KPMG Economics

Turning Points
Annual 2025 Outlook

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"Now this is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning."

-Winston Churchill, November 10, 1942

Churchill used some version of that line repeatedly to mark the allies' progress toward victory in WWII. That provides a useful framework for understanding where the Federal Reserve stands in its war against inflation and how a new set of policies could affect that progress. History is defined by turning points that alter the course of the economy:

- The fiscal stimulus required to fight WWII lifted us out of the Great Depression and ushered in a whole new era of economic prosperity.
- The fall of the Berlin Wall marked the end of the Cold War and reinforced the push toward economic integration and globalization. The economy picked up as inflation cooled, while the ranks of those displaced by offshoring grew.
- The collapse of Lehman Brothers sparked a panic, which precipitated the Great Recession, the worst downturn since the Great Depression. Wages stagnated, inequalities worsened and the wounds inflicted by free trade festered.

Then came the pandemic. The economy fell into the worst contraction since the Great Depression for the second time in twelve years. Fiscal and monetary stimulus provided a lifeline out, but the speed and unevenness of the reopening stoked the flames of inflation.

The surge was global in scope. The road up was faster than the road down.

Economy weakens at year-end

Real GDP rose a revised 2.8% in the third quarter, only two-tenths below the 3.0% of the second quarter. Consumer spending drove overall gains, with a pickup in spending on big-ticket durable goods adding to the gains in nondurable goods and services. Housing lost ground for the second quarter in a row. Business investment slowed, while inventories were drained; a strike in the aerospace industry added to the drawdown in inventories. Gains in federal government spending outpaced gains at the state and local levels. The trade deficit widened as producers and retailers scrambled to order ahead of a new round of tariffs on imports from China in late September.

Prospects for the fourth quarter are not as good, with preliminary data suggesting that growth will come in at a 1.8% pace. Consumer spending remains buoyant, with some scrambling to buy big-ticket items prior to another round of tariffs. The incoming administration has threatened to increase and broaden current tariffs. Housing picks up on short-lived declines in mortgage rates. Business investment falls due to strikes. Inventories remain suppressed due to strikes and storm damages. Government spending is set to slow in response to a continuing resolution, but the current administration is scrambling to get IRA funds out the door. The trade deficit widens only slightly, reflecting the efforts to stock up before more tariffs kick in.

Fed pauses. Much depends upon the sequencing of policy shifts by the new administration. Cuts to the federal budget will stem growth and inflationary pressures, while tariffs and curbs on immigration could rekindle inflation. We now expect to see only three interest rate cuts between now and year-end 2025, one-half percent below what we forecast a month ago. The end-point is now a full percent below when the Fed started cutting in September 2024.

The embers of inflation are still smoldering, while post-pandemic shifts have left us more susceptible to bouts of inflation. Escalating geopolitical tensions, increased protectionism, mounting government debt, shifting global allegiances and a surge in extreme weather events have left supply chains more brittle. That has left us vulnerable to supply chain disruptions and scarcities.

The Fed has taken note. Rate cuts marked the proverbial "end of the beginning" of the Fed's war on inflation. A chorus of Fed leaders is signaling a need to slow the cadence of rate cuts. Ongoing economic strength and hotter recent inflation data may have raised the non-inflationary or neutral fed funds rate.

This edition of *Economic Compass* takes a closer look at the outlook for 2025 by major economic sector. Special attention will be paid to how the president-elect's policy proposals could play out, and what those shifts mean for inflation and interest rates from here. Old rules of thumb have fallen by the wayside in recent years. What was not inflationary eight years ago could be more consequential for inflation today.

The bond market has reacted, with yields rising from a low in September. Concern about inflation is the primary reason for the shift.

