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RESEARCH HIGHLIGHT
ECONOMY

December 4, 2024

2025 U.S. Economic Outlook: The Cycle Should Trump Policy Hurdles

- Barring extreme policy choices, strong macro fundamentals and solid economic momentum will drive continued above-potential U.S. economic growth in 2025.
- While job creation will slow next year, aggregate labor income growth will remain historically solid, supporting continued healthy consumption growth.
- The lack of economic slack combined with solid growth and the potential for policy shocks imply a meaningful upside risk to inflation.
- Resilient growth, sticky inflation, and upside risks to the latter will force the Fed to dial down its policy easing plans next year.
- The Fed will raise its neutral rate estimate further over the coming months, supporting an earlier halting of the easing cycle than it had previously signaled.
- The prospects for expansionary fiscal policy, policy uncertainty and the Fed's acceptance of a higher neutral rate imply upside for long-term bond yields.

As we had expected[1], the U.S. economy has continued to grow above its potential rate this year, with real GDP on track to grow 2.8% in 2024. Considerable policy uncertainty looms over 2025 following the outcome of the election. Still, MRB's view is that the underlying resilience of the business cycle should trump the most likely policy hurdles: strong macro fundamentals and solid economic momentum will drive continued above-potential real GDP growth of 2.5% in 2025 **(chart 1)**. Our U.S. economic growth forecast is once again above the consensus' forecast, the latter being in line with the economy's 2% potential rate.

Our U.S. economic growth forecast is once again above consensus

Our inflation forecast is also higher than the consensus: we expect core CPI inflation to remain sticky above 3% and see the risks to inflation as tilted to the upside, given the lack of economic slack and the potential for adverse (for inflation) policy shocks.

The potential for significantly disruptive policy changes is the elephant in the room.

[1] **MRB:** "***2024 U.S. Economic Outlook: Continued Resilience***", December 7, 2023

Table 1 Trump's Policies Fatten The U.S. Economic Tail Risks

	Economic Impact				U.S. Financial Market Implications		
Policy	Growth	Inflation	Debt/Deficits	Uncertainty	Treasurys	Equities	Dollar
Tax Cuts	Up	Up	**Up**	----	**Bearish**	**Bullish**	----
Deregulation	Up	Up	----	----	Bearish	**Bullish**	Bullish
Tariffs	**Down**	**Up**	Up	**Up**	**Bearish**	**Bearish**	Bearish
Deportation & Anti-Immigration	**Down**	**Up**	Up	**Up**	**Bearish**	**Bearish**	**Bearish**

Note: Bold text denotes where policy has greatest impact; see **MRB:** "*Positioning For The New Fat Tail U.S. Economy*", November 20, 2024, for financial market implications

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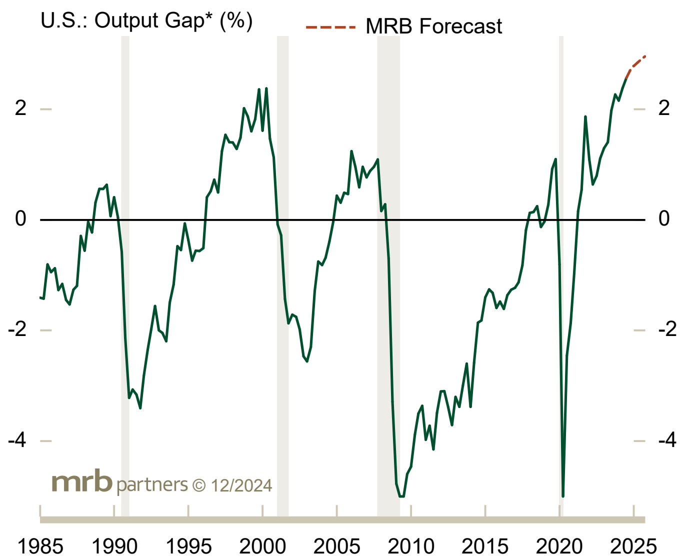
President-elect Trump has campaigned on policies that are both pro-growth (tax cuts and deregulation) and disruptive/ anti-growth (widespread tariffs and deportations/anti-immigration). Thus, from a policy perspective, there are both upside and downside risks to the growth outlook[2] **(Table 1)**. However, all are either inflationary or stagflationary, and thus contribute to greater price pressures.

Coming out of a mid-cycle slowdown in 2016, Trump's policies during his first Administration were initially pro-growth (tax cuts) but were ultimately followed by an anti-growth policy (the trade war). This time the strong economy will provide Trump with the potential to front-load tariffs and reverse/ curb immigration flows, which could initially slow growth and heighten economic and bond market uncertainty before deregulation/tax policy boosts sentiment. Still, there is considerable uncertainty about both the timing and magnitude of changes.

Chart 1 Above-Potential Growth Will Continue In 2025



* GDP as a percent of potential GDP; truncated below -5; sources: Bureau of Economic Analysis and Congressional Budget Office
Note: Shaded for NBER-designated U.S. recessions

The strong economy will provide Trump with the potential to front-load tariffs

While restraining future immigration flows is a highly likely policy action, reversing the flows of recent years (via deportations, which would be very damaging to growth) would prove logistically very difficult, and is therefore not very likely. And although Trump has

[2] **MRB:** "*Positioning For The New Fat Tail U.S. Economy*", November 20, 2024

