# Economic activity in the first quarter of the year decelerated

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Economic activity in the first quarter of the year decelerated, contracting slightly at a -0.2% annualized rate, as net exports subtracted nearly five percentage points from real GDP. Absent the unprecedented 41% surge in tariff-related imports, which we expect to reverse this quarter, the economy would have shown expansion in Q1. In fact, data shows the US trade deficit narrowed in April by the most on record on the largest-ever plunge in imports, pointing to an abrupt end to the massive front-loading of goods by some companies ahead of threatened tariffs, and the distorting short-term impact of these protectionist trade measures. The gap in goods and services trade shrank 55.5% in April from the prior month, to $61.6 billion, the smallest differential since 2023, more than completely reversing the sharp widening that occurred in the first quarter.

Consumption, which accounts for 70% of GDP, advanced 1.2% last quarter, down from an initial estimate of 1.8%, its weakest showing in almost two years. Manufacturing, which accounts for about 11% of GDP, which has had been in recession for the past two years, showed no bounce. While “hard” incoming economic data portrays the economy as continuing to grow, surveys, anecdotal information, and “soft” readings, point to below-trend activity, largely traceable to President Trump’s on-again off-again tariff policy, according to survey respondents.

Last month, a combination of surprise reversals of threatened trade-crushing tariffs on imports from China and the EU, and a decision by the Court of International Trade ruling against Trump’s tariffs imposed through the International Emergency Economic Powers Act (IEEPA), which was soon thereafter reversed, have led to widespread upward revisions to economists’ GDP projections for this year as well as walk backs to their prior recession calls. Inflation forecasts have begun to move lower in the wake of less expected tariff pass-through, and fears of supply chain disruptions have been calmed.

***Even if its reversal is sustained by higher courts, the IEEPA ruling will have a ripple effect, which feeds through to monetary, fiscal and foreign policy. Trade negotiations are likely to become more difficult and protracted in the short run as trade partners feel less pressure to cut a deal. Whether these dampening factors will be enough to tip the economy into recession, as some forecasters contend, remains an open question. But clearly, tariff policy, has increased the odds of stagflation, where economic growth slows amid higher inflation.***

**Drags to Growth**

Despite the easing of trade tensions since early April, several short-term drags on the US economy linked to Trump’s broader trade wars will, in our view, persist, leading to a slowdown in GDP growth in the second half. First, the goods sector should cool as front-loaded spending ahead of the threatened tariffs runs its course by mid-year. Second, consumers' purchasing power will be crimped as tariff-induced price increases filter through the economy beginning this summer. Third a slowdown in capital spending and hiring is likely due to the business sentiment slide linked to US tariff policy disruptions. Fourth, other countries may retaliate, imposing tariffs in response, hurting US exports where investors in export-heavy industries (e.g. agriculture, aerospace, and machinery) face risks of lower demand abroad. Fifth, the Fed is likely to leave interest rates where they are longer, until they can judge whether expected price increases will be permanent, creating headwinds for interest-rate sensitive industries (e.g., housing, autos, real estate) and smaller companies without access to the capital markets.

***Some economists worry tariffs could unleash a negative, short-term economic loop where rising consumer prices spur inflation, inflation leads to elevated interest rates, higher interest rates shrink the value of consumers' bond and stock investments, and depressed investment portfolios crimp consumers' purchasing power, leading to a consumer-led downturn.***
***The détente with China and the EU's fast-tracking of trade negotiations, if they hold, support our earlier expectation that sane heads in the White House would prevail with Trump eventually acceding to financial and political pressures, no longer willing to accept the "short-term pain for long-term gain" approach advanced by some administration tariff***

***hawks. In the wake of that policy shift, equity indices have recovered, amidst high volatility, to levels not seen since early this year as confidence has grown that the most draconian of Trump's tariff proposals will be walked back.***

**Consumer Confidence**

Surveys of consumer and business sentiment, at multiple year lows this winter, rebounded last month. The Conference Board reported US consumer confidence rose sharply in May, breaking a five-month string of declines. The uptick is attributed to the temporary easing of trade tensions. The Conference Board's Consumer Confidence Index rose by 12.3 points to 98.0, up from 85.7 in April (1985=100). The Expectations index, which measures consumers' short-term outlook for income, business and labor market conditions, surged 17.4 points to 72.8, but remained below the 80 threshold, which in some earlier cycles has signaled recession ahead. The University of Michigan also recorded in its final May survey a recovery in sentiment after the rollback of China tariffs. The 52.2 May sentiment index marked an improvement from the preliminary reading of 50.8.

