ECONOMIC AND FINANCIAL DIGEST

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Shock Waves

The economy is reeling from multiple shocks, spurring economists to reshape their outlook for growth, inflation, unemployment, monetary policy, and financial markets. The silver lining is that the economy was in good shape ahead of these shocks, with unemployment low, inflation retreating, and the markets retaining most of the strong gains achieved in recent years. Hence, there is a cushion of strength to buffer the impact from the shocks. But resistance is wearing thin and the longer the shocks keep on coming, the greater the odds that the economy will fall into a recession.

The first shock is higher tariffs – and prices – on US imports, which, by cutting into disposable income, is also creating a demand shock. Though tariffs didn't have a noticeable impact on consumer prices in March, they will soon. There is a lag between tariff adjustments and when they appear in consumer prices.Surging policy uncertainty is the second shock, which is already negatively affecting business investment in both equipment and structures. So far, consumers are still spending, with March retail sales coming in stronger than expected. But much of that strength reflects the front-loading of purchases before tariff-induced price increases kick in. Household sentiment has plunged to recession levels and buying plans have been cut back. Policy uncertainty is unlikely to fade anytime soon because tariffs can change quickly and unexpectedly, as we've seen in the first few weeks of April.

The third shock is disruptions in global supply chains. Unlike the tariffs implemented during Trump's first term, the breadth and magnitude of the new tariffs are significantly larger and could usher in an era of fractured global trade, putting pressure on supply chains. The final shock is tighter financial market conditions as stock prices have dropped noticeably, long-term interest rates have risen, the trade-weighted dollar has depreciated, and corporate bond spreads have widened. The tightening in financial market conditions will hurt consumer and business spending by eroding wealth and increasing borrowing costs. The shock waves are still resonating through the economy and financial markets and their disruptive effects on inflation and growth will pose vexing challenges for the Federal Reserve.

Phantom Wealth

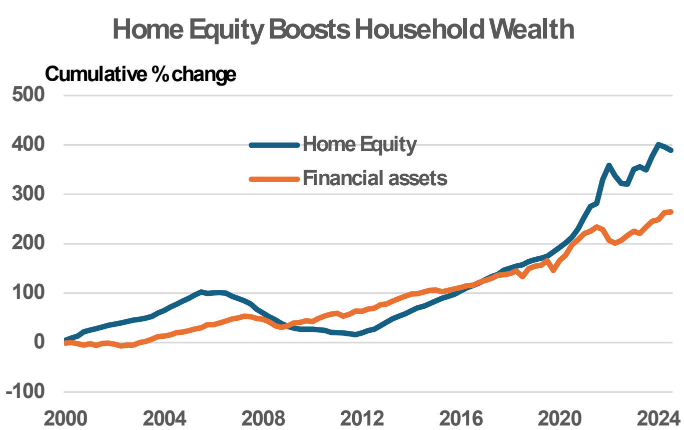
A major tailwind cushioning the blow from trade and tariff shocks is the healthy balance sheets of Americans, reflecting surging stock portfolios and housing equity in recent years. So far this year, stocks have pulled back modestly amid heightened volatility, but most of the previous gains have been retained. The increased wealth, in turn, provides an incentive for households to save less out of incomes than they otherwise would, freeing up more funds for spending. But households hold a record share of stocks in their portfolios, which makes them much more vulnerable to a bear market, something that could happen abruptly and wipe away much of that wealth.

For most Americans, however, housing is their biggest asset, and, like stocks, their values have skyrocketed in recent years. But unlike stocks, home values are not as volatile and provide a more stable source of wealth. At the end of 2024, households had amassed $35 trillion of housing equity, up from $19.5 trillion in less than five years. That far outpaced the rise in total financial assets, including stock and bond holdings. Yet, unlike stocks and bonds, housing equity cannot be easily converted to cash, as a home sale is a lengthy process, and the market is not always receptive to a sale.

Worse, the appreciated property comes at a cost that may be a deterrent to spending. Homeowners, for example, may be subjected to higher property taxes; their appreciated property may disqualify them for college financial aid for their kids; and selling a house could generate a large capital gain tax bill that would eat into the profit. True, an owner could borrow against housing equity if immediate cash was needed, but the cost of a home equity loan might be prohibitive if interest rates are high, and banks might be tightening access to such loans. Indeed, lenders are rejecting refinancing applications at a record rate. Simply put, the wealth effect that helped drive the economy's growth engine over the past three years is not likely to be as potent in 2025.

How Inflationary are Tariffs?

Needless to say, the tariff shock will trigger a one-off rise



in the prices of U.S. goods and in some case services, albeit the pick-up may take place over several months rather than instantaneously. The key question, particularly for the Fed, is whether this large and visible price surge triggers a broader wave of price and wage increases as firms and households seek to insulate themselves from the price shock. The risk of these so-called second round effects will be greater the larger the initial spike in prices.

