



New tariffs and proposals have the potential to cloud the economic outlook

February 24, 2025 | Economic Update

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The first month of the Trump administration has produced a dizzying array of tariff and deportation threats as well as other problematic proposals which have the potential to create supply chain strains, clouding the economic outlook. Concerns have risen that should these proposals be enacted, they may, among other things, spark stronger than forecast inflation, causing the Federal Reserve to keep interest rates higher for longer. While gradually cooling, US inflation remains the most likely scenario in our view, and the one quarter point rate cut later this year now forecast by the financial markets remains likely, the unknown impact of President Trump's agenda could force a different outcome posing upside risks to the inflation outlook where price increases have been stickier than expected and progress toward the Fed's 2% target has fallen short of earlier expectations. Consumer prices, as measured by core CPI, rose 3.3% on a year-over-year basis in January, at the fastest pace since last June, while the Fed's preferred inflation measure, the core Personal Consumption Expenditures index (PCE), rose at a 2.8% year-over-year rate in December 2024. And late last week, final sentiment measures for February reported by the University of Michigan show consumer confidence suddenly falling sharply and inflation expectations spiking to their highest level in over a year on the back of tariff-related concerns. Amid the rising uncertainties over inflation, which has largely stalled since mid-2024, FOMC members kept their reference rate steady at 4¼ to 4½% until they gain increased confidence inflation will dependably fall to its target. Clearly, the uncertainty surrounding Trump's plans has added to the Fed's reluctance to reduce rates any further.

Some Fed watchers warn that should inflation remain stuck at current above-target levels, or if inflation expectations rise, a more restrictive monetary policy would be on the table for Fed officials' consideration. In a worst-case scenario, should the job market coincidentally weaken, the Fed would be forced to choose between fighting stagflation with higher rates or cushioning the economy by easing its policy.

Digging further into the inflation numbers, much of the strength in the January core CPI can be traced to categories like used vehicles and vehicle insurance which have only small weights or use different concepts when they are incorporated into the PCE. Based upon the January CPI and PPI reports, core PCE, when it is reported later this month, will likely bring year-ago inflation down to 2.6%, the lowest reading since early 2021. While that would be about half the size of the core PCE increase measured in January 2024, the decline would be insufficient to alter the Fed's resolve to keep a tight rein on its reference rate.

Labor Market Conditions

The January employment report showed non-farm payrolls rising 143,000 last month, and a net upward revision of 100,000 to the prior two months. Payrolls have now risen by 178,000 per month over the last six months showing the overall labor market remains strong but less tight than it was a year ago when the JOLTS report showed there were two open jobs for every job seeker. That ratio is currently 1:1 for the sixth consecutive month. The unemployment rate dipped to 4.0% in January, the lowest level since May. An even more sensitive, forward-looking job market indicator, the four-week moving average of initial jobless claims for state unemployment benefits, has remained stable near its current 212,500 level. For the Fed, while risks from untested administration fiscal policies abound, hard data shows jobs are coming in close to their Congressionally-mandated goal of full employment.

During the past few weeks economists have begun to opine on the likely impact on future monthly non-farm payroll and weekly jobless claims reports of job cuts announced by the administration for federal employees and contractors. The effects of these layoffs will not be visible for some time. So far, the totals appear small as the federal government directly employs three million workers, as well as many contractors. The layoffs are unlikely to have a noticeable impact on total monthly payroll changes. Employees on deferred resignations will still be paid through at least September 30, which means they will not be counted as unemployed until October 1. The deferred resignation program also allows workers to find new jobs in the private sector even as they receive deferred compensation, so many of these workers could register as having two jobs, boosting reported total employment until September 30. With respect to the USAID layoffs, the number of domestically based employees is small. In short, we fail to see a large government payroll reduction immediately ahead, though layoffs could grow over time. As for jobless claims reports, since many workers will willingly quit their jobs, they will not be eligible to file unemployment insurance claims so the weekly figures will not be impacted.

Consumer Spending

January retail sales figures were a disappointment, as US consumers pulled back sharply, with sales declining by the largest margin in two years, falling 0.9%. It's possible weather, wildfires and worries among consumers and businesses about the administration's policies played their part in the fall, and one month's numbers can often be misleading. However, the details of the report were worth noting as retail sales account for 70% of GDP. The decline was broad-based, with nine of the thirteen categories showing declines, led by a 2.8% pullback in auto sales, which had been in high gear in recent months. Core retail sales, which strips out often volatile categories such as autos, building materials and gas, fell a more modest 0.5% in January, still the largest drop since March 2023. Within core sales, mail-order and internet retailers were responsible for most of the decline, falling 1.9% while sales at restaurants and bars rose a solid 0.9%. Retail sales are up 4.2% on a year-over-year basis. Adjusted for inflation, retail sales are up 1.2% in the past year. In our view, the outlook for consumer spending remains favorable in large part due to the strength of the labor market. As noted earlier, the latest jobless claims figures suggest no imminent deterioration in job market conditions. So, in view of the momentum underpinning spending coming into this quarter, and absent a negative sentiment shock caused by fears over proposed new fiscal policies, it should be possible for real consumer outlays to rise at a strong 2% quarter-over-quarter rate this quarter and beyond.