A new year, a new agenda

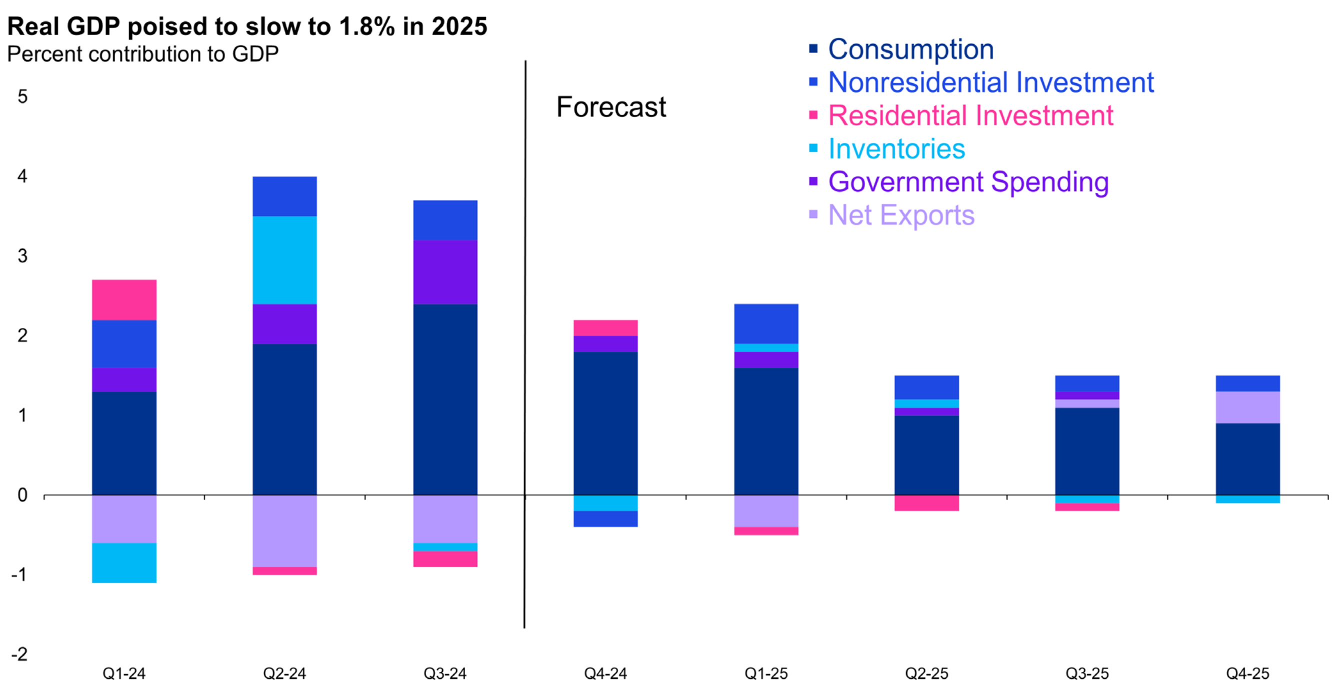
2025 Outlook

Chart 1 shows the contribution to the outlook for 2025 by major economic sectors. Real GDP growth is poised to slow to 1.8% in 2025 from an estimated 2.7% in 2024. However, even those subdued gains mask a larger slowdown in growth starting midyear. Buckle up; the road ahead could be rocky.

The forecast assumes a scaled-back version of the president-elect's slate of policy proposals:

- Deregulation targeting energy, finance, health, hiring and training practices.
- Personal tax cut extensions slated to expire in 2026.
- Tariffs ramp up slowly.
- Retaliation against US tariffs limits exports and disrupts supply chains.
- Border security intensifies, which curbs legal and illegal immigration.
- Government spending slows significantly.

Chart 1



Source: KPMG Economics, Bureau of Economic Analysis

The list is far from complete. The sequencing of events matters for how it will affect the economy. A focus on deregulation and a sweetening of tax cuts could spur growth. A focus on shifts to trade and immigration policy could simultaneously stoke inflation and stem growth. It is hard to get to an equilibrium that cools inflation unless the sole focus is to cut federal government spending.

