US Economic Update May 2025

Growth slowing, but less abruptly than Q1 GDP suggests

- Higher tariffs and uncertainty mean lower growth and higher (near-term) inflation. We do not expect the tariff shock to lead to persistently higher inflation and expect the FOMC can ease from July.
- While the US economy has slowed, a surge in imports and measurement quirks mean that the small decline in Q1 GDP overstates how abruptly momentum shifted at the turn of the year.
- We continue to see US growth slowing to just 0.6% over 2025, as core PCE inflation spikes to around 4%. Exceptional policy uncertainty leaves error bands unusually wide.
- The Fed will respond cautiously to lower activity growth and a (limited) increase in the unemployment rate as it leans against the risk that higher inflation becomes entrenched. We expect the FOMC will start cutting in July, seeing 75bp of cuts by year-end and terminal of 3.0-3.25% in mid-2026.
- A sharper rise in the unemployment rate would leave the Fed further from their full employment mandate and less concerned inflation will persist, leading to a more aggressive easing. In contrast, ongoing labour market resilience would leave them on hold for longer.

Despite a small GDP decline in Q1, solid growth in demand and employment suggest the economy continued to expand. Nevertheless, it is clear that the economy is beginning what is likely to be a difficult adjustment to the major policy changes – particularly trade – underway.

There was a surge in imports in Q1 as firms sought to get ahead of the tariffs. However, it was narrowly based in a few categories, suggesting tariff price pressures may quickly emerge across a range of products.

The ongoing uncertainty around trade policy will weigh on activity. While financial markets have recovered some ground in recent weeks on the back of more positive trade developments, it is still very unclear where tariffs will ultimately settle, which may cause investment decisions to be deferred, as suggested by surveys of capex intentions.

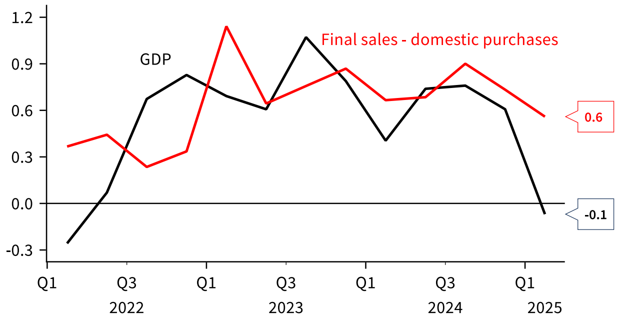
Sentiment has also weakened but the most recent consumption and employment data do not yet point to any major impact yet from this channel. However, as the increases in tariffs flow through to prices or are absorbed by businesses – weighing on household budgets and business profits – economic growth is likely to slow appreciably and risk aversion may grow.

A major weakening in demand will see the labour market soften, including an increase in the unemployment rate. With inflation having been elevated for some time, and likely to spike in coming quarters, the Fed will be in a difficult position as there will be a tension between the Fed's full employment and inflation goals. The Fed Chair views long-term price stability as necessary for a strong labour market over time. Given this focus, we expect that a deterioration in activity and the labour market will see the Fed cut rates (from July) but only cautiously as it seeks to limit the risk of inflation expectations de-anchoring.

Q1 GDP fall

There was a small decline in measured GDP in Q1 (-0.1% q/q), driven (in a GDP accounting sense) by a large increase in imports. However, these imports have not obviously (fully) flowed through to consumption or investment and nor do other data corroborate a pull-back in domestic production. With domestic final demand growing solidly, we think this points to measurement issues, noting that data for early GDP estimates are incomplete and are subject to revision.

GDP and domestic final demand (q/q%)



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

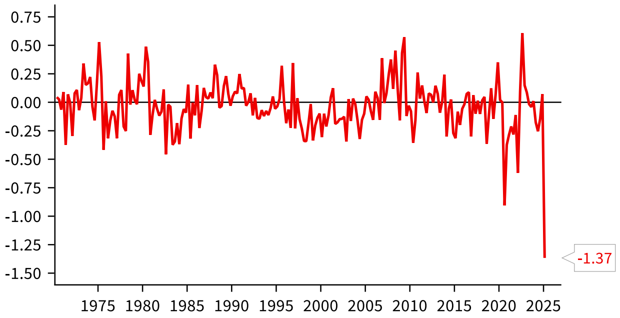
Growth in domestic final demand mainly reflected expansion in personal consumption of 0.4% q/q and in business fixed investment of 2.4% q/q – the weakest and strongest growth rates respectively in these categories since Q2 2023.

There was also a modest rise in residential investment, but Government consumption and investment declined due to a fall in federal spending.

