DIAMOND HILL

INVESTED IN THE LONG RUN

July's Late News Frenzy Leaves a Mark

Jul 2025

Tariffs dominated headlines again in July, with the original 90-day deadline delay being pushed to August 1. The US wrapped up key deals with Japan, the EU and South Korea by the end of July, but tariffs rose for many other countries on August 1. The agreements with Japan and the EU remain opaque, with attention-grabbing headlines but not much detail.

Treasury yields finished the month higher, though not without some mid-month volatility after reports leaked that Trump had considered firing Jerome Powell — an idea he quickly walked back. The final week of July delivered key economic news to the market:

- **Housing market cools off:** Signed home sale contracts hit their lowest level since 2012 — an unusually sharp slowdown during what's typically the busiest season for housing.
- **Consumer confidence edges higher:** The index rose to 97.2 in July, up from 95.2 the month prior, suggesting a modestly more optimistic outlook among consumers.
- **Core PCE shows modest uptick:** The June core PCE index, released on the last day of July, rose 0.3% month over month, pushing the year-over-year rate slightly higher to 2.8%. Personal income and spending both increased by 0.3%, while the savings rate held steady at 4.5%.
- **Fed held rates steady amid dissent:** The FOMC left rates unchanged, and Powell struck a slightly hawkish tone in the post-meeting press conference. Notably, the decision included two dissenters (Waller and Bowman) — the first split vote since 1993.
- **GDP rebounds in Q2:** Second-quarter GDP rose 3.0%, reversing a 0.5% decline in Q1. The swing reflects tariff-driven volatility, as businesses front-loaded imports earlier in the year, leading to a sharp drop in Q2 goods imports.

How is inflation calculated, and how much noise can there be?

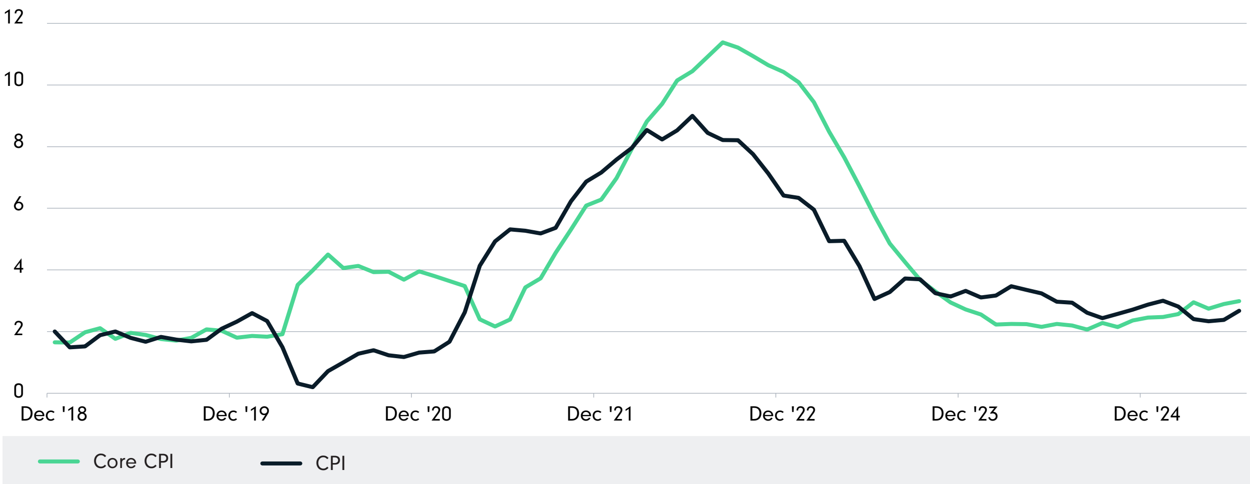
Inflation ranks behind only tariffs (and maybe slightly ahead of the labor market) from a headline-grabbing standpoint, as well as the implications for action/inaction from the Federal Reserve. But how much does the average person know about the process of calculating inflation?

