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ECONOMIC TALKING POINTS

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The Trade War Is On! What Happens Next?

For the first time in nearly two decades, we have raised the probability of a US recession to 60%. The downturn could begin as early as the middle of this year, followed by a sustained period of weak growth in 2026. The severity of the recession will, of course, depend on multiple factors, including the size and duration of the latest tariffs on Mexico, Canada and China, what additional import duties are in the works, the size of government spending cuts and how quickly labor market conditions deteriorate.

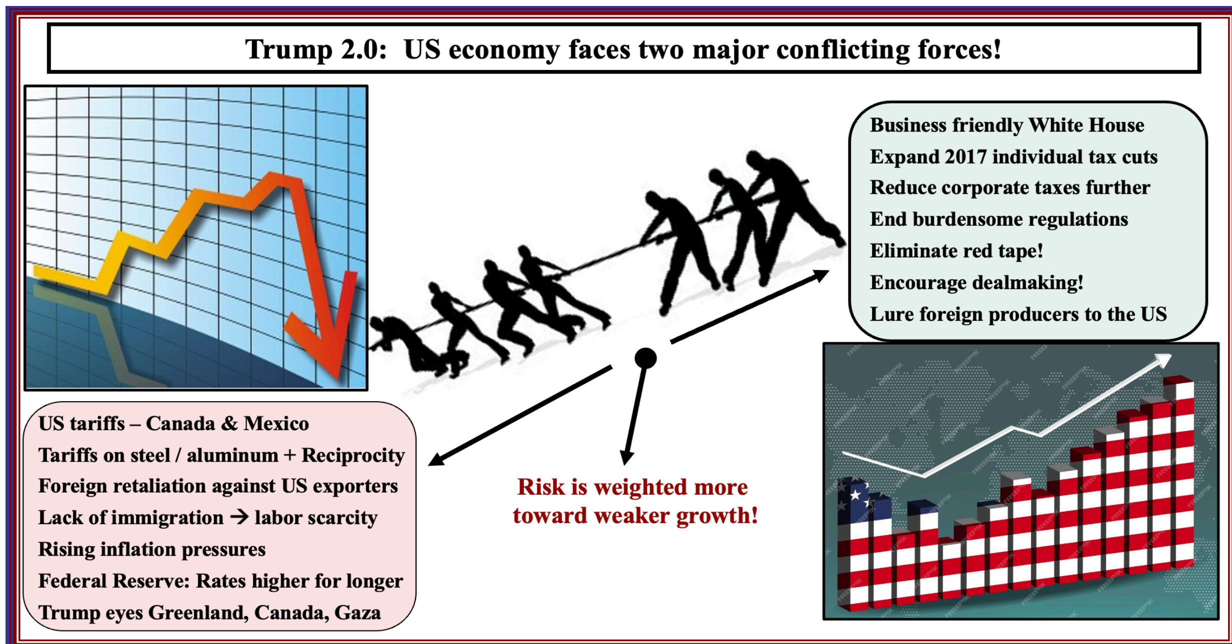
This is our first recession call since the eve of the 2008 – 2009 financial crisis.

Why this sudden increase in risk for the economy? Don't blame high interest rates or a spike in oil prices. The reason for this recession falls into a category we classify as "gross acts of human folly," which is defined as a bewildering assemblage of poorly thought out policies that together can bring business activity to a screeching halt.

"Acts of human folly" have snuffed out business cycles before. We saw this during the dot.com hypermania, which eventually led to massive bankruptcies, a stock market bust and recession in 2001. That was followed a few short years later by the madcap lending and borrowing in real estate that helped detonate the 2008 - 2009 financial crisis and trigger an even deeper economic collapse.

So, here we are in 2025. The current economic cycle is in danger of flopping again because of a series of ill-conceived actions by the White House that will result in a supply shock and higher inflation.

It is worth recalling for a moment how giddy the business community and investors initially were of Trump's electoral victory. After all, he pledged to lower the cost of living for Americans, slash burdensome regulations and red tape, extend and even expand the 2017 individual income tax cuts, reduce corporate taxes from their current rate of 21% (already the lowest since 1939!) to 15%, tack on hefty tariffs on imports to support US producers, incentivize oil and gas companies to boost production, deport undocumented workers and nearly slam the door on immigration in order to protect American workers and reduce crime. All this, he said, would herald in a "Golden Age" for this country.



