MORNINGSTAR

US Economic Pulse: April 2025

The nightmare scenario for tariffs is playing out.

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Morningstar Multi-Asset Research

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Forecast Update

Economic outlook upended by tariffs.

Our Economic Outlook Has Been Upended by Tariffs

US Economy to Get Perilously Close to Recession

Tariff rates have blasted up to levels not seen in a century, which will set in motion a cascade of supply/demand side shocks, all acting to weigh on the rate of economic growth. We've reduced our real gross domestic product growth forecast by 0.7 percentage points in 2025 and 0.9 percentage points in 2026. This is accompanied by some catch-up in 2028 and 2029, but there will be some permanent damage, so the level of real GDP in 2029 is still down by 1.1% compared with our prior forecast.

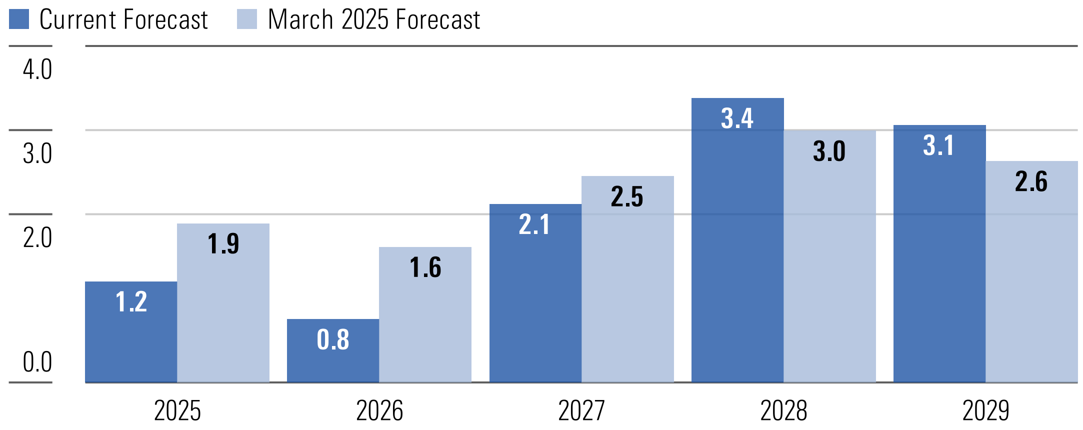
There is plenty of room for uncertainty. Our expected GDP growth rates skirt just above recessionary territory, but we see the probability of a recession at 40%-45%. On the other hand, we could see more of a slow burn, where the deleterious consequences of tariffs for economic efficiency steadily drag on growth for the next 5-10 years.

Inflation[1] to Rise Again on Tariffs

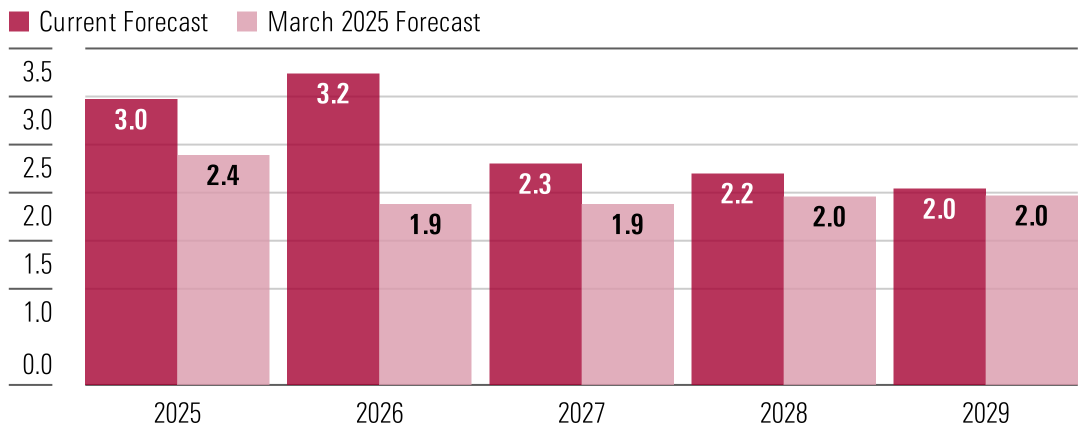
The US had nearly beaten back inflation, which dropped from 6.6% in 2022 to 2.5% in 2024. But tariffs will breathe new life into inflation, starting with goods prices, but likely flowing into the rest of the economy with a lag. Our inflation forecast rises by 0.6 percentage points in 2025 and 1.3 percentage points in 2026. After that, inflation should drop off as the slack created by very weak GDP growth engenders disinflationary pressure.

[1] Our inflation measure is the Personal Consumption Expenditures Price Index, which has several advantages over the Consumer Price Index and is preferred by the Fed.

Real GDP Growth (%) Forecast *Annual Averages*



Inflation (%, PCE) Forecast *Annual Averages*



Tariffs May Be Diluted, but Bulk Will Probably Remain in Place

Once all the tariffs announced on April 2 take effect, we estimate the average US tariff rate will stand at a staggering 25.5%, up 23 percentage points from 2024.

