KPMG Economics

Climbing a wall of worry
Navigating uncertainty amidst an erosion of trust

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Uncertain situations prompt us to err on the side of caution. It is a base instinct that can be tempered by trust. Those who trust those around them tend to weather the tides of uncertainty better. An erosion of trust can amplify the consequences of uncertainty, causing people to behave even more cautiously.

Economists have taken note of these base human emotions and investigated how they affect decision-making and by extension, shifts in the economy. A surge in uncertainty tends to act as a tax on economic activity; it causes us to delay big spending decisions.

Trust is the oil of a market economy. With it, the economy moves forward unencumbered. Without it, the engine of the economy can literally seize and stop functioning. Some of the most extreme examples we have seen are when financial markets have seized and trades could not clear.

That is why economists are alarmed by the one-two punch of a surge in uncertainty amidst an erosion of trust. The experience five years ago with the onset of the pandemic provides a cautionary tale.

Measures of uncertainty spiked on a global scale as Wuhan went into lockdown in January 2020. Fear of contagion was so great that employment fell by a record-breaking 1.3 million jobs between February 16 and March 14, before any lockdown went into place.

This edition of *Economic Compass* takes a closer look at the economic consequences of a surge in economic policy uncertainty can have amidst an erosion in trust. The two together act like a broken stoplight at a busy intersection, slowing the flow of traffic to a crawl as each driver cautiously takes their turn at crossing. Some make a U-turn and opt out of moving forward, waiting until the light is fixed or the traffic has cleared.

Uncertainty breeds hesitation

Real GDP is expected to rise at a tepid 1.0% pace in the first quarter, less than half the 2.3% pace of the fourth quarter. Consumer spending is slowing after a last-minute holiday rush in December. Housing activity is expected to be suppressed by an erosion in affordability and the hesitation that accompanies a surge in uncertainty. Business investment should temporarily rebound as delays following a strike in the aerospace industry are recouped. Firms have attempted to front-run tariffs, which is pulling some demand forward. Inventories are being replenished. Government spending is expected to edge up, aided by gains in state and local spending. The trade deficit is expected to widen on the heels of a surge in imports that were stockpiled ahead of tariffs.

Real GDP is expected to rise only 0.9% in the second quarter, marking the second quarter in a row of sluggish growth. Consumer spending is expected to further moderate, as consumers hold back on big purchases and tariffs start to show up in prices. Housing will likely continue its descent. Business investment is expected to flatline, while inventories edge up. Government spending is expected to contract as the federal workforce is slashed along with grants and funding for scientific research but still a challenge.

A blast from the past?

Sluggish growth amidst an increase in tariffs and pockets of labor shortages due to curbs on immigration is expected to produce a period of rising unemployment and elevated inflation, or stagflation. The coming bout of stagflation is nothing like what we saw in the 1970s, but still a major challenge for the Federal Reserve.

Fed shifts to wait-and-see mode. Fed Chairman Jay Powell recently argued that he is “separating the signal from the noise” in determining the economic effects of the administration’s rapid ramp-up of its policy agenda. We expect the Fed to hold off on rate cuts until early 2026, well after the inflation triggered by tariffs is expected to peak. The Fed will move gradually in any decisions on rates not necessary, given the uncertainty surrounding the outlook.

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The Federal Reserve is expected to hold off on rate cuts until early 2026. Financial markets have front-run rate cuts, which suggests a painful adjustment.

Downgrading the outlook

Chart 1 lays out our three scenarios for growth through 2027: The baseline, an optimistic and a pessimistic path. The trajectory for tariffs is the primary differentiator. They are being levied faster and at higher levels than we previously anticipated. Some $500 billion in goods are not included in the exemptions that the administration brokered with Canada and Mexico. A whole new batch of tariffs is expected in April.

