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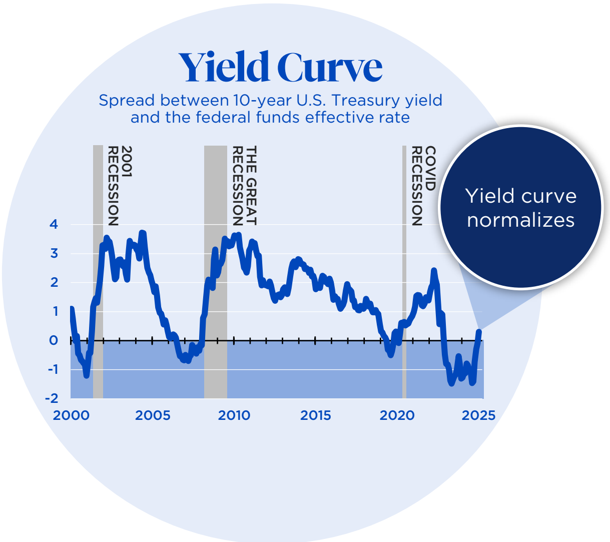
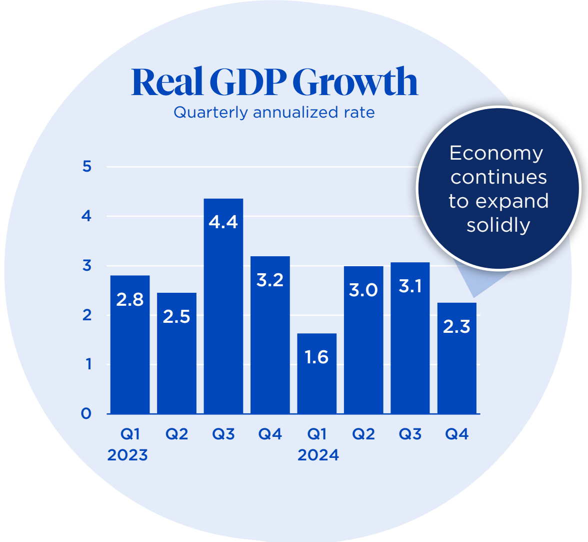
Economic & Financial Markets Monthly Review | February 2025

Tariffs add to outlook uncertainty

Where is the economy now?

Economic data show continued healthy momentum for hiring and consumer activity through January, though inflation turned higher. The barrage of tariff announcements has many firms and households uncertain about the future path of trade policy and has lifted consumers' inflation expectations. Increased uncertainty and elevated interest rates — due to the Fed likely to delay rate cuts until late in 2025 — should weigh moderately on growth in the coming months.





Where we are this month

What does this mean

Strong momentum, but rising headwinds

Buoyant consumer momentum at the end of 2024 has carried into 2025. But tariffs and uncertainty could temper spending activity and business investment. That said, businesses are enthused about fewer regulations and taxes.

- Economic activity entered 2025 with solid momentum as the labor market remains sturdy. Elevated uncertainty surrounding trade policy likely dampens business investment as the corporate sector awaits more clarity on tariffs and the impact on prices.
- Lingering inflation is expected to keep the Fed on the sidelines for much of 2025. Higher interest rates are another tailwind for growth, restricting business investment and consumer spending on autos and homes.

Further yield curve steepening

The rise in long-term rates led the Treasury yield curve to steepen further after normalizing in 2024. However, since it was led by higher long-term yields it is not as stimulative for the economy as being led by a drop in short-term rates.

- The spread between short- and long-term rates remains tight but has steepened. Fed easing usually lowers short term rates below the 10-year Treasury note yield, but the recent steepening reflects the bond market's improved outlook for the economy as well as investor concern about future inflation and fiscal deficits.
- With the Fed likely on an extended hold, any further steepening in the yield curve would be led by higher long-term yields, in other words a bear-steepener.

Steady, solid economic growth

The economy grew at a solid 2.3 percent annualized pace to close out 2024. Strong consumer spending again propelled economic activity.

- Economic growth for all of 2024 was 2.8 percent — far surpassing expectations coming into the year and only a slight downtick from 2023. Consumers contributed 1.9 ppts of that growth, as the economy has become more reliant on the consumer sector.
- Business investment growth pulled back in Q4 as businesses cut spending on equipment. A sharp widening in the trade deficit also dragged on growth as imports were greatly pulled forward ahead of potential tariffs.

