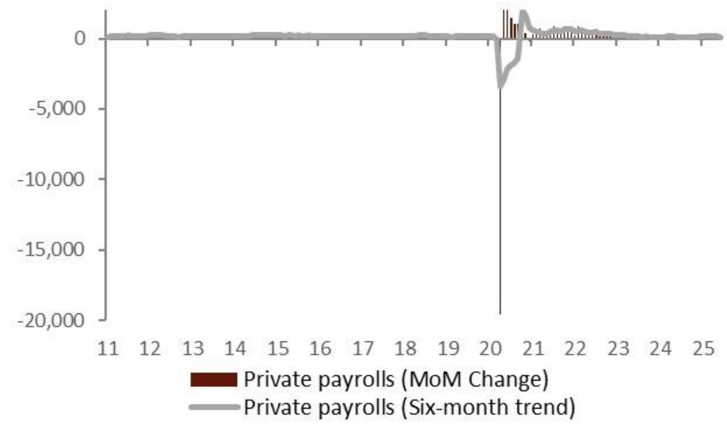




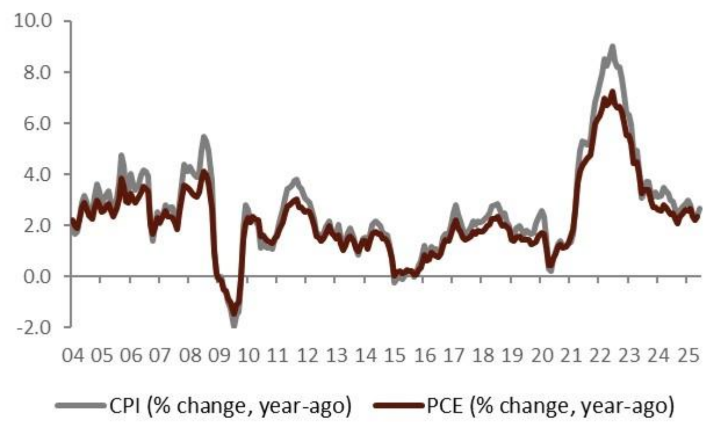


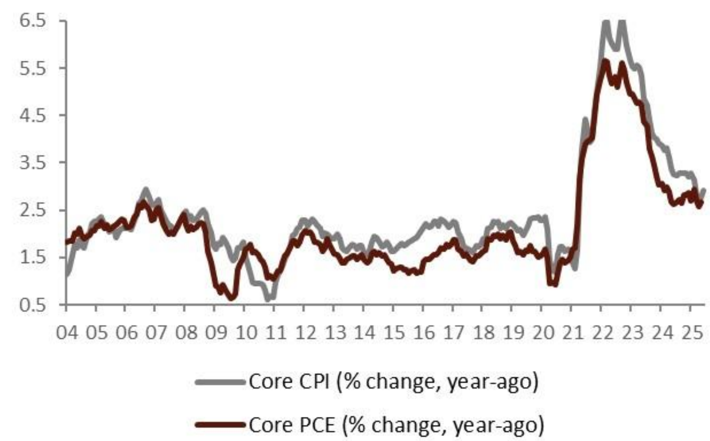


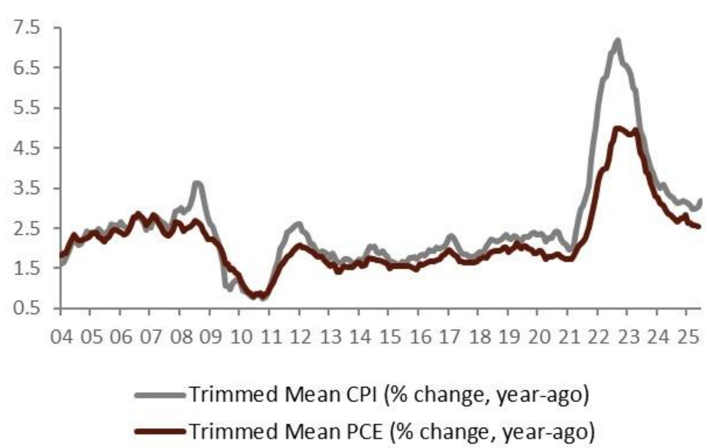


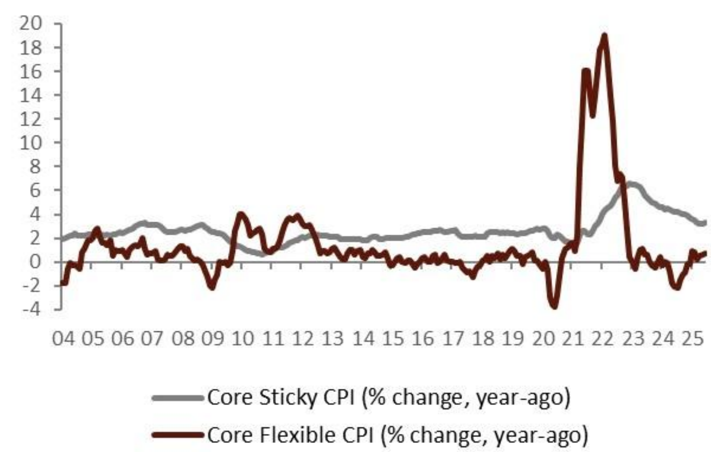


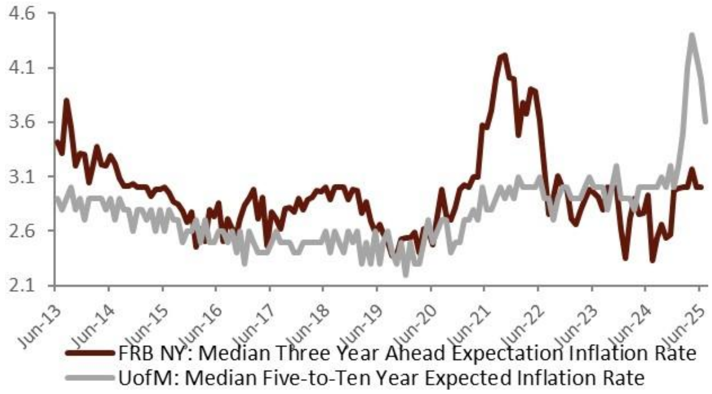
Inflation indicators







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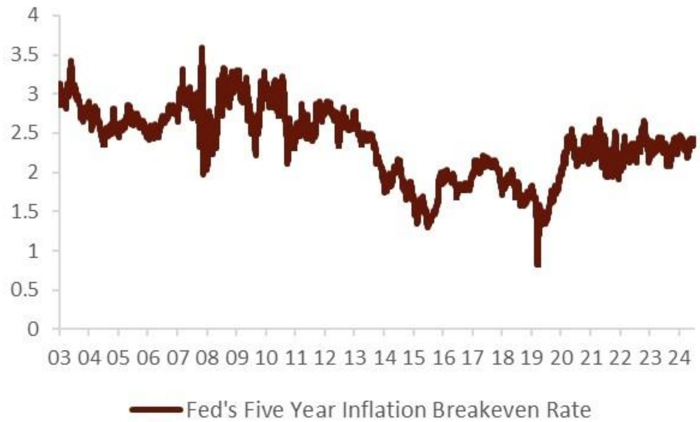
FRB NY: Median Three Year Ahead Expectation Inflation Rate
UofM: Median Five-to-Ten Year Expected Inflation Rate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Fed's Five Year Inflation Breakeven Rate