The base case is now much weaker than just a month ago, especially at the start of the year. It includes:

- A peak in tariffs not seen since the 1930s. Recently announced tariffs cumulate; they are layered on top of each other. The effective tariff rate slowly falls as firms gain waivers and clawbacks for domestic content and reroute goods to avoid tariffs. (See Chart 2.)
- Swift retaliation from our trading partners, targeted to inflict economic and political pain.
- More complex deregulation than many hoped in the aftermath of the election. States are filling a void left by executive orders, which along with breaks with global norms, are forcing firms to navigate a more fragmented regulatory landscape.
- Extensions and expansions to tax cuts are not expected to be permanent to avoid going through full budget reconciliation in Congress.
- An acceleration in cuts to the federal workforce, including curbs on social programs, grants to nonprofits and investments in scientific research.
- A surge in uncertainty amidst an erosion in trust, which tends to delay big spending and investment decisions by households and firms.

The result is weaker growth, rising unemployment and elevated inflation - or stagflation.

Downside risks: Research consistently shows that spending cuts to programs that shore up low-income households and government grants and contracts have the most immediate negative effects on the economy. Proposed tax cuts will not be felt in full until 2026 and 2027. A recession cannot be ruled out.

Chart 1

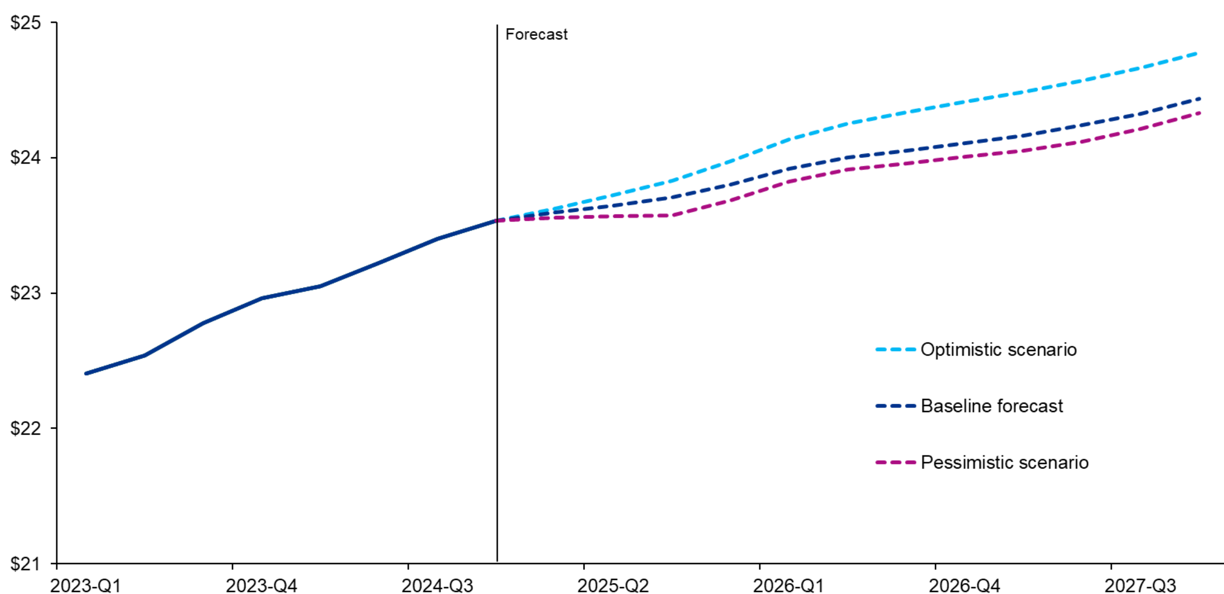

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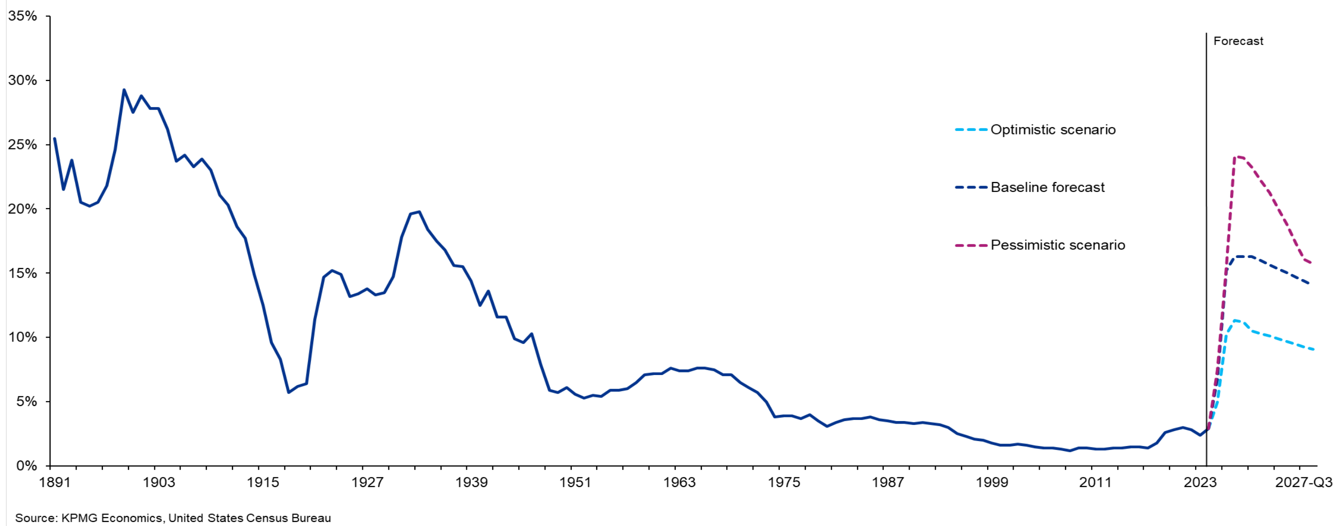
Chart 2



A vicious cycle

Chart 3 shows the surge in economic policy uncertainty post-election. The Global Economic Policy Uncertainty (EPU) index has already eclipsed the pandemic. The US EPU index is catching up rapidly; it reached its second highest level on record in February. Tariffs, threats of retaliation, changes to migration policies and shifting geopolitical allegiances stoked that surge.

