STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

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Overview

Based on recent data, economic growth is solid, unemployment is low, and consumer prices are relatively stable, suggesting that President-elect Trump will inherit a relatively healthy U.S. economy. Of course, the expectation is that the Trump administration will succeed at making it even better. Real gross domestic product (GDP) is on track to grow at a solid 2.5 percent pace in the fourth quarter of last year and 2.6 percent over the four quarters of 2024. In particular, the ongoing strength of consumer spending continues to surprise to the upside as illustrated by the upward revision to real personal consumption expenditures (PCE) in the third quarter (3.7 percent at an annual rate versus the previous estimate of 3.5 percent) and the 3.0 percent gain anticipated in the fourth quarter. That said, there still is some concern about how much longer such a stellar pace of real consumer spending can be sustained, given the expectations of wage and salary gains struggling to keep pace with inflation next year. On balance, the pace of real GDP growth over the four quarters of 2025 is expected to match what I consider to be the U.S. economy's potential growth rate of 1.6 percent.

Recall that in the September Outlook[1], before the outcome of the presidential election was known, economic growth over the four quarters of 2025 was expected to slow considerably from the pace for all of 2024. Based on the policies likely to be pursued by the Trump administration, there is nothing to suggest that the economic forecast for 2025 needs to be revised substantially, although there may be added uncertainty about the longer-term impact of some of these policy changes.

I have frequently noted in the past that the economy has more impact on who is president than the president has on the economy. The first part of my comment that the economy has an impact on who is president refers to the statistical models that rely on economic variables to predict the outcome of presidential elections when the incumbent is vying for a second term. According to such models, the economy should not have been an election issue. The reason is that independent voters generally vote their pocketbook, which means that if they have jobs and are enjoying real income gains, they are less interested in change. Of course, given that the incumbent was not a candidate, the accuracy of predicting the election outcome was distorted. Indeed, all of the candidates represented change to some degree, so it was no surprise that people voted for the candidate who was more familiar to them. Of course, some people were unhappy about their personal economy, claiming that they were not as well off as they were when President Biden took office due to wages failing to keep pace with higher consumer prices. Using some measures of inflation, this was true.

Also, the impact of the president on the economy could be more substantial than usual because of some of the controversial policy changes proposed by President-elect Trump. Given the Republican sweep, I assume that Mr. Trump will get most of what he asks, which could include a more protectionist trade policy, a less restrictive regulatory policy, a very strict immigration policy, and lower income taxes. However, in more recent comments, President-elect Trump acknowledged that tariffs may be inflationary and that his promise to lower food prices may be difficult to achieve. In other words, his comments raise some question about how aggressive he will be about some of the policies he promoted during the campaign. As a result, quantifying the impact of his policy changes on the economy will require various assumptions about what

[1] Data as of September 2024. Sources: Stonebridge Economic Outlook, Stonebridge Chief Economist

proposals are likely to be enacted and the general features of each. Hence, the accuracy of the forecast will depend heavily on the accuracy of the assumptions underlying it.

Trump Policy Assumptions

First, President-elect Trump has threatened to impose massive new tariffs on imports in retaliation to trade partners who fail to follow his directives, to protect domestic industries from foreign competition, to encourage the repatriation of manufacturing capacity that was lost to the rest of the world over the last several decades, and to offset the federal revenue lost from his proposed income tax cuts. Tariffs tend to be a distortive way to raise revenue, especially if they provoke our trade partners to retaliate. President Trump's first term was marked by trade disputes, particularly with China, which saw tariffs imposed on a range of goods. Such a protectionist stance most likely will lead to substantially higher consumer prices over time, especially if the tariffs are universal in nature and in place for a prolonged period.

That said, one benefit of the Trump tariffs in his first term was the leverage they provided the administration in negotiating new trade agreements with China, Mexico, and Canada. The question is whether the shear threat of tariffs a second time will be as effective in trade negotiations as they were the first time. For forecast purposes, I assume that new tariffs will be imposed but that they will fall short of the oversized tariffs touted during the campaign. In addition, the Trump administration is likely to provide special exemptions from the tariffs to certain companies or industries, so they may not be as widespread as promised or as fair as hoped.

