Capital Risk

USA ECONOMIC OUTLOOK

2024 Fourth Quarter

The Price of Greatness

Photo: This image was created with the assistance of DALL·E

The Fed's dual mandate of full employment and moderate inflation will face challenges this year. Goods inflation will exacerbate the persistent rise in housing costs as tariffs disrupt global trade. The Federal Reserve will face the challenge of managing a slowing economy and declining employment. Headline growth may appear stronger than underlying economic conditions, as an improving trade deficit masks weakening exports and consumer demand. Nevertheless, rising unemployment will pressure the Fed to cut interest rates, even as inflation remains above target. This move could reignite housing price increases and fuel further inflation. With monetary policy having limited influence over employment losses driven by trade wars, the risk of stagflation will loom large. The Fed will need politicians to reverse the economic turmoil of their own making.

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Monetary policy is ostensibly slowing the economy, yet growth continues unabated. The impact of monetary policy occurs with a lag, one the consumer will feel shortly.

Politics is initiating a trade war while heightening economic uncertainty. Either of these would conspire with monetary policy to deliver lower growth. Combined they may deliver stagflation or worse. There is a price for greatness.

\- *Jason Prole*

Highlights

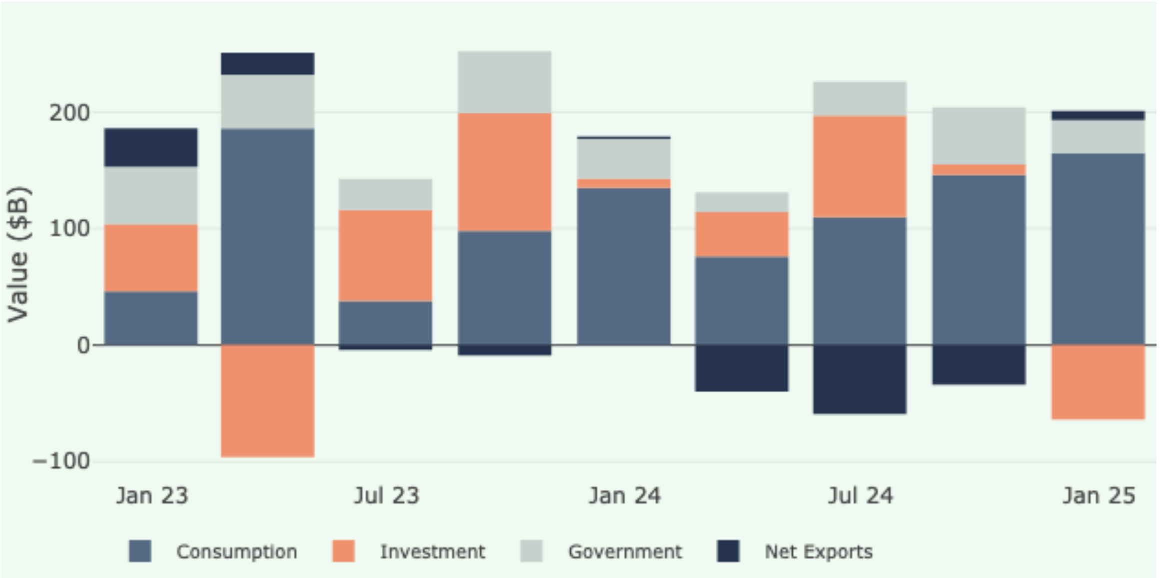
- **Growth** for the year will slow to **zero** as consumption and exports fade.
- The **second half** will experience slower growth with fading consumption.
- **Export-dependent** employment will falter as global trade stalls.
- **Net Exports** will add to growth as imports fall more than exports.
- **All government levels** face budget challenges in the second half.
- **Inflation** continues as costs for housing, goods, and commodities rise.

The Macro View

A turning point. While the economy continues to grow, the impact of high interest rates is beginning to show (Exhibit 1). Investment declined for the first time in four years. The worrisome sign is that the decline was broad-based: all sub-categories declined except structures (both private and residential), which were only modestly positive. Indeed, high interest rates impair investment to some degree, and an investment slowdown in artificial intelligence further magnifies the impact. While an investment retrenchment preceded every recession in the last seventy years, many investment slowdowns have not resulted in a recession. It is only when other sectors are falling simultaneously that a recession is foretold.

Consumers lead while investment fades.

Exhibit 1. GDP Contribution by Component



Source: Federal Reserve Economic Database, CRM Calculations.

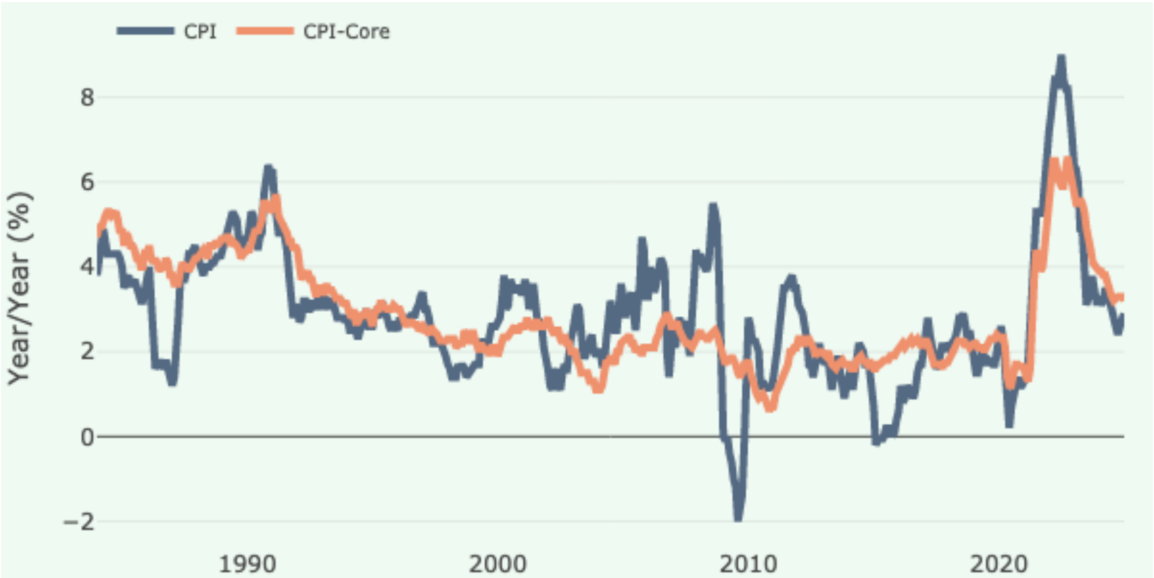
The Fed's challenge is to achieve a *soft landing* of the economy, where policy loosens before employment declines. Unequivocally, investment is slowing. The trouble is that monetary policy is only loosely linked to consumption. Indeed, higher financing costs reduce the marginal borrower, yet housing real estate investment continues apace. The Fed's concern is how inflation limits consumer spending and impacts employment. When consumer spending changes, the Fed's policy must change. The critical indicator is goods consumption, whether domestic or imported.

