ASSET CLASS RESEARCH | JUNE 3, 2025

US Economic Outlook: 2025 Q2

Still in the calm before the tariff storm.

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Multi-Asset Research

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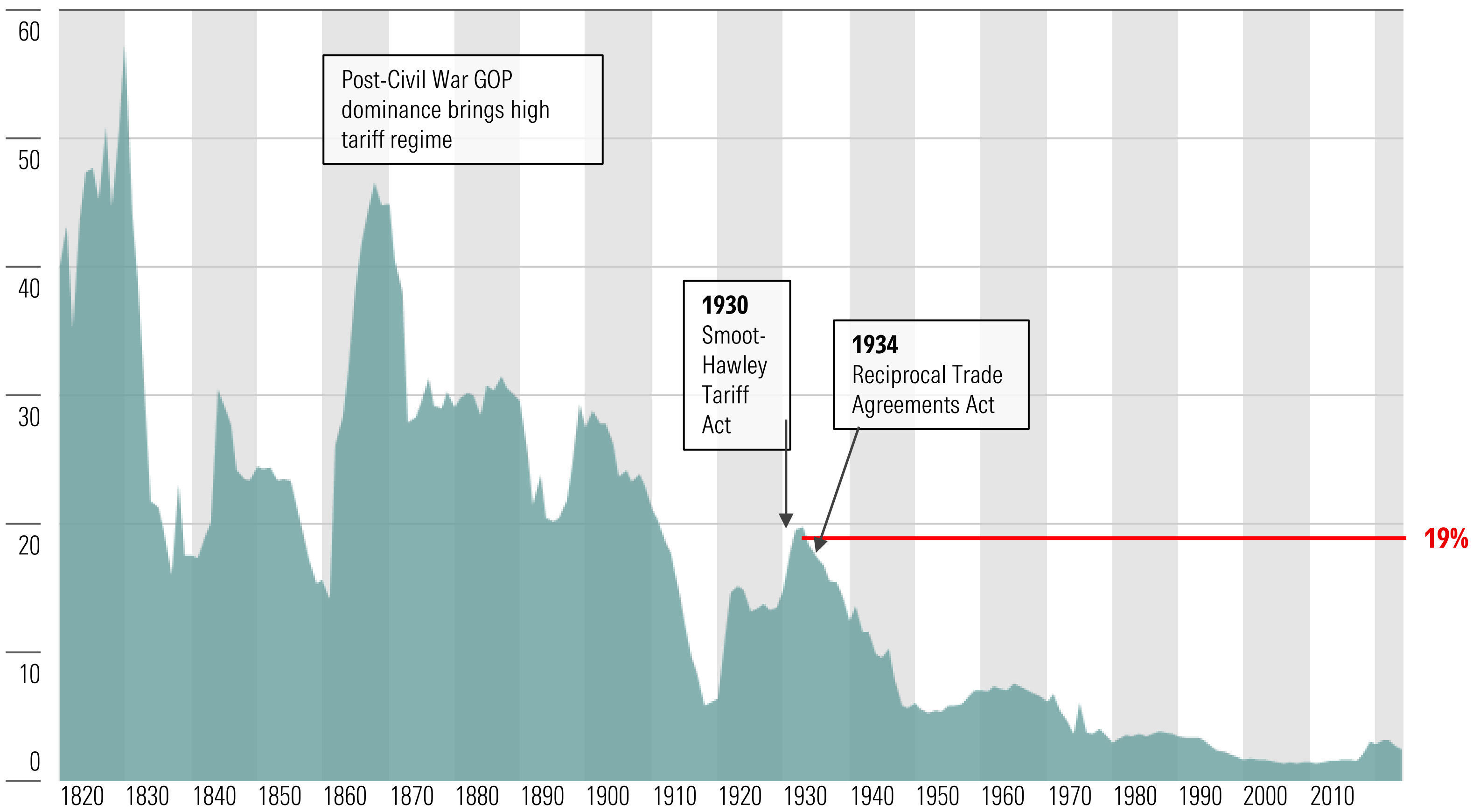
Correction issued on June 4, 2025. See Page 28.

Key Takeaways

- The US average tariff rate stands at nearly 19% as of May 27. This is still up massively from the 2024 level of 2.4% and matches highs not seen since the 1930s.
- The latest data (mostly covering April) doesn't register much economic impact from tariffs, but that isn't surprising, given that businesses and consumers have hardly had time to react. The tariff shock threw the US economy into a disequilibrium state; it will take a few months of grabbling around before it begins to converge on a new equilibrium.
- With the paring back of China tariffs and the accompanying stock market rally, some of the recession risk has come off the table. We've upped our near-term real GDP forecasts, although we still expect the level of real GDP in 2029 to be about 1% lower than our pre-April forecast owing to the tariff impact.

US Average Tariff Rate, %

Customs duties/total imports of goods.



Source: Bureau of Economic Analysis, US Census Bureau, Morningstar.

Forecast Update

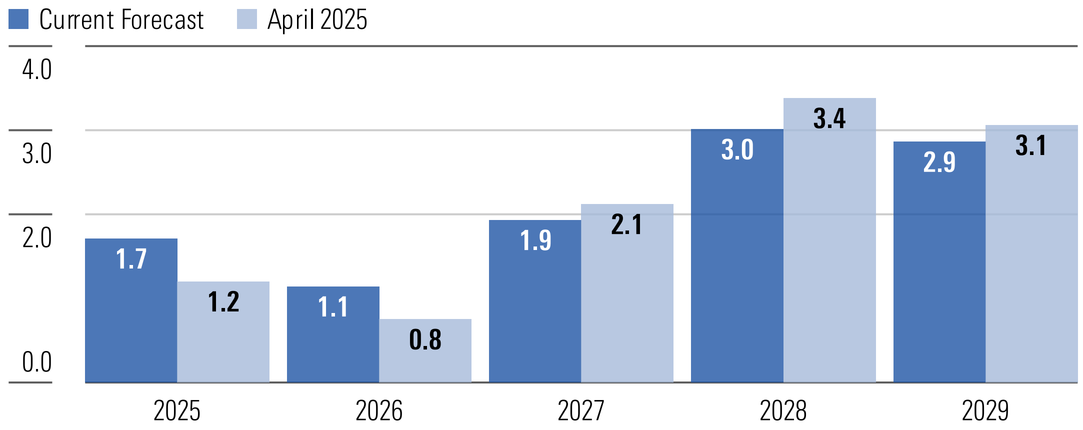
Lower recession risk, but still a large long-run impact from tariffs.

Economic Outlook Remains Dimmed by Tariffs, Although Timing of Impact Now More Delayed

Lower Demand-Side Impact Means Less Recession Risk

The deleterious demand-side impact from tariffs looks diminished for now, with financial conditions having improved and President Donald Trump evincing some willingness to respond to deteriorating economic conditions by pulling back on tariffs. Thus, we've upped our near-term GDP growth figures, and recession risk over the next year looks closer to 25% rather than the 35%-40% we assessed in April. But we still expect a relatively high average tariff rate over the next five years, impairing the economy's productive capacity. Instead of an abrupt downturn, the tariff shock is now more likely to take the form of a long, slow drag on economic growth. Our forecast for the level of real GDP in 2029 is still down by about 1% compared to our pre-April forecast.

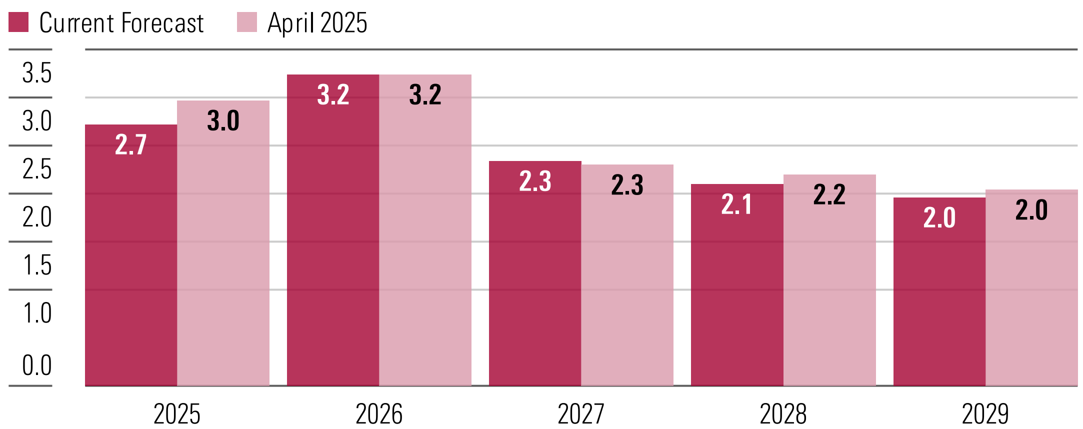
Real GDP Growth (%): Forecast Revisions



Inflation[1] to Rise Again on Tariffs

The US had nearly beaten back inflation, which dropped from 6.6% in 2022 to 2.5% in 2024. But tariffs will breathe new life into inflation, starting with goods prices, but likely flowing into the rest of the economy with a lag. Businesses are reluctant to raise prices, but they will eventually be forced to do so. As such, we expect inflation to peak in 2026. After that, inflation should drop off as the slack created by weak GDP growth engenders disinflationary pressure.

