ECONOMIC OUTLOOK REGIONS
January 2025

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The "Nobody Knows Anything" Annual Outlook Edition . . .

Yeah, right, like that's going to stop us. Wait, was that out loud? Umm, what we meant to say was "welcome to our annual outlook edition." Okay, opting for "nobody knows anything" as the main theme of our 2025 outlook may be a bit harsh, as there are no doubt lots of people who know lots about lots of things. But, in terms of making any kind of detailed forecast of the path of the U.S. economy in 2025, "nobody knows anything" seems a more appropriate theme given the considerable uncertainty that looms over the policy landscape. Even if the broad contours of changes in fiscal, regulatory, trade, and immigration policy to be seen over coming months are taking shape, the range of potential outcomes around the specific details in each of those areas is so wide that it is hard to have much, if any, confidence in any economic forecast for 2025 made before those details emerge.

Sure, that the general theme of our 2025 outlook is "nobody knows anything" will simply be seen by some, if not by many, as affirming what they've thought about us all along. To which we'd respond by, at the risk of appearing immodest, pointing out that our 2023 and 2024 outlooks were not just correct but were spot-on, dead-bang, on-the-money correct. After all, the general theme of our 2023 outlook was "lots of stuff may or may not happen in 2023," while the general theme of our 2024 outlook was "even more stuff may or may not happen in 2024." And, as it turned out, lots of stuff did indeed happen in each of those years, and lots of stuff didn't happen in each of those years. Moreover, in each year, some of the stuff that happened was stuff we thought would happen, and some of the stuff that didn't happen was stuff we didn't think would happen. Okay, fine, some stuff we thought would happen didn't, and some stuff we didn't think would happen did but, really, who has time to quibble over such minor details . . .

Actually, we did have a more specific underlying theme to our 2023 and 2024 outlooks, which was "fumbling toward normal." Our premise was that, as the distortions stemming from the pandemic and the policy response to it worked their way out of the system, the pace of economic activity would normalize back toward the trend rate that prevailed over the decade prior to the pandemic, i.e., real GDP growth of just over two percent. While we did think that the mix of labor force growth and productivity growth – the two drivers of any economy's capacity to grow over time – would change, we thought that there would be little, if any, net change in the underlying trend rate of growth.

Our "fumbling toward normal" theme put us at odds with many other analysts whose underlying themes were more along the lines of "stumbling into recession;" we were part of a very small minority of analysts who did not have recession as their base case in 2023, while there were still some who had that as their base case for 2024. As it turned out, growth surprised us to the upside in both 2023 and 2024 thanks to far more improvement on the supply side of the economy than we had anticipated. Between global supply chains recovering from the severe and prolonged disruptions triggered by the pandemic and faster growth in both the supply of labor and labor productivity, real GDP growth in 2023 (2.9 percent) and 2024 (on course for 2.8 percent) easily topped what we and most others consider to be the economy's sustainable long-term trend rate of growth.

We do not, however, expect this "outperformance" to persist. Indeed, though the BEA's initial estimate of Q4 2024 is not yet available as of this writing, all evidence points to a slower pace of real GDP growth than that seen over the middle two quarters of 2024. Given the heightened financial stress being felt by many lower-to-middle income households, a still-listless manufacturing sector, a slowing trend rate of hiring, and the heavy toll being taken on the housing market by elevated mortgage interest rates, it seems reasonable to think the economy carried less momentum into 2025. To be sure, the economy surprised to the upside over the past two years but, while we by no means expect the economy to roll over in 2025, neither do we expect another outperformance on the order of those seen over the past two years.

The impacts of specific changes across the policy landscape will have to be layered onto that assessment as the details emerge. In the interim, one can either make assumptions about what those details will be and how they will impact the economy, or one can continue to make forecasts based on current policy parameters and simply live with the added layers of uncertainty around those forecasts. Given the range of possible policy outcomes, we see little point in taking the former approach, and while the latter approach may seem at odds with producing a 2025 outlook piece that has any actual value, we'll simply note that our annual outlooks have never been about laying out and then attempting to justify a certain set of forecast numbers. Instead, though the specific form can, and often does, change, our general approach has always been focused on pointing out what we expect to be the main themes and/or the main challenges facing the economy in the new year. Where possible within that broad context, we've laid out certain markers for variables such as real GDP growth or the unemployment rate, and taking an over/under approach has been about the extent of offering "forecasts" in our annual outlooks.

So, in that sense, the high degree of uncertainty around looming changes in policy won't alter our approach in presenting a 2025 outlook. And, regardless of the specific form our annual outlook piece has taken in any given year, one constant has been our looking back and assessing how we did on any calls we made in the prior year's outlook. Our view is that if we put a forecast out there, we'll own that forecast, for better or worse, right or wrong, and when we are wrong we will, as best we can, identify where our forecast went off track and explain that to our readers. That

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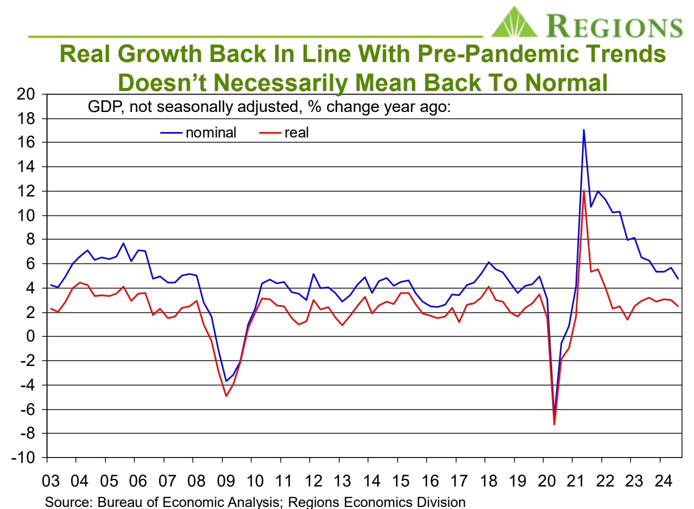
seems a better approach than simply ignoring or running away from our misses, particularly given that we simply don't have the stamina it would take to run away from all of our forecast misses. In any event, in what follows we'll summarize how, given how the (policy) world looks today, we'd expect 2025 to play out and then offer some specific things to watch for that will ultimately help shape the actual path of the economy in 2025, not all of which have to do with potential policy changes.