Despite the bounce in sentiment, concerns persist. The percentage of consumers who believe jobs are hard to get increased to 18.6% from 17.5% in April, indicating ongoing apprehension about the labor market. And the latest Labor Department Job Openings and Labor Turnover Survey (JOLTS) report showed that while available positions increased in April to 7.39 million from 7.20 million in March, a sign of a healthy jobs market, it's also taking longer for those out of work to find a job. So, while the May surveys both reported a positive shift in consumer sentiment, underlying concerns about the labor market and inflation remain. By contrast, hard economic data which has been strong, is likely to show signs of slowing as front-loaded tariff-driven purchasing and inventory building abate. April readings of industrial production and retail sales already reflect this moderating trend.

**Jobs**

The May non-farm payroll report showed a healthy increase in jobs of 139,000, above the expected 126,000-increase. However, taking into account net revisions to prior months totaling 95,000, job growth appears to have settled into a lower run rate, another harbinger of the slower growth we expect during the next few quarters as trade policy uncertainties weigh on hiring decisions. Private payrolls increased by 140,000 in May after a 146,000 increase in April, above the 120,000 expected. The unemployment rate remained at 4.2% in April. Hourly earnings rose by 0.4%, more than the 0.3% gain expected, and followed a 0.2% increase in April. Hourly earnings were up 3.9% year-over-year for the fifth consecutive month, well ahead of inflation, supporting gains in consumer outlays.

**Inflation**

The Federal Reserve's preferred inflation gauge, the Personal Consumption Expenditures (PCE) index, inched closer to its 2.0% target in April, declining 0.1% to 2.1% from 2.3% in March, matching the lowest twelve-month price change since early 2021. The core PCE price index, which excludes volatile food and energy, fell to 2.5% from 2.7% the prior month, also representing the lowest 12 month increase since early 2021. PCE prices over the past three months are up a slim

0.1%.

***Moderating inflation reflects the fact that, among other moving parts in the economy, M2 money supply growth has been flat since 2022. Inflation is ultimately a monetary phenomenon, and it will work its way lower if M2 growth remains low, setting the stage for the Fed to resume easing its monetary stance as economic growth slows.***

**Forward-Looking Economic Indicators**

**ISM Manufacturing Index** continued to show contraction in May, lagging expectations, falling to 48.5, a six-month low, while key individual measures of activity moved higher last month. (Recall that readings of this index below 50 signal contraction while readings above 50 signal expansion.) The overall decline was solely due to a fall in the inventories index, which dropped to 46.7 after two months above 50, likely a reversal of the unprecedented surge in imports as companies stockpiled materials pre-tariffs. The production index rose to 45.4 from 44.0.

**ISM Non-Manufacturing Index** showed services activity contracted in May for the first time in a year, slipping to 49.9. (Recall that readings of this index below 50 signal contraction while readings above 50 signal expansion.) The 1.7-point decline in the index from April stemmed from an abrupt pullback in demand, while prices paid accelerated as higher tariffs filtered through the economy. Respondent comments continued to report difficulty in forecasting and planning and were delaying or minimizing ordering until the effects of tariffs become clear. This “wait and see” mentality was apparent in the business activity index, which registered an unchanged reading in May. Last month also saw the steepest contraction in the new orders index since late 2022. A measure of bookings fell 5.9 points, the sharpest decline since June 2024, to 4.4. The ISM's measure of business activity, which parallels the ISM's production gauge, indicated stagnation, sliding 3.7 points to 50, the weakest reading in five years.

***Both forward-looking surveys for May, Manufacturing and Services, which together account for about 87% of GDP, suggest the economy is slowing in the wake of higher US duties and retaliatory tariffs by other countries.***

**Initial Jobless Claims**, which measures filings for state unemployment insurance benefits, rose in the week ended May 31 to 247,000, an increase of 8,000 over the prior week while the four-week moving average of claims, our preferred high-frequency jobs market indicator, inched higher by 4,500 to 232,000. Continuing insured jobless claims fell by 3,000 to 1.904 million in the week ended May 24. While initial claims continue to inch higher, there was nothing in the latest claims data to suggest the economy is about to fall off a cliff.

