13/05/2025

Recession odds remain elevated

Uncertainty and higher prices expected to take a toll on the economy.

U.S. Economic Outlook

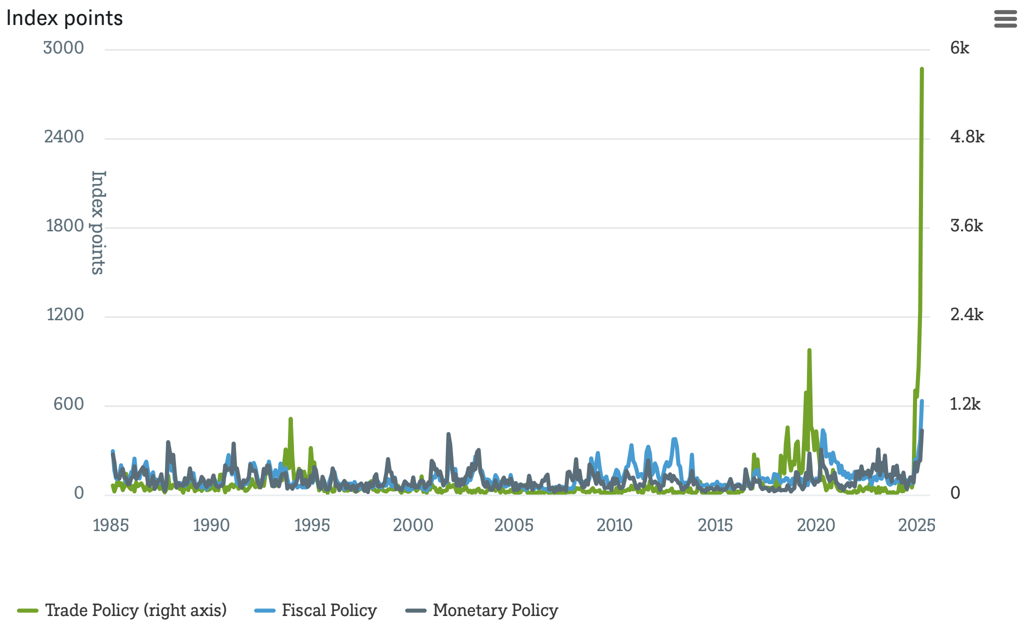
In a nutshell

- **When rule changes are abrupt or even arbitrary, uncertainty about the likely set of future outcomes increases substantially.**
- **We expect negotiations to bring the average tariff rate down to around 14%-15%.**
- **The high level of uncertainty combined with higher input costs implies pressure on corporate margins and on labor markets.**
- **Additional fiscal support is likely to be on the low side going forward, not offsetting the negative impact of tariffs.**
- **In times of high uncertainty, the Fed's dominant strategy is likely to be somewhat delayed, as pre-emptive adjustments may do more harm than good, especially if fiscal policy remains uncertain.**
- **We think the stage is set for a (shallow) recession and assess the probability of this as more likely than not.**
- **Given the current uncertainty and volatility, there is a good chance that we have to revise our forecasts relatively soon – for better or worse.**

Predicting the economy has never been easy. Every second, millions upon millions of people make decisions, take actions, and create new realities. For this reason, economists have long since begun to view the world as an ever-changing, dynamic system in which economies constantly approach, but never reach, some form of equilibrium. Fortunately, economists can rely on certain principles of human behavior and the law of large numbers. This implies that most, but not all, people will behave in certain predictable, sometimes even rational, ways under certain conditions. The famous economist Friedrich Hayek called this "catallaxy," which loosely describes the spontaneous order produced by markets that operate according to a set of (more or less) binding rules. Even if people make irrational decisions in times of high uncertainty, the surrounding rules ensure that the system eventually converges to some form of deterministic outcome. The Fed's dual mandate of price stability and maximum employment is an excellent example of how institutionalized rules provide such clear behavioral guidance. While there are always debates about policy mistakes and unnecessary delays by central bankers, markets tend to agree that the U.S. Federal Reserve (the Fed) will follow through on its objectives – the common wisdom of "never fight the Fed" or "the Fed put" serves as an example. The recent harsh market reaction to challenges to the Fed's independence is a striking example of how deeply such beliefs are embedded in our economic model. Taking institutionalized rules as guidelines for how the spontaneous order within them materializes is usually a well-functioning approach for producing credible forecasts of where the economy might end up in the near future. A necessary condition, however, is that the evolution of the rules themselves remains predictable and that changes – or reforms in this sense – occur smoothly. When rule changes are abrupt or even arbitrary, uncertainty about the likely set of future outcomes increases substantially, over and above the usual uncertainty that arises when external shocks hit the economy.