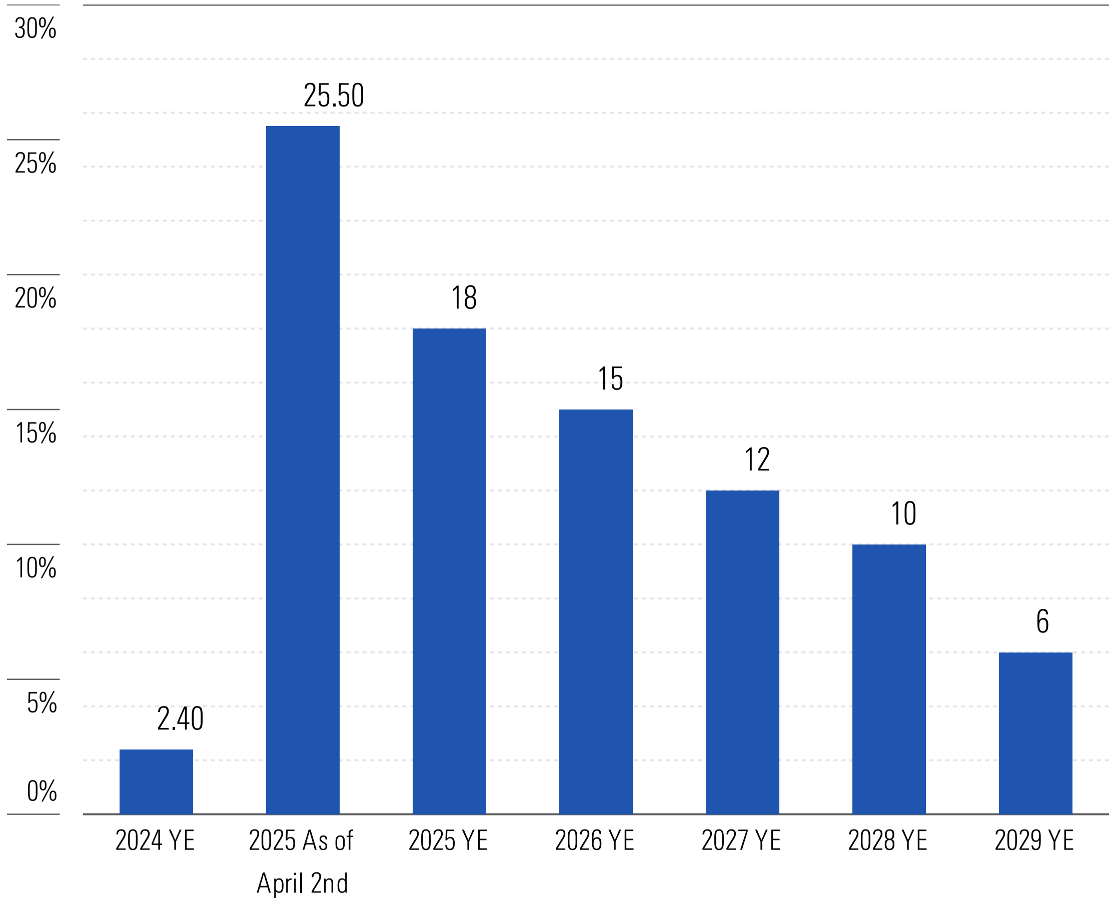
We expect the average tariff rate to still stand at a hefty 18% at the end of 2025. Some exemptions are likely, and the possibility of an about-face from President Donald Trump can't be ruled out. But escalation is also possible, with retaliation following retaliation, as Trump threatens to add another 50% tariff on China.

Previously, we had viewed tariff threats largely as saber-rattling designed to push through ancillary geopolitical goals, as happened during Trump's first administration. The first few months of his second term seemed to conform to this; tariffs were implemented on Canada and Mexico for a few days, but quickly rescinded after he deemed concessions had been made around border security and other issues.

But in his April 2 executive order, Trump's rhetoric was purely mercantilist. He is determined to use tariffs to quash the US trade deficit and revive the country's manufacturing dominance to its historical heights. As he reminded us, he's harbored this vision since the 1980s. In contrast to his first administration, he's now surrounded by personnel who align with this vision.

Thus, we now think high tariffs are here for the long haul. We see tariffs coming down only gradually over several years after the cumulative toll of economic misery (and likely Republican Party election losses) compels a shift in policy.

US-Weighted Average Tariff Rate, %



Tariffs Bring Supply/Demand Shocks

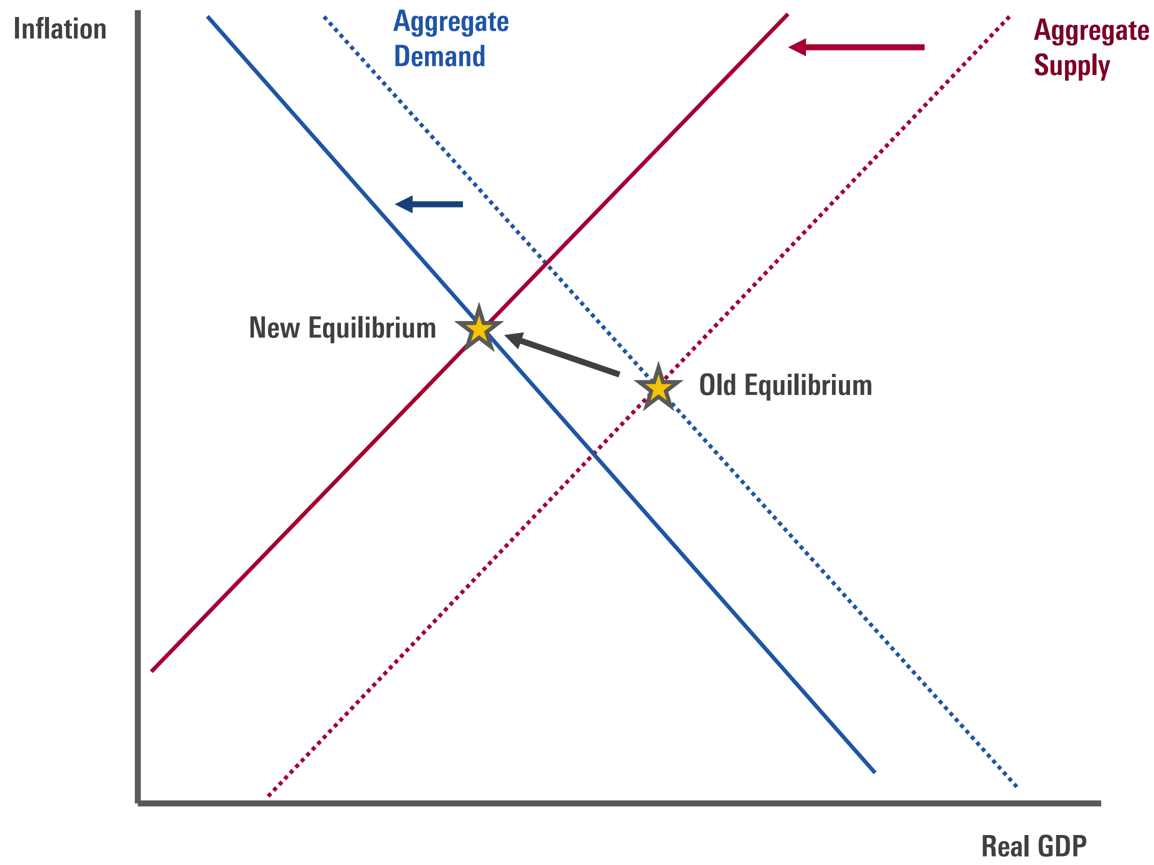
A normal recession is precipitated by an abrupt contraction in aggregate demand—2008 was a classical example. But, like the recent pandemic recession, the tariff surge is associated with a mix of demand and supply-side shocks.

