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Pause for Effect

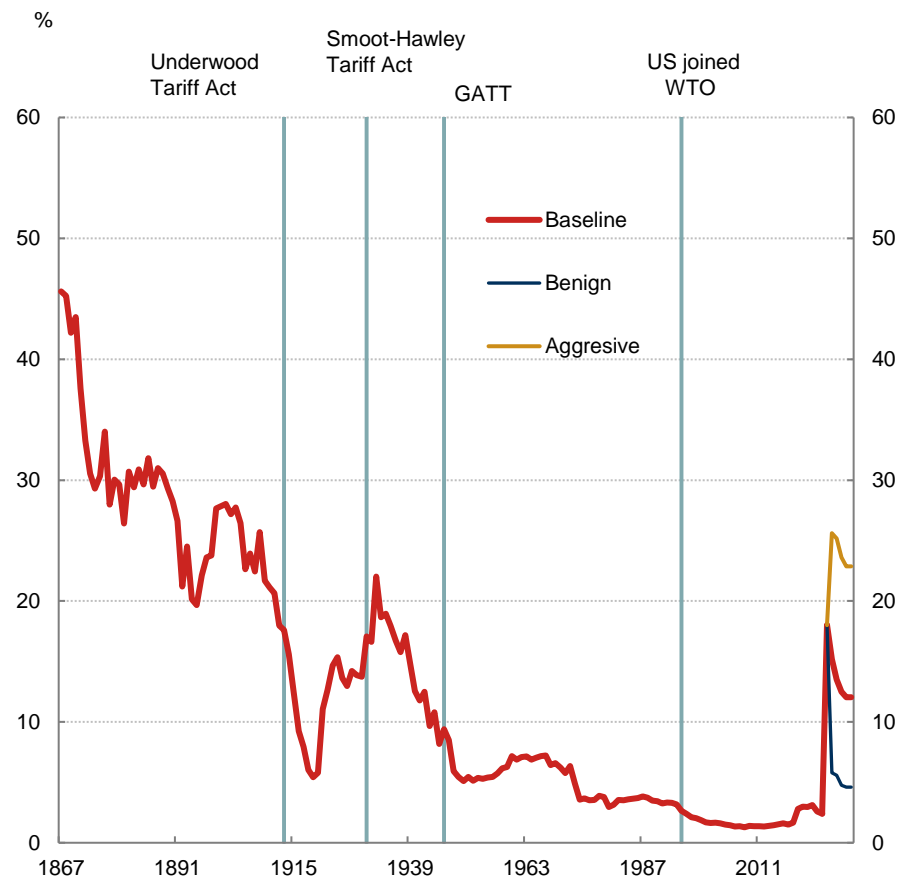
US Economic Outlook

Jeremy Schwartz
US Economics

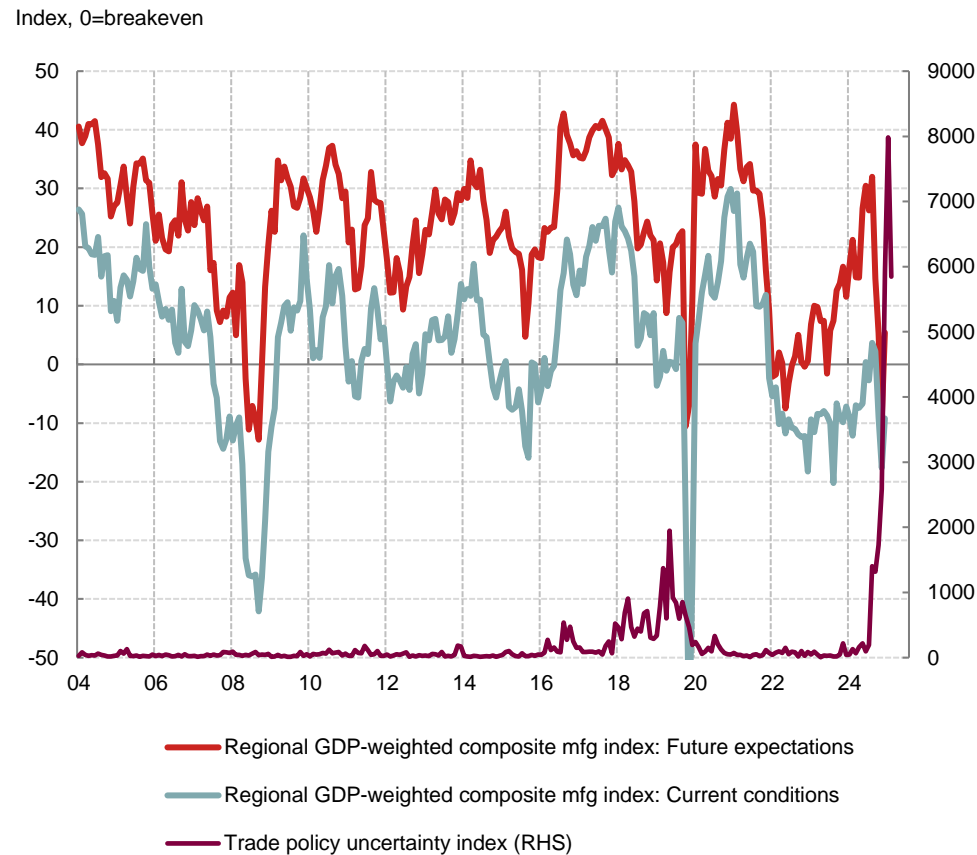
June 2025

Trade war is a large and unprecedented shock

Tariff rates have spiked to their highest level in 90 years



Uncertainty will weigh on sentiment and growth



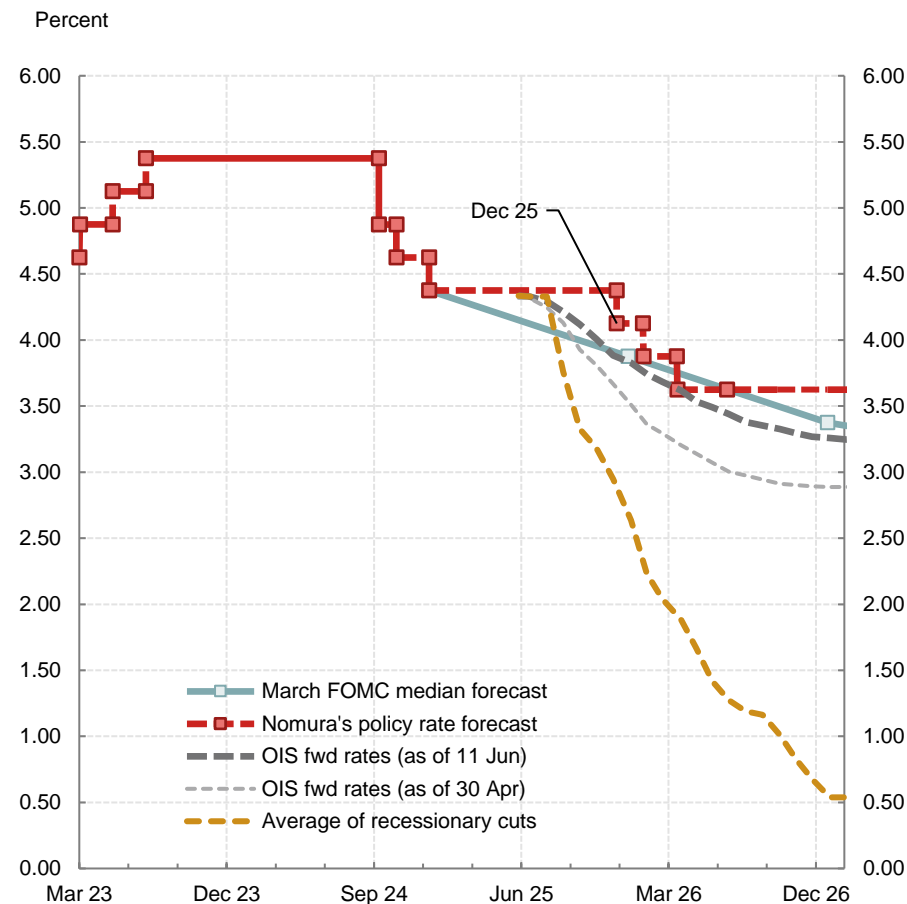
The Fed is in risk-management mode

- When shocks are small and predictable, the Fed attempts to strike a balance between dual mandate objectives.
- Uncertainty + nonlinearity requires a different approach
- If growth muddles along: the Fed will prioritize inflation and remain on hold until confident tariff impact has passed.
- In a recession: the Fed would cut quickly and wouldn't stop after 3-4 eases. Terminal-rate pricing can fall sharply

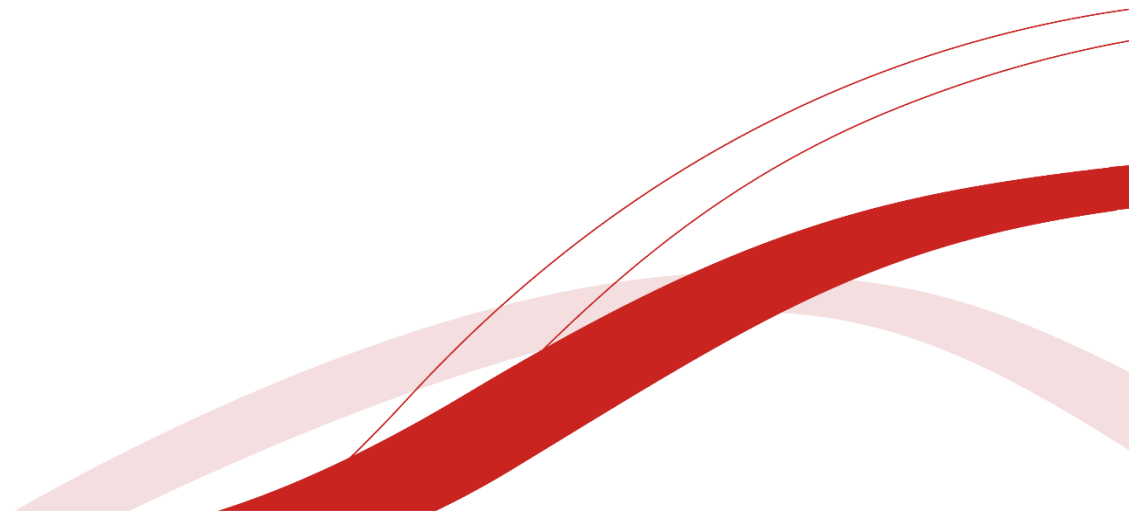
Why no middle path:

- Growth outcome is bimodal. **No such thing as a mild recession.**
- The Fed never finished the job on returning inflation to target. Inflation credibility is a steep cost for “insurance cuts”