Another wildcard is economic policy uncertainty, which spiked after the election. Financial markets hate uncertainty, which makes them more volatile. We have not explicitly included that in the forecast. Volatility could do one of two things: It could worsen economic weakness as firms and households delay big investment decisions; or, it could prompt the new administration to scale back.

Consumer spending slows

Consumer spending slows but does not collapse. In November, consumer confidence hit its highest level since July 2023. Hiring rebounded as the effects of storms and strikes receded, but gains remained concentrated in only three sectors: healthcare and social assistance, leisure and hospitality and state and local governments. Wages outpaced inflation for the twentieth consecutive month. Household wealth hit a record.

That is before cryptocurrency is taken into account; it is not clear it is in the Fed's tally of wealth. The demographics of investors in cryptocurrency are unique. They tend to skew young, are concentrated in a few companies and among foreign investors.

Households are tapping wealth via a rise in the use of home equity lines of credit. A study by the New York Fed revealed that older, wealthier homeowners are the primary drivers of those gains. Much to the chagrin of millennials waiting to buy homes, they are making improvements to age in place.

Storm clouds are forming. Recent updates to the census suggest large downward revisions to employment in 2023 and 2024. That leaves us with less of a cushion should hiring further slow. Sectors most dependent on immigration are at risk: agriculture, construction and leisure and hospitality top the list.

The premium that workers earn over inflation is expected to narrow, while delinquencies are rising. The latter could be a canary in the coal mine. Student loan delinquencies were the largest drivers of loan defaults in the 2010s. As of October, they can once again count against credit scores.

Assets are priced for perfection and look frothy. That ups the risks of bursting an asset price bubble and a correction in broader market valuations.

Housing struggles

Home buying and building will weaken in 2025. Listings of existing homes have picked up in what were some of the hottest post-pandemic markets. Homes are coming on the market in areas that are already experiencing gluts.

Investors are playing a smaller role. Some are even looking to sell instead of rent. That could increase the supply of homes for sale, but not enough to alleviate hurdles to affordability.

Higher home values, a related rise in real estate taxes, escalating insurance premiums and rising home maintenance costs pushed affordability to a record low in late 2024. That is despite modestly lower mortgage rates.

Single-family construction is expected to fare better than multifamily. Single-family builders have moved downscale to smaller, more affordable homes to tap pent-up demand from first-time buyers. Material costs and labor shortages remain hurdles, especially in the wake of recent hurricanes. Consolidation is expected to accelerate, with larger builders buying up smaller ones.

The multifamily market is suffering from a glut of new construction. Apartment and condo completions hit their highest level in fifty years in 2024. That put downward pressure on rents and limited funding for new projects. However, absorption of that space is high, which suggests that rents could reverse course and rise again.

Business investment decelerates

The current administration has rushed to get funds from the Inflation Reduction Act (IRA) out the door before inauguration day, January 20, 2025. Those funds, the insatiable demand for data centers and the catch-up in activity due to strikes are expected to buoy investment at the start of the year.

An easing of regulations could spur more investment, notably in the energy sector. However, investors in the sector are more focused on profits than expansion. The break-even price on existing wells is low, but still high for new wells. It can range from $55-$66 per barrel, depending on the size of the producer.

Companies are expected to shift their focus to shoring up supply chains and avoiding tariffs and retaliatory shifts as the year progresses. The president-elect issued waivers to companies with close ties to the administration during his first term. Hence, the scramble by major firms to curry favor with the incoming administration. Those efforts could shelter them from US tariffs and retaliatory tariffs.

Inventories rebuild

A restocking of aircraft following strikes will occur at the start of the year. That will add to the stocking up ahead of new tariffs, which take time to implement. Threats of retaliation via export controls and foreign exchange moves will lead to more stockpiling.

Government spending stalls

Congress punted on a budget in October; the government is currently running on a continuing resolution. Members need to extend that by December 20, 2024 and lift or suspend the debt ceiling again when it lapses on January 2, 2025.

