Our US Macro Perspectives report covers our views on the US economy and the Fed. It features probability forecasts for key macro drivers, and a rigorous assessment of how shifts in macro regimes shape the Fed policy and Treasury yield outlook.

February 11, 2025

How do tariffs affect the Fed outlook?

Self-inflicted wounds – In our latest *US Macro Strategist* report, we explored the impact of elevated import barriers on inflation. With the aid of a global structural model, we found that duties on China, Mexico and Canada would lift US inflation this year by 0.5%, but a strong dollar, weaker global activity and lower oil prices would quickly reverse this effect.

Would interest rates rise or fall in response? Since the Fed has a dual mandate, the reaction depends also on their impact on unemployment. Tariffs look to fuel activity by favouring local producers. Yet duties since 2018 have done little to reignite manufacturing, with output moving sideways despite strong goods demand (F1).

One key hindrance is tariffs exert upward pressure on the dollar, eroding the external competitiveness of US producers (F2). In addition, duties hurt export volumes directly via weaker global activity and retaliation. Higher import costs also lead to a compression in margins, while heightened uncertainty discourages investment.

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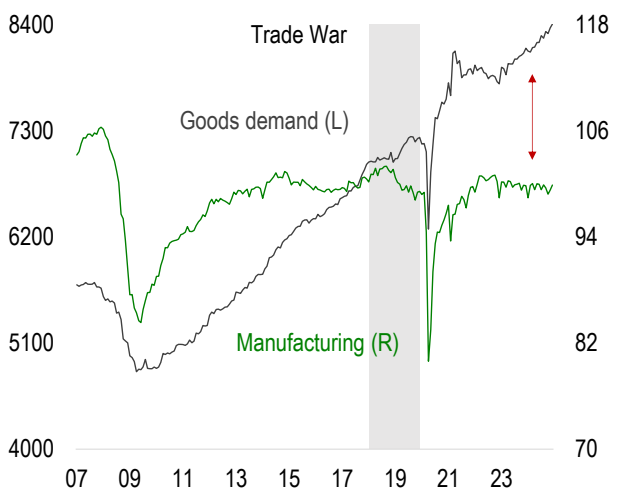
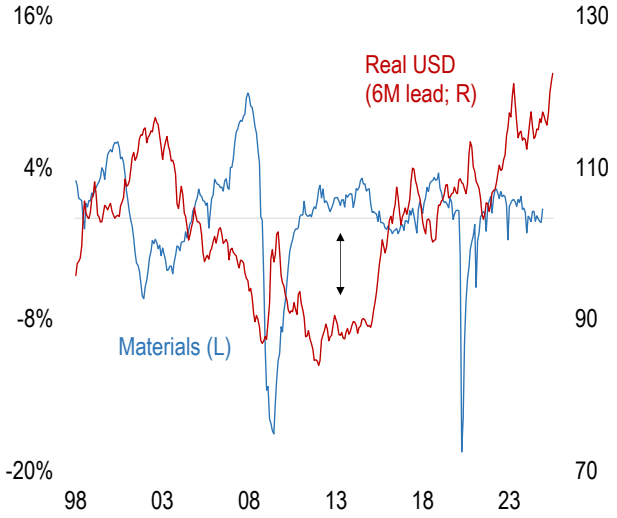
F1: Trade War did not reignite US industry
US goods demand vs. manufacturing activity



Note: Chart plots demand for goods by US consumers and business versus manufacturing output. Source: Federal Reserve, BEA; Numera calculations.

F2: A strong dollar is a major headwind
Real US dollar vs. materials manufacturing



Note: Cyclical fluctuations in US intermediate goods manufacturing versus the real trade-weighted US dollar. Source: Federal Reserve; Numera calculations.

