Monthly Economic Monitor – U.S.

Economics and Strategy

NATIONAL BANK OF CANADA
FINANCIAL MARKETS

April 2025

More tariffs, less growth

By Jocelyn Paquet

Summary

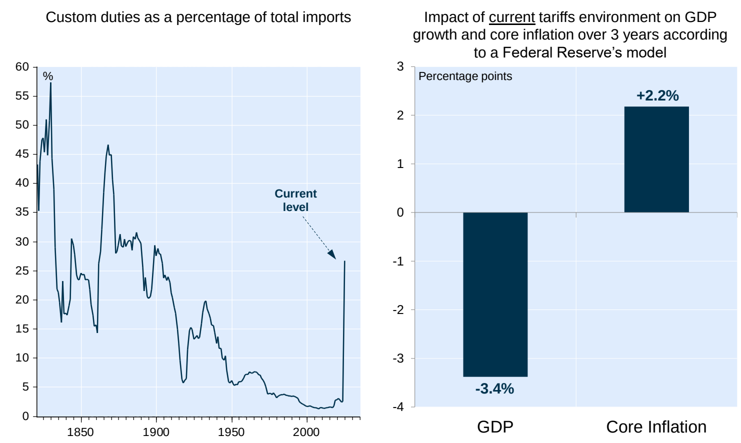
- The considerable expansion of the U.S. administration's protectionist agenda in recent weeks has pushed the average tariff on goods entering the United States to over 25%. As we believe the potential economic impact of such elevated custom duties is unsustainable for Washington in the long term, we expect this rate to be lowered to around 12-15% in the coming weeks through negotiations.
- However, a return to the status quo ante seems unlikely given the administration's protectionist convictions. Some tariffs will probably remain in place, which will have stagflationary effects on the economy. The significant depreciation of the U.S. dollar, which is rather atypical in the current climate of uncertainty, could exacerbate inflationary pressures.
- Aware of the many risks, we have significantly raised our core U.S. CPI forecasts for the end of the year, from 2.7% to 3.6%. Conversely, we have slashed our growth forecasts for this year (from 2.1% to 1.7%) and for next year (from 1.6% to 0.8%) to take into account the disruptions caused by tariffs, which are greater than expected and have undermined business confidence. We remain ready to revise this scenario upward or downward depending on the evolution of trade policy.

After focusing its attention on three of its most important trading partners (Canada, Mexico, and China) at the beginning of its term, the U.S. administration has significantly broadened its protectionist agenda in recent weeks, imposing 25% tariffs on steel, aluminum, and automobiles, as well as a 10% surcharge on most other products entering America.

Tariffs described as “reciprocal,” whose stated purpose was to respond to trade barriers faced by U.S. exporters abroad, were also briefly introduced before being postponed for 90 days to allow time for negotiations, but above all to calm the stock and bond markets. It is important to note that China was not granted this reprieve. Having preferred to stand up to the U.S. administration by imposing tariffs of its own and restricting exports of certain critical minerals to America, it was hit with 145% tariffs. Only certain electronic devices were excluded from the list by Washington, in order to avoid angering U.S. consumers and tech giants such as Apple.

As a result, the average tariff imposed on goods entering the U.S. has skyrocketed from 2.5% last year to over 25% today. And while it is difficult to determine the precise impact of such a protectionist shift, most economists agree that it could be significant. For example, a model presented by the Federal Reserve during President Trump's first term suggested that a one percentage point increase in average tariffs would reduce GDP growth by 0.14 percentage points over three years and increase core inflation by 0.09 percentage points over the same period. According to this model, the tariff policies implemented by Washington in recent weeks could therefore reduce GDP by as much as 3.4 percentage points and increase core inflation by a staggering 2.2 percentage points.

