US Economic Update 28 Feb. 2025

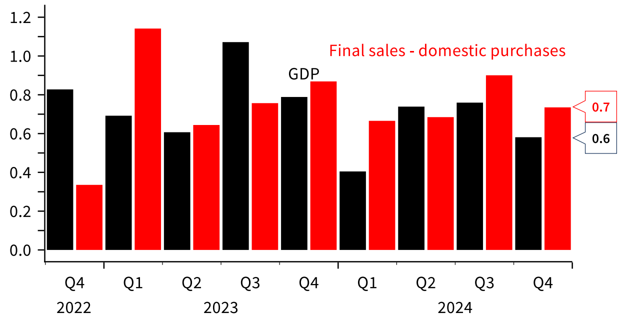
Strong momentum hits policy drags and uncertainty

- **Growth in the economy remained solid in the final quarter 2024. The labour market remains healthy, including some recent strengthening in job gains.**
- **Growth became more narrowly based around household consumption over 2024. January retail sales data point to at least a near term slowdown in consumption growth while business and consumer surveys highlight the potential for elevated policy uncertainty to impact the economy.**
- **Tariffs are occurring earlier than we had pencilled in. The risk is that the increase in tariffs also ends up being greater than assumed.**
- **This reinforces our view that GDP growth will slow this year, leading to some labour market deterioration.**
- **The Fed is on hold for now. Our central forecast still sees 50bps of cuts in the second half of this year, and 50bps next year.**

Economy – 2024 in review

Overall, the economy continued to perform strongly at the end of 2024. While GDP growth was a little below expectations – with q/q growth of 0.6% (we expected 0.7%) and not as strong as Q2 and Q3, this largely reflected a large negative contribution from inventories. Domestic final demand growth was again robust (0.74% q/q), with personal consumption the main driver.

GDP and domestic final demand (q/q%)

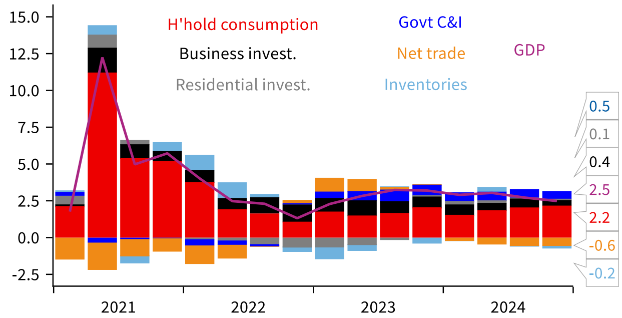


Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond

Over 2024 GDP grew by a robust 2.5%. As with the final quarter, the main support over the year was personal consumption, which grew 3.2% y/y in Q4, slightly higher than over 2023 (even with slower real disposable income growth). In contrast, growth in other major GDP components either slowed (business investment, government consumption and investment and net exports) or were largely unchanged (residential investment), although the detraction from inventories was a bit smaller.

The slowdown in business investment was particularly pronounced in structures investment (from 10% over 2023 to 0.6% over 2024). This included a marked easing in manufacturing structures growth as the run up in tech manufacturing has started to reverse. Equipment investment growth remains moderate while intellectual property investment growth is, by historical standards, subdued – despite the roll-out of AI.

Contributions to year-ended GDP growth



Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond

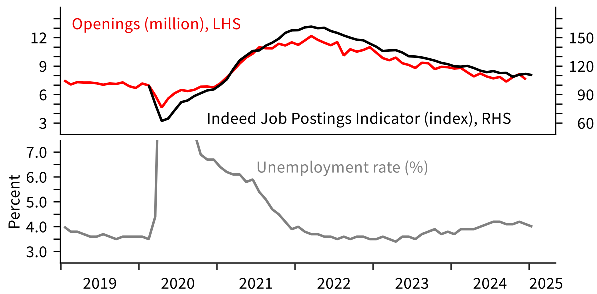
Growth in government consumption and investment moderated over 2024, although it remained relatively strong. The slowdown was driven by state/local governments as Federal spending picked up.

The net trade detraction from growth came despite a pick up in export growth over 2024, as import growth accelerated by more. The net trade detraction from growth is consistent with the relative strength of both US growth (compared to the rest of the world) and the dollar.

Labour market in good shape

The labour market remains healthy. The unemployment rate edged down again in January, to 4.0% from 4.1%, back to where it was in May 2024. Similarly, job openings indicators have stabilised, as have the hiring and quits rates, while layoffs remain low.

