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Economic Update

Tariffs

Hard economic data, including nonfarm payrolls, headline retail sales, durable goods orders and existing home sales, show the US economy continuing to expand. However, the odds of a mild recession, traceable to uncertainties unleashed by the administration's seismic shift in trade policy, have increased sharply in recent weeks. Although difficult to quantify, we have seen numerous reports of declining global commerce and supply chain disruptions, as well as surveys showing deteriorating sentiment among consumers and CEOs, prompting economists to cut their forecasts for GDP growth. Meanwhile a growing minority of forecasters are calling for a mild recession beginning in the second half of this year.

Despite the chaos caused by the on-again off-again tariffs and other threats to economic growth, sound fundamentals including resilient consumers, robust job growth, healthy corporate balance sheets and strong economic momentum coming into the New Year, argue for continued business expansion, albeit at a reduced pace. That said, should the US trade representative (USTR) fail to show material progress soon in concluding its current negotiations to settle outstanding trade disputes with about 18 key countries, setting the stage for a broader pull back of threatened tariffs, our nation's self-inflicted economic wounds will continue to fester. Consumer and business confidence will erode further, more capital spending projects will be put on hold until there is greater clarity in the outlook, and the widely anticipated GDP slowdown could well give way to a downturn, particularly if the current standoff with China persists without some signs of progress.

Late last week, as financial market pressures mounted for the US and China to show progress toward resolving their differences, credible reports emerged that Beijing is considering ways to address the Trump administration's complaints concerning China's role in the fentanyl trade. And there were additional signs of hope for improved relations between Beijing and Washington when China said it is evaluating starting talks to halt a trade war, but only if the US shows "sincerity" through measures such as cancelling unilateral tariffs, clearly signaling de-escalation in the trade war. Global financial markets reacted favorably to these glimmers of hope, with beaten down, economically sensitive investments, those most vulnerable in a recession, showing widespread gains for the first time in the weeks following the announcement of the Trump tariffs. Warning: These gains could quickly evaporate should Trump yet again reverse course.

The jump in US import tariffs, trading partner retaliation, ongoing concessions and policy reversals, and subsequent market turbulence are shocks to a global trade system based upon confidence, trust and stable market prices. The real economy is certain to follow over the near-term, slowing, but by how much we are unable to quantify. We have lowered our GDP growth expectations for 2025 but, at this juncture, we expect the US economy to narrowly skirt recession. However, the immediate risks are clearly to the downside in the form of a possible stronger-than-expected spillover from the tariff shock to the system. Longer-term, the configuration of the global economy, including the role of the US, is also less certain.

GDP

The headline report for first quarter real GDP, the last pre-tariff reading, showed a 0.3% contraction in that measure, the first negative reading since the first three months of 2022, narrowly lagging the consensus. The slight decline was driven almost entirely by the President's trade war. A surge in imports as businesses sought to front-run expected import duties, subtracted nearly five percentage points from headline GDP. Absent the drag from trade, the largest since 1947, the first quarter GDP would have been solidly positive. The largest positive contributions came from inventories which were boosted by the surge in imports. Personal consumption, business investment in equipment, and homebuilding, referred to as "core" GDP, rose at a 3.0% rate, exactly matching the growth rate of the past year, and business equipment investment grew at a 22.5% annual rate in the quarter, defining the economy as strong.

Jobs

Last Friday's employment report, the first since the tariff announcements roiled the financial markets early in April, showed the labor market expanding solidly, adding more jobs than even the most optimistic forecasts, as nonfarm payrolls grew 177,000 last month. The economy needs roughly 100,000 new jobs monthly to keep up with growth in the working-age population. A large part of the gain came from government, education and health services, up 70,000, as well as leisure and hospitality, adding 24,000 jobs. Notably, jobs in the manufacturing sector, most affected by the tariffs, declined by 1,000. Meanwhile, civilian employment, an alternative measure of jobs that includes start-ups, increased by 436,000. Despite these strong job gains, unemployment remained unchanged at 4.2% as the labor force expanded by 518,000 and the labor force participation rate rose to 62.6%. Meanwhile, average hourly earnings rose 0.2% last month and are 3.8% higher over the past year, well ahead of inflation, boosting workers' purchasing power which is also being increased by lower energy prices.

Despite signs of souring business sentiment, the labor market continues to show resilience amid a reluctance by employers to let go of workers after struggling to find labor during and after the COVID-19 pandemic. But keep in mind, that employment data is backward-looking, and it may be premature for the labor market to show the impact of Trump's on-again off-again tariff policy.