Solid January data but tariff impacts are pending

The job market remains solid and economic trends are healthy in early 2025. The manufacturing sector moved back into expansion as supply managers are optimistic about pro-growth policy changes from the Trump Administration. That said, threat of tariffs loom over the near-term outlook as consumers report renewed inflation worries and businesses convey higher policy uncertainty. Even though decisions about large-sized tariffs have been delayed and might not unfold, the heightened uncertainty dampens business investment and hiring as leaders await clarity.

Where we are this month

Inflation continues to trend up

The headline CPI inflation rate climbed for a fourth straight month to 3.0 percent in January, while the core rate ticked up to 3.3 percent.

Labor market remains solid

Nonfarm payroll growth moderated in January, posting a 143,000 gain — held down by extreme wintery conditions and the California wildfires.

ISM manufacturing climbs into expansion

The ISM manufacturing index climbed in January to 50.9, marking its first time in expansion territory since 2022. Supply chain managers are optimistic that Administration's economic policies will improve manufacturing activity.

What does this mean

- Headline CPI jumped 0.5 percent in January, matching the strongest gain in two years. The gain was led by increases in energy and food as well as a pop in used car prices, transportation and recreation services.
- Core goods deflation is fading fast, as the year-on-year rate is now just -0.1 percent — barely deflationary and much higher than the deeply deflationary reading of -1.9 percent just five months ago. And this is the category that will feel the brunt of unfolding tariffs.

- While overall employment growth remains healthy, there is a large concentration of jobs in the retail trade, health care and social services sectors.
- The unemployment rate retreated to low 4.0 percent even with a jump in the reported labor force as more immigrants were represented in the benchmark revisions. Strong wage growth — up a strong 0.5 percent on the month — continues to underpin solid income gains to support consumer spending power.

- The rise in the headline index was driven by strengthening demand metrics as both the new orders and production components continued their recent climbs and posted solid expansion readings. Also, the employment component improved after contracting for the last seven months of 2024.
- Despite the upbeat January report, anecdotal survey responses indicate that the potential negative impacts for prices paid and demand for goods from tariffs are a concern for manufacturers.

Financial Market Review

Investors are cautiously optimistic

After a cautious start to the year, the stock market rebounded by the end of January before leveling off in the past few weeks. Investors are encouraged by resilient economic growth, but higher inflation and concerns about how prospective tariffs could further raise inflation has raised market interest rates and deflated hopes for near-term Fed rate cuts. We anticipate a continuation of encouraging earnings and economic growth trends this year though we now expect only 25 basis points of Fed easing later in the year.

Where we are this month

Stocks rebounded by late January

The stock market climbed higher at the end of January on optimism about earnings and the prospect of meaningful deregulation. The S&P 500 index has leveled off over the past few weeks in part due to tariff uncertainty.

Fed to keep rates steady for much of 2025

The economy's resilience, an upward reversal in inflation and inflation expectations, likelihood for less Fed easing, and rising concerns about the U.S. fiscal path have raised long-term interest rates this year.

Market short-term inflation expectations rise

Break-even inflation spreads determined by the Treasury market shows bond investors significantly pushing up their inflation expectations over the next two years, and to a lesser extent over the longer run.

What does this mean

- Higher long-term interest rates have also weighed on stock prices. Yields are higher due to the prospect of less Fed easing, higher inflation expectations, and concerns about the fiscal outlook.
- Investors remain cautiously upbeat about 2025, casting aside domestic and global uncertainties, namely on the policy front amid a contentious global geopolitical environment. Solid corporate earnings should keep a firm floor under equity valuations.

- The key 10-year Treasury yield has risen as the Fed looks likely to hold short-term rates steady through much of this year due to higher inflation and solid economic activity. The term premium has also increased due to concerns about inflation, the deficit, and tariffs.
- We now expect just 25 basis points of Fed rate cuts in 2025, with the first cut likely delayed until Q4 2025. Higher inflation and uncertainty about prospective policy changes should move the Fed to the sidelines.

- The sharp increase in market-based short-term inflation expectations is in line with increases recorded in consumer-based surveys. Investors and consumers anticipate that increased tariffs will lift inflation in the short-term.
- Longer-term inflation expectations are less affected by the prospect of tariffs since tariff increases are not likely to be repeatedly increased each year. As such, it becomes a short-term inflationary increase that fades over time.

