KPMG Economics

Turbulence beneath the surface
A view from abroad

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I spend a week each summer in off-the-record meetings with economists from around the world. The group has been in existence since 1937; the only break was during WWII. The meetings are Chatham House rules, which means I can't quote anyone verbatim but can share what I gleaned from our deliberations.

This year's meetings were held in Canada. Niagara Falls provided an apt backdrop for the tenor of our discussions. Much as the majestic view masks the turbulence and danger of the drop, growth in the global economy is masking the underlying political turbulence.

The world embraced free trade and international cooperation but broke promises to retrain displaced workers. Inequalities between the developed and developing world narrowed, while inequalities within countries widened. That sowed the seeds of discontent.

A majority of the electorate in the largest democracies no longer feel represented. Barriers are being erected to the flow of trade and people. The post-WWII era of economic and political integration is being replaced with fragmentation.

I couldn't help but wonder if our discussions had come full circle to the founding of our group when protectionism soared in the 1930s. "History may not repeat itself but it often rhymes," as Mark Twain once said.

This edition of *Economic Compass* provides a summary of what factors I gleaned from those discussions and how they are shaping the global economic outlook. The discussions focused more on the structural shifts underway in the global economy, which overlap with our Structural Change Watchlist. The fear was that the US could move further away from the economic integration it spearheaded. Special attention is paid to how changes in tariffs and immigration policy in the US could alter our baseline forecast.

A reprieve in the second quarter

Real GDP is expected to rise by 2.5% in the second quarter, well above the 1.4% pace of the first quarter. Consumers pushed back on price hikes, retailers responded with discounts and consumer spending rebounded. Housing activity slumped on the heels of higher mortgage rates. Business investment moderated, but remained buoyed by subsidies for chip plants and strong technology investments. Government spending slowed to a crawl, with moderate gains at the state and local levels only partially offsetting a drop in federal spending. The trade deficit further widened, as exports fell and imports accelerated. Much of the rise in imports was driven by the rush to get goods into warehouses ahead of new tariffs and before potential port strikes this summer.

Real GDP growth is forecast to slow to 1.5% in the third quarter, a full percentage point behind the pace of the second quarter. Consumer spending is expected to hold up but housing activity is expected to slip further into the red. Business investment is poised to fall slightly, reflecting the uncertainty surrounding the elections. Inventories will be drained, following the surge in stocks in the second quarter. Government spending is expected to pick up a bit. The drag due to a widening of the trade deficit is expected to slow but not reverse.

The Fed ponders a cut. A recent slowdown in the pace of inflation, discounting by major retailers and a strong dollar, which will show up as cheaper imports later this year, have opened the door to a September rate cut. We expect two cuts by year-end, which will bring the fed funds rate down from its pandemic peak of 5.25%-5.5% to 4.75%-5% in December. After that, much depends on the course of policy decisions with regard to trade and immigration, which could reverse some of the recent cooling in inflation.

Global outlook

Undercurrents

Global growth is expected to expand at a subdued 3% annual pace between 2024 and 2026, when measured on a purchasing power parity basis. That is more than a half percentage point below the average of the 2010s.

China is doing a bit better than it was, but is no longer a tailwind for the global economy. India continues to post solid if not spectacular gains, despite much younger demographics than other parts of the world. Hurdles are legislative bureaucracy and an inadequate energy grid.

Emerging Asia and parts of developed Asia are doing considerably better. They are reaping the benefits of shifting supply chains and the frenzy to scale generative artificial intelligence (GenAI) modeling. Taiwan and South Korea are both major chip producers and lower end chip fabrication is spreading to emerging economies in the region. Threats to curb chip imports would take wind from their sails.

Headwinds

Obstacles to stronger growth include:

- The cumulative effect of inflation on price levels and the bite of earlier rate hikes;
- Central banks' fear of cutting prematurely and losing ground gained on inflation;
- The end of COVID-era fiscal stimulus and mounting sovereign debt levels;
- Escalating geopolitical tensions and protectionism;
- Heighted levels of uncertainty, which constrain investment; and
- Aging demographics, which are adding to fiscal challenges and limiting the supply of labor.

The result is a more fragmented global economy, which is more susceptible to supply shocks. That raises inflation risks.

