KPMG Economics

Black Swans flock
Recession risks rise

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I recently walked by a pond where I saw a pair of birds paddling toward me. My husband was puzzled and asked why I was filming them. “You rarely see Black Swans coming,” I replied. The site was simultaneously mesmerizing and ominous.

Black Swan events are defined as consequential but unforeseen and statistically improbable. A sudden change to the global trading system, such as was revealed on April 2, qualifies.

The tariffs announced represent the largest tax hike of the modern era. Taken at face value, the effective tariff rate could jump to its highest level since the early 1900s, a period the president has praised. Tariffs made up as much as 95% of federal tax revenues, before the first major income taxes in 1913.

The shock of the new tariffs roiled financial markets around the world. The risk of a recession went from a remote possibility to probable in a matter of months. The betting markets had the odds at close to 60% as of April 7.

This edition of *Economic Compass* takes a closer look at the fallout from the most recent round of tariffs. Special attention will be placed on why economists dislike tariffs. Historically, tariffs have done more damage than good and triggered a host of unintended consequences.

If the new tariffs hold, the economy could slip into a recession with a bout of stagflation within months. Stagflation is uncommon and occurs when growth slows and both inflation and unemployment rise.

The Federal Reserve will likely cut short-term interest rates, but not until it is sure that the tariff-induced inflation will abate. Our baseline forecast has the first rate cut occurring in the fourth quarter, but a deeper recession could move that timeline forward.

Summer of our discontent

Real GDP growth is forecast to rise at a meager 0.2% pace in the first quarter. Much of that weakness was due to a record widening of the trade deficit. Imports soared as firms scrambled to front-run tariffs and stockpile what they could. Exports rebounded after contracting on weak aircraft exports last quarter, but remained subdued.

Preliminary data on consumer spending suggests it slowed markedly, except for a surge in vehicle sales in March. Those who could, bought ahead of tariffs. Housing rebounded a bit on lower mortgage rates and an increase in listings. Business investment recouped part of what was lost to strike delays in the aerospace industry. Government spending continued to expand, buoyed by aging demographics, the surge in troops at the border and ongoing gains at the state and local levels.

Tariffs trigger recession

Real GDP is forecast to contract at a 1.3% annualized rate in the second quarter, marking the start of a recession. Employment falters as inflation picks up, which is a phenomenon known as stagflation. Uncertainty remains elevated as countries attempt to negotiate with the administration on tariffs; the goalpost keeps moving. Our baseline forecast assumes that many of the tariffs announced on April 2 remain in place.

The federal government will be reluctant to stimulate. Already high deficits, the role stimulus played in stoking the pandemic-induced inflation, and the desire to expand and extend tax cuts in 2026 are likely to keep Congress from acting to blunt the blow of tariffs.

Fed in “no hurry.” Tariffs are a challenge for the Fed as they simultaneously stoke inflation and depress growth. The Fed will wait until it is clear that inflation will cool in response to the blow to demand, which puts the first rate cut in the fourth quarter.

Three scenarios

Tariffs are a moving target

Chart 1 provides an update to our three scenarios:

1. The optimistic scenario assumes that the administration rolls back a good portion of the tariffs announced on April 2. Tariffs peak at their highest level since the 1940s.
2. The baseline forecast assumes that tariffs hit their highest level since the early 1900s. Countries are guarded in their retaliation.
3. The pessimistic scenario assumes that the current tariff announcements hold. Tariffs trigger a more consequential trade war with multiple countries.

Optimistic scenario:

- Growth slips below the economy's potential of just under 2% but skirts a recession.
- Unemployment rises to 4.9% by year-end, 0.7 percentage points higher than in March.
- The Fed's preferred inflation measure – the core personal consumption expenditures (PCE) price index – peaks at 3.8% in the third quarter.
- The Fed starts cutting rates in the fourth quarter of 2025 as inflation starts to abate.