Chart 1 shows the evolution of various sources of policy uncertainty that are more or less subject to the discretion of economic policymakers and that typically serve as guiding rules for markets.

Chart 1: U.S. Policy Uncertainty Index

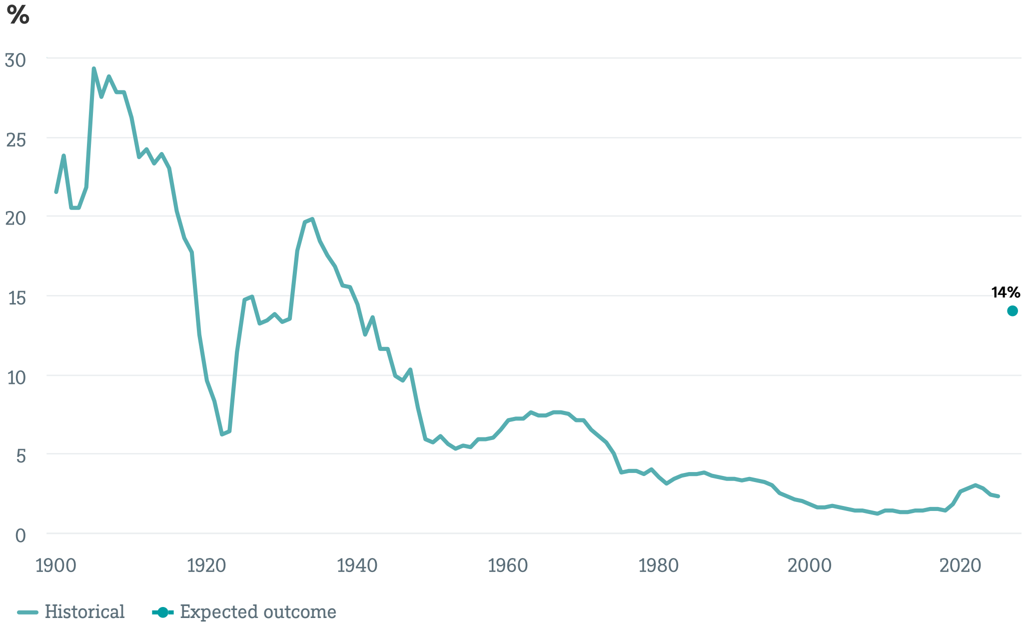


Sources: Economic Policy Uncertainty (EPU), Haver Analytics, DWS Investment GmbH as of May 2025

While there has certainly always been some back-and-forth on the policy side, especially in fiscal and monetary policy, the current trajectory of uncertainty from trade policy stands out. It seems that any challenge to the long-held gold standard that "more trade is better for all" is perceived as a likely abandonment of the previous stability-creating status quo. Without going into the details of the competing political philosophies here, it is clear that President Trump's current foreign policy and trade "reforms" have far-reaching consequences. Moreover, the lack of a clear vision of the ultimate outcome of the new tariff regime leaves markets in an undefined vacuum, making it even more difficult to form accurate expectations for the future. Negotiations with foreign countries have only just begun, and we know from experience that they can take a long time. The most likely consequence is that economic agents will be somewhat paralyzed in their decision-making process. All assumptions underlying business decisions, whether to invest in new projects, to hire or retain employees, or simply to contract with foreign firms for inputs to domestic production, will be called into question. Decision-makers face the risk of high opportunity costs because they are unlikely to be able to keep up with the pace of implementing their plans at the rate at which Washington is changing the rules of the game.