The direct impact of the tariffs is a supply-side shock, representing the hit to economic efficiency from curtailing foreign trade. In general, deviating from the free-market equilibrium diminishes the productive capacity of the economy. But unlike the pandemic shock (when people could eventually return to work), this hit to the supply side is permanent if the tariffs aren't rescinded. There's no scope for countercyclical policy (fiscal or monetary) to offset the impact of a permanent supply-side shock.

Aggregate demand will also contract. Partly, this is because the tariffs represent a large tax increase, hitting private sector incomes, unless the tariff revenue is totally recycled into new tax cuts and government spending. Perhaps the bigger demand-side factor, though, is the surge in uncertainty and associated deterioration in financial conditions, which could lead to firms and households cutting back on spending.

Uncertainty also exacerbates the supply-side contraction—the lack of clarity around the permanence of tariffs makes it hard for businesses to adapt to the new regime. Because of this, we may see little domestic supply response to make up for lower foreign imports. Altogether, we expect the supply shocks to dominate, making the tariffs moderately inflationary over the next couple of years. Both demand shocks and supply shocks will act in concert to reduce real GDP.

Supply/Demand Shocks from Tariffs (Illustrative Diagram)



Source: Morningstar.

The Worst-Case Tariff Hikes Would Erase Nearly a Century of Trade Opening

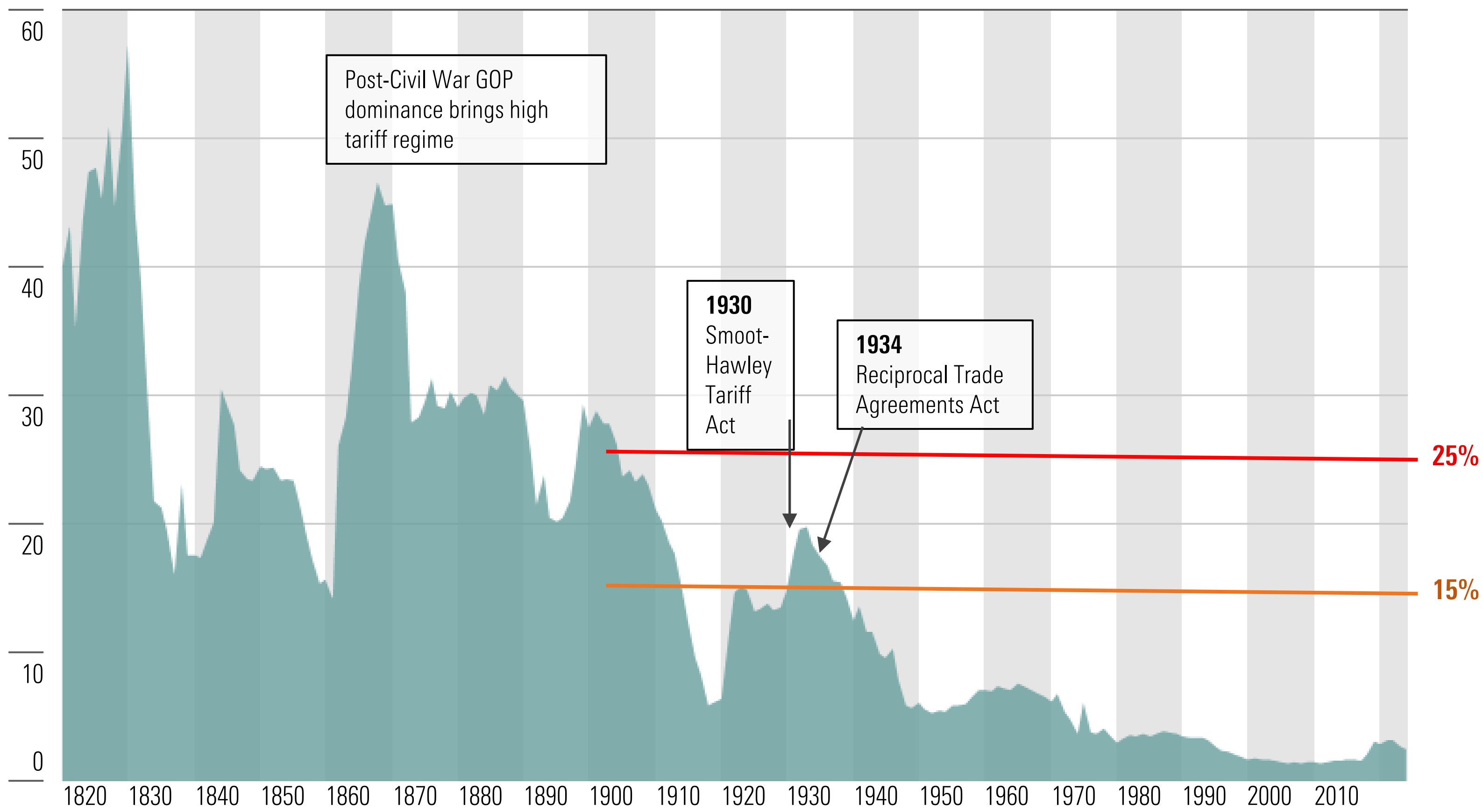
Low tariff rates have been the standard for the US and most other major economies since the end of World War II. The average US tariff rate[1] was about 2.5% in 2024, up only modestly from 1.7% in 2016 owing to the tariff hikes implemented in 2018-19.