Instead, President Trump right out of the gate staggard businesses and consumers by signing a blitzkrieg of atypical executive orders, followed by a slew of controversial policy pronouncements (massive tariffs, DOGE, territorial expansion). These directives were also being carried out with such speed and prejudice that Trump and his team showed little interest about the damaging effects their actions will have on business costs, supply chains, inflation and employment. Worse, Trump displayed a willingness to even bulldoze over the rule of law in order to enact all these plans.

And so in a matter of weeks since Trump took office, whispers have spread among CEOs and money managers --- and even louder voices from consumers --- that something has gone terribly awry. The magnitude of the tariffs Trump imposed on Mexico, Canada and China, along with duties on all steel, copper and aluminum imports planned for mid-March, and the universal tariffs set for April, will only end up rekindling inflation, not reducing it.

The result: The Fed may soon confront its number one enemy -- stagflation! And when they do, policymakers will face a dilemma. Should they focus on containing rising inflation by keeping

rates firm -- or slash rates to rescue a fast sinking economy and deal with the inflation spike another time?

But this is just half the story. The President has also tasked Elon Musk and his DOGE team with the role of amputating federal agencies and throwing thousands of Americans out of work. The fallout from those "musked" (the latest neologism for being axed) will quickly spread to layoffs in the private sector, since there are roughly 2 civilian contractors employed for every federal worker. Again, no thought is given to foresight.

Nor can one ignore Trump's fanciful craving for America to digest Greenland, Canada and the Panama Canal. And let's not stop there! There's a potential real estate and peace deal to be made in the Middle East too. Want lasting calm for the region? Evict 2 million residents and turn Gaza into a swanky "Riviera." (One can only imagine the dazed reaction from Saudi Arabia, the UAE, Egypt and Bahrain who are themselves committing more than $1 trillion to build their own local tourism paradise.)

So, how do we make sense out of all this?

Many companies have set up war rooms to assess how Trump 2.0 will affect their operations, supply chains, pricing, revenues and earnings.

The central question being asked? **Are we going to see a coherent economic and political strategy emerge from the White House, one that is well thought out and deliberative?**

Or is the nation about to labor through four years of essentially a bar room brawl with an antagonistic foreign policy, harmful tariffs, greater inflation, and where most other policy actions taken by Trump and DOGE simply founder in courts on charges they may violate a bevy of laws, including the Constitution? The latter would have the Trump Administration dissolve into mediocrity and condemn the US economy to a period of chronic underperformance.

Evidence is building that the Administration's pell-mell conduct is edging the country toward the latter.

Consumers:

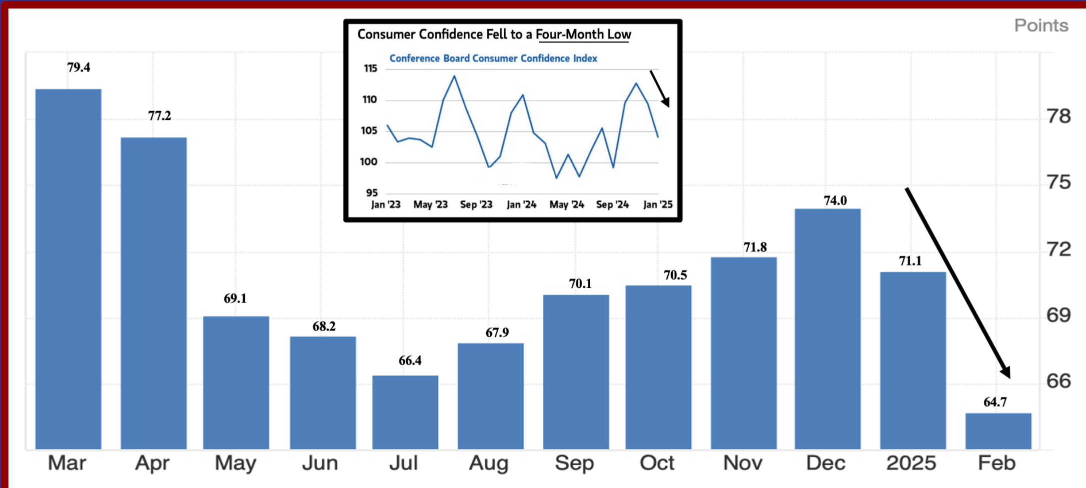
Just look at how quickly consumers have pivoted! Total personal spending fell 0.2% in January, the first decline in 22 months. A separate report showed retail sales in January plummeted 0.9%, the largest monthly dive since March 2023.