We May Not Be Where We Think We Are, But We May Not Know That Until We're Somewhere Else. As we often note, its hard to know where you're going when you're not sure where you are, which is a hard lesson we've learned from a lifetime of being somewhat, let's say, navigationally challenged. That strikes us as a not-so-bad analogy for trying to project the path ahead for the U.S. economy, and this has nothing to do with potential changes to the policy landscape. Instead, this reflects the diminished degree of confidence we have in much of the economic data; we've been doing this a long time and have never had so little confidence in so much of the data as is the case at present.

Amongst the culprits are significant declines in survey response rates across much of the survey-based data, including the monthly employment reports, and seasonal adjustment that in many cases has not kept pace with what, since the pandemic, have been shifts in what for many years had been fairly stable seasonal patterns in economic activity. Thus, we simply have less confidence that the economic data are accurately portraying underlying economic conditions, particularly the headline numbers atop any given data release in any given month. That sizable revisions to the initial estimates of any given data point seem to have become more the rule than the exception goes straight to our point.

This is an issue which has gotten much worse since the onset of the pandemic, though those going no further than crafting narratives around the headline numbers from the various data releases will not have noticed. It could be that some simply think the noise in the data evens out in the end, so there's no need to go through the task of breaking down the details of each and every data release. To some extent, the noise may well even out but our view is that if you're trying to understand, let alone explain, what's going on in the economy, there is simply no substitute for breaking down the details of the data. That includes identifying and assessing the effects of whatever noise may be in a given release.

The reality, however, is that over the past few years it has become easier to both be surprised by and to make mistakes in interpreting much of the economic data. This gets us back to our point about it being hard to know where you're going if you're not sure where you are. One means of getting around what in many data series are ongoing issues with seasonal adjustment is to focus on the trends in the not seasonally adjusted data, which has increasingly been the basis of our analysis over the past few years. On that basis, it may seem that the pace of economic activity is settling back into the trend rate that prevailed prior to the pandemic. For instance, the not seasonally adjusted data show year-on-year real GDP growth of 2.49 percent in Q3 2024, which is more or less in line with the average increase – 2.40 percent – in the ten years prior to the pandemic. It would, however, be a mistake to point to this as evidence of the economy having normalized from the distortions brought about by the pandemic and the policy response to it. Put differently, what may be true of a broad aggregate, real GDP in this case, is not necessarily true of the various components of that broad aggregate.



While the pace of real GDP growth may have fallen back in line with pre-pandemic trends, that is clearly not the case with nominal GDP, which continues to grow at a rate faster than the trend rate that prevailed prior to the pandemic. This is another way of saying that prices continue to rise at a faster rate than that which prevailed prior to the pandemic – note how much wider the gap between growth in nominal and real GDP has been over the past few years. Along those same lines, you'd have a hard time finding anyone who would characterize the housing market as having returned to normal, though this may not be a great illustration of our point given the stark supply-demand imbalance that ruled the housing market for years prior to the pandemic.

Still, relying on the not seasonally adjusted data does not get us around the measurement/collection issues that continue to plague much of the survey-based data. For instance, the not seasonally adjusted data show the running twelve-month sum of changes in nonfarm payrolls, which we see as a good proxy for the underlying trend rate of job growth, has fallen back pretty much in line with the pre-pandemic average, even allowing for the downward to the level of nonfarm payrolls as of March 2024 to be reflected in the BLS's upcoming benchmark revisions to the establishment survey data. We see the pre-pandemic trend rate as more of a temporary resting point than a settling point, but the inherent unreliability of the initial estimates of monthly job growth means that it will take longer for us to know whether we're correct on this point. We could call out other examples, but the broader point is that even under the best of (data quality) circumstances, making an accurate assessment of underlying economic conditions in an economy as large, diverse, and dynamic as the U.S. economy is a challenging endeavor. That there are so many issues with so much of the "top tier" economic data makes it that much more difficult. Whether, or to what extent, these data issues will be resolved over the course of 2025 remains to be seen, but we're not holding out much hope.

Our "Even If The World Looks As It Does Today Our Forecast Will Still Probably Be Wrong" 2025 Forecast. If serving no other purpose, our January baseline forecast can at least act as a point of reference as to how we'll see the impacts of policy changes on the economy as the details of those changes

emerge in the months ahead. Our January baseline forecast calls for real GDP growth of 2.2 percent in 2025, which would be in line with the pre-pandemic trend. To our earlier point, however, that would still leave certain sectors of the economy far from having normalized. For instance, the manufacturing sector has been in contraction for more than two years, and that looks unlikely to change through the first half of this year. Our forecast calls for industrial production in the factory sector to be basically flat, at a very low level, over the first half of the year, with wobbly global growth and uneven capital spending acting as drags, before gently rising over the latter half of the year. With the trend rate of job growth continuing to slow, we expect the unemployment rate to rise, but also expect a slowing pace of growth in the supply of labor to blunt the upward pressure on the jobless rate. We expect the jobless rate to average 4.1 percent for 2025 as a whole.