We must admit that keeping track of the tariff status quo is quite a challenge. Announcements constantly change and translating policies into estimates for average tariffs can also be tricky. However, we have lately been talking about levels not seen since the Great depression, up from around 2.5% in February 2024 when all imports are considered (see Chart 2)..

Chart 2: Average Effective Tariff Rate

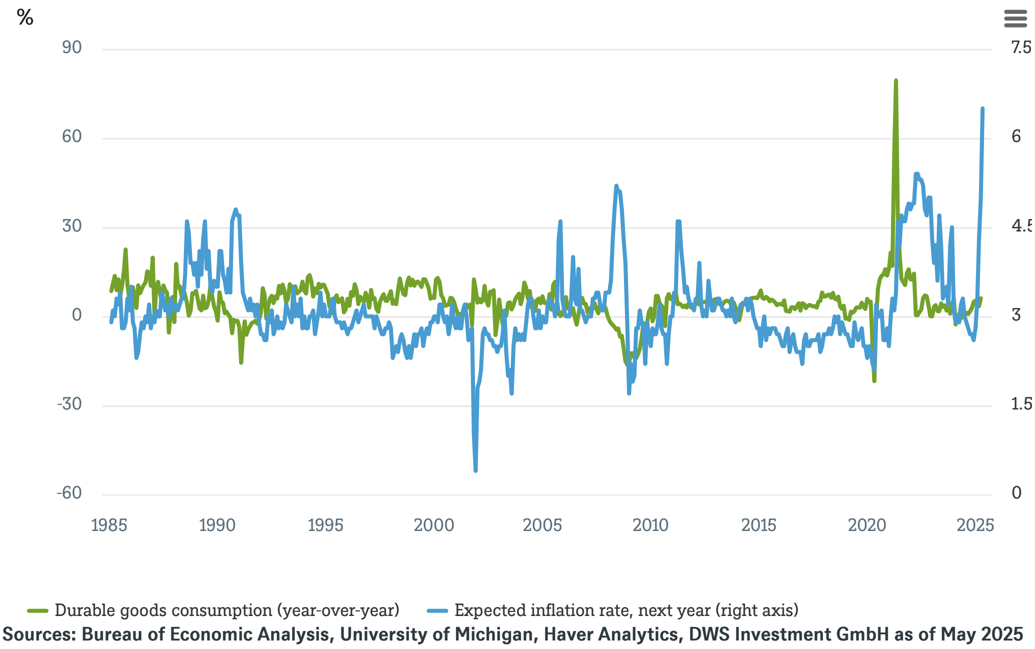


Sources: U.S. International Trade Commission, Bloomberg, DWS Investment GmbH as of May 2025

Such an increase in tariffs clearly represents a shift from an open trade regime to a protectionist approach. Protectionism is used when policymakers seek to shield domestic industries from foreign influence and gain independence from foreign producers in sectors sensitive to national security, as may be the case with China. To some extent, it is understandable that national security interests can sometimes outweigh the pursuit of economic prosperity, and that reshoring certain industrial capabilities makes sense from such a perspective. But the more market-friendly way to achieve this is to first build up production capacity, perhaps supported by fiscal policy, and then slowly begin to shield the relevant sectors. Taking this a step further, if the newly created capacity at home is more competitive than existing capacity abroad, there is probably no need for broad-based tariff walls at all. But this approach takes time, as plans need to be coordinated with domestic producers or investors, who in turn need to build capacity and train people. The current approach, which appears to allow capacity to be built behind protectionist tariff walls, is based on executive orders rather than trade treaties or legislation; companies therefore also face the risk of a quick reversal after President Trump's term ends, which could further upset their investment calculus. Looking ahead, we do not expect the current high level of tariffs to persist and expect negotiations to bring the average tariff rate down to around 14%-15%. However, the actual composition across countries and sectors remains highly uncertain, and this level still represents a significant change from the past free-trade-like status quo.