Inflation (%, PCE): Forecast Revisions



[1] Our inflation measure is the Personal Consumption Expenditures Price Index, which has several advantages over the Consumer Price Index and is preferred by the Federal Reserve.

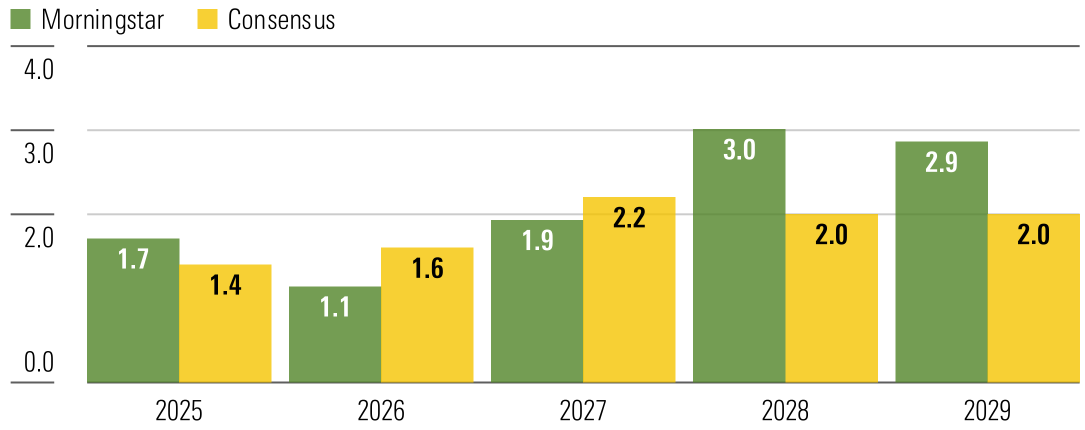
Source: Morningstar.

Our Views on Tariff Economic Impact Align With Consensus

We Remain More Optimistic Than Consensus on Longer-Run Growth

Our GDP growth forecasts are fairly close to consensus in the near term, although we see the tariff impact cresting in 2026 rather than 2025. Consensus has reduced its five-year GDP growth forecast by about 1 percentage point cumulatively since the April tariff surge, in line with our adjustment. As had been the case before tariffs, we're a little more upbeat on longer-run growth than consensus—we expect about a cumulative 1.4 percentage points more real GDP growth through 2029. This is mainly because of our optimism about labor supply growth, including labor force participation rates, where we expect abundant job availability to draw in more people to the workforce.

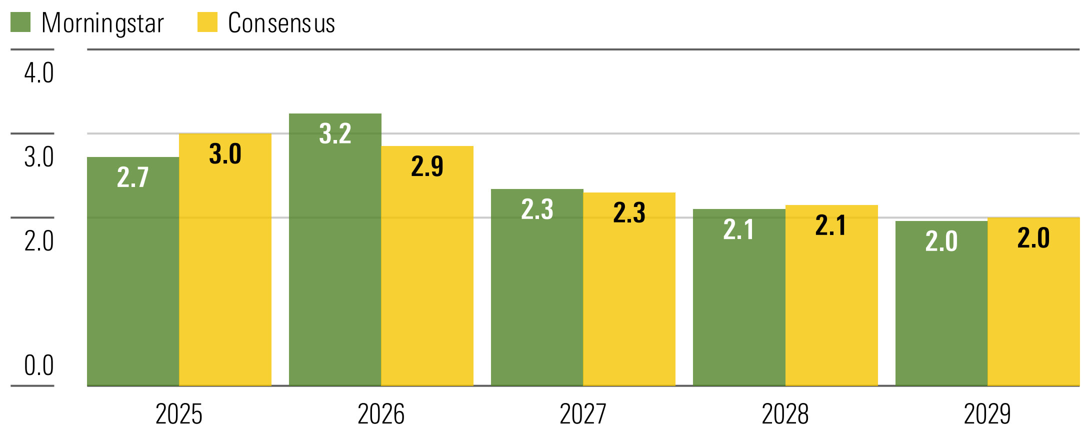
Real GDP Growth (%): Consensus Comparison



We Expect Inflation to Fall a Bit More Than Consensus Does

On inflation, our views track fairly close to consensus, but we expect the inflation impact to peak in 2026 rather than 2025. The cost of tariffs will take time to percolate through the economy.

Inflation (%, PCE): Consensus Comparison



Source: Survey of Professional Forecasters, Morningstar.

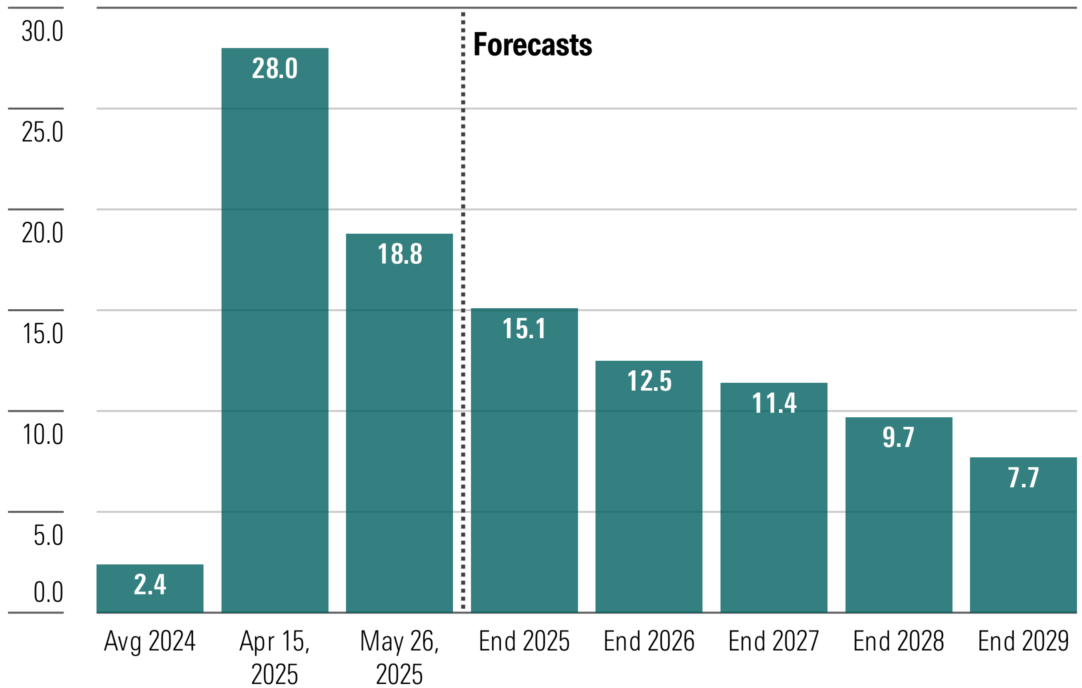
Further Tariff Reductions Will Probably Come, but Only Gradually

The US stock market has thundered back since Trump slashed the tariff hike on China from 145% to 30% on May 12. But the US average tariff rate still remains at about 18.8% currently, up from 2.4% in 2024. We expect tariffs over 2025-29 to average 11.5%, only marginally better than the 13% we expected in April.

If markets are implying that further massive tariff reductions are coming soon, we think that's overly sanguine. The fluctuations in tariffs in the past few months have been nothing short of mystifying. In the near term, we think it's best to model the president's thinking on tariffs as something of a random walk; he could wake up tomorrow and announce major reductions, but renewed escalation is equally possible. The administration has exempted pharmaceuticals and semiconductors from most tariffs so far, but they could eventually face levies as high as 25%-50%, as with steel and autos.

In the longer run, we do expect tariffs to drift down, mainly as the ill economic effects begin to manifest, persuading Trump to shift direction. If the Democrats win the House in the 2026 elections, as seems likely, they could put further pressure on Trump to reduce tariffs. A new president in 2029 (even if still a Republican) would probably be inclined to lower tariffs further. But there is risk that part of the tariffs become entrenched for the long run, especially if relations with China are permanently soured.