With all of the tariffs announced on April 2, the average US tariff rate will explode up to 25%, the highest since 1905. Even our projected end-2026 tariff rate of 15% is the highest since the 1930s. But the US and global economy are vastly more interconnected than in that bygone era. US imports as a share of GDP averaged 3.7% in the 1930s, but stood at 14% in 2024.

[2] The "average tariff rate" (total tariff revenue divided by total imports) is not a perfect measure of trade restrictiveness. To illustrate, imagine that Country A and Country B each account for half of the home country's imports, with tariffs initially at 0%. The home country then levies a 200% tariff on Country B, making imports from them prohibitively expensive. Imports from Country B cease, so the average tariff rate stays at zero (the rate applied to Country A).

US Average Tariff Rate, %

Customs duties/total imports of goods.



Source: Bureau of Economic Analysis, US Census Bureau, Morningstar.

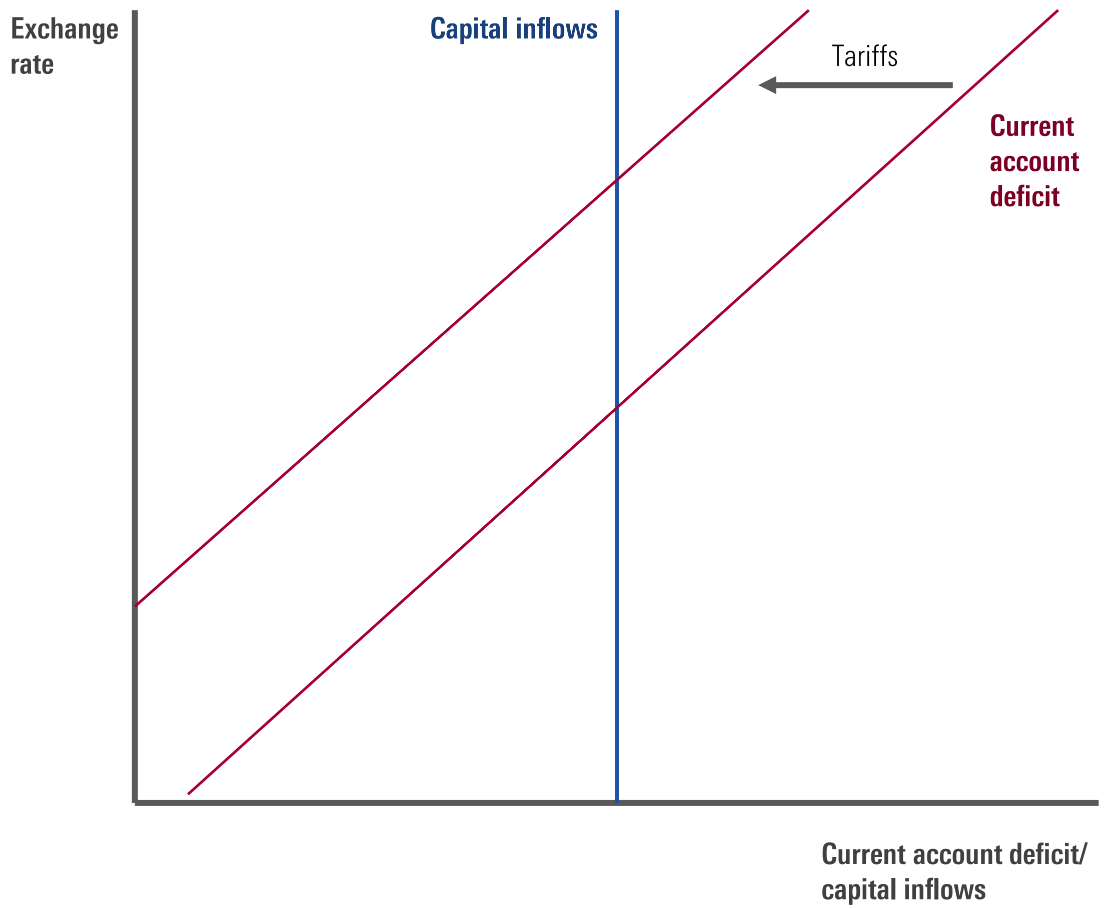
Why It's Unlikely Tariffs Would Reduce the Trade Deficit

In part, Trump's agitation with tariffs stems partly from a long-standing grievance against the US current account deficit.[3] However, the direct impact of tariffs is extremely unlikely to make a dent in that deficit. This may seem counterintuitive, but it's a logical consequence of a basic accounting identity: The current account deficit equals the net inflow of capital. This is not merely a theory, but an accounting identity that holds with certitude.

If the flow of capital is inelastic with respect to the exchange rate (conveyed by the verticality of the line in the diagram), then an increase in tariffs cannot improve the current account deficit. The foreign-exchange market reaches a new equilibrium via exchange-rate appreciation. This appreciation mitigates the tariff hit to imports and causes exports to fall to the exact degree required to leave the current account balance unchanged. Also, to the extent that foreign countries retaliate with higher tariffs of their own, this impairs exports and reduces the need for exchange rates to adjust.

The only assumption we've made is the inelasticity of capital inflows with respect to the exchange rate. It's true that capital inflows should adjust to expectations of future exchange-rate changes, but there's little strong reason for inflows to shift in response to a one-time exchange-rate appreciation. Thus, the standard economic view is that capital inflows would be essentially unchanged in this scenario.

Illustrative Equilibrium in the Current Account Balance



[3] The current account balance equals the trade balance plus the balance on international investment income and various other international transfers. The trade balance is by far the largest component.

Source: Morningstar.