Consumer Confidence

The Conference Board's Consumer Confidence Index fell by 7.9 points in April to 86.0. The Present Situation Index, based on consumers' assessment of current business and labor market conditions, decreased by a modest 0.9 points. And the Expectations Index, based upon consumers' short-term outlook for income, business, and labor market conditions plunged 12.5 points to 54.4, the lowest level since October 2011, and well below the threshold of 80 that often signals a recession ahead. Consumer confidence declined for the fifth consecutive month in April, falling to levels not seen since the onset of the COVID-19 pandemic. The decline was largely driven by consumers' expectations. The three components - business conditions, employment prospects, and future income – all deteriorated sharply, reflecting pervasive pessimism about the future. Notably, the share of consumers expecting fewer jobs in the next six months (32.1%) was nearly as high as in April 2009, amid the Great Recession. In addition, expectations about future income prospects turned clearly negative for the first time in five years, suggesting that concerns about the economy have now spread to consumers who are now worrying about their own personal financial situations.

Consumers' views of present conditions have held up despite the overall decline in the index, suggesting that if significant progress is made on the tariff front soon, confidence may bounce back sharply. Write-in responses on what topics are affecting views of the economy revealed that tariffs are now on the top of consumers' minds, with tariff mentions reaching an all-time high.

Inflation

Both the Producer (PPI) and Consumer (CPI) price indices fell in March, coming in below consensus, as US inflation cooled broadly. The PPI fell by the largest amount since October 2023, declining 0.4%, up 2.7% versus a year ago. CPI declined 0.1% in March, up 2.4% from a year ago, the first monthly decline in five years. Inflation cooled broadly in March despite widespread concerns about tariffs and how they will impact prices. Although reciprocal tariffs were not announced until early April, recall that the US began collecting tariffs on steel and aluminum, as well as higher tariffs on imports from China, back in March. Falling energy prices were a key driver of easing price pressures, with an 11.1% decline in gasoline costs leading overall energy prices down 4.0%. Further declines in oil and used vehicle prices are expected to have tempered price increases in April.

Meanwhile, the Fed's preferred measure of inflation, the Personal Consumption Expenditures index (PCE), was unchanged in March, having risen 2.3% year-over-year. The "core" PCE deflator, which excludes food and energy, was also unchanged in March and is up 2.6% in the past year. While inflation has drifted lower by most measures, it remains above the Fed's 2% target leaving the central bank on hold. With the economy near full employment, the Fed is comfortable awaiting more data on the direction of the economy before changing interest rates.

Forward-Looking Economic Indicators

ISM Manufacturing Index declined to 48.7 in April, ahead of expectations for a sharper decline to 47.9. (Levels higher than 50 signal expansion; levels below 50 signal contraction.) The major measures of activity were mostly higher in April. The new orders index rose to 47.2, while the production index, the source of the monthly decline, fell to 44.0 from 48.3. The employment index increased to 46.5 from 44.7 in March, while the supplier deliveries index rose to 55.2 from 53.5. Recall that prior to this year, the manufacturing sector had been in contraction for two years with the ISM index registering readings below 50 every month. Now, manufacturers must also contend with tariff uncertainties and the resulting supply chain disruptions. That impact is clearly visible in the April data. Survey comments note that some customers have begun to delay orders until they are able to assess how tariffs will impact demand for their products and their margins. In turn, manufacturers are responding by adjusting their hiring efforts, as the employment index remains firmly in contraction. As for the supply chain, respondent comments report delayed border crossings as terms are renegotiated between buyers and suppliers, compounded by duty calculations that are complex and not completely understood. In short, it's a mess as reflected in the supplier deliveries index which rose to a 33-month high of 55.2 in April. However, while the bottlenecks are significant, they are far less severe than those we saw during the pandemic.

ISM Non-Manufacturing Index rose 0.8 points in April to 51.6. (Levels higher than 50 signal expansion; levels below signal contraction.) The prices-paid gauge jumped 4.2 points to a more than two year high of 65.1. The new orders index increased 1.9 points to 52.3, the highest this year, and employment contracted at a slower pace, rising to 49.0 from 46.2 in March. At the same time, a measure of business activity, which parallels the ISM manufacturing output gauge fell to its lowest level since last June, declining to 53.7 from 55.9 the prior month. With the measure of inventories at its highest levels since last October, the April gauge of imports fell by 8.3 points, the highest since June, to 44.3, suggesting the strategy of rushing in foreign-made goods ahead of tariffs is drawing to a close. The overall index implies the services sector is holding up even as manufacturing contracts on the heels of higher US duties.

Initial Jobless Claims. The April 26 report on initial claims for state unemployment benefits, in our view the timeliest window into the health of the labor market, showed a slight increase of 18,000 to 241,000 from the previous week's revised level. The 4-week moving average was 226,000, an increase of 5,000 from the previous week's revised average. Both figures were close to recent levels, indicating the economy has not seen the spike in layoffs which usually precedes the onset of a recession.

FB Economic Model. The April reading of our firm's proprietary Economic Model, designed to forecast a change in the direction of the US economy six to nine months in advance of an inflection point, remained above-trend, virtually unchanged for the month, signaling continued expansion ahead.

