Trade swings mask cooling US demand growth

Tariff front running led to a drop in GDP in the first quarter, but a subsequent plunge in imports means growth of near 4% looks probable in the second. This masks a slowing in private demand growth due to tariff and job uncertainty. We expect the economy to expand 1.6% this year and 1.3% in 2026

People in Times Square, New York

Violent trade swings make forecasting challenging

The US economy contracted in the first quarter as tariff front-running led to a surge in imports and resulted in net trade knocking 4.9 percentage points off headline growth. The subsequent collapse in imports in the wake of the 'Liberation Day' tariff announcements means we could quite easily see GDP growth surge 4% in the second quarter. Trade volatility looks set to mask underlying domestic demand trends for much of this year.

US Goods exports and imports ($bn)

Source: Macrobond, ING

Tariff and trade uncertainty will limit domestic demand growth

Consumer spending and investment held up pretty well in the first quarter, but the steep falls in consumer sentiment seen so far this year suggest we should expect to see a cooling over subsequent quarters. While inflation has been surprisingly benign so far, households are anxious about tariff-induced price hikes that will squeeze their spending power over the summer. At the same time, there is apparent nervousness about the jobs market while equity market volatility has raised concerns about the resilience of household wealth. This is already translating into a rising household savings ratio from 3.5% in December to 4.9% in April. The corporate sector is also wary of putting money to work until there is more clarity on the trading environment.

This is resulting in a slowing in labour demand, particularly for the traditional growth engines of the US economy such as technology, construction and business services. In fact, 87% of all jobs added in the US economy over the past two and a half years have come in just three sectors: government, leisure & hospitality, and private health & education services. In May, the latter two categories accounted for 135k of the 139k total jobs added in America.

Our concern is that all three sectors look vulnerable given the current economic and political climate. Government jobs are now being lost, and this will accelerate after September when those who accepted voluntary severance deals drop off the payroll. Health and education jobs are at risk from government efforts to trim spending on healthcare programmes, while leisure and hospitality spending is one of the first things to be cut when consumers become cautious, suggesting employment growth will slow here too.

Tariff induced inflation will fade

Inflation has been quite soft in recent months, but there are clear upside risks to goods prices from July onwards. There is some optimism that trade deals will be signed, but tariffs are here to stay and will increasingly become evident with the Federal Reserve's Beige Book warning, "*all District reports indicated that higher tariff rates were putting upward pressure on costs and prices... A few Districts described these expected cost increases as strong, significant, or substantial*". This will keep the Fed nervous about cutting interest rates anytime soon.

In the immediate aftermath of 'Liberation Day' tariff announcements, equity markets fell sharply, and Fed funds futures markets were discounting 100bp of US interest rate cuts in 2025. The subsequent de-escalation of tensions led financial markets to believe the downside GDP growth risks have diminished, and upside CPI fears have faded a touch. The sense is that the Fed is still going to be in a position to cut interest rates, just not quite as aggressively/quickly as previously thought.

Financial markets are currently pricing 50bp of Federal Reserve interest rate cuts this year. We don't disagree with this, but we suspect the Fed will follow a similar playbook to 2024 and wait and wait until they are convinced they can afford to cut rates. So, we slightly favour a 50bp move in December rather than two 25bp cuts that start in September. Weakening housing inflation should allow for more interest rate cuts in 2026, with the Fed funds rate expected to settle at around 3.25%.

Big Beautiful Bill provides lots of red ink, but little to boost growth

Trade isn't the only uncertainty in the US. We also have President Trump's Big Beautiful Bill to contend with, which still needs to pass in the Senate. On the face of it, this is a huge fiscal giveaway, but we need to remember that the majority of the Bill is an extension of the 2017 tax cuts, so while it provides lots of red ink for the fiscal metrics, it generates little positive impetus for US economic activity.

Tips and overtime pay will be temporarily removed from taxable income, and there'll be a temporary increase in the standard tax deduction for seniors; these are the main income boosts. This may, on the face of it, lift growth one to two tenths of a percentage point, but will be offset by the cost of tariffs.There are cuts to government grants, particularly for 'green' environmental-related areas, while the government will also be looking to trim spending on healthcare provision, but there will be more money for defence and border security.

The concern is that this will mean US government deficits and debt levels continue to rise, with entitlement spending and healthcare provision growing faster than tax receipts. This runs the risk of higher government borrowing costs that will worsen the debt dynamics of the US economy while also pushing up borrowing costs for households and corporates, which are determined by what happens at the longer end of the yield curve.

Author

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