US-Weighted Average Tariff Rate, %



Change in Tariff Rate vs. 2024 (%)	Apr 15 2025	May 30 2025	Dec 31 2025	Dec 31 2026	Dec 31 2027	Dec 31 2028	Dec 31 2029
China	105.2	34.2	30.0	27.0	25.0	22.0	20.0
Rest of World	13.3	13.6	10.0	7.5	6.5	5.0	3.0
Total	25.6	16.4	12.7	10.1	9.0	7.3	5.3

Source: Yale Budget Lab, Morningstar.

New Court Decision Only Modestly Affects Our Tariff Projections

While a major court decision has opened the possibility that the bulk of Trump's tariffs as currently constituted could be struck down, this has only a minor impact on our forecasts. We expect the Trump administration to be able to use other statutory authority, if needed, to enact massive tariff hikes.

On May 29, the US Court of International Trade issued a decision invalidating the Trump administration's use of the International Emergency Economic Powers Act to impose broad tariffs. Thus, the decision strikes down all of the country-specific tariff hikes implemented in 2025, which relied on IEEPA authority. This includes the 30% tariff increase on China and the 10% baseline increase imposed on all other countries.

Later on May 29, the US Court of Appeals for the Federal Circuit issued a temporary stay preventing the ruling from taking effect. But if the lower court's decision is upheld after further deliberation by higher courts, it would have a major effect on tariff rates at first glance. Altogether, the average US tariff rate falls from about 19% to about 8%. That's still up significantly from the 2024 level of 2.4% but is a much milder shock to the economy than the previous levels.

All product-specific tariff hikes remain in place following the CAFC's decision; the largest ones are the 25% tariff hikes on autos, steel, and aluminum. The product-specific hikes cite Section 232 statutory authority rather than IEEPA, and that authority was unchallenged in the court's decision.

The Trump administration could continue to roll out large tariff hikes on specific products. Indeed, Section 232 investigations of semiconductors and pharmaceuticals are in the works. Furthermore, Trump could switch to using Section 301 authority to impose broad-based tariffs on whole countries. Indeed, the large tariff hikes imposed on China in the first Trump administration relied on Section 301 authority.

Use of these other forms of authority entails more procedure and paperwork, so it may be several months or longer before we get large new tariff hikes under Section 232 or Section 301. However, Trump could use Section 122 authority to impose tariffs of up to 15% for up to 150 days (or a longer duration with congressional authorization, but that seems extremely unlikely). This could fill the gap and keep tariffs elevated until Section 232 or Section 301 tariffs come into place.

Our best guess is that if the lower court's ruling is upheld, Trump will still manage to push through some broad-based tariff hikes (around 20%) on China using Section 301 authority along with a slew of product-specific tariff hikes via Section 232. That could put the average US tariff rate at 12%-15% at year-end 2025. If the CAFC or the Supreme Court rules in favor of the Trump administration, then we'd expect to see year-end 2025 tariffs in the 15%-18% range. For now, we expect a year-end 2025 tariff at 15%, factoring in about even odds that IEEPA authority is struck down by the courts.

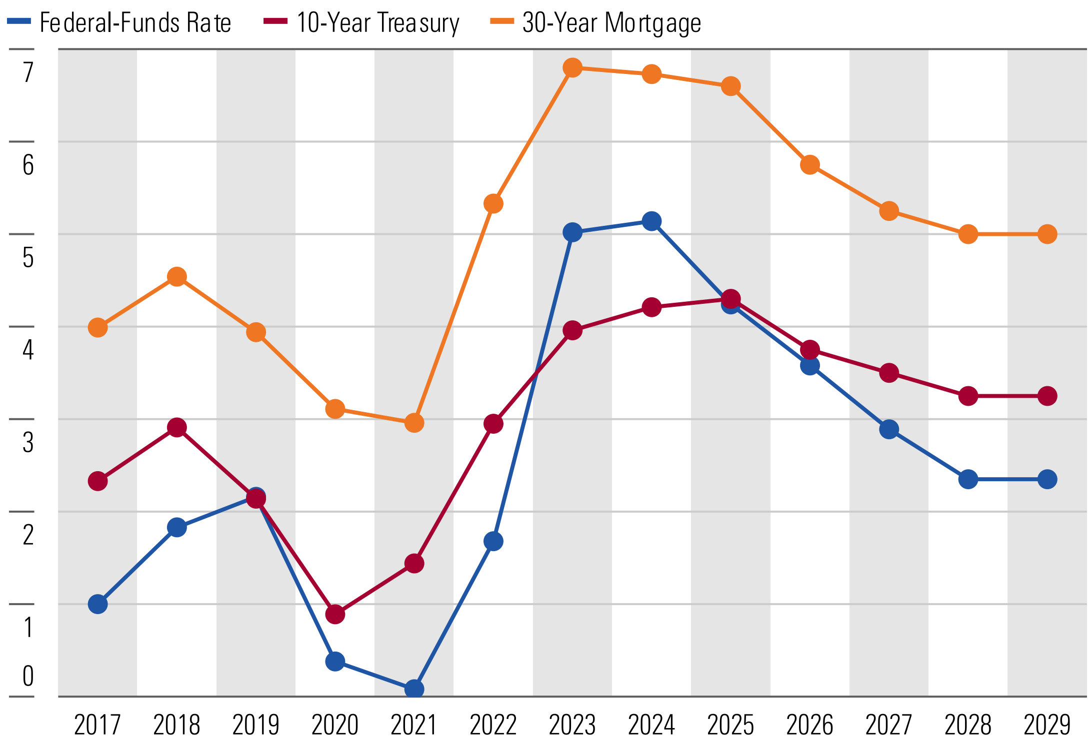
Interest Rates to Fall

More Fed-Funds Rate Cuts Needed to Drive Long-Term Yields Lower

After a federal-funds rate cut of 100 basis points in late 2024, we expect another 200 basis points in cuts through the end of 2027. While we've slowed our expectations of rate cuts owing to tariffs' inflationary impact, we haven't changed our assessment of the long-run neutral rates of interest (a nominal federal-funds rate at about 2.25% and 10-year Treasury yield at 3.25%).

The current 10-year Treasury yield of 4.5% stands above our long-run expectation of 3.25%. Similarly, the current five-year Treasury yield of 4.1% implies an average federal-funds rate of 3.6% over the next five years (assuming a 50-basis-point term premium), above our expectation of 2.9%.

Interest-Rate Forecasts (Annual Average)



(%)	2024	2025	2026	2027	2028	2029
Fed-Funds Rate	5.14	4.24	3.58	2.89	2.35	2.35
10-Year Treasury	4.21	4.30	3.75	3.50	3.25	3.25
30-Year Mortgage	6.73	6.60	5.75	5.25	5.00	5.00

Source: Federal Reserve, Morningstar.

Our Supply-Side View Drives Our Bullish View on GDP

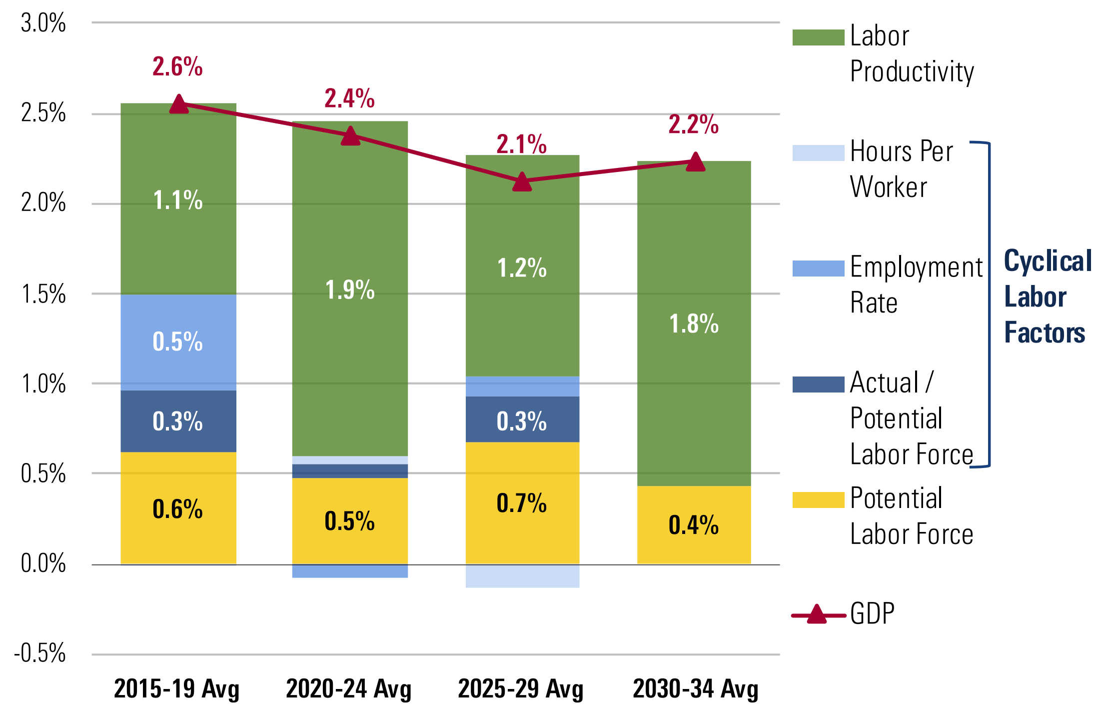
We Expect More Labor Force Expansion Than Consensus

Our longer-run GDP forecast is determined solely by our projections for the supply side of the economy, as we expect the Federal Reserve to calibrate aggregate demand so that the economy is operating at full capacity. GDP growth in the prepandemic years was fueled heavily by cyclical labor market expansion (the long recovery from the Great Recession). Therefore, we can't take for granted that prepandemic growth rates represent a good benchmark for long-term growth.