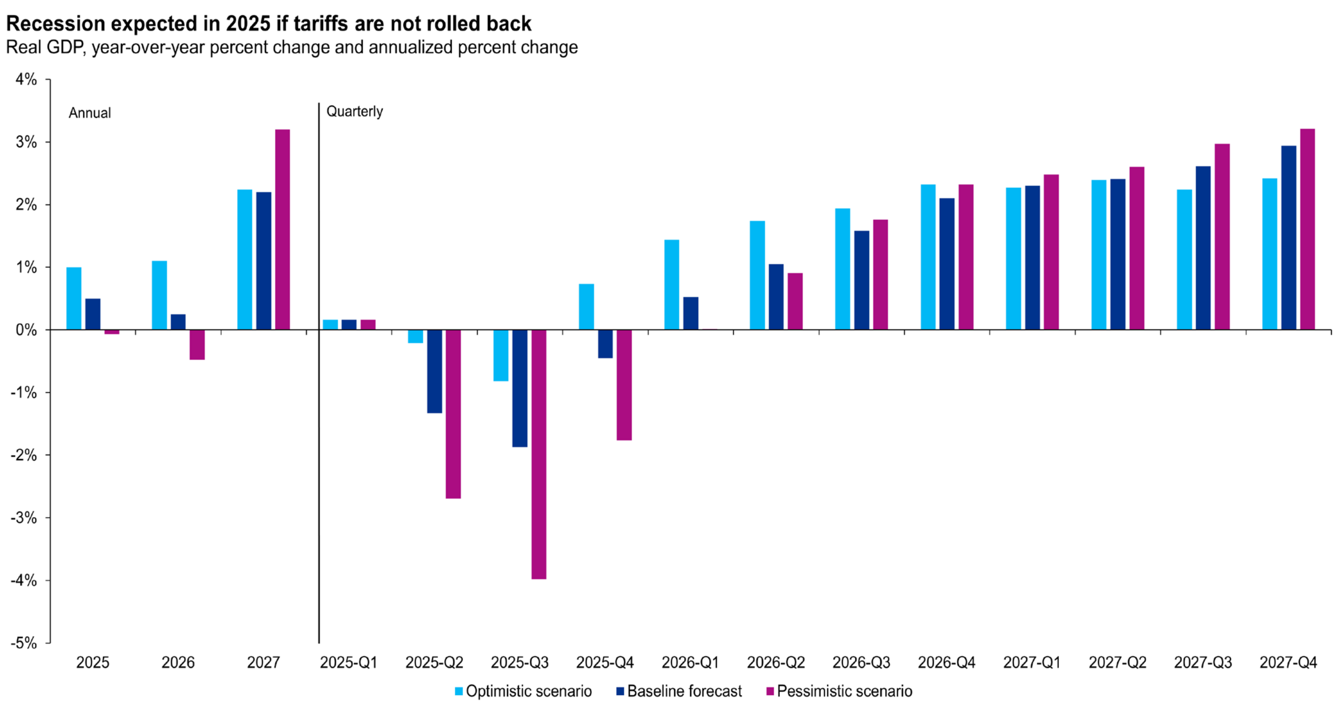
Baseline forecast:

- The economy slips into a mild recession for three quarters, starting in the second quarter.
- The unemployment rate rises to 5.2% by year-end, one percentage point above the March level.
- Core PCE inflation peaks at 4.8% in the third quarter; that is two full percentage points above its February 2025 pace.
- The Fed holds off on rate cuts until the fourth quarter, despite the weakness in the economy; its goal is to avoid the mistakes made in dealing with the post-pandemic inflation.

Pessimistic scenario:

- The economy slips into a much deeper recession.
- Unemployment hits 5.8% by year-end, 1.6 percentage-points higher than in March.
- Core PCE inflation peaks at 4.8%, the same as the baseline, but recedes more rapidly.
- The Fed begins cutting rates in May, but for all the wrong reasons - a deeper, more scarring recession.

Chart 1



Source: KPMG Economics, Bureau of Economic Analysis

Risks. Members of Congress are beginning to feel the ire of their constituents over the president's agenda. That has prompted some Republicans to team with Democrats to try curb the president's power to levy tariffs. They lack support in the House of Representatives, and the super majority needed to overturn a veto.

A deeper recession and financial crisis cannot be ruled out if tariffs are not rolled back. Trade wars are nonlinear and are easier to prevent than end.

Why economists dislike tariffs

A top 10 list

Chart 2 shows that the April 2 tariffs could take the effective tariff rate to its highest level since 1903. If the escalation with China holds and no other deals are cut, the effective tariff rate would cross 32%, a record high. The economic research is unequivocal: Tariffs at that level do more harm than good to the economy.