T1: Tariff impact on growth Simulated effect by year (%)	Change in GDP growth by source: All	Uncertainty	Price effects	Global	GDP loss (BN USD)
2025	-0.6%	-0.3%	-0.2%	-0.2%	-139
2026	-0.4%	-0.2%	0.0%	-0.2%	-242
2027	0.1%	-0.1%	0.3%	-0.1%	-211

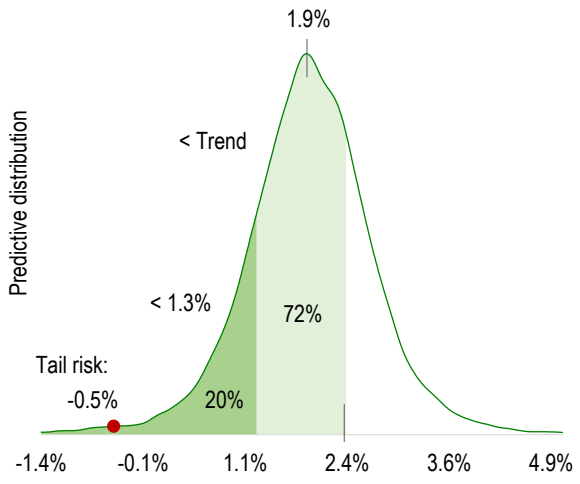
Note: Table shows the simulated impact of a 10% US effective tariff rate on US growth and the GDP level (in BN of USD). The second to fourth columns isolate the estimated contribution of policy uncertainty, price effects and global activity. Source: Numera Analytics.

T1 shows the simulated impact from an increase in the US effective tariff rate to 10%. If duties on Canada and Mexico remain in place, this would lower US growth by 0.6% in 2025, equivalent to a GDP loss of $140B. The key contributing factor is uncertainty, but the tariffs also weaken purchasing power and margins. Absent other shocks, the US would then grow 1.3%, a scenario which based on our models has a one-in-five chance of materializing (F3).

The price effects fade next year as the inflationary impulse lessens. However, tariffs continue to weigh on growth via weaker global activity and retaliatory measures, lowering exports and reducing the profitability of US multinationals. At their peak, our simulation work reveals that the tariffs would create an output loss of close to $250B.

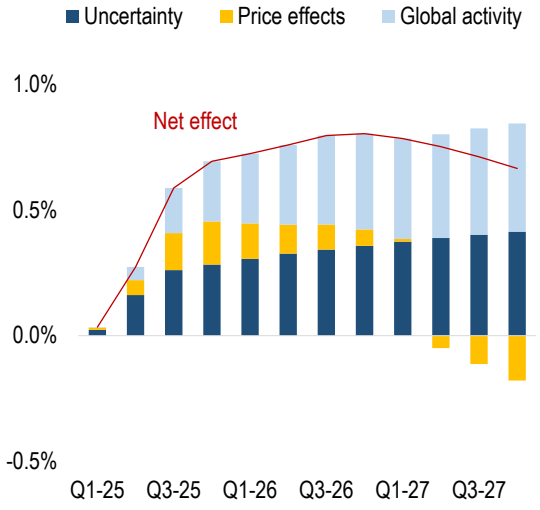
This creates a challenge for the Fed, who would balance a near-term price shock versus a persistent hit to activity. F4 shows the impact of tariffs on unemployment, isolating the effect of uncertainty, price effects and the slowdown in global activity. On net, duties would lift US unemployment by up to 0.8%, with the effect peaking in mid-2026. Relative to our baseline, this would then cause unemployment to near 6%, 1.5 points higher than consensus.

F3: Tariff scenario is not that far-fetched
US real GDP growth outlook - 2025 (%)



Note: There is a 72% probability that GDP grows below trend (2.3%) in full-year 2025, and a 17% chance it grows less than 1.3%. The worst potential outcome would be a 0.5% full-year contraction. Source: Numera Analytics.

F4: Weaker growth would hit job market
Simulated impact of tariffs on unemployment

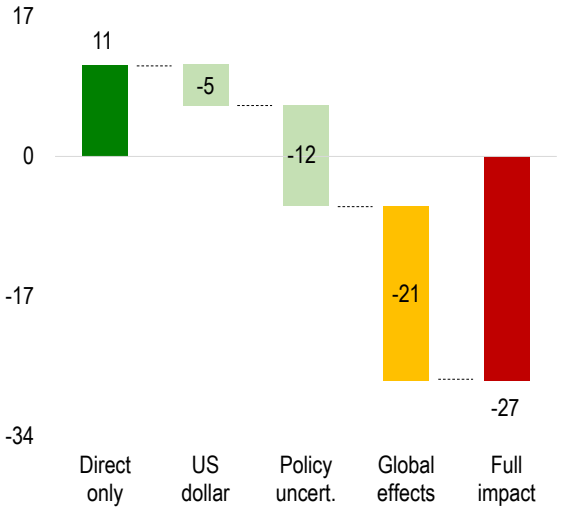


Note: Chart shows the simulated impact of a 10% US effective tariff rate on the unemployment rate. Bars isolate the contribution of heightened uncertainty, the change in purchasing power, and global activity. Source: Numera Analytics.