We expect labor force participation (adjusted for demographics) to recover ahead of prepandemic rates as solid job availability pulls in formerly discouraged workers. The influx of immigration over 2023-24 has also yet to be fully integrated into the workforce.

Since the start of the pandemic, productivity growth has averaged about 1.8%. We expect about 1.2% growth over 2024-29, with about a negative 0.2% annual impact from tariff hikes. Productivity growth should accelerate over 2030-34 as the tariff impact fades and artificial intelligence starts to play out in the broader economy.

US Real GDP Growth: Supply-Side Decomposition



$$\text{Real GDP} = \text{Potential Labor Force} \times \frac{\text{Actual LFP}}{\text{Potential LFP}} \times \frac{\text{Employees}}{\text{Labor Force}} \times \frac{\text{Hours}}{\text{Worker}} \times \frac{\text{Output}}{\text{Hours Worked}}$$

(1 - unemployment rate)

"labor productivity"

Source: Bureau of Economic Analysis, Morningstar.

Economic Overview

GDP growth to slow and inflation to rise over next two years.

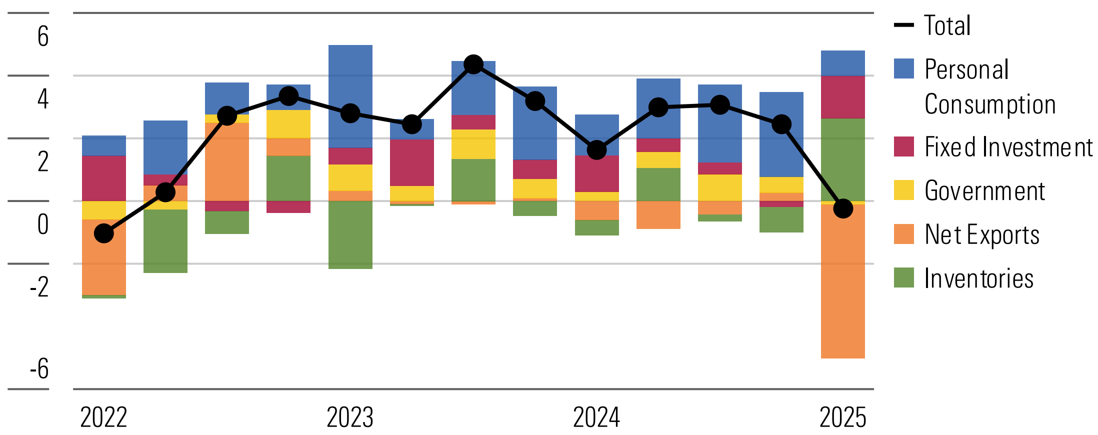
GDP Growth to Trend Down, but First-Quarter Dip Is Misleading

First-Quarter GDP Decline Mostly Reflects Measurement Error

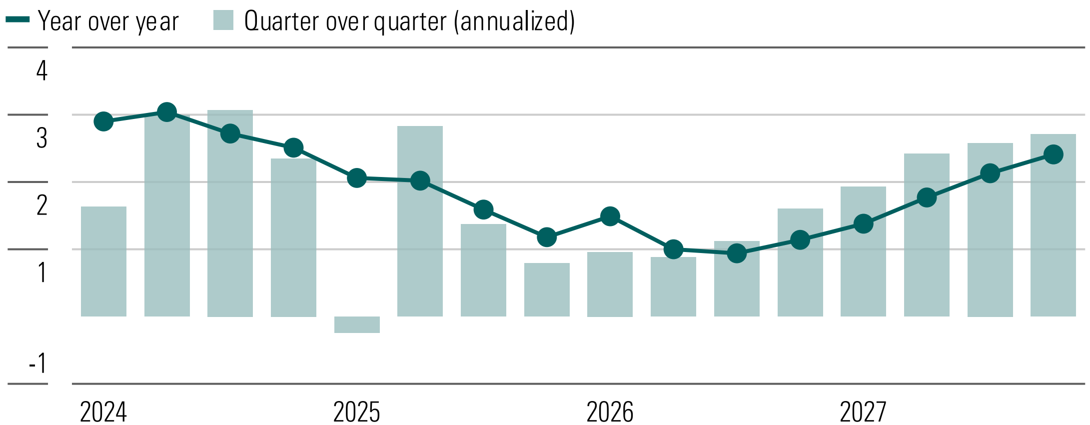
Real GDP decreased 0.2% (quarter over quarter, annualized) in the first quarter of 2025, but this was mostly because of a jump in imports as firms sought to stock up before tariffs. In principle, the process of stocking up should mean that the positive contribution from inventories fully offsets the negative contribution from imports. The fact that this didn't occur in the first quarter (inventories increased, but not enough to offset imports) probably means that inventories were underestimated. This is not surprising, as many parts of GDP are hard to measure on a high-frequency basis, and so a lot of the quarterly volatility in GDP (even in normal circumstances) comes from measurement error. We're likely to see an eventual upward revision in the first-quarter GDP figures, or there will be a rebound effect in the remaining quarters in 2025.

Despite the rebound effect, we do expect GDP growth to trend down in year-over-year terms as tariffs weigh on private spending. While data for April doesn't yet register a slowdown in personal consumption or private fixed investment, both are likely to slow after businesses and consumers react to higher prices and rising uncertainty. We project real GDP growth to hit a trough of around 1.0% in the second and third quarters of 2026, down from annual average growth of 2.8% in 2024.

Real GDP by Expenditure, % Quarter-Over-Quarter Growth (Annualized)



GDP Growth, Quarterly Forecast



Tariffs Bring Supply/Demand Shocks

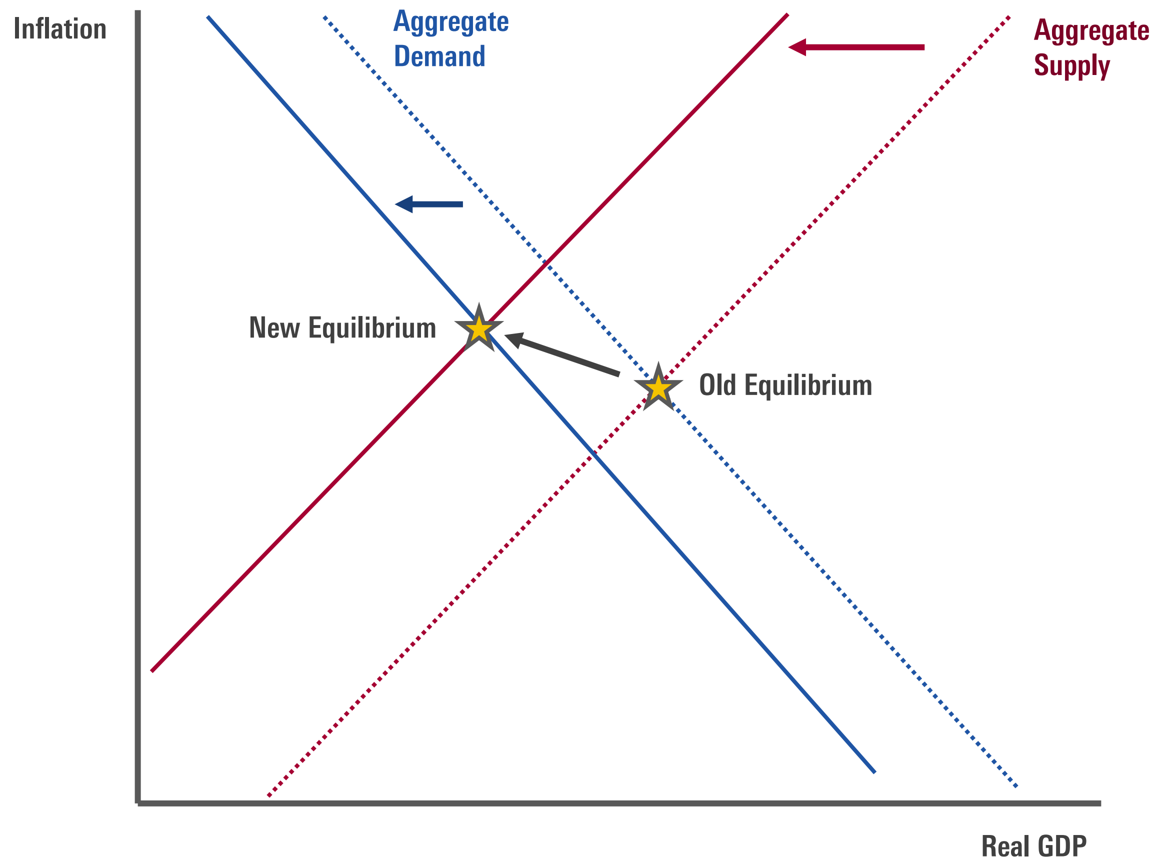
A normal recession is precipitated by an abrupt contraction in aggregate demand—2008 was a classical example. But, like the recent pandemic recession, the tariff surge is associated with a mix of demand- and supply-side shocks.