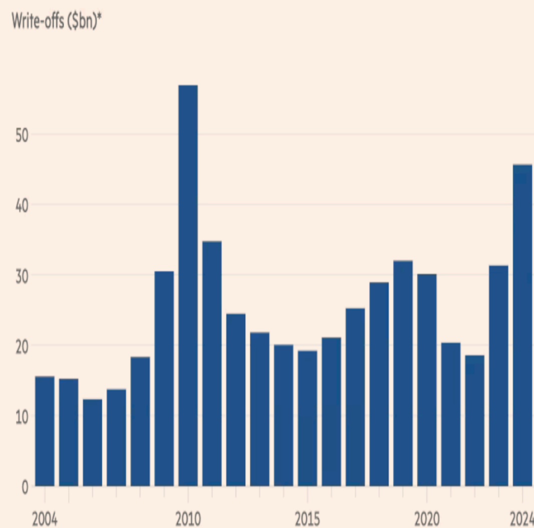
Behind this retrenchment in spending is a serious deterioration of consumer confidence. The University of Michigan survey showed consumer sentiment in virtual free fall. It dropped to a 15-month low in February as Americans feared Trump's tariffs would drive up their cost of living. That survey noted consumers expect inflation to jump to 4.3% by the end of this year. (The CPI is currently running at a 3.0% rate.)

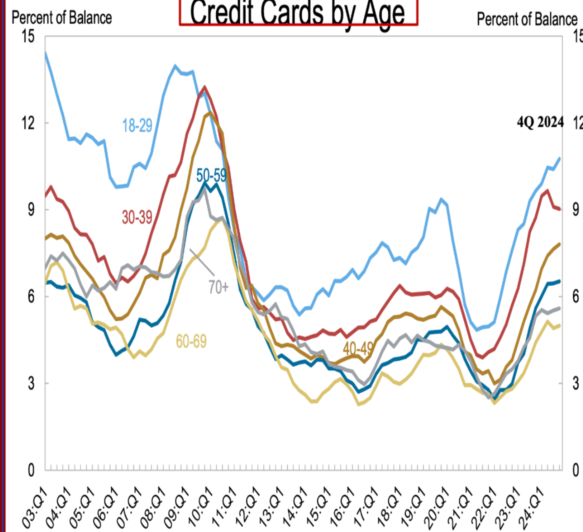
More disturbing to the Federal Reserve was that households saw inflation settle at 3.5% even five years from now, the highest for such a long term forecast since 1995! It's a clear sign that inflation expectations are no longer anchored anywhere near the Fed's goal of 2%.

Another influential poll on the mood of Americans, this time by the Conference Board, showed confidence collapsed last month by the most since early 2021.

And these worries of future inflation appear fully justified. The Institute for Supply Management's (ISM) reported that prices manufacturers paid for material just surged to its highest since June 2022. US producers rely heavily on imported raw materials, and this is the fifth straight month those costs have increased.







Employment:

Aside from concern about rising inflation, new questions are cropping up about job security. The fallout from shutting down federal agencies and subsequent loss of employment, plus the

cancellation of government contracts with private contractors could snowball and drive the unemployment rate past 5% or higher!

Case in point: We have already seen applications for unemployment benefits suddenly triple during the week of February 22nd and those numbers are likely to stay high in the weeks ahead.

These layoffs can not easily be absorbed into the workforce, either because there is a mismatch in skills or employers are unwilling to expand payrolls when the economic outlook is starting to look grim.

One last point; While the BLS will release February's employment numbers later this week, it is probably wise to keep in mind it may take two or three months before these mass dismissals show up in the national data.

Federal Reserve:

Think the fireworks in the Oval Office last week between Presidents Trump and Zelenskyy was monstrously entertaining? Well brace yourself for a new firestorm on March 19th when for the first time this year, the Federal Reserve will issue its multi-year forecasts for inflation, unemployment, economic growth and interest rates. And it is safe to assume the White House has prepared an attack script against the Fed if it dares to issue projections that are not to Trump's liking.

Yet there is already a preponderance of evidence that should concern the President.

- As I noted earlier, the number of Americans seeking unemployment benefits has surged.

- Consumer optimism and spending has been on a steep slide down.