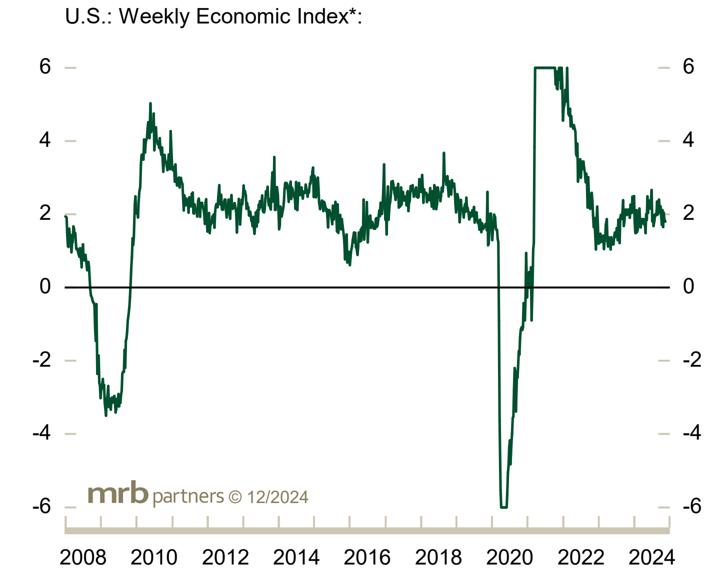
threatened a 10% tariff on all U.S. imports, this too seems unlikely to occur. Additional tariffs on China, and tariffs on auto imports are the most likely outcome for next year, the growth effects of which could be partly offset by pro-growth deregulation, and tax policy changes early next year (over and above the extension of the 2017 Trump tax cuts). Still, investors will need to be open-minded and what actually occurs could end up being quite different than what Trump has discussed to-date.

It is worth emphasizing that the economy's cyclical momentum and underlying strengths will ultimately play a dominant role over the vagaries of policy choices. Note that despite the trade war and related policy uncertainty in the last Trump administration, the U.S. economy grew soundly, with real GDP rising 3% and 2.6% in 2018 and 2019, respectively.

The underlying fundamentals of the U.S. economy today are resilient (including healthy household balance sheets, durable labor market gains and decent income growth), justifying a strong growth outlook as our base-case view.

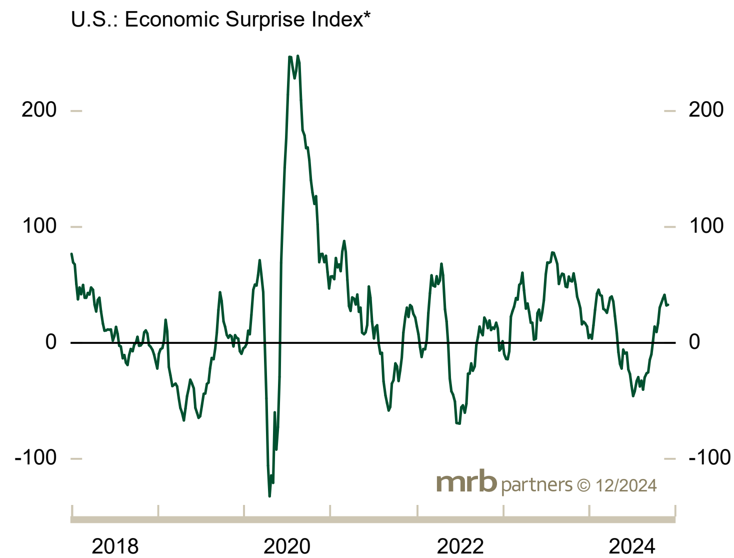
High frequency data underscore that current U.S. growth momentum is solid, and economic surprises have turned positive over the past two months **(charts 2** and **3)**. Moreover, business sentiment, which has been in an extended funk, appears to be perking up following the election **(chart 4)**.

Chart 2 U.S. Growth Momentum Is Solid



* Truncated at +/- 6; source: Federal Reserve Bank of Dallas

Chart 3 Data Has Surprised On The Upside



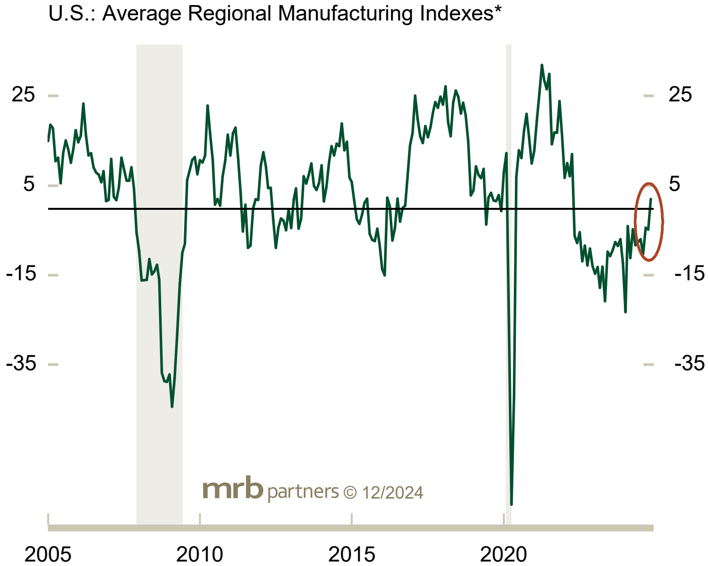
* Source: Citigroup

The bigger risk from policy pertains to inflation. Unlike in 2016, the economy is not operating with much slack today (the opposite is true), and inflation is already sticky above the Fed's goal as opposed to being muted **(chart 5)**. The conclusion is that this is an economy that is primed for overheating, and the risks to inflation from the Trump administration's policy alternatives are clearly tilted to the upside.

The other clear risk is the poor U.S. fiscal outlook. Ongoing large budget deficits and massive Treasury issuance will be bearish for long-term bond yields[3].

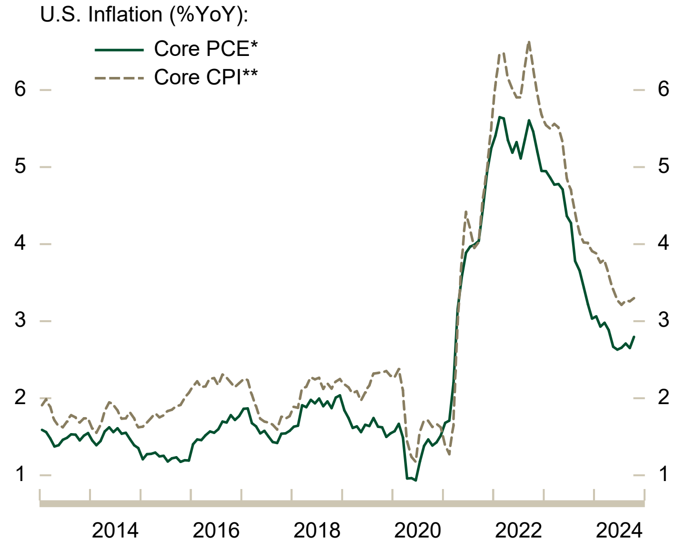
[3] **MRB:** "*Trump 2.0: What It Means For The Fixed Income Market*", November 13, 2024