The direct impact of the tariffs is a supply-side shock, representing the hit to economic efficiency from curtailing foreign trade. In general, deviating from the free-market equilibrium diminishes the productive capacity of the economy. But unlike the pandemic shock (when people could eventually return to work), this hit to the supply side is permanent if the tariffs aren't rescinded. There's no scope for countercyclical policy—fiscal or monetary—to offset the impact of a permanent supply-side shock.

Aggregate demand will also contract. Partly this is because the tariffs represent a large tax increase, hitting private-sector incomes, unless the tariff revenue is totally recycled into new tax cuts and government spending. Perhaps the bigger demand-side factor, though, is the surge in uncertainty and associated deterioration in financial conditions, which could lead to firms and households cutting back on spending.

As of the end of May, the US stock market has rebounded and financial conditions have improved, signaling that the uncertainty channel of impact has diminished compared with the situation in April. Likewise, congressional Republicans are advancing a tax cut bill that will offset much of the fiscal hit to private-sector incomes from tariffs. That suggests that the demand-side hit from tariffs could be minor. However, the supply-side impact remains large, since we still expect a high average tariff rate in coming years.

Supply/Demand Shocks From Tariffs (Illustrative Diagram)



Source: Morningstar.

Consumer Spending

Low saving rate will be cause for pullback.

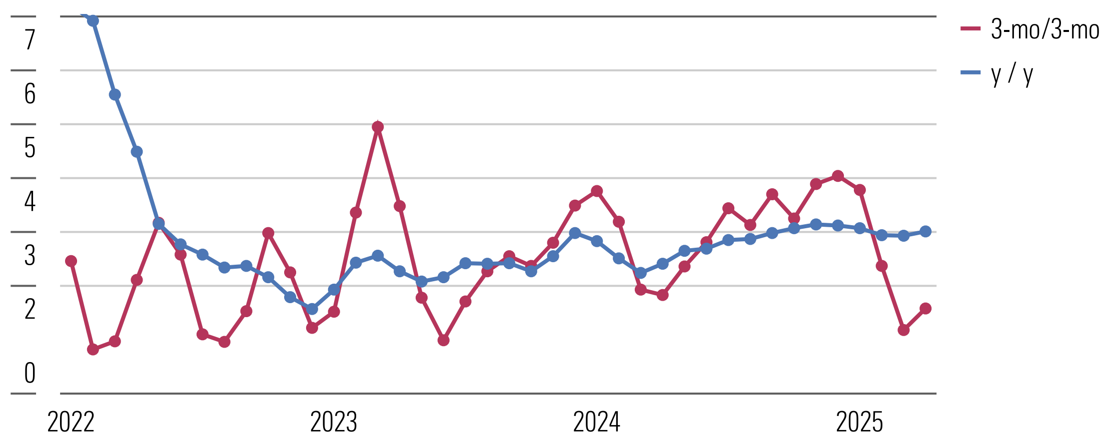
Tariff-Induced Price Hikes Will Add Another Reason for Consumers to Pull Back

Consumption Growth to Slow to 1.4% by 2026 From 2.8% in 2024

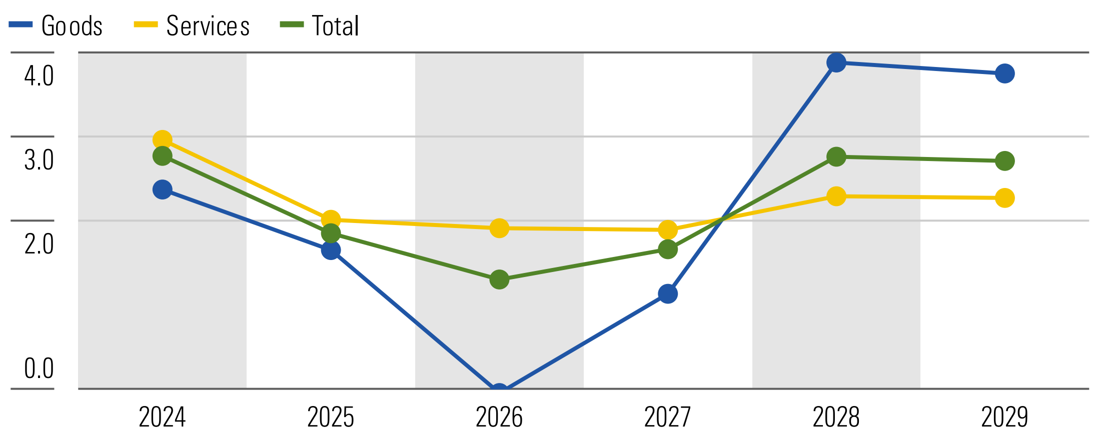
Real consumption growth has dipped to a 2% annualized pace in the first four months of 2025, down from 4% growth in the fourth quarter of 2024. That's a natural downswing after a very strong holiday season; the year-over-year growth rate is holding steady at about 3%, showing no downtrend. Even in the April data, we see little adverse impact from tariffs. That's not surprising, as prices have yet to adjust much to tariffs, so savvy consumers are pulling forward purchases to get ahead of price hikes.

Before the April tariff surge, we had already expected a pullback in consumption growth over 2025 and 2026 owing to the need of households to boost low saving rates. Price hikes from tariffs will add a further downward impulse to consumption. We expect real consumption growth to fall from 2.8% in 2024 to 1.9% in 2025 and 1.4% in 2026. Goods will bear the brunt of the hit, owing to their more discretionary nature and the relative price increase from tariffs.

Real Personal Consumption, % Growth (Annualized)



Real Personal Consumption Growth (%)



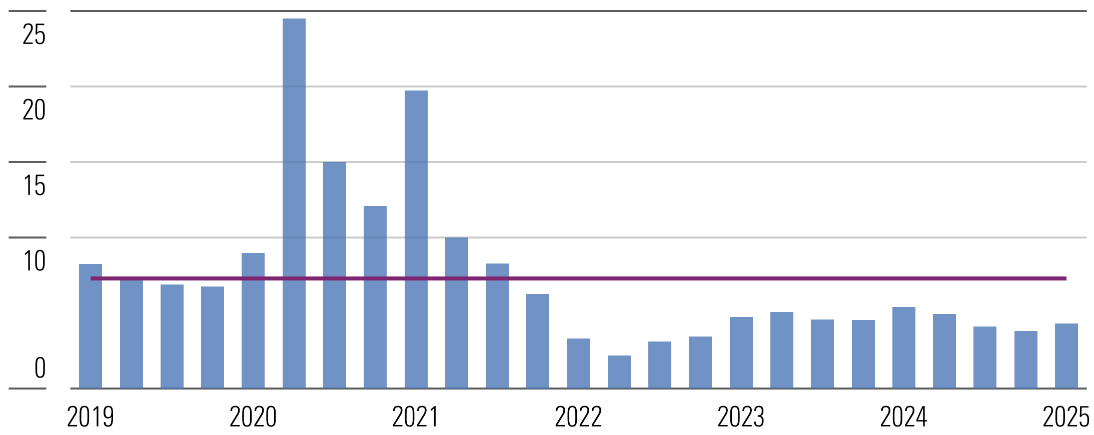
Source: Bureau of Economic Analysis.