Congress lacks the votes for a stand-alone extension to personal tax cuts, which means it will need to get them done via budget reconciliation. Technically, that requires Congress to offset the revenues lost due to the tax cuts with spending cuts or other tax hikes over a ten-year horizon.

The extension of personal tax cuts alone adds an estimated $4 trillion to budget deficits over the next decade. That is without funding for border security, which is costly, or subsidies for industries hit hardest by trade wars. The bipartisan Border Act of 2024 cost $118 billion but did not include the infrastructure for mass deportations.

Tariffs generate some revenues, but nowhere near enough to offset tax cuts. We import $3.1 trillion in goods; any fraction of that cannot begin to fill the $4 trillion hole. Tariffs by executive order cannot be officially used as an offset for reconciliation purposes; only tariffs raised by Congress are eligible.

We have not seen tariffs enacted by Congress since the infamous Smoot-Hawley Tariff Act of 1930. The move, which was designed to boost revenues, ignited a trade war. Trade collapsed 67%, which plunged us deeper into depression territory. That is why Congress has avoided levying tariffs since then.

That leaves other revenue sources and spending cuts. Outside advisors to the administration have proposed cutting $2 trillion from the federal government's $6.1 trillion fiscal 2023 annual budget.

That math is challenging. Two-thirds of the federal budget is mandatory, mostly Social Security and Medicare, the third rail of American politics; the remaining third is discretionary and dominated by defense.

Staff cuts top the list of targets. About one third of the 2.4 million government workers are over 55; attrition rates are high. Again, that would not come close to the cuts needed.

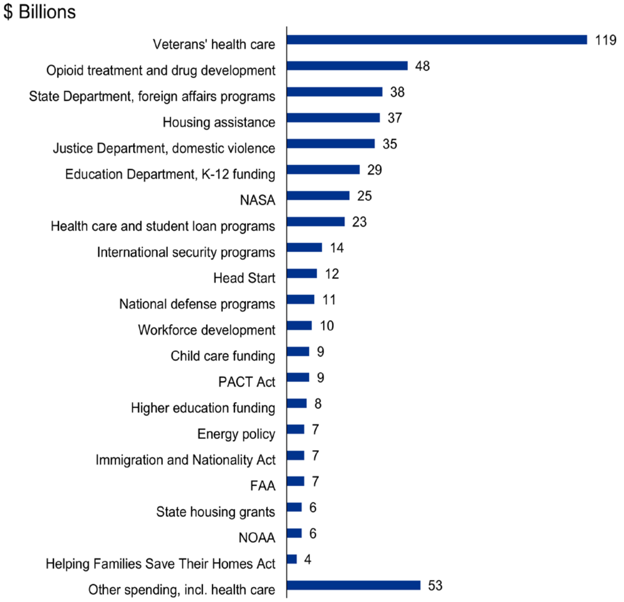
That leaves government agencies and programs with authorization that has lapsed. Chart 2 provides a list of those programs and their costs. The largest are health benefits for veterans at $119 billion and funding to treat opioid addiction at $48 billion.

The Herculean nature of the task has prompted some to argue the tax cuts represent an extension of current law and do not need to be fully offset. Hardliners in the president's own party could push back so that some but not all proposed cuts occur.

Chart 2

Government programs with expired funding authorizations in 2024

$ Billions



Source: Congressional Budget Office

The net result will still be bloated federal deficits with fewer support services for the electorate. The higher cost of servicing the mounting debt will only add to those deficits. Austerity is a bitter pill to swallow. The only clear winners will be government lobbyists.

Funds for individual states are at risk along with those for higher education. Those shifts would worsen the shortfall in state and local government coffers in fiscal 2025 and add to the expected slowdown. State and local government hiring was one of the three legs of support for hiring over the last year and a half.

