KPMG Economics

Walking a tightrope
Biannual economic outlook

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When I was a kid, I saw a man walk a tightrope strung several stories high without a safety net. I remember the anxiety I felt with each step he took, fearing he would slip and fall to the cement below. It was simultaneously terrifying and mesmerizing.

That feeling haunted me as I put pen to paper to write about the outlook. The economy continued on its growth path in May, but the trajectory is precarious.

The sentiment data on the economy has weakened more than the hard data. The challenge is determining when and if the two will cross.

Consumer and business attitudes have soured. Measures of economic policy uncertainty have eclipsed the highs hit during the onset of the pandemic in the US and on a global scale. Trade policy uncertainty is driving those increases.

The response has been a toxic mix of panic and paralysis. Those who could, stockpiled inventories and bought ahead of tariffs. Those who couldn't, moved to the sidelines, waiting for the veil of uncertainty to lift.

The trade deficit widened at its fastest pace on record in the first quarter as imports flooded into the country, only to reverse course at the start of the second quarter. The reversal in the trade deficit in April was the largest on record, as imports plummeted.

A pause in May on the most prohibitive of tariffs on China triggered yet another panic. Much like we saw during the pandemic, supply chains had been scrambled when trade with China resumed.

Ships bringing goods into the country were diverted. Getting them back is costly. Shipping rates jumped at the fastest pace on record in early June as importers attempted to reroute ships to where they are needed.

Tariffs suppress growth

Real GDP edged down by a revised 0.2% in the first quarter, a tenth of a percentage point higher than in the initial release. Consumer spending slowed, largely in response to a later-than-usual Easter and harsh winter weather. Snow in parts of the South curbed discretionary spending. The bulk of the front-running on spending associated with tariffs showed up in vehicle sales late in the quarter. Housing activity cooled in response to higher mortgage rates.

Business investment rebounded as firms scrambled to buy equipment ahead of tariffs and deliveries in the aerospace industry rebounded following a strike late last year. Inventories ballooned but look like they are being undercounted. A rush to store inventories in what are known as bonded warehouses, which are used to hedge tariffs likely accounted for the undercount. The trade deficit widened at its fastest pace on record, as imports surged ahead of tariffs. Government spending contracted, with losses at the federal level offsetting a modest gain at the state and local level.

Prospects for the second quarter are not a lot better. Real GDP growth is expected to rise by 1.2% in the second quarter. Consumer spending is expected to pick up slightly, while housing remains in the doldrums. Business investment is poised to contract and inventories are expected to be liquidated. Government spending is getting a lift from the rush by baby boomer to tap their Social Security benefits early on fears they will be cut. The trade deficit is poised to narrow; it fell at it fastest pace on record in April, as imports fell off a cliff after surging in March.

The Fed remains sidelined by the threat of stagflation. The Fed has made clear that it cannot resume rate cuts until it is convinced the inflation induced by tariffs is tamed. That puts them in the uncomfortable position of holding off on rate cuts, even as unemployment rises. The first rate cut is not expected until December. That leaves us with one less rate cut in 2025 than we forecast a month ago.

Disruptions to supply chains are well underway. Some plants have scaled back in response to parts shortages. We shed 8,000 manufacturing jobs in May as those disruptions cumulated.

Those shocks are colliding with higher tariffs to constrain supply, while boosting costs. The disruptions are so large that they are simultaneously prompting hiring freezes and hesitation, while boosting consumer prices. That is seeding fears of stagflation.

This edition of *Economic Compass* takes a closer look at where the administration is in enacting its policy agenda. The speed and sequencing of policies have been destabilizing; the most costly policy changes are front-loaded. The result is a slowdown in growth with a mild bout of stagflation, which is a period of rising inflation and escalating unemployment.

That has left the Fed stuck on the sidelines, determined to tame any tariff-induced inflation before cutting rates again. The equity market has decoupled from the bond market, as Treasury bonds lose their luster as a global "safe haven." The dollar is in a similar place. The era of cheap money with no consequences is over. Government deficits and debt matter.