Second, during the campaign, Mr. Trump was quite emphatic about making huge changes in the regulatory landscape if he were elected, promising the "most aggressive regulation reduction" in U.S. history. Exactly how he is going to do this is unclear, but the early indication is that deregulation and spending cuts will be untaken in the name of efficiency. Whenever such attempts to make the government more efficient were tried in the past, they generally led to simply rearranging spending and new regulations rather than fewer regulations. I assume a similar outcome again this time, despite two billionaires (Elon Musk and Vivek Ramaswamy) acting as efficiency czars for the Trump administration, Republicans in control of the Congress, and a conservative majority on the Supreme Court.

Third, President-elect Trump remains committed to his anti-immigration and deportation policies, which means they are likely to be implemented. This is one area where the Congress is very likely to provide the funding to support the Trump administration's initiatives. The impact of these policies on the economy will be mostly through the labor market. For example, in November, foreign-born members of the labor force increased 765,000 from a year earlier, while native-born members declined 578,000, resulting in the entire 159,000 gain in the civilian labor force over the 12 months ending in November to be foreign born. In other words, without immigrants, the labor force and employment would have declined over the year ended in November, suggesting that most, if not all, of the 2.7 percent increase in real gross domestic product (GDP) in the U.S. over the same period was due to the gain in immigrant workers. If the Trump administration is as aggressive about restricting immigration as suggested during the campaign, it could have an adverse effect on production and economic growth in 2025 and beyond.

Fourth, tax reform is also very likely under the Trump presidency. In particular, the 2017 Tax Cuts and Jobs Act (TCJA)[2], which was enacted during President Trump's first term, is scheduled to expire in 2025. With Trump's return to the White House, it is doubtful that the TCJA will be allowed to expire. However, there is a good chance that it will be amended, including the reinstatement of the deduction for state and local taxes, a further cut in the corporate tax rate for domestic production, and the added tax exemption of various types of income now taxable. The impact of these proposals will vary depending on which combination of policies are pursued. At first blush, lowering income taxes without a corresponding decline in federal spending could be viewed as stimulus to the economy. The concern is that any added stimulus will put upward pressure on prices rather than increase real output.

2025 Details?

Accurately forecasting the economy is always difficult but it seems unusually difficult this year because of the long list of policy assumptions required, as well as the various indicators suggesting that the U.S. economy may be heading for a recession sometime soon. This is another way of saying that my forecast for 2025 is very tentative, given the considerable uncertainty about the policy options likely to be implemented.

That said, the annual forecast for 2025 has changed very little from what was shown in the September Outlook. In particular, real GDP growth over the four quarters of 2025 is now expected to be 1.6 percent, a tad better than the 1.2 percent pace projected earlier. For the most part, it reflects the assumption that U.S. businesses will be anxious to boost their inventories of imported products prior to tariffs, followed by a sharp drop once the tariffs are imposed. Depending on how quickly our trading partners retaliate with tariffs on U.S. products, exports will eventually slow as well. Government consumption and investment are also likely to slow at some point in 2025, but could be offset by a pickup in business investment. The net effect is that consumer spending will once again hold the key to the outlook. In this regard, consumers are expected to lose some of their momentum in 2025 as well.

As now shown in Table 1, the quarterly growth rates of real GDP in 2025 are expected to slow as the year unfolds, maintaining a pace slightly above the economy's potential rate in the first half but slightly below its potential in the second half. As a result, the unemployment rate is expected to remain around 4.2 percent for the first half before it ticks higher in the second half of the year to an average of 5.0 percent for the fourth quarter. Recall that the unemployment rate tends to be a lagging indicator, so any uptick in the unemployment rate likely occurs after the economy has already started to slow.

