KPMG Economics

Narrowly averting recession
Decoupling, de-escalation and weathering storms

Diane C. Swonk, Chief Economist
KPMG US
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"Oh, thunder only happens when it's rainin' "

-Fleetwood Mac

In a rare moment of joy amidst the pandemic, a video of a man cruising down the highway on his skateboard while lip syncing to the song "Dreams" by Fleetwood Mac went viral. He said he almost didn't post it.

Stevie Nicks, who penned the song, recorded her own version; more than 130,000 others followed suit. The hit once again skyrocketed to the top of the charts decades after its debut. It remains the band's most critically acclaimed and commercially successful song.

The irony is that the lyrics are more about decoupling than coupling. It chronicled her breakup with lead guitarist Lindsey Buckingham and was recorded during one of the band's most tumultuous eras.

That seems an apt metaphor for the escalation of tariffs and trade tensions between the US and the rest of the world. The recent de-escalation with China to lower tariffs from 145% to 30% for 90 days is welcome news. That will help to restart trade between the two countries, but it is unclear whether tariffs will rise or drop at the end of the pause.

Disruptions due to trade have already occurred. The April Institute for Supply Management (ISM) manufacturing report shows the toll tariffs are taking. Higher input prices drove down production for the second consecutive month after a brief reprieve earlier in the year. Every manufacturer in the survey mentioned tariffs as a headwind.

Firms are finding legal as well as illegal work-arounds. Reports of smuggling have picked up much like they did during the Gilded Age, when the US relied almost solely on tariffs for tax revenues. The same was true following the Smoot-Hawley Tariff Act of 1930.

Prospects for growth dim

Real GDP fell by 0.3% in the first quarter of 2025 after rising 2.4% in the fourth quarter of 2024. A push to front-run tariffs pulled consumer spending and investment into the first quarter. Housing activity added modestly to growth as builders offered incentives. Business inventories were stockpiled to blunt the initial cost effects of higher tariffs via a surge in imports. The trade deficit skyrocketed at its fastest pace on record; imports alone subtracted 5% from overall growth during the quarter. Government spending slowed, with gains at the state and local levels tempering a small drop in federal outlays.

Real GDP growth is forecast to rise at a subdued 1.2% pace in the second quarter of 2025. Consumer spending is poised to slow as a payback to earlier gains. Housing activity is buoyed by earlier drops in mortgage rates. Business investment is poised to give back gains that were pulled into the first quarter; inventories are draining. Imports are expected to contract faster than exports – imports from China have hit a wall. That will narrow the trade deficit and add to overall growth, but for the wrong reason: weakness everywhere. Government spending will contract with a slowdown at the state and local levels adding to weakness in federal outlays.

The Fed moves into "wait and see" mode. The Fed is expected to hold interest rates in its current 4.25% to 4.5% range until October, when it resumes rate cuts. The Fed holds off on countering the initial weakness due to tariffs to ensure any increase in inflation they trigger is temporary. The result is an economy that skips a beat over the summer but avoids a recession. The bulk of rate cuts are not likely to occur until 2026. The rate cutting cycle is expected to stop once the fed funds rate drops to 2.75% to 3.0%, which is the Fed's current estimate of neutral.

This edition of *Economic Compass* provides an in-depth look at our baseline forecast, which narrowly averts a recession. Economic policy uncertainty in the US has now eclipsed the pandemic. That prompted many firms to defer earnings guidance for the remainder of the year. Efforts to front-run tariffs borrowed economic activity from later this year.

Special attention is paid to how those shifts are likely to affect inflation, Federal Reserve decisions and Treasury bond yields. The Fed is not expected to cut rates until October due to a bout of stagflation, a period of rising inflation coupled with escalating unemployment. That has not occurred since the 1970s, long before the overwhelming majority of the labor force was born.

