STONEBRIDGE
Capital Advisors

STONEBRIDGE ECONOMIC OUTLOOK

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Overview

The consequences of President Trump's policies during the first year of his second term on the U.S. economy are as follows:

1. Typically, the President does not affect the economy as much as the economy affects the President. The Trump administration has challenged that adage by utilizing existing legislation and debatable interpretations of the Constitution to promote executive powers beyond the norm.

2. Since President Trump has taken office, higher tariffs have had a meaningful impact on the economy. In the first quarter of last year, the surge of imported goods in anticipation of higher tariffs detracted a net 2.3 percentage points from first-quarter real GDP growth (the surge in imported goods detracted 4.9 percentage points, while the uptick in business inventories added 2.6 percentage points). Real gross domestic product (GDP) declined 0.6 percent at an annual rate.

3. In the second quarter, businesses avoided paying the new tariffs by drawing down the inventories of imported goods accumulated in the first quarter, which in turn added a net 1.6 percentage points to overall real GDP growth in the second quarter (the plunge in imported goods added 5.0 percentage points, while the decline in inventories detracted 3.4 percentage points). Real GDP rebounded at a 3.8 percent annual rate.

4. In the third quarter, imported goods declined further, led by nondurable consumer goods, while business inventory accumulation slowed a bit as well, resulting in a net contribution to third-quarter real GDP growth of 0.6 of a percentage point. Surprisingly, exports of both goods and services increased in the third quarter, which contributed another 0.9 of a percentage point to real GDP growth. Real GDP growth accelerated at a 4.3 percent pace.

5. Consumer spending slumped in the first quarter of last year, but recovered in each of the next two quarters, roughly in line with real GDP growth rates for the first three quarters. Real consumer spending is and will continue to be the key to real GDP growth in the United States. However, gains in real spending depend on gains in real permanent income, which has been limited by inflation. Real disposable income grew an average of 1.4 percent an annual rate for the first three quarters of 2025, while real personal consumption expenditures (PCE) grew 2.2 percent, suggesting that either real disposable income improves or real PCE slows down.

6. Apparently, businesses have decided to operate with smaller inventories (relying on just-in-time inventory management once again), hoping that tariffs will be reduced or removed soon.

7. Nonresidential private fixed investment spiked in the first quarter, adding 1.2 percentage points to real GDP growth, before tapering off somewhat in each of the next two quarters. The gains were led by business investment in information processing equipment and software products rather than new structures based on data through August (most recent available).

8. Government expenditures and investment in the third quarter increased after declining in each of the two prior quarters. The increase was led by a 5.8 percent jump in real defense spending.

A Surprisingly Robust Q3

The U.S. economy, as measured by real GDP (GDP adjusted for inflation) grew a stellar 4.3 percent at an annual rate in the third quarter, which was stronger than the consensus estimate of 3.2 percent and well above my estimate of 2.7 percent. A surge in personal consumption expenditures (PCE) and a solid gain in net exports accounted for over 90 percent of the surprisingly robust real GDP growth in the third quarter.

The 3.5 percent surge in real PCE in the third quarter contributed 2.4 percentage points to real GDP growth. This surge in real PCE was a surprise in large part because disposable personal income, which generally drives PCE, was unchanged from the previous quarter. The implication is that the increase in real spending was not funded by real income growth but rather by a drain on savings or an increase in debt financing, both of which may reflect the so-called "wealth effect" of asset price appreciation. Over the four quarters ending in the third quarter of 2025, real PCE increased 2.6 percent, while real disposable personal income increased 1.5 percent. As a result, the personal saving rate for the third quarter fell to its lowest level since the fourth quarter of 2022.

Another surprise was the sizable contribution to third-quarter real GDP growth from net exports, adding 1.6 percentage points to overall real growth after contributing 4.8 percentage points in the second quarter. Both imports and exports contributed to the surprise. On one hand, real imports declined 4.7 percent at an annual rate, adding 0.6 of a percentage point to third-quarter real GDP growth -- imported goods added 0.7, while imported services detracted 0.2. On the other hand, real exports climbed 8.8 percent at an annual rate, adding 0.9 of a percentage point to real GDP growth.