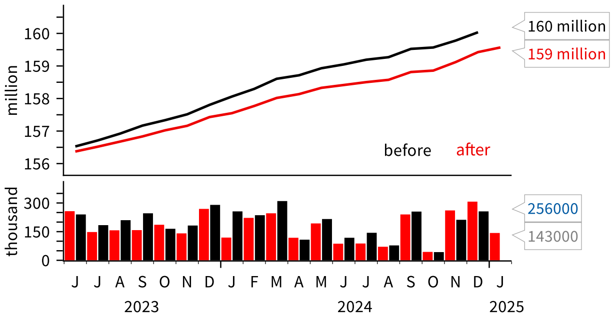
Labour market indicators



Source: National Australia Bank, U.S. Bureau of Labor Statistics (BLS), Indeed Hiring Lab, Macrobond. Unemployment rate scale truncated to exclude COVID extreme

The January employment data did see a downward revision to the level of non-farm employment (by up to 0.4%) but November and December are now estimated to have seen larger jobs gains than previously estimated (total revisions of +100k). While January was a bit softer, there is no evident trend slowing in the non-farm employment data; if anything, labour demand might have strengthened – possibly reflecting robust GDP growth (which typically affects the labour market with a lag).

Non-farm employment -before/after Jan 25 release



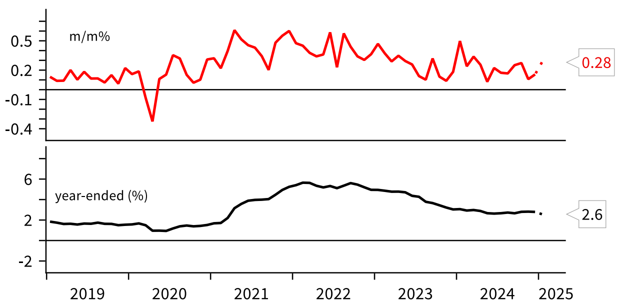
Source: National Australia Bank, U.S. Bureau of Labor Statistics (BLS), Macrobond

Average hourly earnings data from the monthly employment report have also seen some renewed strength of late, although weather impacts may have played some role. Other indicators of wage growth – which have the advantage of being less affected by compositional changes – such as the Atlanta Fed wage tracker and the quarterly employment cost index (ECI) have been easing. The ECI for private sector workers grew by 3.6% y/y (3.8% for all workers) and with non-farm business sector productivity averaging 1.8% annually this cycle, the labour market does not appear to be a source of inflationary pressure, a point the Fed Chair (and other Fed members) have made.

Inflation

Inflation data has been mixed of late, adding to uncertainty about its future path. In January, the core CPI rose by 0.45% m/m (its largest monthly increase since April 2023).

Core PCE inflation



Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond. Jan 25 is a forecast

Based on CPI/PPI data, the move in the January core PCE inflation is likely to be less extreme, most likely around 0.28% m/m. This would still be on the high side but comes after a couple of low readings. It would also be lower than the 0.5% gain seen last year and, if realised, reduce the annual growth rate.

The strength of January inflation (this year and last) means that concerns around 'residual seasonality' in the inflation data remain. This puts a premium on further reductions in the annual growth rate where seasonality is less of an issue. With relatively high prints from February/March last year to drop out of the annual calculation over the next two months, this is possible in the near term, although tariffs will start to add to inflation as soon as February.

Policy uncertainty high

Policy uncertainty remains high. ***On the tariff front***, early this month an additional 10% tariff on Chinese imports went into effect. New tariffs (or removal of exemptions) on steel and aluminium are scheduled to start in mid-March. Tariffs of 10% (Canada energy) or 25% on all other imports from Canada and Mexico are also scheduled for 4 March, but with discussions with Canada/Mexico to address border issues ongoing, they could be deferred again.

In total, these three measures would increase the average tariff rate (before any change in import flows) by almost 8.5ppts, with Canada/Mexico tariffs the main contributor.

Implemented/scheduled tariffs (formal decisions)

Date	Tariff
4 February	China imports: 10% additional tariff
4 March	Mexico imports: 25% tariff on Mexico Canada imports: 25% (10% for energy)
12 March	Steel/aluminium: all countries now 25% (aluminium was 10%, Turkey steel imports 50%, Russia aluminium remains at 200%)

It appears almost certain that further tariff announcements will be made, although the possibility that they are bargaining chips, and are ultimately scaled back, remains.