Three scenarios:

Tariff storm clouds

Chart 1 shows our three scenarios for the 2025-2027 outlook. Each scenario shows persistently high levels of uncertainty, uneven deregulation and some additional fiscal stimulus. Extensions to personal and corporate tax cuts are sweetened a bit but mitigated by restraints on government spending, which could offset some of the boost from that stimulus. The primary differentiator is the level of tariffs and whether our trading partners retaliate:

1. The optimistic scenario assumes that tariffs peak in the mid-teens in the third quarter, up from 2.8% in January. The tariffs announced prior to April 2 and a 10% tariff on most other countries stay in place. New sector tariffs are expected to replace some of the most onerous tariffs initiated by the administration. A mild bout of stagflation results but a recession is averted in 2025. The Fed holds off on rate cuts until early 2026.

   Probability: 20%.

2. The baseline forecast assumes that tariffs in the high teens, boosted by sector tariffs and the new 30% tariff on China holds. Supply chains take time to ramp back up. The economy suffers a more dramatic bout of stagflation, but avoids slipping into a recession. The Fed cuts rates twice prior to the end of the year, starting in October.

   Probability: 60%.

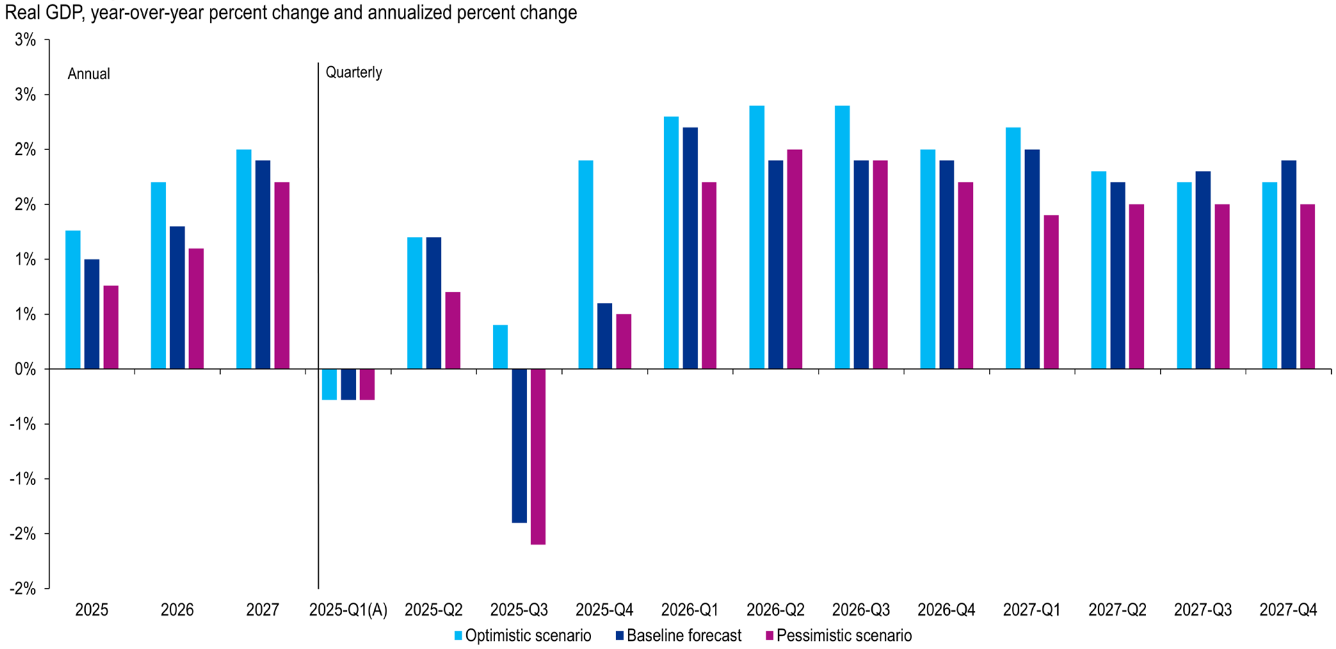
3. The pessimistic scenario assumes that tariffs move up slightly over the summer after the pause for April 2 tariffs is lifted and more of our trading partners retaliate. That takes a toll on both imports and exports, while pushing prices to slightly higher peak. The Fed resumes rate cuts in September, but the economy is closer to flirting with recession than in the base case. A larger financial crisis, including a surge in bankruptcies, cannot be ruled out.

   Probability: 20%.