The only major offset is the promise of productivity gains associated with GenAI. The International Monetary Fund (IMF) has developed an GenAI preparedness index for 174 countries. Many of the wealthiest and largest economies top that list, including the US. Most developing economies are closer to the bottom. Many lack the talent, energy and financial resources necessary to leverage GenAI.

Those who can implement GenAI want their own sovereign models to guard against more nefarious uses of the technology; cyber-attacks are soaring. Not surprisingly, governments are rapidly becoming some of the most aggressive investors in GenAI models.

Global inflation and rate cuts

A long last mile

Inflation appears to have peaked across much of the world, but service sector inflation is looking sticky. That has slowed the glide path on rate cuts in developed and developing economies. A strong dollar is further complicating matters as it could buoy prices abroad.

The exception is the US, where inflation has cooled. The Fed's decision to delay rate cuts appears to be paying off. The strong dollar benefits the US by compounding the downward pressure on prices we have seen due to discounting.

Short-term interest rates have either peaked or moved beyond their peak for most countries. Exceptions are Japan, Türkiye, Russia and parts of Central and Eastern Europe, where rates are likely to rise or remain higher for longer.

The discussion on immigration's role regarding inflation was nuanced. The short-term effects of extremely large inflows, like we saw in Canada in recent years, added to inflation. Wealthy newcomers bid up shelter costs and rents.

The situation is less dramatic elsewhere. Much of the rise in home values and rents in the US was due to acute shortages, the movement of wealthy households from former hot spots on the coast to boom towns in the Sunbelt. An influx of immigration added to those pressures in some local markets, but has already begun to ease. A surge in immigration only exacerbated those pressures in local markets.

Conversely, immigration played a key role in boosting labor supply and easing labor shortages. Over 70% of the growth in the civilian labor force in the US since February 2020 was due to a rise in foreign-born workers. They often filled jobs that were long open in sectors many native-born workers would not accept.

The industries most dependent on foreign-born workers in the US are agriculture, leisure and hospitality, other low-wage service sector jobs and construction. That has helped to slow service sector inflation in the US, even as it persisted in other countries.

Rate cuts across major economies

The **Bank of Canada** was the first among the Group of 7 - Canada, France, Germany, Italy, Japan, the UK and US - to cut rates in June and is poised to cut again in July. Economic growth is expected to remain essentially unchanged in 2024 and rebound on the heels of lower rates in 2025 and 2026. Recent curbs to immigration are expected to limit the upside on growth.

The **Federal Reserve** is expected to join the party and cut before year-end. Recent inflation data has cooled more than expected, while concern about weaker growth late in the year has intensified. Chairman Jay Powell all but admitted as much in his recent testimony to Congress. “Reducing policy restraint too late or too little could unduly weaken economic activity and employment,” he said.

The **European Central Bank** did what was characterized as a “hawkish” cut in June but is expected to remain on hold until at least September. A recovery earlier in the year appears to have fizzled, while service sector inflation has proven sticky. The manufacturing recovery has lost steam which is taking a toll on Germany, the region’s largest economy. France is doing better than Germany but uncertainty triggered by recent elections is a headwind. Growth in the region is expected to pick up a bit in 2025 and 2026.

The **Bank of Japan** hiked short-term rates for the first time in eight years in March and announced that it would curb the pace of its bond purchases starting in August. Another rate hike is expected this year, but not as soon as financial markets would like. In response, the yen depreciated sharply during the first half of the year. Efforts to stem those shifts with currency interventions failed. Wages rose at their fastest pace in 30 years in May but fell for the 26th consecutive month after adjusting for inflation.

Risks of a fiscal crisis

The largest central banks are raising their estimates of what they consider to be the non-inflationary or neutral policy rate. This higher terminal rate marks a return to the norms we saw prior to the global financial crisis. That means that central banks plan to stop cutting rates well short of where they were pre-pandemic, barring a major recession.

Higher rates will increase the cost of servicing government debt. Risks of fiscal crises abound.

A trifecta of events is fueling increases in deficits and debt:

1. Strong spending pressure due to aging demographics, defense spending and climate and industrial policies;
2. Political resistance to an increase in taxes; and
3. A reluctance to endure the pain associated with the fiscal adjustments necessary to bring budgets into balance.