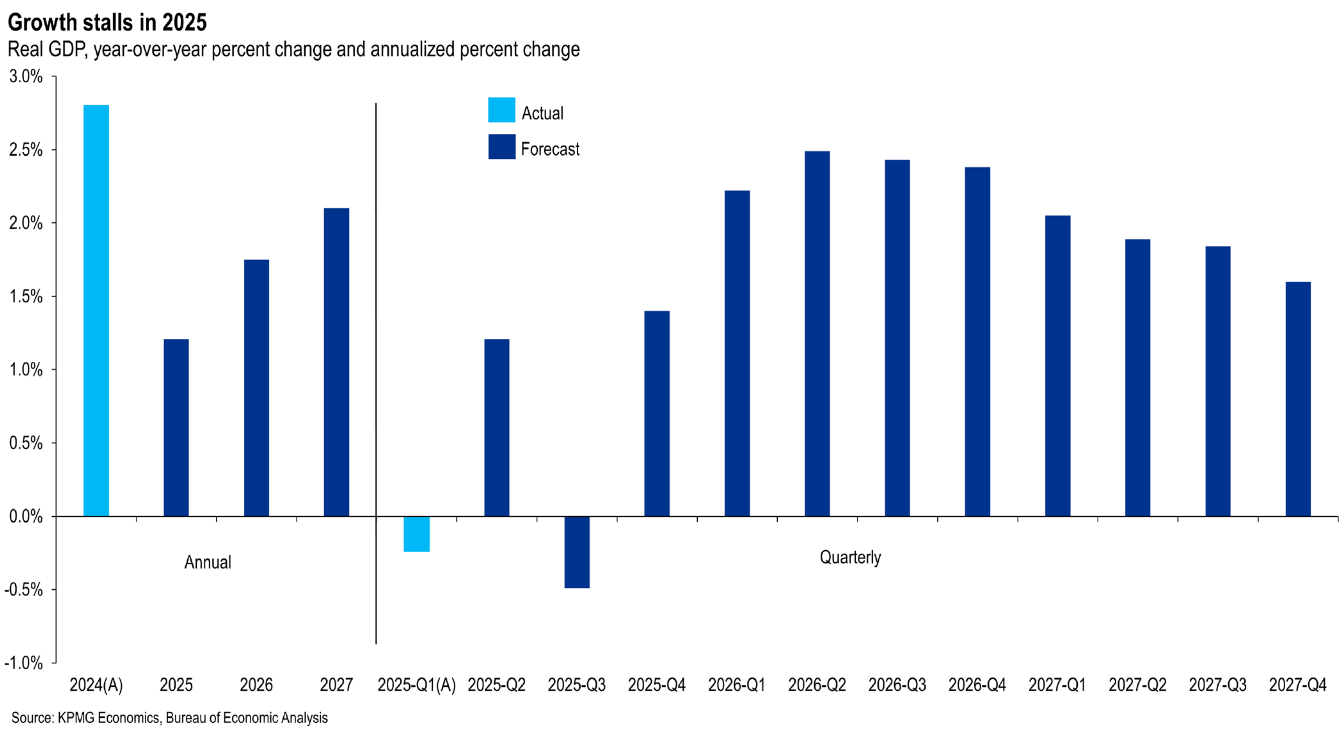
The near-term outlook

A treacherous path forward

Chart 1 shows the forecast from 2025 to 2027. Growth skips a beat over the summer but avoids slipping into an "official" recession. That does not mean we will not feel pain:

- **Consumer spending stalls** as inflation erodes purchasing power. Employment is slowing and consumers are stressed. Delinquencies are rising, with high-income zip codes outpacing less affluent areas.
- **Housing loses ground** as affordability is further strained. Mortgage rates have moved up along with construction costs, which have prompted cancellations. That has boosted demand for apartments. Rents could rebound before year-end.
- **Business investment contracts** as persistently high levels of uncertainty, tight credit conditions and escalating input costs prompt business to hunker down. Data centers are the exception and still strong. Slowing investment in new structures will be a drag on growth.