Despite having more than worn out its welcome, inflation is showing few signs of going away which, in turn, is keeping interest rates higher than would otherwise be the case. Though the data for the month of December are not yet available, headline PCE inflation was tracking at 2.5 percent for full-year 2024 while core PCE inflation was tracking at 2.8 percent, uncomfortably high for an FOMC still targeting inflation of 2.0 percent. Our baseline forecast has both headline and core inflation as measured by the PCE Deflator at 2.4 percent for full-year 2025, though the risks to our forecast are weighted to the upside. Though to some extent the lagged nature in which changes in shelter costs make their way into the price indexes has overstated measured inflation, the reality is that what had been a marked deceleration in "super core" services inflation (core services excluding shelter costs) has stalled and left that measure hovering at around 3.5 percent, while the prices paid component of the ISM Non-Manufacturing Index shows service providers continue to face steady upward pressure for prices of non-labor inputs. At the same time, even before what are likely to be higher tariffs enter into the mix, we expect prices for core goods (consumer goods excluding food and energy) to swing from being a drag on core inflation to at least a support.

This all adds up to another year of inflation remaining above the FOMC's 2.0 percent target rate. Though not precluding further cuts in the Fed funds rate, particularly with many FOMC members nervously eyeing softer labor market conditions, that inflation is proving to be so persistent certainly limits the degree to which the funds rate can be lowered; our baseline forecast anticipates two twenty-five basis point cuts in 2025. Even should that prove to be the case, it may bring little relief from elevated long-term interest rates, as concerns over persistent inflation and the extent to which gaping federal government budget deficits will drive debt issuance figure to put a floor under yields on longer-term U.S. Treasury securities. To the extent that mortgage interest rates are influenced by yields on 10-year U.S. Treasury notes, this does not bode well for the housing market. Our baseline forecast calls for new home sales to little changed from the Q4 2024 pace but, as builders will be focused on paring down elevated spec inventories, we look for a decline in starts of new single family homes in 2025.

While we will touch on some of the specifics in more detail in what follows, that we're offering such a condensed summary of our forecast for 2025 simply reflects the high degree of uncertainty surrounding any outlook for the year ahead, ours included. As for how our 2024 forecast fared, real GDP was on pace to have grown by 2.8 percent for full-year 2024, handily beating the 2.1 percent growth we expected. Consumer spending and business fixed investment proved to be sturdier than our forecast anticipated, largely accounting for our forecast miss. Faster labor force growth than we anticipated facilitated faster job growth than we expected, but at the same time pushed the unemployment slightly higher, with the annual average rate of 4.0 percent for 2024 topping the 3.9 percent rate our forecast anticipated.

Despite inflation having remained higher than our forecast, our forecast of one hundred basis points of Fed funds rate cuts in 2024 (market pricing had anticipated one hundred fifty basis points) proved to be correct, even if that hundred basis points didn't exactly come as we had mapped them out. The full-year average yield on 10-year U.S. Treasury notes was fifteen basis points higher than our forecast anticipated, in part reflecting higher than expected inflation, but the annual average 30-year fixed rate mortgage rate was almost thirty basis points above our forecast, as the narrower spread between the two we anticipated did not materialize. With higher mortgage rates than we anticipated, our forecast of new home sales proved a bit too high, but at the same time the CoreLogic HPI was on course to log an increase of around 4.0 percent for 2025, a bit better than the 3.5 percent gain our forecast anticipated. With the bookkeeping out of the way, we'll move on to what we consider some of the key questions facing the U.S. economy in 2025.

Is The Looming Labor Supply Shock Already Here And We Just Don't Know It Yet? Though many are focusing more on tariffs and the potential implications for growth and inflation, we are much more focused on immigration reform and the potential effects on the supply of labor. As we see it, whether in the form of a sudden decline in the supply of labor or a materially slower pace of growth in the supply of labor, the potential effects on wages, output, and inflation in the broader economy stemming from changes to immigration policy would be felt much more acutely, and more immediately, than the effects of expanded tariffs. As a reminder, we devoted our December 2024 edition to a detailed discussion of the potential impacts of both tariffs and immigration reform, so we won't repeat that discussion here. We do, however, think the dynamics of labor supply are worth emphasizing here; after all, that the labor supply grew much more rapidly than had been anticipated is a key reason real GDP growth so easily exceeded expectations on 2023 and 2024. That will, of course, come as news to those still seemingly unaware that there is actually a supply side of the economy.

The chart on the following page updates a chart we used in last month's *Outlook*, since at that time the 2024 data had not yet been released. The 2024 data incorporate the Census Bureau's updated methodology of estimating international migration, and applying this methodology to prior years' estimates yielded significantly higher net flows of international in-migration than had been previously reported. Those upward revisions are incorporated into the following chart, which illustrates the extent to which international in-migration has driven total U.S. population growth, having accounted for roughly eighty-five percent of the change in total population over the 2022-2024 period.

The importance of international in-migration is nothing new and is something we've been talking and writing about for several years, but what has changed is the extent to which this has driven U.S.

