Optimism about Trump exceptionalism fades amid subdued start to 2025

After a frenetic first month in office, initial optimism that President Trump will deliver ongoing US growth exceptionalism is giving way to concerns about the downside impact of some of his policies, including trade tariffs and government austerity on spending power and jobs

Despite optimism about Donald Trump's policy mix, the US economy has started the year on a soft footing

Subdued start to 2025

Despite plenty of optimism about Donald Trump's policy mix of light-touch regulation and lower taxes, the economy has started the year on a soft footing. January's drop in manufacturing output and retail sales was possibly cold weather-induced with some marginal impact from the LA fires, but the fact that we saw internet sales also drop suggests that softer consumer confidence numbers may be translating into cooler spending.

There are certainly signs of stress amongst lower-income households; the Philly Fed reported that a record 11% of credit card holders only make minimum monthly payments, and the New York Fed reported rising auto and credit card delinquencies. However, higher-income households are still spending strongly and we look for a rebound in February and March, if only to avoid the impact of potential tariffs on the prices of big-ticket items. Thereafter there is much greater uncertainty.

The jobs market continues to hold up well, but the plunge in the quits rate suggests labour market turnover is slowing rapidly, which is a strong predictor of cooling wage pressures. Household income growth looks set to slow meaningfully in the second half of the year and government spending cuts will only exacerbate this situation. Initiatives by the Department of Government Efficiency to cut at least 200,000 federal workers from the government's payroll may be the tip of the iceberg when we consider that upwards of five million private sector jobs are tied to government contracts.

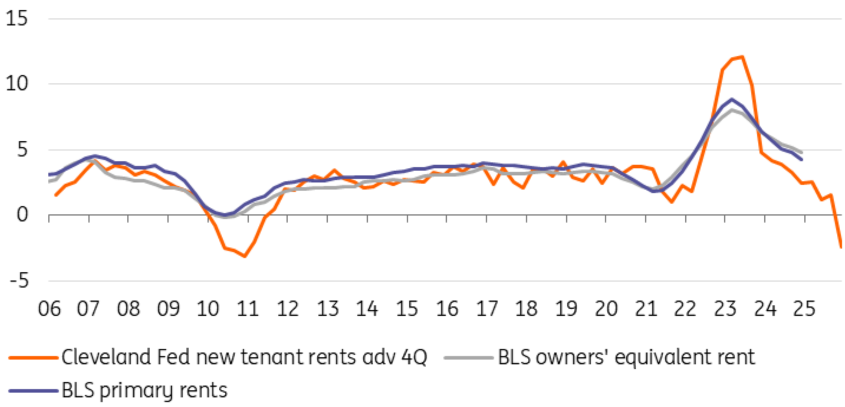
Financial pressures set to build

At the same time, there are likely to be increasing financial pressures from Trump's trade policies. Trade tariffs are likely to be implemented in the second quarter, and while the Administration argues that "foreigners will pay" there is an acknowledgement that there may be some financial pain for consumers. We think this could be significant since it will be difficult to substitute American-made products for all foreign imports.

Trump has suggested lower taxes will provide a more than offsetting boost, but we are not so sure. The extension of 2017 tax cuts will almost certainly pass, but there will be no noticeable change in household after-tax income. The ending of the tax on tips is possible since there is bipartisan support. However, proposals to exempt social security and overtime pay from taxation will likely struggle to pass.

Moreover, while Trump's policies are supposed to prompt reshoring and boost activity in the US, the lack of clarity on the trading environment faced by US corporates suggests action is likely to be slow. At the same time, household and corporate borrowing costs have actually risen despite the Federal Reserve cutting the policy rate by 100bp in late 2024. We forecast GDP growth to slow from 2.4% in 2025 to 1.6% in 2026.

Some potential good news for inflation from housing rents



Source: Macrobond, ING

Inflation outlook clouded by tariffs

In terms of inflation, how the tariffs are implemented will be important for the outlook. If the tariffs are one big step change, then the Fed may choose to look through it and focus on the potential hit to spending power in the knowledge that the base effect will likely drop out next year. However, if it is incremental ratcheting up over time then that is likely to be more bearable for the economy and the Fed sees it more as a structural story that keeps it from cutting rates.

That said, there is some good news potentially coming through on inflation. The Cleveland Fed's new tenant rents series has turned steeply negative and there is also a noticeable slowing in the continuing rents series. They suggest the possibility of the housing components within CPI "normalising" late this year or early next. This can go a long way to offsetting the effect of tariffs given that housing components are 42% of the core CPI basket and keep the door open to Fed interest rate cuts.

Author

James Knightley
Chief International Economist, US
james.knightley@ing.com