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STONEBRIDGE ECONOMIC OUTLOOK

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The Forecast

Real gross domestic product (GDP) declined 0.5 percent at an annual rate in the first quarter but is expected to rebound 2.1 percent in the second quarter. The sharp swings in real GDP growth rates for the first two quarters of 2025 were largely attributed to significant changes in net exports - defined as exports minus imports. In the first quarter, imports increased substantially in anticipation of higher tariffs proposed by President Trump in early April. Consequently, real imports rose by 37.9 percent at an annual rate, according to the Bureau of Economic Research (BEA), which resulted in a deduction of 4.7 percentage points from first-quarter real GDP growth. In the second quarter, imports most likely declined, as the higher "reciprocal" tariffs imposed by President Trump on April 5 were quickly postponed for 90 days. As a result, real imports are projected to decline by roughly 20 percent at an annual rate in the second quarter, which would contribute 2.3 percentage points to second-quarter real GDP growth.

In addition, real personal consumption expenditures (PCE) exhibited sluggish growth in the first quarter, rising a mere 0.5 percent compared to a 2.5 percent increase in real disposable personal income (personal income after adjusting for taxes and inflation). The more restrained gain in consumer spending relative to income growth may be attributed to uncertainty surrounding macroeconomic policies; however, it may also be explained by the "permanent income hypothesis" of consumer behavior, which suggests that consumers adjust their spending only in response to income gains perceived as permanent. In this context, real disposable personal income over the four quarters ending in the first quarter 2025 increased 1.5 percent, aligning somewhat more closely with the 0.5 percent rise in real consumer spending.

In the second quarter, estimating real disposable personal income growth has been complicated by a surge in Social Security benefits associated with the Social Security Fairness Act (SSFA) signed into law in early January 2025, but retroactive to January 2024.[1] The retroactive payments were made in March and April of this year, causing the level of Social Security benefits in April to jump nearly 85 percent at an annual rate from its level in February. The complication is that these retroactive benefits are temporary. Over the final two months of the second quarter, real income is likely to retreat somewhat owing to the end of such payments.

Nevertheless, the April level of disposable income was up 5.5 percent from its first-quarter average, and it was not only Social Security benefits that accounted for the gain. The real wages and salaries component of personal income likely increased a solid 5.0 percent at an annual rate over the same period. It is unlikely that real wages and salaries will continue to climb at such a rapid pace, suggesting that the retracement in SSFA benefits expected in May will slow real disposable personal income growth considerably in the second quarter. As such, real disposable personal income is expected to climb about 2.5 percent at an annual rate in the second quarter and 2.0 percent from a year earlier.

[1] The Social Security Fairness Act, HR 82, was signed into law on January 5, 2025. The Act repeals the Windfall Elimination Provision (WEP) and Government Pension Offset (GPO). These provisions reduced or eliminated the Social Security benefits of over 2.8 million people who receive a pension based on work that was not covered by Social Security (a "non-covered pension") because they did not pay Social Security taxes. This law increases benefits for certain workers, such as teachers, firefighters, and police officers in many states; federal employees covered by the Civil Service Retirement System; and people whose work had been covered by a foreign social security system.

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Table 1
U.S. Economic Forecast

	Annual	2025 Quarterly				Annual	
	2024	**Q1**	***Q2f***	***Q3f***	***Q4f***	***2025f***	***2026f***
Real Gross Domestic Product	2.5	**-0.5**	**2.1**	**1.0**	**0.5**	**0.8**	1.0
Civilian Unemployment Rate	4.2	4.1	4.3	**4.5**	**4.9**	**4.9**	**5.6**
GDP Chain-Type Price Index	2.4	**3.8**	**2.1**	**3.6**	**3.5**	3.3	2.2
Consumer Price Index, All	2.7	3.8	**2.3**	**3.7**	**3.8**	**3.4**	**2.4**
Consumer Price Index, Core	3.3	3.5	**2.6**	**3.7**	**3.8**	**3.4**	**2.4**
Price of WTI crude oil ($/bbl)	71.0	71.4	**64.4**	**65.6**	**70.0**	**70.0**	**68.0**
Trade-Weighted Dollar	126.0	127.9	123.0	122.0	121.0	121.0	121.0
S&P 500 Operating Earnings	233.4	57.8	**59.5**	**57.4**	**52.0**	**228.6**	220.0
Percent vs. Year Ago	9.3	5.9	**1.4**	**-3.0**	**-15.0**	**-2.0**	-3.8
91-Day Treasury Bill Rate*n*	4.6	4.3	4.3	4.3	4.3	4.3	3.5
10-Year Treasury Note Yield*n*	4.2	4.4	4.2	4.4	4.6	4.6	4.0
30-Year Mortgage Rate	6.6	6.8	**6.8**	**6.8**	**7.0**	**7.0**	6.8
Bank Prime Rate	7.6	7.3	7.3	7.3	7.3	7.3	6.5