Forward-Looking Economic Indicators

ISM Manufacturing Index which accounts for 11.4% of GDP, increased to 50.9 in January, the first

expansionary reading since October 2022. (Readings higher than 50 signal expansion; readings below 50 signal contraction.) Major measures of activity were all higher in January. The new orders index rose to 55.1 from 52.1, while the production index rose to 52.5 from 49.9. The employment index increased to 50.3 from 45.4 in December, while the supplier deliveries index inched up to 50.9 from 50.1. The details of the report showed growth in January was split with an equal number (8) of industries showing expansion vs. contraction, while 2 reported no change. The good news is that both demand and supply were responsible for the headline increase. The new orders index rose to its highest level since 2022. Meanwhile, the productivity index pushed higher to 52.5, the first expansionary reading in 8 months. Survey comments were modestly positive, indicating steady-to-strong customer demand for 2025. It's possible a "Trump Bump" could be showing up in the new orders data, as businesses get more certainty on a policy framework from the new administration and are able to look forward to a more friendly regulatory environment in the next four years, as well as lower taxes on profits. However, comments were also mindful of the possible impacts from new tariffs on materials used for manufacturing, with concerns of shortages and cost pressures.

ISM Non-Manufacturing Index which accounts for over 70% of GDP, declined to 52.8 in January, still signaling expansion but lagging the consensus expected 54.0 (Readings higher than 50 signal expansion; readings below 50 signal contraction.) The major measures of activity were mixed in January. The new orders index declined to 51.3 from 54.4 while the business activity index fell to 54.5 from 58.0. The employment index rose to 52.3 from 51.3 and the supplier deliveries index ticked up to 53.0 from 52.5 in December. Activity in the services sector continued to expand in January, albeit at a more measured pace. Fourteen of the eighteen industries reported growth in the month while three reported contraction. The decline in the index was driven by slower growth for business activity and new orders; the business activity index fell to a five-month low while the new orders index declined to the lowest level in seven months at 51.3. Poor weather conditions in January were highlighted by many respondents as impacting business levels and production, so the pullback may have been only temporary. While the major issue for hiring over the past few years has been a lack of supply, that is no longer the case. A notable employment comment from the Transportation and Warehousing industry wrote, "The employment market is softening as we are seeing less natural turn and getting more and better qualified applicants."

S&P Global Composite PMI preliminary reading for February fell to 50.4 from 52.7 in January, the lowest reading in 17 months, indicating a near stall in business activity this month. The decline was mostly attributable to weakness in services, mirroring the pullback in the ISM Non-Manufacturing Index noted above. Fears over tariffs, government layoffs and spending cuts are cited for the weak overall report. The services component showed contraction at 49.7 while manufacturing came in at 51.6, signaling expansion.

University of Michigan Consumer Sentiment Index was revised downward to a reading of 64.7 for February from the 67.8 print in its preliminary estimate, below the 71.7 reading in January. The current conditions index was revised down to 65.7 from the 68.7 preliminary reading, below the 74.1 reading in January. The expectations index was revised down to 64.0 from 67.3. The index was below the 69.5 reading in January. Respondents expected a 4.3% inflation rate over the next year and a 3.5% inflation rate over the next five years, up from 3.3% and 3.2% respectively in January.

Front Barnett Proprietary [Economic Model](#) designed to signal a change in the direction of the US economy six to nine months in advance of an inflection point, remained above trend in January, signaling continued expansion ahead.

Despite the unusually high upside risks to inflation posed by the uncertainties around new

tariffs, deportation policies and other measures the new administration has proposed, forward-looking indicators signal expansion ahead. The US economy is fundamentally sound, resilient, and on solid footing, with no recession in sight. However, notable weaknesses this month in surveys measuring consumer outlays for services and sentiment may be early warning signs of a slowdown ahead and bear watching.