**Outlook**

We expect the on-again, off-again tariff uncertainties to linger, bringing with them the near-term drags to growth we noted earlier. However, we believe the US economy, supported by rebounding consumer confidence, fiscal stimulus and business investment to support AI, will avoid recession. Putting aside the distorting impact of tariff-driven trade flows, we see below-trend growth for a couple of quarters. The job market remains healthy with no signs yet of the spike in layoffs that invariably precedes an economic downturn. With core PCE inflation drifting lower but still above the central banks' target, unless the economy takes a sharp downward turn, and employment spikes toward 5.0%, we expect the Fed to defer any easing in credit policy until later this year by which time officials may have a better idea of whether a tariff-induced price surge is likely to have a permanent impact on inflation.

Meanwhile, our firm's proprietary **Economic Model**, drawn from data available publicly and designed to signal a change in the direction of the economy six to nine months in advance of an inflection point, remains above-trend, pointing to expansion ahead.

**Equity Investment Policy**

US stocks delivered their strongest monthly performance in May since late 2023, as the S&P500 rose over 6% despite the trade war uncertainties. The tech-heavy NASDAQ Composite surged 9.6%. Both indices recovered their April losses which were largely driven by tariff fears. The stock market's rally was triggered by President Trump's decision to back away from some of his most severe tariff threats. Markets gained momentum when on April 9 the President announced a 90-day pause on the sweeping tariffs he had imposed on trading partners during his "liberation day" announcement just a week earlier. Additional impetus to the rebound came from a US-UK trade deal and a temporary US-China agreement to cut tariffs for 90 days.

Better than expected first quarter earnings, particularly from tech companies, and encouraging inflation data also played their parts in the market's May advance. With over 98% of the S&P500 having reported, the index is on track for earnings growth of 13.9% for the quarter led by the volatile mega cap Magnificent Seven tech stocks whose earnings grew by 27.7% compared with the same quarter a year ago, well above the 9.4% reported by the other 493 members of the index. In aggregate, Mag Seven earnings growth exceeded estimates by 11.7%, compared to the 4.6% beat for the other 493 companies, helping to explain why the Mag Seven have been outperforming other stocks amid the recovery, rising over 11% in May, far outpacing the S&P500. Recall that it was these same Mag Seven tech stocks that led the stock market to its all-time highs earlier this year only to shed $11.1 trillion in market value, declining 35% during the market pullback. The Mag Seven cohort includes Apple, Alphabet, Amazon, Microsoft, Meta, Tesla, and Nvidia.

***A positive breakthrough in the current détente with China or a more accommodative Fed could feed the stock markets' advance, while a deterioration in the outlook for economic growth or slowing corporate profit growth could trigger a retest of the April lows. With equities again selling at high multiples by historical standards, leaving the S&P500 cap weighted index richly valued, the ebb and flow of these offsetting forces means we are likely locked in a choppy near-term trading range, characterized by elevated volatility, until there is greater clarity on the economic outlook.***

Looking beyond the near-term trade uncertainties, we find the economy to be fundamentally sound, resilient in the face of the manmade challenges it currently faces. The tax bill working its way through the Congress provides the basis for reduced taxes, incentives for investment domestically and the easing of regulatory burdens on businesses, all major positives for business profitability, if enacted. Lower borrowing costs will be a tailwind for equities and fixed income investments. The eventual investments in the rebuilding of Ukraine and Gaza will stimulate global economic growth. And most important, the benefits of innovative new technologies, including AI, will filter through to the broader economy, eventually enhancing productivity and business profitability.

There has been no change in investment policy. Clients' equity portfolios remain fully invested, well-diversified, balanced between *growth* and *value* investments where, following the recent market weakness, we tactically added to growth shares. Our investment platform includes allocations to small cap domestic equities as well as modest investments in developed and emerging market investments. By blending high quality *growth* and *value* investments in a single portfolio, a style unique to Front Barnett management, we seek to smooth out portfolio returns over a market cycle.

**Fixed Income Investment Policy**

We continue to target a 2.75 year deration in clients' laddered corporate bond portfolios, tactically filling out the longer end of the 4+ year ladder during periods of bond price weakness, using cash or the proceeds of maturing holdings to fund the purchases. Given our economic forecast, which sees inflation drifting lower amid slowing economic growth, and the Fed resuming its easing policy late this year, we expect bond yields to remain locked within their recent trading range, centered around 4.5% as measured by the benchmark 10 year US Treasury note, over the next couple of quarters.


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.