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.*

Based on my assessment of the permanent income hypothesis, real PCE in the second quarter is likely to be up about 1.2 percent at an annual rate, which would add about 0.8 percentage point to real GDP growth. Therefore, if the 2.3 percentage point contribution from net exports and the 0.8 percentage point contribution from real PCE are combined, second-quarter real GDP would be expected to increase 3.3 percent, all else being equal. This estimate of real GDP growth aligns precisely with the latest estimate from the Federal Reserve Bank of Atlanta's GDPNow model.[2] However, it does not yet reflect the inventory data for May or June, which are expected to be a drag on real GDP growth.

In particular, the Atlanta Fed's estimate of the change in business inventories is that they will reduce second-quarter real GDP growth by 0.4 percentage points. However, I anticipate that the drag from inventory changes will be significantly larger. Specifically, fluctuations in business inventories tend to be influenced by variations in imports when substantial. For instance, a surge in imports often leads to increased inventory accumulation, whereas a sharp decline in imports typically results in slower inventory building.

In the first quarter, while the surge in imports detracted 4.7 percentage points from real GDP growth, the change in business inventories added 2.6 percentage points to GDP growth. In the second quarter, the opposite is expected. A plunge in imports could add about 2.5 percentage points to real GDP growth, while a corresponding sharp inventory correction could detract about a percentage point from GDP growth. Moreover, the three remaining general categories of GDP - business fixed investment, government spending, and residential investment - are expected to be net neutral on GDP growth in the second quarter, as the gain in government spending is expected to be offset by the decline in private investment in new structures.

Beyond the second quarter, real PCE is expected to slow markedly due to less favorable income and wealth effects, reflecting an uptick in inflation, rising unemployment, higher long-term interest rates, a disappointing stock market, and a mild retrenchment in house prices. Inflation, although currently very subdued, is expected to reaccelerate again to an average pace of about 3.8 percent at an annual rate for the second half, led by advances in core consumer prices. Tariffs, or the threat of them, will likely be an important factor contributing to higher price inflation.

Over the four quarters of 2025, real GDP growth is expected to expand by 0.8 percent, the consumer price index is projected to increase by 3.4 percent, and the unemployment rate is expected to end the year at 4.9 percent. These projections are slightly less favorable than those provided by the Federal Reserve's Federal Open Market Committee (FOMC) members at their June 2025 policy meeting, which estimated real GDP growth at 1.4 percent, inflation at 3.0 percent, and an unemployment rate of 4.4 percent by year-end. While the forecasts from Stonebridge Capital Advisors and the FOMC differ a bit, the underlying fundamentals of the U.S. economy are consistent across both sets of projections. The accuracy of these projections will significantly depend on the macroeconomic policies implemented in the second half of the year, including those related to taxes, spending, regulation, immigration, trade, and short-term interest rates.

Macroeconomic Policy Assumptions

Given President Trump's pattern of using tariffs as negotiation levers and his willingness to adjust them in response to market reactions, the most probable objective of his tariff policy appears to be using them to extract concessions from trading partners rather than permanently instituting substantial trade barriers.

[2] According to the Federal Reserve Bank of Atlanta website, "GDPNow is not an official forecast of the Atlanta Fed. Rather, it is best viewed as a running estimate of real GDP growth based on available economic data for the current measured quarter. There are no subjective adjustments made to GDPNow—the estimate is based solely on the mathematical results of the model."

However, there still is the revenue aspect of tariffs that Trump seems to want, suggesting that the 10 percent tariff imposed in April as a minimum tax on all imports is likely to survive at least through his term in office. So far, other than a few specific tariffs on some countries and products, the 10 percent tariff is the only new tariff in effect. It is these other tariffs that have made the tariff policy more complex, such as the new 50 percent tariff on steel and aluminum derivative products (on June 23, the 50 percent tariff on steel and aluminum was expanded to include the steel and aluminum content of specific imported consumer products, including refrigerators, stoves, washers, and dryers.)