We expect the Fed to remain on hold until inflation has begun to decelerate

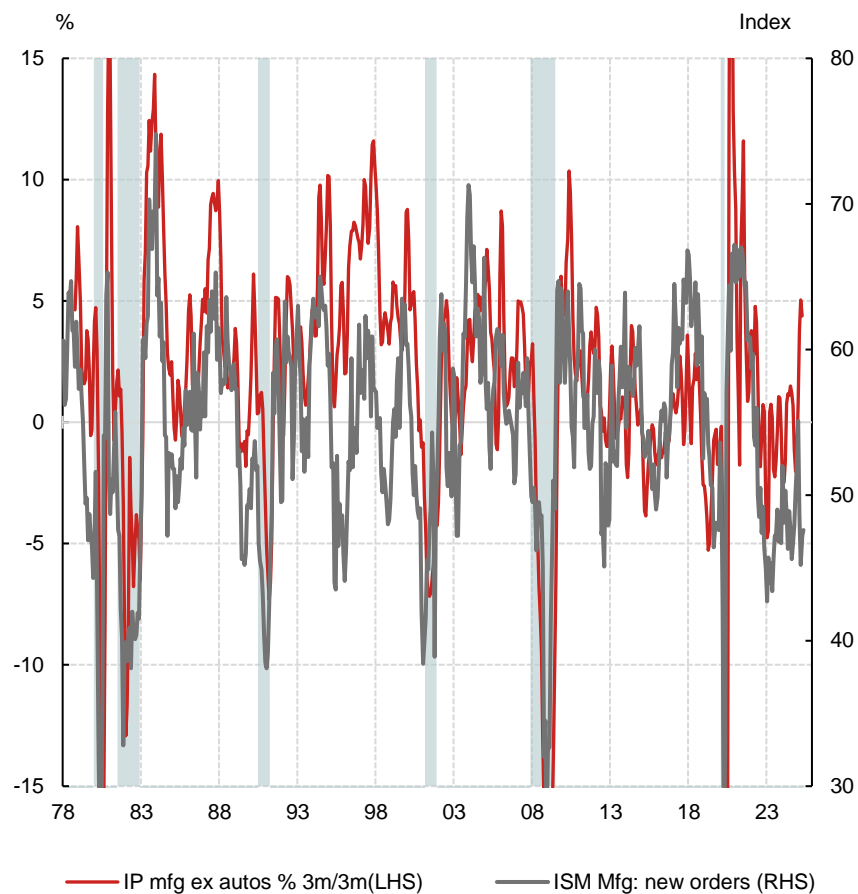


Losing momentum



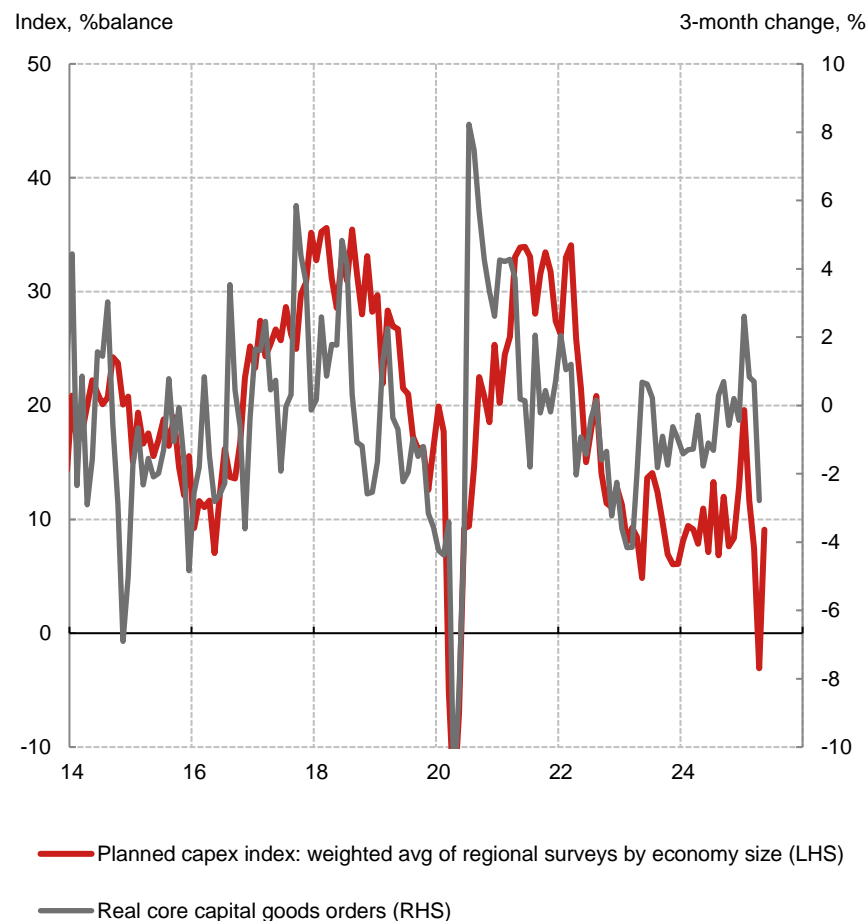
Ignore surveys at your own risk

Sentiment is a reliable indicator of cyclical turning points



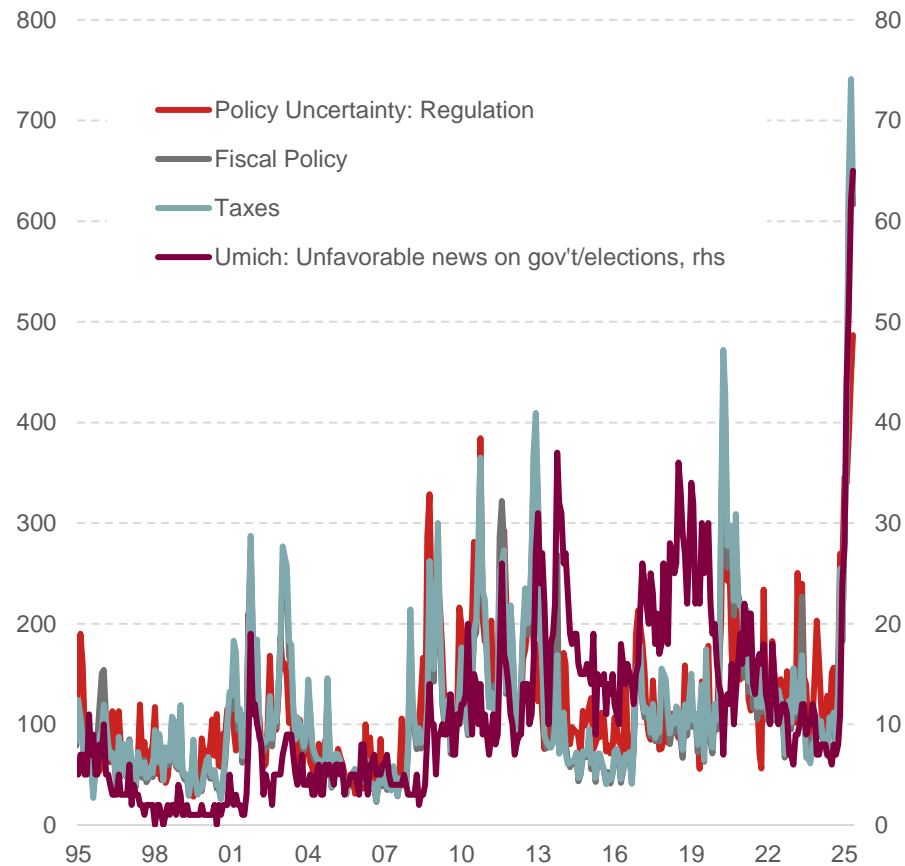
Source: BEA, Federal Reserve, Haver, Nomura