Chart 4 shows the erosion in trust by the public in government. Those who viewed the government as doing the right thing always or most of the time moved from the majority of Americans in the late 1950s and early 1960s, to the minority in recent decades. We are not alone, as the electorate abroad has experienced an erosion in trust.

A study by Pew Research reveals that the deterioration in trust is not limited to the public sector. It extends to the private sector. The pandemic accelerated that decline, especially for large firms, banks and financial institutions.

The exception is trust in small businesses. They get close to 90% favorability ratings from members of both political parties. That is no small feat in these divisive times.

Consumers hunker down

Economic research[1] reveals that consumers tend to focus more on necessities over discretionary purchases during periods of high uncertainty. They shy away from big-ticket purchases, save more and swap expensive for cheaper items to hedge shocks.

Add the regressive nature of tariffs, and lower and middle-income households get hit hardest by those shifts. That will exacerbate inequality, which further erodes trust.

Surveys of consumer attitudes plummeted in January and February on concerns about job security and fears of inflation. Fear of tariffs and a surge in layoff announcements clearly played a role in that shift.

Consumers are more likely to spend with companies they trust when uncertainty spikes. They will even pay a premium for goods and services provided by companies they trust.

They are also more likely to vote with their wallets and coalesce around firms that align with their own ideologies. That is a tough landscape for firms to navigate, given the divisiveness of our politics.

1 https://www.law.nyu.edu/sites/default/files/Kuhnen%20Expectations%20Uncertainty%20and%20Household%20Economic%20Behavior.pdf

