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U.S. ECONOMIC & INTEREST RATE OUTLOOK

IN THIS ISSUE

- **Path Dependent**

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Whenever political questions arise, we always encourage a broader view: politicians don't control the economy, and policy changes rarely move markets. But the past month has raised serious questions over that assertion.

Rapid and unpredictable tariff actions have chilled investor sentiment and distorted import activity. Changes in tariffs' timing and scope have complicated efforts to model their costs and benefits. More pronouncements lie ahead as trade investigations proceed. Many thought the Administration would use tariffs as a bargaining tool, but demands have been vague, and negotiations have lacked substance.

The White House feels that trade realignment will eventually yield benefits to domestic employment, productivity and resiliency, but these outcomes will take time to manifest. In the near term, we have lowered our expectations for growth and raised our expectations for inflation. Monetary policy will proceed cautiously as long as an inflationary acceleration remains a possible outcome.

Following are our thoughts on recent data and developments.

Key Economic Indicators

	2024	2025				2026				Q4 to Q4 change			Annual change		
	24:4a	25:1f	25:2f	25:3f	25:4f	26:1f	26:2f	26:3f	26:4f	2024a	2025f	2026f	2024a	2025f	2026f
Real Gross Domestic Product (% change, SAAR)	2.3	1.7	1.9	1.6	1.7	1.6	1.8	1.9	2.1	2.5	1.7	1.9	2.8	2.1	1.7
Consumer Price Index (% change, annualized)	3.1	3.1	3.0	2.9	2.9	2.8	2.8	2.7	2.7	2.7	3.0	2.7	3.0	2.8	2.8
Civilian Unemployment Rate (%, average)	4.1	4.2	4.3	4.3	4.2	4.2	4.2	4.1	4.1				3.6*	4.0*	4.3*
Federal Funds Rate	4.69	4.38	4.38	4.34	4.13	4.13	3.88	3.88	3.63				5.19*	4.31*	3.88*
2-yr. Treasury Note	4.15	4.29	4.42	4.36	4.30	4.27	4.08	4.06	4.03				4.37*	4.34*	4.11*
10-yr. Treasury Note	4.28	4.60	4.60	4.60	4.60	4.60	4.60	4.60	4.60				4.21*	4.60*	4.60*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The consumer price index (CPI) for February showed prices rose 2.8% over the past year, or 3.1% excluding food and energy. Volatile components like airfare and vehicle prices eased. No categories showed a noteworthy increase; tariff effects were not yet evident. The worrying rise in January's CPI reading was likely attributable to residual seasonality, though the prospects for further declines are limited. The price index on personal consumption expenditures gained 2.5% over the year ending in January. Getting all the way to the 2.0% target this year will be a challenge.
- The U.S. labor market remains resilient. In February, 151,000 jobs were created, though a softer household survey pushed the unemployment rate up by one tenth to

4.1%. Staff reductions in the federal government may take time to manifest as legal challenges are sorted, while other civil servants who agreed to a buyout will still be considered employed through September. Spillover to the private sector may come through slower consulting engagements and cooling in sectors most reliant on federal funding, like healthcare and higher education.

- At their March meeting, the Federal Open Market Committee (FOMC) held rates steady, accompanying their decision with cautious guidance. The quarterly Summary of Economic Projections showed the median FOMC member expects slower growth and higher inflation through 2026. Chair Powell acknowledged uncertainty across several policy domains (trade, immigration, fiscal policy and regulation), supporting a patient stance. We anticipate one cut later this year, and two to follow in 2026.
    - After running down by over $2 trillion in the past three years, the FOMC substantially reduced the pace of decline in its portfolio of U.S. Treasuries and mortgage-backed securities. The reimposition of the debt ceiling has put a constraint on Treasury liquidity.
- The outlook for longer-duration interest rates is unclear, as they can reflect countervailing market expectations. Slower growth prospects are weighing on yields, as is the prospect of tamer inflation that could accompany a downturn, if demand is sapped. However, tariffs and supply chain realignment could prove inflationary. An imbalanced reconciliation package raises the risk of a bond market reaction that raises yields.
- Our forecast of gross domestic product (GDP) has been revised down. A review of its components tells the story: a surge in imports to start the year, ordered ahead of new tariffs, has set expectations of a wide trade deficit weighing on GDP. Stocking those imported goods into inventories will offer some upside, but not for long. Business investment will slow amid uncertainty, and a cooling labor market may diminish consumer resiliency. After two years of exceeding expectations, the years ahead may underwhelm.
- As sentiment has softened, we are more frequently asked if we expect a recession. The answer is still no. The economy grew above potential in recent years, and a downshift is normal. Slower growth is still growth. However, consideration of alternative outcomes is more important than ever. Our forecast assumes actual tariffs do not reach their maximum threatened level and will eventually be partially rescinded. As the scope, duration and severity of tariffs rise, the dampening effects will increase the probability of a contraction.

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