U.S.: At current level, tariffs are an economy killer

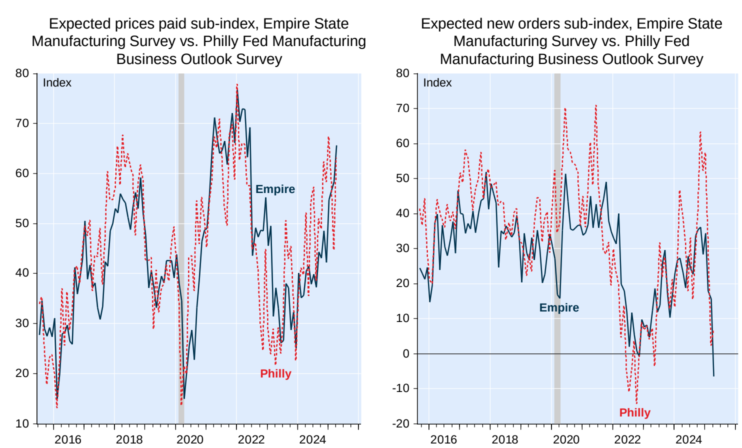


NBC Economics and Strategy (data via the Tax Foundation and the Federal Reserve)

As such a scenario is completely untenable for the current administration, we expect the average rate to be lowered to around 12-15% in the coming weeks through negotiations. A reduction in the rate applied to Chinese products seems particularly likely, in order to give U.S. buyers time to find other suppliers. However, a return to the status quo ante does not seem feasible given the administration's convictions on protectionism. Some tariffs will therefore likely remain in place, which will have stagflationary effects on the economy.

In fact, these effects are already beginning to show in surveys, particularly those of manufacturing companies. Surveys conducted by regional Fed banks, the first available for April, indeed highlighted growing concern among factories about possible increases in input prices and a decline in orders.

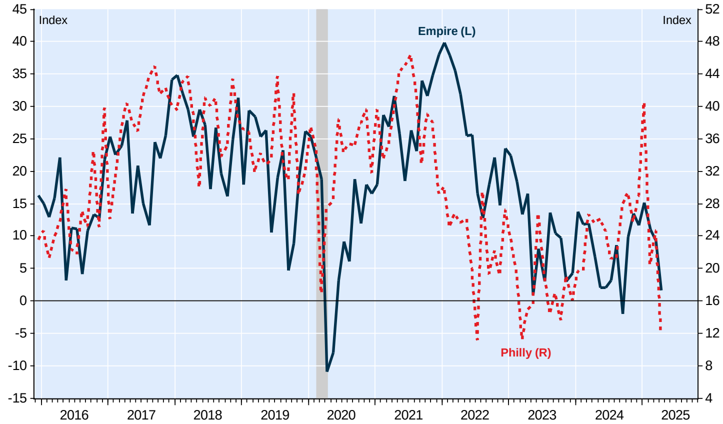
U.S.: Stagflationary vibes



NBC Economics and Strategy (data via Bloomberg)

Unsurprisingly, this deterioration in the outlook has led the companies surveyed to revise their investment plans downward.

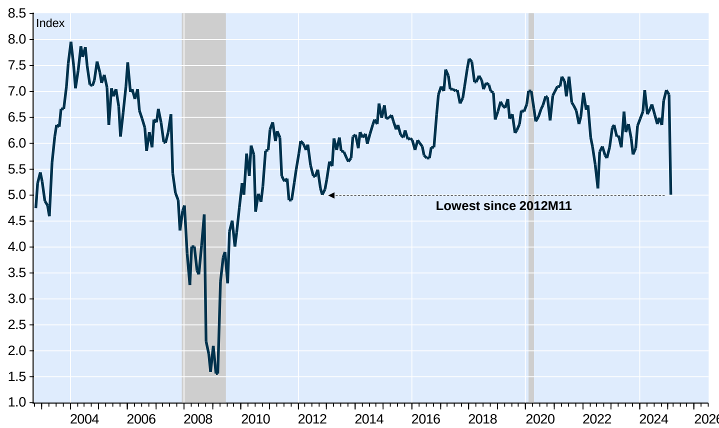
U.S.: Uncertainty reduces manufacturing investment intentions
Expected capital spending, Empire State Manufacturing Survey vs. Philly Fed Manufacturing Business Outlook Survey



NBC Economics and Strategy (data via Bloomberg)

Nor do concerns about the future appear to be limited to the manufacturing sector. The sharp decline in CEO confidence suggests that they are now spreading to several sectors of the economy.