Chart 1



- **Government spending stalls** with a brief pickup in federal outlays tempered by a slowdown at the state and local level. What is left of the fiscal 2025 budget will need to be spent before the end of the fiscal year on September 30. That is assuming a reconciliation package is passed before then.
- **The trade deficit improves** as imports slip below the pace of exports due to high tariffs. Weak growth abroad and the risk of retaliation by our trading partners keeps exports subdued.

Whether the slowdown is enough to qualify as an "official" recession is a matter of semantics. Most Americans thought we were in a recession, when a spike in inflation eroded their purchasing power. The acceleration in inflation is expected to be less this time around but the sting of the earlier inflation lingers.

Prospects for 2026-27 are better, as expansions to tax cuts pretty much offset tariff hikes. However, the effects of tariffs are regressive and spur more inequality than proposed tax cuts.

The unemployment rate rises too slowly to qualify as an "official" recession. It moves up to 4.7% by year-end and peaks at 5% in 2026. It would be higher absent curbs on immigration, which limit the supply of workers.

Downside risks: The risk of a recession is still too high for comfort. The labor market is starting to look fragile; once employment slips into the red, it tends to do so rapidly and stay there.

Assessing policy shifts

The president signed 259 presidential documents since Inauguration Day. They include 157 executive orders, 39 memoranda and 63 proclamations. That is a record, as of June 3.

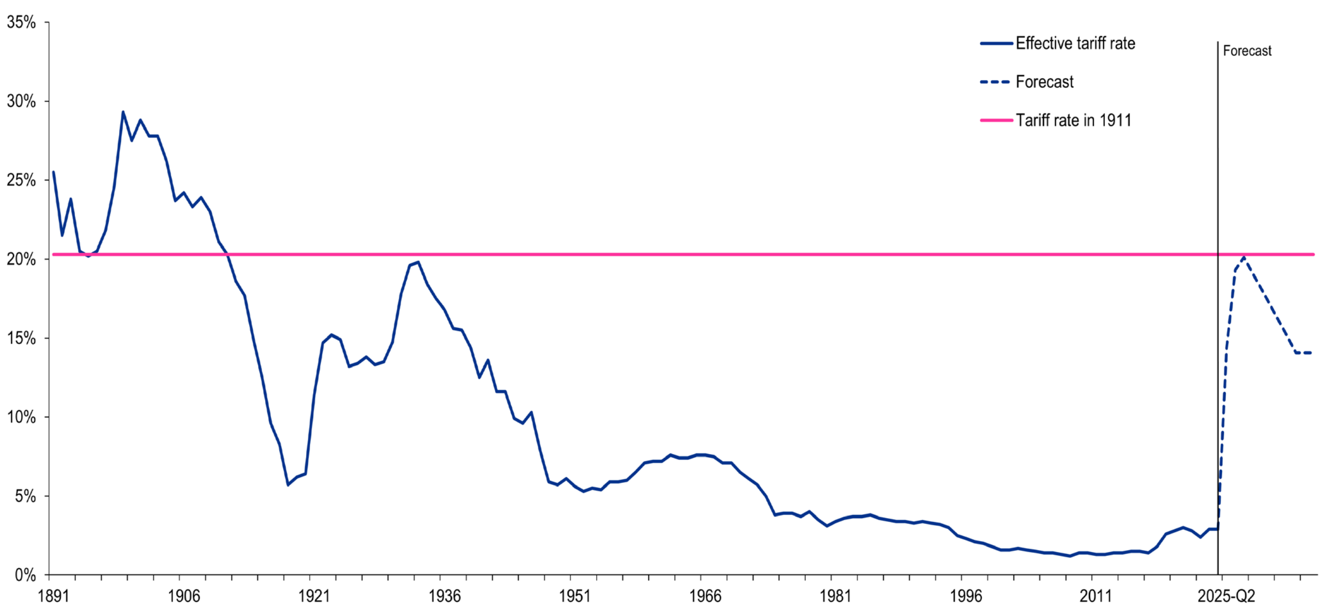
Nearly as many lawsuits have been launched challenging the legality of those actions. That is adding to policy uncertainty.