The Macro View

Inflating Behavior. The pandemic inflation surge is moderating, yet core inflation remains at 30-year highs (Exhibit 2). The prolonged inflation initiates a change in consumer behavior through the substitution effect. As a particular good increases in price (e.g., beef), the consumer substitutes that good with another lower-cost good (e.g., chicken). If inflation is short, consumer behavior does not change permanently, and they will revert to the prior good once inflation moderates. The challenge is that when inflation persists, behavior change may endure.

Core Inflation is at 1993 rates.

Exhibit 2. Consumer Price Index (CPI) and CPI ex Food & Energy (Annual Change, %)



Source: U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis.

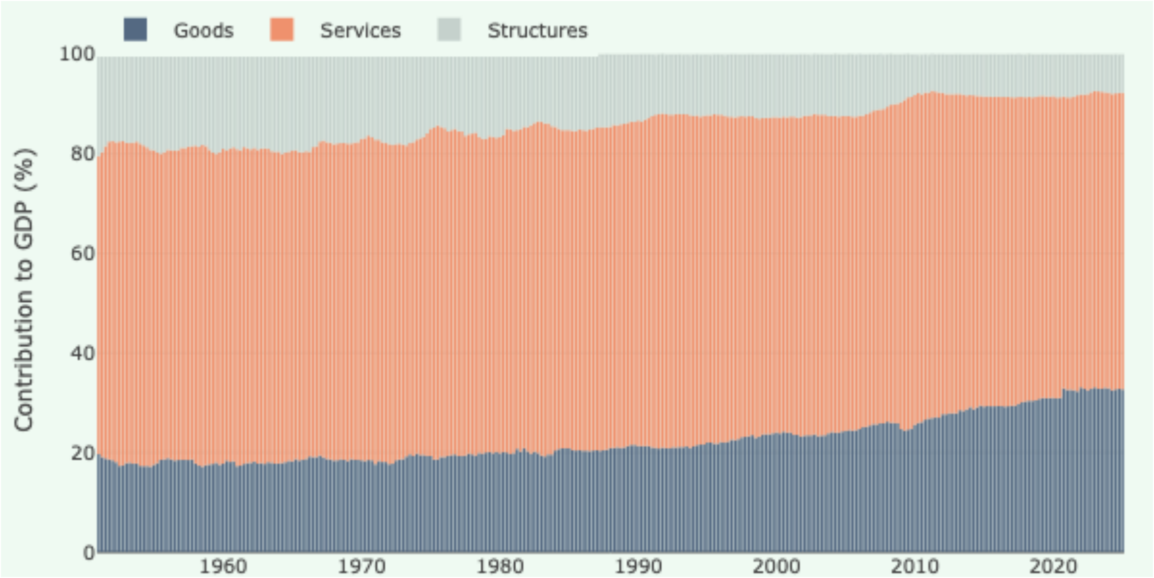
Inflation will likely return to the two percent threshold in a year at the current deceleration rate. This outcome would deliver five years of above-target inflation, which could cause a permanent shift in consumer behavior. Yet, this inflation period would be three years shorter than from 1991 to 1998, when core inflation slowly declined from nearly six percent to two percent. The critical dimension is that consumption buckets changed over the last thirty years, and crucially, *their contribution to GDP*. Housing is a material contributor to core inflation, which monetary policy can indirectly influence; however, there is little impact on goods or services, which is a concern.

The Macro View

Consumer Change. It is said that the only constant is change. This maxim, however, was not always the case for the major product categories for GDP. From 1950 to 1980, the economy's proportion of goods, services, and structures was relatively constant (Exhibit 3). In the mid-1980s, goods started to account for a more significant proportion of the economy, taking off in the early 2000s. Interestingly, the gain in goods came entirely from a decline in structures. The economy shifted from producing long-lived assets like real estate to shorter-term durable and consumer goods, even as the economy doubled in size. This change has implications for both monetary and *foreign* policy.

GDP composition changed since 1980.

Exhibit 3. GDP by Major Product Type



Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

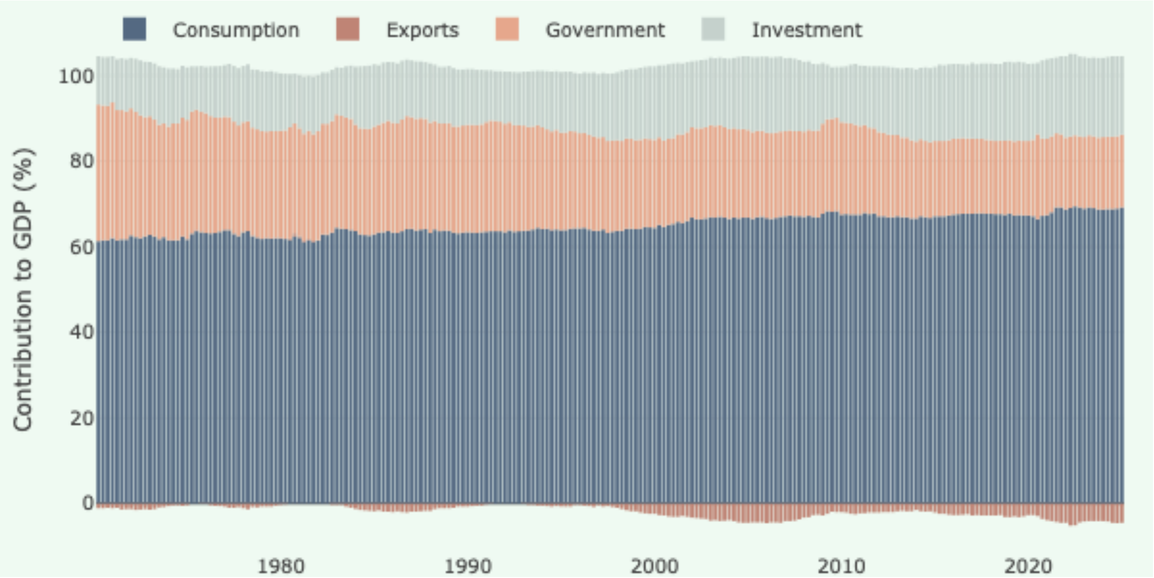
Monetary policy can influence the cost of financing, particularly for long-lived assets usually financed with debt. This is not the case for goods tied less to monetary policy and more to consumer well-being, both domestically and internationally. The key driver is usually employment; however, another critical driver is international trade, which the past 40 years of change in GDP composition highlight. As trade barriers fell, the US consumer enjoyed cheaper and higher-quality goods while their products were exported to foreign markets — *comparative advantage writ large*.