The fall in GDP reflected an historically large negative net export contribution to growth. While exports increased 0.4% q/q, imports surged by 9.0% (10.8% for goods imports). This was the largest quarterly increase in imports, outside of the COVID period, since the early 1980s.

The increase in imports reflected a bringing forward of trade ahead of announced and expected tariff increases. It was most evident in computers and related equipment (up 35%), medicines/pharmaceuticals (up 60%), telecommunications (phones – up 18%) and household appliances (up 10%) but notably absent from some other segments (such as autos). Computing equipment was reflected in fixed investment, and pharmaceuticals drove a large share of the rise in inventories. The BEA made an additional adjustment to what was suggested by the underlying source data to 'account for a notable increase in imports'.

Net export contribution to qtly GDP growth (ppts)



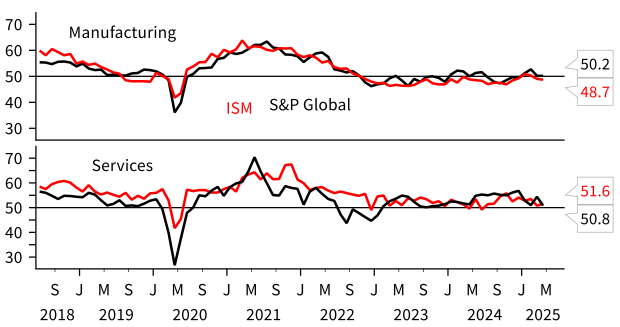
Source: National Australia Bank, U.S. Bureau of Economic Analysis (BEA), Macrobond

With shipping data showing a sharp fall in inward shipments from China from the second half of April, it is notable that the import surge was not especially concentrated in consumer goods, raising the likelihood of a rapid pass through of tariffs to consumer prices. Firms have generally signalled they are reluctant to pass through higher tariff costs while they run down earlier inventory, but the composition of imports does not suggest they substantially increased buffers ahead of higher tariffs.

While stronger than the headline GDP print, consumption growth did slow substantially in the quarter. That was due to a large fall in January – mirroring the experience of January 2024 and so residual seasonality may be an issue, as may hurricane impacts. Consumption grew strongly in the March month – up 0.7% m/m, including 10.4% for new motor vehicles which may reflect activity brought forward.

Other indicators do not corroborate a decline in domestic output. Manufacturing production rose 1.2% q/q in Q1 (the first increase in 3 quarters) while non-farm employment growth remained steady in Q1, rising by 0.3% q/q, similar to what was seen in 2024. Non-farm employment also showed solid growth in April 2024 – rising 177,000. A 29,000 rise in transportation & warehousing employment provides some evidence of a bringing forward of activity (although a monthly gain of this magnitude is not exceptional).

US business surveys (net balance)



Source: National Australia Bank, Institute for Supply Management (ISM), Account in-house, Macrobond

Business survey indicators have softened over recent months, to relatively low levels by historical standards but are still consistent with ongoing growth in the economy. Some component indices are signalling more stress – e.g. the Manufacturing ISM production measure fell to a level, excluding COVID, last seen in the GFC, but this was in April (so not consistent with a Q1 decline) while the S&P Global equivalent held up better.

Outlook

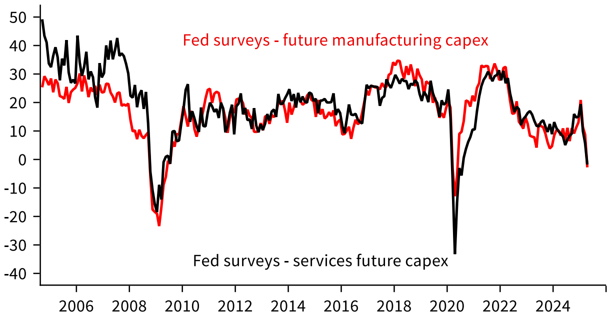
Our forecasts for GDP growth over 2025 and 2026 are unchanged. The Q1 GDP outcome was only a little below our expectation (we had forecast 0.0% q/q) and we now factor in stronger growth in Q2 as the measurement issues that appear to have affected Q1 are reversed.

As such, we still expect a substantial slowdown in growth over 2025 (0.6% on a year-ended basis), before a pick-up over 2026 as tariff drags and uncertainty diminish along with the expectation that fiscal policy provides some stimulus and the Fed has begun to reduce rates.

Weighing on near-term growth are demand destruction from higher import prices, which represent a large increase in taxes that, as yet, have little fiscal offset by Congress, as well as the continued extreme degree of policy uncertainty which provides an incentive for businesses, and households, to defer major decisions.