Chart 4 **Business Sentiment Seems To Have Ticked Up After The Election**



* Source: Federal Reserve Banks of New York, Philadelphia, Dallas & Richmond
Note: Shaded for NBER-designated U.S. recessions

Chart 5 **Core Inflation Is Bottoming Out Well Above 2%**

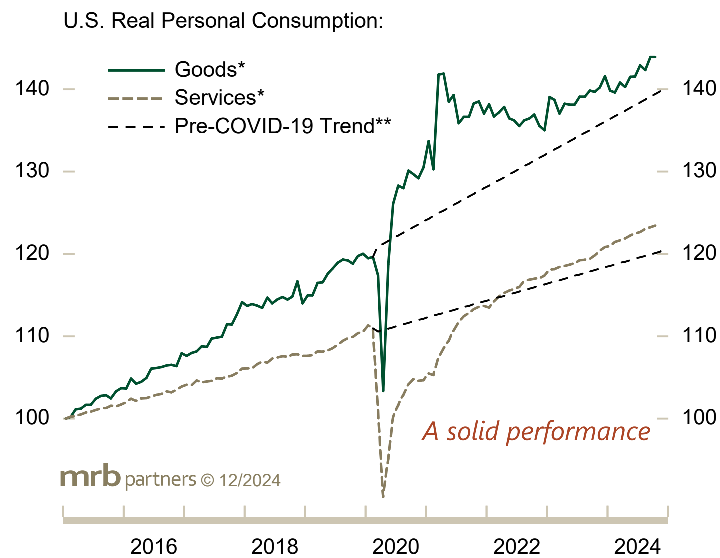


* Source: U.S. Bureau of Economic Analysis
** Source: U.S. Bureau of Labor Statistics
Note: Core excludes food & energy

The Consumer Anchor

As we have repeatedly noted, doubts about the underlying health and sustainability of U.S. consumer spending have been overblown over the past few years **(chart 6)**. Real consumer spending growth has averaged 2.8% (annualized) in the last three quarters. Revisions to the national economic accounts last year showed that spending has been backed by much better income growth, and a higher savings rate than previously estimated[4].

Chart 6 **Consumer Spending Had Been Persistently Strong**



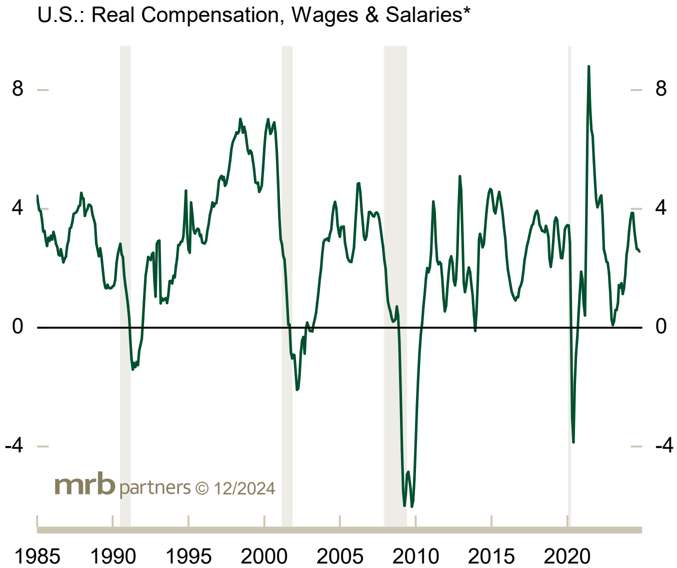
* Rebased to 100 in January 2015; source: U.S. Bureau of Economic Analysis
** MRB calculation

Wage growth has cooled, but it remains above the pre-pandemic rate. Meanwhile, aggregate wage and salary growth (which also reflects employment) is solid, up 3.2% YoY on an inflation-adjusted basis **(chart 7)**. Interest income has exceeded the outflow of households' interest payments **(chart 8)**. Effectively, it means that the ***aggregate*** U.S. household sector has benefitted from higher interest rates, consistent with its status as a net lender to the rest of the economy.

Household debt remains low relative to income and to spending **(chart 9)**. Consumption

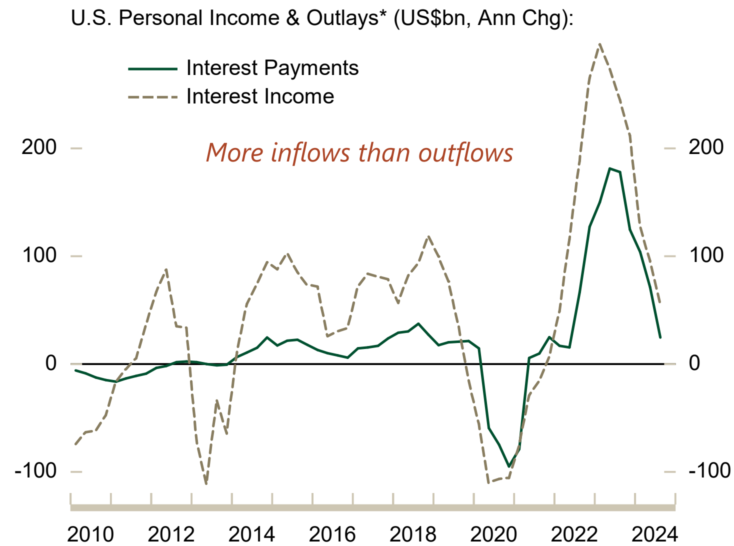
[4] **MRB:** "***U.S. Economy: On Firmer Ground Than You Thought***", October 2, 2024

Chart 7 Real Wage Income Is Up Strongly



* Smoothed; source: U.S. Bureau of Economic Analysis & MRB calculation
Note: Shaded for NBER-designated U.S. recessions