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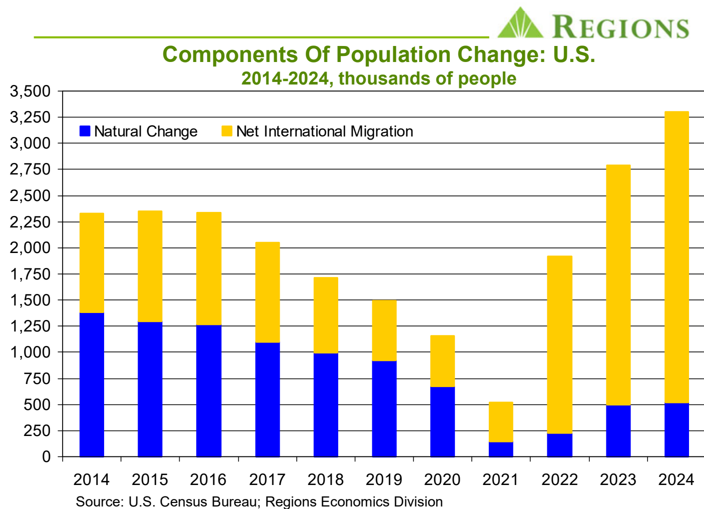
population growth. This has, in turn, contributed to the more rapid growth in labor supply that we've referenced above, but we and others have been arguing for some time now that the effects of faster international in-migration were not being fully captured in the labor market data because Census had been undercounting in-migration. More specifically, while some have argued that the flat level of household employment reported over the past several months is a sign that the economy is either in or on the verge of recession, we've argued that it reflects the extent to which Census had been undercounting foreign born labor.



We'll soon know whether our argument was valid, as the 2025 household survey data will reflect the Census Bureau's revised methodology, which should result in significant level-increases in the size of the labor force and the level of household employment as of January 2025 (with little impact on the unemployment rate). But, even if we are correct on this point, that the household survey data in any given year are collected under the population controls of the prior year means the 2025 household survey data will be missing, at least partly, what already seems to be a sharp easing of in-migration flows. With the Biden Administration having, in June 2024, moved to make it more difficult for migrants who enter the U.S. without legal permission to seek asylum and remain in the country, there has been a sharp decline in migrants crossing the U.S.-Mexico border. Though we cannot be sure, our sense is that this is one reason intra-year growth in the labor force slowed to the extent it did over the final months of 2024.

In other words, even before any changes to immigration policy by the incoming Trump Administration, slower inflows of migrants could already be impacting labor supply which, in turn, could be one factor behind the slowing trend rate of job growth. If so, population controls based on the surge in in-migration over recent years could overstate the size of the labor force and the level of household employment, to the point that growth in household employment could go from lagging to outpacing growth in payroll employment. Either way, however, we think payroll employment, flawed as that measure may be, is the more reliable signal of underlying labor market conditions. To some extent, this goes back to our earlier point about the care that has to be taken when trying to interpret the various economic data series. For instance, while various recession rules were triggered by the unemployment ticking higher in 2024, we took a more sanguine view of labor market conditions and, in turn, the broader economy, given that we thought the rising jobless rate to be much more of a (labor) supply-side story. That said, if we're correct in interpreting the more recent data and how the 2025 data may play out, the household survey data may miss, at least partly, what could be a dramatic slowdown, if not outright contraction, in the pool of labor which would be more fully reflected in the establishment survey data. All of this before any further changes to immigration policy.

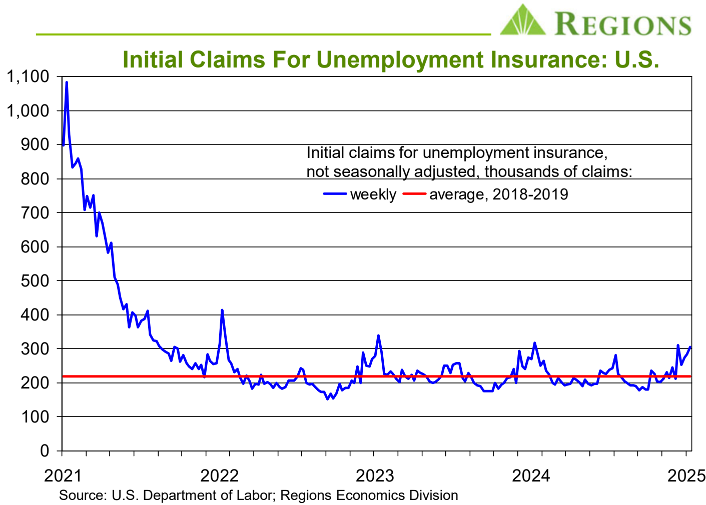
It isn't clear to us that the implications of the long-running deceleration in natural population growth (i.e., the gap between births and deaths in any given year) are sufficiently appreciated, but this points to the importance of foreign born labor in sustaining growth in output and employment. Barring a sudden, and dramatic, acceleration in labor productivity growth, there could be significant adverse impacts from a sudden drop-off in foreign born labor. Put differently, slowing flows of foreign born labor could be the source of an adverse supply shock in 2025 that would cause real GDP growth to be lower and inflation to be higher than is now being anticipated.

Rising Layoffs Would Be A Most Worrisome Sign. While there is little doubt that the trend rate of job growth is slowing, the extent to which that is the case is open to question. Our concerns with the reliability of the monthly estimates of nonfarm employment, hours, and earnings are nothing new, as we were on record back in 2023 with our view that measured job growth was being overstated even beyond what became a steady pattern of downward revisions to the initial estimates of job growth in any given month. Still, even we were taken aback by the BLS's initial estimate of the pending benchmark revisions to the establishment survey data, which suggested the level of nonfarm employment as of March 2024 would be revised down by 818,000 jobs (we were bracing for something on the order of 600,000-650,000 jobs). Moreover, there is reason to suggest that monthly job growth continues to be overstated. At the same time, the monthly data from the Job Openings and Labor Turnover Survey (JOLTS) are not to be trusted. Between the small sample size and a survey response rate hovering at little more than thirty percent since the pandemic, the monthly results reflect roughly six-tenths of one percent of all establishments, meaning the monthly JOLTS data are doing little more than auditioning for a role as a rounding error.

