Navigating uncertain policy shifts

2025 U.S. ECONOMIC OUTLOOK FROM WELLINGTON MANAGEMENT

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Key points

- President-elect Donald Trump's administration is expected to bring significant policy changes, with concurrent impacts on inflation, trade, and economic growth.
- Consumer spending should moderate, with housing affordability remaining a challenge due to high home prices and interest rates.
- Investment spending will likely be positive with artificial intelligence spending alongside equipment investments boosting growth.
- The U.S. Federal Reserve (Fed), with its dual mandate of full employment and price stability, will maintain a vigilant stance on monetary policy, balancing inflationary pressures from potential labor supply constraints and tariffs.

INVESTMENTS

NOT FDIC INSURED | MAY LOSE VALUE | NO BANK GUARANTEE

The decisive victories in November of Donald Trump and the Republican Party appear to be a mandate for meaningful change that will influence the U.S. economic outlook in 2025 and beyond. While the GOP's ambitious agenda is expected to increase U.S. inflation, its impact on economic growth should be more mixed, depending on the scale and sequence of policy measures enacted. The incoming administration expects to reset trade relations with the threat of tariffs, tighten immigration laws and deport undocumented immigrants, broaden industry deregulation, and consider new ideas for increasing U.S. government efficiency.

A Republican-controlled Congress will focus on maintaining personal income tax rates passed under the Tax Cuts and Jobs Act (TCJA) of 2017—which are set to expire at the end of 2025—and possibly cutting some corporate taxes further.

All this change implies heightened volatility for U.S. companies, consumers, trading partners, and financial markets. The Fed is already shifting its thinking on monetary policy recalibration, with two negative supply shocks possible in 2025: a constricting labor supply and higher tariffs.

1 President Trump inherits a solid, though uneven, economic expansion

The administration's starting point is a relatively good economy that has made tremendous progress on disinflation and established better balance in the labor market. Still, the economic expansion has been uneven, with high costs of living and recently high interest rates weighing on corporate and consumer sentiment. Consumer incomes normalized meaningfully in 2024, as inflation receded and as wage growth and employment gains slowed. While spending on goods remained lackluster, services spending by high-income consumers seeking experiences such as travel was a hallmark of the year. Next year should bring moderate consumer spending and better balance between goods and services spending.

Housing remains a weak spot in the U.S. economy. The 50% gain in home prices since the pandemic, compared with a smaller 25% increase in household incomes, has undermined housing affordability. If mortgage rates remain elevated, it is plausible that the benefits of renting over owning a home persist a while longer. Compounding the problem are the low turnover of existing homes and the still-insufficient supply of new homes being built. After declining for the better part of two years, this stagnation means that the sector has been recovering in fits and starts and remains hostage to the interest-rate environment.

Investment spending, in aggregate, was tepid in 2024, dragged down by a correction in commercial property construction along with the broad-based decline in goods spending that has occurred post the COVID boom. Despite overall weakness, however, the Inflation Reduction Act (IRA), CHIPS Act, and artificial intelligence boosted investment spending in certain pockets of the economy. Some measures in the IRA, including spending on electric vehicles (EVs) and renewable energy, as well as part of the CHIPS Act, will be under increased scrutiny as Congress aims to pass a fiscal budget. Still, Washington's focus on U.S. industrial policy suggests that new incentives for domestic manufacturing could be established.