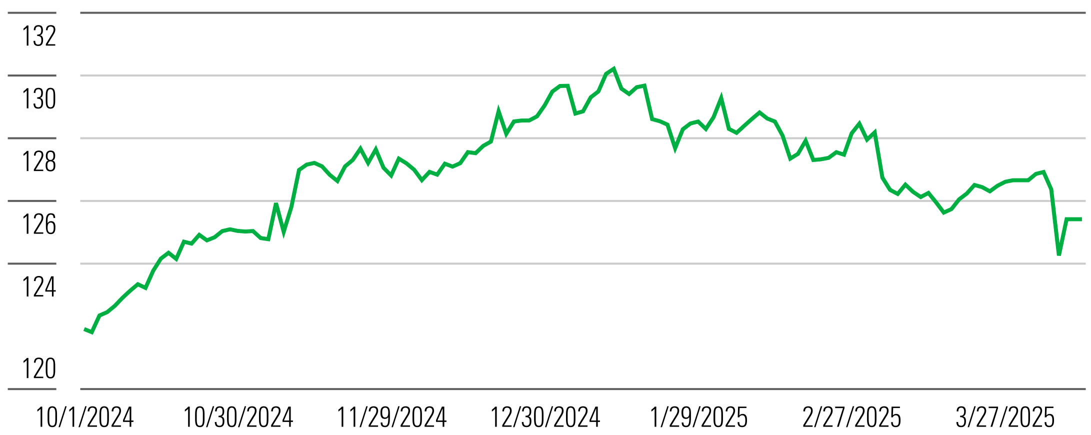
Foreign Capital Flows and Fiscal Policy Will Mediate Economic Consequences of Tariffs

Exchange-rate appreciation would mitigate the inflationary ramifications of the tariffs. On the previous slide, we suggested that economic theory would suggest a large appreciation would be a likely outcome. Yet the US dollar hasn't appreciated at all since the announcement and is down around 3% year to date. Partly, this could be because markets are anticipating retaliation from US trading partners. But retaliation against the US tariffs is unlikely to be measure-for-measure, so the lack of exchange-rate appreciation is something of a puzzle.

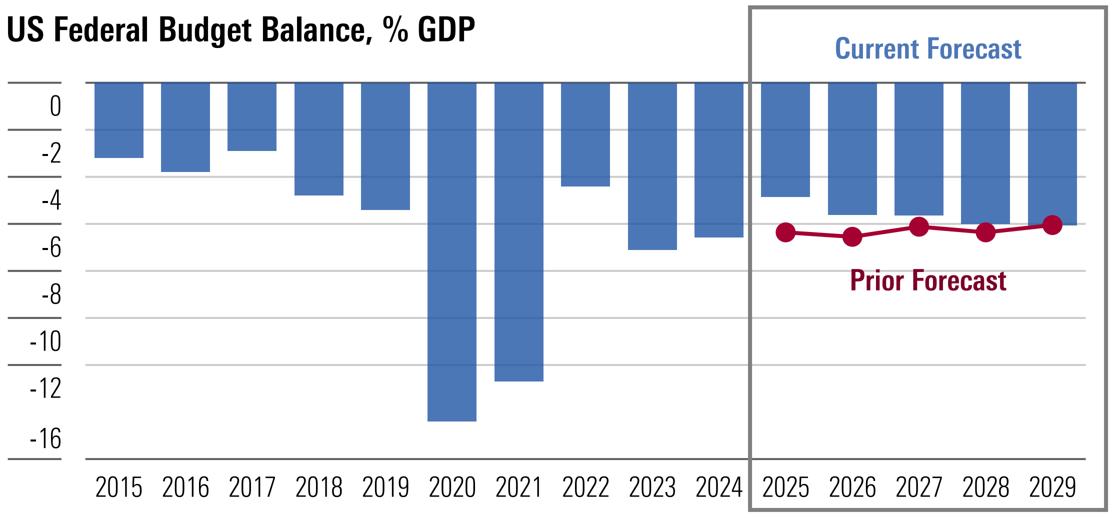
It's possible the tariff chaos is degrading confidence in US markets, stemming the flow of capital into the US. Ironically, such a contraction in capital flows could achieve Trump's goal of making a dent in the trade deficit, albeit not via the intended route. While a measured reduction in capital flows into the US could represent a healthy rebalancing of the global economy, a panic could lead to a sudden stop, with calamitous consequences.

Fiscal policy can't fix the supply-side shock from the tariffs, but it can cushion the demand-side shock. The tariff revenue in 2025 will amount to a fiscal contraction (a reduction in the budget deficit) of around 1.8% of GDP, by our estimates. Given uncertainty around the tariffs' permanence, we doubt Congress will fully pass on the tariff revenue to new tax cuts and spending. Thus, our expectation is for the federal deficit in 2025 to be reduced by 1.5% of GDP compared with our prior forecast. More generous fiscal policy would better prop up near-term GDP growth, albeit at the cost of higher inflation.

US Dollar Index (Federal Reserve Nominal Broad)



US Federal Budget Balance, % GDP



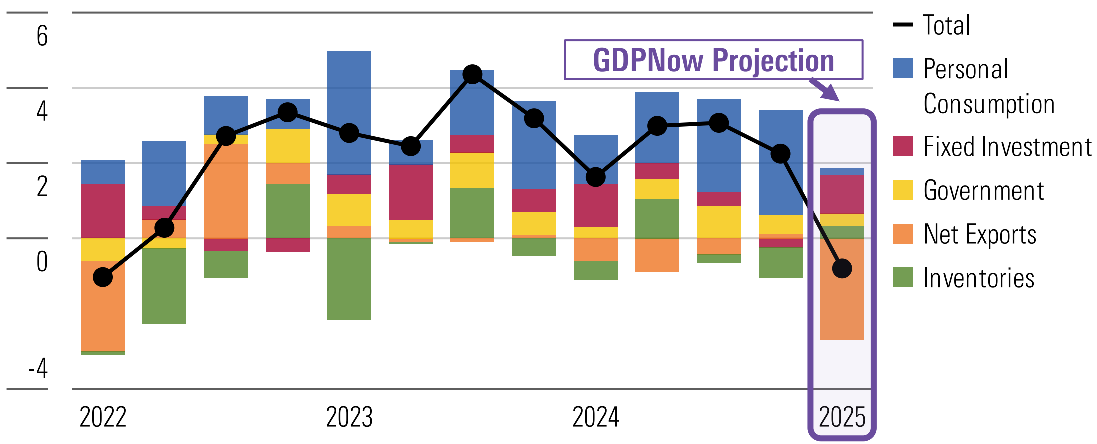
Activity Data: Recession Isn't Here, but Growth Is Probably Trending Down