If you at least believe that the trends in the data can be trusted, it is reasonable to conclude that while the trend rate of job growth is slowing, that slowing reflects less hiring on the part of firms as opposed to more workers being laid off. This is, to us, a distinction that very much matters. We can point to the weekly data on initial claims for unemployment insurance as support for this conclusion, though it is based on the not seasonally adjusted data in order to eliminate one potential source of noise in the data.

As with virtually any economic data series, there are clear seasonal patterns in initial claims, but understanding those patterns is the key to being able to interpret what on the surface can seem to be hopelessly noisy data. For instance, at the beginning of any year unadjusted claims tend to spike, as seasonal workers who had been hired over the final quarter of the prior year are let go, which is what we've seen in recent weeks. Of more importance is that layoffs over the past three-plus years have not

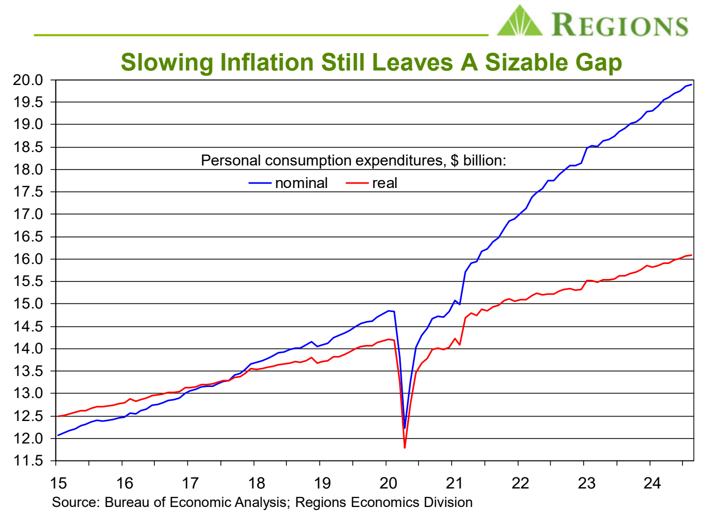
deviated from the typical seasonal patterns in place prior to the onset of the pandemic, as seen in the chart below.



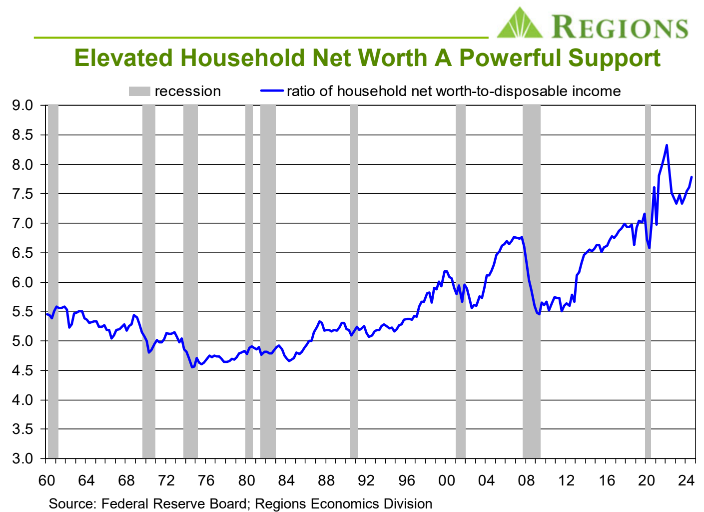
That firms are hiring fewer workers is something that should have been expected, as the frenzied pace of job growth in the early phases of the rebound from the pandemic was never going to be sustained. But, there are no signs that firms are letting workers go at a greater rate than had been the case prior to the pandemic. Some, including us, have argued that firms are engaging in "labor hoarding" as a reaction to how difficult and costly it has been to find, and retain, labor. But, with labor market conditions softening, it could be that firms will become more willing to part with workers if they perceive it will be easier to add back labor should they be faced with rising demand. Or, to the extent firms have been engaging in labor hoarding on the expectation of demand picking up in the future, a downshifting in those expectations could lead them to begin laying off workers they now feel to be unnecessary. Another possibility is that if revenue growth is slowing while input costs continue to rise, mounting pressure on profit margins could lead firms to begin letting workers go. We have noted that the not seasonally adjusted data on initial claims for unemployment insurance is the single most important data series we are tracking. Whatever the trigger, a significant and sustained increase in layoffs would be a red flag for the broader economy.

Stark Divide In The Household Sector. We are often asked for our outlook for U.S. consumers, and our answer is typically "which U.S. consumers?" After all, aggregate measures of income, wealth, and spending mask what tend to be stark differences across the various household income buckets and can also mask differences within any given income cohort. So, we think it fitting to offer two different views here, not in the sense that either is a definitive representation of the state of U.S. consumers, but in the sense that both are relevant in any discussion of U.S. consumers.

We've often used the following chart to help answer the question of why consumers don't seem to be happier about inflation having slowed as sharply as it has. The blue line shows total consumer spending in nominal terms, i.e., not adjusted for price changes, while the red line shows total consumer spending in real terms, i.e., adjusted for price changes. Think of the gap between the two lines as the cumulative effects of higher prices over the past few years. What also stands out to us is that the path of real spending is basically back on the same trajectory it would have been on had the pandemic never happened, which is clearly not the case with the path of nominal spending.



For lower income households who have exhausted whatever saving buffers they had been able to build up with the help of sizable financial transfers in the early phases of the pandemic, the cumulative effect of higher prices has caused a rising degree of financial stress which has sharply curbed discretionary spending. Households in this position are far less likely to have reaped the benefits of rising asset prices over recent years which, in turn, have contributed to a record-high level of household net worth; as of Q3 2024 (the last available data point) household net worth was forty-four percent higher than at the onset of the pandemic.