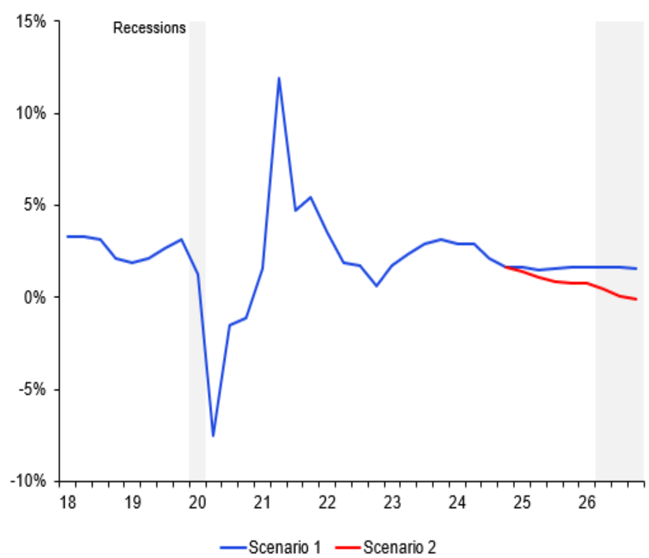
Argentina is an outlier - yes, you read that correctly. The president has taken a chainsaw to the budget and triggered a deep recession to reduce deficits. However, the cuts are temporary and structural reforms are needed. The clock is ticking over how long the population will tolerate the losses they are enduring.

Concern about the debt situation in the US is greatest. The dollar remains the reserve currency of the global economy. Any threat to its status as a means of exchange would rapidly reverberate around the world. Neither political party has shown a willingness to reduce deficits via spending cuts and tax hikes. The last time we saw budget surpluses was during the boom of the 1990s; they were quickly squandered.

Chart 1

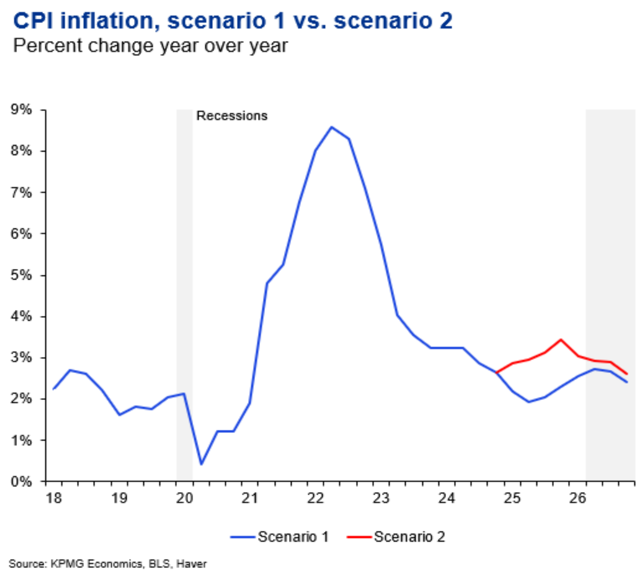
Real GDP, scenario 1 vs. scenario 2

Percent change year over year



Source: KPMG Economics, BLS, Haver

Chart 2



Anticorporate sentiment has surged across both parties. That makes an extension of corporate tax cuts next year a harder sell for members of Congress.

Tariffs are particularly hard on low- and middle-income households. They gain little to nothing from similar sized income tax cuts; that is the tradeoff that is being discussed. (See Chart 3.)

The nonpartisan Congressional Budget Office estimates that the US population could contract as soon as 2040, absent immigration. That would exacerbate the rise in deficits, as the number of people paying into payroll taxes declines. Work done by the Peterson Institute for International Economics reveals that tariffs raise much fewer revenues than more traditional forms of income taxes.