The policy shifts with the largest immediate effect on the economy are:

- Trade and tariffs.
- Immigration and border security.
- Government efficiency and the federal workforce.
- The budget reconciliation bill, also known as the "One, Big, Beautiful Bill," making its way through Congress.
- Regulatory reform.

Chart 2

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



Source: KPMG Economics, United States Census Bureau

Trade and tariffs

Chart 2 shows our estimate of the effective tariff rate over the next three years. Tariffs peak at a little above 20% in the fourth quarter of 2025, the highest rate since the early 1900s:

- The president wants to make good on his campaign promises to raise tariffs to 60% on China and 10% on the rest of the world. We are close.
- Sector tariffs for semiconductors, pharmaceuticals, copper and lumber are next.
- Staffing shortages and tight timelines are bogging down the pace of negotiations; we are less than a month out from the end of the 90-day pause on the highest tariffs on all but China, Canada and Mexico.
- Some reciprocal tariffs on countries with large goods deficits with the US are expected to be reinstated. Vietnam ranks high on that list.
- Trade tensions with China are in flux. The Treasury Secretary has warned against any quick resolutions.

The effective tariff rate tapers as we move into 2026, as firms get better at mitigating the bite of tariffs. Supply chains are being reshuffled and trade rerouted while efforts to document the domestic content of goods to limit tariff costs are on the rise.

Efforts to repeal the tariffs by individual business groups, the states and Congress have all emerged. The administration has levers it can pull to restore any tariffs that are found to be illegal. The administration is testing the waters with applying tariffs retroactively.

Either way, much of the disruption triggered by tariffs has already occurred. Those are hard to reverse.

Tariffs protect some industries at the expense of others. Research on the 2018-19 steel and aluminum tariffs reveals that they cost more jobs than they created; the manufacturing sector lost 75,000 jobs for the 1,000 created in the steel industry.

Adding insult to injury, those earlier tariffs led to what is known as "cascading protectionism." Industries that suffered the consequences of tariffs lobbied the administration for their own protection from foreign competition. That underscores the nonlinear nature of trade wars and illustrates why they are easier to start than stop.

Immigration & Border Security

Illegal border crossings have slowed to a virtual halt. Changes to the legal status of refugees and asylum seekers, high-profile deportations, threats of family separations, efforts to revoke student visas and raids at individual businesses are further curbing legal and illegal immigration. Some are opting out of their own volition.

More than a million foreign-born workers left the labor force in April and May combined. That is curbing the supply of workers and has kept unemployment from rising, despite a slowdown in the pace of hiring.

Payroll employment has risen by a dismal 124,000 per month since the start of the year. That is the lowest pace outside of a recession in more than 20 years. The pace of quits slipped, which is a sign of worker insecurity.

The result has left us with a more fragile labor market, despite pockets of worker shortages. Foreign-born workers often fill jobs that the native-born will not.

The losses have already shown up in the care economy. Payrolls in assisted living facilities, where demand is rising, have declined since February.

In-home elder care and childcare job gains have slowed as well, which is showing up in escalating prices and workforce disruptions. The result is a rise in the number of native-born caregivers who have to reduce hours worked or leave the labor force entirely.

Separately, wages accelerated in May and were revised up for April. The largest gains were in pockets of the economy most sensitive to immigration and the push to get goods into the country before tariffs move higher.

Sectors with the largest one-month wage gains were in information, wholesale trade, healthcare and social assistance and nondurable goods. The latter includes food processing and low value-added manufacturing that depend more on low-wage immigrant workers.

Government Efficiency & the federal workforce

As of April, some 283,000 federal job cuts were announced. Only a small fraction of those cuts has shown up in the payroll data, mostly as retirements. Job openings cannot be filled due to a hiring freeze.

Most federal workers who were cut took buyouts or were put on administrative leave. Those workers still show up on federal payrolls, even though they are not working. That is adding to staffing shortages and sets the stage for larger losses come October, when those workers are slated to come off government payrolls.