Indeed, third-quarter real GDP grew at the fastest rate since the 4.7 percent gain in the third quarter of 2023. Interestingly, nominal GDP in the third quarter of both 2023 and 2025 grew at 8.2 percent at an annual rate, but the real growth rates differed—4.3 percent in 2025 versus 4.7 percent in 2023. The obvious explanation of this difference is the rate of inflation; that is, the GDP price index as reported by the BEA increased 3.3 percent in the third quarter of 2023 and 3.8 percent in the third quarter of 2025. The reason the growth rates of real GDP and the GDP price indexes do not add to 8.2 percent is because of the chain-type measures used to calculate growth rates.[1]

Inflation rose sharply in the third quarter, suggesting that the marked improvement in the second quarter might have been an aberration. For example, the GDP price index climbed 3.8 percent in the third quarter, after slowing to 2.1 percent in the second quarter, which was preceded by a 3.6 percent advance in the first quarter. Indeed, the Trump administration pushed the Federal Reserve to dramatically lower interest rates last summer, suggesting that the Fed had achieved its target of 2.0 percent inflation and that interest rates could return to Trump's definition of "neutral." Although the Fed was less optimistic about the inflation outlook than Trump, the policy committee still lowered the federal funds rate target three times late last year—25 basis points at each of the September, October, and December policy meetings, reportedly in response to concern about a slowdown in the labor market.

[1] In the National Income and Product Accounts, changes in the quantities and prices are calculated using a Fisher index formula that incorporates weights from 2 adjacent period to construct the chain-type indexes. These indexes eliminate the substitution bias found in indexes with "fixed" weights, and their measurements are not affected by the choice of the reference period. Bureau of Economic Analysis. (April 25, 2018). Glossary, Chain-Type-Indexes.

In particular, the unemployment rate most likely increased to 4.5 percent in the fourth quarter of 2025, up only slightly from 4.2 percent a year earlier. This is a guess rather than a fact because the survey data needed to calculate the unemployment rate for October was never collected due to the extensive government shutdown late last year, leaving a gap in the data series.[2] Nevertheless, with the U.S. economy expanding at an average annual rate of 4.0 percent for the second and third quarters, it was no surprise that the unemployment rate for November, which was initially estimated at 4.6 percent, was revised downward to 4.5 percent and that the unemployment rate for December fell to 4.4 percent. Based on this estimate, it suggests that the slowdown in payroll jobs are sufficient to employ the individuals joining the labor force, it just may take a bit more time and effort to find those positions.

Inflation Fluctuations

An uptick in inflation in the third quarter was not surprising given the higher tariffs imposed by President Trump in the second quarter of last year. The available data for the fourth quarter, which does not include October, suggests that inflation slowed down dramatically once again, much like it did in the second quarter following the surge in the first quarter.

The full effect of higher tariffs on domestic prices most likely will be very uneven and will unfold over several years rather than a few months. The advance notice of the tariff increases allowed businesses sufficient time to accumulate imports prior to implementation. Also, businesses have changed or are in the process of changing suppliers, shifting away from the more expensive imports to domestically produced alternatives when possible. However, even though the domestically produced alternatives may be less expensive than the higher tariffed imported goods (such as some capital goods or production materials), the domestically produced alternatives are still probably more expensive than imports before tariffs. Of course, some imported goods have no domestically produced alternative (such as coffee, bananas, or coco beans), which means the tariffs are paid. In both cases, the higher costs most likely will be passed through to consumers in the form of higher prices.

Nevertheless, investors apparently expect the price effect from tariffs to be temporary. Whether it is or not will depend on the policy response. The Trump administration seems to think that affordability will improve if the Fed dramatically lowers interest rates. The implications seem to be that lower interest rates would make it easier for consumers to take on more debt, support corporate earnings, and maintain the strong wealth effect currently in place. President Trump seems confused about affordability and the difference between having more income or taking on more debt to increase spending. In fact, lower interest rates could do more to promote higher prices than improve productivity.

By lowering interest rates late last year by 75 basis points, the Fed already risks an inflationary spiral that could eventually require the Fed to reverse course. However, if President Trump has control of monetary policy by then and slashes interest rates, it will not bode well for inflation or the economy. Some may argue that the President could simply demand stable prices, much like he is demanding that the interest rate on credit card debt be capped at 10 percent for a year. Mandating stable prices does not work (Nixon administration).

Of course, the other side of higher tariffs and the trade war they promote is that some U.S. exports could be adversely affected as well, putting considerable stress on companies that relied on exports for sales and revenue (whiskey distilleries and soybean farmers). Clearly, there are winners and losers. President

[2] My estimate of 4.5 percent for the fourth quarter assumes that the unemployment rate for October, if it had been calculated, would have been 4.5 percent, matching the estimate for November rather than September.

Trump's solution is a $12 billion government aid package for row crop farmers until October 1, 2026, when reference prices on commodities such as soybeans, corn, and wheat, are scheduled to increase up to 21 percent.

The bottom line is that inflation is likely to fluctuate considerably over the next year, reflecting the uncertainty of tariffs, Federal Reserve independence, government debt, and the accuracy of the economic data being released by government agencies. In that regard, because of the prolonged federal government shutdown, the consumer price index (CPI) for October is missing, making the November release the first of the fourth quarter. Interestingly, the November CPI was 2.1 percent at an annual rate above the third-quarter average, suggesting that CPI inflation retreated considerably in the fourth quarter. That does not mean that prices fell but only that consumer prices increased less in the fourth quarter than in the third.

