MACRO STRATEGY | Economic Monthly

A Return to Uncertainty

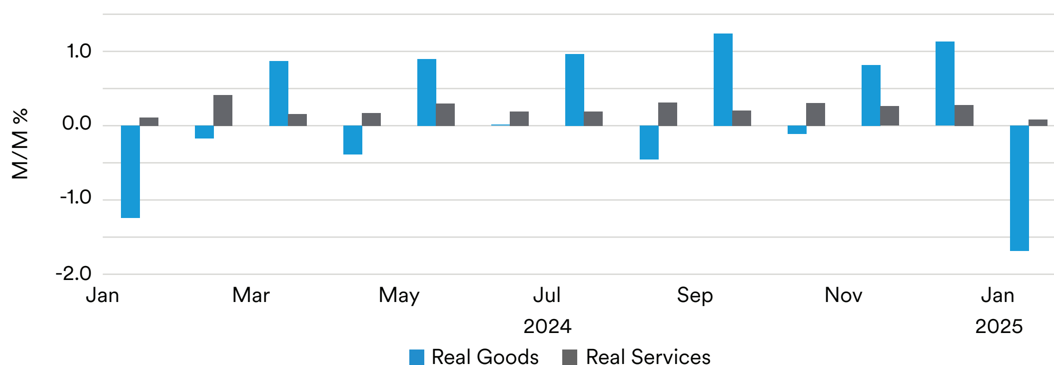
March 19, 2025

We believe that even though 2025 is off to a rough start, firms and consumers will continue to adapt, and growth will stabilize over the year. Many of the negative impacts of lower activity in the beginning of the year (weaker consumer spending, weaker consumer confidence and high imports to front-run tariffs) are idiosyncratic and have the potential to be offset in subsequent quarters, resulting in overall growth that is healthy, albeit weaker than 2024.

Economic and investment uncertainty was high in October and November 2024 owing to the pending U.S. elections. Firms took a "wait and see" attitude toward making decisions. Uncertainty popped post-election, but mixed economic indicators and the new administration's recent policies have created new short-term uncertainties for monetary policy, the government's contribution to growth and firms' investment decisions that can be resolved with clarity about the new administration's policy.

Consumer Spending Could Still be Strong?

Chart 1 | Consumer Goods Spending is Volatile



Source: U.S. Bureau of Economic Analysis (BEA), MIM. As of 3/10/2025.

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While recent data on retail sales and consumer spending appear to show weakness, January alone is far from establishing a conclusive trend. January 2025 was in fact very similar to January 2024. Much of this January's decline was in goods, specifically cars, which frequently exhibit weak or unusual sales behavior at year-end. Real consumer spending on services actually continued to grow in January, as it did for every month of 2024.

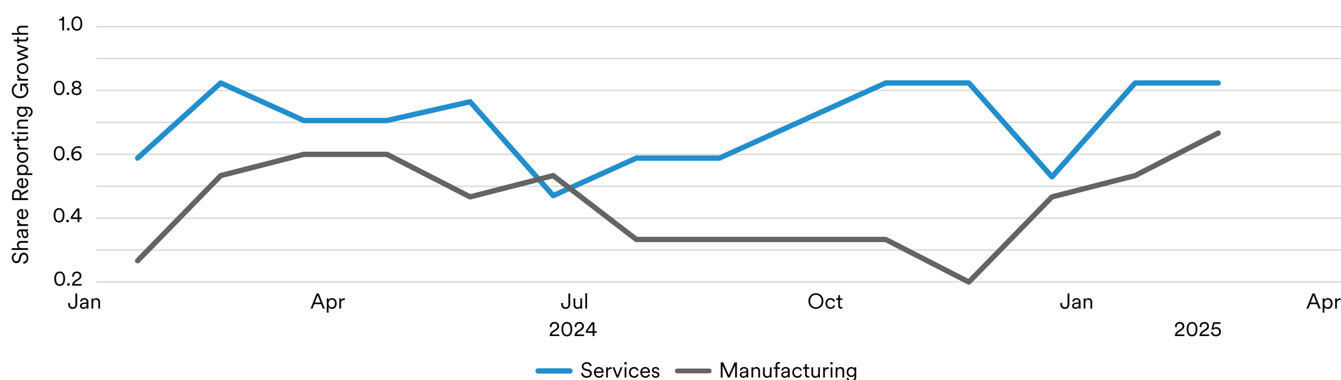
Maintaining consumer spending theoretically hinges on unemployment, but roughly half of consumer spending comes from households earning $250,000 or more (the top 10% of the household income distribution).[1] These higher-earning households have been buoyed by higher asset prices, and we believe that it would take a protracted deterioration in equity and housing prices or a serious spike in the unemployment rate for high paying jobs to meaningfully constrain their spending. For reference, the latest Bureau of Labor Statistics (BLS) data show that even as the overall unemployment rate for workers aged 16+ increased to 4.1% in February, the rate for workers aged 25+ with at least some college education remained a tight 2.5%.

We believe these households will continue supporting aggregate consumer spending through the year, even though we expect a gentle increase in the unemployment rate due both to private and public sector job cuts.

Will Some Firms be Better Off?

Uncertainty is making it more difficult for some firms (and their customers) to plan purchases and make long-term commitments. But others, those that are less exposed to tariffs or are even protected by them may be able to take advantage of the situation to profit and grow.

Chart 2 | Firms are Still Reporting Growth



Source: Institute for Supply Management (ISM), MIM. As of 3/10/2025.
Manufacturing tracks 14 industries, services tracks 17 industries.