Chart 1

US narrowly skirts recession

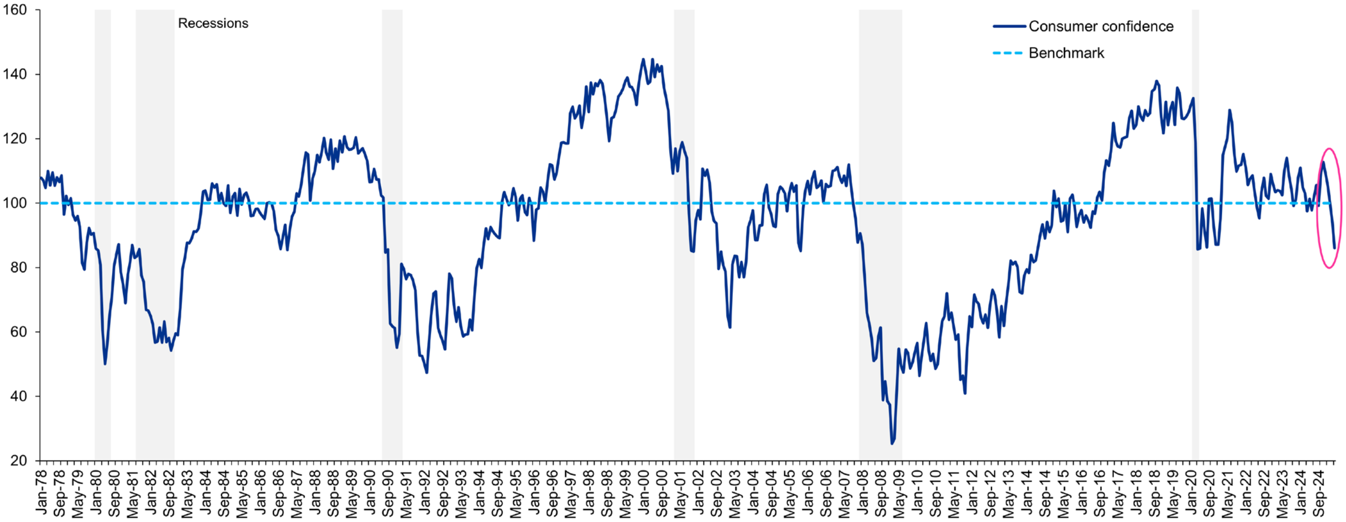
Real GDP, year-over-year percent change and annualized percent change



Source: KPMG Economics, Bureau of Economic Analysis

Chart 2

Drop in consumer confidence signaling a recession is near
Consumer confidence, SA, 1985=100



Source: KPMG Economics, The Conference Board

2025 Baseline

A narrow miss on recession

Consumers hunker down

Chart 2 shows the deterioration in consumer attitudes since the start of the year. The Conference Board Survey of Consumer Confidence fell by 19.3 points over the last three months. A drop of 20 points or more has historically portended a recession.

Expectations for the future fell to their lowest level in 13 years in April and slipped below the level consistent with a recession. People's assessment of current conditions held up better, which limits the pullback in spending to only one quarter.

The job market posted a better-than-expected 177,000 jobs in April but cracks are forming. Permanent job losses hit the highest level since October 2021. The ranks of those laid off for 27 weeks or longer jumped; they are now 32% above the level we saw in 2019.

The Job Openings and Labor Turnover Survey revealed that the pace of hiring and quits in March was below that of 2019. Layoff announcements picked up in April. That leaves little margin for error.

Much of the impact of the reduction in federal employees is still ahead of us. Many took buyouts or were put on administrative leave. Those workers are still being paid and counted as employed. They are not expected to fully roll off the government's payrolls until later this year.

Federal funding freezes and grant reductions are underway. Many are still being adjudicated. Layoffs for contractors and grant recipients are expected to rise. Job postings for scientific research are plummeting.

The largest employment losses are expected to occur in retail, manufacturing and small business. The official data is particularly bad at gauging large shifts in small business employment.

Turning points for that critical sector show up more upon revisions. That could leave the employment data looking deceptively strong until the third quarter.

