Tariffs Present Several Challenges to Outlook

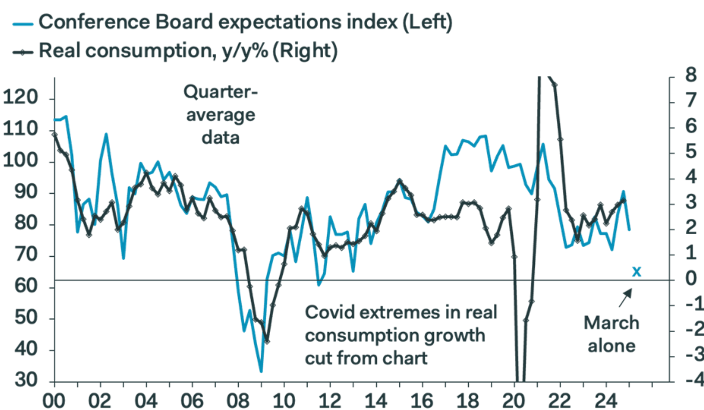
By Mac Johnston
Senior Economist
Pinnacle Financial Partners

Review of 1Q 2025

The S&P 500 fell 4.99% in the first quarter of 2025, which was the worst quarter for stocks since 2022. The technology-heavy Nasdaq fell over 10% as many of last year's best stocks have underperformed so far in 2025. Newly elected President Donald Trump was sworn in on Jan. 20, and on Feb. 3, he announced his second administration's first round of tariffs on Canada, Mexico and China related to fentanyl distribution. Days later he removed the tariffs on Mexico and Canada. Since that point, the administration has announced tariffs on Venezuelan oil, critical minerals, steel, aluminum and a 25% tariff on all imported cars and car parts. Trump has also introduced country-specific reciprocal tariffs to target countries that have high tariffs on American products. The initial optimism over Trump's economic plan has turned to distress as his policies threaten the prosperity of our largest trading partners and allies.

While the tariffs are a starting point for negotiations, they could negatively impact growth in the U.S. if negotiations aren't successful or the affected countries retaliate. We expect the sheer amount of tariffs introduced by the Trump administration to create an opportunity for new trade deals,

Conference Board Expectations Index



Source: Pantheon Economics

but this process will take time. The longer it takes, the more potential damage to the overall U.S. economy. The Trump administration plans to stack tariffs on top of one another. For instance, if there is a 25% tariff on German cars, Trump might announce an additional 15% reciprocal tariff in response to Germany's existing tariffs, for a total tariff of 40% on German cars for sale in the U.S. This is untenable, and we believe a new trade deal will have to be struck.

The country-specific reciprocal tariffs that the president announced on April 3 are much higher than we expected. We have seen recession indicators increase from the 40% area to around 60%. If a recession occurs, it would be shallow in nature. It is essential for the Trump administration to negotiate new trade deals to lessen the effects of all the tariffs, which are a very regressive tax.

Consumer confidence and sentiment has soured as a result of these actions. In Trump's first term, he passed the Tax Cuts and Jobs Act. This bill cut individual and corporate taxes, allowed for accelerated depreciation for corporations and doubled the standard deduction for married couples. These tax cuts were a great benefit to the economy, and most people hardly noticed the tariffs he put into place following the tax cuts.

Potential Impact from Tariffs

	GDP	Capital Stock	Pre-Tax Wages	Hours Worked Converted to FTE Jobs
Total Imposed	-0.4%	-0.3%	0.0%	-309,000
China	-0.1%	-0.1%	0.0%	-82,000
Mexico	-0.1%	-0.1%	0.0%	-116,000
Canada	-0.1%	-0.1%	0.0%	-86,000
Section 232	<-0.05%	<-0.05%	0.0%	-25,000
Total Threatened	-0.3%	-0.2%	0.0%	-236,000
EU (Threatened)	-0.2%	-0.1%	0.0%	-155,000
Vehicles and Parts (Threatened)	-0.1%	-0.1%	0.0%	-81,000

Source: Tax Foundation

In 2025, the Trump administration has chosen to work on tariffs first, with the overall effect of a reduction in GDP growth. Higher inflation readings at the margin will lead to a bout of stagflation until new trade deals are hammered out. The chart on the first page shows the reduction in growth for the U.S. and our trading partners. If you poll American businesses, many leaders (including United Auto Workers) believe the tariffs are essential, while others see potential damage as their companies depend on imported components to operate. The Trump administration is targeting his so-called "Dirty 15" list of countries where we have the largest trading deficit. If overall tariff barriers can fall with our largest trading partners, it could have a multiplier effect that may stimulate growth and be a positive catalyst.