This reminded me of an adage attributed to British economist, Charles Goodhart, known as Goodhart's law, that was expressed by others as, "When a measure becomes a target, it ceases to be a good measure." The CPI and the unemployment rate may have fallen victim to Goodhart's law. My concern was triggered by President Trump's reaction in August 2025, when he fired Dr. Erika McEntarfer from her role as the Commissioner of the Bureau of Labor Statistics (BLS) for the July jobs report released by the agency that according to social media posts by Trump included numbers that were "rigged in order to make the Republicans, and ME, look bad."

The Forecast

Explaining the past is far easier than predicting the future, although both may be erroneous if the quality of the economic measures used are being compromised. In other words, my forecast relies on the economic information being reported, with assumption that they accurately reflect the source data.

According to the Federal Reserve Bank of Philadelphia Survey of Professional Forecasters dated November 17, 2025, fourth-quarter real GDP was projected to increase at an annual rate of 1.1 percent pace, down from the 1.3 percent pace in the previous survey.[3] The fourth-quarter estimate from the GDPNow model managed by the research staff of the Federal Reserve Bank of Atlanta is currently registering growth at 5.3 percent.[4] Although the two estimates often differ, the current gap is unusually wide. Indeed, the shockingly high GDPNow estimate is more intriguing to me given its outlier status. According to the Atlanta Fed, nearly every component of GDP will add to real growth in the fourth quarter. I have no quarrel with the estimate for real PCE contributing 2.1 percentage points to real GDP in the fourth quarter, but I doubt the 2.0 percentage point contribution from net exports and the 0.8 percentage point contribution from the change in inventories in the current GDPNow estimate will survive.

One data series of particular interest in this regard is factory output as reported in the industrial production release from the Board of Governors of the Federal Reserve System. After solid gains in the first three quarters of 2025, factory output declined 0.7 percent at an annual rate in the fourth quarter. The combination of this decline in domestic factory production and the decline in imported goods reported through October (the November estimate of imported goods is scheduled for release on January 29th) seem inconsistent with the substantial increase in business inventories shown in the GDPNow results. In fact, without a boost in factory output, it is unlikely that real consumer spending, real business investment on

[3] Fourth Quarter 2025 Survey of Professional Forecasters, Federal Reserve Bank of Philadelphia, November 17, 2025.

[4] GDPNow, Federal Reserve Bank of Atlanta, Center for Quantitative Economic Research, January 14, 2026.

equipment, real exports, and real inventories increased in the fourth quarter as much as currently estimated by the GDPNow model. Remember that the GDPNow estimate is not a forecast but a calculation of what fourth-quarter real GDP would be based on the economic data currently available. As more data become available, I expect the GDPNow estimate for fourth-quarter real GDP to fall more in line with my forecast of 2.5 percent.

Moreover, according to the Federal Reserve Bank of St Louis, real retail sales (retail sales adjusted for inflation) through November are on track to increase a mere 0.8 percent at an annual rate in the fourth quarter. If consumer spending did increase 2.1 percent in the fourth quarter, real spending on services will need to account for the bulk of it. Real disposable personal income most likely grew at about 2.0 percent annual rate in the fourth quarter, which means that consumers had the means to increase real PCE at about the same pace.

Real GDP, as shown in Table 1, is expected to grow at 1.5 percent for all of 2026, up from 2.4 percent estimated for 2025. The bulk of real growth likely will come from real consumer spending once again, as the positive factors expected to boost real consumer spending will more than offset the likely negative effects. The positives are the new income tax code, the prospect for lower interest rates, further gains in household wealth, a stellar job market, and AI productivity gains driving lower inflation and higher profitability. Tax refunds are expected to be huge, in large part because the withholding schedule last year assumed that the tax code was going to revert to a previous, higher tax structure under a sunset provision scheduled for last year. Under the One Big Beautiful Bill Act (OB3 Act), the tax code did not revert, suggesting that the tax withholdings on wages and salaries were excessive, which will result in larger tax refunds, as well as some relief to this year's income tax withholding schedule. As a result, households may have more after-tax income to spend. Also, President Trump is determined to replace Jerome Powell as Chair of the Federal Reserve Board when his term expires in May, suggesting that interest rates this summer will be more in line with President Trump's preference of much lower rates, which in turn will make it easier for households to take on more debt to maintain spending. However, it will also make it easier for the federal government to add to its debt outstanding.