Chart 8 Interest Rates Have Not Adversely Affected Disposable Income



* Source: U.S. Bureau of Economic Analysis

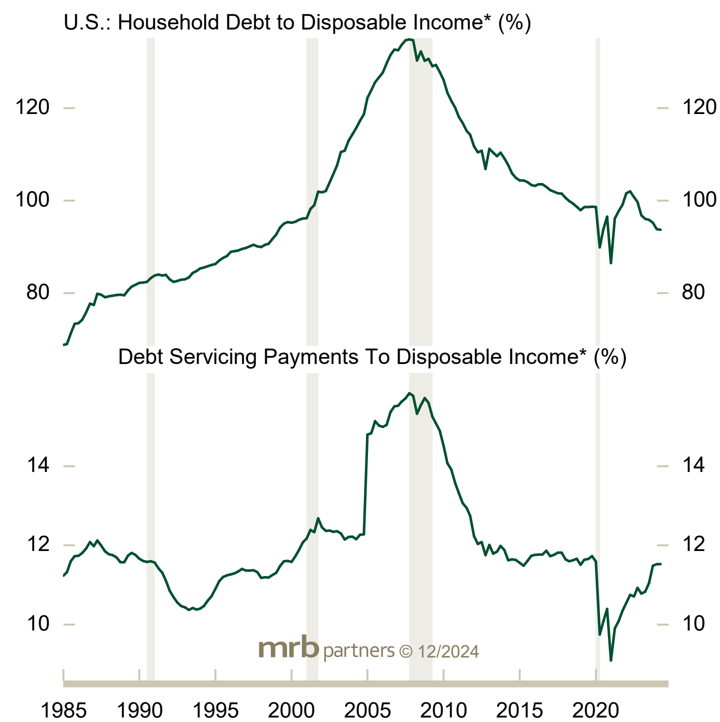
is still less credit-dependent than it was in previous cycles. Debt servicing burdens are low. Delinquency and default rates have ticked up, but not enough to cause a macro drag or herald a looming threat to consumer spending.

With a further moderation in employment, we expect that consumer spending growth will cool next year, albeit only modestly. Note that the effective average savings rate in this expansion has exceeded 8%, indicating that the consumer has a much better savings cushion than in the past three business cycles **(chart 10)**.

Will The Housing/ Manufacturing Funk End?

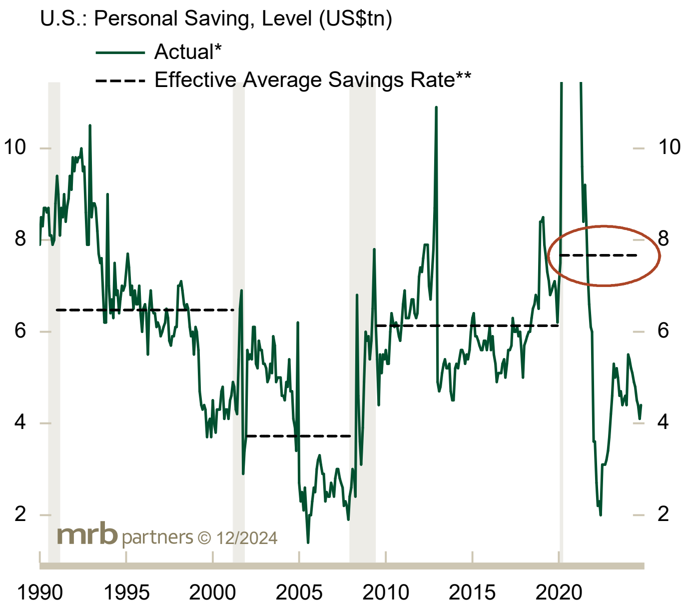
As is true globally, U.S. manufacturing activity too remains in a funk **(chart 11)**. Manufacturing sentiment has also been downbeat with the ISM manufacturing index stuck below 50, and capex activity and plans have been tepid at best.

Chart 9 Household Balance Sheets Remain Solid



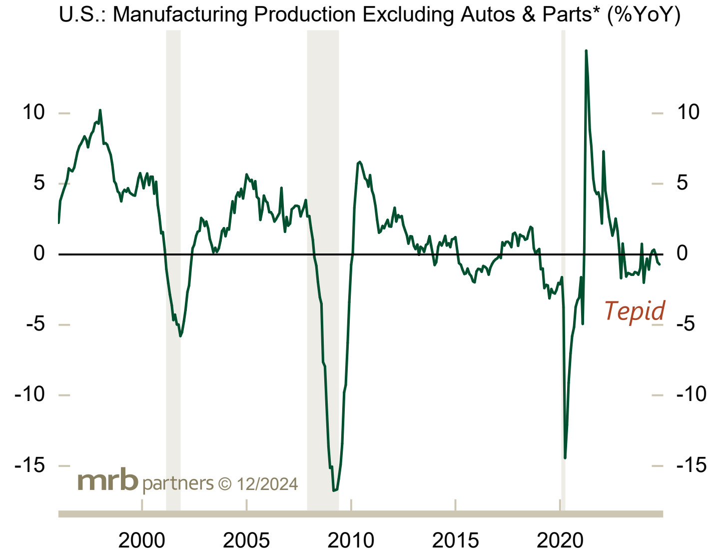
* Source: Federal Reserve
Note: Shaded for NBER-designated U.S. recessions

Chart 10 **The Effective Savings Buffer Is Much Higher This Cycle**



* Truncated at 12%; source: U.S. Bureau of Economic Analysis
** Total savings to total disposable income over the period

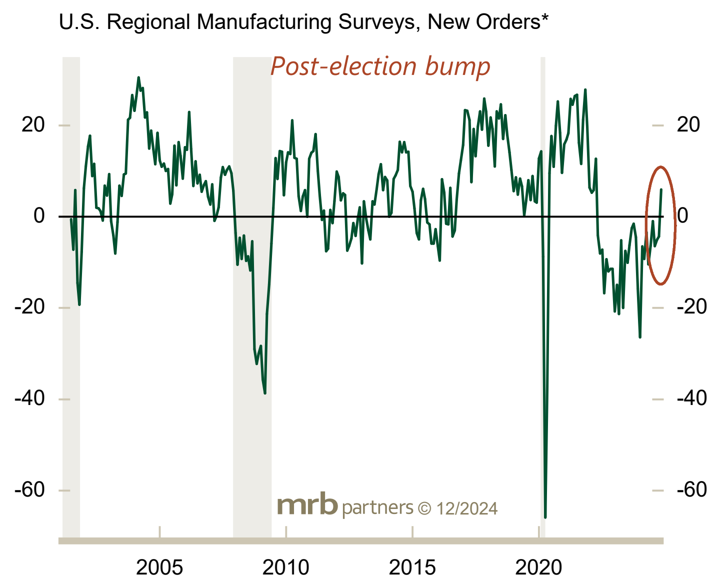
Chart 11 **Manufacturing Activity Has Been Tepid**



