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ECONOMIC TALKING POINTS

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The Stagflation Threat Is Real and the Fed Needs To Take It More Seriously

How frustrating this must be for the Federal Reserve. They came so close last year to navigating inflation down toward the 2% target without slowing the economy's growth momentum. It was an impressive feat, one the rest of the world watched with envy.

And then it all unraveled in an instant.

Just 8 weeks into President Trump's second term, his fetish for broad tariffs set the stage for inflation to reaccelerate. Those tariff shocks, along with the chaos caused by DOGE's amputation of federal agencies, followed by mass government layoffs, hastily arranged deportations, and the Administration's dismissive contempt for the judicial system have induced such vertigo with the public that it now threatens to shove the economy into a ditch. I have said this before and will say again, history has shown how gross "acts of human folly" can lead to the demise of business cycles. (On this point, see my note from March 4th.) And we're about to demonstrate that again.

Just about every part of the US economy is being held hostage to the uncertainties of how tariffs will play out. Will they hold up over time? Is Trump going to de-escalate? Could he be working on an off ramp and simply claim America's trading partners have capitulated? Or are things going to get still worse?

For now, though, a virus is brewing in the economy---stagflation--- and all eyes should turn to the Federal Reserve for their response.

In its just-released Summary of Economic Projections (SEP), signs of peril ahead are noticeable. We are about to face the worst of two worlds: higher prices for consumers as companies pass on the cost of new import taxes and, at the same time, an economy that began the year with such energy is now at risk of losing it all.

Table 1. Economic projections of Federal Reserve Board members and Federal Reserve Bank presidents, under their individual assumptions of projected appropriate monetary policy, March 2025

Percent

Variable	Median[1]				Central Tendency[2]				Range[3]			
	2025	2026	2027	Longer run	2025	2026	2027	Longer run	2025	2026	2027	Longer run
Change in real GDP	1.7	1.8	1.8	1.8	1.5–1.9	1.6–1.9	1.6–2.0	1.7–2.0	1.0–2.4	0.6–2.5	0.6–2.5	1.5–2.5
December projection	2.1	2.0	1.9	1.8	1.8–2.2	1.9–2.1	1.8–2.0	1.7–2.0	1.6–2.5	1.4–2.5	1.5–2.5	1.7–2.5
Unemployment rate	4.4	4.3	4.3	4.2	4.3–4.4	4.2–4.5	4.1–4.4	3.9–4.3	4.1–4.6	4.1–4.7	3.9–4.7	3.5–4.5
December projection	4.3	4.3	4.3	4.2	4.2–4.5	4.1–4.4	4.0–4.4	3.9–4.3	4.2–4.5	3.9–4.6	3.8–4.5	3.5–4.5
PCE inflation	2.7	2.2	2.0	2.0	2.6–2.9	2.1–2.3	2.0–2.1	2.0	2.5–3.4	2.0–3.1	1.9–2.8	2.0
December projection	2.5	2.1	2.0	2.0	2.3–2.6	2.0–2.2	2.0	2.0	2.1–2.9	2.0–2.6	2.0–2.4	2.0
Core PCE inflation[4]	2.8	2.2	2.0		2.7–3.0	2.1–2.4	2.0–2.1		2.5–3.5	2.1–3.2	2.0–2.9	
December projection	2.5	2.2	2.0		2.5–2.7	2.0–2.3	2.0		2.1–3.2	2.0–2.7	2.0–2.6	
Memo: Projected appropriate policy path												
Federal funds rate	3.9	3.4	3.1	3.0	3.9–4.4	3.1–3.9	2.9–3.6	2.6–3.6	3.6–4.4	2.9–4.1	2.6–3.9	2.5–3.9
December projection	3.9	3.4	3.1	3.0	3.6–4.1	3.1–3.6	2.9–3.6	2.8–3.6	3.1–4.4	2.4–3.9	2.4–3.9	2.4–3.9

What stands out in the March SEP?