1) Regressive. The tariffs announced on April 2 amount to a $750 billion tax increase, the largest in modern history. That is the equivalent of a major sales tax, the most regressive form of tax.

Low-and middle-income households are hit harder than high-income households due to their reliance on goods purchases. Small businesses suffer more than large companies due to narrower profit margins.

This adds insult to injury in an economy where inequality has already spiked. Work done by Moody's Analytics reveals that the top 10% of earners accounted for nearly half of all spending in 2024, the highest on record.

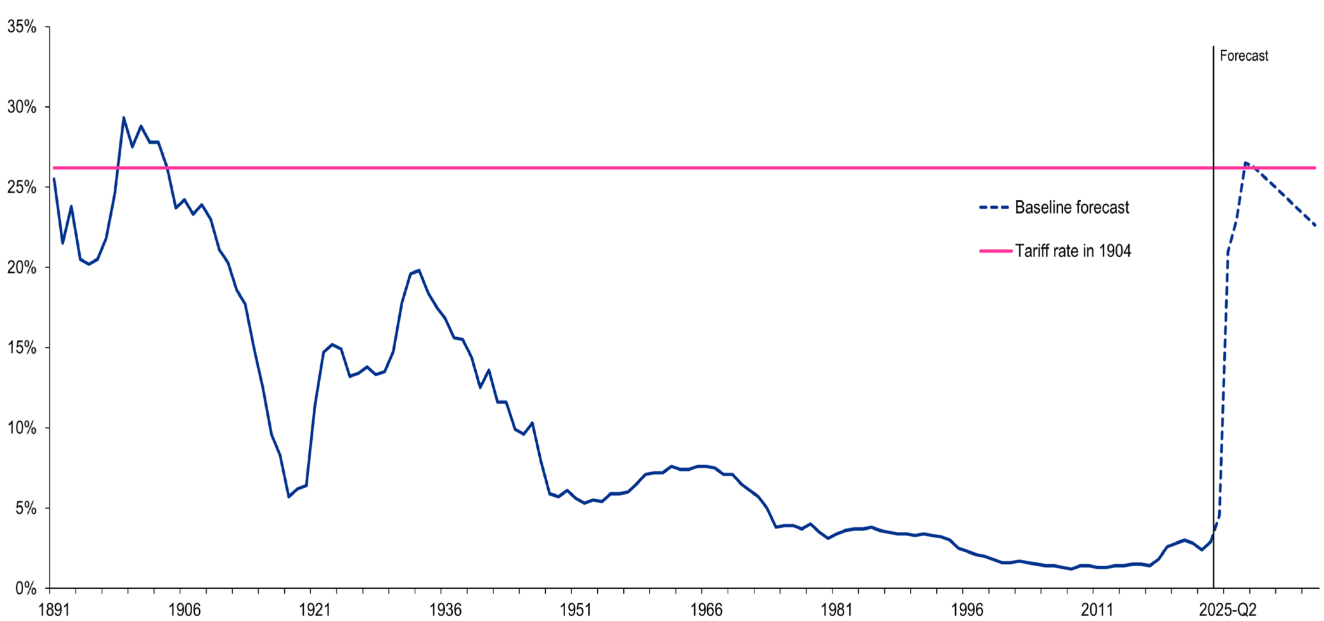
That raises the question: How will spending stay afloat if layoffs and a contraction in wealth deal a blow to high-income households?

2) Stoke uncertainty. Tariffs trigger retaliation, which can rapidly escalate. That spurs uncertainty, measures of which have already eclipsed the pandemic globally. Domestic measures of uncertainty are close to all-time highs and likely did the same, given financial market volatility over the last week.

The fact that the tariffs are issued via executive orders further muddies the water. Tariffs raised with the stroke of a pen can be reversed almost as fast, which adds to our collective paralysis.

