alloya
Corporate Federal Credit Union

Economic Update

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Commentary

A slew of impending tariffs has the markets concerned about the impacts to economic growth and inflation. President Trump has declared April 2 as "Liberation Day" and is set to announce reciprocal tariffs on multiple countries. This is on top of the end of the delay on 25% tariffs on Canadian and Mexican imports and a 25% auto tariff. The size and scope of the reciprocal tariffs are unknown at this time, but the markets have grown weary of the trade wars. The stock market (based on the S&P 500) has declined by 4% thus far this month and is down 3% for the year.

The word "stagflation" has been spoken more often in reference to the potential near-term state of the economy. The Fed's latest economic projections also tilt more towards that scenario. Their projections for gross domestic product growth moved lower, and their projections for inflation moved higher than their last release in December 2024. To be fair, their current expectations (if they were to come true) would not be stagflation, but clearly, they are showing that those risks are rising.

The Fed is in a difficult spot right now. There is high uncertainty in the path of tariffs and their potential impact. The Fed can be preemptive when there is uncertainty on the demand side of the economy since it pushes the policy response to both sides of their dual mandate (full employment and stable inflation) in the same direction (i.e., low demand leads to higher unemployment and lower inflation, so rate cuts make sense to move both in the direction that they want). Uncertainty related to supply pushes the policy response to their two mandates in opposite directions (i.e., a supply shock pushes unemployment higher, which calls for rates cuts, and inflation higher, which calls for rate hikes). Therefore, the Fed needs to wait and see which mandate is impacted more. We agree with the Fed's current "wait and see" approach, but it increases the risk of a hard landing.

Federal Reserve Chairman Jerome Powell addressed concerns over the economic outlook from the sharp downturn in consumer surveys since year-end. Two of the more popular surveys are at multi-years lows, with one survey showing consumers' expectations of their finances dropping to their lowest level ever recorded (since 1978). As Chairman Powell noted, and somewhat surprisingly, consumer sentiment (a.k.a. "soft data") has a relatively poor correlation with consumer spending (a.k.a. "hard data"). Case in point, consumers have been pessimistic on the future path of the economy for the past four years, but consumer spending has been strong.

We believe that risks to the economy are building and now see recession odds close to 50/50. There will be near-term pain if the Trump administration continues to take a hard line on tariffs and government expenditure cuts. The administration believes that their moves will lead us to a better economic path in the future. We are doubtful that this will be the case on the tariff side, as most evidence points to a large pass-through of the tariffs onto the consumer. Greater fiscal

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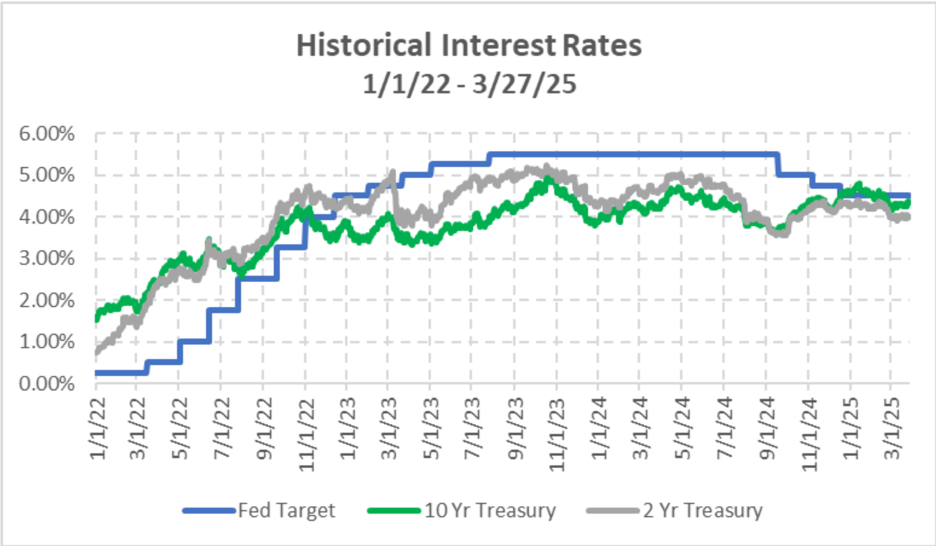
discipline is certainly welcomed, but it will be hard to make a significant dent in the deficit without higher taxes or reductions in entitlement spending.

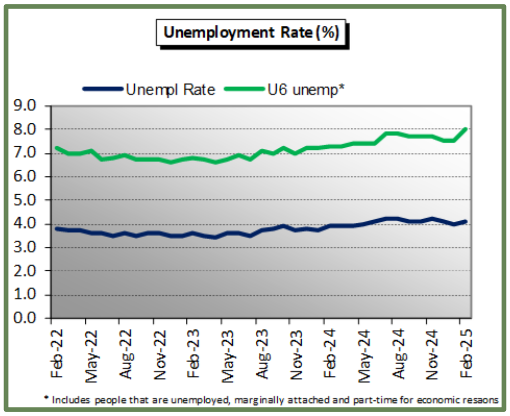
Fixed Income Outlook

Treasury yields were little changed on a month-over-month basis as the stagflation viewpoint gained in popularity. The Federal Open Market Committee meeting brought few surprises, with the Fed clearly on the sidelines until there is more "hard evidence" on economic growth and inflation. They retained their expectation of two rate cuts this year. The market is pricing in three rate cuts in 2025, with the first occurring in June. We think that risks lean more towards an economic downturn and greater Fed easing.