Inflation data can be complex, with several measures capturing different facets of price changes. Here's a quick overview of the four key indicators often referenced in markets and policy discussions:

- **Consumer Price Index (CPI):** Often called **headline inflation**, CPI tracks the average change in prices paid by consumers for a fixed basket of goods and services. It aims to reflect everyday cost-of-living changes. Recently, volatility in data collection — mainly due to missing price inputs — has led the Bureau of Labor Statistics (BLS) to rely more heavily on estimation methods, or **imputation**, to fill in gaps. These imputations have become more prevalent amid tariff uncertainty.

- **Core CPI:** This version of CPI **excludes food and energy prices**, which tend to be highly volatile. By doing so, it offers a more stable view of underlying inflation trends. While Core CPI smooths out short-term swings, it often still moves in line with headline CPI over time (Exhibit 1).

Exhibit 1 — Inflation Trends (%)



Source: Bureau of Labor Statistics (BLS)

- **Personal Consumption Expenditures Price Index (PCE):** Produced by the Bureau of Economic Analysis (BEA), the PCE is the Fed's preferred inflation gauge. Unlike CPI's fixed basket, the PCE adjusts for **changes in consumer behavior** — like shifting from beef to chicken when prices rise — offering a more dynamic view of spending patterns.
- **Core PCE:** Similar to Core CPI, this version of PCE strips out food and energy to focus on more persistent inflation trends.

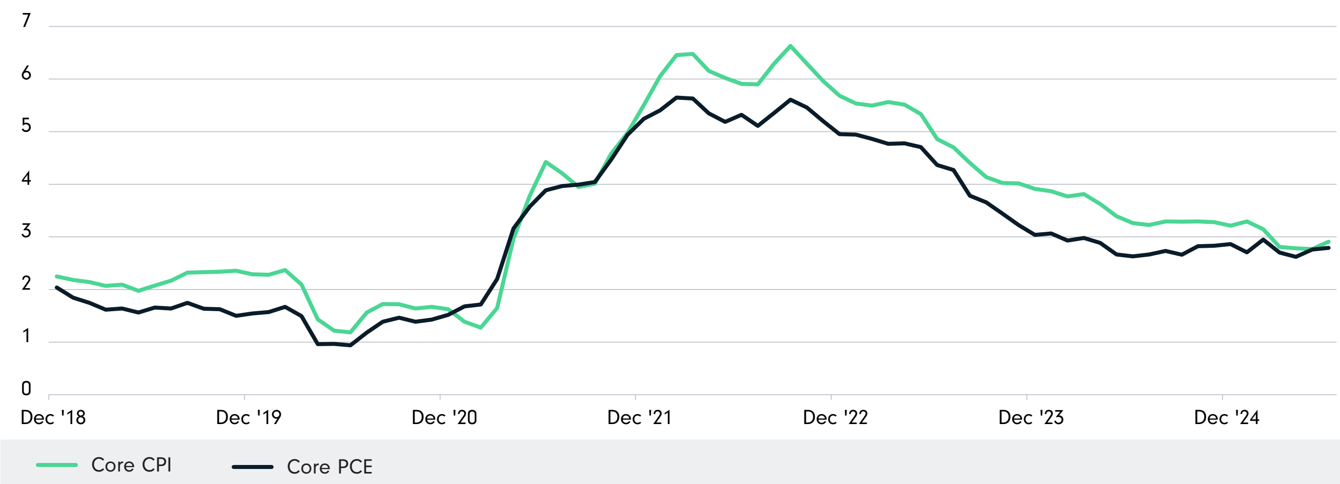
Why are there different measurements of price inflation/deflation?

CPI and PCE PI are both used to track inflation, but they rely on distinct methodologies. CPI focuses on spending by urban consumers, while PCE captures a broader view of consumer activity, including spending in rural areas and employer-covered expenses like health care.