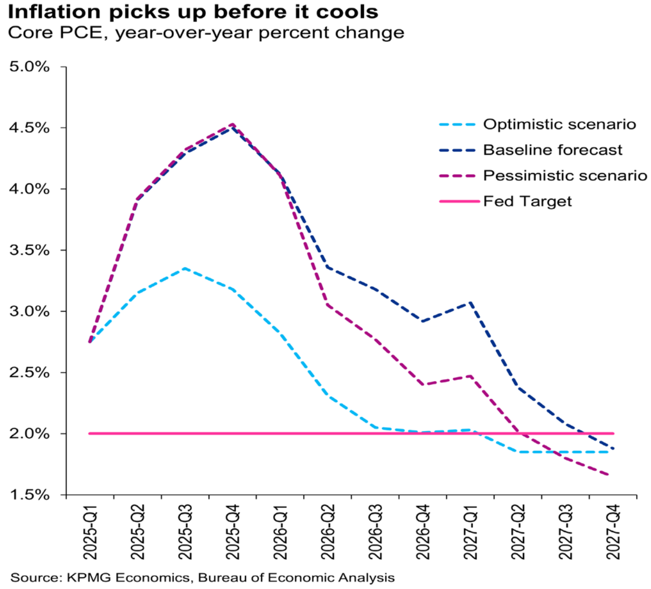
Chart 2

Tariffs peak at highest rate since early 1900's
Effective tariff rate, percent



Source: KPMG Economics, United States Census Bureau

Chart 3



3) Boost inflation. The April 2 tariffs are significantly larger than anything the president levied during his first term. They will cascade through supply chains and raise costs, much of which will be passed along to consumers.

Chart 3 shows the inflation forecast under the three scenarios. Inflation picks up in all three but is more consequential in our baseline forecast.

Weaker demand and falling commodity prices will blunt the boost to inflation due to tariffs. Another mitigating factor could be a strong dollar. Tariffs typically trigger an appreciation in the value of the dollar.

Thus far, that has not occurred. Fears of recession are forcing the dollar lower against the currencies of our trading partners. That makes imports more expensive and compounds the effects of tariffs on costs.

4) Spark financial market volatility. Financial markets have been late to acknowledge the fact that tariffs are as much a threat as a reality. That shifted on April 2. High tariffs turned into an undeniable fact.

The Volatility Index (VIX) for the S&P 500 stock index jumped to its highest levels since the pandemic in recent days; it is well above the highs of the 2018-19 trade war.

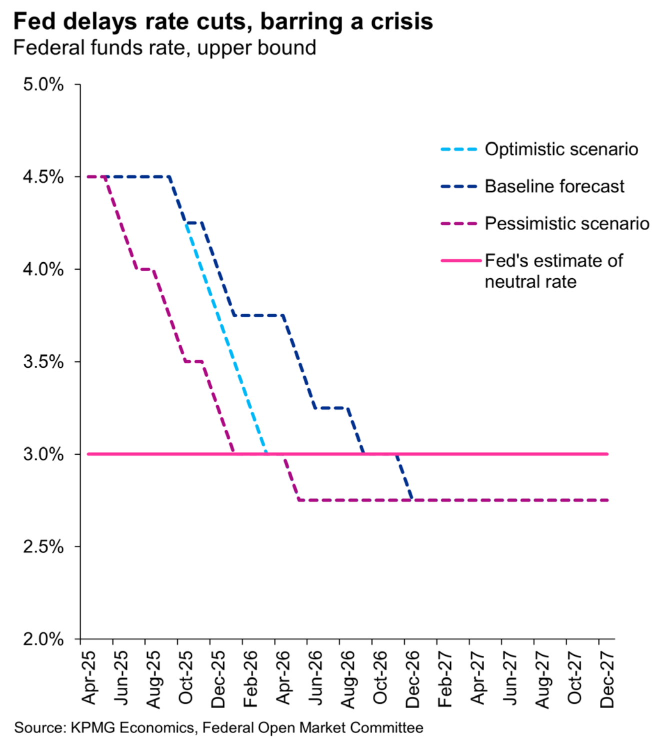
Financial markets are pricing in the risk of recession and assessing the exposure US firms have to economies abroad. About 40% of profits of the stocks listed in the S&P 500 come from outside the US. That makes them vulnerable to how the global economy weathers the tariff storm and prime targets for retaliation.

Markets are hoping the Fed can cut rates aggressively. Fed Chairman Jay Powell has pushed back on that notion, saying after a speech on April 4 “We are in no hurry” to cut rates.

The challenge for the Fed is the one-two punch of inflation and weaker growth, or the stagflation that tariffs could trigger. The Fed has internalized the lessons of the pandemic and those of the 1970s. That means it needs to hold the line on rates until it is sure that inflation will recede.