Hard data on investment is tracking sentiment lower

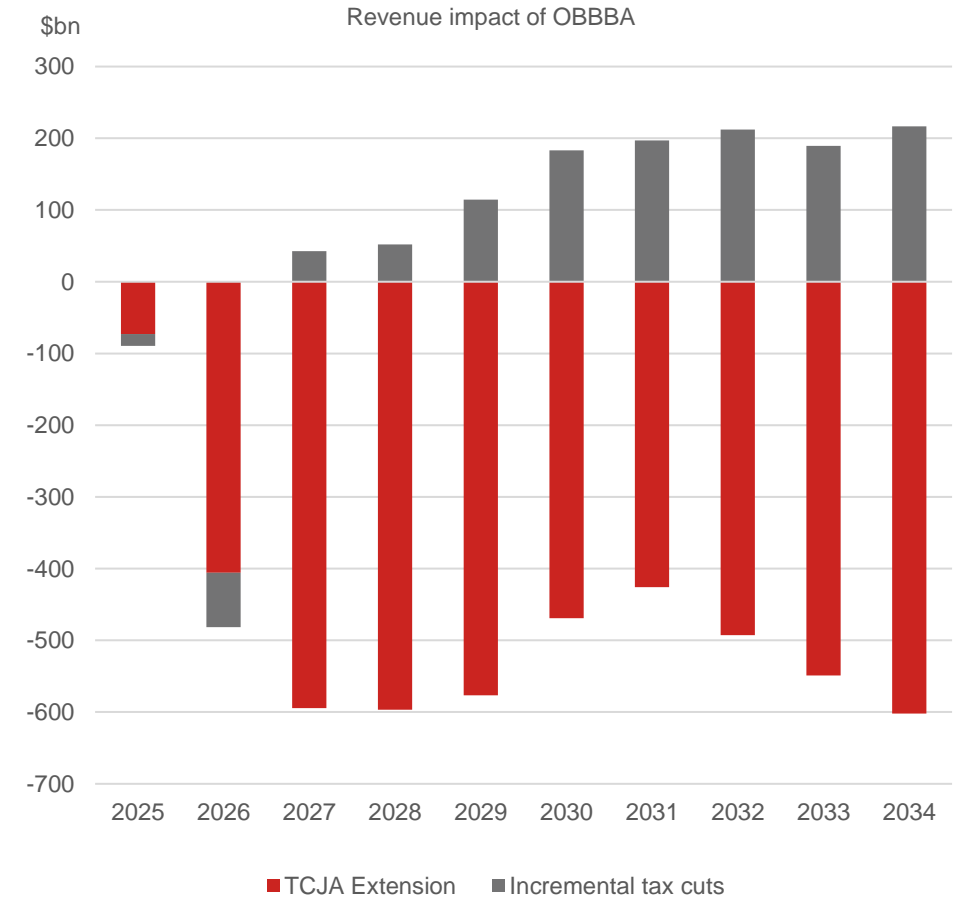


Pro-growth policies won't offset drag from trade

Deregulation unlikely to be a near-term boost

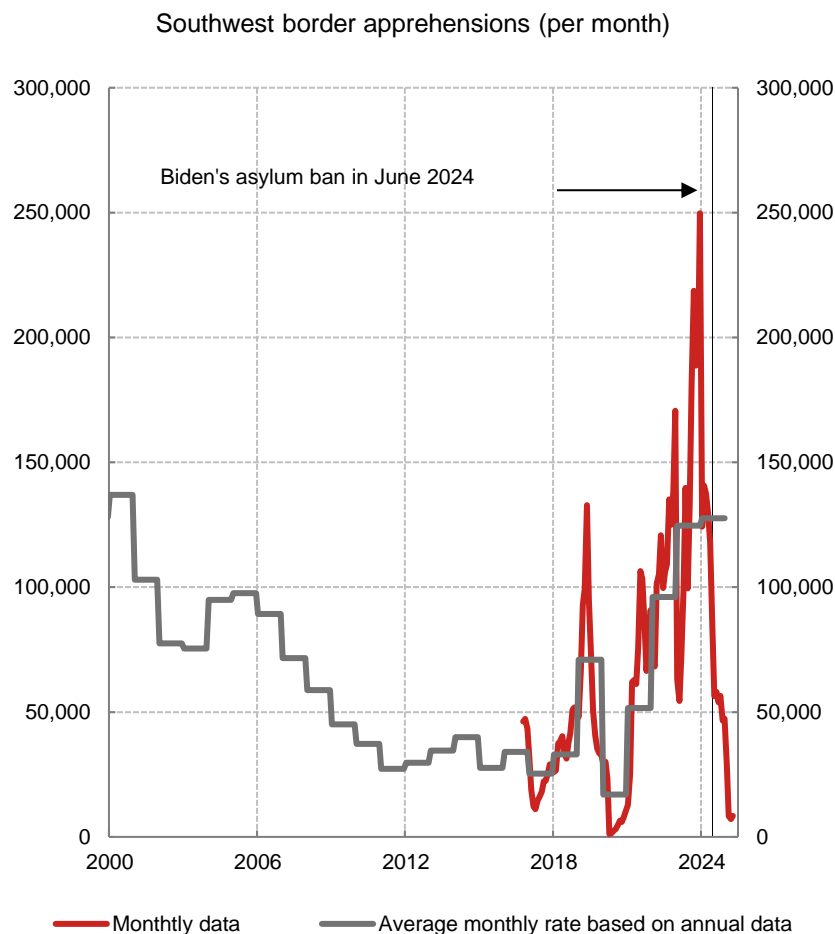


Incremental fiscal stimulus is modest

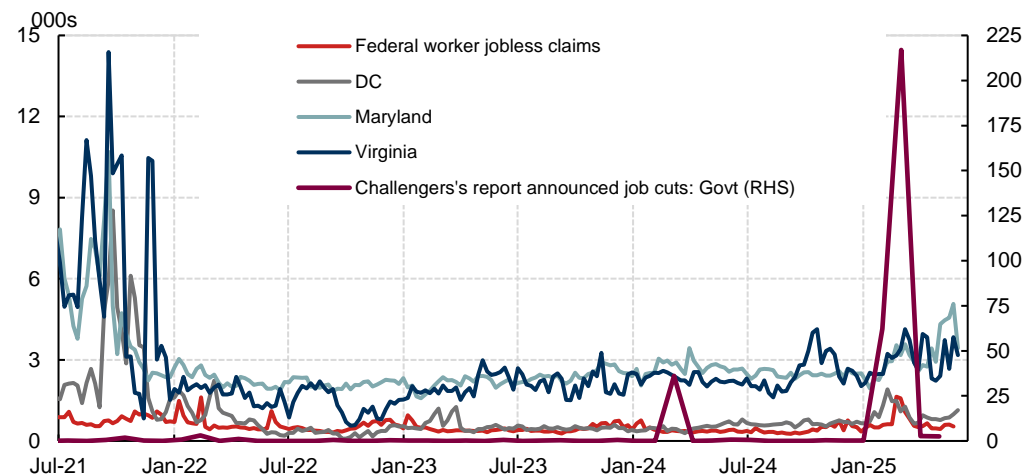


Trump 2.0 policies are negative for labor market

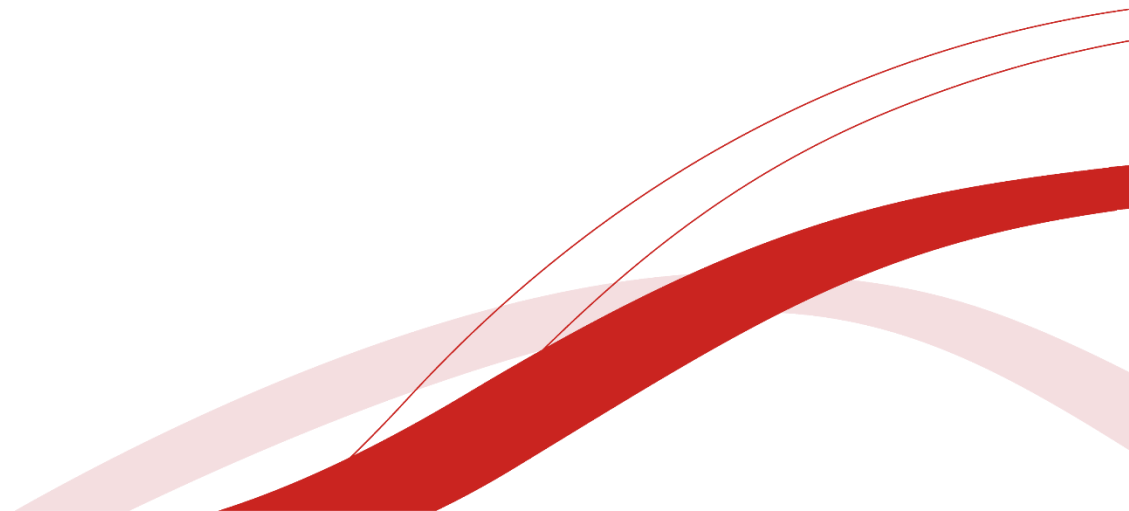
Immigration has already tapered off



DOGE has a small, but noticeable labor market impact

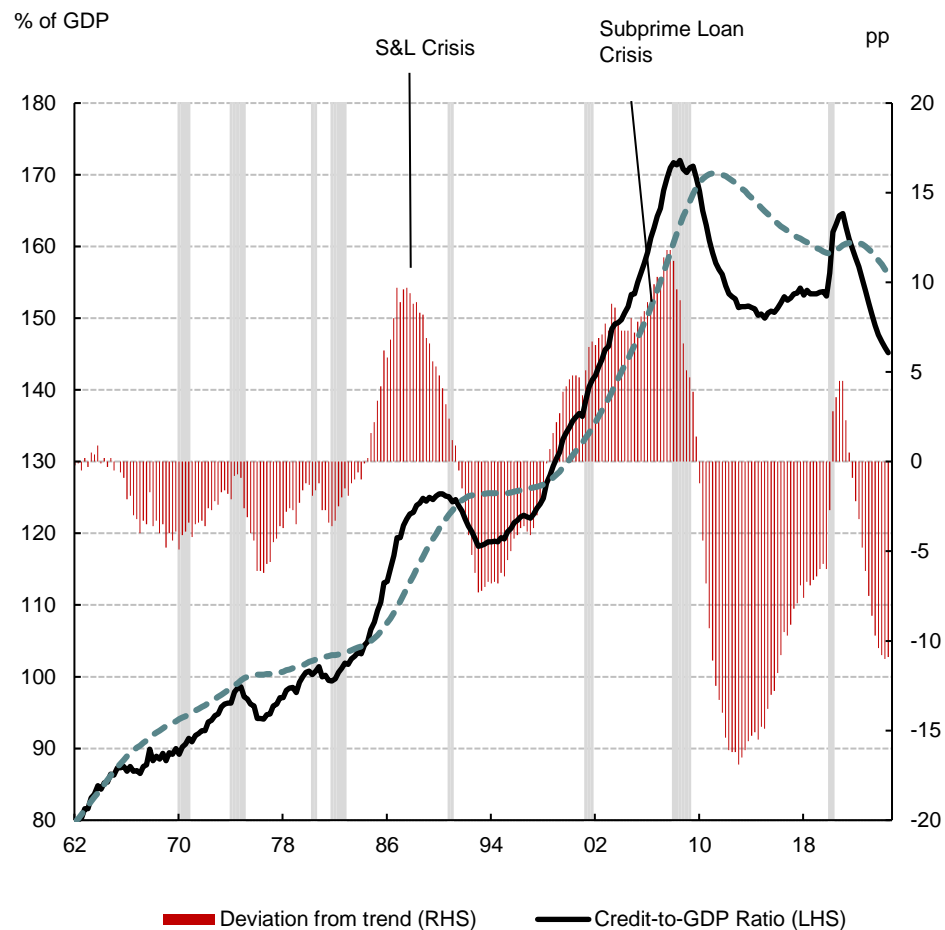


Recession risk

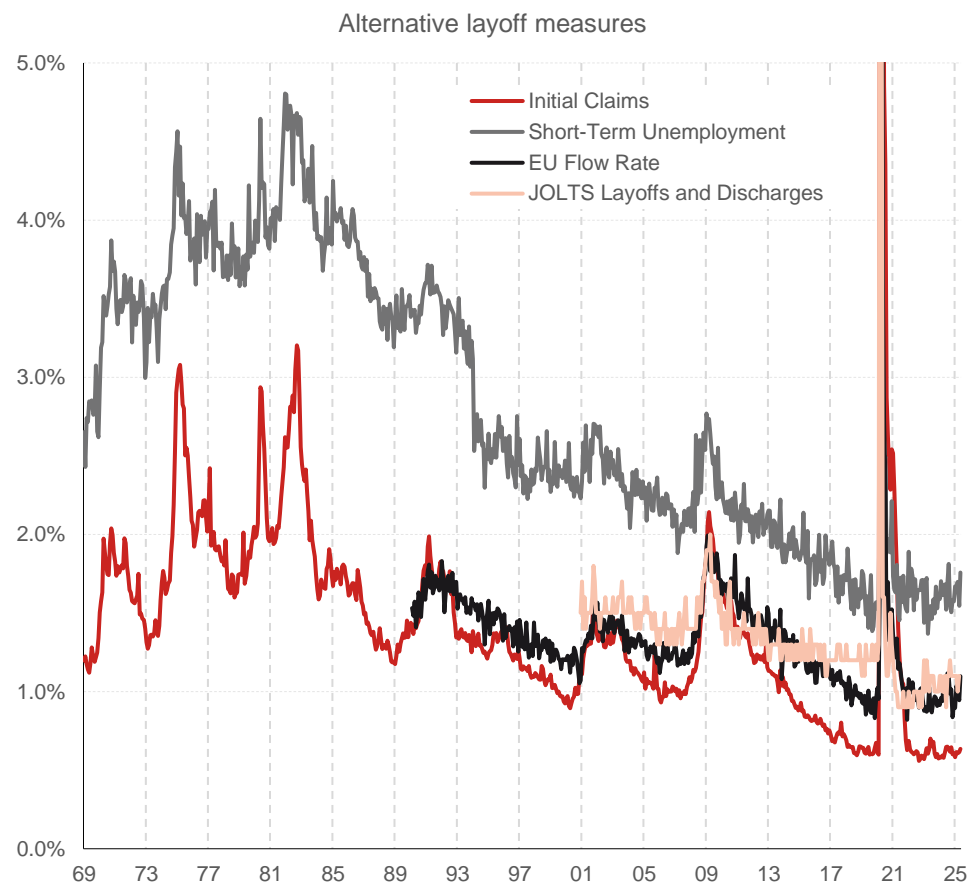


The case for resilient growth

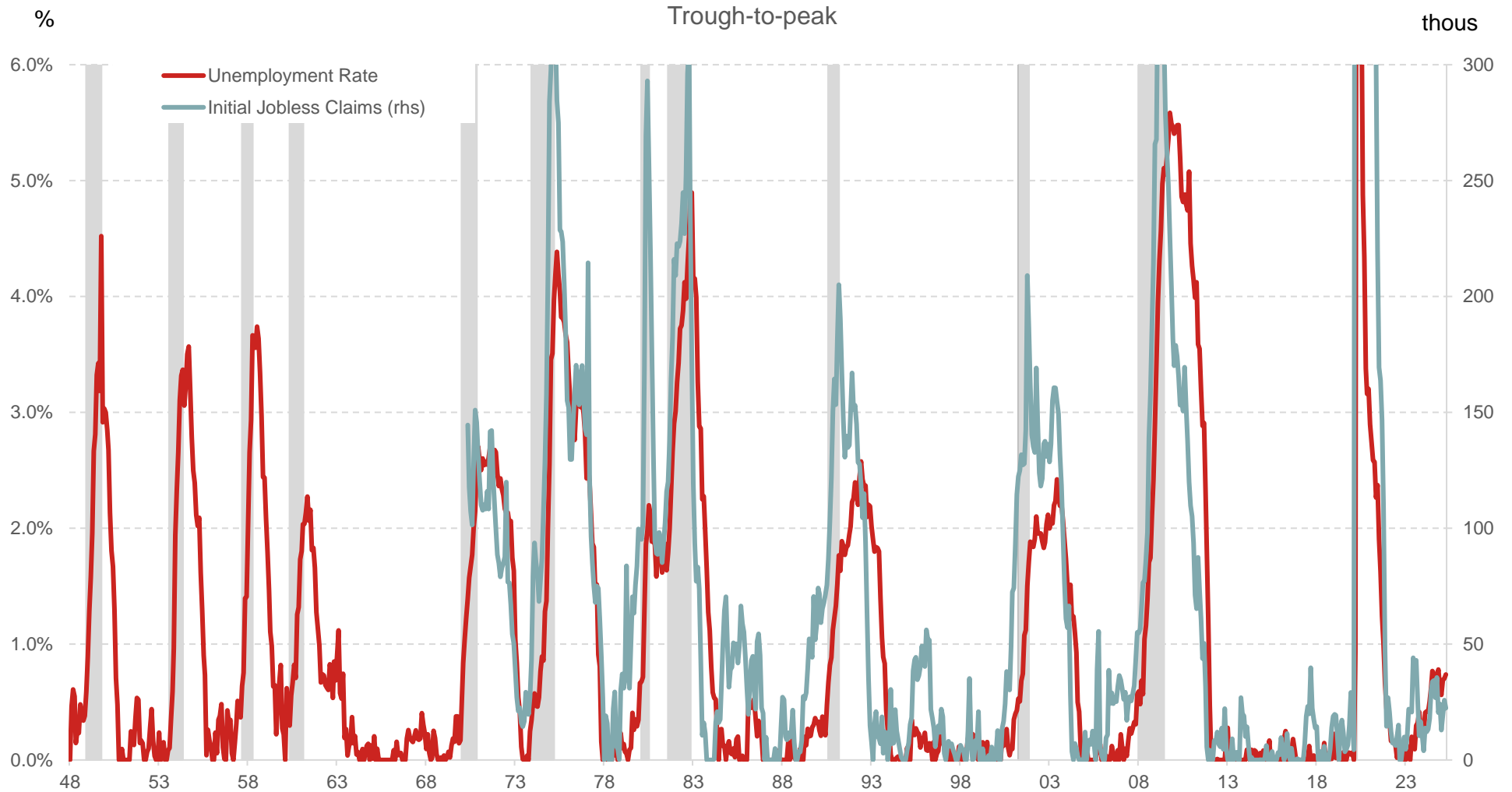
Private sector balance sheets appear healthy