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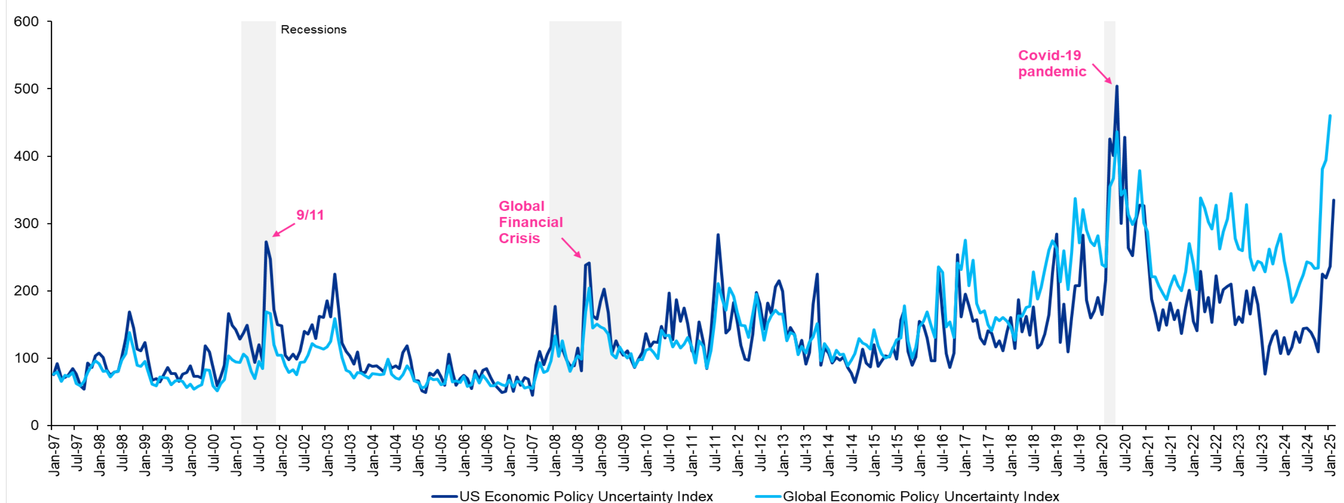
Chart 3



Housing suffers

Home buying and building are already extremely unaffordable. Add a spike in mortgage rates and the tendency to shy away from large purchases, such as a mortgage, and residential investment is expected to contract in 2025.

Home builder confidence has already plummeted. Escalating material costs and fears surrounding tariffs on key inputs contributed to that decline. The industry is also disproportionately dependent on immigrant labor, which represents another cost hurdle to overcome.

Businesses hesitate

Firms tend to shelve[2] big investment decisions during periods of heightened uncertainty. Those with the largest and most irreversible investments, such as a manufacturing plant, are among the most paralyzed.

Another hurdle is credit conditions, which tend to tighten[3] during periods of high uncertainty. This is in addition to the tightening[4] of credit conditions for the firms most at risk for tariffs. That adds insult to injury to firms required to front the funds needed to prove they can pay the tariffs on their imports.

Investment in R&D tends to slow during periods of elevated uncertainty. Politically sensitive industries tend to see less of a negative effect on their R&D activity; it could even stoke investments in high-growth tech firms.

Firms unable to fully pass the costs of tariffs onto buyers will suffer a margin squeeze. That, coupled with weaker sales due to high prices, will curb profits, cash flow and resources for investment. Firms concentrate their business with trusted counterparties as uncertainty persists.

What about on-shoring? The reduced competition triggered by tariffs is spread between prices and production, while innovation suffers. The 2018-19 trade war with China caused a net loss in manufacturing employment. The steel industry, which benefited the most from those earlier tariffs, failed to add any new capacity.

Inventories accumulate

Companies are trying to front-run tariffs where possible and stockpile goods likely to be tariffed. That is a short-term solution considering the high costs of financing inventories. A larger rise in inventories is expected as demand slows more dramatically as we move into the year.

Government spending hits a wall

Cuts to the federal workforce are expected to accelerate, along with efforts to scale back grants and transfers to state and local governments. The bill the House of Representatives sent to the Senate included large cuts to social programs; that would be an added drag to government spending.