U.S. GDP Estimates

'23 Act.	'24E	1Q '25E	2Q '25E	3Q '25E	4Q '25E	'25E	'26E
2.9%	2.7%	1.0%	1.6%	2.0%	2.2%	1.7%	2.4%

Source: Pinnacle Financial Partners

During the fourth quarter the incoming data on consumer spending surprised to the upside. In January, the retail sales numbers slowed and showed a much more dire picture, with the Retail Sales Control Group moving from 0.7% in December to -0.8%. This group is a specific set of retail figures that excludes volatile sectors like food services, autos, building material and gasoline. This weak data caused economists to substantially reduce GDP growth for the first half of 2025. Coming into the year we expected GDP growth to slow by only 0.4%. Following the weakness shown in the retail sector and the litany of tariffs, pessimism has spread, and most economists see growth falling by more than 1% in 2025. Most recession indicators track employment, industrial production, real retail sales and real income. Many of these indicators have jumped recently, showing an increased chance of a recession.

U.S. Core PCE YOY

'23 Act.	'24E	1Q '25E	2Q '25E	3Q '25E	4Q '25E	'25E	'26E
2.9%	2.8%	2.5%	2.4%	2.3%	2.3%	2.4%	2.2%

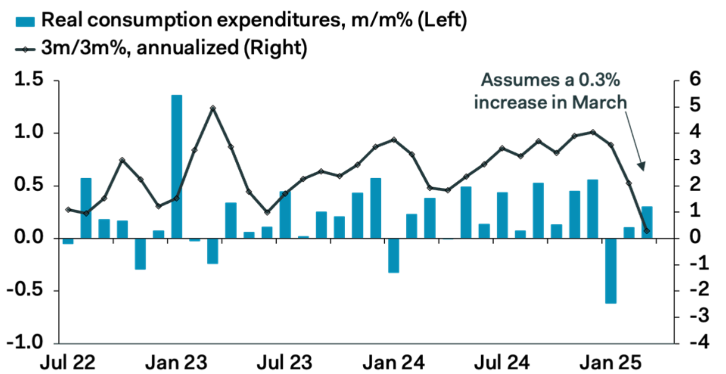
Source: Pinnacle Financial Partners

Economic Outlook

Our outlook for 2025 is mixed. As we discussed last quarter, President Trump's America First tariffs anger our largest allies and trading partners and present several challenges to our outlook. Consumers will bear the brunt of these actions, and we see additional challenges because all of Trump's policies are inflationary. If the 25% tariffs remain, even the prices of American-made cars like Chevrolet and Ford could rise, because these cars contain foreign-made parts. The supply chain for automobile manufacturers is global. The risk is that if the economy does poorly, the upcoming passage of additional tax cuts could be jeopardized.

It is important to remember that most recessions are preceded by consumers pulling back and slowing their purchases. Often this occurs due to external factors like war or terrorism. U.S. consumers have already been under substantial pressure due to the higher cost of living brought on by inflation. The longer the Trump tariffs remain in place, the more damage that could occur to the overall economy. We do not believe that consumers can withstand another wave of inflation, which is currently a risk.

Real Consumption Indicators Month over Month



Source: Pantheon Economics

While we believe that we might have a tough six months as the president's tariffs, tax cuts and trade deals take shape, the weakness in the economy in the near term is not surprising. The U.S. economy has been unbalanced for a while. Overall economic growth has been trending downward since 2022 when GDP was reported at 3.1%, outside of the capex story on artificial intelligence. Current home sales have been about the same as 2012, and overall business conditions deteriorated in the second half of the Biden administration.