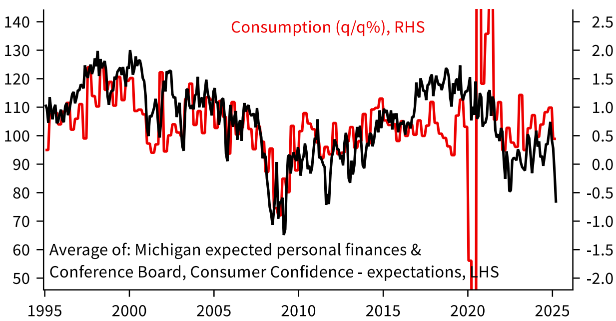
Measures of future capital expenditure intentions from regional federal banks experienced large falls in April, approaching levels seen around past recessions. Similarly, consumer expectations have fallen significantly, although they are not always a reliable guide to consumption growth.

US business investment expectations



Source: National Australia Bank, Macrobond

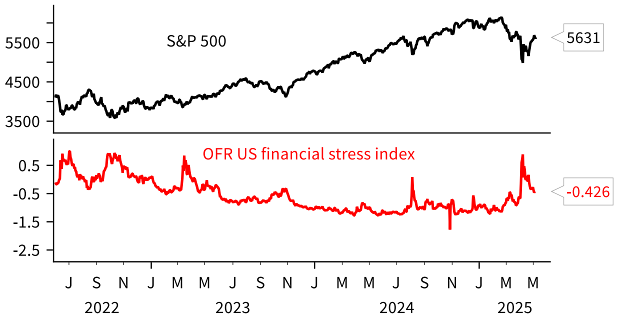
Consumer expectations and consumption



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

Hopes of some winding back in tariffs have increased in recent weeks with the Trump administration, adding some exemptions and China reportedly also doing the same with its tariffs on US imports. The administration has also indicated that it is considering, or close to agreeing to, trade agreements with a range of countries. US officials have said discussions are progressing with 17 of 18 major trading partners, and US/China officials will reportedly begin talks this week. There has been some improvement in financial conditions with equities recovering some of the losses seen since February, credit spreads stabilising and measures of financial stress easing.

Equity prices & financial stress (index)



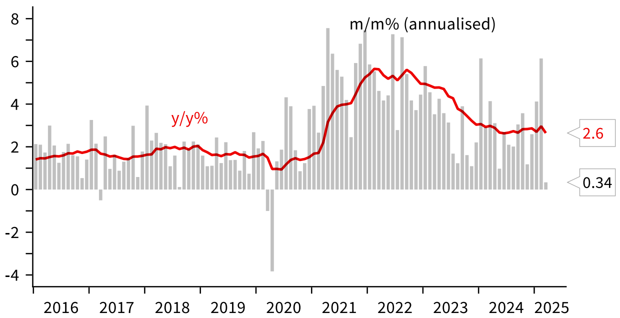
Source: National Australia Bank, S&P Global, The Office of Financial Research (OFR), Macrobond

While this points to a reduction in tail risks around the outlook, it is unclear what the trade deals involve, whether they will actually be agreed and, if so, to what extent they will reduce tariffs currently in place (as opposed to forestalling further increases). It is easy to see a scenario where tariffs increase from here – e.g. when the pause on reciprocal tariffs above 10% ends on 9 July, or the mooted sector specific tariffs (semi-conductors, pharmaceuticals, copper, lumber) are introduced. While the administration has been talking up the prospect of trade deals, the President's declared intent to tariff movie imports and his declaration this week that he will dictate tariff levels for US trading partners rather than engage in back and forth negotiations sends a less positive signal.

We base our forecasts on tariffs currently in place, but tariff and broader policy uncertainty is exceptionally elevated, and forecasts of the economy come with a much wider error band than normal, and the risk of a recession is real.

If our expectations of growth are correct, we expect to see the labour market weaken, particularly in the second half of the year. There is little evidence of firms shedding staff in anticipation of weaker demand in the hard data so far, but the latest payrolls data only reflected the pay period covering 12 April.

Core PCE inflation



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

Inflation data have been very volatile in recent months ahead of what are likely to be significant tariff impacts in coming months, with a 0.5% m/m rise in core PCE inflation in February followed by 0.03% in March. The March result saw year-ended inflation decline to 2.6% (from 3.0%), back where it was in June 2024. The lack of clear progress on lowering inflation back towards target means the Fed is not in a good starting point ahead of the likely tariff impacts. One comfort is that the wage growth continues to slow – one aspect of broader price setting in the economy.