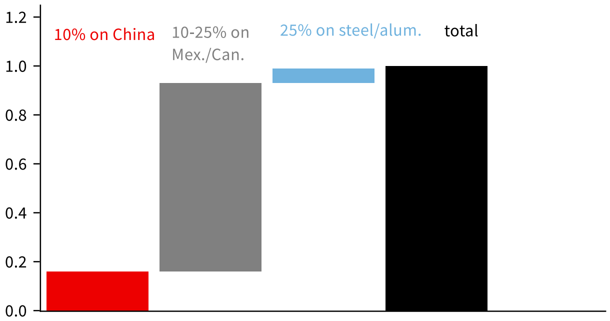
Overnight the President flagged a further 10% tariff on Chinese imports (from 4 March). Reports to the President on his America First Trade Policy and reciprocal tariffs are due early April with 2 April firming as a possible start date for resulting tariff measures. President Trump this week indicated he is planning a 25% tariff on EU imports and has also recently indicated that April will also see tariffs on semi-conductors, auto and pharmaceutical imports.

Officials have also been asked to investigate digital services taxes as well as other matters impacting US tech businesses (freedom of speech restrictions, intellectual property loss).

Foreign investment is also now coming under scrutiny but with a mix of easing and tightening of restrictions. There will be greater restrictions on Chinese investment in the US and potentially by US companies into China. However, the President plans to put in place a fast track process to facilitate investment from allies, but with the caveat that investors not partner with 'foreign adversaries'.

Tariffs are also relevant to ***fiscal policy*** (budget). The February China tariff is equivalent to a tax imposition of 0.2% of GDP (although diversion to other imports may reduce the impost). All up the already announced tariff measures would represent a tax increase (before diversion impacts) close to 1% of GDP.

Formally announced tariffs - implied revenue (% of GDP)



Source: National Australia Bank

While it is still unclear what tariffs will ultimately be imposed, announcements of job cuts, a deferred resignation scheme, a federal hiring freeze, and cuts to some federal spending mean that additional fiscal tightening is underway. Gauging the scale of these changes is difficult - so far, cumulative daily Treasury withdrawals are similar to what was seen last year.

Our assumptions, for forecasting purposes, have been that there would be a 10ppt increase in the average tariff rate, spread over four quarters and starting around the middle of the year. Clearly however, it is occurring sooner than we assumed and so we have brought forward the timing of the assumed 10ppt increase (essentially by two quarters) but still assume it is implemented over about a year. Based on possible tariffs flagged by the President the risk is that the increase in the average tariff rate is greater than 10ppt.

On the ***fiscal policy***, our assumption had been that settings will be roughly neutral out to 2026, which would allow for extension of the expiring (mostly at end 2025) TCJA tax provisions as well as some additional tax cuts or spending funded by tariff revenue.

The cuts in federal employment and the imposition of tariffs already underway mean that there is a building fiscal drag on the economy currently underway. However, how the fiscal stance will evolve beyond this remains unclear.

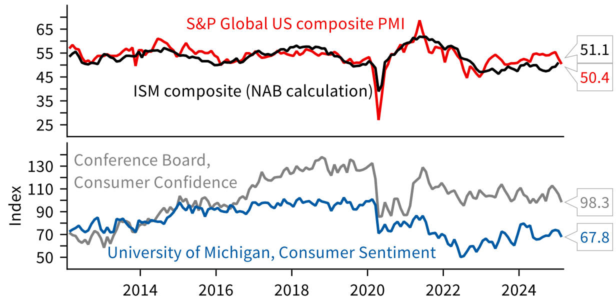
This month's House budget resolution allows for $4.5 trillion in tax cuts (TCJA extension plus some other cuts), additional spending in priority areas (e.g. border security and defence) as well as $2 trillion in spending cuts, all over a ten year timeframe. The net cost ($2.8 trillion) is less than the cost of extending the TCJA expiring provisions but: this is over a 10-year window (so out to 2026 the change is unclear) and the House resolution is just the first step towards budget reconciliation later in the year.

Outlook

The near-term outlook is clouded by very weak retail sales data for January 2025 as well as the large fall in the S&P Global services PMI this year.

The S&P Global services PMI had another large fall in February, falling below its breakeven level to 49.7 (from 56.8 in December). Respondents cited political uncertainty and federal funding cuts as reasons. The manufacturing PMI provided some offset but according to S&P Global 'many' manufacturers put this down to tariff front-running (a temporary boost). Consumer confidence measures have also declined recently.