“An influx of immigrants helped to fill the surge in job openings following reopening. That brought labor demand into better balance with labor supply and helped cool inflation...”

Trade deficit widens

Stronger growth at home, coupled with a strong dollar, is expected to blunt the initial effect tariffs have on imports relative to exports. Tariffs issued by executive order can take weeks to months to execute and include a comment period to enable waiver petitions.

The rest of the world is prepared. China has already retaliated on an increase in tariffs by the current administration. A ban on exports of rare earths was the most recent act. China intends to disrupt operations of foreign companies there and those who rely heavily on Chinese components for their supply chains. The goal will be to disrupt production activity in both countries.

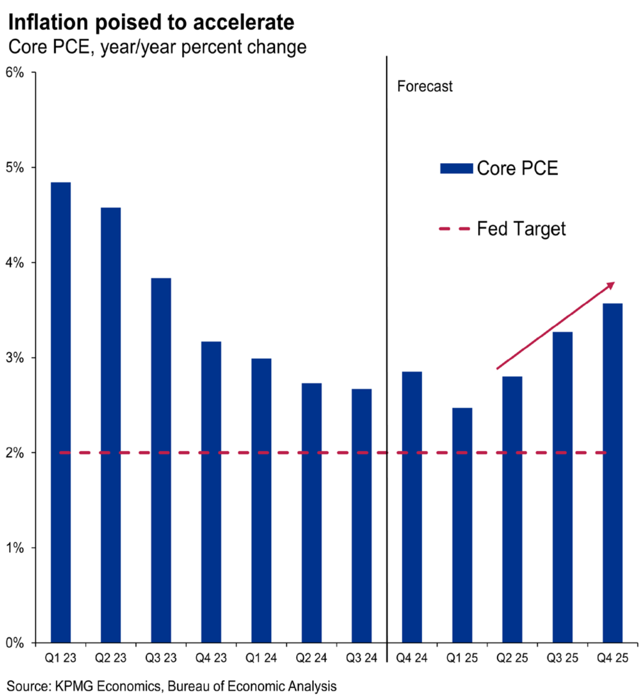
Risks: Sequencing the slate of policy proposals is important. If the focus is more on deregulation, tax cuts and potential sweeteners than changes to tariffs and immigration, then growth could be much stronger in 2025. Otherwise, risks are for higher inflation and weaker expansion.

Inflation accelerates

Chart 3 shows the forecast for the core personal consumption expenditures (PCE) deflator, which strips out the volatile food and energy components. It appears to have plateaued in recent months. We could still see some added progress:

- A drop in rents and slowdown in home values has yet to fully work its way into inflation measures. Leases roll over slowly, while an unusual number of renters has opted to renew rather than foot the costs of a move.
- A strong dollar should help mitigate tariff costs.
- Oil prices are expected to fall a bit further due to weaker global growth and an increase in US production.

Chart 3



Service sector inflation excluding shelter has proven stickier. Some costs, such as insurance and healthcare, are more structural. They are rising in response to the aging population and a surge in extreme weather events, which have increased the cost of repairing and replacing destroyed property.

Separately, we will see a bump in inflation due to tariffs, some of them left over from the current administration. Retailers and producers stockpiled ahead of tariffs that went into effect in late September, but those inventories will be depleted by the start of the year.

Additional tariffs under the new administration will start to phase in over spring and summer of 2025. Tariffs do not peak until early 2026.

The threat of tariffs is already having an effect. The University of Michigan's preliminary December survey of consumer sentiment hit its highest level since April, but for the wrong reasons. A record number of consumers said that they were going to buy big-ticket items ahead of tariffs, as inflation expectations spiked.

Consumers and producers still have a muscle memory of inflation, which can be its own self-fulfilling prophecy. Buying ahead of tariffs puts upward pressure on the prices of goods at risk of tariffs. Those inflationary impulses were dormant for decades ahead of the pandemic.