2 https://www.sciencedirect.com/science/article/abs/pii/S0275531923000090

3 https://www.sciencedirect.com/science/article/abs/pii/S1544612318303672

4 https://www.federalreserve.gov/econres/ifdp/files/ifdp1383.pdf

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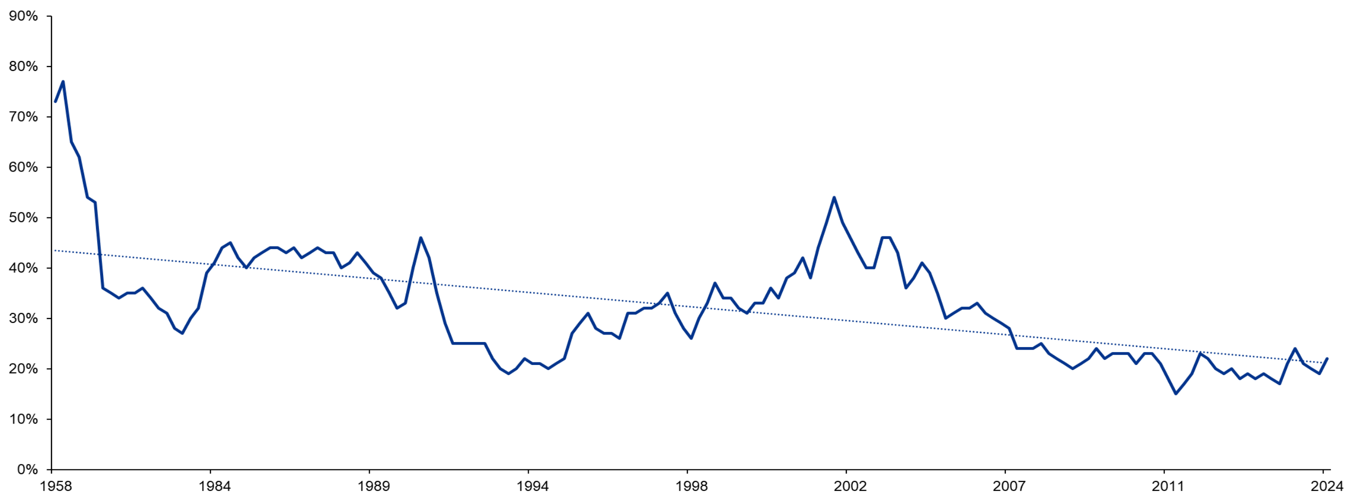
Chart 4



The Federal deficit continues to rise throughout the duration of the forecast. Cuts to spending and the revenues generated by tariffs cannot begin to fill the hole left by expansions and extensions to tax cuts and aging demographics.

Two thirds of the federal budget is mandatory, and dominated by Social Security and Medicare; the remaining third is discretionary, and dominated by defense spending. That will get a lift from border protection and the cost of deportations.

The trade deficit flatlines

The trade deficits remains essentially flat in 2025. Weaker domestic demand and the toll of higher tariffs crimp spending on imports, while retaliatory measures and a strong dollar keeps a lid on exports.

A mild bout of stagflation

Tariffs and curbs to immigration simultaneously stoke inflation and stem growth. The context in which they are occurring today is different than it was in 2018:

1. The embers of inflation are still smoldering, which ups the risk they will reignite.
2. Supply chains are longer than they were pre-pandemic and more susceptible to retaliatory disruptions.
3. The size and scope of tariffs are larger than they were in 2018-19, with a greater set of goals; they are intended to punish our trading partners, create incentives for domestic production, protect strategically important industries and generate revenues all at once.
4. Companies have already begun to raise prices of intermediate goods in the pipeline for items slated to be tariffed. Steel, aluminum and lumber prices have all spiked in recent months.
5. Labor shortages due to deportations and a change in the legal status of immigrants could reignite service sector prices, which have proven stickiest. Childcare and eldercare costs, which rely more on immigrant labor than other sectors, are already rising at twice the pace of overall inflation.
6. Work done by Moody's Analytics suggests that the top 10% of earners account for nearly half of all consumer spending, a new record; they can better absorb the cost of tariffs and create a floor under inflation.

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The largest offset to inflation is: a strong dollar (as long as it stays that way). There are some within the administration who believe they can engineer a sharp depreciation in the dollar by revaluing the nation's assets. Color us skeptical, given the havoc such moves could trigger in financial markets.

Inflation as measured by the personal consumption expenditures (PCE) index, peaks at a 4.1% rate in the second quarter, but remains elevated well through year-end. That leaves us with a mild bout of stagflation in 2025.

The PCE index slowly cools in 2026 but does not return to the Fed's 2% target until the second half of 2027. The deceleration in inflation is helped by a drop in the effective tariff rate late in the year and into 2026.