Still no signs of labor market stress

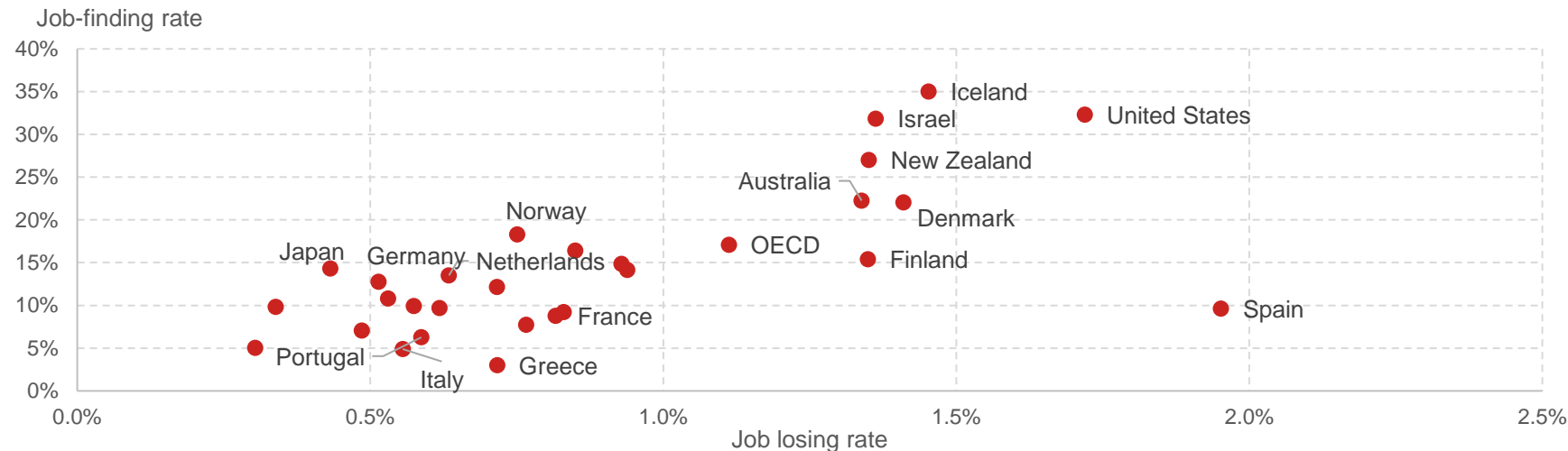


US recessions are not close calls

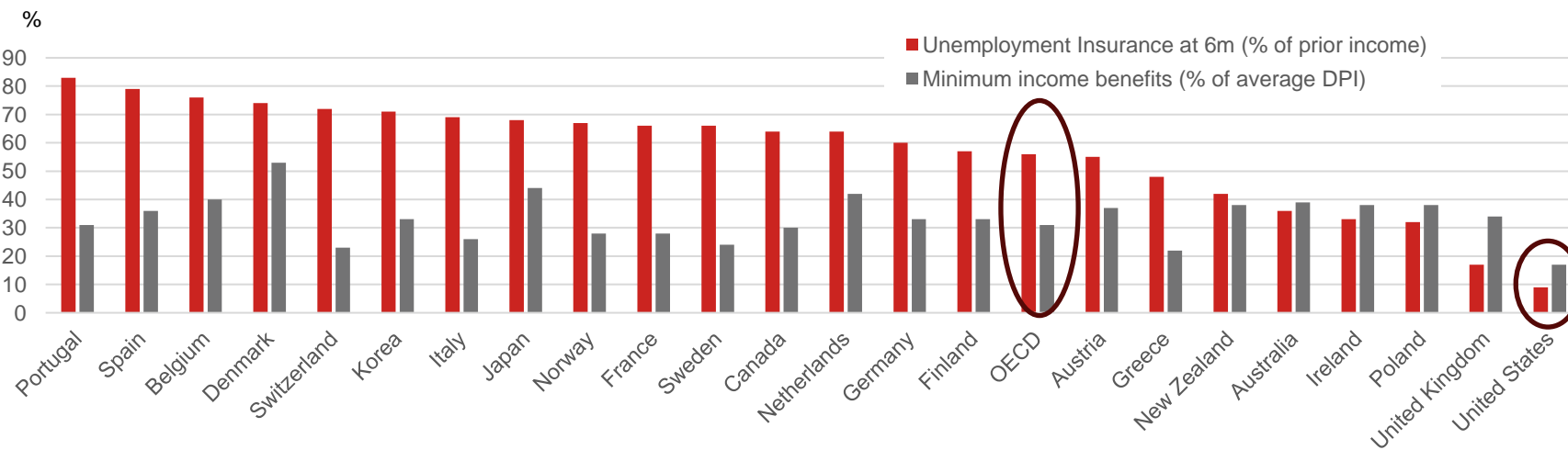


Why no small recessions?

US labor market is exceptionally dynamic

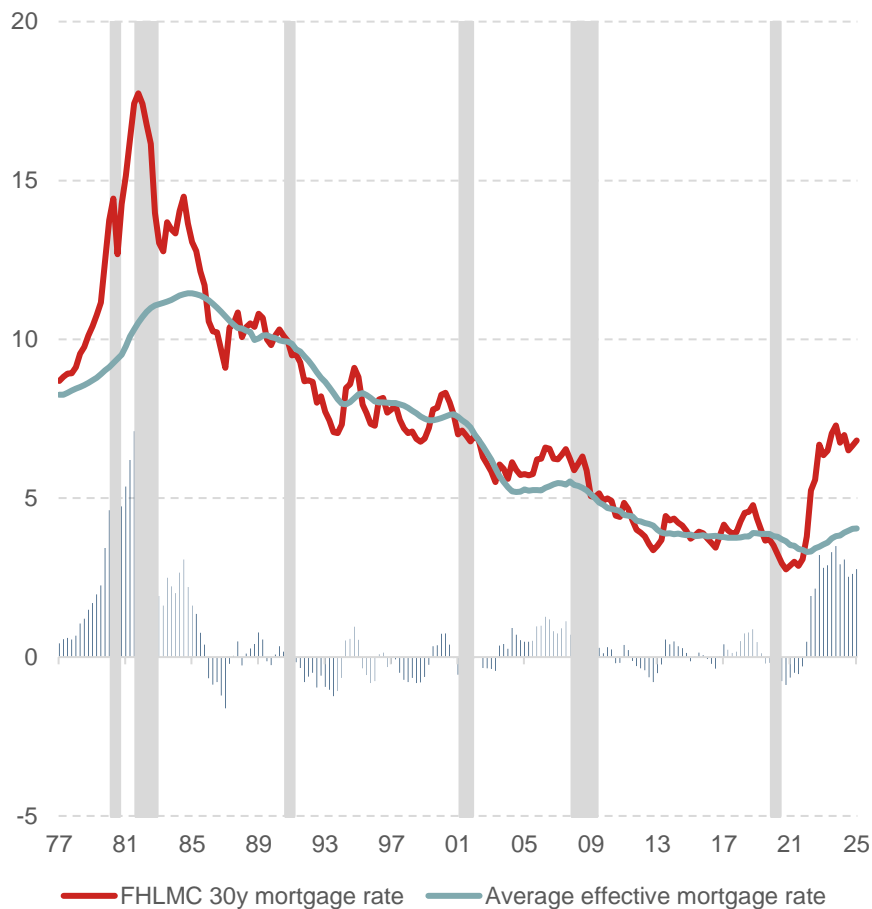


While public safety net offers little margin of error



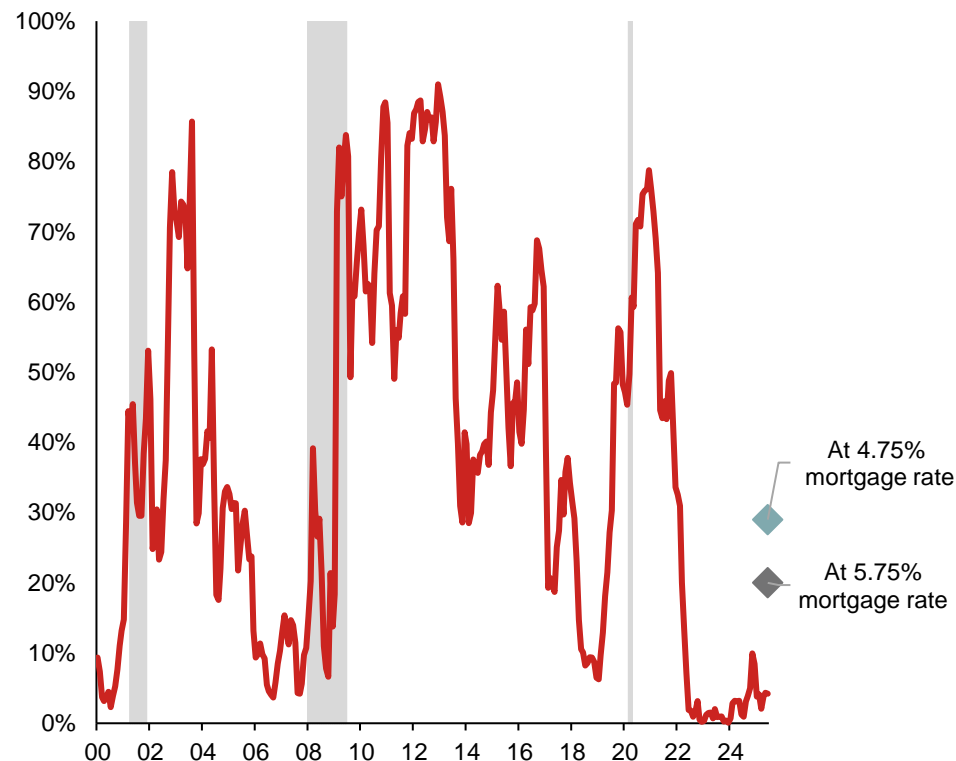
Rate cuts are unlikely to have traction in a downturn

