US Economic Update 4 April 2025

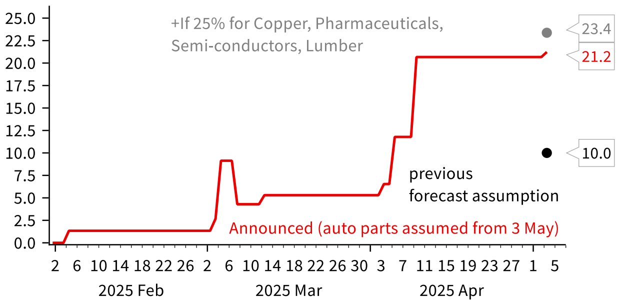
Growth to slow to a crawl; recession risk rising

- **The major tariff increases announced by President Trump this week will weigh on the US economy. Growth is likely to be weak and there is a risk the economy will contract.**
- **Policy uncertainty is likely to remain high for a while. There are likely to be some further tariff announcements and whether, and by how much, broader fiscal policy at some point reverses the large fiscal drag currently underway (e.g. through tax cuts) will be important and is a major forecast uncertainty.**
- **While inflation will be elevated, and the Fed will want to lean against the risk of inflation expectations de-anchoring, we expect rising unemployment will see the Fed reduce rates starting around mid-year – we expect 125bp of rate cuts over H2 2025 and into 2026.**

Economic developments

There were substantial additional tariffs announced by President Trump last week (autos) and this week (reciprocal tariffs). In all, our estimate of the increase in the US average tariff rate this year (based on 2024 data and before any substitution effects) is around 21.2ppts. This is around double the assumption (10ppts) that had been underpinning our forecasts up to now.

Cumulative change in US average tariff rate (ppts)



Source: National Australia Bank. NAB calculations based on 2024 trade flows before substitution effects. 75% of Canada/Mexico exports to US assumed to be USMCA compliant.

The implied tariff revenue is around 2.6% of GDP (again before substitution effects) – a major fiscal drag on the economy. While of a much smaller magnitude, federal government employment and spending cuts are an additional headwind.

The ultimate tax burden on US households/businesses will be lower as they substitute away from imports (either by changing what they consume or switching to domestically produced or lower-tariffed alternatives). However, the broad-based nature of the tariffs do, to a degree, limit substitution options.

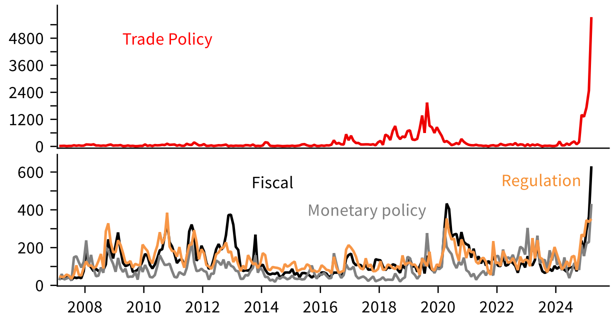
Other channels through which tariffs can impact the economy include retaliatory trade measures by affected trading partners, financial markets and through uncertainty and confidence impacts.

Based on comments by other countries at least some retaliatory trade measures are likely, but the extent is not yet clear. So far, relative to the size of the US economy, such retaliation has been relatively small.

While equity prices have fallen this year (including a further large decline following the tariffs announced on 2 April), measures of financial stress have been well contained, although if the economy slows (as expected) some pressures are likely to emerge and banks may tighten lending standards.

Consumer and business sentiment had already started to sour, even prior to this week's announcement. Policy uncertainty in the US is extremely high (and not just related to trade) and, unsurprisingly in this environment, measures of future capex intentions have pulled back sharply in recent months.