Another factor is curbs on immigration, which will take a toll on the supply of workers. Foreign-born workers tend to participate in the labor force at a higher rate. They often fill jobs that domestic workers will not. That could keep a lid on the rise in unemployment.

The cushion in savings amassed during the pandemic has been largely depleted. Those who could afford to buy ahead of tariffs did. Consumer spending surged at the fastest pace in two years in March with spending on vehicles driving those gains.

Vehicle sales remained elevated at the start of April but tapered off as the month wore on. Those gains will borrow from spending as we move into the third quarter.

Wealth effects dissipate while the savings rate rises. That hits higher income households, which now make up a disproportionate share of overall spending. Moody's estimates that the top 10% of earners account for nearly half of consumer spending.

Housing activity contracts

Home buying and building barely budged in the first quarter. A temporary drop in mortgage rates opened the door to some first-time buyers. That drop and sweeteners from builders to unload unsold inventories buoyed sales.

Affordability bites harder as we move into the second quarter. The overhang of new space is largest in some of the most popular post-pandemic destinations. Discounts and all-out declines in prices have begun, the largest of which have occurred in parts of Florida, Texas and Louisiana.

Home builders are in the crosshairs of changes to trade and immigration policy, which is boosting construction costs. Consolidation is expected to accelerate as demand softens and margins erode.

Investment slackens

Business investment is expected to weaken. Some of that reflects the payback to the front-running of tariffs in the first quarter. Spending on information technology, where tariffs hit hardest, was the strongest in the first quarter.

Persistently elevated economic policy uncertainty, volatile financial market conditions, tighter credit conditions and soaring construction costs are all hurdles. Even plans for data centers, which drove investment gains in 2024, are at risk.

Inventories ballooned in the first quarter of 2025 as firms stockpiled ahead of tariffs. The liquidation of those inventories will place a drag on production and overall growth during the remainder of the year.

Government spending weakens

Federal spending dropped in the first quarter as funds were frozen by the administration. Many of those decisions are being adjudicated. The cuts to federal spending are not large enough to offset proposed tax cuts, which means larger federal deficits.

The timing of a tax deal is still up in the air. The odds among our own tax experts on a budget bill are split between July and December. A downturn in economic activity could accelerate that timeline.

The debt ceiling is another hurdle. It needs to be lifted between July and October to avoid a default. The debt ceiling could be temporarily suspended to allow for the horse trading needed to get a reconciliation bill done.

Cuts to federal spending are expected to remain limited given pushback on the largest cuts by key Republicans. Tax cuts are expected to be short-lived to avoid the offsets in spending needed for a full (10-year) budget reconciliation.

State and local government spending is poised to slow. Much of the momentum due to COVID-era stimulus is dissipating, while transfers to the states are drying up. Those shifts will exacerbate the shortfall in state and local tax revenues since fiscal 2024.

The trade deficit narrows

The trade deficit is poised to narrow after blowing up as firms front-ran tariffs in the fourth and first quarters. Imports are expected to be hit harder than exports, but both will be weak.

The baseline does not assume much retaliation from our trading partners; that may be optimistic. China and Canada have been the most aggressive. An escalation of tensions could take a larger toll on trade.

When are tariffs strategic? Tariffs can be leveraged for security purposes and to stem unfair trade practices. The challenge is to erect "optimal" tariffs, which take more time to calculate. They are usually associated with an overarching strategy on industrial policy.

Downside risks

Trade wars tend to be nonlinear in their effects and could cause more spillover effects than we are currently allowing for the rest of the world. Those shifts and even modest retaliation by our trading partners would mean weaker growth.

The Smoot-Hawley tariffs tipped off multiple trade wars less than a year into the Great Depression. Global trade plummeted by 67%, which plunged the global economy deeper into the depths of the Great Depression.

Congress currently lacks a supermajority to override a presidential veto on tariffs, which is needed to roll them back. That could change if tariffs prove more costly, or if we see a major shift in the composition of Congress following midterm elections in 2026.

Higher inflation

Chart 3 shows the inflation forecast under the three scenarios. The core personal consumption expenditures (PCE) index strips out the food and energy components. The baseline shows inflation peaking at 3.3% in the third quarter.