Exhaustion of Excess Savings Will Push Households to Cut Back on Spending

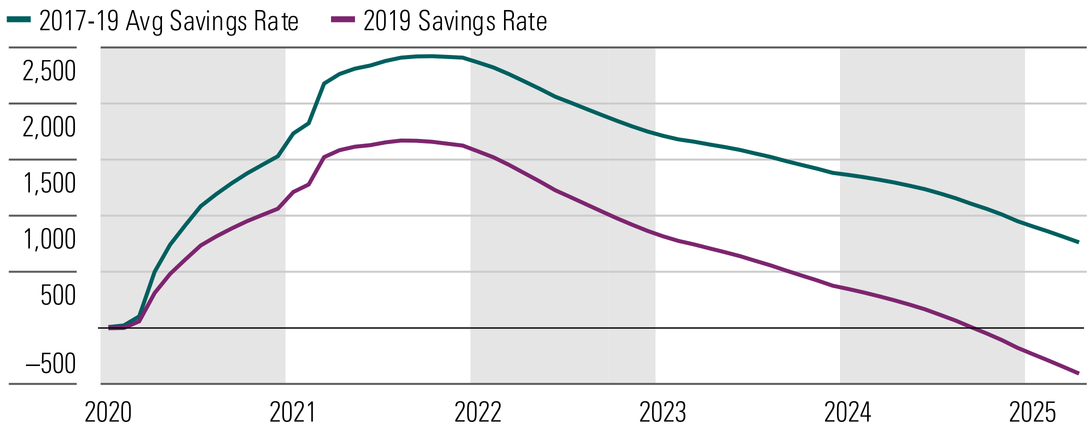
Low Saving Rate Explained by Asset Prices, Excess Savings
The personal saving rate was a paltry 4.3% in the first quarter of 2025, 3.0 percentage points below the 2019 average of 7.3% and 2.2 points below the 2017-19 average of 6.5%.

The biggest contributor to the depressed saving rate may be the remaining stockpile of excess savings. The estimated amount of excess savings depends on which baseline saving rate you use. Using the 2019 saving rate, excess savings are entirely gone; using the 2017-19 average rate, households still have another year left. It's also quite likely that remaining excess savings are heavily concentrated in higher-income households. Rising credit card and auto loan delinquencies also point to stress at the lower end of the income distribution.

Personal Saving Rate (%)



Estimates of Excess Savings, $ Billions



Source: Bureau of Economic Analysis.

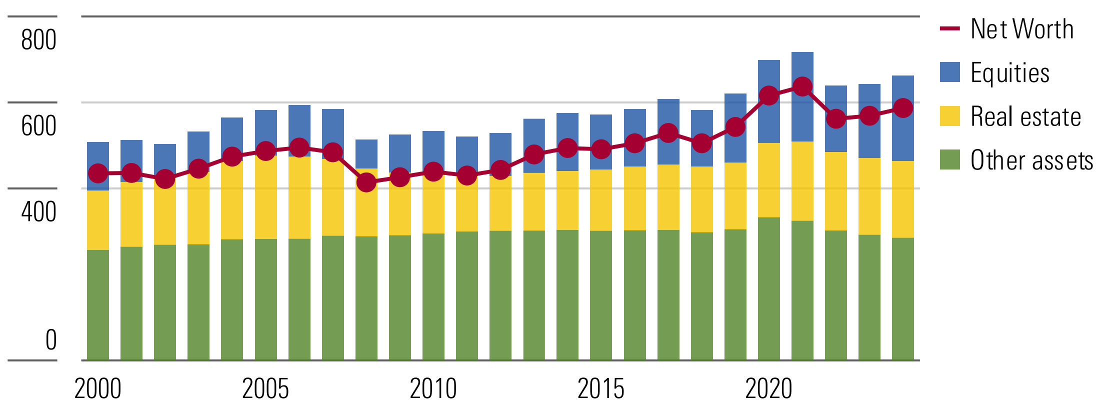
High Asset Prices Partly Explain Low Saving Rate via Wealth Effect

With equity prices soaring 24% in 2024 and home prices up a decent 4%, household net worth climbed higher in 2024. Household net worth stood at 580% of GDP at the end of 2024, up from 561% at the end of 2023 and 544% at the end of 2019, before the pandemic.

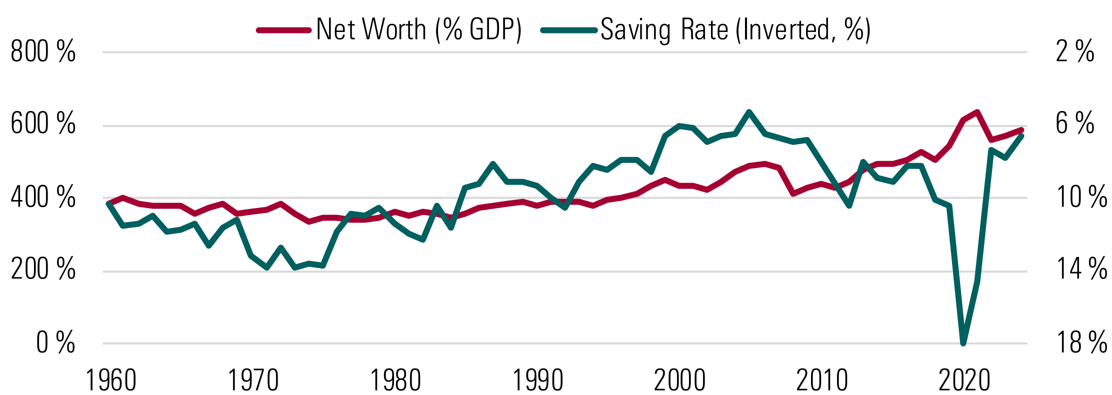
Historically, higher household net worth has been associated with a lower saving rate. A plausible causal channel is that higher wealth leads households to try to pull consumption forward in time, generating a lower saving rate. Based on a historical regression, the cumulative increase in household net worth since 2019 explains about 1 percentage point of the drop in the saving rate, or about one third of the total deviation compared with the 2019 average saving rate.

Even if asset prices hold steady, the likely absence of further price appreciation on par with that seen in the past several years will remove one major support to higher consumption growth.

Household Assets and Net Worth (% GDP)



Household Wealth and Saving Rate



Investment

AI boom not enough to stop tariffs from weighing on investment.

Tariffs, Along With More-Cautious Consumers and High Interest Rates, Will Weigh on Investment

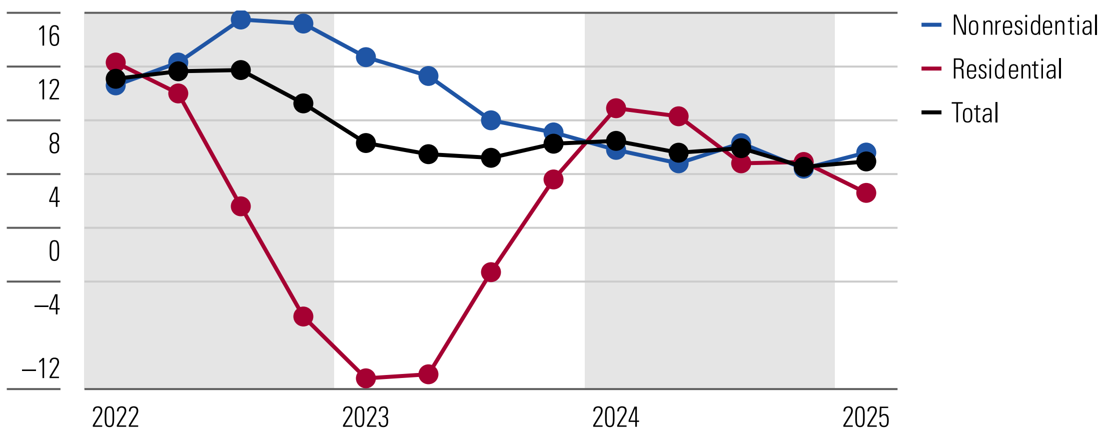
Nonresidential to Decelerate through 2026; Residential to Decline Outright

Total private fixed investment was up 2.7% year over year as of the first quarter of 2025, down from the average 2024 growth rate of 3.8%. That deceleration is due to residential investment, which dropped 0.6% year over year after growing 4.3% in 2024. Residential investment experienced a recovery in 2024, with a large volume of projects pushing to completion, but it is now experiencing a renewed decline as projects wrap up. Nonresidential fixed investment was up 3.7% year over year in the first quarter of 2025, about in line with the average 2024 growth rate of 3.6%.