GDPNow's Projected First-Quarter Decline Reflects Measurement Error

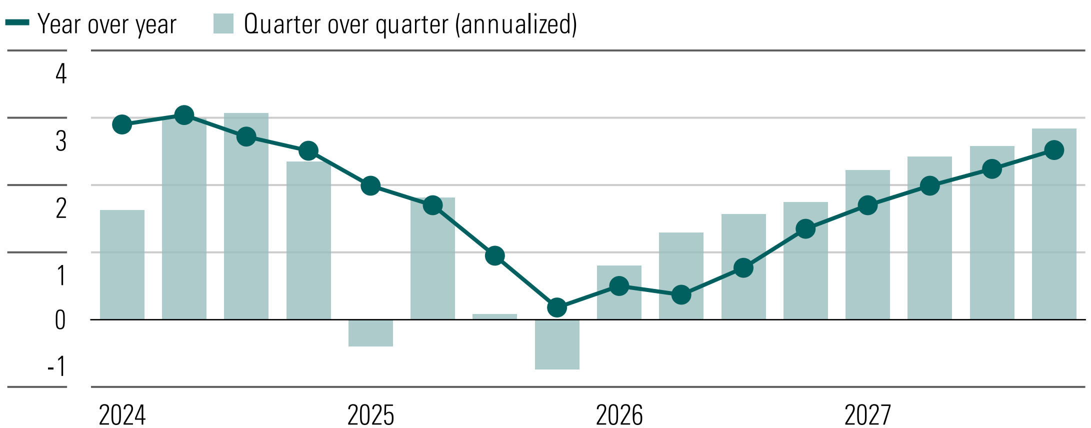
The Federal Reserve Bank of Atlanta's GDPNow currently projects a 0.8% decline in real GDP in the first quarter of 2025 (quarter over quarter, annualized). But, while there are signs of slowing growth, this is not yet the beginning of a recession. The cause of the large negative figure is a surge in imports (subtracting from net exports) as companies race to stock up on imported goods before tariffs hit. In principle, that should be fully offset by an increase in inventories and other expenditures accounting for the use of the imported goods. The offsetting impact isn't yet showing up owing to measurement error, but it eventually will, either via revisions to the first-quarter estimate or a rebound in the second quarter.

Still, real consumption growth is likely to slow to around 0.5% in the first quarter. Even prior to the tariffs, we had cited consumer exhaustion and other factors as likely to provoke a growth slowdown in 2025. Now with the tariffs, we're expecting the US economy to dance on the edge of recession. We project real GDP growth in year-over-year terms to reach a nadir sometime between fourth-quarter 2025 and second-quarter 2026, at around 0%-0.5%. A negative year-over-year reading for real GDP growth would be unambiguously a recession, in our view.

Real GDP by Expenditure, % Quarter-Over-Quarter Growth (Annualized)



GDP Growth, % Quarterly Forecast



Financial: Further Fed Rate Cuts Still to Come

We Expect More Cuts Than the Market Does

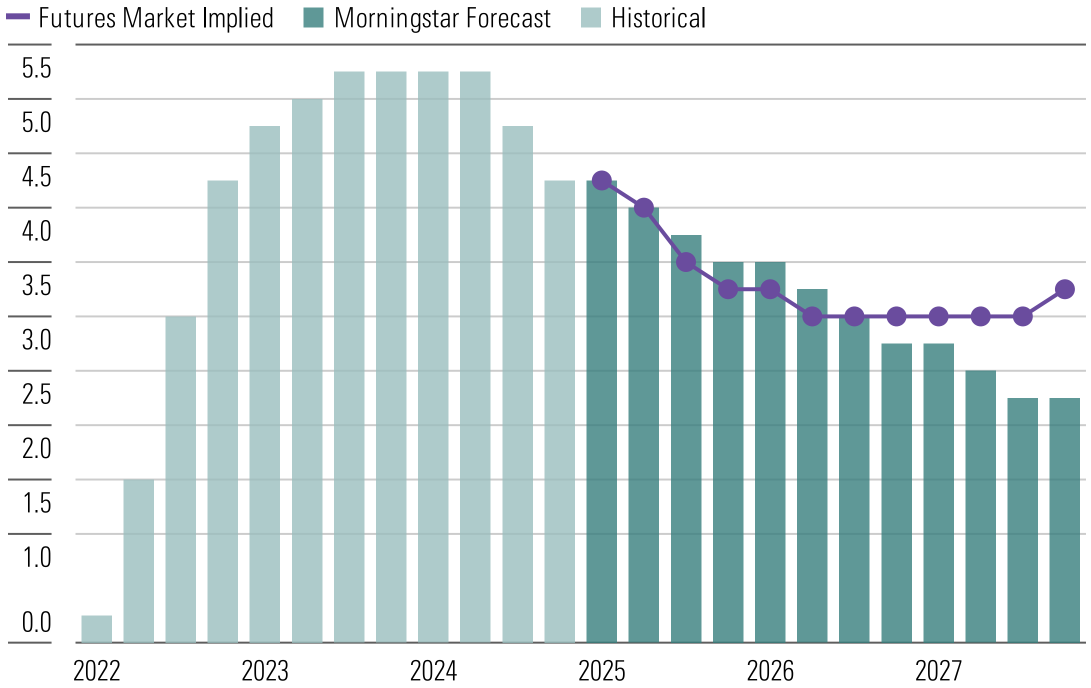
The federal-funds rate has been maintained in the target range of 4.25%-4.50% since last December. The Federal Reserve cut it by 1 percentage point over September to December 2024. That followed a period with rates at 5.25%-5.50% from July 2023 to September 2024, which, having risen from nearly 0% during the pandemic, constituted the largest rate hike in over 40 years. Even with the downward adjustment last autumn, current rates are still well above the prepandemic (2017-19) average federal-funds rate of 1.7%.