Disruptions due to tariffs are already occurring and will take time to reverse. Shipments from China have come to a near standstill. That means empty store shelves as soon as May. It will take time for idled factories to ramp back up again. Other goods could suffer “shrink-flation,” when we pay the same for less product.

Firms are more willing to pass along prices to consumers than pre-pandemic. Consumers expect those increases but are not able to absorb as much as they could during the pandemic. The COVID-era cushion on savings has been depleted.

Efforts to mitigate tariffs gain momentum in 2026. Those supply chain shifts alleviate the upward pressure on tariffs in 2026.

Upside risks. Congress could accelerate fiscal stimulus to offset the toll that tariffs take on the economy, but at the expense of even higher inflation.

Fed waits for clouds to lift

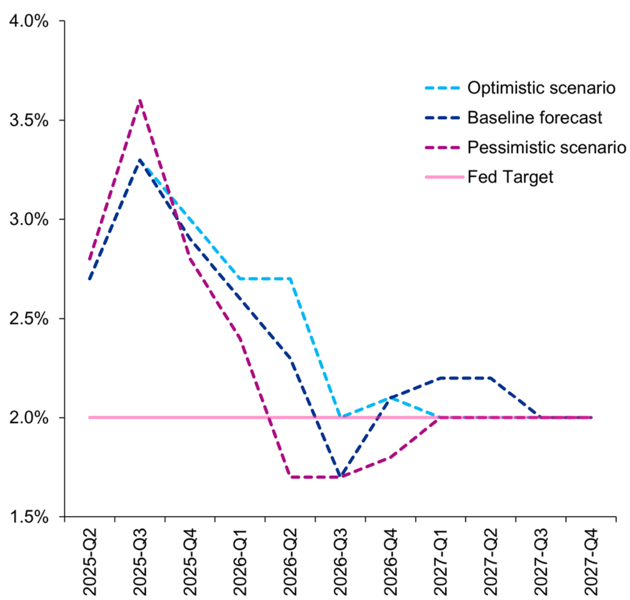
Chart 4 shows the trajectory for rate cuts by the Fed under the three scenarios. The surge in inflation due to tariffs is expected to keep the Fed on the sidelines until October in the baseline.

Fed Chairman Jay Powell made clear following the May meeting that the Fed is willing to wait out more clarity on inflation due to tariffs before cutting rates. That is even if the economy shows signs of weakening.

The Fed is still smarting from the results of its slow response to the pandemic-induced inflation and is committed to avoiding the mistakes of the 1970s. Back then, political pressure to boost employment with lower rates before the battle against inflation was won backfired.

Chart 3

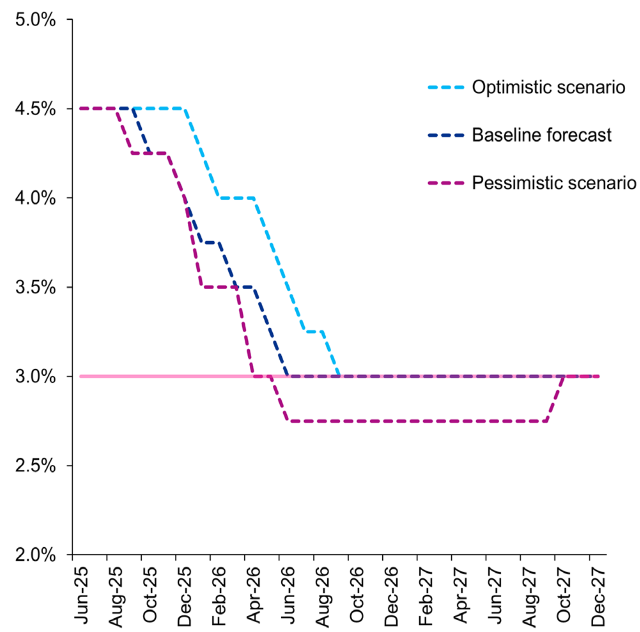
Inflation picks up before it cools
Core PCE, year-over-year percent change



Source: KPMG Economics, Bureau of Economic Analysis

Chart 4

Fed delays rate cuts, barring a crisis
Federal funds rate, upper bound



Source: KPMG Economics, Federal Open Market Committee

Sustaining Fed independence

The first board position at the Fed will become vacant in January 2026 when Governor Adriana Kugler must step down. The president could nominate one of Chairman Powell's likely replacements at that time.