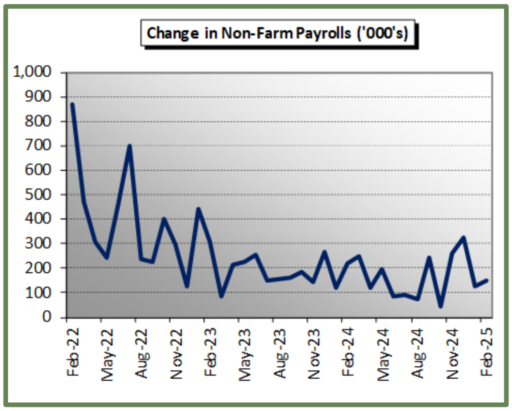
Labor Readings

(Data source: Bloomberg)



Unemployment Rate Moves Higher

The unemployment rate in February increased to 4.1% from 4.0% the prior month. The market expected the rate to remain unchanged. The underlying details were weak. The number of people working part-time for economic reasons climbed to almost a four-year high, which helped to push the underemployment rate to the highest level since 2021.

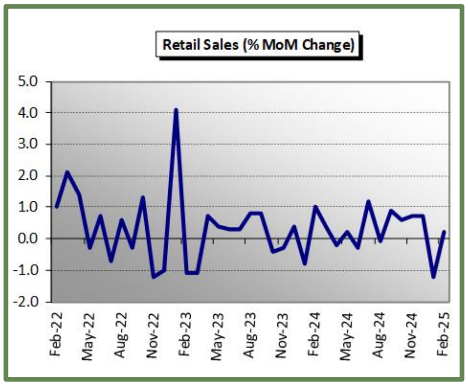


Payroll Growth Meets Expectations

Payroll growth in February was largely in line with expectations. Payrolls increased by a net 151,000 jobs versus an estimated 160,000 gain. The survey was taken before many of the federal government firings took place, so March data will likely look much worse. The impact of more federal job losses and lower immigration should weigh on job growth in coming months.

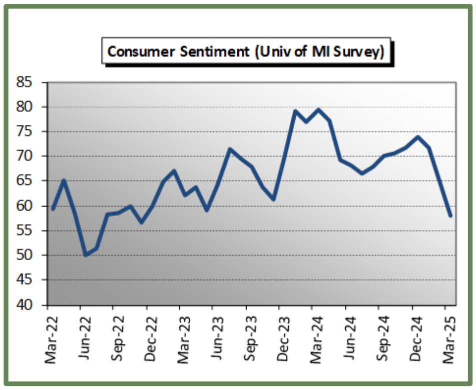
Consumer Readings

(Data source: Bloomberg)



Retail Sales Disappoint Again

Retail sales in February were below expectations for the second consecutive month. In addition, sales for the prior month were revised downwards to make it the largest drop since July 2021. The only service sector category in the report, spending at restaurants and bars, declined by the largest amount in a year.

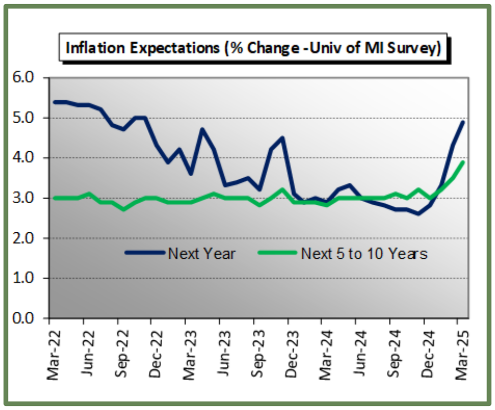


Consumer Sentiment Continues to Decline

Consumer sentiment fell for the third consecutive month and has experienced a steep decline since the end of the year. Sentiment (based on March's preliminary reading) was below expectations and dropped to a two-year low. Consumers' expectations of their finances dropped to the lowest level on record (since 1978).

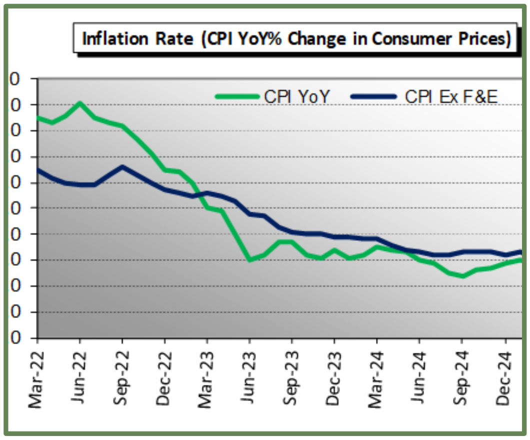
Inflation Readings

(Data source: Bloomberg)



Inflation Expectations Rise Again

Consumers' long-term inflation expectations for the next 5-10 years already had moved to a three-decade high in February. March's preliminary reading showed that inflation expectations shifted even higher from 3.5% to 3.9%. Long-term inflation expectations remained well anchored during the post-COVID inflation bounce but are now increasing rapidly. For now, the Fed does not seem overly concerned.



Consumer Inflation Cools

Consumer inflation rose less than expected in February. The monthly increase of .2% was the slowest pace in the last four months. The lower reading was a relief after the .5% gain the previous month. Many economists are concerned that an escalating trade war will push inflation higher in the ensuing months.