US

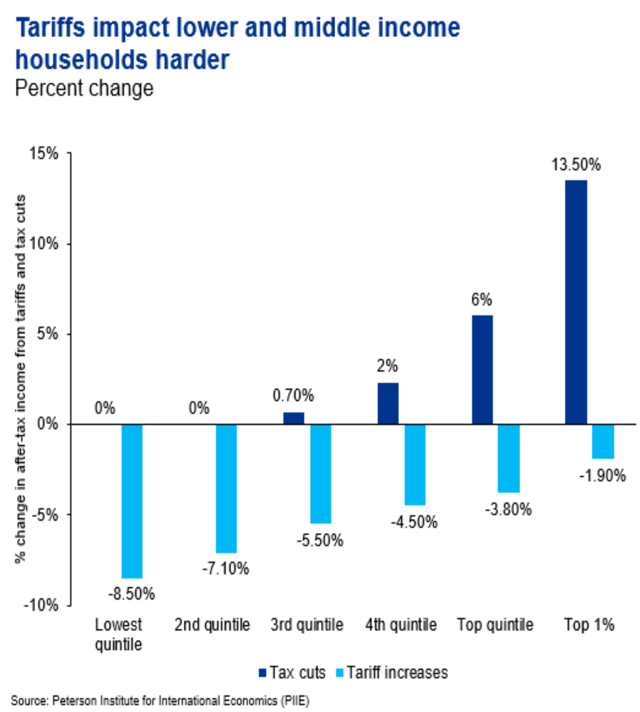
Tariff and immigration scenarios

Charts 1 and 2 compares our baseline forecast against a more aggressive stance on tariffs and immigration. The real GDP and inflation figures are shown on a fourth-quarter-to-fourth-quarter basis, to show the shift in momentum. The gap is significant:

- Scenario 1 is our baseline. It assumes an extension of current tariffs and immigration policy, which is an update of the forecast that we published in detail last month. The largest difference is the recent improvement in inflation, which opened the door to two rate cuts by year-end. The Fed is expected to reach its 2.75%-3% neutral rate by mid-2026. That is more than one percentage point above February 2020.
- Scenario 2 assumes a 10% across-the-board increase in tariffs on imported goods and sharp curbs on immigration. Those shifts trigger a resurgence of inflation, which forces the Fed to do a u-turn on rate cuts and return to its current 5.25%-5.5% "higher for much longer" strategy.

Both scenarios assume a rise in uncertainty and escalation of financial market volatility surrounding the election. An extension of personal tax cuts is expected. Extending corporate tax cuts is a heavier lift.

Chart 3



Spillover effects

An increase in tariffs by the US would no doubt be countered by retaliatory tariffs and an increase in protectionist policies by our trading partners. That has the potential to trigger a more vicious cycle of inflation and subdued growth, or worse, stagflation. Similar policies exacerbated the depth and duration of the Great Depression. A full scale trade war with two or more of our largest trading partners could easily shave more than a percent from our already subdued forecast for global growth.

Separately, the United States-Mexico-Canada-Agreement is unique in that it includes a sunset clause. That agreement is up for renegotiation in 2026. A failure to approve it would set in motion the collapse of the agreement by 2036. Tariffs would complicate that process. (Understatement.)

Bottom Line

The risk is that we enter a negative feedback loop of escalating trade and geopolitical tensions that diminish our collective ability to grow. The whole is only greater than the sum of its parts when its parts work together. Breaking bread is better than breaking ties.

That brings me back to where I started, at the base of Niagara Falls. A young boy, not more than six, stood next to me as our boat got closer to the falls. He was startled by the force of what we were seeing; so was I. He reached up to hold my hand and I gave it a gentle squeeze. As our view grew hazy in the mist, Mother Nature surprised us. The sun's rays hit at the very same moment. A rainbow emerged, as a reminder that every cloud has a silver lining and, in that lining, there is hope.