Recent research by the Atlanta Federal Reserve suggests that we could lose up to 1.2 million jobs in total. Most federal employees work outside of Washington DC; the layoffs are hitting the entire ecosystems of local communities.

Those losses are in addition to funding freezes and cuts to research, higher education and a large array of government contractors. Cuts in key personnel at the statistical agencies could compromise the quality and speed of economic data. That worries economists.

The fate of future layoffs is up in the air, given the public breakup between the man leading the charge on those cuts and the president. The break is still too fresh to discern which way the wind will blow on federal cuts.

The "One, Big, Beautiful Bill"

The nonpartisan Congressional Budget Office has scored the budget reconciliation package passed by the House of Representatives. It will add an estimated $2.4 trillion to our government debt over the next decade. The debt-to-GDP ratio rises from more than 100% in fiscal 2025 to 156% in 2055.

Those figures are conservative, as they include large cuts to Medicaid that Senate Republicans oppose and are based on current law. That means that they assume temporary extensions to tax cuts will lapse, even though the opposite has repeatedly occurred.

Aging demographics are catching up with us. Younger baby boomers scrambled to apply early for Social Security in April, even though that meant smaller payouts. They fear losing their benefits to future cuts.

Congress stopped worrying about debt and deficits in 2003. The last time the US saw surpluses were fiscal years 1999, 2000 and 2001. There was a moment in the late 1990s when many in the Treasury bond market feared that new issuances would grow scarce. That thought seems comical today.

Regulatory reform

The animal spirits the administration hoped to unleash with deregulation have been at least temporarily tamed by the destabilizing effects of tariffs and the fragmentation of regulatory oversight.

The largest efforts were hoped to boost oil production and spur stable coins and the crypto markets. The sticking point for oil production is the level of oil prices, which is too low to justify the break evens on new wells.

High tariff regimes tend to stoke fraud and abuse, which has prompted an increase in enforcement by Customs and Border Protection. That is adding to regulatory burdens along with the paperwork associated with tariffs.

Separately, the administration has significantly increased food and drug regulations. Ten major initiatives have been introduced to expand Food and Drug Administration oversight, enhance safety requirements and strengthen enforcement.

Those are in addition to the void left by executive orders, which the states have been eager to fill. Our internal regulatory group is currently tracking nearly 1,000 bills on AI making their way through state legislatures. Those are in addition to regulations on privacy, employment and consumer protections.

Higher inflation

Chart 3 shows the forecast for the core Personal Consumption Expenditures (PCE) Index, the Fed's preferred inflation measure. It peaks at 4.3% on a year-over-year basis in the fourth quarter, nearly two percentage points above the level hit in April.

That is more than one-half percentage point above the level we expected just a month ago. The move up reflects the higher peak in tariffs and dollar depreciation.

A recent survey by the Federal Reserve Bank of New York revealed that nearly three quarters of firms raised prices in response to the initial tariffs; some passed all of the increases on. Only 25% absorbed the cost.

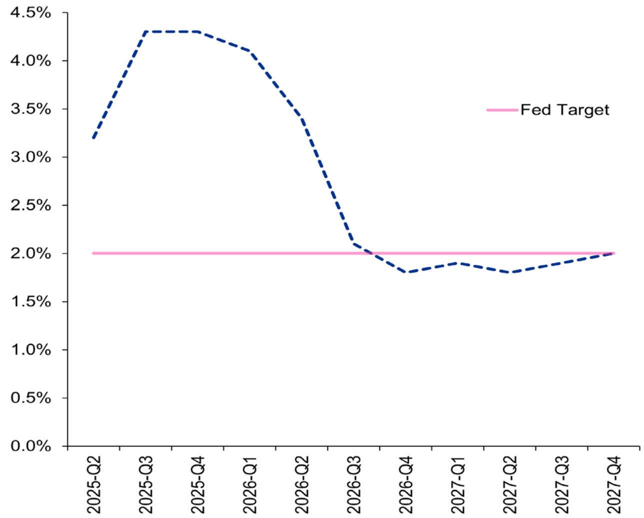
Even more stunning was the speed with which costs were passed on. More than "half of both manufacturers and service firms said they raised prices within a month of experiencing tariff-related cost increases – many within a day or week," the report said.

