Economic Update

FIRST QUARTER 2025

APRIL 4, 2025

Quarterly Key Points

- 4Q GDP growth measured 2.4% q/q annualized, bringing 2024 GDP growth to ~2.5% for the year. 1Q GDP growth forecasts vary widely among the estimates we track, ranging from -1.8% to 2.3% q/q annualized.
- The yield curve rallied with the 2-year Treasury decreasing by 36 bps and the 10-year Treasury decreasing by 37 bps, resulting in no change to the shape of the curve. We would characterize the rally in rates as a "flight to quality" rally. With increased volatility and equities resetting lower, investors looking for insurance are happy to buy Treasury yields that are still healthy.
- The FOMC stayed on hold at its meeting in March. Notably, the Fed is slowing the runoff of its balance sheet by reducing the monthly cap on Treasuries. The post-meeting statement highlighted patience in the face of uncertainty. The median dot plot indicates only two cuts in 2025, unchanged from December.
- Inflation remains above the Fed's target, with most measures of inflation bottoming out and perhaps even trending higher since last fall. Short-term inflation expectations have catapulted to ~3.30%. Long-term inflation expectations have increased only slightly with 5-year and 10-year breakeven rates registering 2.63% and 2.37%, respectively.
- The labor market remained healthy despite the general tone of market uncertainty during the quarter. While January and February payrolls were more muted, March saw an overall solid employment report. Manufacturing and business orders weakened following a brief rebound, and services also dipped lower.

Our View

- We entered the new year expecting considerable change and uncertainty. Thus far, the President's policy changes have been wide reaching, and more time is needed to judge the impact. The repricing of risk has been orderly and more muted than we would have expected. However, the market reaction to the tariffs announced in the first few days of the second quarter has been negative. Risks of rising inflation are not yet behind us, especially with the potential risk posed by tariffs.
- Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value when yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

1Q2025 – NEW YEAR BRINGS UNCERTAINTY

The first quarter of 2025 can be summarized with one word: uncertainty. Signing executive orders at a record pace, the returning President is seeking to reform immigration, foreign policy, trade policy, and government spending. With so many moving parts, it is difficult at best to opine on possible outcomes, both short-term and long-term. The Global Economic Policy Uncertainty Index and the Bloomberg Economics Global Trade Policy Uncertainty Index have spiked to the highest levels on record. Market reaction has been negative as well, with measures of implied volatility rapidly increasing and major U.S. equity indexes down 5%-10% for the quarter.

Responding to the uncertainty, the yield curve rallied with the 2-year Treasury decreasing by 36 basis points (bps) and the 10-year Treasury decreasing by 37 bps, resulting in no change to the shape of the curve. The rally in interest rates (yields lower, prices higher) has primarily come from real rates on the long-end of the curve: 10-year real rates are 39 bps lower whereas 10-year breakeven inflation is only higher by 2-3 bps. The short-end of the curve is a different story, however, with 2-year real yields plummeting by 113 bps and 2-year breakeven inflation higher by 77 bps. We would characterize the rally in rates as a "flight to quality" rally. With increased volatility and equities resetting lower, investors looking for insurance are happy to buy Treasury yields that are still healthy.

4Q GDP growth measured 2.4% q/q annualized, bringing 2024 GDP growth to ~2.5% for the year. Personal consumption registered 4.0% q/q annualized, handily beating estimates and signaling consumers remained quite healthy through year-end. 1Q GDP growth forecasts vary widely among the estimates we track, ranging from -1.8% to 2.3% q/q annualized. Importers attempting to front-run tariffs by accelerating shipments are distorting the U.S. trade balance, which in turn will distort measures of GDP, but this will likely reverse over the near term. While it is too soon to tease out the ultimate impact that increased tariffs will have on the economy, the heightened level of uncertainty muddies the outlook. For now, recession probabilities remain relatively low with the median recession probability forecast on Bloomberg at 30%.