The Macro View

Declining Government. America led the neoliberal free trade dictum in the 1980s and 1990s. Its economy followed suit with trade deficits expanding. Yet the dramatic increase in the trade deficit post-2000 was primarily a function of the entry of China into the World Trade Organization (WTO) (Exhibit 4). This resulted in two further outcomes for GDP proportions: consumption increased at the government's expense. The US could consume more as the benefits of trade delivered a bonanza of cheaper tradeable goods.

Trade elevated consumption and diminished government.

Exhibit 4. GDP Contribution by Sector



Source: Bureau of Economic Analysis. Retrieved from FRED, Federal Reserve Bank of St. Louis.

A trade deficit, however, requires balance in national accounting. As the US consumer provides their currency to pay for the imports, the seller must do something with the money. The seller may either repatriate the funds to their currency or keep it in US dollars. In the latter case, they then invest in the US capital markets. This outcome is evident in the change of investment from 2000 to current: the two percent decline in net exports is wholly offset by a two percent increase in Investment.[1] Trade enabled more consumption in the US, highlighting the central tenet of free trade: *comparative advantage*.

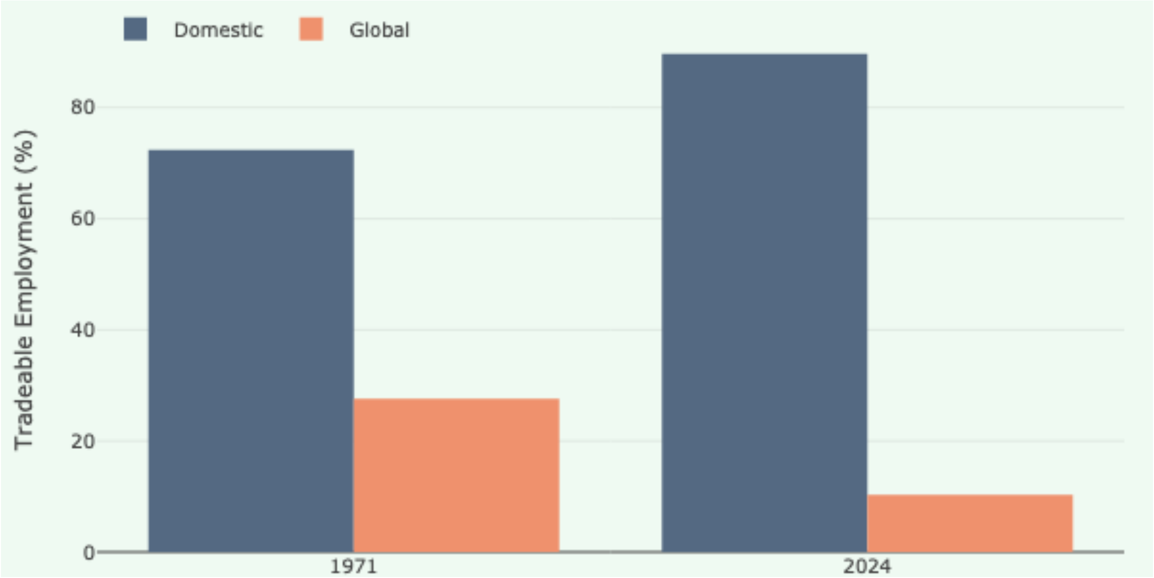
[1] This simplifies national accounting yet is intended to highlight the required balance.

The Macro View

Employment Evolution. Over the past fifty years, the US employment landscape has evolved from a scenario where global market jobs comprised approximately a quarter of employment to one in which only one in ten workers faces global competition (Exhibit 5).[2] This outcome reflects the diminishing contribution of exports to total gross domestic product (GDP) during a similar timeframe. This observation underscores a vital strategic rationale for trade barriers: the domestic employment market *may not be directly vulnerable to a trade war*.

Domestic sectors dominate employment.

Exhibit 5. Employment Share by Domestic vs Global.



Source: U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis. Global sectors include mining, manufacturing, and information technology.

This conclusion, however, creates a fallacy of composition. While employment sensitivity to global markets may have less impact on domestic employment, trade wars affect a country's exports and *imports*. This outcome is the central tenet of comparative advantage: produce where you possess an efficiency advantage and import everything else. The critical dimension of the argument involves *substitute products and switching costs*.

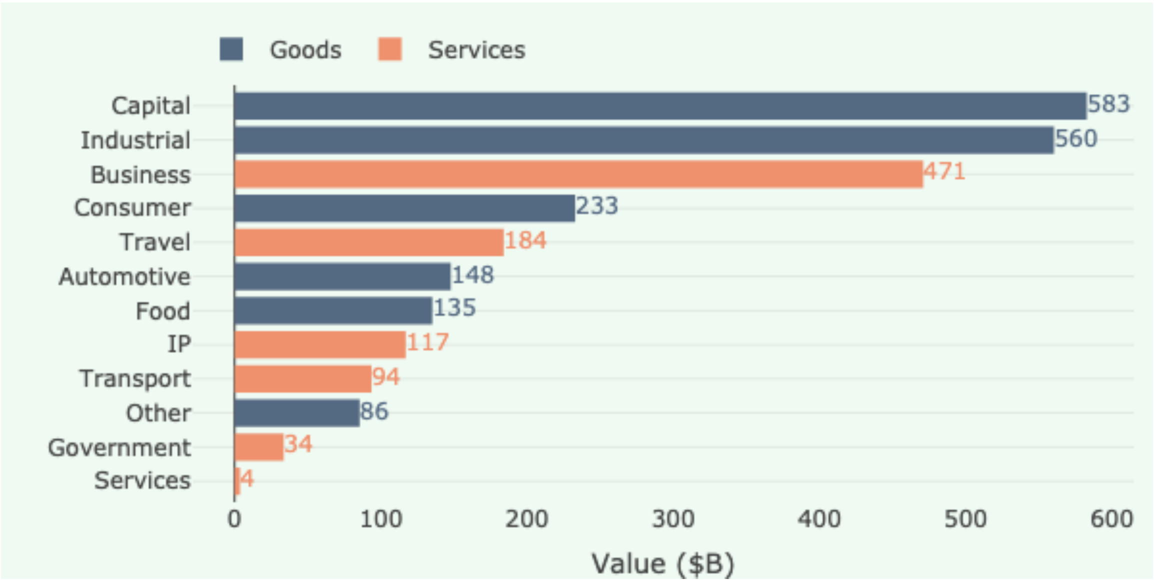
[2] In this accounting, mining, manufacturing, and information technology are global tradeable goods, all other sectors are domestic-focused, i.e., location-based.