- The housing market is barely showing a pulse. Pending home sales, a measure of contracts signed to buy existing homes, collapsed in January to its lowest level ever recorded! (The National Association of Realtors first began this series in 2001.)

- The US trade deficit in goods swelled in January as US importers front loaded their purchases ahead of tariffs. A widening gap in the trade balance, however, will act as a drag on economic growth in the first quarter.

- Most alarming is the estimate for 1Q 2025 growth by Federal Reserve Bank of Atlanta. Its GDPNow model shows the US economy contracting (-2.8% rate).

Stagflation:

As I noted earlier, If economic conditions sour just when tariffs are kicking up inflation, the Fed has a hellishly tough decision to make. There is no greater nightmare than stagflation. How will they proceed? Should the Fed lower interest rates to keep the economy out of recession and therefore relegate the fight against inflation? Or, ought monetary policy remain restrictive in order to keep consumer prices from accelerating, and accept the cost of more economic weakness?

Our assumption: If the economy modestly contracts due to ill-conceived White House policies that are then hastily rammed through, then we expect the Fed will stay on its current of course on interest rates and stay focused on bringing inflation back toward its 2% target. Again, the only caveat here is on the severity of an economic decline and how high the unemployment rate climbs.

What lessons does history offer when an economy simultaneously gets hit with high unemployment and high inflation?

When it occurred in the 1970s, Fed chief Arthur Burns, under pressure from President Nixon to lower rates, complied and borrowing costs plummeted. But that ultimately drove inflation to crippling double digit levels. Paul Volcker, who took charge of the Fed later that decade and into the 1980s, chose the opposite strategy and waged a fierce but successful battle against inflation, fully aware the cost would bring on a painful recession, and it did!

Virtually all historians have sided with Volcker's approach, since it is easier to reduce unemployment with lower rates, but far more difficult to unwind inflation once the psychology of rising prices gets imbedded in the minds of consumers and businesses.

We may get a peak how the Fed under Jerome Powell might respond to the prospect of stagflation later this month with the release of the Summary of Economic Projections and the press conference that follows. I suspect the White House will be hovering over that event with a menacing stare.

Geopolitics and the economy.:

Much has already been said about last week's confrontation in the Oval Office between Presidents Trump and Zelenskyy. But what are the economic implications from this fiasco? Not much in any immediate sense. However, the widening political chasm between the US and its European allies will have long term economic repercussions.

Let's step back and see how. It is a truism that Russia, China, North Korea and Iran are working closely together to keep the world safe for authoritarian regimes. In contrast, the US, Canada along with 30 other nations in Europe that make up NATO are working to keep the world safe for democracies. This is inherently a zero-sum battle between two organically incompatible ideologies. What is worrisome is that the solidarity within NATO has greatly eroded under Trump. He has not only expressed skepticism on the viability of this political and military alliance, but warned the US would be unwilling to come to the aid of any NATO member under attack if its domestic spending on defense fails to please him.

NATO is not at risk of complete disintegration! But Trump's pugnacious relationship with Europe, his apparent embrace of despots, full-throated support of universal tariffs, and insistence on the US annexing Greenland, Canada and the Panama Canal --- should tell you that the international order that set the stage for nations to benefit from mutual trade and economic interdependence is now gone. The global economy and geopolitical relationships are in a state of transmutation.

Europe now realizes it has to rely much more on their own resources to protect their economies and achieve national security. And its resources to accomplish both are actually quite substantial. The European Union and the UK together represent the second largest economy in the world (after the US). They have nearly twice the US population, and even possess a credible nuclear deterrent against any adversary. Both the UK and France have their own nuclear military arsenal that include hundreds of land-based ICBMs and submarine ballistic missiles, a force of 2 million personnel in uniform and spends roughly $350 billion per year on defense, more than enough to deter Russia. The point here is that the European Union and the UK have the means to protect Ukraine's democracy, without "explicit" support of the US. (Would Putin really risk killing French and British peace-keeping soldiers in Ukraine?)

In terms of global economics, the imposition of tariffs by the US is certain to snowball into an all-out trade war. Other nations will retaliate, as we've already seen from Canada and China. Mexico is to announce how it will respond this weekend. Will that provoke Trump to counter-retaliate against these countries --- or back down somewhat? And it's fair to say all this turmoil is occuring against the backdrop of heightened geopolitical tensions. It's a combination hardly conducive to global economic growth.