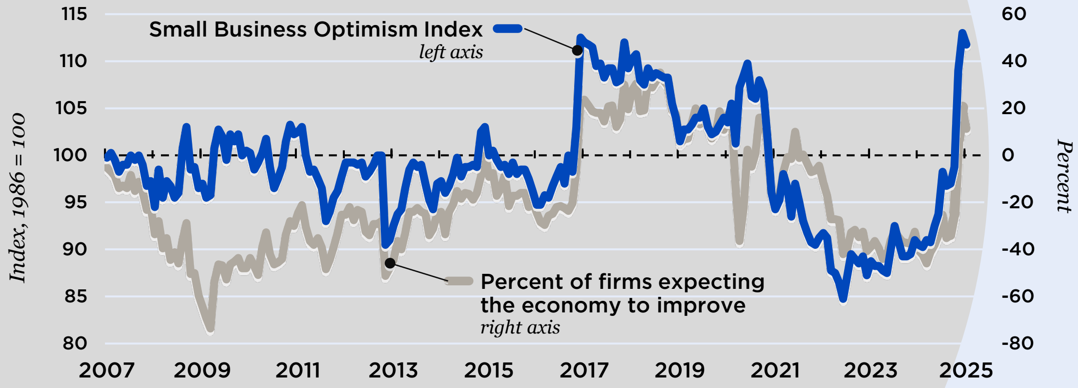
Outlook

Will the surge in business optimism boost investment?

The prospect of substantial deregulation and lower corporate tax rates have sharply boosted business sentiment since the November election. More than half of small business owners now expect the economy to improve, while many CEOs and CFOs have boosted their outlook for company performance. Many hope that the unleashing of ‘animal spirits’ could drive a renewed surge in business activity to lift business investment and hiring in the year ahead.

Despite the building optimism, there are multiple headwinds for increased investment. The uncertainty surrounding the impact of tariffs on the cost of goods and supply chains has already disrupted investment plans for many firms. Interest rates are also projected to remain elevated over 2025, curtailing business lending and startup activity. Finally, consumer demand has started to fade in the face of rising prices and tight household budgets — factors which could temper future sales and profit margins.

Business surveys show increased optimism



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Data as of February 2025

	2024 ACTUAL	2025 ESTIMATE	2026 FORECAST	2027	2028
REAL GDP	2.8%	2.1%	2.0%	2.0%	2.0%
UNEMPLOYMENT RATE	4.0%	4.3%	4.2%	4.2%	4.2%
INFLATION [1] (CPI)	2.7%	2.6%	2.0%	2.0%	2.0%
TOTAL HOME SALES	4.75	**4.79**	**5.62**	6.16	6.25
S&P/CASE-SHILLER HOME PRICE INDEX	3.8%[a]	3.1%	3.2%	3.0%	3.0%
LIGHT VEHICLE SALES	15.8	15.8	16.2	16.5	16.6
FEDERAL FUNDS RATE [2]	4.25%	4.00%	3.25%	3.00%	3.00%
5-YEAR TREASURY NOTE [2]	4.38%	4.15%	3.60%	3.55%	3.55%
10-YEAR TREASURY NOTE [2]	4.58%	**4.30%**	**4.00%**	4.00%	4.00%
30-YEAR FIXED-RATE MORTGAGE [2]	6.91%	6.60%	5.30%	5.00%	5.00%
MONEY MARKET FUNDS	4.96%	4.21%	3.47%	3.03%	3.03%

[1] *Percent change Q4-to-Q4*
[2] *Year end*
[a] *Actual*

No improvement for housing until 2026

With mortgage rates and prices likely to remain elevated over 2025, affordability concerns for buyers will linger. Housing supply should remain limited with the mortgage ‘lock-in’ effect constraining homeowners from listing their homes. This should keep home sales relatively stagnant until 2026 when rates are projected to drop closer to 5.0 percent.

Higher long-term rates

Renewed inflation concerns should continue to prop up long-term interest rates. The 10-year Treasury rate is projected to remain near 4.5 percent through the third quarter.

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Sources

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	Business Cycle	*Nationwide Economics*
	Yield Curve	*Bloomberg; National Bureau of Economic Research*
	Real GDP growth	*Bureau of Economic Analysis*
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	Consumer Price Index	*Bureau of Labor Statistics*
	Nonfarm payroll gains	*Bureau of Labor Statistics*
	ISM manufacturing index	*Institute for Supply Management*
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	Small business optimism	*National Federation of Independent Business*
	Latest Forecast	*Nationwide Economics*

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