Chart 4 lays out the forecast for rate cuts under the three scenarios. The Fed resumes cuts in October under our optimistic and baseline scenarios. It starts to cut rates in May under the pessimistic case for all the wrong reasons. A deeper recession forces inflation to peak sooner.

Chart 4



5) Job losses outweigh job gains. Tariffs reduce competition, with the most protected industries not hiring enough to offset the blow to the hardest hit industries. This is especially true when there are so few domestic substitutes.

Few goods are 100% American made. That limits the industries that benefit from the protection of tariffs, while increasing those exposed to the downside.

6) Undermine productivity. Tariffs reduce competition, divert investment to less productive, protected industries and stifle large infrastructure investments. That undermines overall investment in and adoption of new technologies.

A recent study on the Gilded Age, when tariffs dominated our federal revenues, is particularly chilling. Some of the most "protected" firms exhibited a setback in productivity growth. Firms diverted funds to curry favor with politicians and lobby for their own interests.

Banks tighten their credit standards during periods of high uncertainty, especially for firms that may be exposed to tariffs. A widening of spreads between investment grade and junk bonds makes it harder for firms that need credit most.

7) Poor revenue generators. Tariffs have a more direct effect on demand than other taxes. They often fall short of estimates of what they can generate in terms of revenues.

The leverage of executive orders to implement tariffs further undermines their revenue-generating power, as they could be revoked at any point. That is why the nonpartisan Congressional Budget Office does not include tariffs issued via executive order in its scoring of the federal budget.

8) Erode export competitiveness. The blow to productivity, tighter credit standards and diversion of resources to protected sectors diminish our ability to export. Retaliatory tariffs, boycotts of US goods, curbs on foreign investment and travel to the US will further undermine exports.

9) Fail to level the playing field. Tariffs act as a stick instead of a carrot when lowering trade barriers. They often backfire as trade tensions escalate, which hurts our competitiveness at home and abroad.

Multilateral trade agreements work better at reducing hurdles to trade but require countries to adhere to rules and global enforcement mechanisms. The trust in global arbiters of trade conflicts eroded with China's ascent to the global stage.

This year, the administration further weakened funding for rule-setting organizations and overrode the USMCA to penalize Mexico and Canada. That could have a lingering effect on our ability to negotiate trade pacts.

10) Stokes nationalism. Last, but by no means least, tariffs tend to stoke nationalism. The Smoot-Hawley Tariff Act of 1930 triggered a trade war between the US and 10 of the 25 countries affected by the tariffs. The tariffs covered more than 20,000 goods.

In response, global trade plunged 67%, which threw the global economy deeper into the depths of the Great Depression. Those losses helped sow the seeds of World War II.

The Marshall Plan and efforts to rebuild after that war were seen as key ingredients to a more lasting peace. The postwar dismantling of trade barriers was another component. The hope was that economic integration would diminish the incentives to go to war.

In more recent decades, that view shifted. There was a hope that countries that embraced trade would be more open to the tenets of democracy. That did not prove to be the case. China and Russia are two key examples.

Bottom Line

One rarely sees Black Swan events coming, but much like the swans in that pond, the tariffs were in plain sight. The president was adamant about his preference for tariffs on the campaign trail and for decades before he ran for office.

However, nothing prepared us for the breadth and size of the tariffs announced on April 2. The jump in the effective tariff rate sharply increases the likelihood of a global recession. It is not too late for the White House to roll back the most devastating of tariffs. Some within the administration have signaled a willingness to negotiate. Breaking bread is better than breaking ties with our closest allies. Be kind; pay it forward.