The contagion associated with those price hikes was high. "[A] significant share of businesses reported raising the selling prices of their goods and services unaffected by tariffs."

That's before taking dollar moves into account, which work with a lag. The dollar has depreciated about 10% against a broad basket of currencies since its peak in early January but remains about 20% overvalued.

Chart 3

Inflation peaks at higher level
Core PCE, year-over-year percent change



Source: KPMG Economics, Bureau of Economic Analysis

Another double-digit depreciation is possible. That would amplify the inflationary effects of tariffs and slow the descent in inflation. The silver lining is the impact on exports, which is to the upside as we get into 2026 and 2027.

Separately, productivity growth tends to suffer during high-tariff regimes. Research on the Gilded Age, an era known for its reliance on tariff revenues, revealed that productivity growth fell at firms that were most protected by tariffs. That is even though we were in the middle of the Industrial Revolution.

Downside risks: Consumers lack the cushion of fiscal stimulus that they had to absorb price hikes during the pandemic. The loss of those funds, coupled with downside risks to employment, could deal a larger blow to demand, which would blunt the rise in inflation associated with tariffs.

Policy purgatory for the Fed

Chart 4 shows the forecast for rate cuts by the Federal Reserve. The Fed is expected to hold off until December before cutting rates. That is one rate cut less than we expected a month ago. Rising unemployment is expected to provide the cover the Fed needs to make that cut.

Rate cuts are now slower in the first half of 2026 due to a more moderate descent in inflation. A change in the Fed Chairman and at least one seat on the Board of Governors next year opens the door to more aggressive easing midyear.

We are expecting the Fed to cut by a quarter point twice in the first half of the year and three times in the second. That may be too conservative given the political pressure to stimulate prior to mid-terms.

The current estimate for the Fed's neutral or "terminal" fed funds rate is in a 2.75% to 3% range. That is where we expect the Fed to stop on rate cuts.

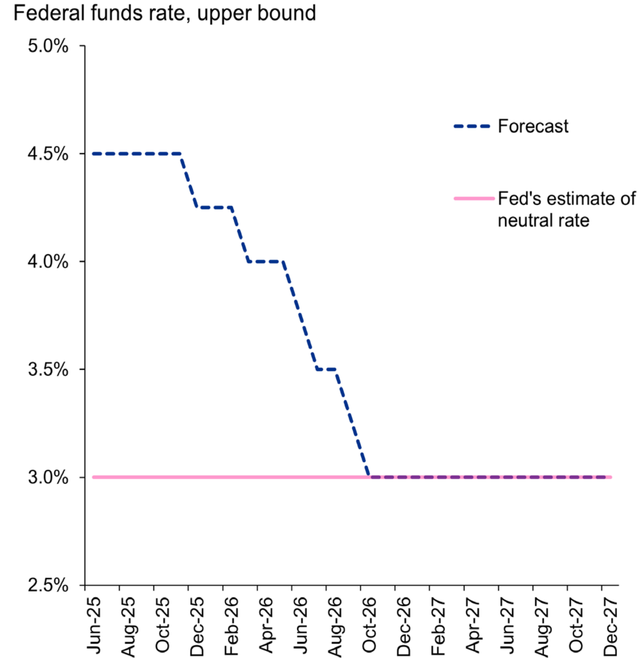
There is a risk that the Fed bows to political forces after Chairman Jay Powell's term ends in May 2026. That will leave at least two pivotal seats for the president to fill.

The president is expected to appoint loyalists to those roles, who are more likely to push for rate cuts. That ups the risk of overstimulating later in the cycle, despite resistance from remaining Fed leaders.

Downside risks: Weaker growth or a recession, coupled with a change in Fed leadership could prompt it to cut more aggressively in 2026. That would be highly destabilizing to the bond market, which is already showing signs of strain.