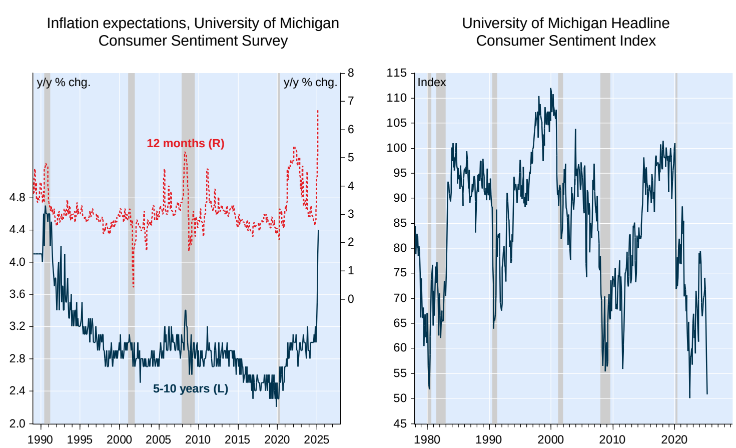
U.S.: CEO confidence collapsed in March
CEO Confidence in the economy 1 year from now



NBC Economics and Strategy (source: Chief Executive Magazine via Bloomberg)

They also appear to be widespread among consumers, whose confidence fell in April to its second-lowest level ever, according to a survey conducted by the University of Michigan. Here again, inflation fears were to blame...

U.S.: Inflation fears cause consumer confidence to fall



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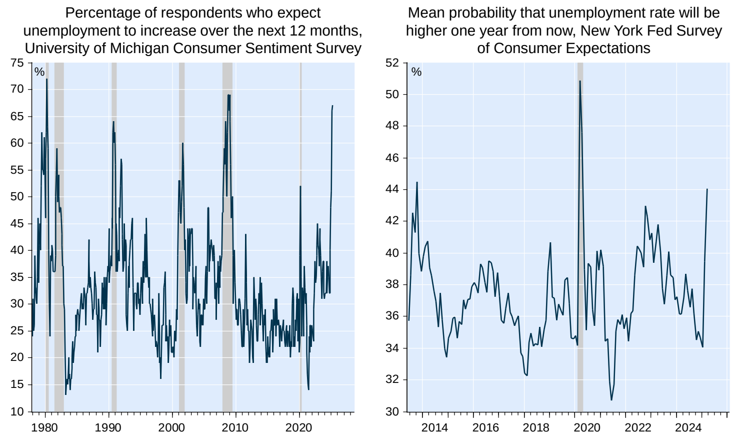
...although employment expectations were also a factor, with a growing proportion of respondents to various polls fearing an increase in unemployment in the coming months.

U.S.: Households growing more pessimistic about their job prospects



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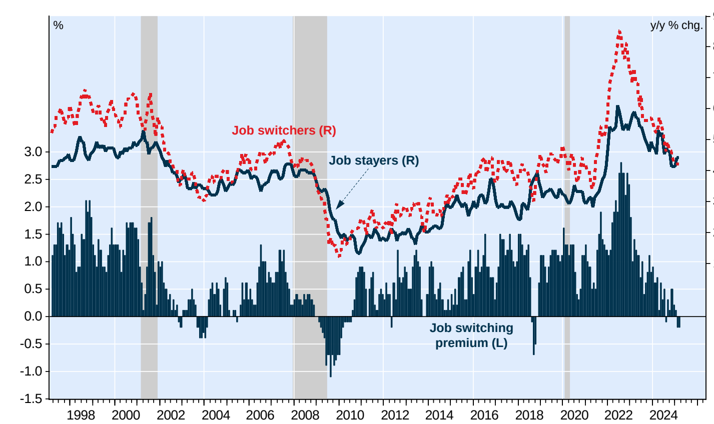
Outside the public sector, these fears have so far proved unfounded, with job creation remaining strong overall in the private sector. However, signs of a slowdown in labour demand are visible in the data, particularly in wage data. For the second month in a row, in March, wage growth for people who changed jobs was lower than that of those who kept their jobs, marking a sharp reversal from the post-COVID period and indicating either that companies can no longer afford to poach employees from their competitors by offering higher wages, or that they are simply not seeking to do so in a context where they do not require additional staff.