Of course, under such circumstances, I expect the Federal Reserve to be more aggressive about cutting interest rates in an effort to forestall a recession. The dilemma facing the Fed will be that inflation never falls to its target level on a sustained basis unless the U.S. economy is in a recession, which in turn could moderate Fed rate cuts in 2025. In its latest projections, the FOMC reduced the number of rate cuts expected over the next twelve months to two from the four cuts anticipated earlier. The assumption by the FOMC is that the economy continues to expand at a 2.0 percent

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[2] L. 115-97, is a congressional revenue act of the United States originally introduced in Congress as the Tax Cuts and Jobs Act (TCJA), that amended the Internal Revenue Code of 1986. Data as of January 6, 2025.

pace. My forecast for 2025 is not that robust, providing room for the Fed to do more. In that regard, the Stonebridge Capital Advisors' forecast continues to expect the Fed to cut at least four times or a total of 100 basis points. As a result, the current federal funds rate of 4.4 percent is expected to end 2025 at 3.4 percent.

Table 1
U.S. Economic Forecast

	Annual	**2025 Quarterly**				**Annual**	
	2024	**Q1*f***	**Q2*f***	**Q3*f***	**Q4*f***	**2025*f***	**2026*f***
Real Gross Domestic Product	**2.6**	2.0	1.7	1.5	1.0	1.6	1.0
Civilian Unemployment Rate	4.2	4.2	4.2	4.4	5.0	5.0	5.5
GDP Chain-Type Price Index	2.4	2.3	2.2	2.1	2.0	2.1	2.2
Consumer Price Index, All	2.7	2.8	2.6	2.4	2.2	2.5	2.5
Consumer Price Index, Core	3.2	3.0	2.8	2.6	2.4	2.7	2.5
Price of WTI crude oil ($/bbl)	**71.0**	70.2	70.5	70.5	70.0	70.0	70.0
Trade-Weighted Dollar	**126.0**	126.0	124.0	122.0	121.0	121.0	121.0
S&P 500 Operating Earnings	**232.1**	60.0	61.0	59.4	57.2	**237.6**	235.0
Percent vs. Year Ago	**8.1**	3.9	6.9	14.2	7.6	**2.4**	-1.1
91-Day Treasury Bill Rate*n*	4.6	4.5	4.4	5.2	3.4	3.4	2.5
10-Year Treasury Note Yield*n*	**4.2**	4.3	4.2	4.1	4.0	**4.0**	4.0
30-Year Mortgage Rate	**6.6**	6.6	6.5	6.5	6.4	**6.4**	6.5
Bank Prime Rate	**7.6**	7.5	7.4	8.2	6.4	6.4	5.5

Sources: Bureau of Economic Analysis, Bureau of Labor Statistics, Standard and Poor's, Federal Reserve Board, Department of Energy, and Federal Home Loan Mortgage Corporation.

Annual changes in real gross domestic product (GDP) and all measures of inflation are percent changes from the fourth quarter of the previous year to the fourth quarter of the year indicated. The annual estimates of the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates are averages for the last quarter of the year indicated. S&P 500 operating earnings per share are for the period indicated.

Quarterly changes in real GDP and all measures of inflation are percent changes from the previous quarter at annual rates. For the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates, quarterly estimates are averages for the quarter indicated. S&P earnings are per share for the period indicated. Trade-weighted dollar is the new broad index from the Federal Reserve Board.

***n**—The 3-month and 10-year Treasury yields are at "constant maturities," which are interpolated by the U.S. Treasury from the daily yield curve for Treasury securities. This curve, which relates the yield on a security to its time to maturity, is based on the closing market bid yields on actively traded Treasury securities in the over-the-counter market that are obtained by the Federal Reserve Bank of New York.*