* Source: Federal Reserve
Note: Shaded for NBER-designated U.S. recessions

Prospects for business investment next year are mixed. On the one hand, resilient final demand implies an underlying source of support for capex. Additionally, select business surveys have perked up after the election, reflecting the optimism around favorable tax and regulatory changes supported by the Trump administration - which suggests that the ISM PMI could also potentially rise above 50 in the coming months **(chart 12)**. However, the positive effects of the same could be counterbalanced by the potential for policy uncertainty and trade related disruptions from a potential trade war. Consequently, we expect real fixed business investment growth to remain in a 4-5% range next year, with scope for further gains, albeit limited by policy uncertainty.

Chart 12 **New Orders Sentiment Has Picked Up After The Election**



* Source: Federal Reserve Banks of New York, Philadelphia & Richmond
Note: Shaded for NBER-designated U.S. recessions

New housing activity is likely to continue to increase only marginally, as a trickle of new demand provides only modest impetus for new construction amid a still-frozen resale market **(chart 13)**. Housing will not boost GDP growth materially unless mortgage rates fall sustainably below 6% and release latent housing demand **(chart 14)**. The latter is unlikely, in view of the upside risks to inflation. Moreover, some fiscal deterioration is probable from the Trump administration's potential policies implying upside for U.S. Treasury yields.

The Labor Market: Less Bearish Than It Appears

The Fed and the consensus are gradually coming around to our view[5] that the U.S. labor market has been in much better shape this year than implied by bearish, flawed indicators like the "Sahm rule[6]".

The rise in the unemployment rate to 4.3% by mid-year from 3.7% at the beginning of the year, was largely led by an unusually large increase in the labor force due to immigration, and not due to layoffs. Without immigration, we estimate that the unemployment rate would have been 3.6% at the end of Q3, instead of 4.1% (**chart 15**, next page).

There has been no evidence of a meaningful rise in layoffs that would indicate a pernicious deterioration in the labor market in recent months (**chart 16**, next page).

Job creation has slowed to 150,000 per month as of September[7], but it is important to note that this is higher than the "breakeven" job creation rate for the economy of 120,000 per month[8]. As immigration inflows slow ahead, both the rate of job creation and the breakeven pace of job creation will slow (we assume that prime-age participation will not rise further).

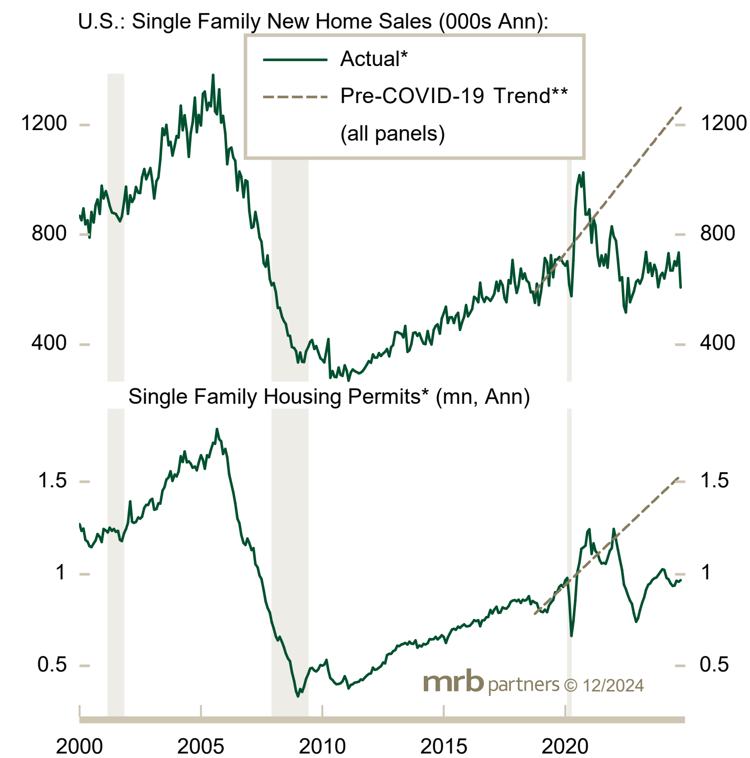
[5] **MRB:** "*U.S. Labor Market: Less Bearish Than It Appears*", August 9, 2024

[6] This rule of thumb is that if the three-month average of the unemployment rate rises at least half a percentage point above its prior-year low it has historically marked the beginning of a recession.

[7] The October average is lower but reflects the effect of hurricanes.

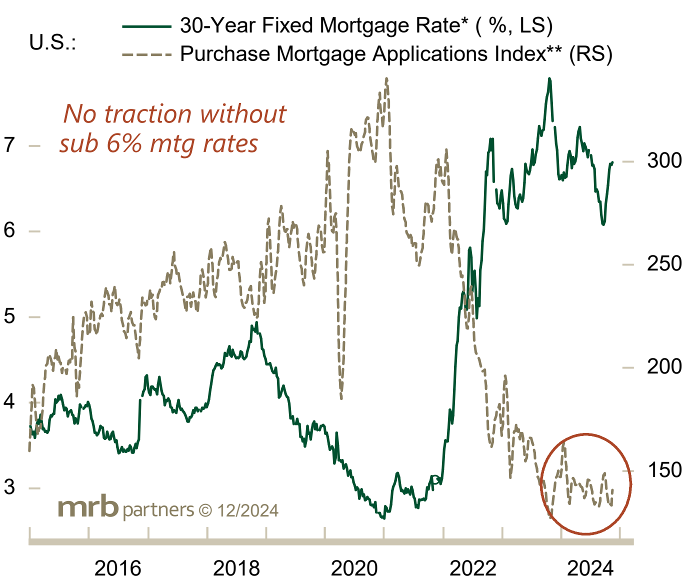
[8] The breakeven pace is the gain in employment needed to keep labor demand and supply in balance, that is absorb the trend additions to labor supply each month. This figure accounts for elevated immigration.