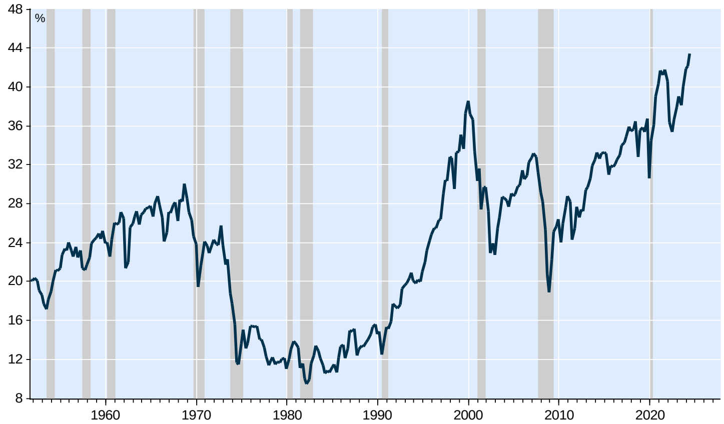
U.S.: Job switching wage premium reversal hints at fading labour demand
Atlanta Fed Wage Growth Tracker, premium of job switchers over job stayers



NBC Economics and Strategy (data via Bloomberg)

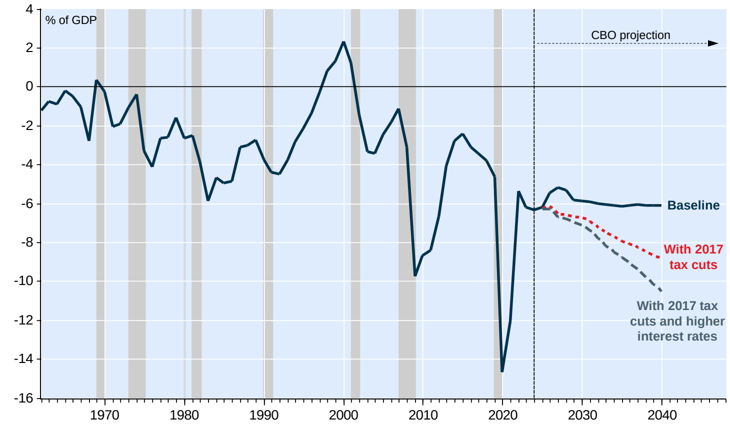
Admittedly, it may take a few more months before labour demand weakens enough to show up in hard employment data (such as the unemployment rate) and lead to a more noticeable slowdown in wage growth. In the meantime, however, households could still be affected by falling asset prices, particularly equities. Obviously, the stock market should not be confused with the economy, but it must be recognized that the link between the two has strengthened in recent years, with equities accounting for an ever-increasing share of household assets. And while this helped to stimulate the economy when markets were on the up through a positive wealth effect, the opposite is also likely to be true in a less favorable environment, such as the one we are currently experiencing.

U.S.: Households more exposed than ever to stock market movements
Directly and indirectly held corporate equities as a percentage of total households' financial assets



NBC Economics and Strategy (data via Bloomberg)

U.S.: Fiscal trajectory raising doubts about safe-haven status of Treasuries
Federal fiscal deficit as a percentage of GDP



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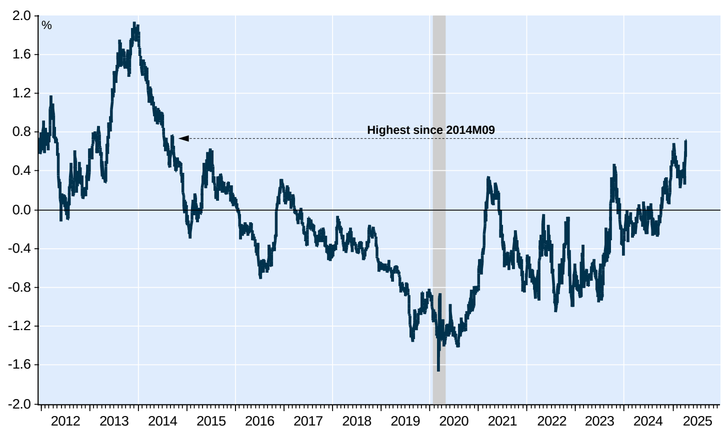
In addition to the direct consequences of the new tariff environment, companies and households could also suffer in the longer term from the fact that it could keep interest rates higher than they would otherwise be. At the short end of the curve, this would result from the Fed's inability to lower rates as much as it would like in a slowing growth environment, for fear of seeing inflation drift further above its target. At the long end of the curve, investors' desire for greater compensation for taking on duration risk is likely to reduce the chances of rates falling as much as they usually do during an economic slowdown. The fairly sharp rise in the term premium in recent months suggests that these considerations are already weighing on bond prices.