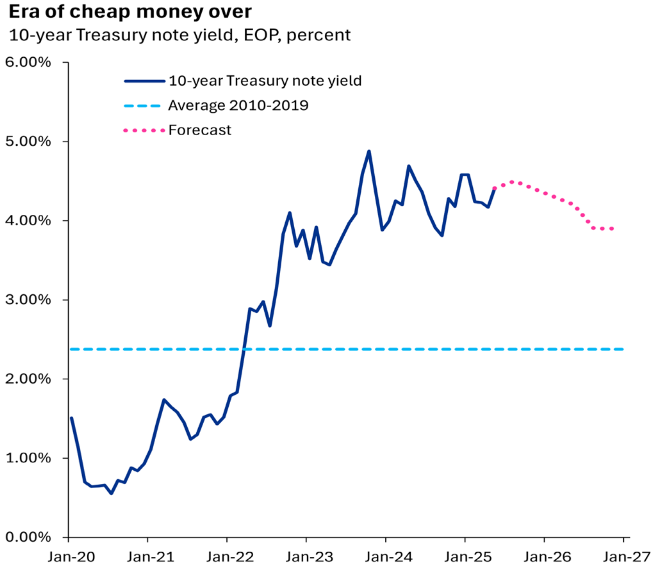
Chart 4

Fed is forced to cut more slowly
Federal funds rate, upper bound



Source: KPMG Economics, Federal Open Market Committee

Chart 5



Source: KPMG Economics, Federal Reserve Board, Haver Analytics

Treasury bonds lose their luster

Chart 5 shows the forecast for Treasury bond yields, which have risen with a return of what is known as the term premia. That is the extra amount investors require to hold long-term over short-term debt. Several factors are contributing to that shift:

- Central banks, which tend to hold Treasury bonds to maturity, have reduced their purchases over the last decade.
- The move out of Treasuries and into other “safe assets” accelerated after Russia’s invasion of Ukraine – gold and German Bunds are two examples.
- Individual investors, who tend to be more price sensitive, have filled the void left by central banks. They need to be compensated via higher yields due to concerns about higher inflation and escalating government debt.
- A surge in government debt is flooding the market with new supply, which is pushing bond prices lower and yields higher. (The two move in opposite directions.)
- Concerns about the Fed’s independence have intensified, which raises the risk of more inflation and further erodes the safe haven status of Treasuries.
- The dollar has lost some of its luster as a reserve currency, which has spillover effects for the attractiveness of the Treasury bonds.

That does not equate to “de-dollarization” – there is still no substitute for the dollar as a reserve currency. However, it has lost market share to a basket of other currencies and safe haven assets in recent years. Crypto currencies and stable coins are on that list.

Upside risks: The Senate is expected to push back on many of the cuts in the budget package by the House of Representatives. That could further spook Treasury market investors and push yields higher instead of lower.

Bottom Line

The speed, scope and sequencing of the administration’s agenda have left us traversing a high-wire, hoping to avoid a fall. The anxiety and uncertainty about the outlook are about as high as I have ever experienced. It is worse than during the height of the Global Financial Crisis in 2008-09, or the pandemic.

It is hard to imagine how bad the devastation would have been if the Fed and lawmakers hadn’t come together to provide a safety net to cushion the blow of those earlier events. Now it is hard to imagine our political leaders agreeing on just about anything, especially when it comes to efforts to rein-in the federal deficit.

If we fail to put ourselves on firmer financial footing, financial markets could do so for us. That is a fall from grace worth avoiding for the world’s largest economy. Tread cautiously, keep your focus on the horizon; don’t look down. Be kind; pay it forward.