Key Forecasts:

The fog of uncertainty remains high because we don't know how long the tariffs on Canada, Mexico and China will last. Nor do we have details how the universal or "reciprocal" tariffs will work in April. About the best we can do at this moment is to shape the fog based on currently available information.

US - While the economy entered 2025 with lots of momentum, that energy appears to have dissipated in just a matter of weeks. The primary risk now is of stagflation and rising unemployment. We expect to see an economic contraction in Q1, followed three relatively weak quarters. Again, much depends on the duration of tariffs and how the Federal Reserve will respond once inflation veers further away from the 2% goal.

Consumers are already under pressure from record personal debt and high interest rates. Credit card delinquencies are currently the highest since the 2008 – 2009 recession. Businesses will also be struggling with higher input costs and an uncertain future. We expect real GDP to increase a meek 1.1% this year and 1.9% in 2026.

Eurozone – The ECB will continue to lower rates now that inflation is in decline. On top of all the political uncertainty, the region's manufacturing and export sectors have suffered. Global demand for European goods has fallen, especially from China, and the threat of US tariffs are forcing European companies to pause capital investments. We do expect to see industrial output ramp up in the latter half of the year as member nations increase spending on defense and ship more military aid to Ukraine. It is not the best way to allocate funds since Europe is also is in desperate needs to invest in raising labor and capital productivity. As a result, the Eurozone economy is seen expanding 0.9% in 2025 and 1.3% next year.

Canada –Both Canada and Mexico economies will be in recession this year assuming Trump keeps the 25% tariffs in place for a prolonged period (6 months or longer). Inflation in Canada is

expected to slide further as business conditions weaken. This will prompt the Bank of Canada to further lower rates in an effort to cushion the economy's fall. National elections will take place no later than October 2025 now that Justin Trudeau has chosen to resign from his post as PM and leader of the Liberal Party. Yet the country seems unified that retaliatory tariffs and other actions against the US are justified, well aware these measures will hurt their own economy. Canada's GDP could shrink by 1.5% this year and then grow by 1.1% in 2026.

Mexico - President Claudia Scheinbaum has tried to work with Trump in recent weeks to avoid more tariffs, but to no avail. Its economy will not be able to escape recession, since more than 85% of its exports go to the US. The key to Mexico's outlook will depend entirely on the duration of the tariffs. Frankly, given how much the US relies on Mexico for food, auto parts, and other critical material, it seems improbable that Trump would keep these tariffs in place for a lengthy period, especially if American anger erupts over the subsequent rise in the food. But even a shortened period of tariffs can cause dislocations. Our forecast calls for Mexico's economy to decline by 0.5% this year and recover in 2026 with growth at 1.6%

China – Despite efforts by the Communist Party to revive growth, China's economy remains in dire straits. There is really only one solution that can put it on firmer footing and that is to liberalize its business sector and give market forces a greater role in allocating capital. How likely will that happen under President Xi Jinping's leadership? Very unlikely! If anything, he wants to tighten his grip on the political and economic system. It will thus take 5 to 10 years for China to recover from its economic woes. Moreover, with domestic demand so soft, Chinese manufacturers have little choice but to sell much of their products overseas, even at the risk of dumping those goods and irritating other nations. China is also struggling with poor demographics. Its population has been declining for three consecutive years, and is projected to be cut in half by the end of this century. In the meantime, the shortage of young workers has become more severe. Tariffs imposed by the US poses an additional burden on China's economy. The official data still projects growth in the neighborhood of about 4.5% to 5% in 2025 and 2026, about the same as in recent years. But all these numbers are very suspect. There's a common joke that 77.34125% of all economic statistics out of China are made up. We believe China was teetering on recession in 2024 and see little change in store this year. Stronger growth is forecast for 2026 as more aggressive fiscal and monetary stimulus later this year take effect.

Russia –The war in Ukraine has been catastrophic for Russia's economy. It's important to note than even prior to this war, Russia's GDP was actually smaller than Italy's. Yet Russia has always made a point to punch above its economic weight geopolitically. Inflation is still near double digit levels and the central bank has kicked up interest rates to a two-decade high of 21%. What's kept the country out of a deep recession is it now operates as a war economy. But keep in mind that nearly 1 million Russians, many with valued skills, have fled the country since it invaded Ukraine, and this does not even count the tens of thousands of workers who were conscripted into the military for the war. Russia's GDP is seen growing 1.7% this year and 1.9% next.

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):																
%	-0.6	0.8	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 %	0.9	1.3	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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