Tariffs typically take about two months to feed through to inflation. Given the current temporary exemptions, inflation could therefore pick up sharply in Q2 2025. From there, the price level shift effect is expected to peak in Q3 and Q4 2025, with year-on-year (yoy) growth rates of around 3.5-4%, before easing back to current levels in Q2/Q3 2026. The high level of uncertainty combined with higher input costs implies pressure on corporate margins and thus on labor markets, as labor costs are among the first items to be adjusted. This makes an increase in the unemployment rate very likely. Tighter immigration controls may act as a kind of cap on unemployment, but the shift in sectoral demand towards, for example, manufacturing jobs could imply a building structural mismatch with rising wages in certain sectors, which could add to inflation. Beyond such structural labor market issues, distortions in supply chains and redirection of demand towards domestic capacity could contribute to second-round inflationary effects. In any case, second-round effects or not, consumers are already struggling with high prices and are likely to experience a further erosion of their real purchasing power through lower real incomes and, more recently, lower wealth from risky assets. Consumers' near-term inflation expectations are rising, and they have already pulled forward consumption, as evidenced by a reacceleration in durable goods consumption in particular (Chart 3).

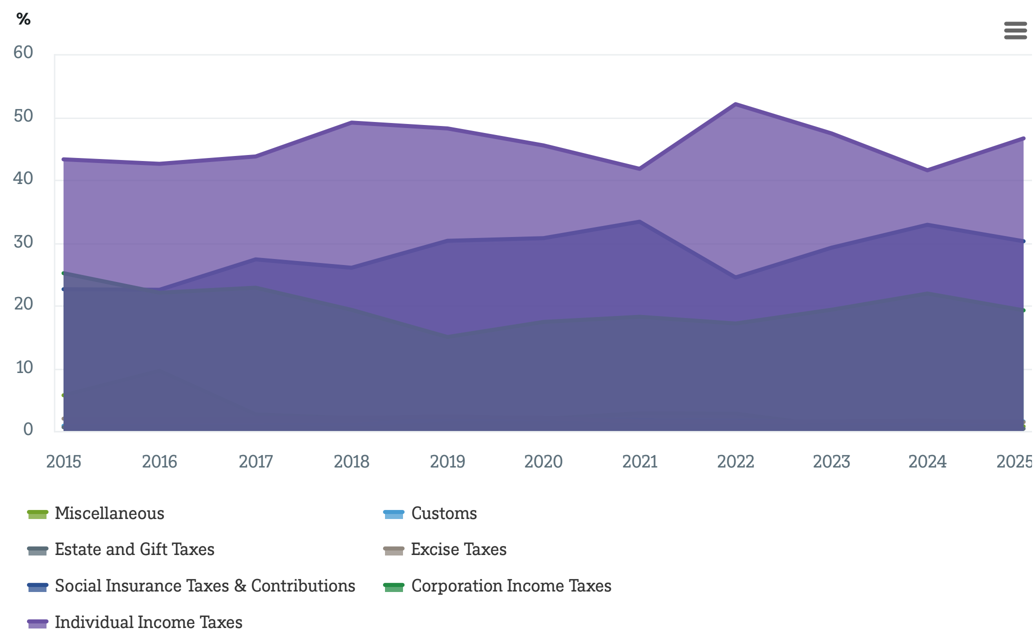
Chart 3: Consumer inflation expectations and durable consumption



Sources: Bureau of Economic Analysis, University of Michigan, Haver Analytics, DWS Investment GmbH as of May 2025