How would the FOMC react in this context? F5 shows the estimated change in the Fed funds rate by late 2026. Without any indirect effects, tariffs would cause the Fed to adopt a more hawkish tone, but not enough to merit a hike. This is because duties have a one-off impact on the price level, and so are unlikely to alter inflation expectations.

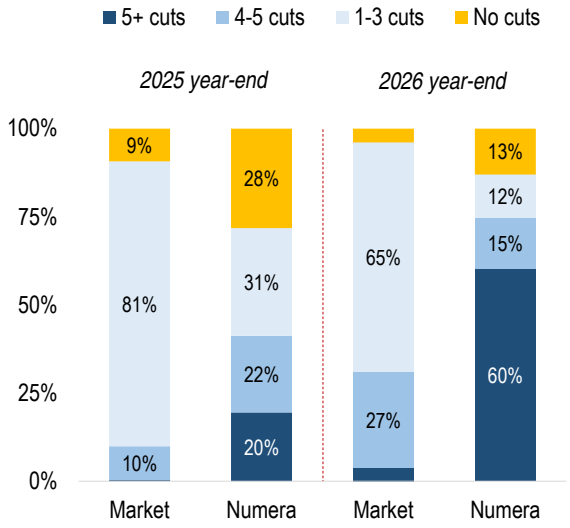
Accounting for second round effects, however, we find that the tariffs encourage the Fed to cut once more by Q4/26 than they would absent the policy change. One reason for this is a strong dollar, which helps lower import costs. Policy uncertainty plays an even bigger role, because of its sizeable drag on job creation. But it's the global effects that matter the most, both through their impact on activity and by reducing inflation (e.g. via weaker oil prices).

F5: Tariffs would eventually force Fed cuts
Simulated impact on policy rates by Q4/26



Note: Chart shows the simulated impact of a 10% US effective tariff rate on the Fed funds rate. Bars isolate contribution of USD gains, US policy uncertainty and global effects to the Fed response. Source: Numera Analytics.

F6: Market discounting rate uncertainty
Market vs. model Fed cut probabilities



Note: Chart compares market versus model-based probabilities of future Fed cuts by December 2025 and 2026. Source: Numera Analytics.

The market reaction after the tariff announcements suggests investors largely understand these dynamics. In particular, the benchmark 10Y yield weakened, despite higher breakeven inflation. A closer examination reveals the main factor behind lower yields was a downgrade in Fed policy expectations, in expectation of weaker activity.

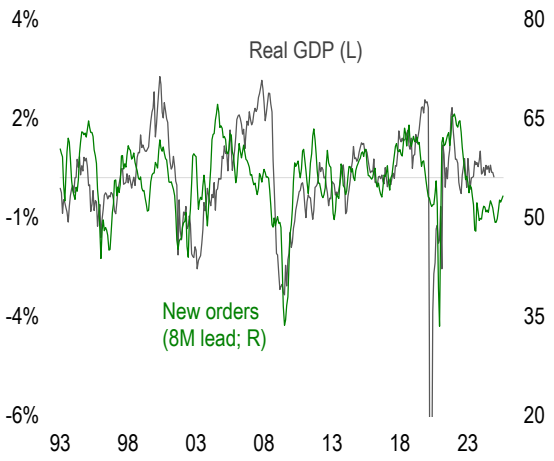
Importantly, our simulation results are not forecasts, but rather a tool to understand how the Fed would respond absent other shocks. In fact, our models now signal a more modest response this year, with one less expected cut than in last month's update. A hawkish tilt in the Fed's tone, with Board members showing less confidence around inflation, affects the outlook by reducing the speed at which the FOMC pushes rates back to 'neutral'.

Even if the base case is for three cuts instead of four this year, the near-term outlook remains more uncertain than market perceptions. We can see this in F6, which compares market versus model-based probabilities for Fed cuts in 2025 and 2026. Markets attach an 80%+ chance to 1-to-3 cuts in 2025, a very narrow set of outcomes. Our models, in contrast, suggests investors should not discard the possibility of aggressive cuts, as is common in late cycles.