Besides tariffs and consumer spending, there are several other headwinds for the economy. These include the crackdown on illegal immigration, the DOGE initiative and a realization that the rosy forecasts for 2025 were not reality. We expect this restructuring of the economy to take an additional six to nine months. In Trump's first administration, it took 10 months for Congress to pass the Tax Cut and Jobs Act.

There are approximately 11-14 million undocumented immigrants in the U.S. The crackdown on illegal immigration is having a ripple effect across the country, with approximately 8.4 million undocumented immigrants working in the U.S., which is just over 5% of the workforce. These workers account for about 20% of workers in agriculture and 10% in food service. As deportations rise, the cost of harvesting crops and operating restaurants could rise as these businesses replace immigrant workers. We expect the deflationary benefit of these workers to fall as deportations rise.

DOGE is attempting to reduce the number of government employees by 10%. The DOGE initiative, led by Elon Musk, cut approximately 30,000 federal workers in the first two month of 2025. It is unclear how successful this initiative will be, as there is a significant amount of litigation regarding the specific targeting of certain government agencies. Federal government spending is about 20% of GDP. As these cuts occur, the incoming economic data will soften to reflect these actions. The last time the federal government made significant reductions in workforce and spending was under Bill Clinton. It is important to remember that cuts in government spending will be de-inflationary if the various agencies introduce new technologies to do more with less or rely more on the private sector to accomplish their tasks.

Bloomberg U.S. Dollar Index

Source: Bloomberg

Tariffs are typically intended to be long lasting. Looking at an example of a 10% tariff on China, an importer of Chinese goods like Walmart must pay the duty as they are processed through customs. As a result, Walmart will pass some of the increased costs to consumers, resulting in less Chinese merchandise purchased at higher prices, creating elasticity of demand. Most large retailers preordered larger than usual amounts of inventories to partially offset the effect of the tariffs. As a result, American goods will have a price advantage initially, but overall tariffs lead to higher prices for both imported and domestic goods. The tariff or duty that is paid theoretically causes the dollar to rise in value because of the additional cash flow provided, which offsets partially the total effect of the tariff in real terms.

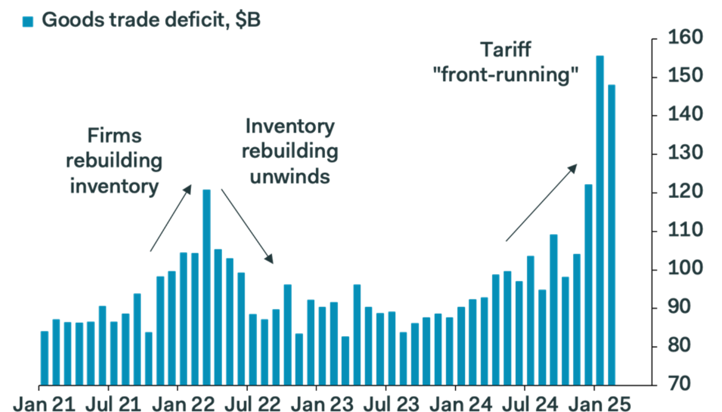
The currency markets are sensitive to the economic impacts of tariffs and an economic slowdown. The dollar peaked right as Trump took office in late January and has sold off as estimates for GDP growth fall. Besides tariffs, the Trump administration is trying to lower long-term Treasury rates. In September 2024 the 10-year Treasury yielded 3.6% just as the FOMC began cutting rates. The yields peaked at 4.8% on Jan. 14. At quarter end, the 10-year Treasury yield had traded back down 4.21%. We expect yields on the 10-year Treasury to fall below 4% as the tariffs take hold and new trade deals are hammered out. We believe that getting longer rates down would help stimulate the housing market.

Pending Home Sales

Source: Pantheon Economics

The U.S. dollar has been a headwind for the economy since March 2022 when the FOMC first started tightening rates. If the Trump administration can maintain a weaker dollar through his presidency, it would allow U.S. goods to become more attractive and allow the exports markets to grow. This would be an additional positive for U.S. manufacturing, which has been weak since the pandemic.

