U.S. ECONOMIC & INTEREST RATE OUTLOOK

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- **Pre-Season Prospects**

Global Economic Research
50 South La Salle Street
Chicago, Illinois 60603
northerntrust.com

Carl R. Tannenbaum
Chief Economist
312-557-8820
ct92@ntrs.com
@NT_CTannenbaum

Ryan James Boyle
Chief U.S. Economist
312-444-3843
rjb13@ntrs.com

Vaibhav Tandon
Chief International Economist
630-276-2498
vt141@ntrs.com

If you follow sports for any length of time, you will experience a fair share of disappointments. After a poor season, the excitement starts in a franchise's front office: turnovers in coaching, player trades and draft positions can put the team on a new trajectory. Hope once again springs eternal.

Unlike a team in need of a rebuilding year, the U.S. economy did not disappoint in 2024. Economic activity was robust, job creation proceeded and inflation fell. Investors saw asset appreciation, while workers' wage gains exceeded inflation. Momentum was strong as 2025 began; the stage is set for the nation's winning streak to continue.

Washington is in the midst of a change in leadership. The new administration will prioritize an agenda of domestic growth and deregulation, adding to momentum. Changes to immigration and trade policies may raise risks to the goal of taming inflation. These elements reinforce our expectation of a more cautious monetary policy posture.

Following are our thoughts on recent data and developments.

Key Economic Indicators

	2024				2025				Q4 to Q4 change			Annual change		
	24:1a	24:2a	24:3a	24:4f	25:1f	25:2f	25:3f	25:4f	2023a	2024f	2025f	2023a	2024f	2025f
Real Gross Domestic Product (% change, SAAR)	1.6	3.0	3.1	2.9	2.1	1.9	2.0	2.1	3.2	2.6	2.0	2.9	2.8	2.3
Consumer Price Index (% change, annualized)	3.8	2.8	1.2	2.4	2.6	2.6	2.7	2.7	3.2	2.6	2.6	4.1	2.9	2.4
Civilian Unemployment Rate (%, average)	3.8	4.0	4.2	4.2	4.3	4.3	4.2	4.2				3.6*	4.1*	4.3*
Federal Funds Rate	5.38	5.38	5.31	4.69	4.38	4.34	4.09	3.82				5.05*	5.19*	4.16*
2-yr. Treasury Note	4.48	4.82	4.03	4.15	4.34	4.32	4.20	4.05				4.58*	4.37*	4.23*
10-yr. Treasury Note	4.16	4.44	3.95	4.28	4.65	4.50	4.50	4.50				3.96*	4.21*	4.54*

a=actual
f=forecast
*=annual average

Influences on the Forecast

- The U.S. labor market finished the year on a high note with a broad-based increase of 256,000 jobs in December; the unemployment rate fell one-tenth to 4.1%. Average hourly earnings declined slightly to 3.9% year over year, still higher than pre-pandemic norms and frustrating hopes of services disinflation.
    - Details of other labor data show mixed signals. Weekly continuing jobless claims have stayed elevated, while the rates of both hiring and quitting are holding low. Fewer employees are leaving their jobs, and fewer employers are terminating their workers. However, fewer job seekers are finding work. We expect improving business sentiment to support a return to more hiring.

- Inflation's improvement has stalled. The November consumer price index (CPI) rose to a 2.7% annual gain, or 3.3% on a core basis (excluding food and energy). The deflator on personal consumption expenditures, the basis for the Federal Reserve's 2% target, also showed a discouraging step up to 2.4% headline and 2.8% core over the past twelve months. While we do not see a risk of rapid reflation, these rates are too high for comfort.
- The December meeting of the Federal Open Market Committee (FOMC) delivered a rate cut that we expect to be the last easing before a prolonged pause. The cut was accompanied by a quarterly Summary of Economic Projections showing a consensus of much slower progress toward the 2% inflation target, with no participants seeing a return to 2% next year. After a full percentage point of reduction in 2024, the median committee member now expects only 50 basis points of overnight cuts in 2025.
    - In his press conference, Chair Powell admitted that policy uncertainty surrounding the change in presidential administrations did arise in the committee's discussion. While it would be speculative to change course based on future policies, the committee is positioning for higher inflation risks ahead by keeping rates higher for longer.
    - More optimistically, the U.S. economy is not in urgent need of support through easing, with employment and activity holding up well. Inflation and unemployment will remain the primary drivers of rate decisions, and neither supports the need for further easing at this time. If the FOMC needs policy clarity, it will need to be patient for several months while new policies are finalized. We have adjusted our forecast for the Fed to make three cuts in 2025, starting in June.
- U.S. Treasury yields have entered a new, higher range, which we expect to persist. Higher short-term yields reflect the Fed's more cautious signaling, while long-end yields reflect greater term and risk premia for the highly indebted nation. Higher yields have brought the Treasury yield curve out of inversion after more than two years.
- Front-loaded import orders to capitalize on the current trade environment will increase the trade deficit and weigh on gross domestic product (GDP) in the fourth quarter, though inventory accumulation will be accretive to economic growth estimates. We expect the final demand components of GDP (consumption and business investment) to continue their gains despite economic noise.

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@NT_CTannenbaum