For those households in the higher income cohorts and those which have seen significant increases in net worth, higher prices have not necessarily been an impediment to discretionary spending. The above chart helps illustrate the extent to which household net worth has risen, and though down from the peak seen in late-2021 the ratio of household net worth to disposable personal income is nonetheless easily above the pre-pandemic trajectory. This helps put the "wealth effects" that many argue are a key support of discretionary spending into context, but also lends

support to the premise that, when it comes to consumer spending, there is a clear divide across income/wealth levels.

In the context of these two snapshots, here are a few things to keep in mind when considering the path of consumer spending in 2025. First, further increases in prices, even if at a slower pace and regardless of the cause, will only add to the degree of financial stress being felt by lower income households and could broaden the range of households feeling such stress. Second, spending amongst lower income households will be more dependent on the labor market holding up. Though the pace of job growth has slowed, growth in aggregate labor earnings, the biggest block of personal income, continues to easily outpace inflation. Should the labor market deteriorate more sharply than we are anticipating, that will be felt more immediately amongst lower-to-middle income households. Third, a sharp correction in equity prices and/or a meaningful decline in house prices could easily trigger negative wealth effects amongst those households in the upper income cohorts more likely to be owners of assets, which in turn would curb discretionary spending. Finally, to the extent interest rates remain elevated, spending on consumer durable goods will be impaired, while at the same time will those households with variable rate debt obligations, including credit card debt, will get less, if any, relief from debt service burdens. Our forecast calls for growth in consumer spending to become more aligned with growth in disposable income than has been the case over the past few years, but there are clearly downside risks to that forecast.

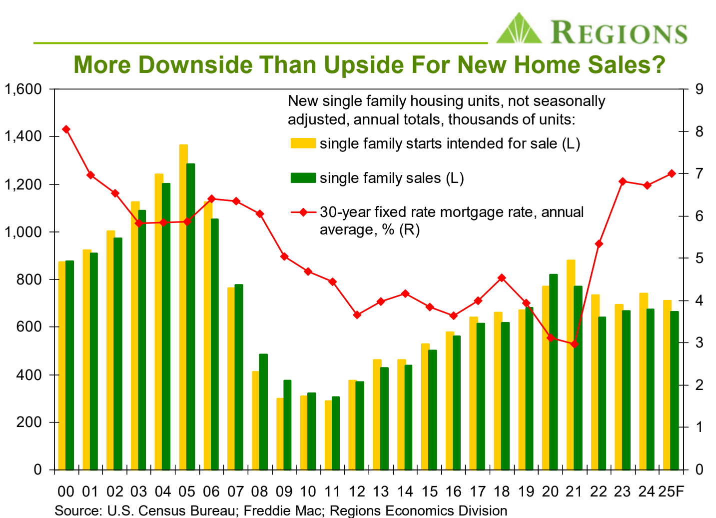
Trade Policy: Isolated Skirmishes Or Battle Royale? As with immigration reform, we discussed potential impacts of expanded tariffs in our December 2024 edition. While we won't repeat that discussion here, we do want to touch on one point that is getting considerable attention, which is the potential link between tariffs and inflation. Again, it is far too soon to try and do any sort of formal analysis or to incorporate any such links into our baseline forecast given that we're lacking a few key details, such as what the U.S. will do and how other nations, foreign and U.S. firms, and U.S. consumers will react. You know, just a few minor details.

In any event, as a quite simple and general example, suppose expanded tariffs result in prices of imported consumer goods rising by ten percent. This increase in the level of prices would push inflation, as measured by the year-on-year percentage change in whichever price index is being used, higher, but if that's the end of the story, i.e., no retaliation from abroad, no further increases in tariffs, then after twelve months have passed, that initial jump in prices basically washes out and measured inflation returns to where it would have been in the absence of expanded tariffs. In order for there to be a sustained impact on measured inflation, you'd have to see successive increases in tariffs, which could result from foreign nations retaliate by imposing tariffs on imports from the U.S. and the U.S. in turn retaliating by further raising tariffs which are passed along in the form of higher prices for consumer goods. That, by the way, didn't work out all that well in 1930 . . .

It is the former scenario, i.e., one and done, that Federal Reserve Governor Christopher Waller likely had in mind in comments made at an Organization for Economic Cooperation and Development event. Governor Waller noted that if, as he expects, "tariffs do not have a significant or persistent effect on inflation, they are unlikely to affect my view of appropriate monetary policy." In other words, there is a difference between one-time increases in prices and repetitive increases in prices, and most central bankers would likely agree that the former would not merit a policy response while the latter would. We have no quarrels with Governor Waller's remarks, as he is simply relaying how many central bankers probably think about this issue. But, that a one-off increase in prices may not merit a monetary policy response would not mean there would be no impacts elsewhere in the economy.

Even if not sparking sustained higher inflation, a one-off increase in prices would reduce real incomes and, in turn, spending. It is highly unlikely that those lower-income households already feeling financial stress from the cumulative effects of higher prices over the past few years would be all that interested in a debate over the appropriate monetary policy response to higher tariffs. One thing that strikes us as we listen to discussions of the potential impacts of expanded tariffs is that many seem to jump to the new, post-tariff "steady state," as in, sure, tariffs go up, but everyone adjusts and then it's just run rate from then on. Aside from the obvious point that there are really no such things as "steady states" in a dynamic economy, we'll just note that it isn't the steady states that get you, it's the adjustments between steady states that get you every time. We're a way off from having any specific details on expanded tariffs, and a much longer way from fully understanding the impacts throughout the broader economy.