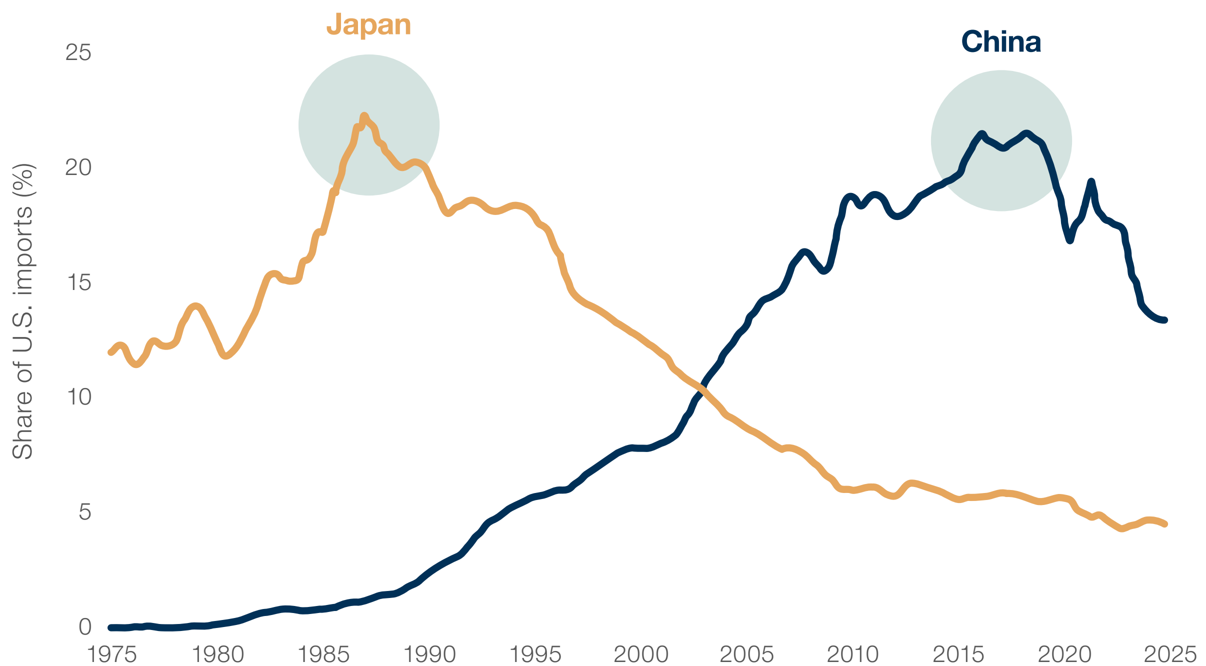
2

Areas of focus for the new administration

Trade: The correction in the goods economy worldwide has slowed global trade appreciably over the last few years. Tariffs are a renewed threat for many U.S. companies with overseas exposure, as well as for those U.S. trading partners whose exports are a substantial contributor to their economies' growth. Some companies may try to increase imports in the near term to circumvent or precede tariffs; however, the generally diversified base of operations for most multinationals should allow for better overall trade management if targeted tariffs emerge.

Overshadowing the trade discussion is the ongoing economic decoupling from China, which remains a priority for policymakers, just it was with Japan 40 years ago (**Figure 1**). While China is the priority, bilateral trade deficits with Germany and even Mexico (the U.S.'s second-largest trading partner) will be on the radar. Broad-based tariffs would likely dampen economic growth and be a major challenge for companies, denting both profitability and margins, especially if countries choose to retaliate against U.S. measures. Trump's overarching theme of protectionism will continue to reverberate in shifting trade dynamics across the global economy.

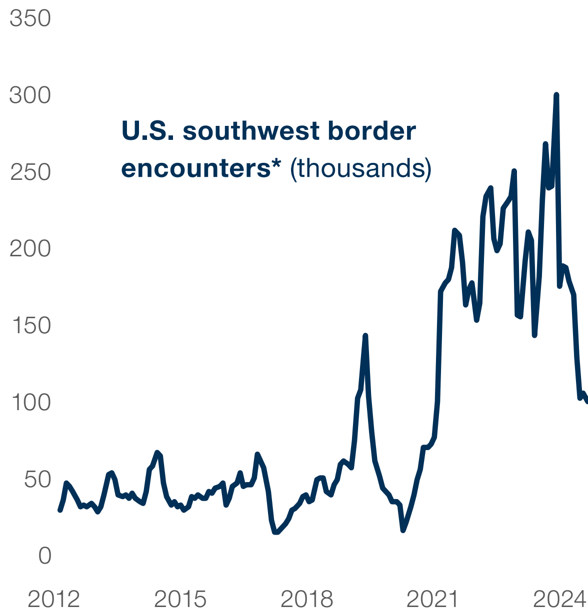
Figure 1: Decoupling from China is a policy focus, analogous to Japan 40 years ago