Goods Trade Deficit



Source: Pantheon Economics

Unemployment Rate

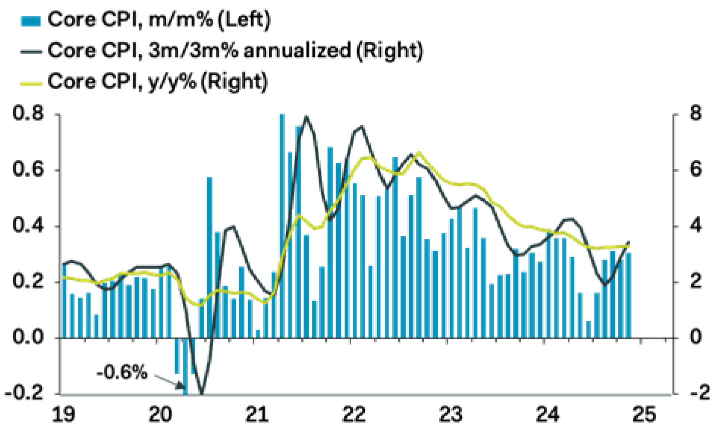
'24 Act.	1Q '25E	2Q '25E	3Q '25E	4Q '25E	'25E	'26E
4.4%	4.4%	4.5%	4.4%	4.4%	4.4%	4.3%

Source: Pinnacle Financial Partners

All these factors present a challenging backdrop for the FOMC. The risk from here is that even if first quarter GDP growth rate is negative, inflation readings will move higher. We expect the U.S. to experience a brief period of stagflation. We believe that the FOMC will be forced to act if the economy slows dramatically. The volatility within the Treasury market has made predicting the number of FOMC cuts difficult. At quarter end, the Federal Funds Futures expected the FOMC to cut rates by over 1%. We believe that the inflationary effects of tariffs will limit the number of cuts they do. We expect the FOMC to cut rates enough to limit the damage of the tariffs. The labor market continues to soften, which should be concerning to the committee.

At the March 2025 FOMC meeting the committee announced an additional tapering of its quantitative tightening program. It reduced Treasury bond sales by $25 billion per month down to $5 billion per month, which will lower its monthly sale from $60 billion to $35 billion, providing additional liquidity for the financial markets to operate. The FOMC also updated its outlook and dot plot at the March meeting.

Core PCE Month to Month



Source: Pantheon Economics

Portfolio Strategy

At quarter end the S&P 500 traded at 22.9x earnings, down from 24.7x in 4Q24. The index is currently estimated to be trading at 20.8x 2025 earnings. Our 2025 S&P 500 earnings projection is $240, which is below the street's earnings of $270, but we still expect earnings to rise by 9% in 2025, providing a positive backdrop. We expect 2025 to be a more normal year with equity prices rising 7 to 9%. We expect volatility to continue until there is greater clarity on the Trump economic agenda.

The best-performing sectors year to date were energy, up 10.21%; health care, up 6.54%; and consumer staples, up 5.23%. The worst-performing sectors year to date were information technology, down 12.66%; consumer discretionary, down 12.63%; and communication services, down 6.21%.

The S&P 500 sectors currently trading below the S&P 500 at the end of the first quarter were: Energy at 16.34x, Financials at 18.25x and Communications Services at 19.88%. The most expensive sectors at the end of the first quarter were Real Estate at 42.75x, Information Technology at 35.19x and Consumer Discretionary at 26.02x.

Although the information included in this report has been obtained from sources we believe to be reliable, we do not guarantee its accuracy or completeness. All opinions expressed in this report constitute judgments as of the dates indicated and are subject to change without notice. This report is for informative purposes only and is not intended as an offer or solicitation with respect to the purchase or sale of any product or as investment advice for any purpose. Investors should contact their financial advisor prior to making investment decisions. The accuracy of any forecasts is dependent on the occurrence of future events which cannot be assured; therefore, actual results may vary from any forecasts.