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Economic Commentary:

Understanding the Impact of Reciprocal Tariffs

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The announcement of the "reciprocal" tariff policy by President Trump is the single biggest negative trade shock since the 1930s. Even before the announcement, consumers were slowing consumption and businesses were shelving capex plans. The reciprocal tariffs will only accelerate these trends. A slowing economy with inflationary pressures that will be exacerbated by the tariffs puts the Federal Reserve in an unenviable position. The following updates feel stale due to the new trade policy, but they do show that we are entering this period of change and adjustment with an economy that was already slowing and inflationary pressures that remain stubbornly elevated.

Inflation, Income & Spending

Despite better-than-expected monthly readings in February on the Consumer Price Index (CPI) (+0.2%) and the Producer Price Index (PPI) (+0.0%), the Fed's preferred measure for inflation, the Core Personal Consumption Expenditure (PCE) index, came in hotter than expected at 0.4% – its highest monthly reading since January 2024. As a result, the year-over-year Core PCE moved up to 2.8% from 2.7% in January. Looking at the last three and six months for the Core PCE, it is up 3.6% and 3.1% respectively (both annualized), indicating continued inflation pressures in the economy, and the full impact of tariffs have not impacted this inflation measure yet. It is likely that tariffs will push the Core PCE above 3.0% on a year-over-year basis in the next few months. The developing weakness in the U.S. dollar only exacerbates the upward inflation pressures.

In February, and for the second month in a row, Real Disposable Personal Income (+0.5%) was greater than Real Personal Consumption Expenditures (+0.1%). As a result, the Personal Savings rate improved to 4.6% from a downwardly revised 4.3% in January. Due to very weak consumer spending in January, real consumer spending in the first two months of the year is -0.5% from the end of 2024. Of note is the fact that real consumer spending on services declined in February for the first time since January 2022. With consumer spending responsible for two-thirds of GDP, first quarter GDP is being revised down. Cracks in this main support of economic growth are starting to appear.

Impact of Tariffs

The tariffs mark the largest tax increase since the Revenue Act of 1968, estimated at approximately 1.3% of GDP. Tariffs are a regressive tax that impacts lower income households the most because a greater percentage of their income is spent on necessities compared to higher income households. Lower income households are already struggling, as shown by elevated delinquency rates on credit cards and auto debt. At the other end of the income scale, spending by higher income households is seeing one of its supports erode with the correction in the stock market.

GDP Growth

There was a slight upward revision to the final estimate of real GDP in the fourth quarter 2024. Of concern, however, is the fact that private domestic investment contracted at a 5.6% annualized rate, largely due to the weakest spending on equipment since third quarter 2021. Weak business equipment spending raises a yellow flag as equipment spending is one of the most sensitive components of GDP to changes in policy. Noteworthy was the fact that corporate profits in the fourth quarter 2024 showed the largest percentage increase since the second quarter of 2022.

Although real GDP for the first quarter of 2025 won't be published until the end of April, estimates for growth have been falling as data through February show that consumer spending is weakening, and the surge of imports since the beginning of the year has caused the trade deficit to grow wider by $24 billion. Much of that increase in the trade deficit was due to efforts by businesses to increase inventories via imports before tariffs were enacted. An increase in the trade deficit is a negative when calculating GDP. Consequently, there is a possibility of a negative reading for first quarter real GDP.

Key Indices

- The **ISM Manufacturing Index** for February showed the impact of tariffs and policy uncertainty by moving back into contraction with a reading of 49.0 after two months of expansion.
- The **New Orders, Production and Employment** sub-indices declined and are in contraction territory.
- The **Prices Paid** sub-index surged to the highest level since June 2022, reflecting the impact of tariffs.
- The **ISM Services Index** showed limited expansion (50.8), falling to a nine-month low as employment moved into contraction (46.2 from 53.9 in February).
- **New Orders** eased to 50.4, a ten-month low.
- When combined, the two **ISM** surveys fell to a nine-month low, indicating slowing economic activity ahead of the tariff announcement.

The Labor Market

The March Employment report showed an increase of 228,000 in non-farm payrolls, which was above expectations, but gains in January and February were revised down by 48,000. The three-month average of payroll gains fell from 184,000 to 152,000. The unemployment rate moved up to 4.2% from 4.1% as the labor force increased by 232,000, but household employment only rose by 201,000. Wages were up 0.3% during the month following a downwardly revised 0.2% in February. That brought the year-over-year growth in wages to 3.8% from 4.0% the previous month. There was little change in most of the other internal employment statistics.

According to the Challenger report, 275,240 were laid off in March – three times the year-ago level – with 79% of the layoffs associated with DOGE plans to eliminate positions in the federal government. Hiring plans in the first quarter were the lowest since 2012, and conditions remain difficult for those looking for work.

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Rate Predictions

The Federal Open Market Committee met on March 18-19 and held the target range for Fed Funds steady between 4.25% and 4.50%, as expected. The tariff announcement has increased concerns about a possible recession this year. Therefore, the Fed must decide between lowering rates to cushion the economy or maintaining (or raising) rates to tame inflation pressures.

Chair Powell spoke after the Employment Report and said that the Fed does not need to be in a hurry to act but acknowledged that the economic impact of the new tariffs is likely to be significantly larger than expected and may lead to higher inflation and slower growth. He said that "while tariffs are highly likely to generate at least a temporary rise in inflation, it is also possible that the effects could be more persistent." He stressed that the Fed will be focused on concerns that inflation pressures may become more entrenched.

Markets appear to be more concerned about a slowing economy than a renewed acceleration in inflation. Ten-year yields have declined 30 basis points since the beginning of March and are now slightly under 4.0%. Expectations for rate cuts are now at nearly four cuts for 2025, with the first cut occurring in June.

The reciprocal tariff policy could take the average effective tariff rate in the U.S. to 22% from 2.3% in 2024. That would be higher than levels reached after the 1930 Smoot-Hawley Act. If this trade policy remains in force, we are embarking on a period with new rules that will slow the global economy and necessitate the development of new strategies and alliances.

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