The Macro View

Exporting Excellence. America is a world leader in technology and advanced manufacturing. Naturally, its exports reflect this outcome (Exhibit 6). Capital and industrial goods are its largest export sectors, each accounting for one-third of the total. The threat is whether there are substitutes for these products. This is the first concern: about 40% of the industrial category is petroleum products with minimal switching costs. Further, semiconductors, telecom, and electric appliances lead the capital goods category. While these latter products have high switching costs, substitutions do exist. Critically, these sectors are more straightforward to focus upon for targeted responses.

Capital and Industrial goods lead exports.

Exhibit 6. Export Value by Sector ($ Billions)



Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

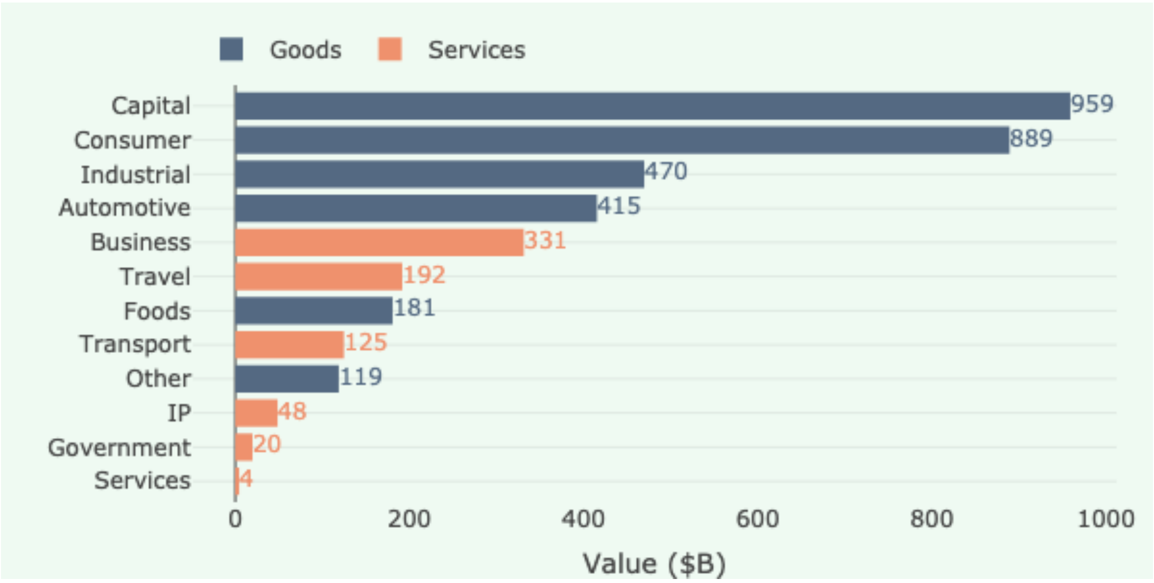
Business services are a significant export component, yet fungible on the world market. While food is a strategic resource, there are close substitutes on the global market. These varying categories highlight the challenge for America in a trade war: there are either substitute products or low switching costs for their material exports. While the lower relative employment in these sectors makes the impact less burdensome, it does enable American trade competitors to make targeted countermeasures that are less impactful to them. Precision may trump power in this instance.

The Macro View

Import Importance. Imports are about a third larger than exports and led by Capital and Consumer goods (Exhibit 7). The American trade deficit is primarily a function of these two categories. In contrast, services and industrial goods run at a surplus, highlighting the risk of a trade war. The degree of price sensitivity and substitute products for consumer goods will determine the degree of effectiveness of tariffs. The trouble is that there are no close domestic substitutes after decades of outsourcing.

The US depends upon consumer and capital goods imports.

Exhibit 7. Import Value by Sector ($ Billions)



Source: U.S. Federal Reserve Board, retrieved from FRED, Federal Reserve Bank of St. Louis. The grey area indicates recession periods.

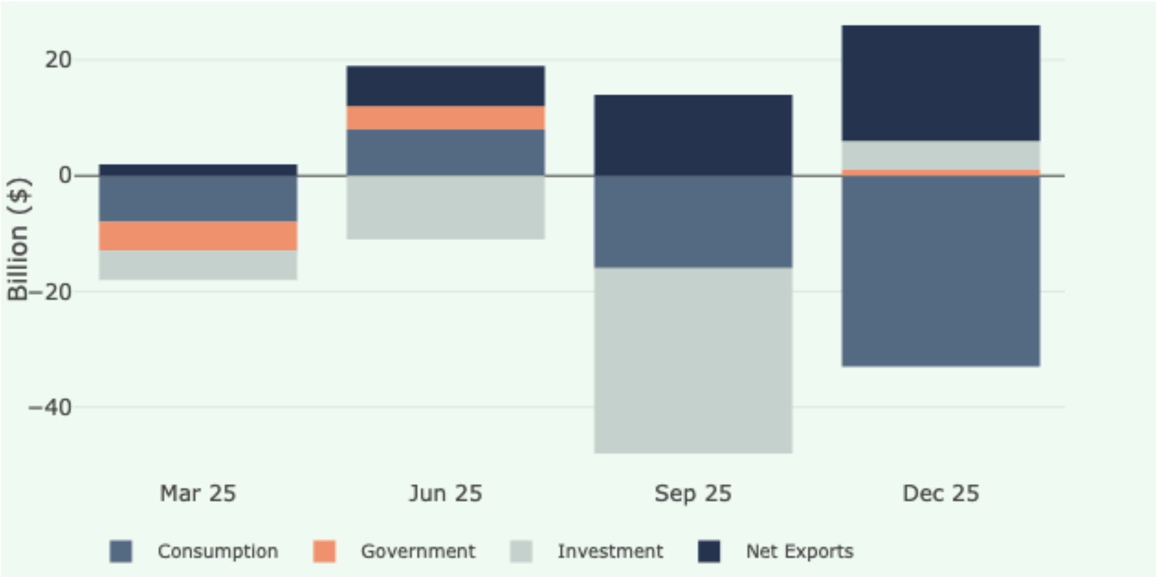
The critical issue, however, is capital goods without close substitutes. Tariffs will increase prices with no corresponding productivity increase. The tariff increase will act as a direct tax on consumption because substitute products are unavailable. Yet, the rest of the world enjoys alternate sources for its imports (i.e., US Exports). The result is that imports could increase at the tariff rate (e.g., 25%) while exports decline as counter-tariffs are imposed that reduce the competitiveness of US exports. The unfortunate outcome in this scenario would be that the net export deficit *expands*. Strategic substitutes may counteract tactical tariffs, *impoverishing the US consumer*.