Economic Forecast — July 2024

	2023	2024	2025	2023:4(A)	2024:1(A)	2024:2	2024:3	2024:4	2025:1	2025:2	2025:3	2025:4
National Outlook												
Chain Weight GDP[1]	2.5	2.4	1.5	3.4	1.4	2.5	1.5	1.2	1.3	1.5	1.5	1.7
Personal Consumption	2.2	2.3	2.0	3.3	1.5	2.2	2.5	2.0	2.0	1.7	1.7	1.8
Business Fixed Investment	4.5	4.2	1.9	3.7	4.4	7.0	2.4	1.7	1.6	1.3	1.1	1.1
Residential Investment	-10.6	2.3	-1.8	2.8	16.0	-3.9	-10.6	-7.8	0.2	2.6	4.1	5.5
Inventory Investment (bil $ '17)	44	68	62	55	28	95	79	69	59	59	64	66
Net Exports (bil $ '17)	-928	-1012	-1057	-919	-960	-1025	-1027	-1033	-1047	-1055	-1063	-1064
Exports	2.6	1.9	3.4	5.1	1.6	-0.6	3.8	3.5	3.3	3.8	4.2	4.6
Imports	-1.7	3.8	3.7	2.2	6.1	7.2	2.9	3.2	3.9	3.6	3.8	3.4
Government Expenditures	4.1	2.5	0.6	4.6	1.8	0.4	1.2	0.7	0.7	0.4	0.4	0.4
Federal	4.2	1.3	1.0	2.4	-0.2	-1.4	1.6	1.2	1.3	0.8	0.9	0.8
State and Local	4.0	3.2	0.4	6.0	3.0	1.5	1.0	0.4	0.3	0.2	0.2	0.2
Final Sales	2.9	2.3	1.5	3.9	1.8	1.3	1.8	1.4	1.5	1.4	1.4	1.7
Inflation												
GDP Deflator	3.6	2.5	2.4	1.6	3.1	2.4	2.2	2.4	2.5	2.4	2.4	2.3
CPI	4.1	3.0	2.1	2.7	3.8	3.0	1.9	1.9	1.9	2.0	2.4	2.8
Core CPI	4.8	3.5	2.6	3.4	4.2	3.4	2.9	2.6	2.5	2.4	2.4	2.3
Special Indicators												
Corporate Profits[2]	5.1	3.1	0.9	5.1	6.4	10.5	7.2	3.1	4.3	0.5	0.6	0.9
Disposable Personal Income	4.1	1.7	3.0	0.9	1.3	2.0	2.9	2.9	3.6	2.9	2.7	2.8
Housing Starts (mil)	1.42	1.33	1.32	1.48	1.41	1.31	1.31	1.30	1.31	1.32	1.33	1.35
Civilian Unemployment Rate	3.6	3.9	4.4	3.8	3.8	3.9	4.0	4.1	4.2	4.4	4.5	4.6
Total Nonfarm Payrolls (thous)[3]	2936	2295	139	617	771	646	577	301	141	49	-29	-22
Vehicle Sales												
Automobile Sales (mil)	3.1	3.0	3.1	3.1	2.9	2.9	3.0	3.0	3.1	3.1	3.1	3.1
Domestic	2.3	2.1	2.1	2.3	2.0	2.1	2.1	2.1	2.1	2.1	2.1	2.1
Imports	0.9	0.9	1.0	0.9	0.9	0.9	0.9	0.9	1.0	1.0	1.0	1.0
LtTrucks (mil)	12.4	12.6	12.8	12.6	12.4	12.7	12.7	12.8	12.8	12.8	12.8	12.9
Domestic	9.9	10.0	10.0	9.9	9.9	10.1	10.0	10.0	10.0	10.0	10.0	10.0
Imports	2.5	2.7	2.8	2.6	2.5	2.7	2.7	2.8	2.8	2.8	2.8	2.9
Combined Auto/Lt Truck	15.5	15.6	15.9	15.7	15.3	15.7	15.6	15.7	15.9	15.9	15.9	16.0
Heavy Truck Sales	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Total Vehicles (mil)	16.0	16.1	16.4	16.2	15.8	16.2	16.1	16.2	16.4	16.4	16.4	16.5
Interest Rate/Yields												
Federal Funds	5.0	5.3	4.3	5.3	5.3	5.3	5.3	5.1	4.8	4.6	4.2	3.7
10 Year Treasury Note	4.0	4.3	3.8	4.4	4.2	4.5	4.4	4.2	4.0	3.8	3.7	3.6
Corporate Bond BAA	5.9	6.0	5.9	6.2	5.7	6.0	6.0	6.1	6.0	5.9	5.9	5.8
Exchange Rates												
Dollar/Euro	1.08	1.09	1.10	1.08	1.09	1.08	1.09	1.09	1.10	1.10	1.10	1.10
Yen/Dollar	140.5	154.6	145.5	147.8	148.6	155.9	158.0	153.0	150.0	147.0	145.0	140.0

[1] in 2023, GDP was $22.4 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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