Outlook

On balance, from the data and surveys we have seen, the economy continues to expand but uncertainties around trade policy are pervasive. While the economy entered 2025 on a high note, underpinned by strong consumer confidence, the outlook is now clouded by policy decisions yet to be taken. Most activity indicators, aside from manufacturing, which accounts for 11.4% of GDP, continue to perform well. Manufacturing remains in contraction, where it has largely been for two years. Services, which account for 70% of GDP, continue to expand but at a slowing pace when compared with earlier months. Meanwhile, job growth remains strong with no signs of increased layoffs yet. Inflation has drifted lower but remains above the Fed's 2% target. So, unless the economy takes a sharp turn downward, Fed officials will keep lending rates where they are, restrictive, disproportionately impacting interest rate sensitive industries such as housing, autos and small businesses with limited access to public markets.

Looking ahead, absent an imminent change in trade policy, three drags are expected to build in coming months, interacting with each other and the financial markets to slow economic growth. The first drag is a drop in consumer and business sentiment in response to the uncertainties around the trade war. The second drag is the squeeze on US household purchasing power as tariffs pass through to consumer prices. The third drag is the reversal of the prior administrations' highly stimulative spending policies. While these drags will take time to materialize, the initial impact, a decline in household and business sentiment, is already evident in April's surveys. The combination of these three drags, plus a likely hangover from spending pulled forward to front-run the tariffs, and a mid-year inflation spike, could tip the US into recession in the second half of this year. ***Simply stated, the near-term course of the economy, whether or not we slip into a recession, hinges on how quickly Trump succumbs to financial market and political pressures to pull back on his tariffs.***

Equity Investment Policy

There has been no change in equity investment policy. Portfolios under our supervision remained fully invested during one of the most tumultuous periods in recent stock market memory. Driven by fears Trump's tariffs would plunge the global economy into a recession, the S&P500 completed both a 20%+ decline from its cycle high and a subsequent 19% rebound from its intraday low in a matter of just a few weeks. So much for market timing!! In just four trading sessions, the S&P500 lost 12% of its value. The tech heavy NASDAQ, which reached its high late last December, declined 27% peak-to trough before rebounding 22% from its low. Individual tech names, which experienced some of the most aggressive selling, had declines of as much as 50% before bouncing. The so-called Mag 7 index of mega cap tech stocks, which had led the market to all-time highs, declined 35% during the drawdown prior to an 18% rebound, losing $2.5 trillion in market capitalization. All in all, $11.1 trillion in market value has been wiped out since mid-January. Despite the rebound, most indices remain in the red for year-to-date with the NASDAQ showing the largest decline. While the worst of the stock market's correction is likely behind us, the coast is not yet clear.

A breakthrough in negotiations with China or a more accommodative Fed could sustain the markets' recovery, while a further deterioration in growth prospects, earnings disappointments, erosion in confidence or 10-year US Treasury yields above 5% could trigger a retest of the April lows. These offsetting forces mean we are likely locked in a choppy near-term trading range with elevated volatility until there is greater clarity on the course of the economy for the next couple of quarters.

Longer term, despite the uncertainties around trade policies, we find the economy to be fundamentally sound, resilient in the face of its near-term, man-made challenges. The administration has signaled its intention to reduce taxes and the regulatory burden on US firms, major positives for business profitability. While the Fed is unlikely to cut its reference rate anytime soon, we see the direction of short-term rates as lower, as further progress is made on reigning in inflation. Lower rates will be a tailwind for equities. Corporate profits continue to surprise to the upside, though the rate of increase is likely to moderate over the near-term, and balance sheets are strong. The US banking system is extremely well-reserved and is expected to benefit from a more friendly regulatory environment under the current administration. And, most importantly, the benefits of innovative new technologies, including AI, will filter through the broader economy eventually enhancing productivity and profitability.

Clients' portfolios are well-diversified, balanced between large cap *growth* and *value* investments where, following the recent market weakness, we have tactically added to *growth* shares. Our investment platform also includes investments in small cap domestic equities as well as modest allocations to developed and emerging market investments. By blending high quality *growth* and *value* investments in a single portfolio, an approach unique to Front Barnett management, we hope to smooth portfolio returns over a market cycle.

The recent correction brought the valuation of the stock market as measured by the S&P500, down to about 20.2x forward earnings. While not cheap, stocks are now more fairly valued than they have been for some time, down from a peak multiple of 23.5x.

Fixed Income Investment Policy

Bond prices, as measured by the 10-year US Treasury, have also been volatile within a fairly narrow 50 basis point range, since Trump's tariffs were announced in April. Early in the month amidst the stock market turmoil, investors sought refuge in the relative safety of high-quality fixed income investments, bidding bond prices up and driving yields lower. Later, as there appeared to be progress on tariffs and inflation fears spiked, bonds were sold in favor of risk assets, driving bond prices lower and yields higher. During this time, we used cash and the proceeds of bond maturities to fill out clients' diversified, laddered, high quality corporate bond holdings during periods of bond price weakness. We continue to target portfolio durations of 2.75 years.

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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.