Lost in translation is the outsized role that immigration played in the "soft landing" narrative. An influx of immigrants helped to fill the surge in job openings following reopening. That brought labor demand into better balance with labor supply and helped cool inflation, notably in the service sector, without a surge in layoffs.

Risks: We have only phased in a portion of the president-elect's promised tariffs and retaliation by our trading partners. The trade war could be larger in scope and inflation hotter. Conversely, efforts to scale back tariffs and de-escalate could dampen but not eliminate the threat of inflation.

Fed does not front-run policy shifts

The gap between what a politician says and does can be large. The Fed must wait and see how shifts in policy play out before changing its decision rule for rate cuts.

That leaves us with three rate cuts before the Fed pauses in the second half of 2025. The fed funds rate is forecast to end 2025 in the 3.75% - 4.0% target range, one-half percent higher than a month ago.

The Fed is expected to end Quantitative Tightening (QT) or reductions in the size of its balance sheet in early 2025. It is not expected to resume Treasury bond and mortgage-backed security purchases any time soon.

That creates a higher floor under long-term bond yields and mortgage rates. The spread between the 10-year bond yields and mortgage rates has already widened significantly since the Fed started QT in June 2022.

Risks: The Fed may have to shift its balance of risks back to inflation and slow the pace of rate cuts more than forecast or worse, reverse course. Conversely, a de-escalation of trade tensions coupled with more restrictive fiscal policy could alleviate those pressures.

Profits weaken

Profit warnings have begun to pick up in the wake of a strong dollar and the crimp of higher rates. Consumers have proven more discerning, especially when it comes to buying nondurable goods. They are opting for off-brand items and moving downscale to protect their purchasing power from the cumulative effects that inflation has had on balance sheets.

Deregulation in some sectors should partially offset the initial drag from tariffs. However, a full-blown trade war would be costly.

Risks: There are some in Congress who are mulling a further lowering of the minimum corporate tax rate, which would blunt the blow of tariffs. Support among the electorate is low, given a surge in anti-corporate sentiment across party lines since the onset of the pandemic. Trust in large companies is down there with trust in government institutions.

Bottom Line

The pandemic was a turning point. We entered it following a decade-long struggle to recoup what we lost to the Great Recession. A deeply divided nation came together to ensure that COVID would not be the iceberg that sank the ship. The bipartisan stimulus packages that were passed lifted us out of the chill of the COVID recession.

Those gains were fleeting and eroded by the burn of inflation. Fed rate cuts marked the proverbial "end of the beginning" of that battle, not the end of the war. To achieve a victory, the Fed has signaled it will slow the cadence of rate cuts. The extent to how much it slows and how low it eventually goes depends on the sequencing of policies by the new administration. In the interim, I will borrow another famous quote from WWII London, "Keep calm and carry on." Cheers.