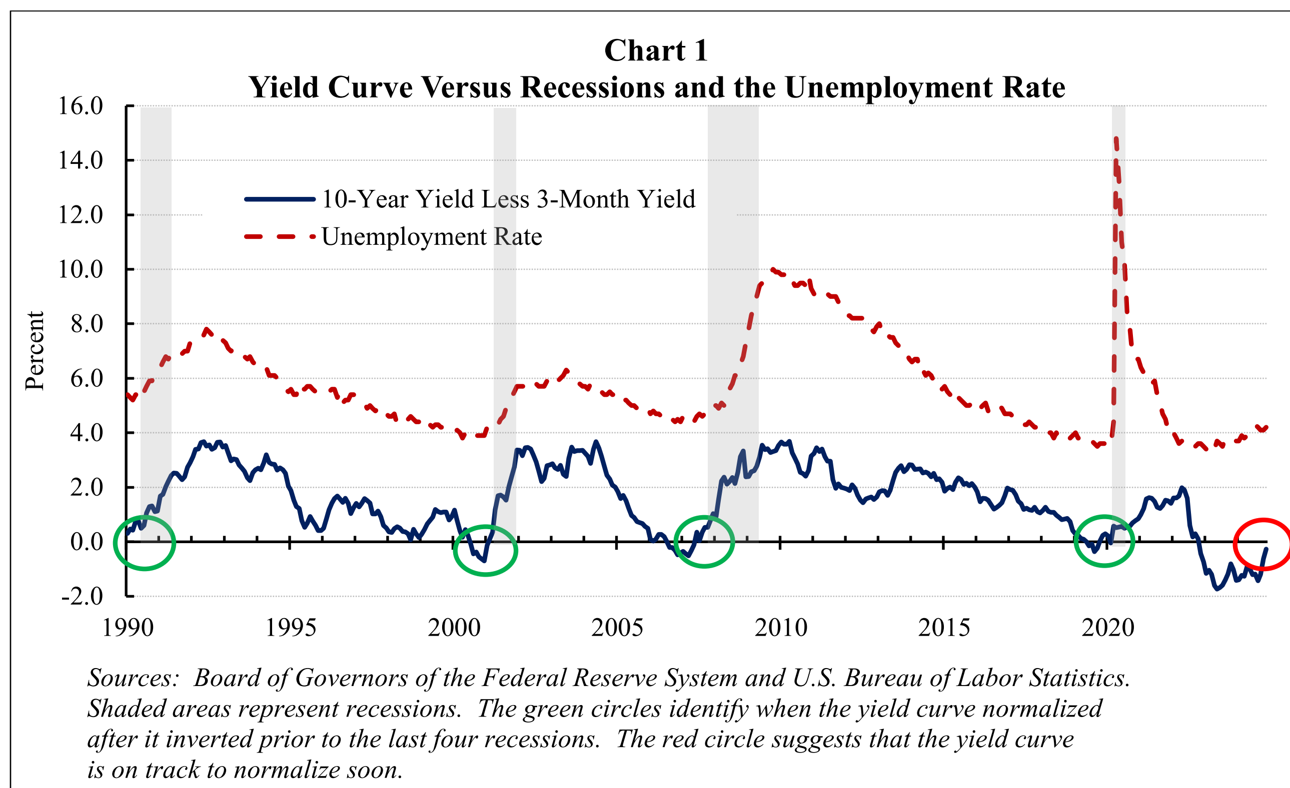
***f**—forecast: data points in bold type reflect a major change from the previous forecast.*

As measured by the Consumer Price Index (CPI), inflation is expected to average 2.5 percent over the four quarters of 2025, down a bit from the 2.7 percent expected over the same period for 2024. However, the measure of inflation preferred by the Federal Reserve is the Personal Consumption Expenditures (PCE) Price Index, which is expected to be up 2.4 percent over the four quarters of 2024. Indeed, based on historical data since January 2000, the PCE Price Index tends to be about 0.35 of a percentage point lower than the CPI. Hence, an increase of 2.5 percent for the CPI expected over the four quarters of 2025 would translate into an increase for the PCE Price Index (the Fed's preferred measure) of about 2.2 percent over the same period, implying that inflation next year will be very close to Federal Reserve's 2.0 percent target. In fact, with economic growth below its potential in the second half of the year, the level of inflation is expected to match the Fed's preference by the end of 2025. Nevertheless, such an outcome assumes that the Trump administration will not pursue its trade, immigration, regulatory, and tax policies as aggressively as contemplated during the campaign.