Because of these differences, PCE has historically run lower, averaging 3.3% from 1960 to 2025, compared to CPI's 3.8% over the same period. CPI does not account for substitution (e.g., consumers shifting from one product to a cheaper alternative) or spending paid by third parties, making PCE potentially more representative of actual consumption behavior.

Both measures are valuable. CPI plays a role in the cost-of-living adjustments for Social Security and serves as a benchmark for inflation-linked securities like Treasury Inflation Protected Securities (TIPS) and inflation swaps. Meanwhile, the Federal Open Market Committee (FOMC) adopted PCE as its preferred inflation gauge in January 2012, citing its broader coverage, ability to reflect substitution effects, and adaptability for revisions and updates.

Exhibit 2 — Core CPI vs Core PCE(%)



Source: Bureau of Labor Statistics (BLS), Bureau of Economic Analysis (BEA).

The Fed continues to hold the line

The Federal Reserve wrapped up the month by holding rates at 4.25% to 4.50% for the fifth meeting in a row, despite ongoing demands from the president for lower rates. For the first time since 1993, the decision was concluded with two dissents (Waller and Bowman), both of whom clearly communicated their intentions well before the meeting occurred. Some contend that the dissensions are based more on political gamesmanship than true economic theory, but that seems like an overreach.

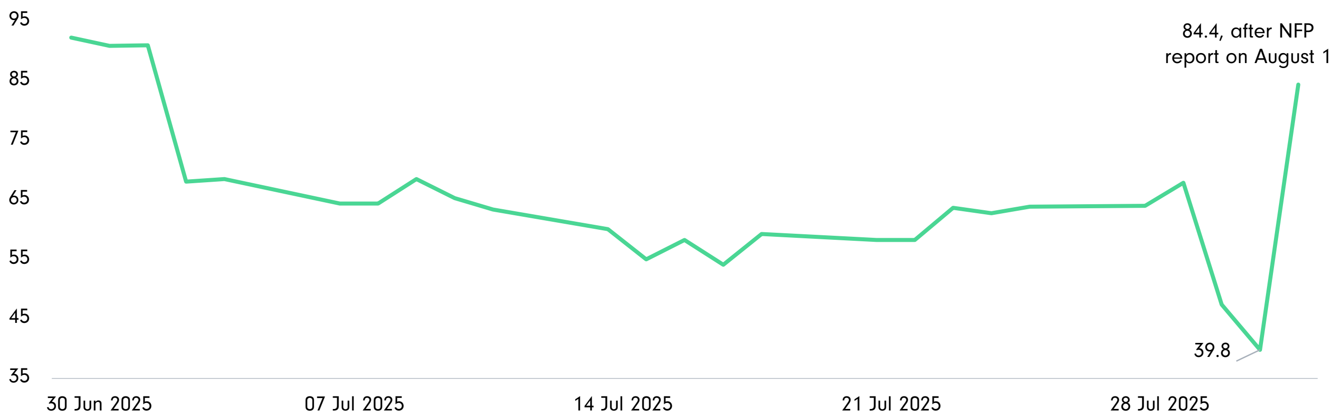
With economic news becoming cloudier, consensus will become harder to achieve as the combination of a weakening labor market and somewhat stubborn inflation makes the FOMC's job much more difficult. So, while chalking up the two dissents to political wrangling is intriguing, it's much more likely that members of the Federal Reserve are becoming divided over the future course of action based on the data they are seeing.

The movement of September 2025 Fed fund futures during the press conference shows the market shift in real time (Exhibit 3). Powell's more hawkish tone in this press conference jolted the futures market, bringing down expectations for a 25 basis-point rate cut from 67.9% on the day before the meeting to 39.8% the day following the meeting (Exhibit 4).