Rates downtrend made policy more effective in past cycles

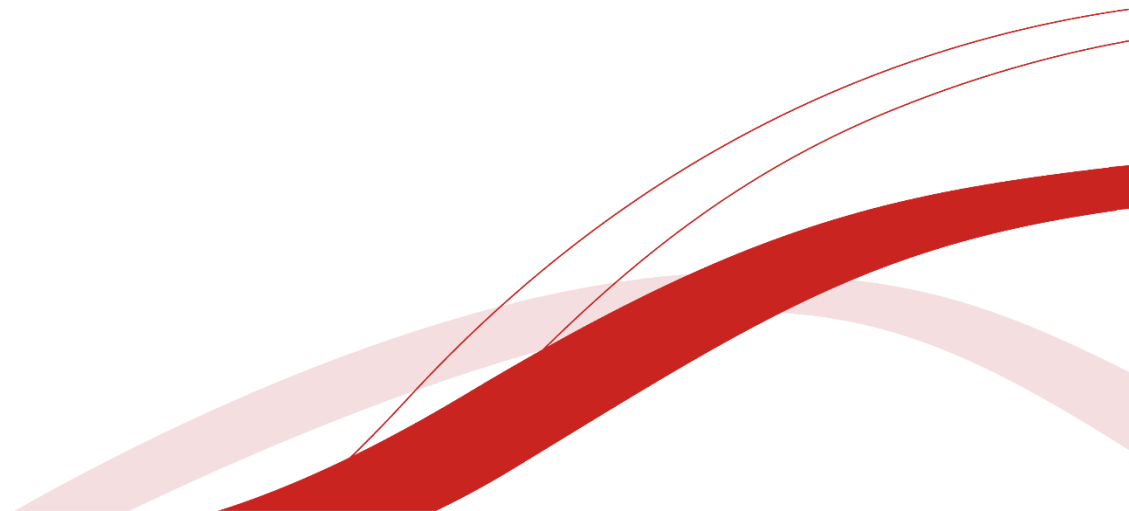


Refi tailwind will be limited even if Fed cuts aggressively

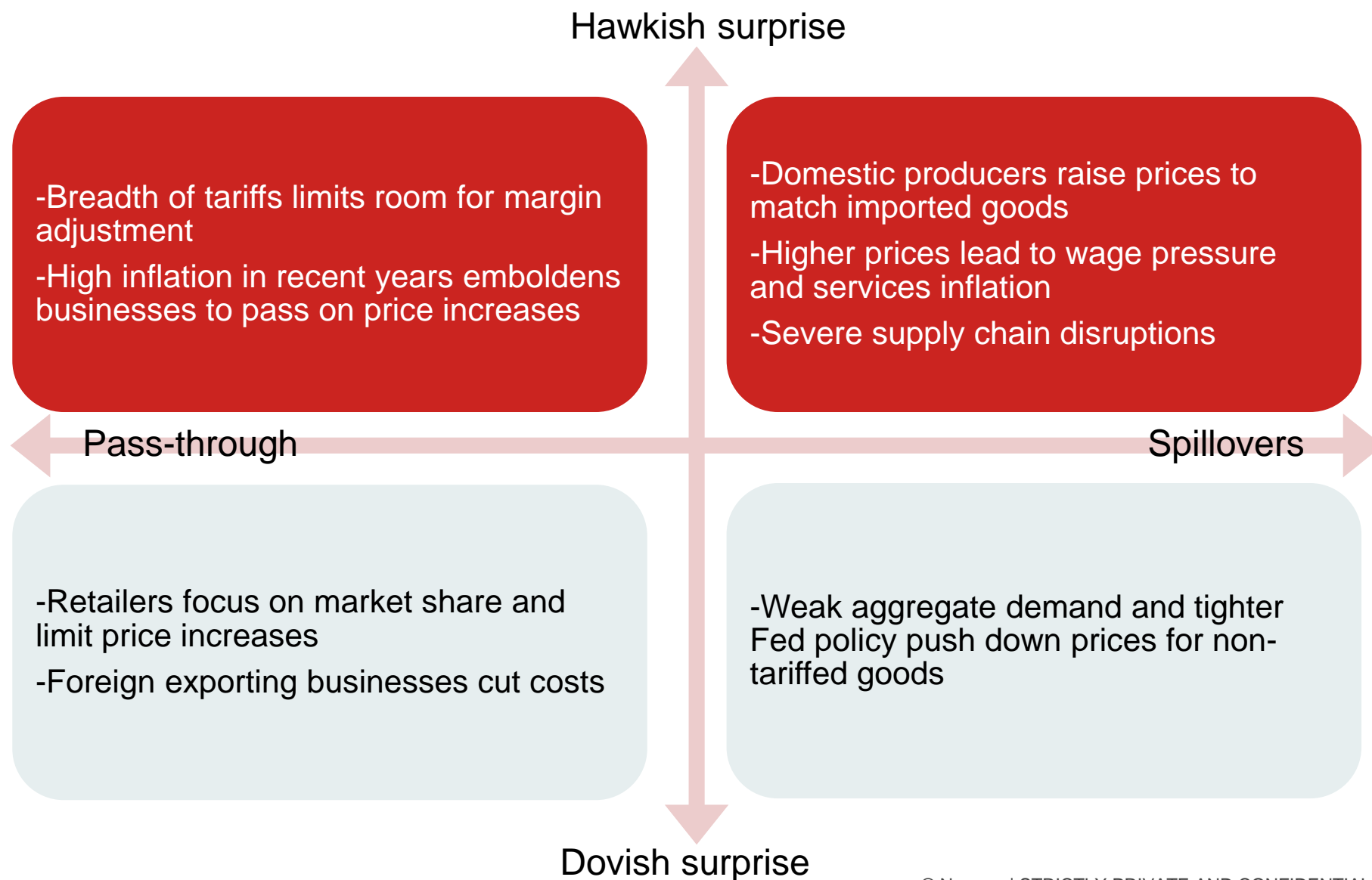
Share of outstanding 30yr conventional mortgages that are >50bp ITM



Inflation: From bad to worse



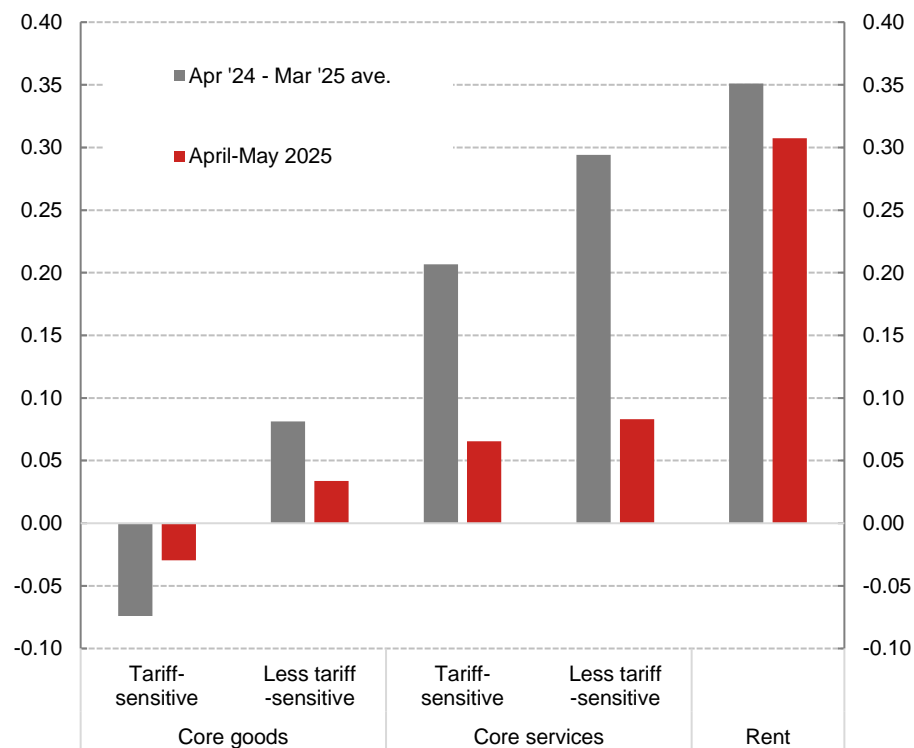
Tariffs and inflation: what could go wrong?



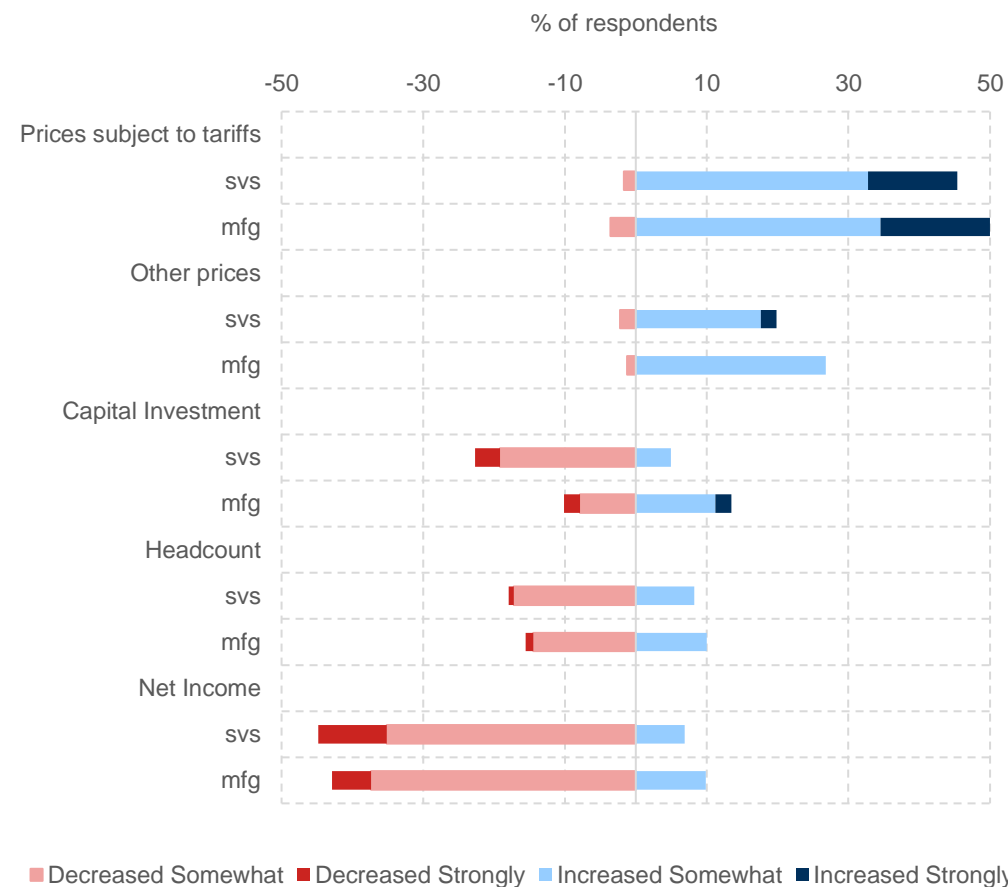
Inflation will likely accelerate into the summer