United States - business and consumer surveys

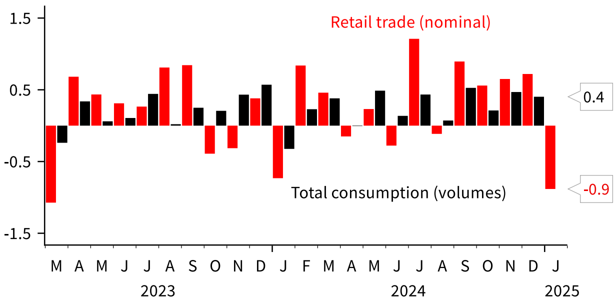


Source: National Australia Bank, Conference Board, University of Michigan, Macrobond, Account in-house

Retail (and food) sales declined by 0.9% m/m in nominal terms, after four months of solid growth. Retail sales mainly cover goods consumption which, together with food services, is less than 40% of total consumption. The data can be volatile and prone to relatively large revisions. Retail sales fell 0.7% m/m in January 2024 but did not signal the end to US consumer strength.

Accordingly, we discount the signal from the January report, although we have lowered our expectation for consumption growth in the quarter.

United States - consumption indicators (m/m %)



Source: National Australia Bank, U.S. Census Bureau, U.S. Bureau of Economic Analysis (BEA), Macrobond. Total consumption only through to Dec '24

While the retail sales data and February PMI highlight downside risks, the continued strength of domestic final demand in Q4 2024 suggests there was still considerable momentum heading into this year. This can also be seen in the lift in employment growth over recent months which will support incomes and near-term consumption growth.

Balancing these factors out, we have left our forecasts basically unchanged as we await greater clarity on the timing and extent of the policy shifts underway. The 2025 year average growth forecast is slightly lower (2.2% from 2.3%) reflecting the lower than expected 2024 Q4 outcome.

Our forecasts incorporate a slowing in US growth this year, and we see the recent weak data prints as providing support for this view. The expectation for a growth slowdown is based on several factors, including some drag from tariffs (both from direct impacts and from heightened uncertainty).

Further, population growth was already slowing heading into this year and the new administration's migration policies will only confirm this trend. Tech related manufacturing construction expenditure is easing, as is growth in state & local government spending, with a federal government drag now starting to kick-in (although the magnitude is unclear). While the Fed has eased its policy settings, and the tightening in bank lending standards is largely over, interest rates remain at high levels.

While growth is likely to slow, we do not have it falling much below its estimated longer trend growth rate (of ~1¾%). The economy starts from a strong position as it leans into these headwinds and some sectors are still seeing strong growth (e.g. data centres as part of the AI rollout). While policy uncertainty is high, business appears hopeful that fewer regulations and lower taxes will provide a boost.

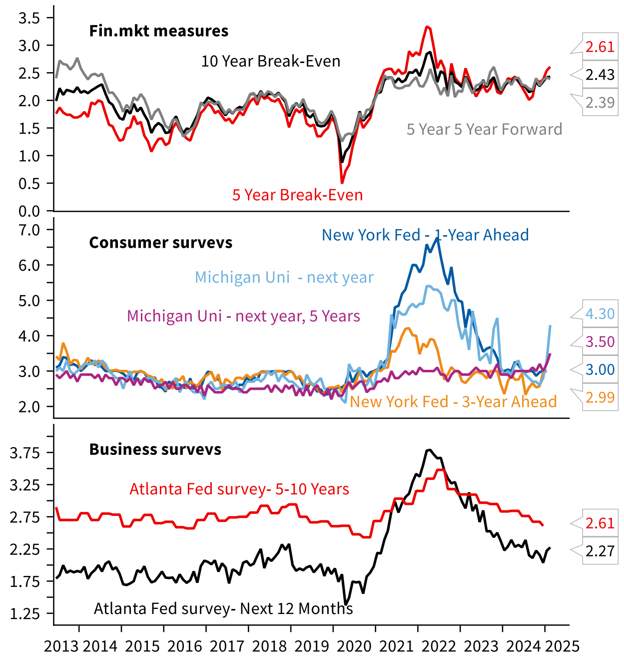
As the slowdown in growth is partly (population) supply driven, we only expect a modest increase in the unemployment rate which we still see peaking at 4.4%.

We have lifted our inflation forecasts for this year (core PCE inflation from 2.4% to 2.7%) with 2026 unchanged (2.3% y/y) – this is due to bringing forward the tariff increases assumed in our forecasts.