Will The Housing Market Ever Catch A Break? If the old idiom "don't kick a man when he's down" were applied to the economy, you'd have to think it'd be applied to the housing market. We have for years chronicled the persistent undersupply that has held down sales and supported price appreciation, while significantly higher mortgage interest rates since mid-2022 have further exacerbated affordability constraints, in part as they have acted as a drag on growth in inventories of existing homes for sale. As we enter 2025, mortgage interest rates are again flirting with seven percent, while the prospect of expanded tariffs threatens to push materials costs higher and the prospect of immigration reform could worsen existing labor supply constraints which would, in turn, act as a drag on construction of new single family homes. Those factors would push new home prices even higher and further thin the pool of able and/or willing buyers.



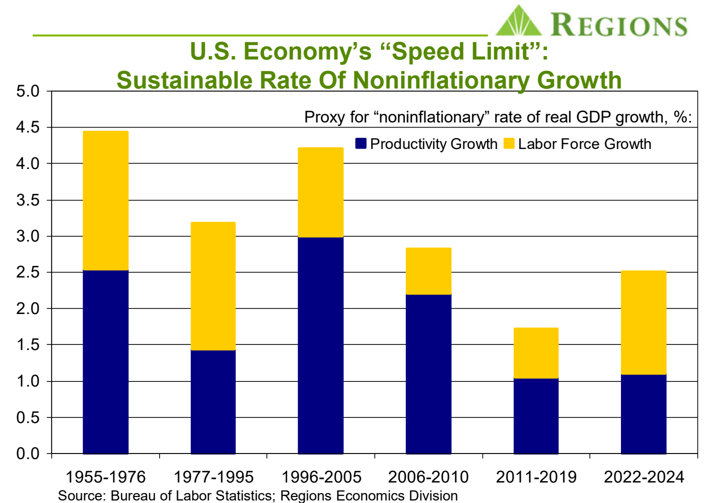
It's hard to see things getting much better for the housing market in 2025. If it seems that our forecasts of starts and sales of new

single family homes are too high given that we expect mortgage interest rates to hover around seven percent, recall another point we've made frequently over the past few years, which is that there remains a considerable pent-up demand for home purchases. We saw evidence of that in 2024 when dips in mortgage rates were met by stepped-up applications for purchase mortgage loans. At the same time, many builders were aggressively using incentives, including mortgage rate buydowns, to facilitate sales.

It is more than fair, however, to ask how much longer builders will be willing or able to do so if mortgage rates rise further, tariffs push construction costs higher, and labor supply constraints limit construction. Moreover, one key reason many builders have been so willing to use sales incentives is that inventories of spec homes for sale had risen to uncomfortable levels. Though there has been some progress in paring those inventories down, the prospect of being able to construct fewer homes – at higher costs – may make builders more willing to hold inventories of units either already completed or somewhere in the construction process. As noted earlier, the spread between rates on 30-year fixed rate mortgage loans and longer-term U.S. Treasury securities remains well above historical norms. As we expect 2025 to play out, that spread narrowing, perhaps due to rising demand for mortgage-backed securities, may be the only path to meaningful reductions in mortgage interest rates this year. Sure, there is another path to meaningfully lower mortgage interest rates, but the set of conditions that would put us on that path – the economy slowing sharply, if not contracting, a marked deterioration in labor market conditions, downward pressure on prices – probably isn't on anyone's wish list for the U.S. economy in 2025. Either way, this figures to be a tough year for the housing market.

Productivity Growth Up To The Task? Perhaps one of the most underappreciated stories of the recent past is the marked acceleration in labor productivity growth. That this has been, and apparently remains, an underappreciated story can be seen in a common reaction to the rapid growth in real GDP in 2023 and 2024, which was along the lines of "wow, growth in consumer spending fueled GDP growth." Or, take a common reaction to the December employment report showing a jump in nonfarm job growth, which was along the lines of "oh no, faster job growth means higher inflation must be on the way." No matter how many times we hear stuff like this, it never ceases to amaze us, and that we keep hearing stuff like this is why we feel compelled to repeatedly point out that the economy doesn't grow because consumption grows, rather, consumption grows because the economy grows or, put differently, workers are able to consume only because they produce. As we noted earlier, the rapid growth in real GDP in 2023 and 2024 largely reflects the combination of faster growth in both the supply of and the productivity of labor. Whether, or to what extent, this can be sustained seems a fitting way to wrap this discussion of key points to watch in 2025.

A topic we return to often, reflecting the importance we attach to it, is the rate at which any economy can grow over time on a sustained basis without sparking inflation pressures, which we refer to as an economy's "speed limit." For any economy, the speed limit is a function of two things – the rate of growth of total labor input and the rate of labor productivity growth. Productivity growth allows for wages growing over time without impinging on profit margins or igniting inflation pressures. Productivity growth is also an ally of firms in the face of labor supply constraints. Over time, productivity growth has moved in a highly cyclical manner, with often prolonged cycles of faster/slower growth, and the chart below is one we typically use when discussing how the speed limit of the U.S. economy has changed over time.



One thing that jumps out is the significantly faster growth in the labor force over the 2022-2024 period, which goes directly to the earlier discussion about the potential impact of immigration reform on the supply of labor. We'll also note that productivity growth over the 2022-2024 period is somewhat shortchanged by the sharp declines in measured productivity over the first half of 2022, corresponding to the contraction in real GDP – the infamous "textbook recession" that wasn't actually a recession. In any event, over the eight quarters ending with Q3 2024 (the latest available data point) productivity growth has averaged 2.4 percent.