The Yield Curve and Recessions

Most analysts focus on the shape of the Treasury yield curve, frequently referring to the yields on the 3-month to 10-year segment of the curve, as a leading indicator of a recession. Although the yield curve inversion correctly predicts a recession, the lag between when the curve inverts and the recession varies between a few months to three years. When the yield on the 10-year note is above the yield on the 3-month bill, the yield curve is considered to be normal, but when the yield on the 10-year note is below the 3-month bill, the yield curve is considered to be inverted.

Chart 1
Yield Curve Versus Recessions and the Unemployment Rate



Sources: Board of Governors of the Federal Reserve System and U.S. Bureau of Labor Statistics. Shaded areas represent recessions. The green circles identify when the yield curve normalized after it inverted prior to the last four recessions. The red circle suggests that the yield curve is on track to normalize soon.

I contend that a more consistent indicator of a forthcoming recession is when the yield curve turns normal after a period of inversion. This is shown in Chart 1 by the green circles, which identify the yield curve returning to normal just before every recession since 1990, including the pandemic recession of 2020. Also in Chart 1, the red circle identifies the more recent return to a normal shaped yield-curve after a period of inversion, suggesting that a recession may be in our near future. This return to a normal positive spread between the 10-year and 3-month Treasury yields is due to the combination of lower yields on the 3-month Treasury bill and higher yields on the 10-year Treasury note that has occurred over the last three months.

At the short end, the FOMC of the Federal Reserve has cut its federal funds rate target by a total of 100 basis points in its last three policy meetings; 50 basis points in September and 25 basis points in both October and December. As a result, the effective federal funds rate is currently at 4.4 percent, as is the yield on the 3-month Treasury bill. At the same time, long-term Treasury yields have moved in the opposite direction, with the 10-year Treasury note yield climbing to 4.4 percent in mid-December, which is about 75 basis points higher than it was when the Fed started cutting the federal funds rate in September. As a result, the Treasury yield curve is positive for the first time since 2022. Of course, the timing of the recession following the return of a normal yield curve is still variable, but far less so than relying on the yield curve inversion alone as a predictor of recessions.

Also shown in Chart 1 is how the unemployment rate generally does not spike higher until the recession is already underway and usually does not peak until the recession has already ended. The implication is that the unemployment rate provides confirmation of a recession but it does not predict it. Clearly, with the unemployment rate at 4.2 percent on average for the last quarter of 2024, the economy is not in a recession. The bottom line is that the risk to Stonebridge Capital Advisors" forecast is that economic growth in 2025 is even weaker than currently anticipated.

Implications for Interest Rates

In the September Outlook, I noted that the only way the Federal Reserve could justify aggressively cutting interest rates over the remainder of 2024 was if the economy showed signs of slipping into a recession. That was not the case. Despite the economy remaining strong, the Fed felt the need to cut its federal funds rate target by a total of 100 basis points. Interestingly, fixed-income investors seemed to agree with my assessment, given that the yield on the 10-year Treasury note climbed 75 basis points since the Fed started cutting short-term interest rates in September.

Moreover, at its December meeting, the FOMC adjusted their expectations about rate cuts in 2025 to a total of two (25 basis points each) from the 100 basis points of cuts projected earlier. However, the Stonebridge Capital Advisors' forecast shows the pace of U.S. economic growth over the four quarters of 2025 to be about half the pace expected for all of 2024 and markedly slower than the FOMC's projection of real GDP growth this year. For that reason, I expect that the FOMC's earlier expectation of rate cuts will be closer to the actual outcome than the two cuts now being advertised. Exactly how much more the FOMC will cut depends on the mix of inflation and growth under the Trump administration policies. Under such circumstances, corporate earnings may struggle, long-term interest rates most likely will remain elevated, and credit spreads will widen.

Important Disclosure Information
All information herein is as of January 6, 2025, unless otherwise indicated.

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