FED ON HOLD; GOVERNMENT SPENDING IN FOCUS

The Fed held rates steady at its January policy meeting; given it had already signaled the intent to slow policy easing at the FOMC meeting in December, this was not a surprise. While the Fed did not meet in February, the release of the January FOMC meeting minutes mid-month revealed that voting members were unanimously comfortable being patient with additional policy easing. The impact of trade policy and immigration policy were noted as potential sources of inflation.

As highly anticipated, the FOMC stayed on hold at its meeting in March. Notably, the Fed is slowing the runoff of its balance sheet by reducing the monthly cap on Treasury securities from $25 billion to $5 billion while the Agency MBS monthly cap remains at $35 billion per month. The post-meeting statement highlighted patience in the face of uncertainty. Chair Powell also noted that the labor market remains healthy, citing low unemployment and a relatively low level of firing. As a result, the Fed does not believe labor markets are a source of inflationary pressure

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at present. Goods inflation, on the other hand, is increasing. Powell offered that it is too early to determine what impact tariffs are having on the broader economy. For now, the Fed's base case is for transitory price increases from tariffs. With all that is in play, Powell reinforced that the FOMC "will not be in any hurry to move" on policy rate decisions.

The median dot plot indicates only two cuts in 2025, unchanged from December. Additionally, the median Fed forecasts for 2025 include GDP growth moving down to 1.7% from 2.1%, unemployment moving up to 4.4% from 4.3%, and core inflation moving up to 2.8% from 2.5%. Continued trends of higher unemployment and elevated inflation could conflict with the Fed's dual mandate of price stability and full employment.

The U.S. debt ceiling was reinstated in early January after previously being suspended via the Fiscal Responsibility Act of 2023. Reinstatement set the debt ceiling at the current amount of borrowing, requiring the government to act or face the possibility of running out of funding. By late January, Treasury Secretary Yellen invoked "extraordinary measures" until mid-March to continue paying federal obligations in the absence of additional debt financing. Treasury Secretary Bessent, Yellen's successor, has since extended the extraordinary measures through late June. Current estimates suggest the government will run out of cash sometime between July and October. However, estimates of when this will happen are highly dependent on tax receipts.

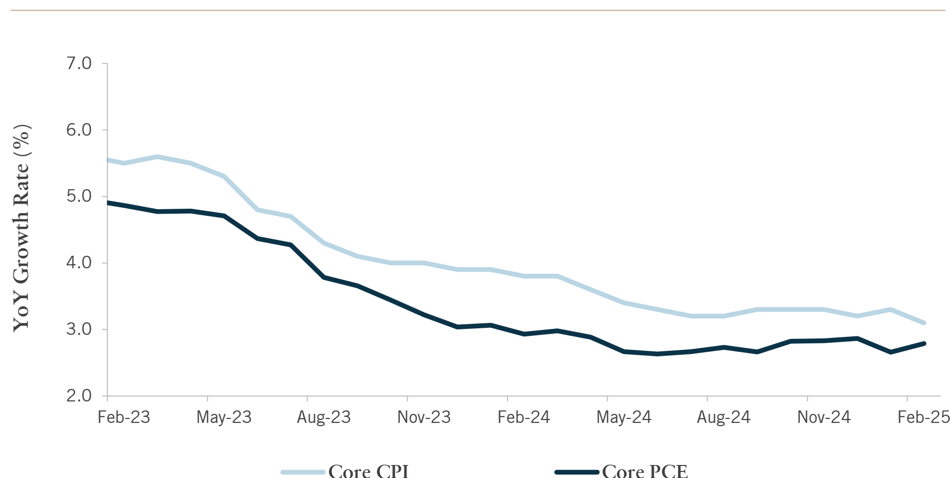
In the fourth quarter, a stopgap continuing resolution was passed that avoided a government shutdown and extended funding until mid-March. More recently, another continuing resolution passed extending funding until the end of September. Meanwhile, the newly created Department of Government Efficiency, or DOGE, tasked with reducing government spending, has been busy cutting costs by eliminating contracts and reducing headcount at government agencies.