T2: US macro drivers	Baseline				2025 probabilities		
Growth rates (%)	2024	2025	2026	2027	> Trend[1]	> 2024	Tail risk[2]
Real GDP	2.8%	1.9%	0.8%	1.2%	23%	11%	-0.5%
Consumer spending	2.8%	2.2%	1.0%	1.2%	11%	18%	-0.3%
Private investment	3.8%	0.5%	-1.5%	0.3%	11%	5%	-4.5%
Non-farm payrolls	1.3%	0.9%	-0.2%	0.6%	41%	16%	-1.4%
Unemployment rate	4.0%	4.4%	4.7%	4.8%	27%	65%	6.4%
Housing starts	-4.0%	2.3%	-1.1%	-4.6%	56%	83%	-12.3%
New home sales	2.4%	-0.5%	1.4%	-4.6%	46%	39%	-24.6%
Manufacturing	-0.4%	1.2%	1.0%	1.4%	80%	89%	-2.1%
Durables	-1.0%	1.6%	1.4%	2.0%	77%	89%	-3.9%
Non-durables	0.2%	0.7%	0.6%	0.7%	70%	67%	-1.6%
CPI inflation	3.0%	2.7%	2.3%	2.1%	4%	30%	4.8%
Hourly wages	4.1%	3.3%	2.4%	2.1%	0%	6%	2.2%
Housing prices	5.1%	4.9%	6.0%	5.1%	0%	39%	2.9%
US dollar (DXY)	7.0%	0.4%	-0.5%	-0.4%	31%	7%	-8.8%

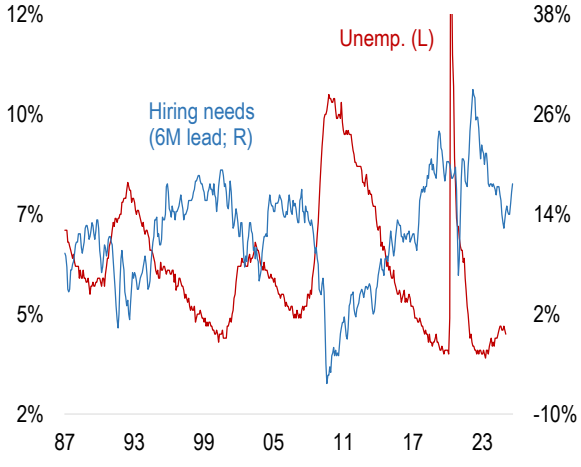
1. Probability that next year's growth exceeds its 5-year average. 2. Tail risk measures potential drawdown, calculated as the expected loss at the 5% quantile. For unemployment and CPI inflation, tail risk is set to the 95% quantile. All forecasts and probabilities, except for the US dollar, are based on full-year averages.

F7: Economic cycle vs. ISM new orders
Deviations from trend and diffusion index



Note: Chart compares cyclical fluctuations in real GDP against 8-month prior changes in the combined ISM manufacturing and service new orders indices. Source: Numera Analytics on BEA, ISM data.

F8: Unemployment rate vs. hiring needs
Share of workforce and of SMEs (%)



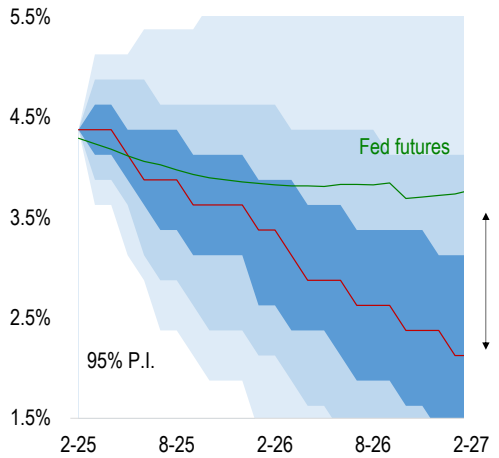
Note: Chart compares the headline unemployment rate against 6-month prior changes in SME hiring needs. Source: BLS, NFIB.