Compared to its projections on December 18th, the Fed has now downgraded economic growth this year and in 2026 , while seeing inflation creep up. Instead of 2.1% GDP growth in 2025, the Fed sees economy slowing to 1.7%. Frankly, even that may be optimistic. Our forecast calls for 1.1% growth, with the probability of one or two quarters in contraction.

What of inflation?

Last December, the Fed saw headline PCE inflation settle at 2.5% in 2025, but that was just raised to 2.7%. Core PCE had been projected to increase to 2.5% this year, and that was hiked to 2.8%.

Not to worry, however. Fed policymakers believe headline inflation in 2026 will drop back to 2.2%, with core sliding to 2.1% The explanation (or perhaps prayer…) according to them, is that the boost in tariffs will likely trigger a one-time increase

in inflation, with no significant repercussions in 2026 and 2027. The price spike should be a "transitory" one.

Here, again, I think this is wishful thinking. There is a greater risk inflation will continue to rumble through well into next year. Here is the broad sequence that will flow into 2026 and perhaps beyond:

(1) Tariffs will drive up input costs for producers and they will ultimately pass part or all of those expenses on to consumers.

(2) As the price tag for those items increase, many domestic producers that sell similar products <u>but do not rely as much on imports</u> may take advantage of the opportunity to also boost their prices to match those of importers. More inflation!

(3) America's trading partners, hurt by Trump's tariffs, will retaliate. This is likely to push Trump to penalize them by further jacking up tariffs. US consumers will have to brace for another round of pass-throughs.

(4) As the cost of living climbs, workers will demand higher wages to offset the erosion in their purchasing power.

(5) Employers will then come under increasing pressure to offset higher labor costs by passing those expenses on to consumers again. And then we're off to the races with a dangerous wage-price spiral.

Yet, despite this looming inflation threat, the SEP's dot plot still suggests that the Fed may cut rates two times this year, with the fed funds slipping to 3.9%. Another two reductions are foreseen in 2026.

Our forecast has no change in rates for most of this year, if at all, with cuts commencing in 2026.

Why are we sticking to this view? Because there is an abundance of evidence that inflation expectations are no longer anchored, and it was surprising to see Powell downplay this evidence.   In their preliminary March report, the University of Michigan's Consumer Sentiment survey showed that 12-month inflation expectations jumped to 4.9%, the highest level since November 2022, from 4.3% in February.

Powell has said in the past that he prefers a longer time horizon, specifically the five-year outlook, when assessing inflation expectations. Well, if so, then the news is even worse. Over the next five years, consumers see inflation running at 3.9%. That was the highest reading since February 1993!

Powell appears unruffled by the Michigan surveys, but that would be a mistake. Here's more evidence why the Fed ought to be more concerned. US producers claim they are already feeling the inflation upswing. The Institute for Supply Management reported that prices paid for supplies by manufacturers jumped in February to its highest level since June 2022!

Firms in the service industry have also seen their costs jump, with the prices paid index now up to 62.6 last month, according to the ISM. This was the third consecutive reading above 60 percent, a trend we haven't seen since March 2023.

The reality is Trump's policies have whipsawed everyone --- corporate decision makers, investors, households, members of Congress and even policymakers at the Fed. We are all flying blind at the moment, struggling to understand the end game from the cumulative shocks over trade policies, the prospect of a constitutional crisis between Trump and the judiciary, and geopolitics. There will be a long term cost to all this chaos.

But one stubborn beast is already on our radar screen --- stagflation, and that is what the Fed should focus on more vigorously. By the time 2026 rolls around, Trump is expected to replace Powell with a new Fed Chair, one much more inclined to significantly lower rates *long before inflation has been tamed.* That would be a dangerous mixture.

Fifty years ago the Fed, under Arthur Burns, took the same action and the country suffered heavily as a result! It's the echo of that distant pain that should still reverberate in our minds.