Chart 13 **Tepid Supply Reflects Muted Demand**



** Source: U.S. Census Bureau
** MRB calculation
Note: Shaded for NBER-designated U.S. recessions

Chart 14 **No Traction Without Lower Mortgage Rates**



* Source: Freddie Mac
** Source: Mortgage Bankers Association

Note that if the volume of immigration were to fall back to its 2012-2018 average (around 900,000 new entrants per year), then the economy would need to add only about 85,000 jobs per month to keep labor demand and supply in balance. The bottom line is that a further moderation in hiring to somewhat below 100,000 in the context of slower immigration next year would be normal, and not a bearish signal.

In addition to a slowdown in new job openings, the pickup in labor supply (implying more competition for jobs) has likely played a meaningful role in dampening job quits and reining-in wage growth. As immigration drops and labor supply growth slows ahead, so will the downward impetus on wage growth (which is important, given that wage growth is still running above the pre-pandemic rate and thus is a source of inflation pressure).

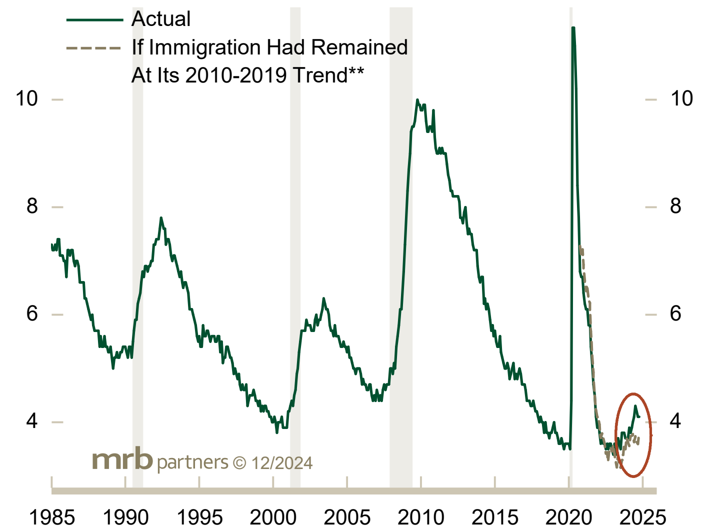
Overall, although job creation should slow a bit next year, we expect that aggregate labor income growth will remain historically solid, supporting continued consumption growth.

Inflation: Firmer Than The Fed Expects

After easing for much of this year, core inflation has firmed somewhat in the last two months, consistent with strong economic growth and contributed to a pause in the Fed/consensus narrative that inflation is well on its way to 2% (**chart 17**, next page).

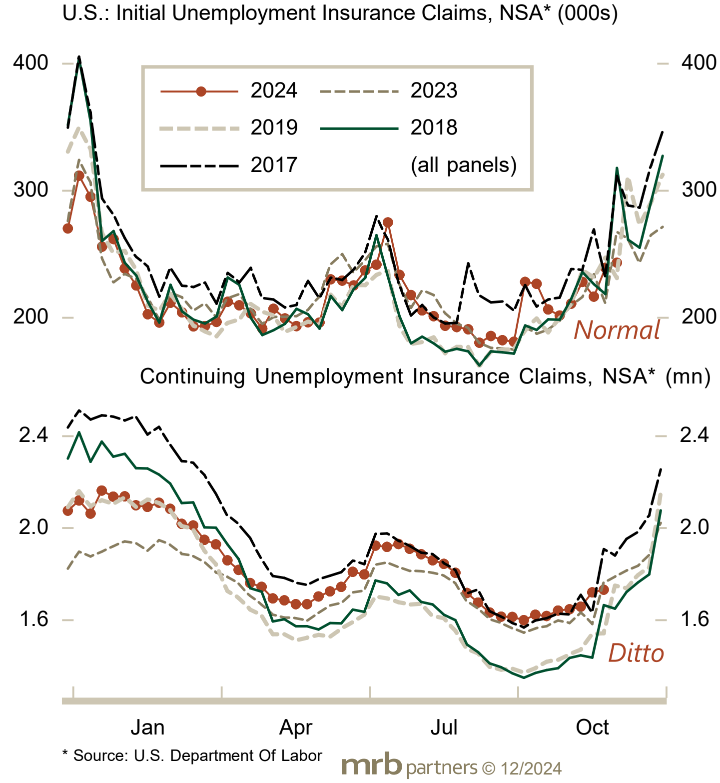
MRB's view remains that the so-called "last mile" on inflation – (the distance to the Fed's 2% inflation goal) will not be easy to achieve. This is partially because the steady run-rate of inflation is well above 2% in the absence of the secular disinflationary forces that existed until the late-2010s. In this respect, the last mile requires a weak or recessionary economy to

Chart 15 Immigration (Not Layoffs) Has Lifted The Unemployment Rate



* Trucated at 11.3%; source: U.S. Bureau of Labor Statistics** MRB calculation
Note: Shaded for NBER-designated U.S. recessions