Excluding tariff impacts the forecasts still imply that inflation will track towards 2.0% over the forecast horizon.

Our forecasts assume that price increases caused by tariffs do not lead to a permanent shift in price setting behaviour (i.e. inflation expectations remain 'anchored'). There is a risk that this assumption will not hold.

Inflation and inflation expectations (%)



Source: National Australia Bank, Macrobond Financial AB, Federal Reserve, Federal Reserve Bank of New York, University of Michigan, Federal Reserve Bank of Atlanta, Macrobond

There have been large upwards moves in some inflation expectations measures. The closely watched Michigan University consumer survey has seen a large jump in one-year ahead expectations as well as in the 5-year expectation; the latter is at its highest level since the mid-1990s. However, other indicators have not seen such large changes. There is also a great degree of political polarisation in the Michigan Uni survey which makes the implications for future inflation less clear.

Fed policy

The Fed made no change to rates in its January meeting and the meeting minutes are consistent with recent member commentary that the Fed will remain on hold for now. There is an easing bias, with the discussion in the minutes framed around staying on hold or rate cuts (for the latter to occur needs further progress on inflation or labour market deterioration).

Having already made policy less restrictive, and with the economy in good shape, the Fed is in a position to be patient given still elevated inflation. Reinforcing this is the current elevated policy uncertainty - a majority of members noted "the current high degree of uncertainty made it appropriate for the Committee to take a careful approach in considering additional adjustments".

While tariffs will increase prices, as we have noted previously, Fed staff analysis in 2018 found that the best policy approach would be to 'look through' tariff impacts on inflation. However, that conclusion only holds if inflation expectations remain anchored and pass-through to prices is short lived. As noted above, some inflation expectation measures have started to rise, which will only add to Fed caution on whether those conditions will hold. This reduces the (already low) chance of rate cuts in coming meetings absent a sharp weakening in the labour market.

Our central case sees 50bps of easing though the second half of 2025 and another 50bps in 2026. This reflects our expectation that there will be some labour market deterioration as the economy slows and that, excluding tariff impacts, inflation will continue to track back to target.

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U.S. economic forecasts

					2024		2025				2026			
	2023	2024	2025	2026	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
US GDP and Components	year average				q/q%									
Household consumption	2.5	2.8	2.6	1.8	0.9	1.0	0.6	0.5	0.4	0.4	0.5	0.5	0.5	0.5
Private fixed investment	2.4	3.7	1.6	2.5	0.5	-0.3	0.7	0.5	0.5	0.6	0.6	0.6	0.8	0.8
Government spending	3.9	3.4	2.1	0.9	1.3	0.7	0.4	0.3	0.2	0.3	0.2	0.2	0.2	0.2
Inventories*	-0.4	0.0	0.0	0.0	-0.1	-0.2	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.5	-0.5	-0.3	-0.1	-0.1	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Real GDP	**2.9**	**2.8**	**2.2**	**1.7**	**0.8**	**0.6**	**0.6**	**0.4**	**0.4**	**0.4**	**0.4**	**0.4**	**0.5**	**0.5**
Note:														
GDP q/q annualised rate					*3.1*	*2.3*	*2.3*	*1.7*	*1.4*	*1.5*	*1.7*	*1.8*	*2.0*	*2.1*
GDP year-ended %	*3.2*	*2.5*	*1.7*	*1.9*	*2.7*	*2.5*	*2.7*	*2.3*	*1.9*	*1.7*	*1.6*	*1.6*	*1.7*	*1.9*
US Other Key Indicators														
PCE deflator-headline	year -ended %				q/q%									
Headline	**2.8**	**2.5**	**2.7**	**2.1**	**0.4**	**0.6**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**0.5**	**0.6**	**0.5**
Core	**3.2**	**2.8**	**2.7**	**2.3**	**0.5**	**0.7**	**0.6**	**0.7**	**0.7**	**0.6**	**0.6**	**0.5**	**0.6**	**0.6**
Unemployment rate - qtly average (%)	**3.8**	**4.2**	**4.3**	**4.3**	**4.2**	**4.2**	**4.1**	**4.2**	**4.2**	**4.3**	**4.4**	**4.4**	**4.4**	**4.3**
Note:														
core PCE inflation y/y%					2.7	2.8	2.6	2.6	2.7	2.7	2.6	2.4	2.4	2.3

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