Downside risks: A full-blown recession with a much larger pullback in global trade could cool inflation more rapidly. The Smoot-Hawley Tariff Act of 1930 is our only reference point; it triggered trade wars with 25 countries, reduced global trade by 67% and plunged the global economy deeper into the depths of the Great Depression.

A wary Fed

The Fed is on hold pending policy shifts by the administration. Fed Chairman Jay Powell said, "We do not need to be in a hurry and are well positioned to wait for greater clarity [on the direction of policies and their impact.]"

When asked who his favorite Fed Chair was, he responded "Paul Volcker" - the man who broke the back of inflation in the early 1980s. That is why several Fed presidents have evoked the inflation nightmare of the 1970s as a cautionary tale. They are signaling that they are willing to trade a rise in unemployment - and rate hikes if necessary - to stop a more pernicious bout of inflation. The fact that the war on inflation has not yet been won only hardens that resolve.

The Fed would prefer to stop short on rate cuts and wait to see how tariffs ripple through the economy before cutting again. Our forecast suggests it will need to stay on the sidelines through 2025 before it cautiously resumes rate cuts in 2026.

Separately the Fed is getting close to announcing an end to its quantitative tightening program. That does not mean the Fed will be increasing its balance sheet anytime soon. The goal is to prevent a liquidity problem in the Treasury bond market like we saw in September 2019[5].

Paralysis risks: The Fed finds itself in a bit of a pickle: if it cuts too soon, we could suffer a more pernicious bout of inflation; it it waits too long to cut, it could trigger a recession; or if it raises rates, it could trigger an even deeper recession and scarring bout of unemployment.

Financial markets wake up

We have begun to see volatility in financial markets pick up in response to escalating trade tensions. However, the markets have yet to fully price in the damage those shifts could mean to profits. More than 40% of the profits in the S&P 500 are derived from abroad.

Treasury bond yields fell in response to the potential weakness that trade wars and cuts to federal spending could cause. A rise in the U-6 measure of unemployment in February, a gauge of stress in labor markets, confirmed those fears.

That rally is expected to reverse. Continued federal deficits, higher inflation and a prolonged pause by the Fed are expected to put upward pressure on yields. The 10-year Treasury note is expected to move back above 4.5% by mid-2025.

Volatility risks: The bout of stagflation we have forecast is mild and nothing like that of the 1970s, but could still be very destabilizing for financial markets. Efforts to depreciate the dollar could add to market volatility.

Bottom Line

Uncertainty amidst an erosion of trust is akin to scaling a mountain, without a rope or partner. Each step takes us further up and increases the risk of a fall. It can be paralyzing. That is what we are beginning to see. Tariffs boost inflation, the result is sluggish growth and inflation, or stagflation.

Where's the hope? When I first learned to drive, I had a bad accident. I violated my father's trust by destroying his vehicle, while my own doubts soared. I became a more skittish and tentative driver.

Soon after, I found myself in a traffic jam at a broken stoplight. I froze at the intersection. Then a stranger at an adjacent corner caught my eye and gave me are reassuring nod. That small gesture enabled me to leave my fear behind and move through the intersection without incident. Trust, a key ingredient to get us to move beyond our doubts, can be rebuilt in increments. Be kind; pay it forward.

5 https://www.federalreserve.gov/econres/notes/feds-notes/what-happened-in-money-markets-in-september-2019-20200227.html