And consumers are right. Recent studies show that in the case of the first trade war, tariffs were almost fully passed through to domestic prices, essentially making domestic consumers pay the government for consuming foreign goods. This raises the question of whether this wealth transfer is efficient, i.e. whether the tax revenue (which the government can redistribute) exceeds the loss to individual households. Taking into account the substitution effects of higher prices, which reduce the demand for foreign goods and thus reduce the tax revenue somewhat, it can be shown that each dollar of government revenue from tariffs costs between $1.2 and $1.5 in terms of negative benefits to the U.S. consumer, which is similar to the effect of a general income tax increase.[1] Tariffs account for about 1.6% of total government revenue in 2024 (see Chart 4), and if our steady state of an average tariff of 14-15% proves correct, their contribution to government revenue could double once substitution effects are taken into account. But even this would still fall well short of the 50% contribution from individual taxes.

Chart 4: Sources of government revenue

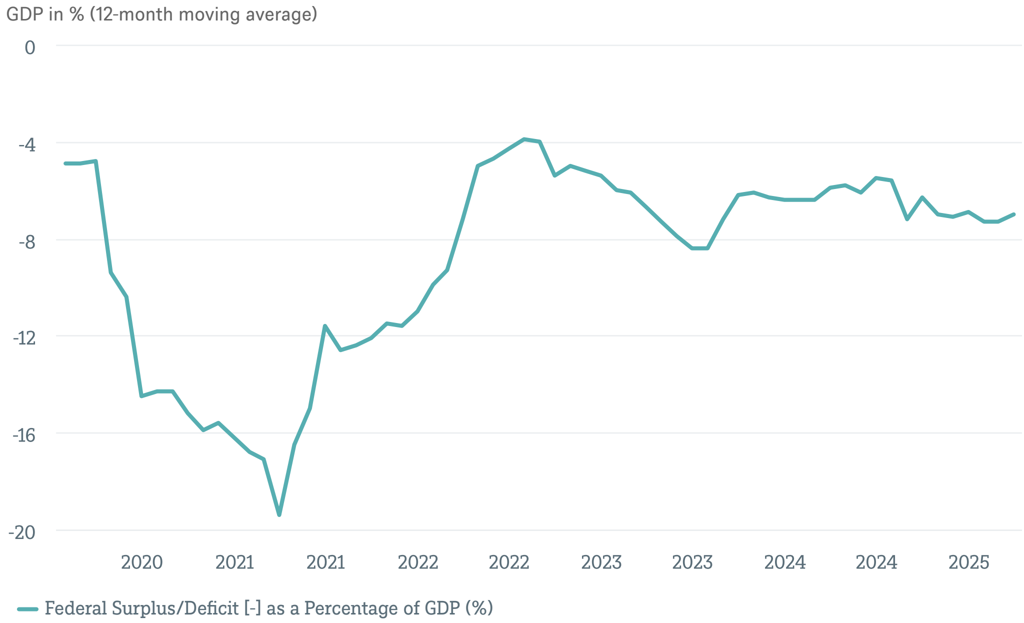


Sources: Haver Analytics, DWS Investment GmbH as of May 2025

Speaking of fiscal policy, households tend to rely on the predictability of politicians who want to get re-elected or act in the interest of their party when their term is up. Political economy has coined the term "methodological individualism" to describe the rational motivation behind such voter-pleasing behavior. This time may be no different, given all the promises made during the campaign. The question is, can tax relief be delivered? Grand Old Party (GOP) lawmakers in the Senate are looking for a bill that likely adds $4 trillion to the deficit through 2034, which will likely include some sort of Tax Cuts and Jobs Act (TCJA) extension and at least some of President Trump's promises as well as some spending cuts. It should be noted that extending the current TCJA measures already costs about $3.8 trillion over the next 10 years and is the bare minimum, as not doing so would implicitly increase the tax burden in 2026. Given the current trajectory of the deficit, which remains stuck on a course toward 7% of gross domestic product

(GDP), it is questionable whether there is room for additional spending beyond that (see Chart 5). In our view, the revenue side is likely to disappoint due to the limited impact of Department of Government Efficiency (DOGE) savings and tariff revenues. Our most optimistic estimates are that both revenue sources could reduce the deficit by less than 1% of GDP. In addition, general tax revenues are likely to be lower across the board as higher prices imply less economic activity. All in all, additional fiscal support is likely to be on the low side going forward, not to mention not offsetting the negative impact of tariffs.