INFLATION TRENDS ABOVE TARGET

Inflation remains above the Fed's target, with most measures of inflation bottoming out and perhaps even trending higher since last fall (Figure 1). Headline CPI crept up to 2.9% y/y in December, 3.0% y/y in January, and 2.8% y/y in February. Core CPI increased by 3.2% y/y, 3.3% y/y, and 3.1% y/y in December, January, and February, respectively. On a month-over-month basis, headline CPI jumped to 0.5% January before falling back to 0.2% in February. Core CPI followed a similar pattern, increasing by 0.4% m/m in January and 0.2% in February. On a rolling 3-month average basis, headline CPI has averaged 0.3% in every three-month period since September, whereas core CPI has averaged 0.3%-0.4%. These rolling averages imply an annualized run rate of approximately 2.5% to 3.5%, above the Fed's target range and the measured run rate when the Fed started to ease monetary policy early last fall.

PCE and PPI inflation numbers show a similar sticky pattern. Headline PCE accelerated to 2.5% y/y in November where it has remained for three of the past four months, while core PCE edged up to 2.9% y/y in December before slipping back slightly to 2.8% by February. Measured month-over-month, headline PCE has been 0.3% every month since December, and core PCE increased to 0.4% in February. Headline PPI for final demand increased to 0.5% m/m in December and 0.6% in January before measuring 0.0% in February. Core PPI followed along, measuring 0.4% m/m in December and 0.5% in January before falling by -0.1% in February. On a year-over-year basis, core PPI was 3.4% in February while headline PPI was 3.2%.

FIGURE 1: CORE CPI VS. CORE PCE



Source: Bloomberg.

1Q'25 ECONOMIC UPDATE

Short-term inflation expectations, represented by the 2-year breakeven inflation rate, have catapulted to ~3.30%. Meanwhile, long-term inflation expectations have increased only slightly with 5-year breakeven and 10-year breakeven rates registering 2.63% and 2.37%, respectively. Importantly, the 5-year, 5-year forward breakeven rate remains anchored at 2.19%.

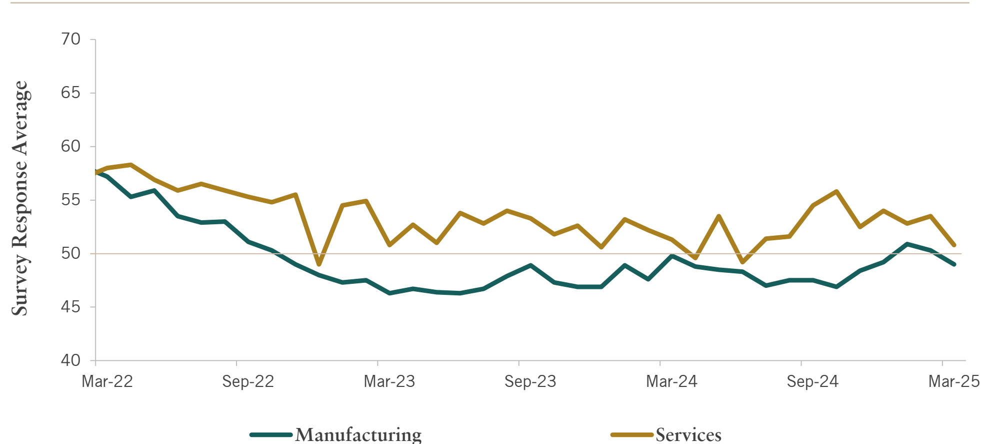
LABOR MARKETS HEALTHY AMID WANING SENTIMENT AND BUSINESS ACTIVITY

The labor market remained healthy despite the general tone of market uncertainty during the quarter. While January and February payrolls were more muted with 111k and 117k jobs added, March saw another 228k jobs added in an overall solid employment report. Looking at the three-month average to smooth out distortion, March measured 152k, reflecting lower revised numbers in January and February. Despite swings in job creation, the unemployment rate has been steady, measuring between 4.0% and 4.2% every month since last May. The most recent reading of 4.2% in March, while higher than the unemployment rate before the Fed started tightening monetary policy, is not cause for alarm just yet.