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Economic Forecast — March 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	1.7	1.4	2.3	1.0	0.9	1.0	1.6	2.0	1.4	0.9	0.9
Personal Consumption	2.8	2.4	1.4	4.2	1.9	1.6	1.3	1.2	1.6	1.4	1.3	1.5
Business Fixed Investment	3.6	0.8	0.3	-3.2	2.9	0.0	-0.1	0.6	1.0	0.3	-0.5	-0.4
Residential Investment	4.2	-2.3	-2.3	5.4	-3.6	-3.8	-6.0	-2.4	-1.4	-2.1	-1.5	1.8
Inventory Investment (bil $ '17)	39	52	101	10	53	55	42	59	88	104	108	103
Net Exports (bil $ '17)	-1036	-1111	-1023	-1061	-1155	-1142	-1091	-1056	-1033	-1021	-1018	-1021
Exports	3.2	2.5	1.2	-0.5	5.4	0.5	-0.7	0.7	1.1	2.3	2.1	1.8
Imports	5.4	3.9	-1.5	-1.2	14.6	-1.0	-5.7	-3.1	-1.7	0.3	1.2	1.7
Government Expenditures	3.4	1.1	-0.2	2.9	0.5	-1.5	-0.9	-0.2	0.0	0.0	0.0	-0.2
Federal	2.6	0.4	-0.4	4.0	-1.3	-5.4	-2.1	-0.1	0.3	0.4	0.3	-0.2
State and Local	3.9	1.5	-0.1	2.2	1.6	1.0	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Final Sales	2.7	1.6	1.2	3.2	0.3	0.8	1.2	1.3	1.5	1.1	0.8	1.0
Inflation												
GDP Deflator	2.4	3.4	2.9	2.4	4.3	4.1	3.9	3.0	3.6	1.5	2.3	2.5
CPI	3.0	3.4	2.9	3.0	4.9	3.9	3.4	2.7	3.3	1.8	3.0	2.9
Core CPI	3.4	3.7	2.9	3.4	4.5	4.4	3.6	2.8	2.8	2.5	2.4	2.4
Special Indicators												
Corporate Profits[2]	6.5	-3.7	2.4	0.9	-3.9	-21.2	3.2	6.8	8.2	0.0	1.9	0.4
Disposable Personal Income	2.7	2.0	2.9	2.5	2.4	0.3	5.7	1.6	3.4	3.1	2.2	2.5
Housing Starts (mil)	1.37	1.29	1.26	1.39	1.34	1.31	1.27	1.26	1.27	1.24	1.25	1.26
Civilian Unemployment Rate	4.0	4.3	4.8	4.2	4.1	4.3	4.4	4.5	4.6	4.7	4.8	5.0
Total Nonfarm Payrolls (thous)[3]	2080	1381	-271	504	539	298	-28	-170	-71	-47	-104	-183
Vehicle Sales												
Automobile Sales (mil)	2.9	2.6	2.5	3.0	2.9	1.9	2.8	2.7	2.6	2.5	2.4	2.4
Domestic	2.0	1.9	1.7	1.9	1.9	1.9	1.8	1.8	1.8	1.7	1.7	1.7
Imports	0.9	1.0	0.8	1.1	1.0	1,0	1.0	0.9	0.8	0.8	0.7	0.7
LtTrucks (mil)	12.8	12.7	11.7	13.5	12.9	12.8	12.6	12.4	11.9	11.8	11.6	11.3
Domestic	10.1	10.1	9.8	10.7	10.1	10.1	10.0	10.0	9.9	9.9	9.8	9.7
Imports	2.7	2.6	1.8	2.8	2.8	2.7	2.6	2.4	2.0	1.9	1.8	1.6
Combined Auto/Lt Truck	15.8	15.3	14.1	16.5	15.8	14.7	15.4	15.1	14.5	14.3	14.0	13.7
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)	16.3	15.7	14.5	17.0	16.3	15.2	15.9	15.5	14.9	14.7	14.4	14.1
Interest Rate/Yields												
Federal Funds	5.1	4.4	3.5	4.7	4.4	4.4	4.4	4.4	4.2	3.7	3.3	2.9
10 Year Treasury Note	4.2	4.4	4.4	4.3	4.4	4.4	4.5	4.4	4.4	4.4	4.4	4.3
Corporate Bond BAA	5.8	6.3	6.5	5.8	6.1	6.4	6.6	6.4	6.5	6.6	6.5	6.5
Exchange Rates												
Dollar/Euro	1.08	1.06	1.09	1.07	1.08	1.08	1.08	1.08	1.08	1.09	1.10	1.10
Yen/Dollar	151.5	153.5	147.0	152.5	155.0	148.0	148.0	148.0	145.0	145.0	145.0	145.0

[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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