T3: Fed funds rate bps and probabilities	Baseline scenario		Probabilities			
	Numera	Futures	> Futures	-50 bps	-100 bps	-200bps
6M ahead	3.9%	4.1%	40%	60%	28%	3%
12M ahead	3.4%	3.9%	31%	77%	57%	18%
24M ahead	2.1%	3.7%	13%	89%	82%	57%
Dec. 2025	3.6%	3.9%	23%	63%	40%	9%
Dec. 2026	2.4%	3.7%	13%	88%	80%	53%

T4: Treasury market Percent and probabilities	10-year yields[1]			Yield curve[2]		
	Baseline	> Current	Tail risk	Baseline	Steepening	Inversion
6M ahead	4.1%	30%	5.8%	0.3%	56%	33%
12M ahead	3.8%	24%	6.1%	0.5%	65%	27%
24M ahead	3.2%	14%	6.4%	0.9%	74%	21%
Dec. 2025	3.9%	25%	6.1%	0.2%	50%	40%
Dec. 2026	3.2%	15%	6.4%	0.9%	72%	22%

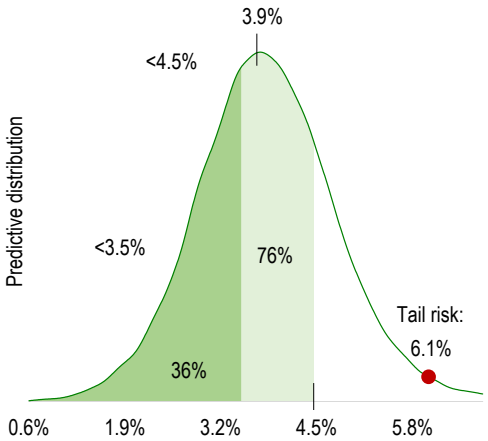
1. The 10Y yield columns show the probability that yields are higher than their current level (4.5%), and the maximum expected yield at the 95% quantile. 2. The yield curve projections show likelihood that the 10Y-2Y term spread steepens and inverts over a given holding period.

F9: Fed funds rate target vs. FFR futures
Baseline and probability forecast, 2025-27



Note: Probability forecast for Fed funds rate target against the February 6th CME Fed funds futures curve. Fan chart denotes 50 / 80 / 95% prediction intervals. Source: Numera Analytics, CME.

F10: 10-year Treasury yield outlook
Probability forecast - 12M ahead (%)



Note: There is a 76% chance that 10Y yields trade below current levels (4.5%) one year from now, and a 36% probability they fall below 3.5%. The most likely outcome is for 10Y yields to fall to 3.9%. Source: Numera Analytics.

Data release calendar:

Economic indicators	Date	2023	2024	Oct-24	Nov-24	Dec-24	Jan-25
ISM manufacturing *Diffusion index*	3-Feb-25	47.1	48.2	46.9	48.4	49.2	50.9
New orders *Diffusion index*	3-Feb-25	46.0	48.7	47.9	50.3	52.1	55.1
Non-farm payrolls *Δ in 000s workers, SA*	7-Feb-24	216	166	44	261	307	143
Unemployment rate *% workforce, SA*	7-Feb-24	3.6%	4.0%	4.1%	4.2%	4.1%	4.0%
CPI inflation *YoY (%)*	15-Jan-24	4.1%	3.0%	2.6%	2.7%	2.9%	-
Core inflation *YoY (%)*	15-Jan-24	4.8%	3.4%	3.3%	3.3%	3.2%	-
Retail sales *MoM SA (%)*	16-Jan-24	2.4%	2.5%	0.5%	0.9%	0.6%	-
Industrial production *MoM SA (%)*	17-Jan-24	0.2%	-0.3%	-0.5%	0.2%	0.9%	-
Housing starts *MoM SA (%)*	17-Jan-24	-8.4%	-2.4%	-0.8%	-3.7%	15.8%	-
New home sales *MoM SA (%)*	27-Jan-24	4.5%	1.4%	-15.3%	9.6%	3.6%	-
Consumer spending *MoM SA (%)*	31-Jan-24	2.5%	3.0%	0.2%	0.5%	0.4%	-

Sources: ISM, Bureau of Labor Statistics, US Census Bureau, Federal Reserve, Bureau of Economic Analysis.

Data sources:

- **Growth**: Spending: BEA, Labour: BLS; Housing: US Census Bureau; Industry: Federal Reserve
- **Prices**: Inflation and wages: BLS; Housing: S&P Case-Shiller; US dollar: ICE
- **Rates**: Fed funds: Federal Reserve; Yield curve: Department of Treasury

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