Source: U.S. Census Bureau

Figure 2

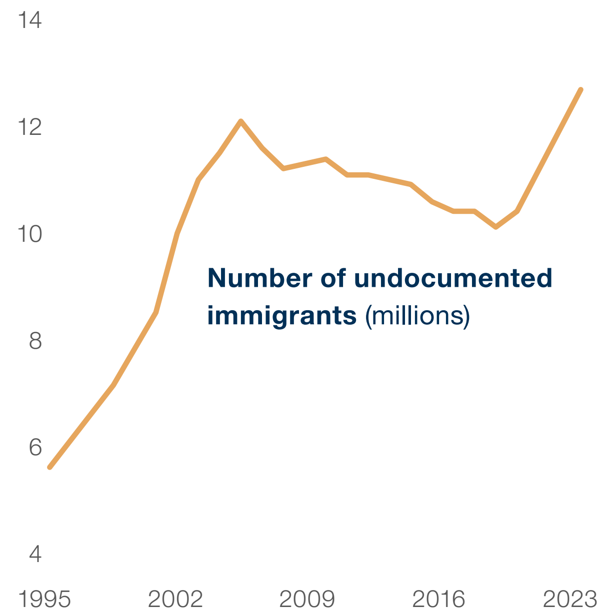
Influx of illegal immigrants has slowed sharply...



*Refers to land border apprehensions, inadmissibles, and expulsions. Source: U.S. Customs and Border Protection.

Figure 3

...and millions of undocumented workers and immigrants face the risk of deportation



Source: Pew Research Center, 2023 estimate based on Center for Immigration Studies, December 2023 study.

Immigration: Next year, the Fed faces the challenge of understanding what the underlying labor supply looks like. Tougher restrictions at the southwestern U.S. border put in place by the Biden administration in 2024 have resulted in a sharp slowing in the influx of illegal immigrants (**Figure 2**). Additionally, more than 11 million undocumented workers already in the U.S. are going to be under scrutiny of the new government (**Figure 3**). How effective will deportations be, and at what pace will they occur? Answers to these questions will be critical in determining wage growth — a key input for inflation — especially in industries such as food processing and construction where undocumented immigrant workers account for a substantial share of labor.

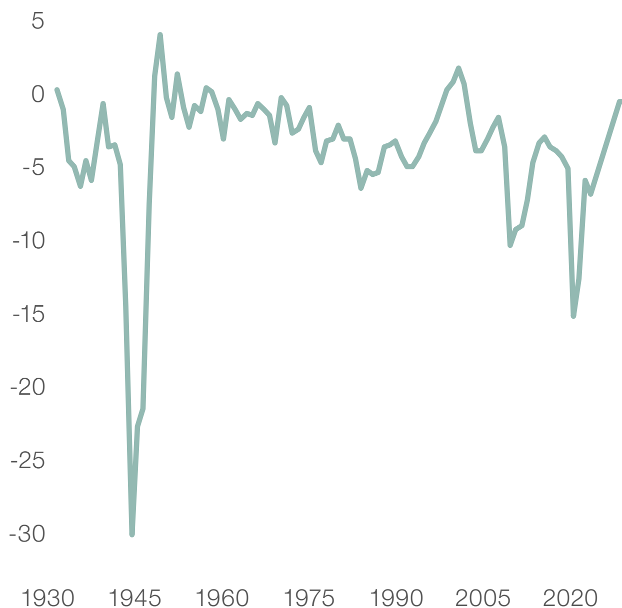
The theme of relative labor scarcity in the post-COVID economy due to aging demographics bolsters the argument that inflation could reignite under a possible negative labor supply shock, particularly if coupled with higher tariffs.