Apart from upcoming tariff impacts, the fall in the US dollar that has occurred will also add some upwards impetus to prices. The recent fall in oil prices will provide some offset (but less so to the core measures that tend to the be focus). We still expect core inflation to reach around 4% although, as with the activity forecasts, there is considerable uncertainty about the ultimate pass through to consumers as it will depend on many factors including the availability of substitutes for highly tariffed imports, the extent to which the tariffs are absorbed by overseas producers and US businesses.

We do not expect pass through of the tariff shock to consumer prices to echo through into second round effects or de-anchored inflation expectations, but this is not guaranteed. The FOMC will be watchful and will need to tolerate lower activity growth and some increase in the unemployment rate, as this would constrain second round price effects, to be confident inflation expectations remain anchored.

Monetary policy

We expect the Fed to be in a position to cut in coming months, but they will be cautious until there is greater clarity on the balance of inflation and unemployment risks. We continue to expect the Fed to cut rates by 75bp this year and a further 50bp in 2026).

We continue to expect an initial cut in July but are conscious the FOMC may take more time to gain sufficient comfort to begin to cut rates. Playing to that risk, Powell said in the press conference this morning that "*we don't feel like we need to be in a hurry. We feel like it's appropriate to be patient.*"

Much will depend on the data flow and whether an opening up of spare capacity in the economy is evident ahead of the July. There are three CPIs and two payrolls releases ahead of the 30 July decision. A later starting point for cuts needn't mean less easing. Powell also added that "*when things develop, of course, we have a record of—we can move quickly when that's appropriate.*"

The framework the Fed will take to the tension between full employment and inflation objectives is clear. Powell overnight repeated that if the goals are in tension, "*we could consider how far the economy is from each goal and the potentially different time horizons over which those respective gaps would be anticipated to close*" but also that "*our obligation is to keep longer-term inflation expectations well anchored and to prevent a one-time increase in the price level from becoming an ongoing inflation problem.*"

If price passthrough is short-lived and second round effects are minimal, the Fed can look through much of a short-term price impact, but that won't be obvious in real time. The appropriate response to this tension was elucidated in previous Fed analysis. We wrote about it previously and concluded that the Fed can only partially 'look through' price rises in the current environment. (Tariffs and what it could mean for the Fed).

If the deterioration in the labour market is materially larger than we expect, the Fed will be less concerned about persistent inflation and respond in a more unconstrained way. Equally, if hard data remains resilient or there is evidence of broader price pressures, the FOMC would be more constrained. Much will depend on how policy uncertainty, both whether high tariff rates are sustained and the extent the broader policy mix becomes more supportive of growth.

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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	1.9	1.3	0.9	1.0	0.4	0.1	-0.1	0.1	0.4	0.6	0.6	0.6
Private fixed investment	2.4	3.7	1.8	1.7	0.5	-0.3	1.9	-0.2	-0.2	0.0	0.5	0.8	1.0	1.1
Government spending	3.9	3.4	1.3	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	0.0	-0.1	-0.1	-0.2	0.6	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports*	0.5	-0.4	-0.7	0.3	-0.1	0.1	-1.4	0.8	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**	**-0.1**	**0.4**	**0.1**	**0.1**	**0.4**	**0.6**	**0.6**	**0.6**
Note:														
GDP q/q annualised rate					*3.1*	*2.5*	*-0.3*	*1.5*	*0.6*	*0.6*	*1.5*	*2.2*	*2.5*	*2.5*
GDP year-ended %	*3.2*	*2.5*	*0.6*	*2.2*	*2.7*	*2.5*	*2.0*	*1.7*	*1.1*	*0.6*	*1.1*	*1.2*	*1.7*	*2.2*
US Other Key Indicators														
PCE deflator-headline		year -ended %			q/q%									
Headline	**2.8**	**2.5**	**3.8**	**2.2**	**0.4**	**0.6**	**0.9**	**0.9**	**1.3**	**0.8**	**0.6**	**0.5**	**0.5**	**0.5**
Core	**3.2**	**2.8**	**4.1**	**2.3**	**0.5**	**0.7**	**0.9**	**1.1**	**1.3**	**0.7**	**0.7**	**0.6**	**0.5**	**0.5**
Unemployment rate - qtly average (%)	**3.8**	**4.2**	**4.6**	**4.6**	**4.2**	**4.2**	**4.1**	**4.2**	**4.4**	**4.6**	**4.7**	**4.8**	**4.7**	**4.6**
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

					2024 Q3	2024 Q4	2025 Q1	2025 Q2	2025 Q3	2025 Q4	2026 Q1	2026 Q2	2026 Q3	2026 Q4
Note:														
core PCE inflation y/y%					2.7	2.8	2.8	3.2	4.0	4.1	3.9	3.4	2.5	2.3

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