U.S.: Investors asking for compensation to take on duration risk
Adriam Crump & Moench 10-year term premium



NBC Economics and Strategy (data via Bloomberg)

This increase undoubtedly reflects growing doubts about the ability of inflation to return sustainably to the central bank's target, a fear that is only exacerbated by rumors of a possible dismissal of Fed Chair Jerome Powell. But the rise in the term premium could also be the result of growing fears about the U.S. fiscal trajectory. Never before has the federal government run such a large budget deficit for so long during an economic expansion, and this situation is now raising questions about the safe-haven status that Treasury bonds have always enjoyed. And with good reason, because an increase in their supply at a time when the Fed would probably not be able to absorb some of this debt would indeed risk driving down their price.

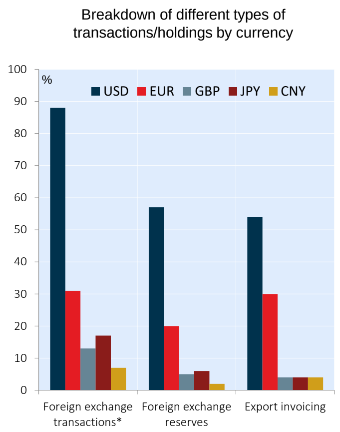
The recent behavior of the greenback only reinforces market doubts about the safe-haven status of the United States and its currency. Instead of appreciating in a context of growing uncertainty, as has almost always been the case in the past, the Greenback has depreciated by around 10% against a basket of currencies since the beginning of the year.

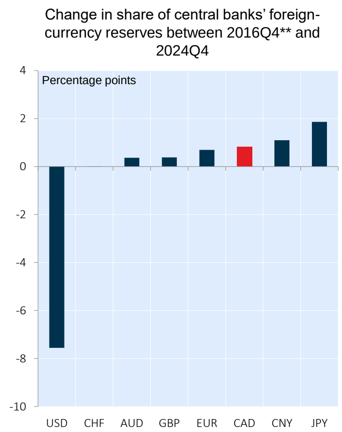
U.S.: Is the USD's safe-haven status being challenged?
U.S. Dollar Index (DXY)

NBC Economics and Strategy (data via Bloomberg)

Of course, we must be careful not to draw hasty conclusions from this slowdown. After all, the U.S. dollar remains stronger than before the pandemic and continues to reign supreme in international markets, where it is by far the most widely used currency in foreign exchange transactions, foreign exchange reserves, and export invoicing. However, it is difficult not to notice the significant decline in the share of international foreign exchange reserves allocated to the U.S. dollar in recent years, a trend that probably reflects the emergence of a more multipolar world, but also the desire of many economies to reduce their dependence on the trade infrastructure put in place by Washington after World War II. It is also difficult not to wonder whether this trend could accelerate in a context where the U.S. administration itself seems determined to dismantle these infrastructures.

World: Greenback still king… but losing ground

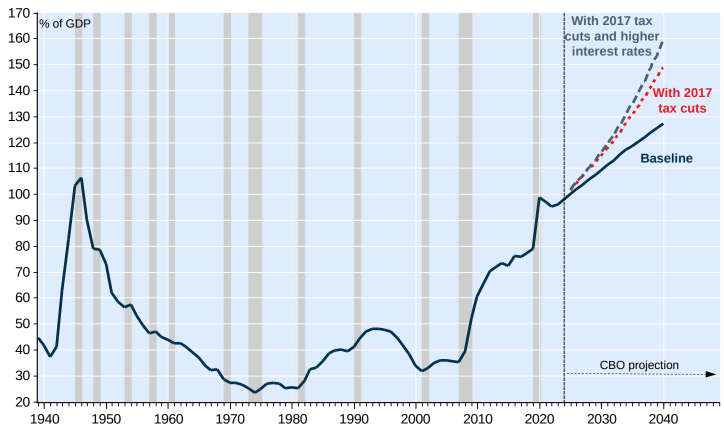




*Sums to more than 100 because each transaction involves two currencies
**First quarter in which CNY was included in the data
NBC Economics and Strategy (data via the Atlantic Council and the IMF)

And while a structurally weaker dollar could undeniably help US-based exporting companies, these gains would come at the high cost of eliminating what Valéry Giscard d'Estaing, then French Minister of Economy and Finance, once called the "exorbitant privilege" of Washington, namely its ability to borrow at lower interest rates in a context of structurally higher demand for the U.S. currency and, at the same time, Treasury bonds. The loss of this privilege would have even more impact in a context where public debt is about to reach a new historic high.