The Fed has plenty of room to cut further and the threat of a recession would seemingly present an easy choice. Still, unlike a typical recession, the mixture of demand and (potentially permanent) supply-side shocks puts the Fed in a bit of a bind. We expect inflation to rise again and remain significantly above the Fed's 2% target in 2025 and 2026. If inflationary momentum becomes entrenched (also known as "unanchored inflation expectations"), then the tariff shock is not just a one-time hit to inflation, but would require some stringency from the Fed to push inflation back to 2%.

Given drastically slowing growth and the recession risk, on balance we expect the Fed to move cautiously, but ultimately push the federal-funds rates down to 3.50%-3.75% at end-2025 (three cuts), 2.75%-3.00% at end-2026 (three cuts), and 2.25%-2.50% at end-2027 (two cuts).

Federal-Funds Rate Expectations, %

Bottom of Target Range



(%) Annual Average	2025	2026	2027	2028	2029
Federal-Funds Rate	4.20	3.35	2.67	2.38	2.38
10-Year Treasury	4.10	3.50	3.25	3.25	3.25
30-Year Mortgage	6.35	5.50	5.00	5.00	5.00

Source: Chicago Mercantile Exchange, Morningstar.

Labor Market: Slowing GDP Growth Likely to Drag on Job Growth Later in 2025

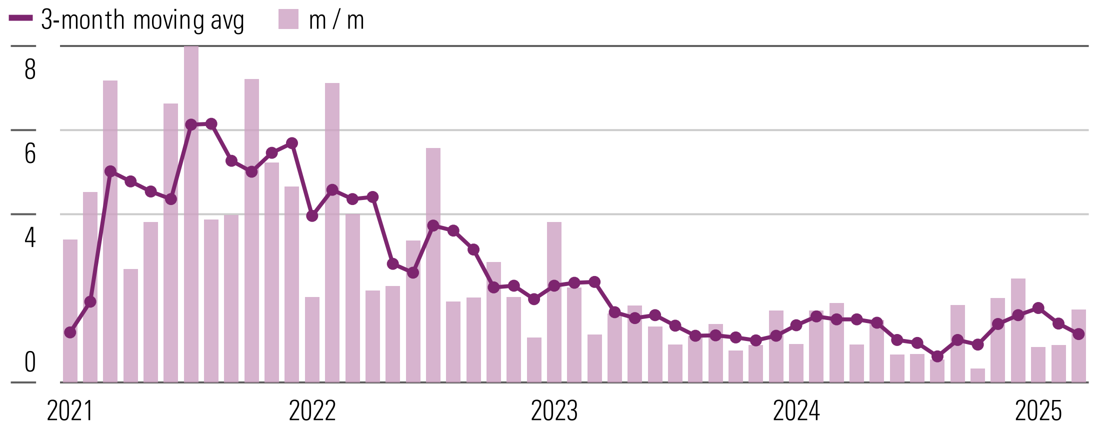
Labor Market Is Still in Calm Before the Storm

Nonfarm payroll employment grew at a 1.2% annualized pace in the three months ended February 2025, slipping slightly from 1.8% as of January, but still a solid result. In year-over-year terms, employment growth stood at 1.2%, about where it's been since mid-2024. For comparison, employment growth averaged 1.5% in the prepandemic period of 2017-19. The unemployment rate has been steady in the last several months at around 4.1%, following a climb over the year through August 2024.

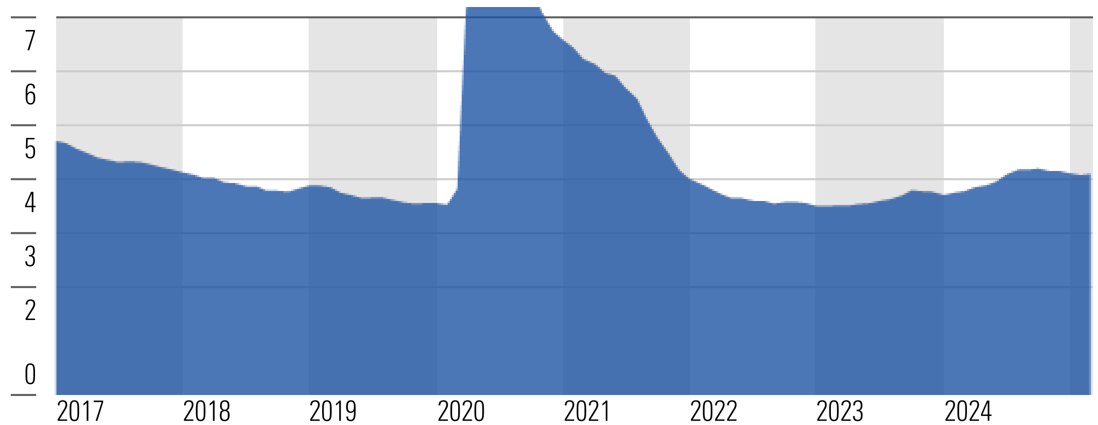
The Bureau of Labor Statistics' surveys likely have yet to register all of the impact of federal government layoffs. Federal employment decreased by a combined 15,000 in February and March, whereas the total number of announced cuts have been tallied at nearly 300,000. It's possible that the legal limbo associated with many of these cuts is preventing them from registering in the official figures, for now.

We expect unemployment to rise from an average 4.0% in 2024 to 4.4% in 2025 and 4.8% in 2026. This is consistent with our expected GDP growth slowdown and high recession probability.