The Macro View

Taxing Consumption. There is a credible argument for taxing consumption through tariffs or a national sales tax. The latter is preferred for two reasons: the precision at which it can target specific consumption baskets and the perception that it is not directly targeting trade, thus limiting the competitor's strategic response. In contrast, a trade war led by tariffs invites retaliatory tariffs because of the composition of US exports and imports. In this environment, the economy will likely fade through the year as tariffs impair exports and investment (Exhibit 8). The only unknown is how much.

Exhibit 8. Forecast for US GDP Growth

Contraction could occur throughout the year.



Source: CRM estimates for each component.

The expectation is zero growth for 2025, below the consensus estimate of 2.4%.[3] This level of growth will cause a conundrum for the Fed as inflation persists in housing and higher import prices. The latter highlights the key risk: the durability of the consumer as they face higher prices. The uncertainty from the political situation will force the Fed to act despite persistent inflation above their target. As the Fed's focus switches to employment from inflation, the prospect of *stagflation* will emerge, a politically dire conundrum indeed.

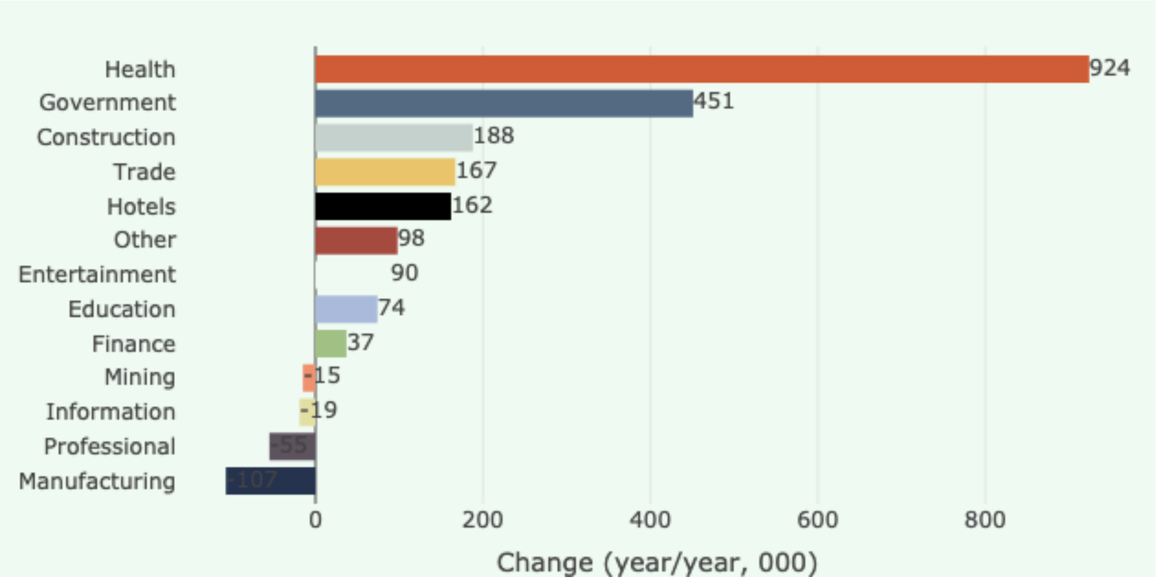
[3] Federal Reserve Bank Philadelphia, *Survey of Professional Forecasters*, First Quarter 2025.

Consumption

As manufacturing and professional services slow in the private sector, government employment and its sibling, healthcare, continue apace. The healthcare sector is undergoing extraordinary employment growth, which expanded more than *all the other sectors combined* (Exhibit 9). The average monthly job growth rate is about 160 thousand; without healthcare, it is only *80 thousand*. This situation brings two challenges: the healthcare sector's growth durability and the leisure sector's sensitivity to a slowing economy. If both continue to their trajectory, then recession follows.

Healthcare dominates employment growth.

Exhibit 9. U.S. Private Employment Change by Sector (Thousands)



Source: Federal Reserve Economic Database. Change from Dec 2023 to Dec 2024.

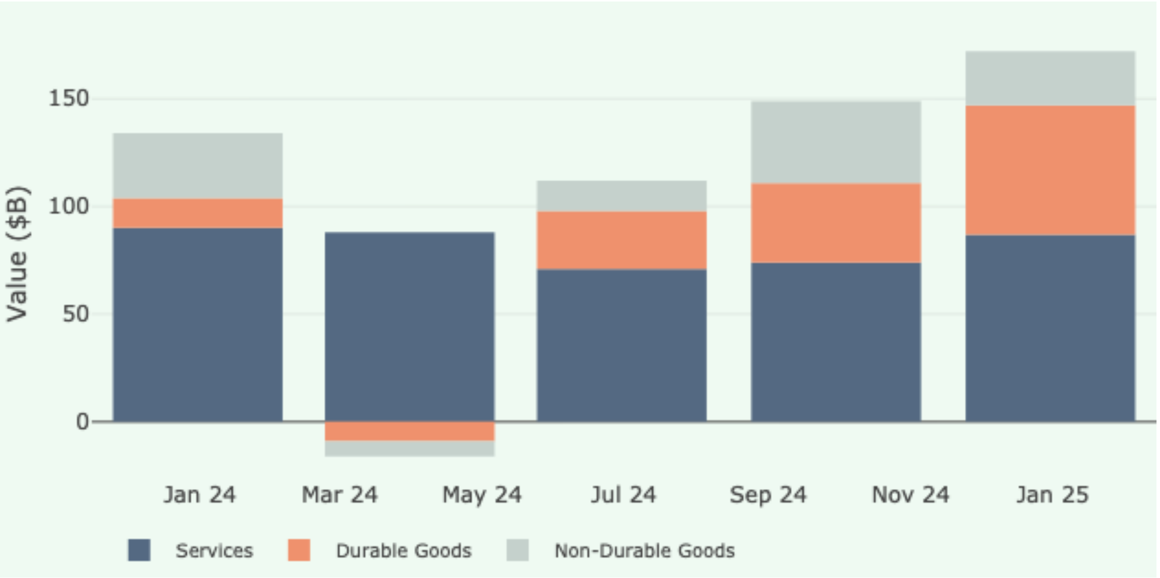
The trouble arises with home health care and hospitals. The former is at 160 thousand and the latter at 200 thousand, *four times their average rate.* This excess growth is about 270 thousand jobs per year. An aging workforce with increased health care requirements may contribute to excess growth; however, the impact of pandemic contractions in these sectors is a more likely cause. If this effect is mean reverting, then employment growth will slow. While not enough to cause a recession, it can conspire with other fading sectors to deliver an unpalatable outcome.