The greatest threat to our resilient economy is clearly around the path of US policy. The incoming administration has signaled its desire to reduce taxes on businesses and to ease the regulatory environment, which many view as stimulative to growth and innovation. That's positive for investors. At the same time, the administration has proposals to increase tariffs and to reduce immigration, which, if enacted, will raise business costs. That's inflationary. Some fear that the possible upending of long-term trade relationships due to new tariff policies could result in significant supply chain disruptions not like those we experienced during and following the pandemic, but on a much smaller scale. Others point to early signs that key economic policies will be milder than those promised on the campaign trail, clearing the way for solid growth. This back and forth reinforces the notion that some of the tariff levels are being floated as negotiating tactics, rather than final proposals. In any event, it's clear that President Trump is a disrupter, intent upon shaking up the old order. Keep in mind that disruption both poses risks and creates opportunities.

Equity Investment Policy

Equity investment policy remains unchanged. Portfolios under our supervision remain fully invested within their policy guidelines. As long-term investors, so long as the economic fundamentals remain sound and corporate profits are forecast to grow, we look beyond the near-term political and economic uncertainties, as well as the short-term volatility inherent in equity investment, in structuring portfolios. Clients' accounts are well diversified between large cap growth and value investments. Our investment platform also includes small cap domestic stocks as well as allocations to developed and emerging market investments. Recall that Front Barnett management uniquely bends core, high-quality, large cap growth and value shares in a single portfolio, positioning it to grow over the course of market cycles during which the broader market will inevitably rotate, favoring either the growth or value style for a time. This strategy seeks to smooth portfolio returns over the longer-term.

In our view, the long-term case for equity ownership remains compelling despite the growing likelihood of the 5 to 10%+ near-term market correction we have been expecting. Uncertainties around the administration's disruptive fiscal policies could prove to be the catalyst for that pullback. Higher long-term interest rates and the stronger dollar are also headwinds for the market currently. While high-flying, AI-related tech stocks and other high-priced shares are likely to bear the brunt of the selling in a sentiment-driven correction, the entire stock market is likely to experience a healthy reset. We would view such a decline as an opportunity to add to equities in under-invested accounts.

While stocks were on pace for earnings growth of 16%+ in the fourth quarter of 2024 compared with the prior year and are expected to deliver earnings gains of 7-10% in 2025, they remain expensive. The S&P500, where mega-cap tech equities represent about a 35% weight in the index, is richly valued at about 22x forward earnings, near its highest reading since 2021. Valuations of AI-related shares are even more stretched with an average p/e of about 34x. The S&P500 Equal Weight index is less expensive but not cheap at 18x earnings, though more reasonably priced, leaving room for further rerating as the stock market's leadership broadens out.

Fixed Income Investment Policy

Fixed income investment policy remains unchanged. We target portfolio durations of 2.75 years.

Bond yields are close to a nine-week low due to several factors including signs of slowing economic growth, as well as some safe-haven buying due to geopolitical uncertainties, and guidance from the US Treasury that assuaged market concerns about imminent increases in long-term government bond issuance. The prior backup in yields gave us an opportunity to add to clients laddered corporate bond portfolios with yields to maturity of better than 5%. Funds for these purchases were available from maturities of older holdings or cash on hand.

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Indexes are unmanaged, do not include fees or expenses and are not available for direct investment. Definitions: Personal Consumption Expenditures Index (PCE): A measure of the prices that people living in the United States, or those buying on their behalf, pay for goods and services. The PCE price index is known for capturing inflation (or deflation) across a wide range of consumer expenses and reflecting changes in consumer behavior.

Conference Board's Confidence Index: The Consumer Confidence Survey® reflects prevailing business conditions and likely developments for the months ahead. ISM Manufacturing Index: The ISM manufacturing index or purchasing managers' index is considered a key indicator of the state of the US economy. It indicates the level of demand for products by measuring the amount of ordering activity at the nation's factories. ISM Non-

Manufacturing Index: The Institute of Supply Management (ISM) Non-Manufacturing Index is an economic index based on surveys of more than 400 non-manufacturing (or services) firms' purchasing and supply executives.

S&P 500 Index: The S&P 500 Index, or Standard & Poor's 500 Index, is a market-capitalization-weighted index of 500 leading publicly traded companies in the US. S&P 500 Growth Index: The S&P 500 Growth Index is a stock

index administered by Standard & Poor's-Dow Jones Indices. As its name suggests, the purpose of the index is to serve as a proxy for growth companies included in the S&P 500. S&P 500 Value Index: The S&P 500 Pure Value Index refers to a score-weighted index developed by Standard and Poor's (S&P). The index uses what it calls a

"style-attractiveness-weighting scheme" and only consists of stocks within the S&P 500 Index that exhibit strong value characteristics.

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