The list includes Kevin Hassett, who is the current Chairman of the National Economic Council, Kevin Warsh of the Hoover Institution at Stanford University and Treasury Secretary Scott Bessent. All have been openly critical of the Fed.

Efforts to hasten the pace of rate cuts beyond what is justified by the data would be resisted. Remaining Fed leaders and the bond investors would revolt.

Powell refused to answer whether he would retire and vacate his board position when asked after the May meeting. That is important.

President Harry Truman was furious with Fed Chairman Thomas McCabe for not cutting rates to finance the Korean War. He replaced him with William McChesney Martin, who was wrongly seen as a loyalist.

Martin later famously likened inflation to a bout of drunkenness on Wall Street. He coined the phrase that it was the Fed's job to pull the punch bowl just as the party is "really warming up."

Fed chairs have a long history of defying the presidents who appointed them. They have consistently supported the independence of the institution when challenged.

A notable exception was Arthur Burns in the 1970s, who bent to the political pressure of President Richard Nixon. He is blamed for stagflation and remembered as the worst Fed Chairman on record. (Everyone at the Fed knows who Burns is, even the janitor.)

Upside risks. Congress could implement shifts in fiscal stimulus to blunt the initial blow of tariffs. Those shifts could delay the desent in inflation.

Higher Treasury bond yields

Treasury bond investors have grown more skittish than in the past. They are demanding higher yields to compensate for the risk of lending longer term than they have in decades.

Recent research by Brookings reveals why. The share of Treasuries held by private investors has risen to nearly 30%, while the share held by foreign investors (including central banks) has fallen to 30% from about 50% in 2015.

Those shifts, along with the ballooning of the federal deficit, have upped what is known as the term premium. That is the additional amount investors in Treasury debt require to compensate them for the risks of lending longer term.

That includes the threat of higher inflation. It has added 30 basis points to the 10-year Treasury bond yield over the last year alone.

Upside risks. Persistently large deficits could add to the term premium in the bond market and create a higher floor under bond yields.

Bottom Line

A man who jumped on a skateboard to get to work turned a song about breaking up into an anthem of hope. That song united us during the darkest days of the pandemic, despite chronicling some of Fleetwood Mac's most turbulent times. The band managed to stay together, despite never writing another number one hit like "Dreams."

That seems a good metaphor. Tariffs damage long-held relationships and threaten to diminish the starring role the US plays in the global economy. Some of our trading partners could move forward without us as the flow of trade slows.

That is the opposite of the division of labor that the father of modern economics, Adam Smith, touted in his seminal work "The Wealth of Nations." Close relationships are an asset, not a hurdle to prosperity, when they are functional. Be kind; pay it forward.