Consumption

Service-oriented. The US economy is service-based, like most advanced economies. Consumer spending accounts for about 70% of the economy, with services accounting for about 65%. The net contribution from services is about 45% of the economy and double the next largest category, goods. Services grew consistently over the last year, while goods were much more volatile, particularly durable goods (Exhibit 9). In the previous 75 years, services fell only twice: during the Pandemic and in 1954 with the de-militarization after the Korean War. It is goods that are volatile and, critically, usually forewarn a recession. This situation provides a key performance indicator: goods.

Services continue to drive consumption.

Exhibit 9. Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

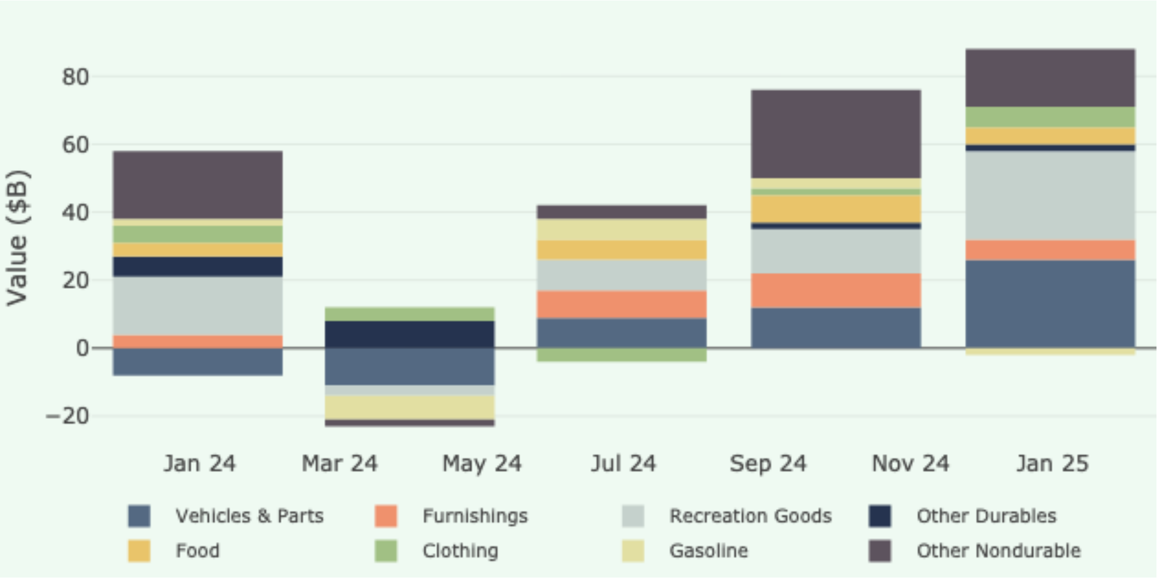
Goods are comprised of two types: *nondurable goods* are disposable items used only once (e.g., food, drugs, gasoline, etc.) that are constant in their application (e.g., eating and cleaning), while *durable goods* are one-off items used repeatedly over time (e.g., cars, televisions, computers, etc.). The latter is the key performance indicator due to two features: consumers can postpone big-ticket items during employment uncertainty, and the current environment of trade disruption may make their purchase more costly. Higher prices will usually lead to lower consumption without easily substituted prices.

Consumption

Back to the Future. Goods consumption jumped materially during the Pandemic as services cratered. This outcome appears fully reversed as goods consumption continues with its prior trend. Interestingly, goods consumption is returning to a more familiar composition (Exhibit 10). Motor vehicles, recreation, and furnishings are growing again after a nearly four-year plateau. This outcome is expected as durable goods have an expected life span of more than three years, and durable goods must be replaced at some point. These insights suggest future consumption growth may persist as the economy stabilizes at its past equilibrium.

Durable goods consumption is growing.

Exhibit 10. Goods Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values annualized rates.

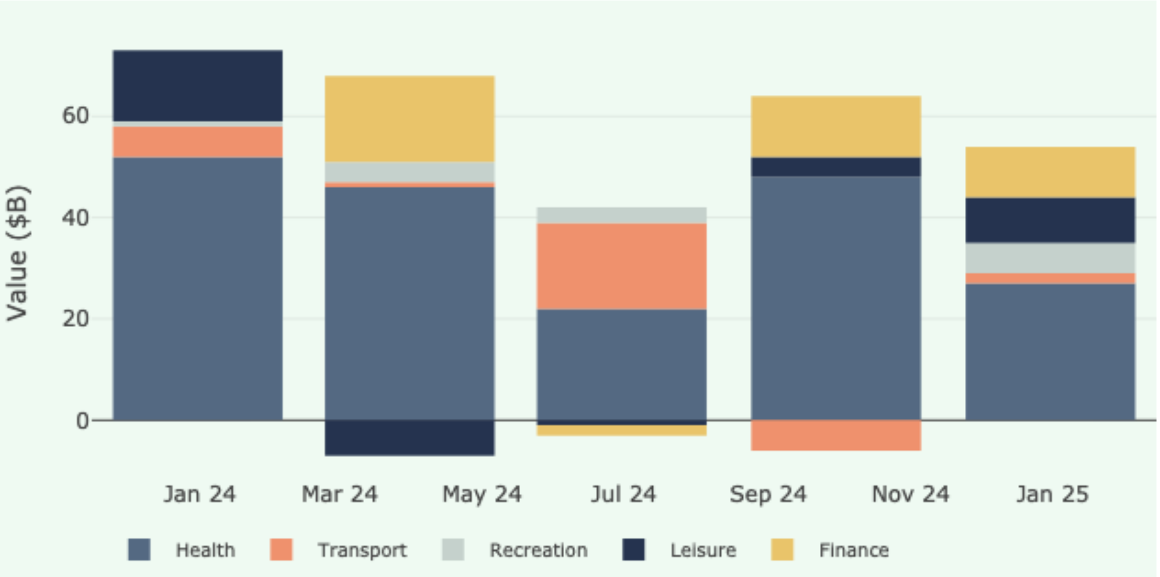
A similar story unfolds in other goods (e.g., jewelry and cell phones) and clothing. Both increased as pandemic stimulus reached consumers' pockets, then saw flattening growth over the last four years. Thus, it is credible that consumer spending on goods will continue for the foreseeable future. Yet trouble arises here. Supply shocks are a catalyst for recession as consumers adjust their behavior. A further supply shock caused by trade barriers may limit domestic consumption and exports of goods. The erstwhile US consumer may behave as expected, their vote notwithstanding.