On this score, we expect tariffs to push the inflation rate to a peak of around 5 percent by the middle of the year, up from the current 3.1 percent, according to the Fed's preferred inflation gauge. That would be a significant leap, but still peaking well below the post-pandemic high of 7.9 percent reached in June 2022. There are three reasons why the expected increase will fall short of the earlier peak. First, an imported product goes through several intermediate stops on the supply chain before it reaches consumers. Each stop will absorb part of the tariff cost so by the time it reaches the consumer the final price increase will be a small percentage of the initial tariff.

Second, while certain goods will be more deeply affected than others, only about 10 percent of the total basket of goods and services that consumers purchase are affected by tariffs. Hence, the impact on the headline inflation rate will be much smaller than the tariff increase. Finally, the sharp drop in the price of oil this year will partially offset the tariff-related price shock. The offset comes from two sources: lower oil prices reduce the cost of shipping goods from overseas and lower prices at the pump will offset some of the impact of tariff-related higher prices on other goods that consumers buy.

Background Will Not Sustain Higher Inflation

The tariff announcements are unfolding in a chaotic fashion, with most of the "liberation day" blitz on April 2 postponed for 90 days. With so much unsettled, it's almost impossible to know what the tariff landscape will look like a few months from now. That said, we expect the universal 10 percent tariff imposed earlier this year will stay on the books, the 145 percent tariffs placed on China will be permanent (although Trump hinted at a reduction on April 23) and the pause on other trading partners will be extended indefinitely. It could get worse if tensions with our trading partners intensify and they impose reciprocal tariffs leading to a tit-for-tat escalation. As it is, the effective tariff rate is poised to reach the highest level since the 1930s.

To be sure, tariffs have the capacity to create lasting inflationary impacts if they coincide with a strong economic backdrop that enables firms to raise prices and encourages workers to demand bigger wage increases. But that's not the case now. The tariff hikes are occurring against a much weaker economic backdrop than was the case when the U.S. and other economies reopened after the pandemic. Consumers are no longer sitting on a mountain of excess savings from enormous stimulus payments that enabled them to accept steep price hikes and sustain consumption during that earlier period. Likewise, the worker shortages that stoked big wage increases then no longer exists, as the labor market is now balanced, and wage gains are slowing.

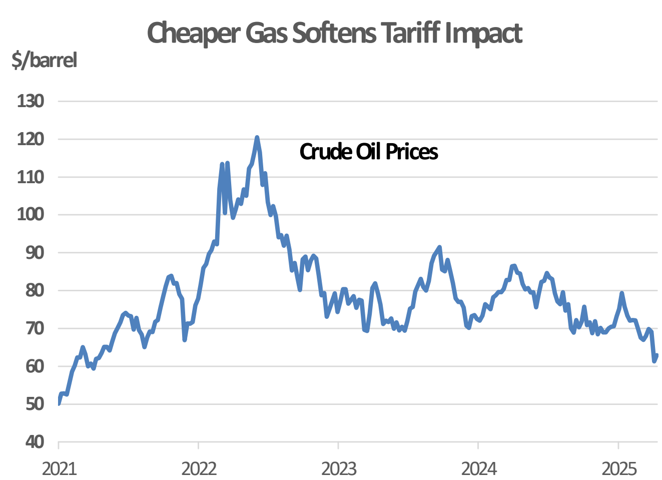
We suspect that the inflation spike will fade soon after hitting a peak in a few months. The front-loading of consumer spending to beat tariffs has almost run its course. Having moved up their purchases that otherwise might occur over the spring and summer will result in a payback and weaker spending over those coming months. Firms too have accelerated their orders from domestic and overseas suppliers to build up inventories before tariffs kick in. Imports at the port of Long Beach were up 26% in March. Those accumulated inventories will boost growth in the first quarter but will be a drag on GDP as they are drawn down in the second quarter. Simply put, the economic backdrop will not be hot enough to support a sustained inflation pickup.

A Fork in the Road

Yogi Berra once famously quipped "when you get to a fork in the road, take it." Such is the dilemma facing the Federal Reserve. The aggressive tariff hikes underway both stifles growth and stokes inflation. The Fed has a dual mandate to pursue maximum employment and stable prices. When those two goals are in tension, it presents a vexing problem for the Fed. For sure, conditions now do not measure up to the extreme stagflation environment that bedeviled policy makers during the 1970s. But the choices facing the Fed are the same, and the risk of a miscalculation is as high.

Unsurprisingly, economists are divided over what the correct choice should be. Some believe that the almost certain slowdown the tariffs will cause requires the Fed to cut rates now to short-circuit a recession. That's clearly the position favored by President Trump, who is already attacking the Fed chairman for moving too slowly and appears ready to blame him if a recession materializes. Others believe that inflation is the more immediate threat, and the risk is that tariff-related price hikes over the near term could inflame inflationary expectations, sowing the seeds of a more enduring inflationary outbreak.