In January and February, an increasing share of manufacturing industries reported growth even as the effects of uncertainty around tariffs had already begun. In the comments, many firms across both manufacturing and services were concerned about tariffs. However, some industries, such as electronics products, reported minimal to no tariff impact. Comments from electrical equipment and fabricated metal product firms showed indications of improved demand and stronger new orders.

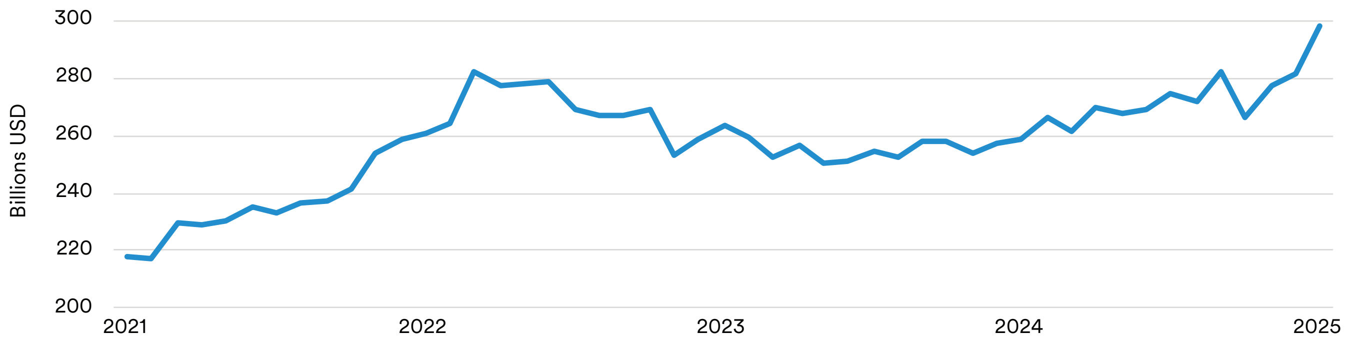
Will The Trade Deficit Drag Down Growth?

In our February Economic Monthly, we pointed out that firms significantly altered their behavior in response to policy changes after the 2016 election, with U.S. trade exposure to China plummeting. Now many "friendly" country imports, like those from the EU, Mexico and Canada, will also probably be subject to tariffs. Firms have tried to pre-empt the tariffs, as evidenced by a spike in goods imports in January.

We expect goods imports to continue to be high for the next few months, as firms try to accumulate capital and industrial supplies before more tariffs take effect. While this may be a drag on Q1 growth, net exports are a very small component of GDP, and our expectation is to see lower imports later in the year to balance out the first quarter.

Second, even though imports represent a subtraction in the GDP calculation, it is important to remember that at the end of the day, imports are consumption. It is a positive sign for the state of the economy if imports are high, because that means firms and consumers can buy things.

Chart 3 | Goods Imports Have Skyrocketed



Source: USCB, MIM. As of 3/10/2025.
Imports excluding monetary gold.

Outlook

We expect growth in 2025 to be slightly weaker than 2024 but still above trend and without a recession.

While there is increasing amounts of data to indicate bimodal consumer behavior with differences between higher- and lower-income consumers, aggregate balance sheets remain healthy, and wage growth continues to grow slightly above inflation. If the administration provides more clarity on tariffs and fiscal policy, healthy corporate profits could drive an increase in investment. We do not expect strong real investment growth in Q1 of 2025, but we do expect it to ramp up slowly over the year as uncertainty is absorbed.

As expected, the new administration presents a high noise-to-signal ratio, and election uncertainty has been replaced with policy uncertainty. Tariffs can be expected with certainty. But the timing and extent keep changing, although April 2 is now a date that has been reiterated. Margin compression and inflation effects can be expected, depending on the industry affected.

We expect government spending—a major supporting player in the recent growth story—to be pared back over the first half of the year. Stimulative effects and deficit increases could subsequently arise from an extension of the Tax Cuts and Jobs Act.

We expect the Fed to continue to move slowly toward the neutral rate by cutting two more times by year-end 2025. A moderate pace fits with the Fed's caution about where the long-run neutral fed funds rate is, even as we expect inflation will take longer to converge toward 2%.

MIM Forecast

	2024	2025
Policy Rate (Upper Bound, YE %)	4.25-4.50*	3.75-4.00
GDP (Ann. Avg. % Chg.)	2.8*	2.3
CPI (Dec. Y/Y %)	2.7*	2.8
10-year Treasury (YE %)	4.57*	4.25
Unemployment (YE %)	4.1*	4.3

*Actuals. *Source: BEA, BLS, Treasury, Federal Reserve, MIM. As of March 2025.*

Risks to The Outlook

We believe the risks to growth are primarily to the downside.

President Trump's policies on tariffs, immigration and other matters could create a range of escalatory economic effects, which may depress investment or reaccelerate inflation. Pro-growth strategies by the new administration, such as extending or implementing new tax cuts, particularly in the context of an already-strong economy, could contribute to overheated conditions. But these will likely be offset by government cost cutting, frozen funding and other canceled government contracts, which would have the opposite effect on growth with potentially significant secondary effects.

Many of the possible policy combinations have the added potential to throw a wrench in the Fed's rate cut plan.

Even as we expect tariffs to have a muted inflation impact, risks to inflation are certainly to the upside. The link between tariffs and higher consumer goods prices is clear, but many services could be forced to raise prices as well through higher costs for capital equipment and industrial supplies.

Although we see downside growth risks and upside inflation risks, we don't expect them to take place simultaneously; that is, we don't see a high risk of stagflation. Instead, a significantly more likely off-base-case scenario is that either weaker growth or higher inflation prevails.

Endnotes

[1] Wall Street Journal, February 2025

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