Although personal income growth was trending lower on a year-over-year basis during the fourth quarter, the trend seems to have reversed this year. Personal income growth measured 0.7% m/m and 4.6% y/y in January and 0.8% m/m and 4.6% y/y in February. Nominal hourly earnings measured 0.4% m/m and 0.2% m/m in January and February, and 3.9% y/y and 4.0% y/y in those months, respectively. Year-over-year real hourly earnings have been positive in every month for the past two years. Despite income and earnings growth, the University of Michigan Consumer Sentiment Index decreased to 57 in March. While this is the lowest reading since the pandemic, consumer sentiment measures have historically provided a weak signal of consumer spending. The personal savings rate slipped below 4.0% during November and December, only to rebound to 4.3% in January and 4.6% in February. Revolving credit has also decreased, consistent with waning consumer confidence, a slowing of personal income and hourly earnings growth rates, slowing job growth, and the expectation of increased unemployment.

Manufacturing and business orders weakened following a brief rebound, and services also dipped lower (Figure 2). The ISM Manufacturing PMI turned contractionary once again after breaking above 50 for the first two months of the year. Business new orders largely followed a similar pattern, measuring 55.1 in January, 48.6 in February, and 45.2 in March with the sharp runup in activity in January potentially reflecting expectations for tariffs. The ISM Services PMI had been strong, measuring 54.0, 52.8, and 53.5 in December, January, and February, respectively. However, the index dipped to only 50.8 in March marking the lowest reading since last June when it briefly turned contractionary. Industrial production has been between 102 and 103 since early 2022, most recently increasing to 104.2 in February. Since reaching a post-covid peak of 81% in 2022, capacity utilization has rebounded slightly from its low point of 76.8% in November to 78.2% in February.

FIGURE 2: ISM MANUFACTURING VS. SERVICES SECTOR



Source: Bloomberg.

30-year fixed mortgage rates, as measured by Freddie Mac, are back down to 6.7% after briefly touching 7% at the end of January. Existing home sales increased just slightly to a 4.3-million-unit annualized pace in February. New home sales volumes have bounced around between 600-700 thousand units annualized for the past several years, most recently measuring 676,000 in February. Existing home supply remains very low at ~3 months. The supply of new homes remains elevated at ~9 months, well above pre-pandemic levels. Despite mortgage rates hovering near decade highs, the S&P Case Shiller home price index continues to grind higher. On the heels of strong monthly gains, the 20-city composite registered home prices increasing 4.7% y/y in January.

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LOOKING AHEAD

We entered the new year expecting considerable change and uncertainty. Thus far, the President's policy changes have been wide reaching, and more time is needed to judge the impact. The repricing of risk has been orderly and more muted than we would have expected. However, the market reaction to the tariffs announced in the first few days of the second quarter has been negative. Risks of rising inflation are not yet behind us, especially with the potential risk posed by tariffs. As consumers and businesses adjust, we believe the risk of an economic downturn is increasing. The direction of monetary policy continues to be highly uncertain, and the Fed may face difficult decisions on the path forward.

Government policy changes at home and abroad will continue to be sources of volatility. Portfolios are fully invested, generally speaking, and we are comfortable with positioning given the market environment. Going forward, we will continue to opportunistically add value when yields and spreads look relatively attractive. However, we continue to be mindful of downside risks and potential headwinds that may impact our portfolio allocation and positioning decisions.

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