Increased labor turnover in the wake of the pandemic likely helped spark faster productivity growth, as it allowed for a better match between workers and their skills and/or interests, while firms reacting to tighter labor market conditions stepped up spending on productivity enhancing equipment/technology. While we hold out high hopes for investment in artificial intelligence (AI) to boost labor productivity, that is a longer-term story or, at least not so much a 2025 story. But, if we are correct in anticipating a marked slowdown in labor supply growth this year, faster labor productivity growth will be critical in blunting the drag this would impose on real GDP growth and the knock-on effects on corporate profits and/or inflation. Even without the slower pace of labor supply growth we expect, a less dynamic labor market in which labor turnover has slowed significantly could choke off the acceleration in productivity growth seen over the past several quarters. One encouraging sign is still-strong business spending on intellectual property products, primarily in the form of spending on research and development, which tends to lead productivity growth, but it takes time for the former to translate into the latter.

Though perhaps not getting the attention it deserves, productivity growth is a key factor in shaping the paths of growth and inflation, making it relevant in the FOMC's debates on the appropriate path of monetary policy. While we think productivity growth to be always worth watching, that is even more the case in 2025 with the risks to the inflation outlook seemingly tilted to the upside.

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ECONOMIC OUTLOOK

January 2025

Q2 '24 (a)	Q3 '24 (a)	Q4 '24 (f)	Q1 '25 (f)	Q2 '25 (f)	Q3 '25 (f)	Q4 '25 (f)	Q1 '26 (f)		2022 (a)	2023 (a)	2024 (f)	2025 (f)	2026 (f)
3.0	3.1	2.6	1.6	2.0	2.3	2.1	2.0	Real GDP[1]	2.5	2.9	2.8	2.2	2.0
2.8	3.7	3.2	1.8	2.1	2.1	2.0	2.0	Real Personal Consumption[1]	3.0	2.5	2.7	2.5	2.1
3.9	4.0	-0.4	1.6	2.8	3.9	4.8	4.6	Real Business Fixed Investment[1]	7.0	6.0	3.8	2.4	4.0
9.8	10.8	-3.3	0.9	2.5	4.6	6.3	6.2	Equipment[1]	4.4	3.5	3.7	2.9	5.0
0.7	3.1	3.0	3.2	4.2	5.0	5.1	5.1	Intellectual Property and Software[1]	11.2	5.8	4.1	3.6	5.0
0.2	-5.0	-1.8	-0.7	0.0	0.3	1.3	0.4	Structures[1]	3.6	10.8	3.2	-1.0	0.0
-2.8	-4.3	5.3	2.7	-1.3	-0.9	-2.0	-1.5	Real Residential Fixed Investment[1]	-8.6	-8.3	4.2	0.4	-1.1
3.1	5.1	0.0	1.9	1.8	1.4	0.8	0.5	Real Government Expenditures[1]	-1.1	3.9	3.2	1.9	0.7
-1,035.7	-1,069.2	-1,080.4	-1,128.2	-1,080.7	-1,086.5	-1,086.0	-1,100.4	Real Net Exports[2]	-1,041.7	-932.8	-1,040.6	-1,095.4	-1,104.8
1,004	971	994	984	978	973	962	956	Single Family Housing Starts, ths. of units[3]	1,006	949	1,008	974	951
336	361	340	353	345	343	344	344	Multi-Family Housing Starts, ths. of units[3]	546	473	346	346	345
4.7	3.6	3.2	2.9	2.6	2.1	1.3	1.1	CoreLogic House Price Index[5]	13.1	4.1	4.2	2.2	1.2
15.6	15.6	16.5	16.2	16.3	16.3	16.3	16.3	Vehicle Sales, millions of units[3]	13.8	15.5	15.8	16.3	16.4
4.0	4.2	4.1	4.1	4.1	4.2	4.1	4.1	Unemployment Rate, %[4]	3.6	3.6	4.0	4.1	4.0
1.7	1.5	1.4	1.3	1.1	1.1	1.0	0.9	Non-Farm Employment[5]	4.3	2.3	1.6	1.1	0.8
1.0	1.1	3.2	3.0	1.6	1.3	2.0	3.3	Real Disposable Personal Income[1]	-5.6	5.1	2.9	2.1	2.4
2.6	2.3	2.4	2.3	2.2	2.4	2.4	2.4	GDP Price Deflator[5]	7.1	3.6	2.4	2.3	2.2
2.6	2.3	2.4	2.2	2.2	2.5	2.6	2.5	PCE Deflator[5]	6.6	3.8	2.5	2.4	2.3
3.2	2.6	2.7	2.6	2.6	3.0	2.8	2.6	Consumer Price Index[5]	8.0	4.1	3.0	2.7	2.4
2.7	2.7	2.8	2.4	2.4	2.5	2.5	2.6	Core PCE Deflator[5]	5.4	4.1	2.8	2.4	2.4
3.4	3.2	3.3	2.9	2.8	3.0	2.8	2.8	Core Consumer Price Index[5]	6.2	4.8	3.4	2.9	2.6
5.38	5.31	4.69	4.34	4.09	3.88	3.88	3.88	Fed Funds Target Rate Range Mid-Point, %[4]	1.73	5.07	5.19	4.04	3.88
4.44	3.95	4.28	4.71	4.68	4.71	4.75	4.78	10-Year Treasury Note Yield, %[4]	2.95	3.96	4.21	4.71	4.82
7.00	6.51	6.63	7.02	6.98	6.99	7.02	7.04	30-Year Fixed Mortgage, %[4]	5.34	6.81	6.72	7.00	7.07
-3.8	-4.2	-4.0	-4.1	-4.0	-3.9	-4.0	-3.9	Current Account, % of GDP	-3.9	-3.3	-3.9	-4.0	-3.8

a = actual; f = forecast; p = preliminary

Notes: 1 - annualized percentage change 2 - chained 2017 $ billions 3 - annualized rate 4 - quarterly average 5 - year-over-year percentage change

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