From our lens, the Fed is taking a rational approach to the dilemma it faces. In his recent comments, Chair Powell indicated that the choice will be determined by which target is further away from being reached. With the unemployment rate, at 4.2 percent, hovering close to a level consistent with maximum employment, and inflation well above the Fed's 2 percent target, the odds-on choice is to keep interest rates at the current mildly restrictive level. Simply put, the Fed will likely wait as long as possible to cut rates again, moving only after visible signs of weakening job market conditions emerge. That may change on the dime if the trade wars escalate and delivers a severe shock to the economy. The good news is that as of this writing, President Trump is sending signals that he intends to deescalate the trade war with China, the main adversary in a shape-shifting battle that is unnecessarily disrupting an otherwise healthy economy.



KEY ECONOMIC AND FINANCIAL INDICATORS

Financial Indicators *

								12-Month Range	
	March	February	January	December	November	October	September	High	Low
Prime Rate	7.50	7.50	7.50	7.65	7.81	8.00	8.30	8.50	7.50
3-Month Treasury Bill Rate	4.20	4.22	4.21	4.27	4.42	4.51	4.72	5.25	4.20
5-Year Treasury Note Rate	4.04	4.28	4.43	4.25	4.23	3.91	3.50	4.56	3.50
10-Year Treasury Note Rate	4.28	4.45	4.63	4.39	4.36	4.10	3.72	4.63	3.72
30-Year Treasury Bond Rate	4.60	4.68	4.85	4.58	4.54	4.38	4.04	4.85	4.04
Tax-Exempt Bond Yield	4.30	4.20	4.19	4.04	4.14	3.96	3.83	4.30	3.83
Corporate Bond Yield (AAA)	5.29	5.32	5.46	5.20	5.14	4.95	4.68	5.46	4.68
Conventional 30-Year Mortgage Rate	6.65	6.84	6.96	6.72	6.81	6.43	6.18	7.06	6.18
Dow Jones Industrial average	42092	44209	43524	43656	43717	42494	41491	44209	38401
S&P 500 Index	5684	6039	5980	6011	5930	5792	5621	6039	5112
Dividend Yield (S&P)	1.34	1.24	1.26	1.24	1.23	1.28	1.31	1.39	1.23
P/E Ratio (S&P)	24.0	25.5	27.2	26.5	27.0	26.0	26.3	27.2	24.0
Dollar Exchange Rate (vs. Major Currencies)	126.5	128.1	129.0	127.8	126.5	123.8	122.1	129.0	122.1

* Monthly Averages

Economic Indicators

								12-Month Range	
	March	February	January	December	November	October	September	High	Low
Housing Starts (Thousands of Units)	1324	1494	1361	1526	1305	1344	1355	1526	1262
New Home Sales (Thousands of Units)		676	664	713	676	623	726	736	623
New Home Prices (Thousands of Dollars)		415	427	417	396	426	421	436	396
Retail Sales (% Change Year Ago)	4.6	3.5	4.2	4.4	4.0	3.0	2.0	4.60	2
Industrial Production (% Change Year Ago)	1.3	1.5	1.8	0.5	-0.9	-0.3	-0.7	1.8	-0.9
Operating Rate (% of Capacity)	77.8	78.2	77.7	77.6	76.8	77.1	77.4	78.2	76.8
Inventory Sales Ratio (Months)		1.35	1.36	1.35	1.37	1.37	1.37	1.38	1.35
Real Gross Domestic Product (Annual % Change)				2.4			3.1	3.1	1.6
Unemployment Rate (Percent)	4.2	4.1	4.0	4.1	4.2	4.1	4.1	4.3	3.9
Payroll Employment (Change in Thousands)	228	117	111	323	261	44	240	323	44
Hourly Earnings (% Change Year Ago)	3.8	4.0	4.0	4.0	4.2	4.1	3.9	4.2	3.6
Personal Income (% Change Year Ago)		4.6	4.2	4.9	5.0	5.1	4.8	5.9	4.2
Savings Rate (Percent of Disposable Income)		4.6	4.3	3.3	3.7	4.0	3.8	5.2	3.3
Consumer Credit (Change in Blns. Of Dollars)		-0.8	8.9	-110.0	-5.6	10.9	4.2	17.6	-110.0
Consumer Prices (% Change Year Ago)	2.4	2.8	3.0	2.9	2.7	2.6	2.4	3.4	2.4
CPI Less Food & Energy (% Change Year Ago)	2.8	3.1	3.3	3.2	3.3	3.3	3.3	3.6	2.8
Wholesale Prices (% Change Year Ago)	2.7	3.2	3.7	3.4	2.9	2.7	2.1	3.7	2.1