Economic Forecast — June 2025

	2024	2025	2026	2024:4(A)	2025:1(A)	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3	2026:4
National Outlook												
Chain Weight GDP[1]	2.8	1.2	1.7	2.4	-0.2	1.2	-0.5	1.4	2.2	2.5	2.4	2.4
Personal Consumption	2.8	2.2	1.5	4.0	1.2	2.4	0.3	0.6	1.8	1.9	2.1	2.3
Business Fixed Investment	3.6	0.9	-0.7	-3.0	10.3	-3.3	-7.0	-3.5	-1.8	1.3	1.2	1.6
Residential Investment	4.2	-1.4	-0.4	5.5	-0.6	-2.7	-7.5	-1.7	-0.8	1.9	4.7	6.0
Inventory Investment (bil $ '17)	39	23	33	9	163	-22	-35	-13	6	27	42	56
Net Exports (bil $ '17)	-1034	-1189	-959	-1053	-1379	-1176	-1137	-1064	-1001	-965	-941	-931
Exports	3.3	2.0	3.1	-0.2	2.4	1.4	-0.9	0.7	3.6	5.7	5.7	4.8
Imports	5.3	5.7	-3.8	-1.9	42.6	-17.9	-4.7	-7.0	-4.2	0.1	1.5	2.5
Government Expenditures	3.4	1.8	0.4	3.1	-0.7	1.8	1.6	0.5	0.0	0.1	0.0	-0.2
Federal	2.6	2.0	1.2	4.0	-4.6	3.0	3.5	2.3	0.3	0.4	0.3	-0.2
State and Local	3.9	1.6	-0.1	2.5	1.7	1.1	0.4	-0.6	-0.2	-0.2	-0.2	-0.1
Final Sales	2.7	1.3	1.7	3.3	-2.9	4.5	-0.3	1.0	1.9	2.1	2.2	2.2
Inflation												
GDP Deflator	2.4	3.6	2.6	2.3	3.7	5.3	5.8	2.4	2.4	1.4	1.2	1.7
CPI	3.0	3.5	3.1	3.0	3.8	3.7	6.5	3.0	2.9	2.3	1.8	2.0
Core CPI	3.4	3.9	3.1	3.4	3.5	4.9	6.9	2.9	2.6	2.2	1.6	1.8
Special Indicators												
Corporate Profits[2]	7.9	-5.8	1.0	23.3	-11.3	-29.0	-9.0	-1.1	7.4	8.5	7.9	6.1
Disposable Personal Income	2.7	1.4	3.0	1.9	2.9	2.2	-3.0	0.9	8.0	2.8	3.0	3.6
Housing Starts (mil)	1.37	1.31	1.30	1.39	1.40	1.32	1.29	1.26	1.26	1.28	1.31	1.33
Civilian Unemployment Rate	4.0	4.4	4.9	4.2	4.1	4.2	4.4	4.7	4.9	5.0	5.0	4.9
Total Nonfarm Payrolls (thous)[3]	2081	1472	-123	509	543	459	-63	-253	-136	30	118	148
Vehicle Sales												
Automobile Sales (mil)	3.0	2.6	2.4	3.1	3.0	2.7	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	0.9	0.7	1.1	1.0	0.9	0.8	0.7	0.7	0.7	0.7	0.7
LtTrucks (mil)	12.8	12.4	11.6	13.5	13.5	12.7	11.8	11.6	11.6	11.6	11.6	11.6
Domestic	10.1	9.8	9.2	10.7	10.5	10.1	9.3	9.2	9.2	9.2	9.2	9.2
Imports	2.7	2.6	2.4	2.8	2.9	2.6	2.5	2.4	2.4	2.4	2.4	2.4
Combined Auto/Lt Truck	15.8	15.0	14.0	16.5	16.4	15.4	14.3	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	15.4	14.4	17.0	16.9	15.8	14.7	14.4	14.4	14.4	14.4	14.4
Interest Rate/Yields												
Federal Funds	5.1	4.4	3.6	4.7	4.3	4.4	4.4	4.3	4.1	3.9	3.4	3.0
10 Year Treasury Note	4.2	4.5	4.1	4.3	4.5	4.5	4.5	4.4	4.3	4.2	3.9	3.9
Corporate Bond BAA	5.8	6.4	6.3	5.8	6.1	6.4	6.5	6.5	6.5	6.4	6.2	6.2
Exchange Rates												
Dollar/Euro	1.08	1.13	1.17	1.07	1.08	1.13	1.14	1.15	1.15	1.16	1.17	1.18
Yen/Dollar	151.5	144.0	138.5	152.5	149.9	144.0	142.0	141.0	140.0	139.0	138.0	137.0

[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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