VIEWPOINT

Northmarq

Economic Commentary:

Is Stagflation on the Horizon?

March 2025

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Last month's commentary concluded by saying that "uncertain" is the most used adjective in describing the economic outlook for the coming year, due to policies by the new administration. Nothing has changed in that regard. The tariffs alone, real and threatened, are causing consumers to slow consumption and businesses to shelve their capex plans. The impact of other policy initiatives on immigration, health care, tax reform and international relations will only become clearer as the year progresses. For now, uncertainty is expected to slow economic activity in the near term, although the degree of slowing remains an open question.

Inflation Trends & Tariff Impacts

Regarding inflation, January's reading of the Personal Consumption Expenditure (PCE) index, coupled with revisions to fourth quarter data, show that inflation is running with a bit more momentum than previously thought. Core PCE for January, the inflation measure followed by the Fed, came in at 0.3%, bringing the year-over-year reading to 2.6%. The Consumer Price Index for January was reported to have risen 0.5%, causing the year-over-year figure to increase from 2.9% to 3.0%. The Fed's inflation target remains 2.0%, but inflation expectations have increased in response to concerns about tariffs. The degree of impact of tariffs on the U.S. consumer will be significantly determined by the strength of the U.S. dollar. Dollar strength will mitigate the impact of tariffs, while a weaker dollar will increase the impact of tariffs.

The second estimate of real GDP in fourth quarter 2024 showed the economy grew at a 2.3% annualized rate, down from the 3.1% reading for third quarter 2024. Real GDP in fourth quarter 2024 was supported by +4.2% annualized consumer spending – the strongest consumer spending since first quarter 2023. Of concern, however, is the fact that private domestic investment contracted at a 5.7% 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. Looking ahead, recent data for January that are included in the GDP calculation have been weaker than expected and have caused estimates for first quarter 2025 GDP growth to be revised lower to less than 1.0%.

Bifurcated Consumer Spending

The January report on Personal Income and Spending showed that Real Disposable Personal Income outpaced Real Personal Consumption Expenditures for only the second time in the past 12 months. Consumer spending in January actually declined for the first time since March 2023. With income greater than spending, the Personal Savings rate improved to 4.6%, its highest level in the past seven months.

Since the consumer accounts for two-thirds of GDP, it's important to understand that consumer spending is as bifurcated as we've seen in at least the last 30 years according to Moody's Analytics. The top 10% of households by income account for nearly 50% of all spending, which is a record amount. The spending by these high-income households is supported by the tight labor market, increases in housing values and the strong stock market. Changes in any of these three supports would likely change the spending patterns of these households.

Lower income households, on the other hand, are showing financial strain by way of increasing serious delinquencies (90 days or more overdue) on credit card and auto loan debt. The imposition of tariffs will particularly impact lower income households.

Manufacturing Trends

The ISM Manufacturing index for February indicated expansion for the second consecutive month with a reading of 50.3, following 50.9 in January, but the impact of tariffs was clearly seen throughout the report. The new orders, production and employment subindices showed significant declines. The pullback in new orders to a four-month low does not bode well for production in the near term. The prices paid sub-index, on the other hand, moved to the highest level since the summer of 2022 – a concern for Fed monetary policy if this persists.

Labor Market Challenges

The February Employment report indicated a continued cooling in the labor market as non-farm payrolls increased by 151,000 following a downwardly revised increase of 125,000 in January. Year-over-year non-farm job growth has been running at less than 1.3% for the past eight months – a level that has been seen at the beginning of every recession since 1980. As job growth eases, productivity must continue to improve in order to maintain economic growth.

The unemployment rate ticked up 0.1% to 4.1% due to a 588,000 decline in the number employed according to the household survey and a drop in the labor force participation rate of 0.2% to 62.4%, which is a two-year low. Federal government payrolls declined by 10,000 – the first signs of the administration's efforts to cut government employment.

Job openings and hirings continue to trend down, meaning that workers have less leverage relative to employers which will continue to moderate wage growth. The number of people working more than one job is at the highest level since April 2009. Job-cut announcements in February were up 103% from last year and were the highest since July 2020 according to the recent Challenger report. Conditions remain difficult for those looking for work, and slower economic growth could lift the unemployment rate. Mass deportations could quickly alter the current supply/demand balance in the labor market and the moderate trend in wage growth. Another risk is the proposed cuts to government employment. In the next three months, 50,000 to 100,000 in headcount reductions are possible.

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Rate Cut Projections & Stagflation Concerns

The next meeting of the Federal Open Market Committee (FOMC) is March 18-19 where they are expected to maintain the current target range for Fed Funds between 4.25% and 4.50%. Several members of the committee have indicated that more time will be required to assess the impact of the administration's policies on inflation and economic growth. If the current trend of soft economic data and elevated inflation continues for a few more months, the Fed may be forced to decide between fighting inflation or supporting the labor market.

Markets are more concerned about a slowing economy than a renewed acceleration in inflation. One month ago, markets were pricing in only one interest rate cut in 2025, which was expected to occur in late summer or early fall. Expectations for rate cuts are now at nearly three cuts for 2025, with the first cut occurring in June. The 10-year Treasury yield is 4.3%, down from 4.8% in mid-January.

The fallout from the ongoing uncertainty regarding policies of the new administration will be slower economic growth in the near term that will likely be the catalyst for the Fed to resume their easing of monetary policy. In the meantime, with slowing economic growth and stubborn inflation, the word "stagflation" is more frequently being used in discussions of the economy – a condition that was last experienced in the U.S. in the 1970s and early 1980s.

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