Economic Forecast — April 2025

	2024	2025	2026	2024:4(A)	2025:1	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3	2026:4
National Outlook												
Chain Weight GDP[1]	2.8	0.5	0.2	2.4	0.2	-1.3	-1.9	-0.4	0.5	1.0	1.6	2.1
Personal Consumption	2.8	0.9	0.1	4.0	0.5	-2.3	-0.7	-1.1	0.5	0.7	1.3	1.9
Business Fixed Investment	3.6	0.2	-2.5	-3.0	7.9	-5.6	-4.8	-3.4	-2.2	-1.4	-0.7	0.3
Residential Investment	4.2	-2.3	-5.6	5.5	0.7	-4.2	-10.8	-8.9	-7.5	-3.2	0.2	3.0
Inventory Investment (bil $ '17)	39	47	25	9	78	71	14	25	13	15	25	46
Net Exports (bil $ '17)	-1034	-1101	-858	-1053	-1229	-1121	-1061	-992	-923	-868	-832	-810
Exports	3.3	-0.1	-0.8	-0.2	2.7	-2.1	-9.3	-4.8	-0.6	4.1	4.9	4.7
Imports	5.3	1.8	-7.1	-1.9	22.7	-12.0	-12.6	-10.6	-8.0	-3.4	-0.6	0.9
Government Expenditures	3.4	1.2	-0.2	3.1	1.0	-1.4	-0.8	-0.2	0.0	0.0	0.0	-0.2
Federal	2.6	0.3	-0.4	4.0	-1.6	-5.4	-2.1	-0.1	0.4	0.4	0.3	-0.2
State and Local	3.9	1.8	-0.1	2.5	2.6	1.0	-0.1	-0.2	-0.2	-0.2	-0.2	-0.1
Final Sales	2.7	0.5	0.3	3.3	-1.0	-1.2	-0.9	-0.6	0.7	1.0	1.4	1.8
Inflation												
GDP Deflator	2.4	3.8	3.6	2.3	3.7	7.1	3.9	3.8	2.7	3.8	3.0	2.7
CPI	3.0	3.7	3.8	3.0	4.1	5.6	3.6	3.9	3.1	4.3	3.8	3.2
Core CPI	3.4	4.3	3.6	3.4	3.8	7.7	3.9	3.7	2.1	4.6	3.2	2.6
Special Indicators												
Corporate Profits[2]	7.9	-8.6	-1.7	23.3	-7.2	-41.4	-12.3	-5.2	4.2	11.3	8.3	7.2
Disposable Personal Income	2.7	0.6	1.4	1.9	3.1	-2.3	-0.8	-1.8	5.6	0.9	2.1	3.1
Housing Starts (mil)	1.37	1.28	1.20	1.39	1.41	1.31	1.23	1.18	1.18	1.18	1.21	1.22
Civilian Unemployment Rate	4.0	4.6	6.2	4.2	4.1	4.4	4.8	5.2	5.7	6.1	6.4	6.6
Total Nonfarm Payrolls (thous)[3]	2081	723	-2593	509	615	-116	-534	-867	-815	-701	-488	-246
Vehicle Sales												
Automobile Sales (mil)	3.0	2.6	2.4	3.1	3.0	2.6	2.5	2.4	2.4	2.4	2.4	2.4
Domestic	2.0	1.8	1.7	2.0	2.0	1.8	1.7	1.7	1.7	1.7	1.7	1.7
Imports	1.0	0.8	0.7	1.1	1.0	0.8	0.8	0.7	0.7	0.7	0.7	0.7
LtTrucks (mil)	12.8	12.2	11.6	13.5	13.5	11.9	11.9	11.7	11.6	11.6	11.6	11.6
Domestic	10.1	9.6	9.2	10.7	10.5	9.2	9.3	9.2	9.2	9.2	9.2	9.2
Imports	2.7	2.7	2.4	2.8	2.9	2.7	2.6	2.5	2.4	2.4	2.4	2.4
Combined Auto/Lt Truck	15.8	14.8	14.0	16.5	16.4	14.5	14.4	14.0	14.0	14.0	14.0	14.0
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	16.3	15.2	14.4	17.0	16.9	14.8	14.7	14.4	14.4	14.4	14.4	14.4
Interest Rate/Yields												
Federal Funds	5.1	4.3	3.3	4.7	4.4	4.4	4.4	4.1	3.7	3.4	3.1	2.8
10 Year Treasury Note	4.2	4.2	4.1	4.3	4.5	4.2	4.1	4.1	4.1	4.1	4.1	4.2
Corporate Bond BAA	5.8	6.4	6.6	5.8	6.1	6.5	6.6	6.5	6.5	6.5	6.6	6.7
Exchange Rates												
Dollar/Euro	1.08	1.09	1.11	1.07	1.05	1.09	1.08	1.09	1.10	1.11	1.12	1.12
Yen/Dollar	151.5	147.7	143.5	152.5	152.4	148.0	147.0	146.0	145.0	144.0	143.0	142.0

[1] in 2024, GDP was $23.3 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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