Chart 5: Deficit not improving



Source(s): Haver Analytics, DWS Investment GmbH, as of May 2025

The only thing that can come to the rescue is monetary policy. But the Fed remains caught between a rock and a hard place. On the one hand, inflation came in lower than expected, which is likely a blast from the past. On the other hand, inflation expectations are rising as people anticipate the likely impact of tariffs. Important inputs to the economy, such as the final shape of tariffs or what to expect from future fiscal policy, also remain in flux. Given this high degree of uncertainty, it may indeed be appropriate for central bankers to let the data tell the story first and then react. Any preemptive action in the face of such high uncertainty runs the risk of playing the wrong side, either by supporting inflation or by unnecessarily dampening demand. In the near term, we expect the Fed's focus to remain on inflation and risks to financial stability, with weak economic growth and the labor market not yet in the spotlight. In times of high uncertainty, the Fed's dominant strategy is likely to be somewhat delayed, as pre-emptive adjustments may do more harm than good, especially if fiscal policy remains uncertain. Depending on the speed of the slowdown, a first adjustment rate cut in Q2 2025 remains possible, followed by a pause to see if the expected disinflationary effects of weaker labor markets offset possible second-round effects of tariffs and protectionism (e.g., effects beyond the one-time price shift). Regardless of whether the Fed makes an initial adjustment cut in Q2 or waits for the data, a series of cuts can be expected to begin in Q3 2025 if inflation turns out to be transitory. The central bank may want to lower policy rates to slightly above neutral, implying 3 rate cuts by the end of Q1 2026 and 4 cuts by the end of 2026, which is our base case. A deterioration in financial conditions that has the potential to turn a slowdown into a financial crisis would significantly accelerate the Fed's easing bias, as disinflationary expectations can be built up relatively early. However, we know from the recent past that a cascading intervention with targeted purchases focused on problem areas is more likely than outright large-scale quantitative easing (QE) and a rapid lowering of interest rates to zero.

Putting all the pieces together, we think the stage is set for a (shallow) recession and assess the probability of this as more likely than not. In the very short term, the volatile effects of front-loaded consumption and imports could imply a very volatile quarterly profile in Q1 and Q2, before growth trends weaken in Q3 and Q4. The lack of fiscal space and a Fed that will have to wait and see if inflation is indeed transitory this time around imply only a shallow recovery in 2026. Needless to say, given the current political uncertainty and volatility, there is a good chance that we, like others, will have to revise our forecasts relatively soon - for better or worse.

Overview: key economic indicators

	2025				2026			
	Q1	Q2F**	Q3F**	Q4F**	Q1F**	Q2F**	Q3F**	Q4F**
GDP (% qoq, annualized)	-0.3	0.8	-0.4	1.6	1.2	1.2	1.6	1.6
Core inflation (% yoy)*	2.6	3.4	4.2	3.8	3.8	3.1	2.5	2.4
Headline inflation (% yoy)*	2.4	3.2	4.1	3.6	3.5	3.0	2.6	2.5
Unemployment rate (%)				4.4				4.7
Fiscal balance (% of GDP)				-6.8				-6.5
Federal funds rate (%)				3.75-4.00				3.25-3.50

***PCE Price Index**

**** Forecast**

Source: DWS Investment GmbH as of 5/5/25

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1 Amy Finkelstein and Nathaniel Hendren - Welfare Analysis Meets Causal Inference in Journal of Economic Perspectives—Volume 34, Number 4—Fall 2020—Pages 146–167

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