Economic Forecast — May 2025

	2024	2025	2026	2024:4(A)	2025:1(A)	2025:2	2025:3	2025:4	2026:1	2026:2	2026:3	2026:4
National Outlook												
Chain Weight GDP[1]	2.8	1.0	1.3	2.4	-0.3	1.2	-1.4	0.6	2.2	1.9	1.9	1.9
Personal Consumption	2.8	2.2	1.9	4.0	1.8	1.9	-0.5	1.7	2.3	2.6	2.5	2.3
Business Fixed Investment	3.6	0.8	-0.6	-3.0	9.8	-5.0	-4.0	-3.2	-1.0	2.9	2.8	3.3
Residential Investment	4.2	-0.8	-3.3	5.5	1.3	1.5	-8.1	-9.4	-5.0	0.1	3.6	4.7
Inventory Investment (bil $ '17)	39	61	99	9	140	74	24	6	74	90	107	124
Net Exports (bil $ '17)	-1034	-1244	-1225	-1053	-1374	-1255	-1198	-1150	-1164	-1203	-1244	-1289
Exports	3.3	1.4	3.0	-0.2	1.8	-1.9	0.2	2.2	3.3	5.1	5.4	4.4
Imports	5.3	6.8	1.6	-1.9	41.3	-12.4	-5.6	-3.4	3.8	7.8	8.1	7.7
Government Expenditures	3.4	0.8	-0.3	3.1	-1.4	-0.5	-0.9	-0.7	0.0	0.0	0.0	-0.2
Federal	2.6	-0.1	-0.6	4.0	-5.1	-2.7	-2.5	-1.2	0.3	0.4	0.3	-0.2
State and Local	3.9	1.3	-0.1	2.5	0.8	0.8	0.1	-0.4	-0.2	-0.2	-0.2	-0.1
Final Sales	2.7	0.9	1.1	3.3	-2.5	2.3	-0.5	0.9	1.1	1.6	1.7	1.6
Inflation												
GDP Deflator	2.4	2.9	2.6	2.3	3.7	1.9	5.7	1.2	3.5	0.9	2.2	2.8
CPI	3.0	2.7	2.7	3.0	3.8	0.9	4.9	1.1	3.6	1.8	3.0	3.2
Core CPI	3.4	3.2	2.6	3.4	3.5	2.5	5.1	1.4	2.9	1.9	2.5	2.8
Special Indicators												
Corporate Profits[2]	7.9	-5.3	1.7	23.3	-11.8	-37.0	16.1	-3.3	8.3	2.3	6.7	2.9
Disposable Personal Income	2.7	1.3	2.9	1.9	2.7	3.6	-4.7	2.1	5.1	5.9	2.9	3.3
Housing Starts (mil)	1.37	1.30	1.25	1.39	1.39	1.37	1.25	1.20	1.22	1.24	1.27	1.29
Civilian Unemployment Rate	4.0	4.5	5.3	4.2	4.1	4.2	4.6	4.9	5.1	5.3	5.4	5.4
Total Nonfarm Payrolls (thous)[3]	2081	1140	-895	509	543	276	-291	-574	-251	-80	-112	-87
Vehicle Sales												
Automobile Sales (mil)	3.0	2.8	2.7	3.1	3.0	2.8	2.8	2.8	2.6	2.7	2.7	2.7
Domestic	2.0	2.0	2.0	2.0	2.0	2.0	2.0	2.0	1.9	2.0	2.0	2.0
Imports	1.0	0.9	0.7	1.1	1.0	0.8	0.8	0.8	0.7	0.7	0.7	0.7
LtTrucks (mil)	12.8	12.5	12.0	13.5	13.5	12.8	11.9	12.0	12.0	12.0	12.0	11.9
Domestic	10.1	9.9	9.6	10.7	10.5	10.1	9.3	9.5	9.6	9.6	9.6	9.5
Imports	2.7	2.7	2.4	2.8	2.9	2.7	2.6	2.5	2.4	2.4	2.4	2.4
Combined Auto/Lt Truck	15.8	15.4	14.7	16.5	16.4	15.6	14.7	14.8	14.6	14.7	14.7	14.6
Heavy Truck Sales	0.5	0.4	0.4	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Total Vehicles (mil)	16.3	15.8	15.1	17.0	16.9	15.9	15.0	15.2	15.0	15.1	15.1	15.0
Interest Rate/Yields												
Federal Funds	5.1	4.3	3.2	4.7	4.3	4.4	4.4	4.1	3.7	3.3	2.9	2.9
10 Year Treasury Note	4.2	4.2	3.9	4.3	4.5	4.2	4.1	4.1	4.1	3.9	3.8	3.8
Corporate Bond BAA	5.8	6.0	5.8	5.8	6.1	6.2	6.0	5.9	5.8	5.9	5.8	5.6
Exchange Rates												
Dollar/Euro	1.08	1.13	1.17	1.07	1.08	1.13	1.14	1.15	1.15	1.16	1.17	1.18
Yen/Dollar	151.5	144.0	138.5	152.5	149.9	143.0	142.0	141.0	140.0	139.0	138.0	137.0

[1] in 2024, GDP was $23.3 trillion in chain-weighted 2017 dollars.

[2] Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change.

[3] Total nonfarm payrolls, quarterly data represents the difference in the average from the previous period. Annual data represents 4Q to 4Q change.

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, $ figures reflect adjustment for inflation. Total may not add up due to rounding.

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