Nonfarm Payroll Employment, % Growth (Annualized)



Unemployment Rate, % Three-Month Moving Average



Appendix

Morningstar - US Economics Dashboard

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025 E	2026 E	2027 E	2028 E	2029 E	CAGR: 2014-19	CAGR: 2019-24	CAGR: 2024-29
U.S. Real GDP by Expenditure (% Growth)																					
Personal Consumption	1.4%	1.7%	2.8%	3.4%	2.5%	2.6%	2.7%	2.1%	-2.5%	8.8%	3.0%	2.5%	2.8%	1.6%	0.7%	1.7%	2.9%	2.7%	2.7%	2.9%	1.9%
Residential Investment	13.0%	12.7%	4.3%	10.6%	7.1%	4.3%	-0.7%	-0.9%	7.7%	10.9%	-8.6%	-8.3%	4.2%	-6.9%	-0.1%	4.7%	9.2%	7.9%	4.0%	0.9%	2.8%
Business Investment	10.6%	6.2%	7.0%	5.0%	-2.1%	4.5%	7.6%	4.3%	-7.9%	7.6%	10.5%	3.2%	3.7%	0.8%	-1.3%	3.5%	5.7%	4.9%	3.8%	3.2%	2.7%
Government Spending	-2.1%	-2.4%	-0.9%	2.0%	2.0%	0.6%	2.0%	3.9%	3.4%	-0.3%	-1.1%	3.9%	3.4%	1.0%	0.8%	1.2%	1.4%	1.4%	2.1%	1.8%	1.2%
Exports	4.0%	3.0%	3.9%	0.3%	0.5%	4.1%	2.9%	0.5%	-13.1%	6.5%	7.5%	2.8%	3.2%	-3.0%	-5.0%	-3.0%	1.0%	1.0%	1.6%	1.1%	-1.8%
Imports	2.4%	1.2%	5.2%	5.2%	1.5%	4.7%	4.0%	1.2%	-9.0%	14.7%	8.6%	-1.2%	5.4%	-3.0%	-6.0%	-3.0%	0.5%	0.5%	3.3%	3.4%	-2.2%
GDP Growth %	**2.3%**	**2.1%**	**2.5%**	**2.9%**	**1.8%**	**2.5%**	**3.0%**	**2.6%**	**-2.2%**	**6.1%**	**2.5%**	**2.9%**	**2.8%**	**1.2%**	**0.7%**	**2.1%**	**3.4%**	**3.1%**	**2.6%**	**2.4%**	**2.1%**
Nominal GDP - $ Trillion	**16.3**	**16.9**	**17.6**	**18.3**	**18.8**	**19.6**	**20.7**	**21.5**	**21.4**	**23.7**	**26.0**	**27.7**	**29.2**	**30.3**	**31.4**	**32.7**	**34.5**	**36.2**	**4.1%**	**6.3%**	**4.4%**
% Growth	4.2%	3.9%	4.3%	3.9%	2.8%	4.3%	5.3%	4.3%	-0.9%	10.9%	9.8%	6.6%	5.3%	3.9%	3.5%	4.2%	5.5%	5.0%			
Inflation (% Growth)																					
GDP Deflator	1.9%	1.7%	1.7%	0.9%	1.0%	1.8%	2.3%	1.7%	1.3%	4.6%	7.1%	3.6%	2.4%	2.7%	2.7%	2.0%	2.0%	1.9%	1.5%	3.8%	2.3%
PCE	1.9%	1.3%	1.4%	0.2%	1.0%	1.7%	2.0%	1.4%	1.1%	4.1%	6.6%	3.8%	2.5%	3.0%	3.2%	2.3%	2.2%	2.0%	1.3%	3.6%	2.5%
PCE - Core	1.9%	1.5%	1.5%	1.2%	1.6%	1.6%	1.9%	1.6%	1.3%	3.6%	5.4%	4.1%	2.8%	3.4%	3.5%	2.3%	2.2%	2.2%	1.6%	3.4%	2.7%
Labor Market																					
Unemployment Rate (%)	8.1%	7.4%	6.2%	5.3%	4.9%	4.4%	3.9%	3.7%	8.1%	5.3%	3.6%	3.6%	4.0%	4.4%	4.8%	4.4%	3.9%	3.5%			
Labor Force Participation (%)	63.7%	63.2%	62.9%	62.7%	62.8%	62.9%	62.9%	63.1%	61.7%	61.7%	62.2%	62.6%	62.6%	62.7%	62.7%	62.7%	62.7%	62.7%			
LFP % - Prime Age	81.4%	81.0%	80.9%	80.9%	81.3%	81.7%	82.1%	82.5%	81.4%	81.6%	82.4%	83.3%	83.4%	83.3%	83.5%	83.7%	83.8%	84.0%			
Supply Side (% Growth)																					
Total Hours Worked	1.9%	1.3%	2.0%	2.1%	1.2%	1.2%	1.9%	1.0%	-6.5%	4.4%	3.2%	1.4%	1.0%	0.8%	0.1%	1.0%	1.2%	1.4%	1.5%	0.5%	0.9%
Labor Productivity	0.4%	0.8%	0.6%	0.8%	0.6%	1.3%	1.1%	1.5%	4.7%	1.6%	-0.6%	1.5%	1.8%	0.4%	0.6%	1.1%	2.2%	1.7%	1.1%	1.8%	1.2%
Output Gap (% Potent. GDP)	**-5.1%**	**-4.9%**	**-4.3%**	**-3.6%**	**-3.8%**	**-2.9%**	**-2.0%**	**-1.8%**	**-4.9%**	**-0.8%**	**-1.2%**	**-1.1%**	**-0.4%**	**-1.9%**	**-2.5%**	**-2.2%**	**-0.9%**	**0.0%**			
Other																					
Govt Budget Balance (% GDP)	-9.3%	-5.9%	-5.2%	-4.6%	-5.4%	-4.4%	-6.1%	-6.7%	-15.0%	-11.8%	-3.7%	-7.6%	-7.6%	-6.1%	-6.9%	-6.9%	-7.3%	-7.4%			
Net Exports (% GDP)	-3.4%	-2.8%	-2.9%	-2.9%	-2.7%	-2.8%	-2.9%	-2.7%	-2.9%	-3.6%	-3.7%	-2.9%	-3.1%	-3.1%	-2.9%	-2.9%	-2.8%	-2.8%			
Market (Year Avg)																					
Fed Funds Rate	0.14%	0.11%	0.09%	0.13%	0.40%	1.00%	1.83%	2.16%	0.38%	0.08%	1.68%	5.02%	5.14%	4.18%	3.35%	2.67%	2.38%	2.38%			
10-Year Treasury Yield	1.80%	2.35%	2.54%	2.14%	1.84%	2.33%	2.91%	2.14%	0.89%	1.44%	2.95%	3.96%	4.21%	4.10%	3.60%	3.25%	3.25%	3.25%			

Source: Bureau of Economic Analysis, Morningstar.

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