Economic Forecast — December 2024												
	2024	2025	2026	2024:3(A)	2024:4	2025:1	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3
National Outlook												
Chain Weight GDP[1]	2.7	1.8	1.5	2.8	1.8	1.9	1.3	1.3	1.4	1.4	1.7	1.4
Personal Consumption	2.7	2.3	1.4	3.5	2.7	2.4	1.5	1.6	1.3	1.1	1.7	1.5
Business Fixed Investment	3.7	2.1	1.2	3.8	-1.4	3.7	2.2	1.6	1.3	1.2	1.1	0.8
Residential Investment	4.1	-2.2	-1.8	-5.0	4.4	-2.6	-5.9	-3.5	1.1	-2.5	-1.9	-1.4
Inventory Investment (bil $ '17)	52	62	60	64	53	59	66	65	59	57	59	63
Net Exports (bil $ '17)	-1042	-1106	-1016	-1078	-1079	-1112	-1114	-1111	-1087	-1050	-1021	-1003
Exports	2.9	3.2	2.2	7.5	-2.0	6.3	3.5	1.8	2.2	1.5	2.5	2.4
Imports	5.3	4.0	-0.9	10.2	-1.3	8.2	2.7	0.9	-1.0	-2.8	-1.3	-0.2
Government Expenditures	3.3	1.4	0.3	5.0	1.2	1.0	0.3	0.6	0.2	0.6	0.0	0.0
Federal	2.4	2.3	1.1	8.9	1.1	0.8	1.6	1.9	0.9	1.9	0.4	0.3
State and Local	3.8	0.9	-0.2	2.7	1.3	1.1	-0.4	-0.2	-0.2	-0.2	-0.2	-0.2
Final Sales	2.6	1.8	1.5	3.0	2.0	1.8	1.2	1.3	1.5	1.5	1.7	1.3
Inflation												
GDP Deflator	2.4	3.1	3.3	1.9	2.7	2.3	4.5	4.2	4.3	4.3	1.5	1.9
CPI	2.9	2.9	3.4	1.2	2.9	2.0	4.6	3.6	3.5	4.0	2.8	2.6
Core CPI	3.4	3.3	3.4	2.2	3.3	2.4	4.4	4.2	4.2	3.8	2.5	2.1
Special Indicators												
Corporate Profits[2]	6.8	-0.4	-4.2	6.1	2.4	4.9	0.0	-1.8	-4.4	-6.9	-6.2	-3.2
Disposable Personal Income	2.8	2.7	2.7	0.8	2.7	3.3	1.8	6.3	1.9	2.7	2.6	1.6
Housing Starts (mil)	1.35	1.30	1.27	1.33	1.33	1.33	1.29	1.29	1.28	1.27	1.28	1.26
Civilian Unemployment Rate	4.0	4.2	4.4	4.2	4.2	4.2	4.2	4.2	4.2	4.3	4.3	4.5
Total Nonfarm Payrolls (thous)[3]	2480	903	-702	421	326	263	151	-40	-208	-259	-254	-158
Vehicle Sales												
Automobile Sales (mil)	3.0	2.4	2.7	3.0	3.2	3.0	2.8	0.9	2.7	2.7	2.6	2.6
Domestic	2.1	1.9	1.8	2.0	2.1	2.0	1.9	1,9	1.9	1.9	1.8	1.8
Imports	1.0	0.9	0.8	0.9	1.1	1.0	0.9	0.9	0.8	0.8	0.8	0.8
LtTrucks (mil)	12.9	12.6	12.6	12.6	13.7	12.7	12.6	12.6	12.6	12.6	12.5	12.6
Domestic	10.2	10.1	10.1	9.9	10.9	10.0	10.0	10.1	10.1	10.0	10.0	10.1
Imports	2.7	2.6	2.5	2.7	2.8	2.7	2.6	2.5	2.5	2.6	2.5	2.5
Combined Auto/Lt Truck	15.9	15.1	15.2	15.6	16.9	15.7	15.4	13.5	15.3	15.3	15.1	15.2
Heavy Truck Sales	0.5	0.5	0.4	0.5	0.5	0.5	0.5	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	16.4	15.5	15.6	16.1	17.4	16.2	15.9	13.9	15.7	15.7	15.5	15.6
Interest Rate/Yields												
Federal Funds	5.2	4.0	3.9	5.3	4.7	4.3	4.1	3.9	3.9	3.9	3.9	3.9
10 Year Treasury Note	4.2	4.3	4.2	4.0	4.2	4.4	4.3	4.2	4.2	4.2	4.2	4.1
Corporate Bond BAA	5.8	6.1	6.3	5.7	5.7	6.0	6.1	6.1	6.2	6.3	6.3	6.3
Exchange Rates												
Dollar/Euro	1.09	1.10	1.10	1.10	1.08	1.09	1.10	1.10	1.10	1.10	1.10	1.10
Yen/Dollar	150.5	143.3	133.0	148.9	149.0	147.0	144.0	142.0	140.0	135.0	133.0	132.0

[1] in 2023, GDP was $22.7 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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