Taxes, spending, and fiscal deficits: One of Washington's first orders of business next year will be to pass the federal debt ceiling to ensure that the government continues to function normally. Congress will then devote itself to the path forward on tax and spending policy. We are watching the potential lifting of the State and Local Tax (SALT) credit as well as the child tax credit, both of which increasingly receive bipartisan support in Congress.

The ultimate size of a U.S. budget package matters a great deal to bond markets, given the high U.S. fiscal deficit and debt level (**Figure 4**). Any plan that either limits the extension of tax relief or considers budget offsets, such as slashing IRA spending, will be important to watch. The potential for further reduction of the tax rate for manufacturing companies, a reinstatement of the research and development (R&D) tax credit, and possible shift in business interest tax deductibility by using EBITDA (earnings before interest, taxes, depreciation, and amortization) rather than EBIT are also on the table. Given the slim congressional majorities for the Republican Party, quick agreement on all elements of the fiscal bill so quickly seems unlikely; rather, the beneficial effects of tax cuts should be apparent in 2026.

Figure 4: Markets will focus on the budget deficit as tax policy is negotiated

Fiscal deficit as a share of GDP by fiscal year (%)



Source: Office of Management and Budget

At the state and local level, government spending has been especially strong over the past couple of years. Officials spent down some excess savings that had accrued via federal grants, even as local revenues flatlined. While states' nest eggs have stayed ample, budget plans suggest a marked slowdown in 2025 spending — closer to the recent flatlining revenue projections. This deceleration should translate into weaker job gains in most states as well.

Deregulation and cost cutting: Finally, while the proposed Department of Government Efficiency may recommend radical federal budget cuts, it is unclear how quickly those could be implemented, given the hurdle of legislative approval needed to execute some plans. In the meantime, the administration's deregulatory drive could ease onerous bank capital requirements, lessen the burden of Environmental Protection Agency (EPA) restrictions, and lower the cost of doing business for companies across the economy.

3

Keeping an eye on inflation and the Fed

Inflation: A long-drawn battle plan against inflation finally gained ground in 2024 as both the rate and breadth of inflation approached historically normal levels. Much of the improvement came on the more volatile goods side, with sticky services price inflation lingering somewhat above normal throughout the year. Structural factors, such as elevated homeowners' insurance rates based on climate shifts, are reminders that policymakers and investors should remain vigilant on inflation. The slow deceleration in shelter inflation, given long lags in lease adjustments across the economy means that it should still help into 2025.

Federal Reserve: The low unemployment rate and sticky inflation suggest that the Fed will remain vigilant and keep monetary policy moderately restrictive, adjusting upward its previous guidance on the ultimate resting point of short-term interest rates. The degree and duration of the Fed's patience will partly depend on the government's approach to tariffs, immigration, and fiscal prudence, as the central bank will seek to counterbalance the inflationary impact of negative supply shocks.

Next year is also likely to bring new guidance from the Fed on the end of quantitative tightening and reinvestment plans for maturing securities. Specifically, the central bank may choose to limit its investments to the front end of the Treasury curve, gradually relieving the downward pressure of outstanding stock of Treasury holdings on longer-term interest rates. All told, medium-term upward pressure on longer-term interest rates seems likely.

Closing thoughts

The breadth of change proposed by the President-elect suggests that 2025 could be a choppy year, as businesses, consumers, and the central bank calibrate expectations about the new direction in Washington, DC. Financial markets have had an exceptionally strong 2024. Given current high valuations for the S&P 500, there is little room for disappointment and markets could face a more difficult path should policy uncertainty linger. Investors may need to exercise patience next year in order to find potential relative winners in the U.S. and global markets. The Fed and Congress will both play key roles in determining the level of bond yields, with higher yields posing a risk to future growth prospects for the U.S. economy and return potential of the U.S. equity market.

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