The negatives are that consumers most likely have already taken on considerable debt, as suggested by the personal saving rate falling to 4.2 percent in the third quarter from 6.2 percent in the first quarter of 2024. For the most part, the recent upturn in consumer spending has been supported by a very substantial household wealth effect, driven by higher asset prices. Another concern is whether the distribution of the tax benefits from the OB3 Act will be inclusive enough to support further gains in overall spending. The consensus is that they will. Another concern is that employment slowed last year and is expected to continue to struggle somewhat in the face of the AI tsunami that is underway. If consumers are unemployed, income tax relief does not matter. Finally, lower short-term interest rates may not be as beneficial to consumer spending as many anticipate, especially if inflation remains elevated, causing long-term interest rates to climb. Of course, any effort to cap the interest rate on credit card debt most likely will have the unintended consequence of forcing credit card companies to cancel the cards of riskier cardholders, which for many may be the only credit available.

Relying on anecdotal evidence is generally unacceptable but it can help prove a point at times. In this case, my anecdote is the price of a small can of whole kernel corn. For most of last year, the price was $0.99 a can. The price rose to $1.29 in December and ticked up again to $1.59 last week. From the average for the fourth quarter of 2025, the price of a small can of whole kernel corn increased 45.9 percent in the first two weeks of 2026. Obviously, this could be an outlier, but it also suggests that the highly anticipated decline in gasoline prices in early 2026 could be more than offset by higher food prices.

Table 1
U.S. Economic Forecast

	Annual	2025 Quarterly				Annual	
	2024	**Q1**	**Q2**	**Q3**	**Q4*f***	**2025*f***	**2026*f***
Real Gross Domestic Product	2.4	-0.6	3.8	**4.3**	**2.5**	**2.4**	**1.5**
Civilian Unemployment Rate	4.2	4.1	4.3	4.3	4.5	4.5	**5.0**
GDP Chain-Type Price Index	2.4	3.6	**2.1**	**3.8**	**2.4**	**3.0**	**2.7**
Consumer Price Index, All	2.7	3.8	1.6	**3.1**	**1.9**	2.6	**2.7**
Consumer Price Index, Core	3.3	3.5	2.1	3.3	**1.6**	2.6	**2.7**
Price of WTI crude oil ($/bbl)	71.0	71.4	64.6	65.8	**59.6**	**59.6**	**60.0**
Trade-Weighted Dollar	126.0	127.9	122.8	120.6	**121.2**	**121.2**	**119.0**
S&P 500 Operating Earnings	233.4	57.5	64.0	**72.0**	**67.0**	**260.2**	264.0
Percent vs. Year Ago	9.3	5.9	9.7	9.9	9.4	11.6	1.4
91-Day Treasury Bill Rate***n***	4.6	4.3	4.4	4.3	3.9	3.9	**2.8**
10-Year Treasury Note Yield***n***	4.2	4.4	4.2	4.3	4.1	**4.1**	**3.8**
30-Year Mortgage Rate	6.6	6.8	6.8	6.6	**6.2**	**6.2**	**5.8**
Bank Prime Rate	7.8	7.5	7.5	7.5	7.0	7.0	**6.0**

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 estimates for real GDP and all measures of inflation are annual rates of change from the previous quarter. The quarterly estimates for the unemployment rate, the price of crude oil, the trade-weighted dollar, and all interest rates 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.*

In addition, I expect the unemployment rate to edge higher over the four quarters of 2026. The combination of slower growth and weaker employment is expected to justify further cuts in the federal funds rate target by the FOMC in 2026, but probably not until later. What happens to the federal funds rate will depend on who Trump appoints to replace Jerome Powell as Chair of the Federal Reserve Board and whether Jerome Powell decides to stay on to complete his term on the Federal Reserve Board after he is replaced as Chair. Even though he would no longer be the Chair of the Federal Reserve Board, Governor Powell could still leave his mark on monetary policy through his role on the Federal Open Market Committee.

Considerable uncertainty rules the outlook, most of it self-inflicted. Unfortunately, I do not see it waning anytime soon. In fact, it is more likely to intensify in the months ahead, especially as we get closer to the mid-term elections. For this reason, I have postponed providing quarterly estimates of the forecast for 2026. Needless to say, I expect quarterly growth rates to be volatile. In the first half of the year, I expect stronger growth, higher inflation, a steady unemployment rate, and a slightly steeper Treasury yield curve. In the second half, the economy may be under more pressure owing to a steeper Treasury yield curve owing to lower short-term rates, lower inflation, slower growth, and a slightly higher unemployment rate. Of course, this is subject to change at any time—and probably will.

I just turned 80, so I am entitled to be cantankerous and old enough to be a pessimist. According to a quote attributed to J. Robert Oppenheimer, "the optimist thinks this is the best of all possible worlds, while the pessimist fears it is true."