The complexity surrounding tariffs makes assessing their economic impact more complex as well. If tariffs are temporary and not too severe, U.S. companies might absorb costs rather than raise prices; they also might push foreign suppliers to lower prices temporarily, even though this is less likely. Of course, to avoid tariffs that are perceived to be temporary, companies might boost imports before they take effect, which would increase inventories and their overhead costs. This may provide insight into the lower-than-consensus S&P 500 earnings in the first quarter, as well as the comparatively mild inflation observed in the second quarter. However, if tariffs are expected to be permanent, they are more likely to cause inflation as companies would raise prices to cover the added cost of the tariffs and protect their profit margins.

In addition, the budget reconciliation bill, referred to as the One Big Beautiful Bill, has passed the House and is now being considered in the Senate. This Bill includes a permanent extension of the 2017 tax cuts, but it also includes several other provisions, some of which have already been excluded from the House passed version based on the Byrd rule.[3] This may apply to spending provisions more often than tax provisions because spending decisions generally involve a change in policy, which cannot be passed by the Senate by a simple majority. The final version of the Bill is likely to include the tax cuts but not all of the spending cuts being proposed. As such, the impact on the budget deficit over the next ten years is estimated by the Committee for a Responsible Federal Budget to be $3 trillion (or $5 trillion if the temporary provisions are made permanent)[4] rather than the decline of $11.8 trillion currently being touted by the Trump administration.

Finally, in the wake of uncertainty about the future of tariffs and inflation, the Federal Reserve kept its federal funds rate target range steady at its June meeting. President Trump had been lobbying for the Fed to cut rates aggressively but failed to convince the FOMC to do so, at least not yet. Although consumer price inflation has been relatively benign in recent months, it still may be too soon to determine the impact of tariffs on inflation. Federal Reserve Board Chair Powell noted in recent testimony that "near-term measures of inflation expectations have moved up over recent months, as reflected in both market- and survey-based measures. Respondents to surveys of consumers, businesses, and professional forecasters point to tariffs as the driving factor."[5] Part of the context is that the higher reciprocal tariffs, which were imposed and then postponed in April, are scheduled to be reintroduced in early July.

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[3] The Byrd rule, named after the late Senator C. Byrd of West Virginia, requires that every line of a reconciliation package must have a direct and substantive impact on federal spending or revenues. Provisions that serve primarily policy goals—rather than budgetary ones—are subject to elimination by a parliamentary maneuver known as a point of order. Whether a point of order is sustained is ultimately made by the parliamentarian (Elizabeth MacDonough), who is essentially the Senate's umpire tasked with providing nonpartisan advice and ensuring that lawmakers are complying with the Senate's rules. MacDonough has rejected several provisions, including measures to bar non-citizens from receiving SNAP benefits and one that would have made it more difficult to enforce contempt findings against the Trump Administration.

[4] Committee for a Responsible Federal Budget,

[5] Chair Jerome Powell, Board of Governors of the Federal Reserve System, Semiannual Monetary Policy Report to Congress, Before the Committee on Financial Services, U.S. House of Representatives, June 24, 2025.

Given this uncertainty, it may be prudent for the Federal Reserve to wait until then to observe any actions taken by the administration before considering adjustments to its monetary policy stance. After all, the FOMC's "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."[6] According to Chair Powell, "policy changes continue to evolve, and their effects on the economy remain uncertain." Although he specifically addressed tariffs, his comment could have a broader interpretation, including the implication of tax and spending policies on deficits and government debt. However, it is customary for Federal Reserve officials not to comment on fiscal policies, since that is traditionally in the domain of Congress. Currently, I have the Fed keeping the federal funds stable this year because the economic expansion is expected to continue. That too could change, given the evolving policies noted by Chair Powell. If the economy experiences a more significant slowdown and the unemployment rate rises more rapidly than expected, I am confident that the Federal Reserve would respond appropriately by adjusting its funds rate target downward, even if inflation remains somewhat elevated.

Finally, the foreign exchange value of the U.S. dollar has fallen significantly this year, as forecasted in the previous Stonebridge Economic Outlook.[7] Starting the year at 129.7, the broad dollar index fell to 121.4 by June 23 - a 6.4 percent decline. It is expected to stay around 121 for the rest of the year, assuming sluggish economic growth, rising inflation, and a mild uptick in the unemployment rate.

[6] Ibid.
[7] Daniel E. Laufenberg, Chief Economist, *Stonebridge Economic Outlook: Special Update*, April 7, 2025.

Important Disclosure Information

All information herein is as of June 27, 2025, unless otherwise indicated.

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