U.S.: Loss of "exorbitant privilege" would hurt with debt at record high
Federal debt held by the public expressed as a percentage of GDP



NBC Economics and Strategy (data via the U.S. Office of Management and Budget and the Congressional Budget Office)

But we are not there yet, and in the short to medium term, the main risk associated with a weaker U.S. dollar is that it could exacerbate the inflationary effect of tariffs. Aware of this risk, we have significantly raised our core CPI forecasts for the end of the year, from 2.7% to 3.6%. Conversely, we have slashed our growth forecasts for this year (from 2.1% to 1.7%) and for next year (from 1.6% to 0.8%) to take into account the disruptions related to tariffs, which are more significant than expected and have undermined business confidence. We remain ready to revise this scenario upward or downward depending on the evolution of trade policy.

United States
Economic Forecast

(Annual % change)*	2022	2023	2024	2025	2026	Q4/Q4 2024	Q4/Q4 2025	Q4/Q4 2026
Gross domestic product (2012 $)	2.5	2.9	2.8	1.7	0.8	2.5	0.9	1.4
Consumption	3.0	2.5	2.8	2.4	1.1	3.1	1.5	1.2
Residential construction	(8.6)	(8.3)	4.2	0.2	(0.1)	2.8	(0.5)	1.0
Business investment	7.0	6.0	3.6	1.8	(0.6)	2.3	1.2	0.3
Government expenditures	(1.1)	3.9	3.4	1.6	(0.4)	3.2	(0.0)	0.1
Exports	7.5	2.8	3.3	1.1	(1.1)	3.0	(0.6)	(0.3)
Imports	8.6	(1.2)	5.3	3.1	(3.0)	5.5	0.1	(1.9)
Change in inventories (bil. $)	119.1	33.1	39.0	6.3	(6.3)	8.9	(25.0)	10.0
Domestic demand	2.3	2.7	3.0	2.1	0.6	3.0	1.1	0.9
Real disposable income	(5.6)	5.1	2.7	1.5	0.5	2.2	1.0	1.3
Payroll employment	4.3	2.2	1.3	0.8	(0.3)	1.2	0.1	0.6
Unemployment rate	3.6	3.6	4.0	4.4	4.9	4.1	4.8	4.8
Inflation	8.0	4.1	3.0	2.7	2.8	2.7	2.9	2.7
Before-tax profits	7.8	6.9	7.9	(1.1)	1.8	6.9	(6.4)	4.7
Current account (bil. $)	(1,012.1)	(905.4)	(1,133.6)	(1,337.5)	(1,075.0)	...	...	...

** or as noted*

National Bank of Canada

Financial Forecast**

	Current 4/18/25	Q2 2025	Q3 2025	Q4 2025	Q1 2026	2024	2025	2026
Fed Fund Target Rate	4.50	4.25	4.00	3.75	3.50	4.50	3.75	3.00
3 month Treasury bills	4.23	3.90	3.65	3.55	3.30	4.23	3.55	2.85
Treasury yield curve								
2-Year	3.81	3.60	3.45	3.35	3.25	4.25	3.35	3.40
5-Year	3.95	3.80	3.70	3.55	3.50	4.38	3.55	3.40
10-Year	4.34	4.25	4.15	4.10	4.05	4.58	4.10	3.85
30-Year	4.80	4.70	4.60	4.55	4.50	4.78	4.55	4.30
Exchange rates								
U.S.$/Euro	1.14	1.09	1.11	1.14	1.15	1.04	1.14	1.17
YEN/U.S.$	142	146	143	142	140	157	142	135

*** end of period*

Quarterly pattern

	Q1 2024 actual	Q2 2024 actual	Q3 2024 actual	Q4 2024 actual	Q1 2025 forecast	Q2 2025 forecast	Q3 2025 forecast	Q4 2025 forecast
Real GDP growth (q/q % chg. saar)	1.6	3.0	3.1	2.5	0.7	2.9	(0.1)	(0.0)
CPI (y/y % chg.)	3.2	3.2	2.7	2.7	2.7	2.3	2.8	2.9
CPI ex. food and energy (y/y % chg.)	3.8	3.4	3.3	3.3	3.1	3.0	3.4	3.6
Unemployment rate (%)	3.8	4.0	4.2	4.1	4.1	4.2	4.4	4.8

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