Consumption

Caring for Growth. Since the end of the Pandemic, healthcare growth has exceeded its pre-pandemic rates. Defining the exact driver of this increased demand (e.g., catch-up for missed healthcare during the pandemic or an aging population) is challenging. Yet, it is unequivocal that higher healthcare employment occurs at rates multiples of prior trends (Exhibit 8). This outcome is evident in the service sector, as healthcare is the dominant growth contributor (Exhibit 11). The critical insight is that this consumption will continue; however, it is likely at a much-reduced rate.

The healthcare sector dominates services.

Exhibit 11. Service Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate. Leisure = Dining & Hotels.

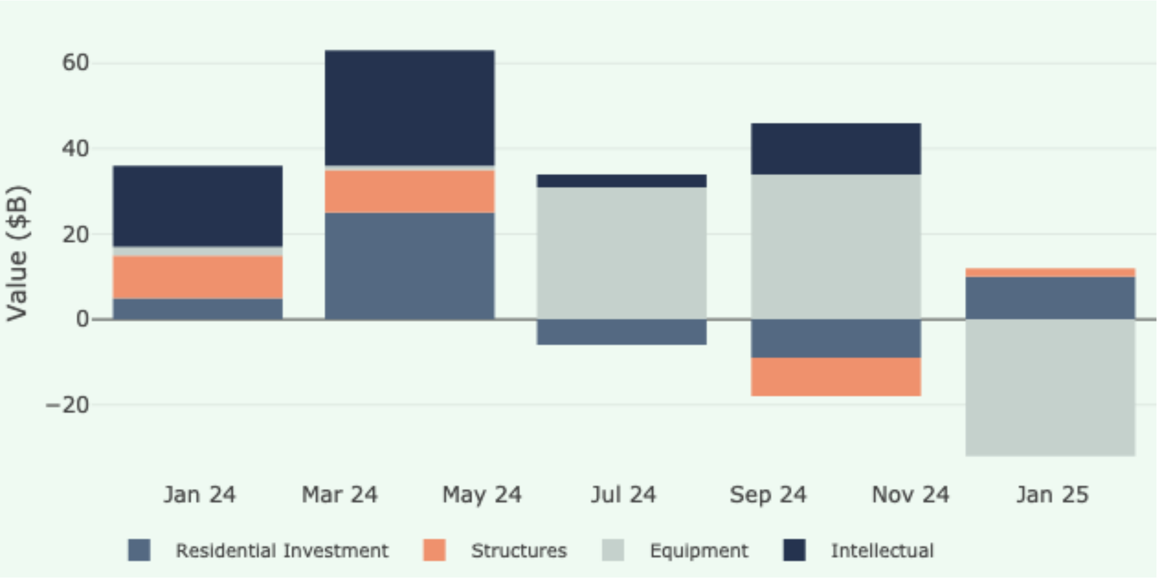
The challenge is that finance is the next leading contributor to service consumption growth, while leisure and recreation provide modest support. It is positive that marginal growth exists in these sectors, yet the ability for the consumer to pivot from these services is high should costs change in other sectors, notably goods. Thus, the key performance indicator for service consumption change lies within these sectors. While any slowdown will not follow the extremes reflected during the Pandemic, the 1930s are a reminder of the significant impact of trade wars on consumer spending and the economy.

Investment

The residential housing bust of 2023 stabilized in 2024, yet housing is not materially contributing to investment. Either is commercial structures. This situation is troubling when the equipment investment and intellectual property detract from investment (Exhibit 12). Housing faces the dual challenge of high financing costs and the prospect of higher input costs from tariffs. While the return of manufacturing to domestic shores is appealing, its timing and amount are uncertain. In a service- and technology-driven world, the need for office and industrial space is not as significant as in the past, even more so as work-from-home persists.

Equipment is falling with no substitute.

Exhibit 12. Investment Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

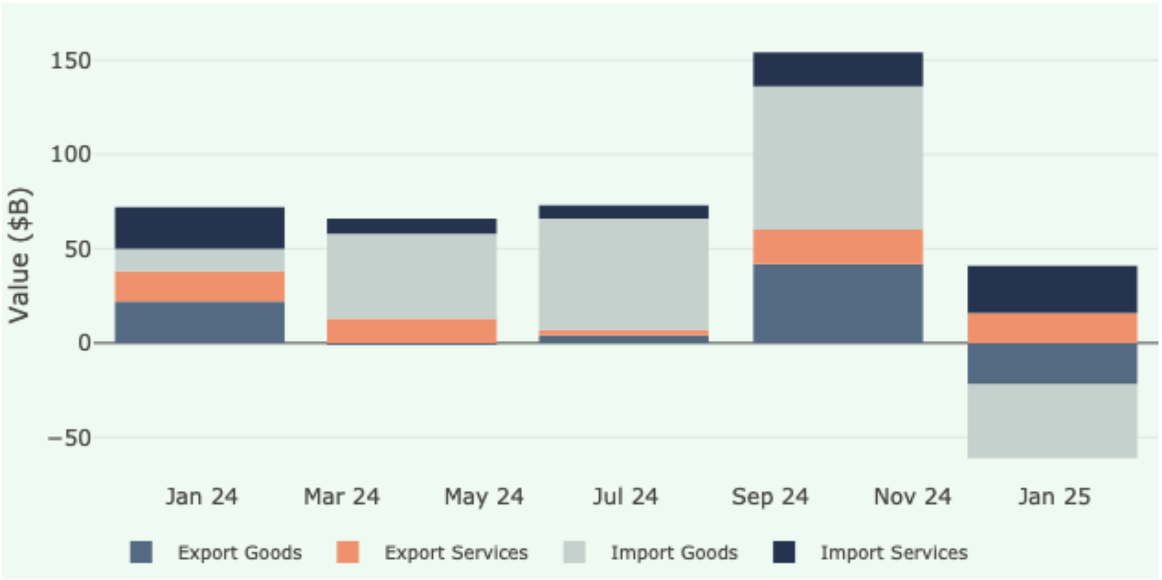
While undoubtedly governmental policies can offset these structural forces, they do not appear to be the preferred method for the current administration. Crucially, the government's focus may be on sectors (e.g., oil extraction) that businesses may not be inclined to invest in for 30 years. The equipment component is another challenge, with the information technology component leading the way. Yet, this artificial intelligence bonanza only returns equipment investment to the pre-pandemic trend level. The critical question is whether this investment will produce *incremental growth*.

Exports & Imports

The U.S. consumer is legendary for importing goods, leading to a material trade deficit. Yet, the recent strength of imported goods was driven by capital goods (e.g., computer chips for data centers), which is abating (Exhibit 13). Since capital and consumer goods account for nearly two-thirds of imported goods at $1.7 trillion, the impact of tariffs is substantial. Crucially, higher prices for these goods could *expand the trade deficit*, contingent on the price sensitivity of the buyers. In fact, 25% tariffs on capital goods would expand the trade deficit by $250 billion and reduce GDP by 0.2%, excluding reciprocal tariffs' impact on US exports.