Tariff-sensitive goods prices only modestly outperformed in April and May

m-o-m, %

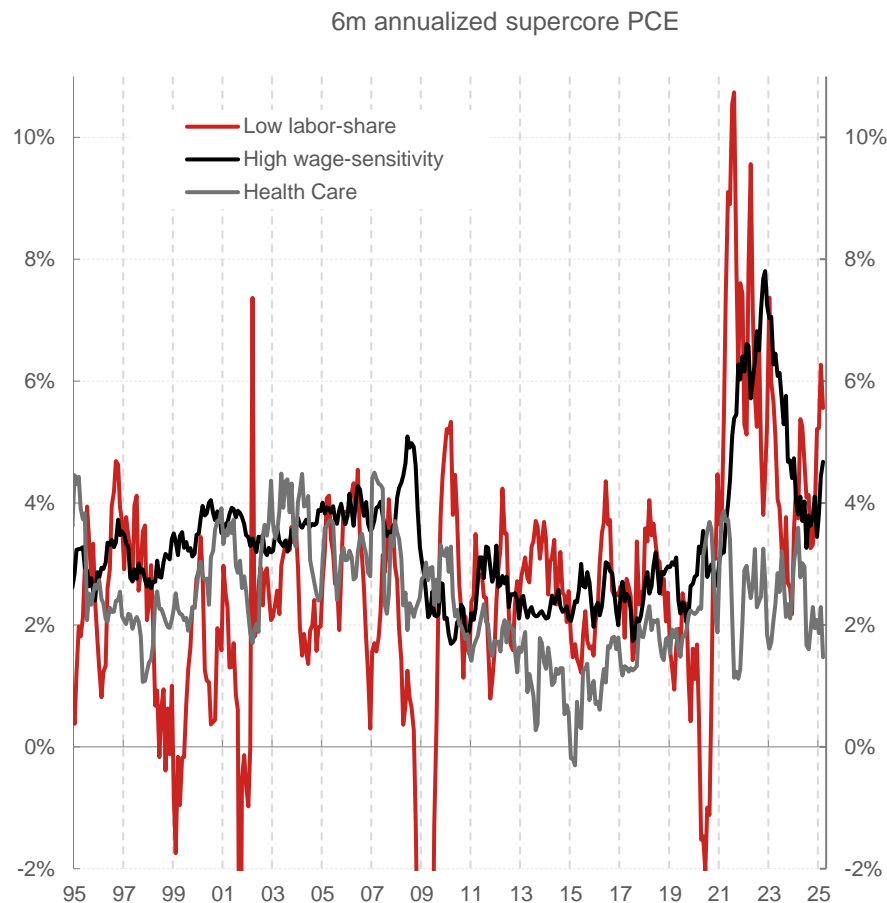


Surveys and anecdotes indicate firms will pass on price increases



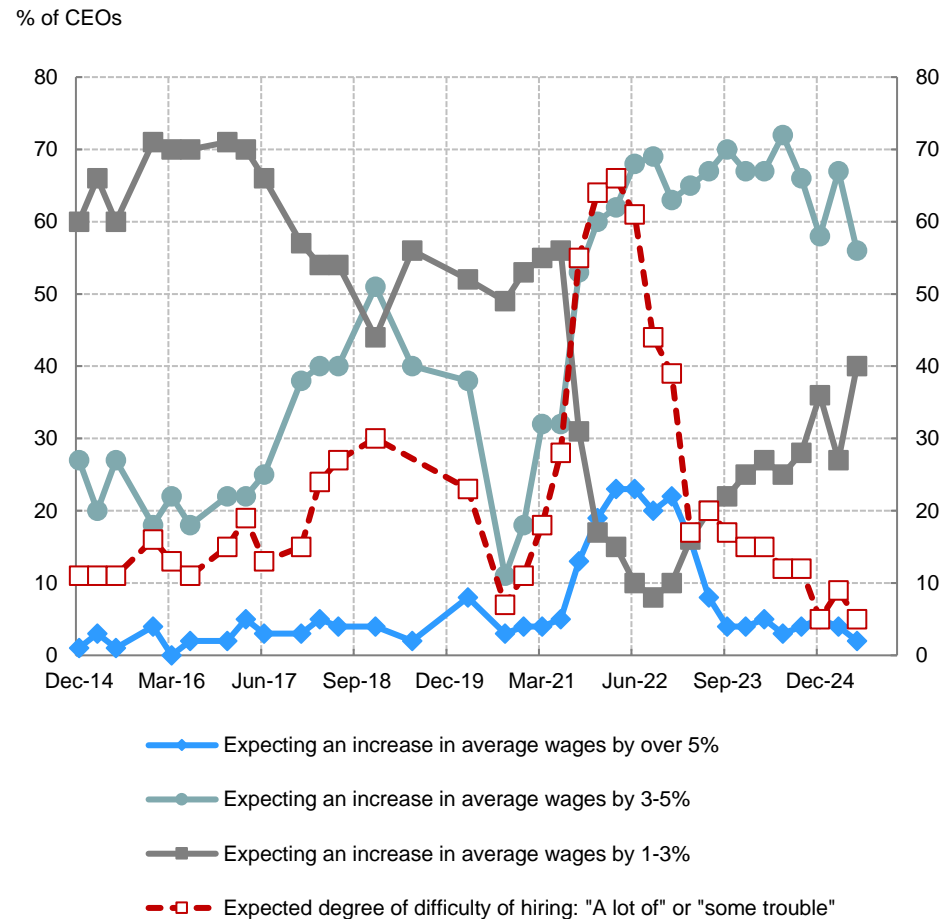
Lingering wage pressure

Wage-sensitive inflation components never returned to pre-pandemic run rate



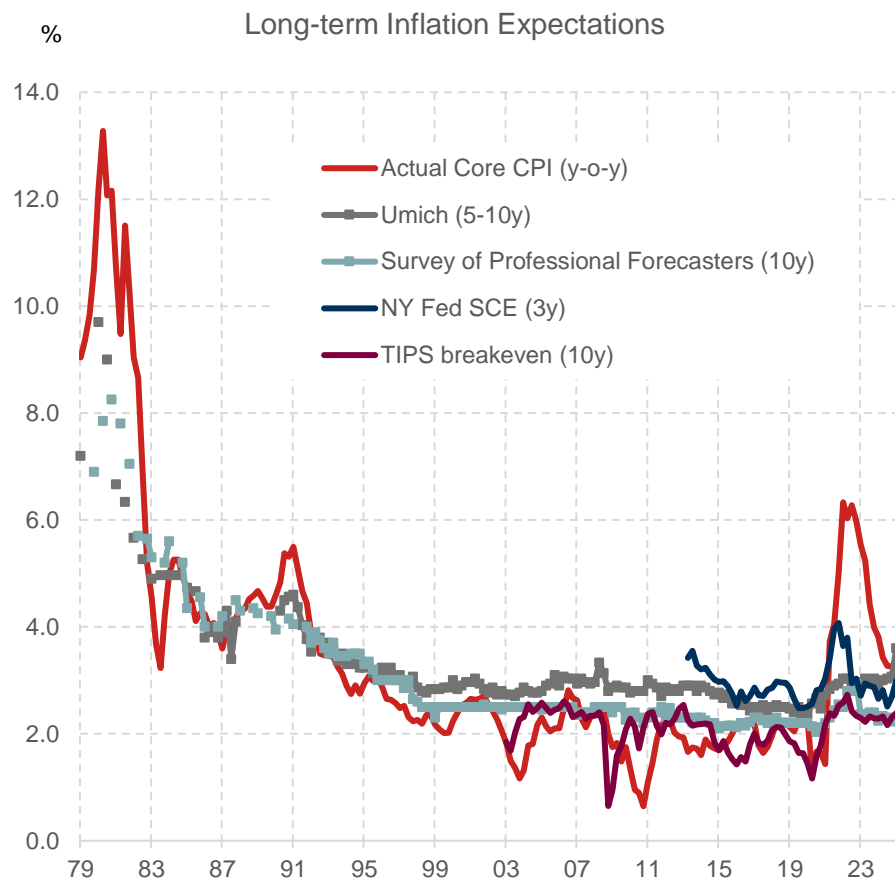
Source: BEA, Conference Board, Haver, Nomura