Economic Policy Uncertainty Index – US



Source: National Australia Bank, Economic Policy Uncertainty, Macrobond

It is possible that policy uncertainty may ease, if the perception takes hold that the bulk of the tariff increases are behind us. Even if this means we are left with a much higher level of tariffs than before, businesses (and households) may feel that they can now better plan their investment decisions. However, President Trump has indicated that the tariff rates could change in either direction – up if there is retaliation or down if countries reduce their trade barriers. It also looks likely that some of the carve outs from the reciprocal tariffs are likely to be subject to future tariff measures (e.g. pharmaceuticals, semi-conductors, lumber and copper). In short, policy uncertainty is likely to remain high in months to come.

Forecast changes

We now expect GDP growth of around 0.6% over 2025, revised down from 1.3% (this lowers the year average growth forecast to 1.3% from 1.8%). Growth is expected to pick up over 2026 as policy uncertainty wanes, the Fed eases rates and as fiscal policy turns stimulatory.

The further downgrade to growth in 2025 is mainly due to the large drag on household income and corporate profits that will result from the tariffs – which will weigh on consumption and business investment.

Complicating the outlook are two factors. Firstly, it is difficult to gauge the degree of momentum in the economy ahead of the major tariff announcements. At the end of 2024 the economy appeared to be growing at a robust rate, but January (in particular) and February data have been very weak and we now are factoring in almost zero GDP growth in Q1 (and a negative print would not be a big surprise). We still think there is an element of 'noise' as the big net trade drag being flagged in the data to-date should be offset by higher consumption/investment or inventories (absent a large fall in domestic production which is not signalled by other indicators).

Secondly, while the tariff measures in themselves represent a substantial fiscal drag, Congress is at the same time considering extending expiring tax provisions as well as various tax cuts, although this may be partially offset by net spending cuts. There is no clarity what the magnitudes (and timing) will be, but our broad working assumption is that part of the fiscal drag in place right now will be reversed starting later in year or in early 2026.

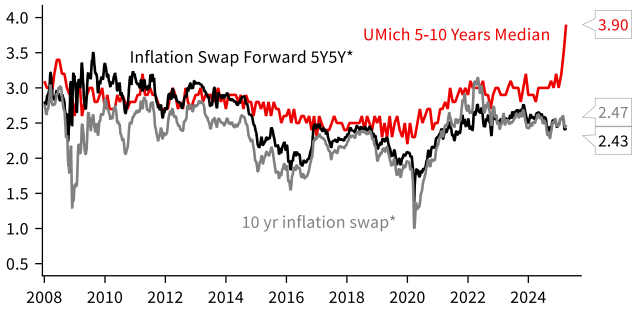
These forecasts see the economy close to stalling this year. Given that it is hard to be confident in any point forecast given the magnitude of the policy changes (as well as shifts in sentiment) underway, clearly the risk of the economy contracting this year is elevated. The US is starting from a relatively strong position – the labour market is healthy, corporate profits are high, loan delinquency rates are generally low, as is household gearing and debt servicing ratios (for households and corporates). This means there is some capacity to absorb the shock underway, but with uncertainty elevated businesses and consumers may not be inclined to use it.

The expected slowdown in growth is likely to see the unemployment rate rise – we see it peaking at around 4¾%. Consumer price inflation is likely to pick up materially as the tariff increases are passed on. We now see core PCE inflation of around 4.0% this year, before easing through 2026.

The inflation forecasts assume that price and wage setting behaviour in the economy will remain 'anchored' at around the Fed's 2% inflation target. Lower growth and higher unemployment are likely to constrain broader price growth.

However, as inflation has been elevated for several years, and likely to accelerate again this year, there is a risk that this assumption does not hold. Some measures of inflation expectations – particularly surveys of households, have seen very steep increases. However, longer-dated market-based measures have seen no or only small increases and up to now (at least) some Fed members, including the Fed Chair, have been discounting the household indicators.