Export and import goods are declining.

Exhibit 13. Net Exports



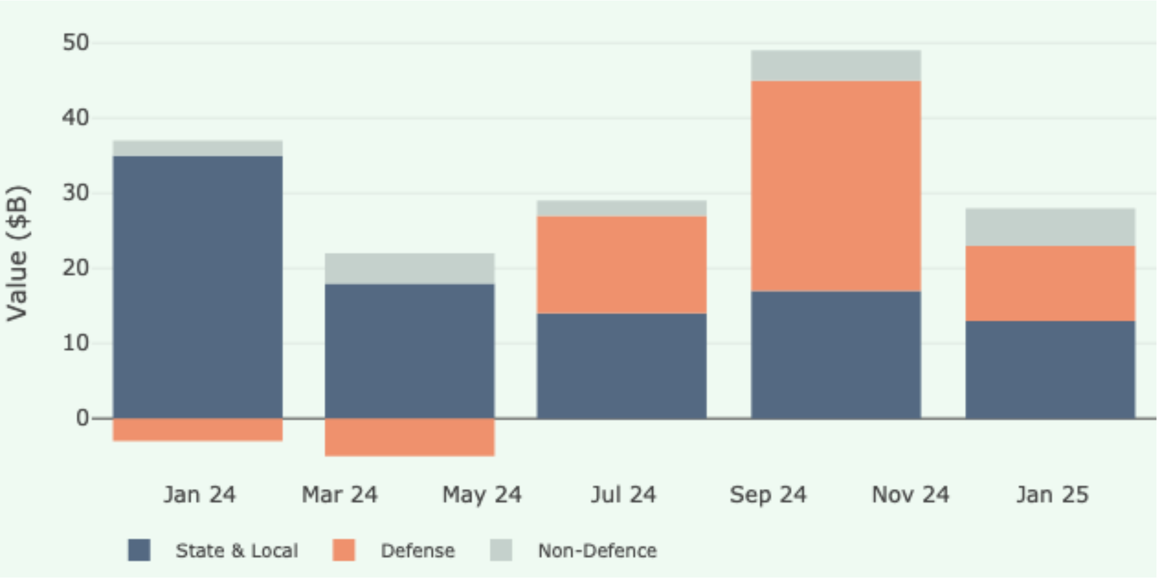
Source: Federal Reserve Economic Database. Values are an annualized rate.

Indeed, a response to US tariffs on imports is inevitable. The challenge lies in the US being such a significant importer that other nations don't need to impose universal tariffs; instead, they can selectively choose what to target. This creates an imbalance, as imports surpass exports by $1.2 trillion. From a tactical perspective, there is more to tax on imports. Strategically, the US could potentially lose its $2.7 trillion in exports while still needing to purchase $3.7 trillion in imports, albeit at a higher rate. The disconnect between expectation and reality may lead to suboptimal outcomes for US consumers and businesses. Tactics may undermine strategy, undermining the economy.

Government

Federal expenditures on defense are leading the way, even as the more consequential State & Local continue to contribute to government expenditures (Exhibit 14). The Federal transfers to local government from the Pandemic are largely spent, resulting in State & Local growth contributing less. Critically, local tax collections depend on the housing market and sales tax collection, both at risk if trade wars escalate further. If these revenue sources falter, this spending growth may stall.

Exhibit 14. Federal and State Government



Source: Federal Reserve Economic Database.

State & Local government is crucial to growth.

The issue is at the Federal level, with a mantra of program cutting taking hold. These programs indirectly pass money to local and state governments for spending, which will then be forced to balance budgets. As the Federal deficit expands and debt service remains high due to elevated interest rates, the Federal government may be forced to reduce transfers to State & Local governments further. With tariffs impairing trade, higher prices reducing consumption, and investment slowing, the ability of fiscal policy to stabilize the economy is critical. Yet, federal policy is seeking to *reduce spending*. Indeed, the US economy and its consumers may face an economic reckoning not seen in a century. A price for greatness is certain; whether the burden is bearable is uncertain. Caveat emptor.

Forecast

The GDP forecast for *2025 is* ***0% (zero)***, with a consensus estimate of 2.4%.[4] Consumption will drag as tariffs impact consumption, with goods as the main detractor. The path forward for investment is uncertain as real estate faces a weakening consumer and persistently high financing costs. Equipment investment may help as artificial intelligence expands, yet Deepseek shows the peril of too much hardware investment. The critical challenge is on two fronts: the expected cuts to spending and the uncertainty of the trade wars. Both are within the control of the US.

The expected headline CPI Inflation for *2024 is 2.6%, and core CPI is 3.0%* versus a revised consensus rate of 2.5% and 2.7%, respectively. The main driver of the divergence from consensus is a slower moderation of housing prices and a sharper drop in commodities prices, primarily gasoline. While the trajectory will appease the Fed, the levels will remain higher than the Fed's two percent inflation target. This dilemma will guide the Fed to incremental rate cuts that will gradually lower the rate over the year.

Lower growth and higher inflation forecast.

Exhibit 15. Annual Forecast Versus Actual (%, y/y)

	2025	2024	2023	2022
Real GDP				
Forecast	*0.0*	*2.1*	*1.9*	*0.2*
Actual		2.5	3.1	0.7
Consensus	**2.4**	2.4	1.3	3.7
CPI				
Forecast	*3.2*	*2.6*	*2.9*	*4.6*
Actual		2.9	3.3	6.4
Consensus	**2.8**	2.5	3.1	3.8
Core CPI				
Forecast	***3.0***	*3.0*	*3.4*	*4.4*
Actual		3.2	3.9	5.7
Consensus	**2.9**	2.7	3.4	3.6

Note: All rates are percent changes 4Q/4Q. The consensus is the first-quarter Survey of Professional Forecasters.

[4] Survey of Professional Forecasters, *First Quarter 2025*. https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/

Exhibit 16. GDP Component Summary Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	23,536	0.6	2.5
Personal Consumption Expenditures	16,279	1.0	3.1
Services	10,744	0.8	3.1
Goods	5,558	1.5	3.3
Durable Goods	2,120	2.9	5.7
Non-Durable Goods	3,452	0.7	2.1
Investment	4,314	-1.5	1.6
Fixed Investment	4,263	-0.3	2.4
Non-Residential Fixed Investment	3,510	-0.8	2.2
Residential Investment	797	1.3	2.8
Federal	1,535	1.0	4.2
State & Local	2,459	0.5	2.6
Defense	876	1.2	5.5
Non-Defence	659	0.7	2.4
Research	868	-0.4	1.6
Exports	2,635	-0.1	2.9
Imports	3,696	-0.3	5.7

Source: Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

Capital Risk

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