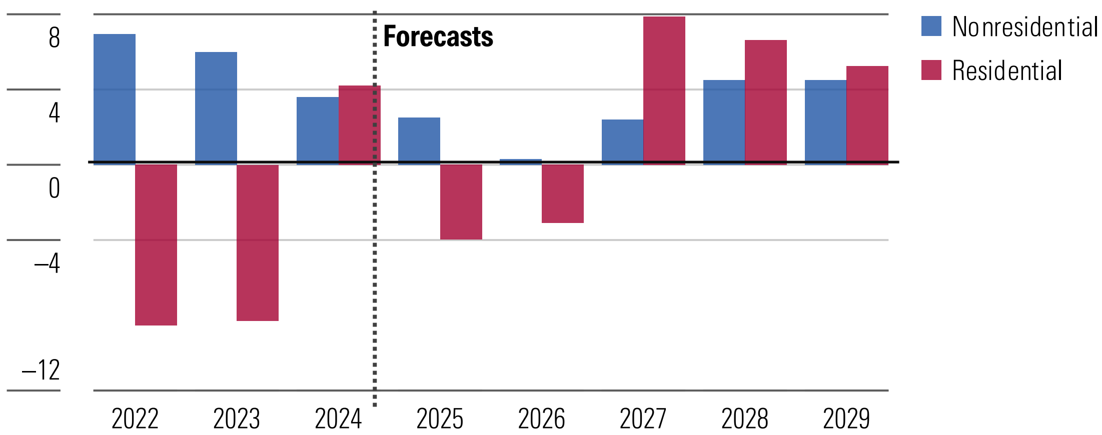
We expect private nonresidential fixed investment growth to slow to 2.5% in 2025 and 0.3% in 2026. We had already expected a modest slowdown before the tariff shock, owing to slowing consumption growth and continued high interest rates. Tariffs add further reason for businesses to cut back on investment. We expect residential investment to dip back into negative growth in 2025 and 2026, owing to persistently high mortgage rates and declining consumer sentiment caused by tariffs.

Tariffs could prove to be more damaging than we're assuming, if businesses react to the surge in uncertainty by pausing approval of new projects. We don't yet see signs of that. On the flip side, AI deployment could boost investment more than we anticipate.

Real Private Fixed Investment, % Growth Year Over Year



Real Private Fixed Investment, % Growth



Source: Bureau of Economic Analysis, Morningstar.

AI Hype Not Leading to a Boom in Total High-Tech-Related Investment

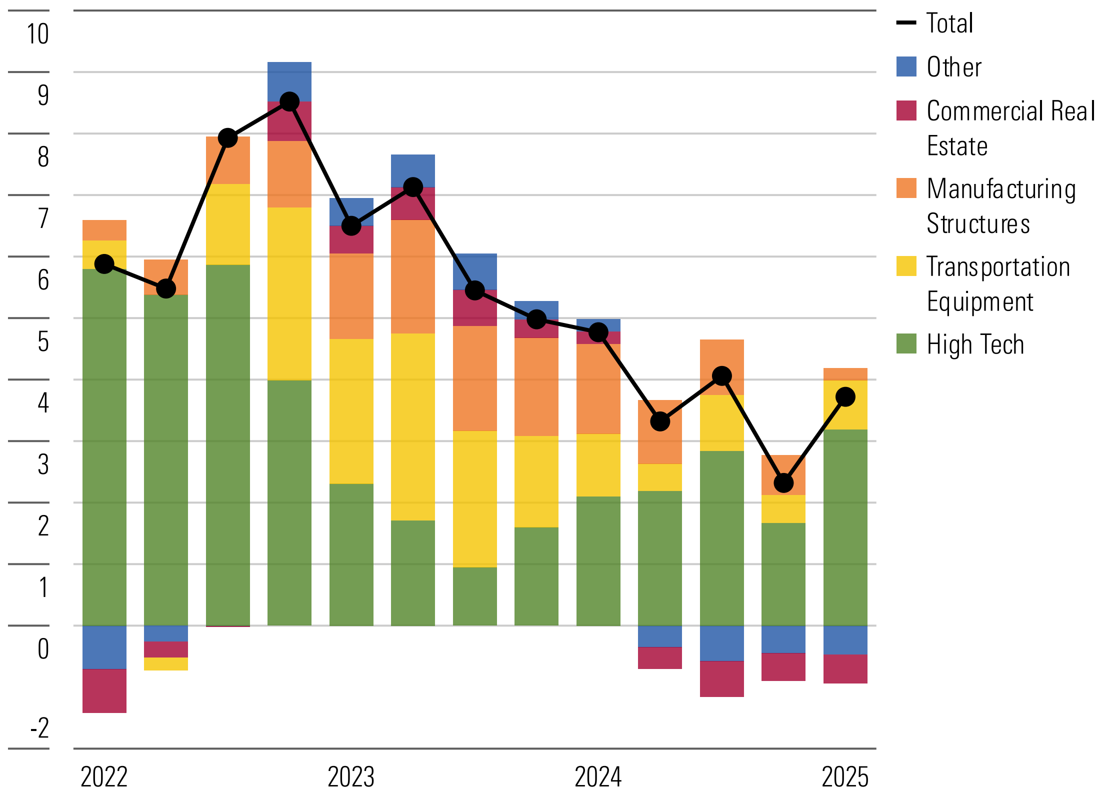
Real nonresidential fixed investment growth was 7% in 2022 and 6% in 2023 but then slowed to 3.6% in 2024. Two main factors supported strong growth in 2023 but have faded since the start of 2024. First, there was a building boom in manufacturing structures, mainly the construction of semiconductor and electric vehicle plants spurred by new federal subsidies. Transportation equipment spending also experienced a catch-up after previously being held back by supply chain issues.

The Fed's monetary policy tightening has also weighed on growth to a degree. Higher interest rates and tightening credit availability have caused commercial real estate structures investment to drop by a cumulative 5% in real terms since mid-2023.

Equity prices soared in 2024 and, except for short-lived ructions around tariffs, have remained resilient in 2025. Much of this has been driven by hype around AI. That hype drove spending on IT equipment to a stellar growth rate of 21% year over year in the first quarter of 2025, in support of the buildout of AI data centers. But the broader category of high-tech-related investment, comprising not only IT equipment but also spending on software and research and development, remains below the recent peak in growth in 2022. This shows that businesses in the broader economy aren't yet stepping up their investments to take advantage of AI tools. It's possible, however, that AI is leading to unmeasured gains in the productivity of firms' software and research spending, which would cause the real rate of growth to be understated.

Real Nonresidential Fixed Investment, % Growth Year Over Year

Contribution to Growth



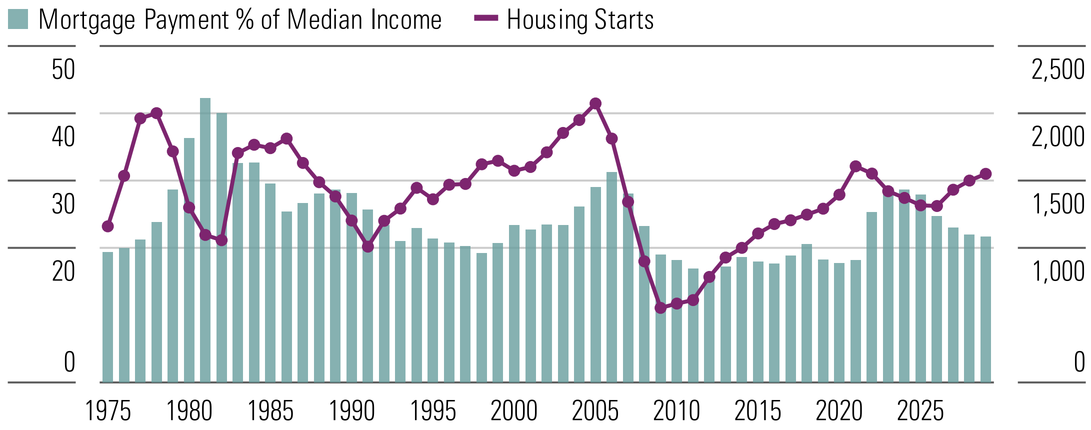
Source: Bureau of Economic Analysis.