The sharp jump to 84.4% on August 1 is tied mainly to a weaker-than-expected July non-farm payroll (NFP) report, which showed just 73,000 jobs added versus a 104,000 consensus. More significantly, the previous two months were revised down by a combined 258,000 jobs — a historic downward adjustment. As a result, the three-month average for NFP gains has dropped to a sluggish 35,000 per month, while various measures of inflation (core inflation 2.9%, headline inflation 2.7% and Core PCE 2.8%) remain well above the Fed's targeted level of 2%.

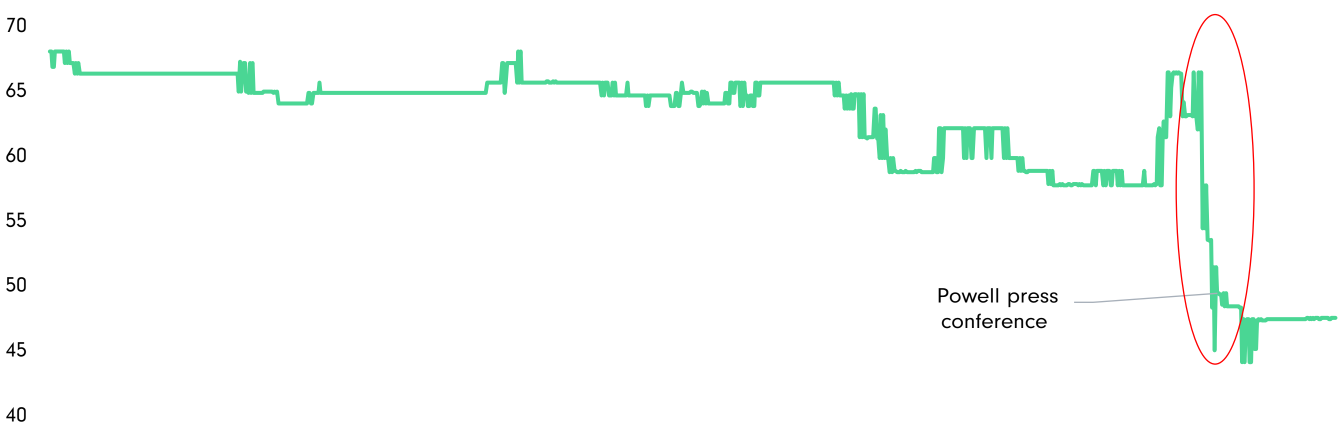
Somewhere, Waller and Bowman might be enjoying a quiet "I told you so" moment.

Exhibit 3 — Percentage Measure of 25-bps Cut at September Meeting (%)



Source: Bloomberg.

Exhibit 4 — September 2025 Fed Fund Futures, July 30 (%)



Source: Bloomberg.

Where do we go from here?

This is probably the most critical question currently in the market as uncertainty around tariffs continues to impact the economy and the markets, and the recent labor market report creates concerns around the future path of interest rates.

While we will continue to hear from various Fed members in the coming weeks, the next official FOMC meeting is not until September 17. However, we do have the Jackson Hole Symposium on August 21-23, which has, at times, served as an opportunity in the past to provide some guidance on any changes to the Fed's thought process between meetings. This year's symposium topic, "Labor Markets in Transition: Demographics, Productivity, and Macroeconomic Policy," is timely, considering the weakening that has arisen from the most recent labor report.

The Fed will continue to rely on incoming economic data and use the media and speeches to convey shifts, if any, in its outlook for the path of rates. And the markets will continue to attempt to read the tea leaves and discern meaning from every comment and paper that emerges over the next several weeks.

After the tumult of April and subsequent recovery in May and June, fixed income spread levels are essentially at or below levels before Liberation Day. Continuing to focus on relative value and temporary (or longer-term) dislocations in the market to take advantage on behalf of clients will remain key through the end of the year. However, as investors, it is crucial to focus on current market conditions when evaluating opportunities and value, rather than trying to predict future market trends. Because as soon as you think you might know how things are going to go, something unexpected will emerge...like a weaker-than-expected labor report.