United States

	I 2025	II 2025	III 2025	IV 2025	I 2026	II 2026	III 2026	IV 2026	I 2027	II 2027	III 2027	IV 2027	I 2028	II 2028	III 2028	IV 2028
Real Gross Domestic Product (GDP):																
%	0.0	1.0	1.7	2.6	0.8	2.1	2.3	2.4	1.2	2.0	1.5	1.8	1.7	2.3	2.0	1.9
Personal Consumption Expenditures:																
PCE %	0.5	0.8	1.0	2.7	1.1	1.4	2.2	3.0	0.9	1.6	1.7	2.1	1.3	1.9	2.0	2.2
Inflation, end of period, year-over-year:																
CPI %	3.3	3.5	3.2	3.3	3.2	3.5	3.5	3.6	3.6	3.3	3.3	3.1	2.9	2.9	2.7	3.0
Unemployment Rate (end of period):																
%	4.3	4.3	4.1	4.0	4.2	4.0	4.0	4.1	4.0	4.1	4.3	4.2	4.3	4.4	4.4	4.4
Non-farm Payrolls, monthly avg. thousand:																
	145	130	120	135	110	125	130	125	125	110	115	120	125	130	140	145
Treasury 10-yr Note Yield % (end of period):																
	4.10	3.80	3.65	3.65	3.45	4.10	4.40	4.65	4.70	4.60	4.40	4.20	4.20	4.15	4.30	4.10
Federal funds rate % (mid-point, end of period):																
	4.38	4.38	4.38	4.38	4.38	3.88	3.63	3.63	3.38	3.38	3.38	3.38	3.13	2.88	2.88	2.88

GDP Growth - Global Economy - Year over Year

Country	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
US	2.6	1.6	2.2	1.8	2.3	2.7	1.8	2.5	3.0	2.6	-2.2	6.1	2.5	2.9	2.8	1.1	1.9	2.2	2.3
Eurozone	1.7	1.4	-0.9	-0.2	1.4	2.1	1.9	2.5	1.8	1.6	-6.2	5.7	3.5	0.5	0.7	0.9	1.3	1.3	1.5
United Kingdom	1.7	0.7	0.3	1.8	2.9	2.2	1.9	1.9	1.7	1.6	-10.4	8.7	4.3	0.1	1.1	0.7	1.3	1.4	1.5
Japan	4.6	-0.4	1.6	1.5	-0.1	1.1	0.5	1.7	0.6	-0.4	-4.3	2.3	1.0	1.5	0.1	1.1	1.0	0.8	1.0
Canada	3.1	3.1	1.8	2.3	2.9	0.7	1.0	3.2	2.8	1.9	-5.1	5.0	3.4	1.1	2.3	-1.5	1.1	2.2	2.4
India	8.4	8.6	6.7	4.9	7.4	8.0	8.1	7.2	6.4	4.0	-5.9	9.2	7.2	7.7	6.4	6.1	6.1	6.0	5.8
China	10.5	9.5	7.8	7.7	7.3	6.9	6.7	6.8	6.7	6.0	2.2	8.5	3.0	5.2	5.0	4.1	4.5	4.7	4.9
Brazil	7.5	2.7	0.9	2.3	0.1	-3.5	-3.5	1.2	1.2	1.4	-3.6	5.3	3.0	2.9	3.8	2.1	2.2	2.6	2.6
Mexico	5.2	4.0	3.9	1.4	2.3	2.7	2.7	2.4	2.2	-0.3	-8.8	6.1	3.9	3.2	1.5	-0.5	1.6	2.2	2.4
Australia	2.8	2.6	3.6	2.4	2.6	2.5	2.4	2.4	2.7	1.8	-1.1	4.7	3.7	1.5	1.4	2.0	2.1	2.2	2.3
Russia	4.0	4.3	3.4	1.3	0.6	-2.8	-0.2	1.6	2.8	2.2	-2.7	5.6	-1.2	3.6	4.1	1.7	1.9	2.2	2.1
World	4.2	3.1	2.5	2.6	2.8	2.8	2.6	3.4	3.2	2.7	-3.0	6.2	3.0	2.7	3.2	2.4	2.6	2.7	3.2

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