US Inflation Expectations



*2 week moving average
Source: National Australia Bank, Bloomberg

Monetary policy

Past Fed staff analysis has found that if certain conditions hold, the best policy approach would be to 'look through' tariff impacts on inflation. This means cutting rates in response to lower growth and a weaker labour market and discounting the rise in prices. That conclusion only holds if inflation expectations remain anchored and pass-through to prices is short lived – as noted above, there is a risk that this may not hold and we expect the Fed can only partially 'look through' price rises in the current environment. (Tariffs and what it could mean for the Fed)

The unemployment rate has been tracking sideways for a while now, and employment continues to rise at a decent rate. Given the remaining still elevated policy uncertainty, still high inflation (and likely to rise higher), and the need to assess how inflation expectations react, the Fed is likely to remain on hold at least for the next meeting.

As we expect unemployment to start rising in coming months, we continue to expect the Fed to cut rates starting around mid-year. We now expect it to cut rates by 75bp this year and a further 50bp in 2026 (previously 100bp over 2025/2026).

This would reduce the federal funds rate target range to 3.00 - 3.25% – around neutral. An unemployment rate peaking at around 4 ¾% could justify further rate cuts. However, while it is possible they could move further, and more quickly, we think the need to lean against the risk of inflation de-anchoring will see them move relatively cautiously. Much will also depend on whether broader fiscal policy moves to reverse the drag from tariffs, and by how much and when.

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U.S. economic forecasts

	2023	2024	2025	2026	2024 Q3	Q4	2025 Q1	Q2	Q3	Q4	2026 Q1	Q2	Q3	Q4
US GDP and Components	year average				q/q%									
Household consumption	2.5	2.8	1.5	1.3	0.9	1.0	0.1	0.1	-0.1	0.1	0.4	0.6	0.6	0.6
Private fixed investment	2.4	3.7	1.1	1.8	0.5	-0.3	1.2	-0.2	-0.2	0.0	0.5	0.8	1.0	1.0
Government spending	3.9	3.4	2.1	1.0	1.3	0.8	0.4	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Inventories*	-0.4	0.0	-0.1	0.0	-0.1	-0.2	0.2	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net exports*	0.5	-0.4	-0.2	0.2	-0.1	0.1	-0.5	0.4	0.2	0.1	0.0	0.0	0.0	0.0
Real GDP	**2.9**	**2.8**	**1.3**	**1.5**	**0.8**	**0.6**	**0.0**	**0.2**	**0.1**	**0.1**	**0.4**	**0.6**	**0.6**	**0.6**
Note:														
GDP q/q annualised rate					*3.1*	*2.5*	*0.1*	*1.0*	*0.6*	*0.6*	*1.6*	*2.3*	*2.5*	*2.5*
GDP year-ended %	*3.2*	*2.5*	*0.6*	*2.2*	*2.7*	*2.5*	*2.1*	*1.6*	*1.0*	*0.6*	*0.9*	*1.2*	*1.7*	*2.2*
US Other Key Indicators														
PCE deflator-headline	year -ended %				q/q%									
Headline	**2.8**	**2.5**	**3.9**	**2.3**	**0.4**	**0.6**	**0.9**	**1.3**	**0.9**	**0.7**	**0.7**	**0.6**	**0.5**	**0.5**
Core	**3.2**	**2.8**	**4.0**	**2.4**	**0.5**	**0.7**	**0.8**	**1.4**	**1.0**	**0.8**	**0.7**	**0.6**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**4.2**	**4.6**	**4.7**	**4.2**	**4.2**	**4.1**	**4.3**	**4.4**	**4.6**	**4.8**	**4.8**	**4.8**	**4.7**
US Key Interest Rates														
Fed funds rate (top of target range)	**5.50**	**4.50**	**3.75**	**3.25**	**5.00**	**4.50**	**4.50**	**4.50**	**4.00**	**3.75**	**3.50**	**3.25**	**3.25**	**3.25**

Source: NAB Group Economics.

*Contribution to real GDP growth

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