Businesses expect faster wage growth even without labor-market tightness

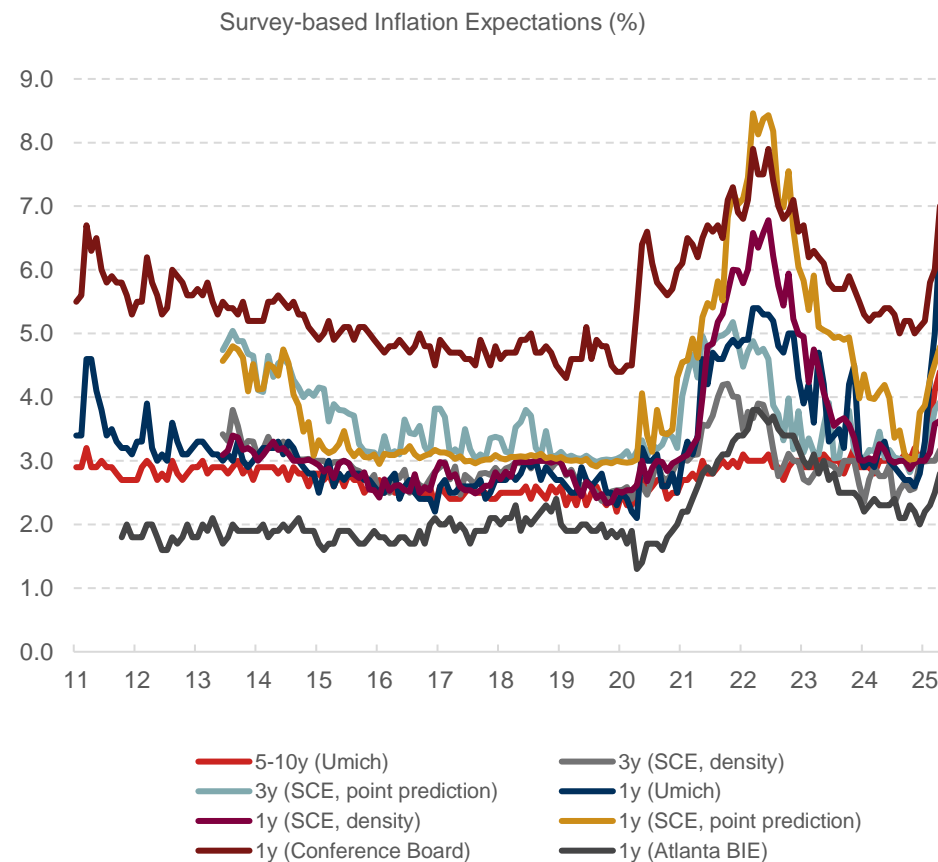


Inflation expectations – theory and practice

Inflation expectations tend to lag, not lead, actual inflation

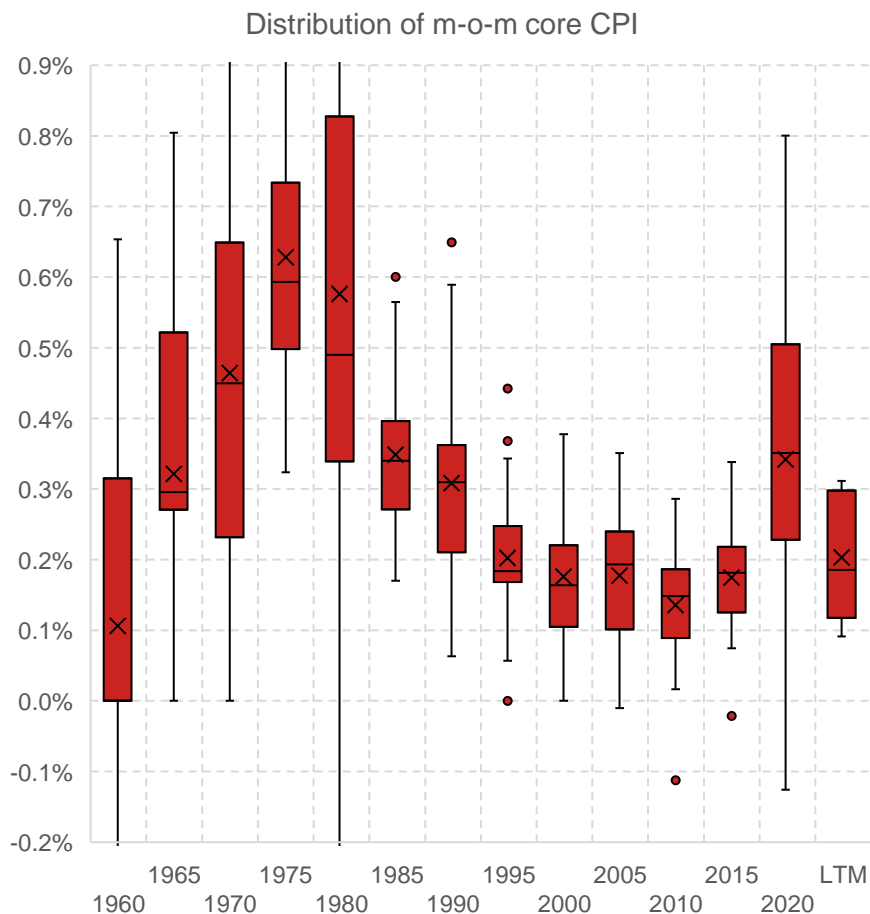


Warning signs in survey-based expectations



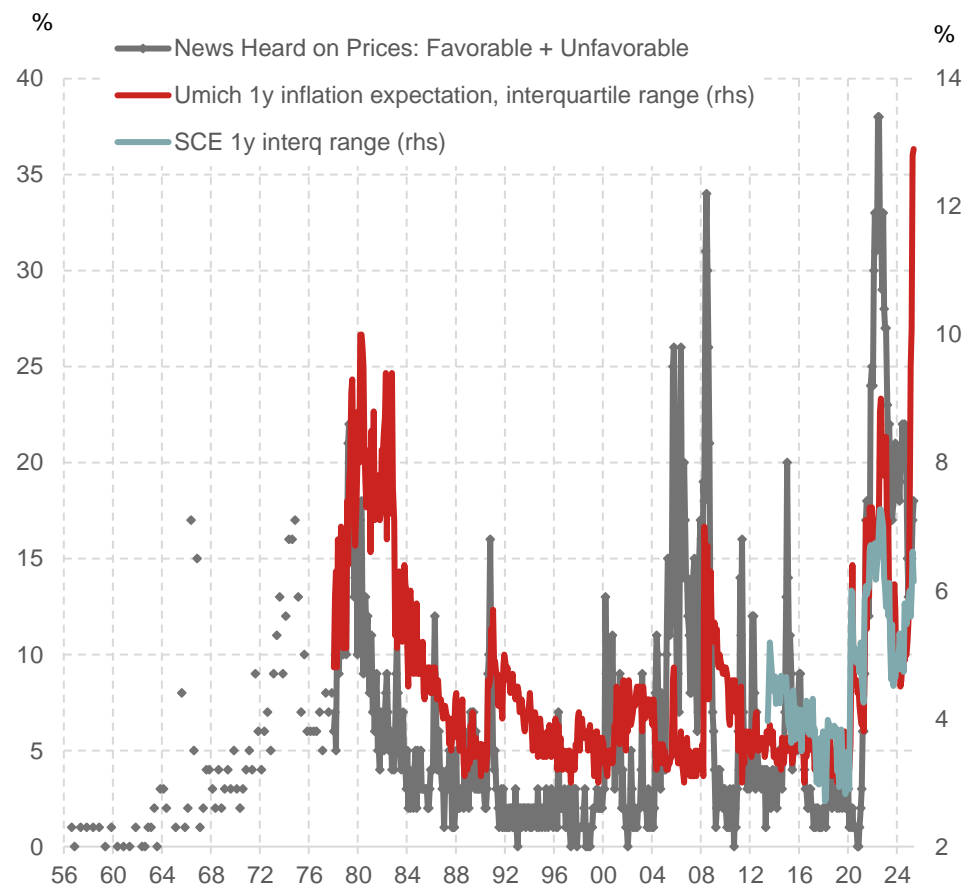
Inflation regimes: The noise is a signal

Inflation volatility was elevated even before tariff shock



Source: Richmond Fed, BLS, Haver, Nomura

Pricing behavior changes across inflation regimes

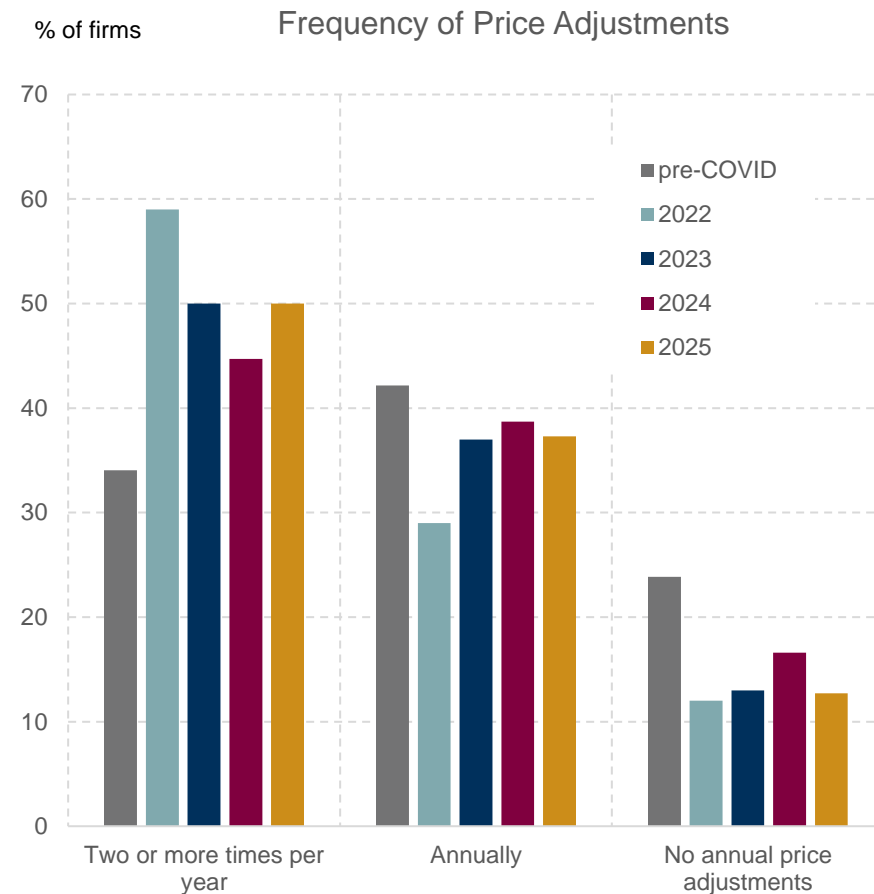


Inflation is unanchored

Consumer surveys point to front-loading purchases

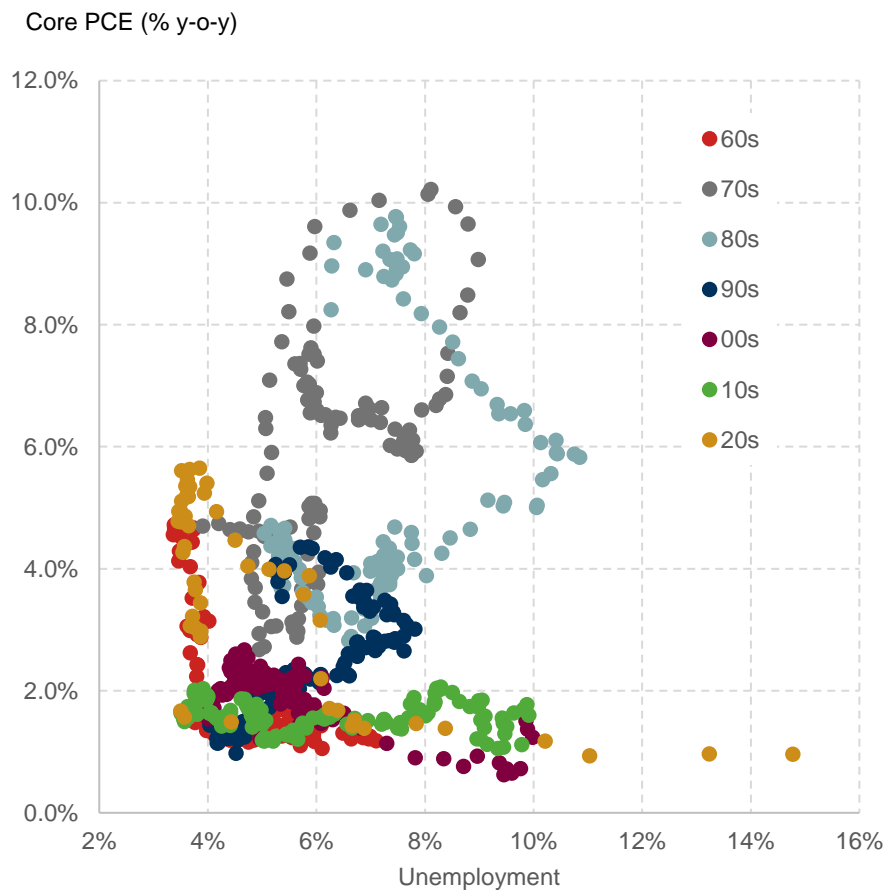


Pricing behavior changes across inflation regimes

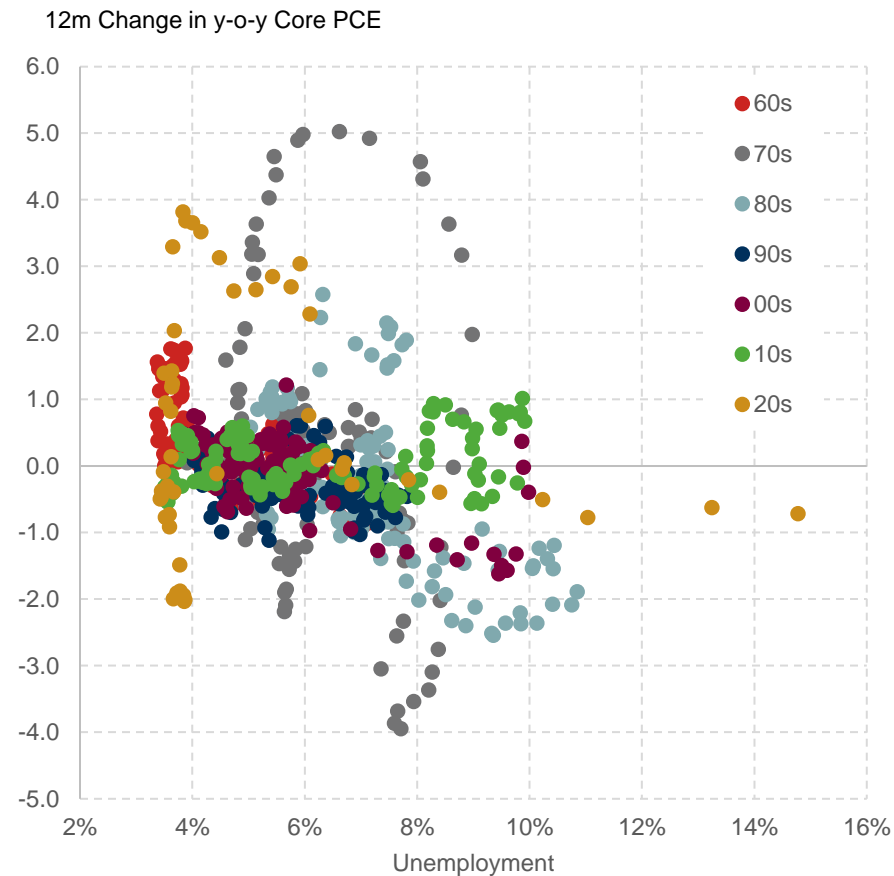


Volatile inflation raises stagflation risk

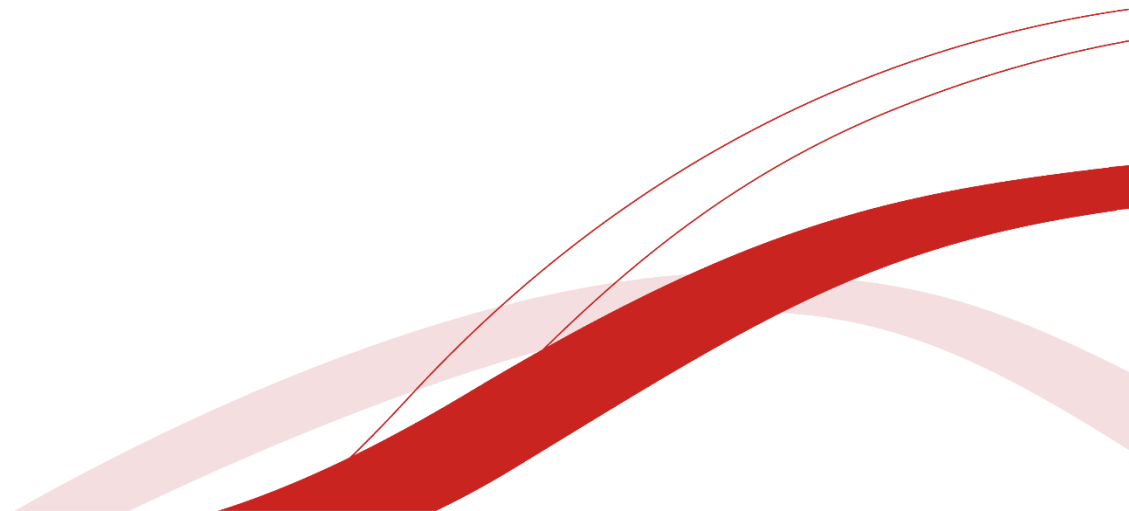
The Phillips Curve alternates between flat and steep