Chart 16 No Sign Of Spiking Layoffs



* Source: U.S. Department Of Labor

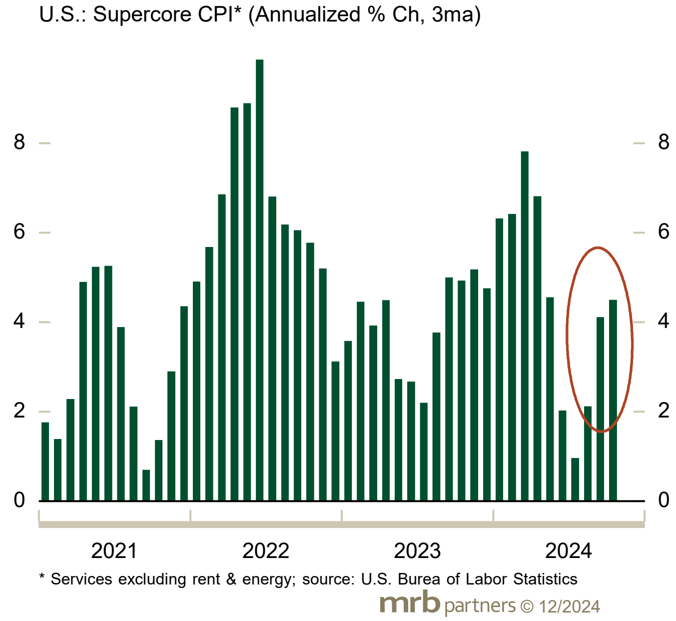
Deleveraging of households, technological advancements, globalization achieve. Indeed, the underlying trend in inflation is likely closer to 3%, which means that inflation can run hotter given cyclical inflationary pressures.

The Fed's policy tightening has had relatively less to do with the decline in inflation since early-2023 than most people believe (a restrictive Fed policy would have impacted inflation via the demand channel, and demand growth has maintained an above-potential rate). Instead, the unwinding of post-pandemic distortions, and the increase in immigration flows, have played major roles in lowering inflation to-date[9]. The effect of these factors will fade ahead[10].

Meanwhile, underlying price drivers are still supportive of inflation remaining sticky at or above 3%; this includes the fact that the economy is growing well above potential. Any restraint that monetary policy could have imposed on the economic cycle is now fading with the still Fed easing interest rates. Meanwhile, service sector wage growth remains well above the pre-pandemic norm, implying that supply-side pressure on non-rent services inflation remains above the level consistent with 2% overall inflation **(chart 18)**. Finally, PCE/CPI rent indexes are still lagging the prior increase in market rents[11], implying that they will put upward pressure on core inflation gauges for an extended period **(chart 19)**.

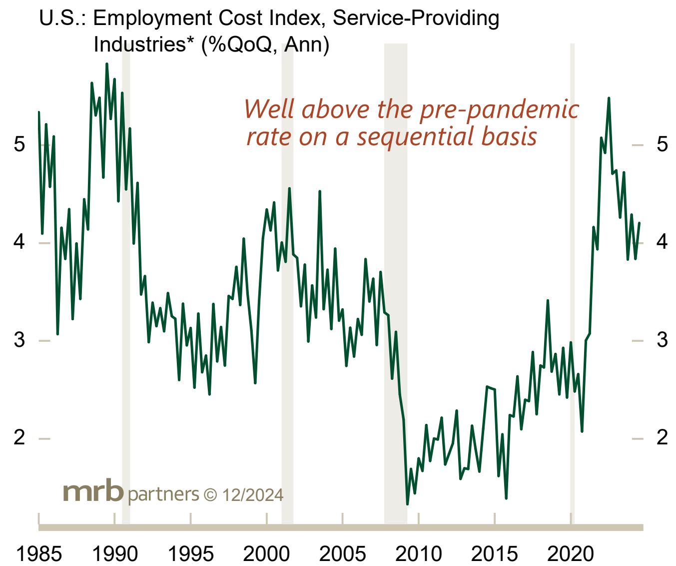
Our view remains that core CPI inflation will remain sticky above 3%. Moreover, risks to inflation are clearly tilted to the upside from tariffs, which as history shows will mostly get passed on to consumers. Eventually sticky, above-target inflation and a resilient economic cycle will limit how much the Fed can ease rates next year.

Chart 17 The Sequential Downshift In Inflation Has Stalled



* Services excluding rent & energy; source: U.S. Burea of Labor Statistics

Chart 18 Services Wages Still Imply Elevated Pressure On Prices



* Smoothed; source: U.S. Bureau of Labor Statistics
Note: Shaded for NBER-designated U.S. recessions

9 Had immigration maintained its pre-pandemic trend beyond 2020, the labor force would have had around 4.5 million fewer workers, as per the U.S. Bureau of Labor Statistics' official counts plus other border crossings data.

10 Except for autos, the unwinding of goods price pressures is largely behind us. Immigration flows are set to drop ahead.

11 **MRB:** "***U.S. Rents: Another Source Of Sticky Inflation***", April 24, 2024

Fed Policy: A Pivot Next Year

The Fed's September dot plot showed the policy rate at 3.25%-3.5% by the end of next year (median projection), in the context of 2% real GDP growth in this and the next two years, core PCE inflation falling to 2.6% this yearend and further to 2.2% by next end-2025, and the unemployment rate reaching 4.4% by this December and staying there next year.

These economic projections already look unrealistic: growth is tracking a significantly higher 2.5% this year[12], the unemployment rate has ***eased*** to 4.1%, and the core PCE inflation rate ticked ***up*** to 2.8% in October.

The Fed will be forced to dial down on its policy easing plans next year, with growth surprising on the upside and likely to continue doing so next year, with inflation firming and facing meaningful upside risks ahead, and the labor market holding up better than feared.

Unsurprisingly, market expectations for Fed policy have shifted in anticipation, and are now pricing a 3.8% policy rate by the end of next year **(chart 20)**.

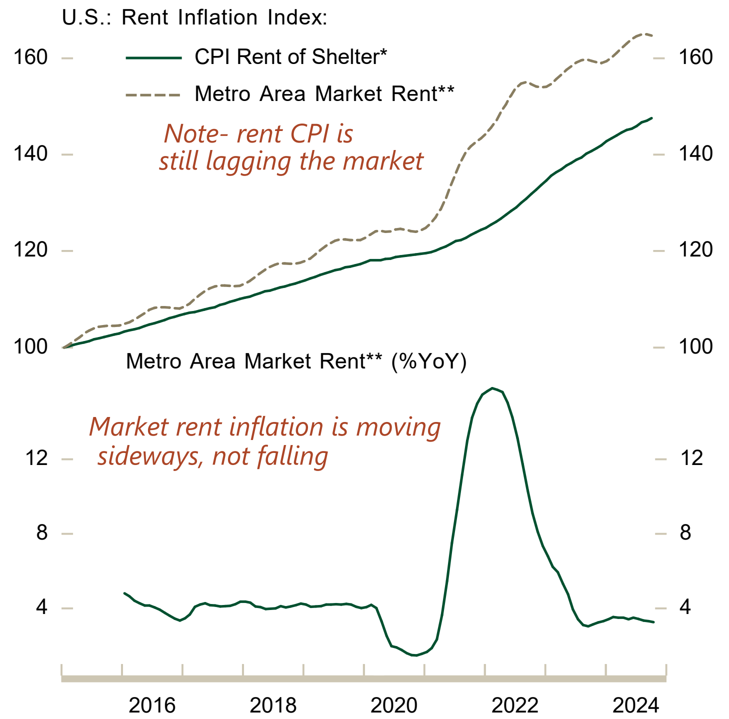
We expect that the Fed will follow through with another 25 bps rate cut at the FOMC meeting later this month, taking the policy rate to 4.25%-4.5%. However, we expect that the Fed will halt rate cuts next year after ***at most*** two additional rate cuts, with the Fed funds rate at 3.75% to 4%.