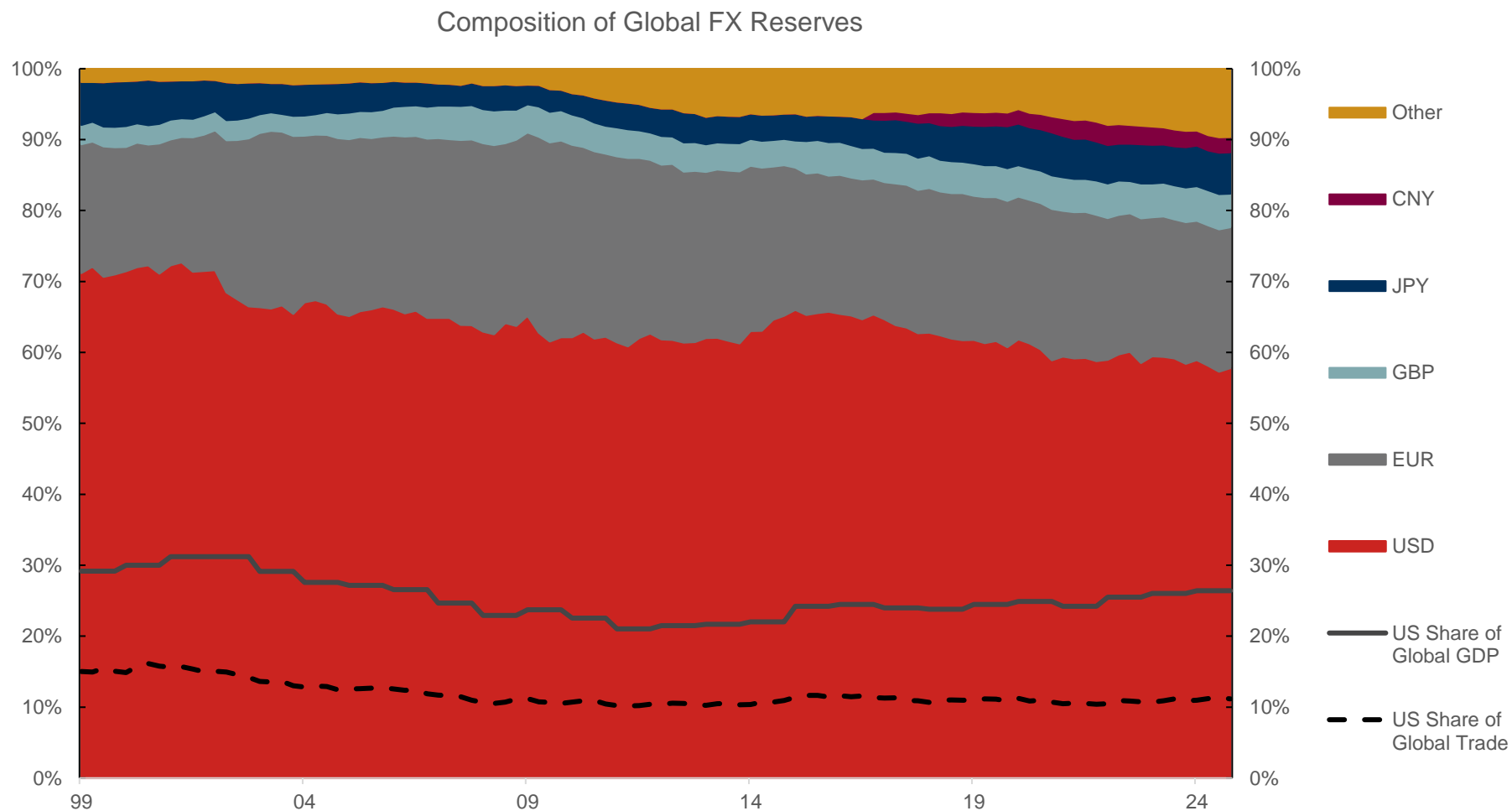
Unemployment pushes in the right direction, but relationship is unpredictable



US un-exceptionalism

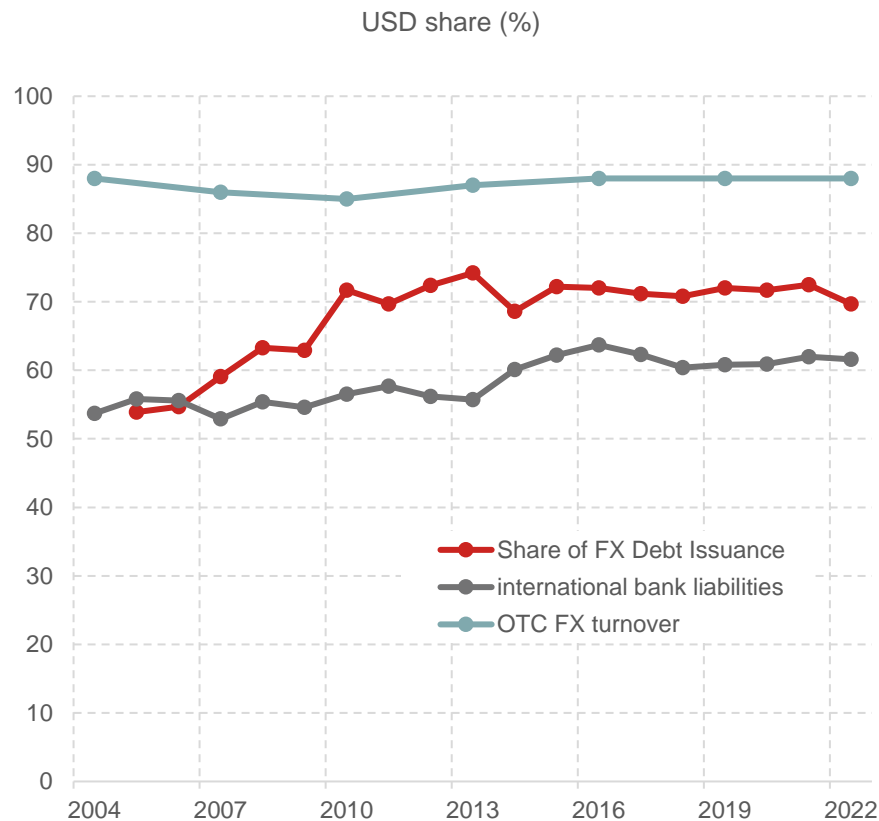


We are skeptical of extreme de-dollarization narratives

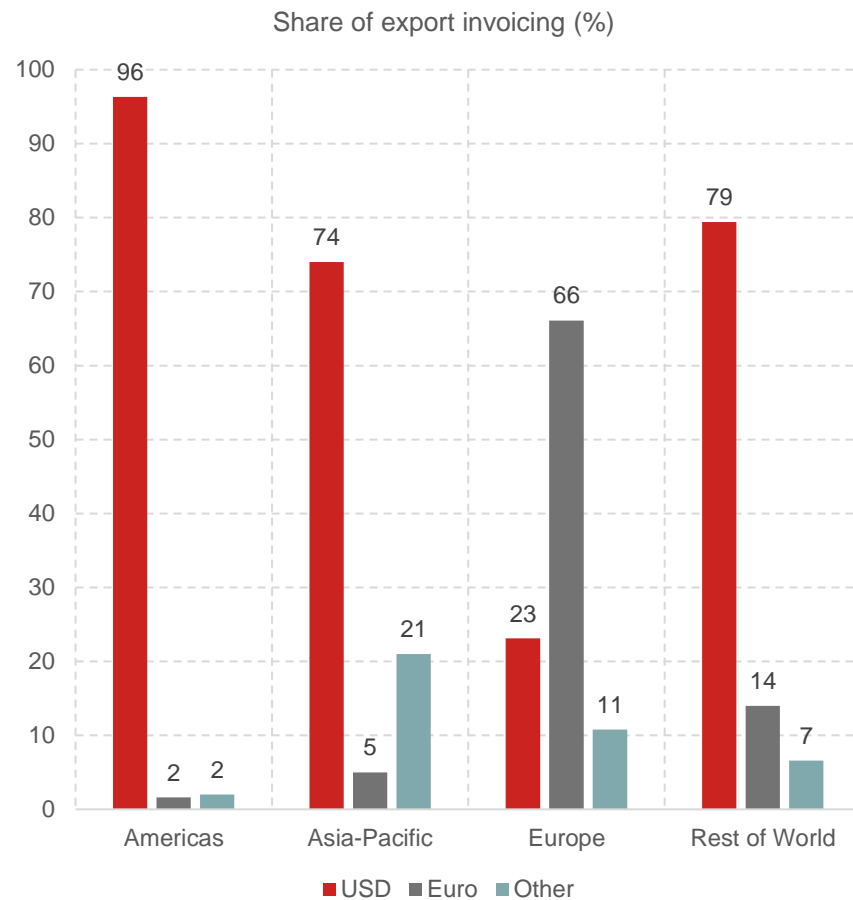


Inertia for dollar system

The dollar remains predominant in international borrowing and transactions



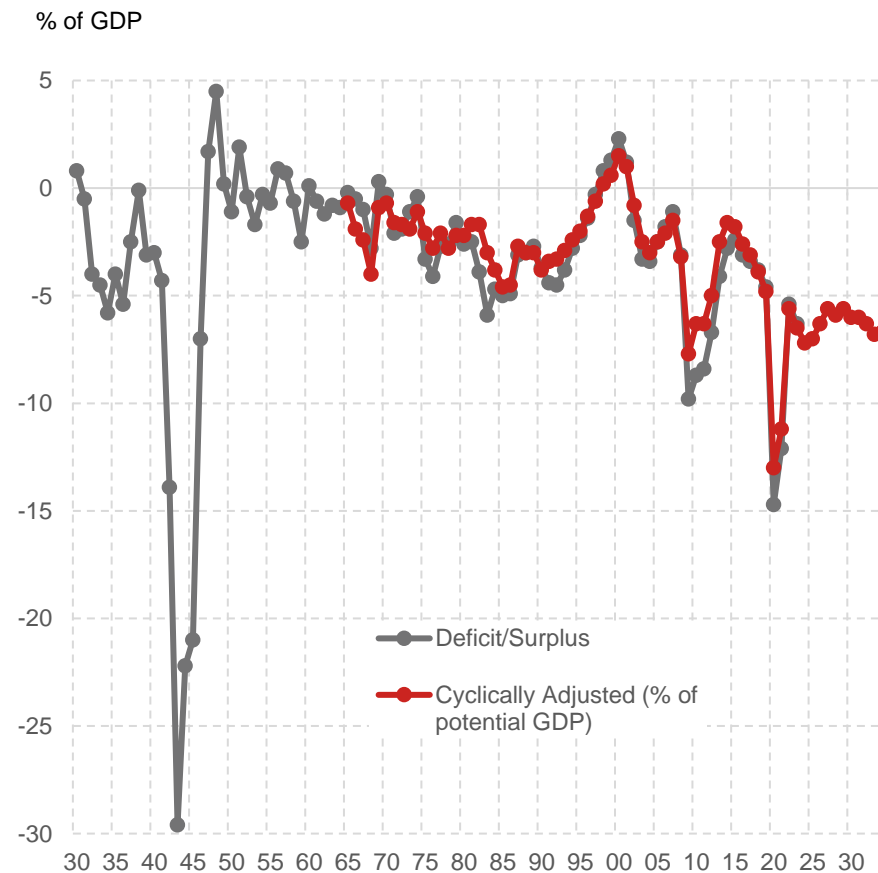
As well as invoicing for global trade



Risks for duration will increasingly be “wrong-way”

- Threats to Fed independence
- Fiscal temptation in a future downturn
- “Weaponization” of foreign reserves
- Stagflation and return of macro-volatility

New frontiers of fiscal irresponsibility



Final thoughts

- Recessions and inflation tend to move in regimes. **Feedback loops in macro are powerful**
- Large and unprecedented policy shocks raise the likelihood of a bad outcome. Risks are skewed towards worse growth and stickier inflation
- A lot more can go wrong than right – even in our benign base case, there will be inflation and growth scares along the way

Appendix A-1

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