It is important to keep an eye on the Fed's longer-run, or "neutral[13]" policy rate. The Fed has (finally) raised its estimate of the neutral rate from 2.5% in

[12] On a Q4 over Q4 basis

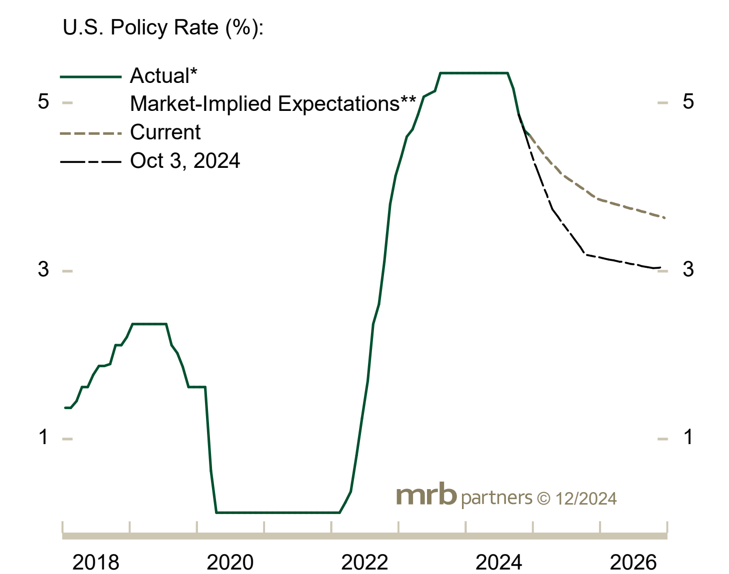
[13] The "equilibrium" or "neutral" policy rate is used interchangeably to refer to the rate that is consistent with aggregate output at its potential growth rate and stable inflation at the central bank target in the medium-to-long term.

Chart 19 **CPI/PCE Rents Levels Are Still Lagging Market Rents**



* Source: U.S. Bureau of Labor Statistics
** Source: Zillow

Chart 20 **Rate Cut Expectations Have Seen A Dramatic Revision**



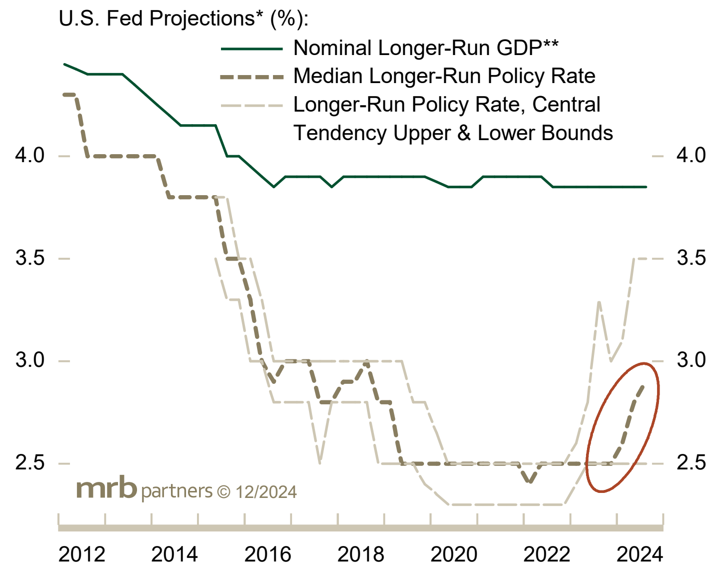
* Source: Federal Reserve
** Source: Bloomberg; last observation 12/02/2024

December 2023 to 2.9% this September, as we had anticipated **(chart 21)**. However, we expect that the Fed will raise its neutral rate estimate further over the coming months and ***use such a shift to contextualize the halting of its easing cycle.***

MRB's view is that a realistic estimate of the neutral policy rate for the U.S. should be at least in the 4.5% range. Importantly, this is a number that a Fed member has recently acknowledged as plausible, for the first time in years[14].

Amid the Fed's pivot to policy easing this year, the rise in its neutral rate estimate has flown under the radar. However, future increases in the Fed's median longer run policy rate, especially as they will coincide with a curbing of rate cuts, could have a have a profound implication for U.S. Treasury yields (higher) and shape of the yield curve (steeper).

Chart 21 The Fed's Neutral Rate Estimate Will Continue Rising



* Source: Federal Reserve, FOMC meetings SEP
** Midpoint of central tendency plus 2% inflation

Final Word: *The outcome of the election has raised the tail risks for the U.S. economy. Barring extreme policy outcomes, however, MRB's base-case view is that the sound underlying economic fundamentals and strong growth momentum will power the economy to another above-potential performance in 2025. We see a bigger risk to an upside inflation outcome, given the prospect of policy shocks, and given that the economy is not operating with slack. The Fed will be forced to pivot away from its aggressive easing plans next year and acknowledge a higher longer-run policy rate for the economy. We see further upside to long-term bond yields from greater inflation risks, policy uncertainty, and a worsening fiscal outlook*

Prajakta Bhide
Strategist, U.S.

[14] **MRB:** "*The Fed Is (Predictably) Talking Up The Neutral Rate*", November 18, 2024

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