Large Drop in Mortgages Rates Needed for Lasting Housing Recovery

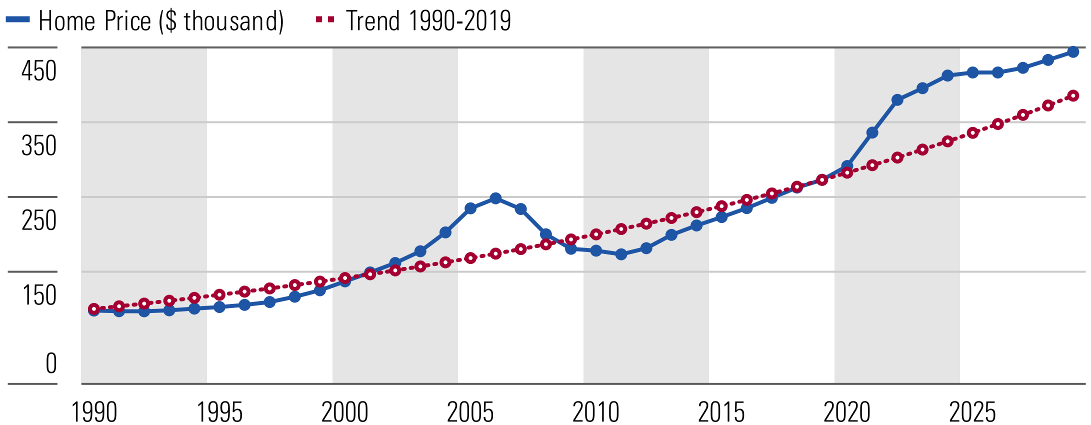
Housing starts in 2024 were 12% below the recent peak in 2022 but still 6% above the 2019 level. Given the massive deterioration in housing affordability, we might expect housing demand and activity to be much weaker. Mortgage rates averaged a lofty 6.8% in 2023 and 6.7% in 2024 and stand at 6.9% as of May 29, versus 3.9% in 2019. The cumulative 50% runup in housing prices since 2019 has also exceeded income growth. The median mortgage payment as a share of household income has risen from 18.2% in 2019 to 28.6% as of 2024—the highest since the housing boom peak in 2005-07.

Current homebuyers seem to be mostly placated by the hope of refinancing on an eventual drop in mortgage rates. Mortgage rates will have to fall drastically to justify those hopes—and justify very elevated home prices. If the Fed does not drive down mortgage rates as we expect, then another leg down for housing prices and activity is very likely, in our view. Even with monetary easing, we expect tepid home price growth averaging about 1.5% over 2025-29. That will combine with lower mortgage rates to ease housing affordability and push price/rent ratios almost back to prepandemic levels.

Housing Affordability vs. Housing Starts



Housing Price Forecast



Source: Bureau of Economic Analysis, Federal Reserve, US Census (top); Zillow, National Association of Realtors (bottom); Morningstar.

Labor

Job gains holding steady for now.

Job Growth Still Proceeding at a Solid Pace for Now

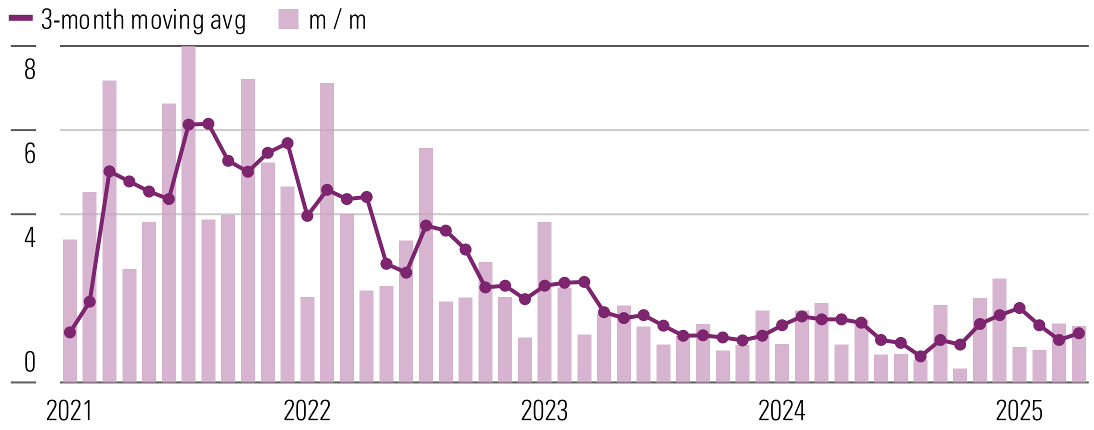
Employment Up 1.2% Year Over Year as of April 2025

Nonfarm payroll employment grew at a 1.2% annualized pace in the three months ended April 2025, a minor slowdown from 1.8% growth in the prior three-month period (through January), but still quite solid. In year-over-year terms, employment growth stood at 1.2%, about where it's stood since mid-2024. For comparison, employment growth averaged 1.5% in the prepandemic period of 2017-19. The unemployment rate averaged 4.2% in the three months ended April, around where it's hovered since August 2024.

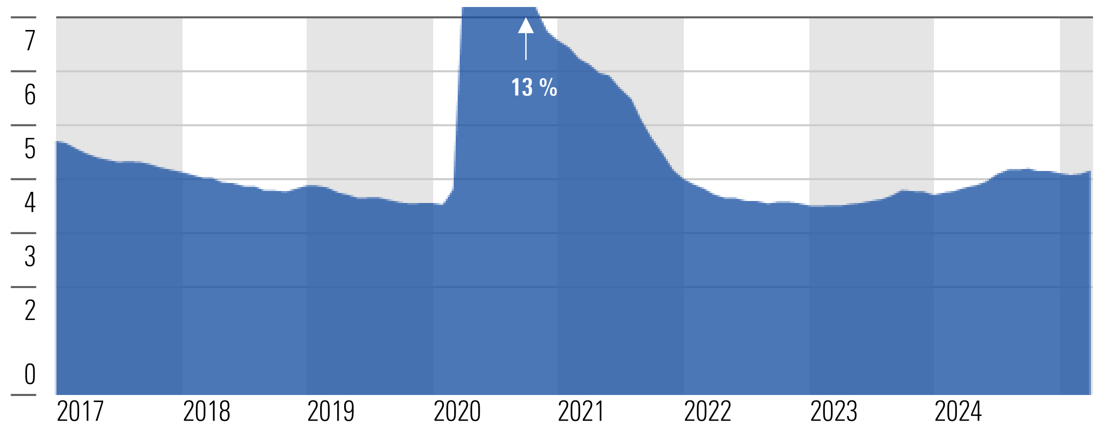
Altogether, federal employment has fallen by 26,000 jobs since January, or 0.9%. That's short of the reductions tallied by *The New York Times*, which include 58,000 firings and 76,000 employees who accepted a buyout offer. Employees aren't removed from the payroll figures while still receiving severance, which could be one driver of the discrepancy. Also, ongoing court challenges have delayed many of the terminations.

Private-sector job gains have held up fine in recent months. It's too early for tariffs to be affecting the job figures, which reflected the pay period including April 12.

Nonfarm Payroll Employment, % Growth (Annualized)



Unemployment Rate, % Three-Month Moving Average



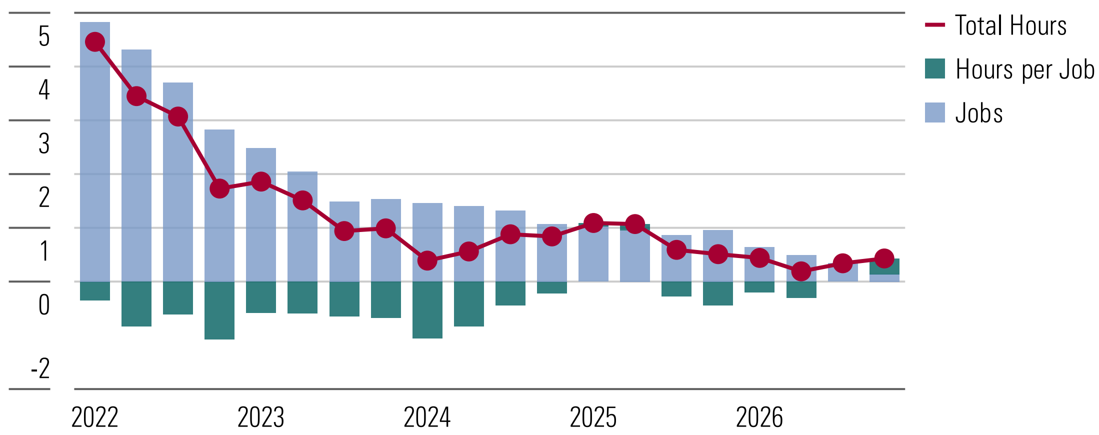
Falling GDP Growth and Limited Room to Cut Hours Should Push Job Growth Lower Through 2026

Employment Growth to Dip Below Normal by Second Half of 2025

Firms cut back workers' average weekly hours over 2022-24 in order to curb labor costs. In 2024, while total jobs grew 1.3%, average hours per job fell 0.6%, so total hours worked increased just 0.7%. Going forward, there's much less room to cut hours, so further declines in labor input will have to be accommodated by slowing job growth.

Over 2025-26, with our expectations of declining GDP growth, firms will need to maintain a subdued growth rate in total hours worked, lest labor costs cut into profits. We expect growth in nonfarm payroll employment to drop to 1.0% year over year by the fourth quarter of 2025 and 0.1% by the fourth quarter of 2026.

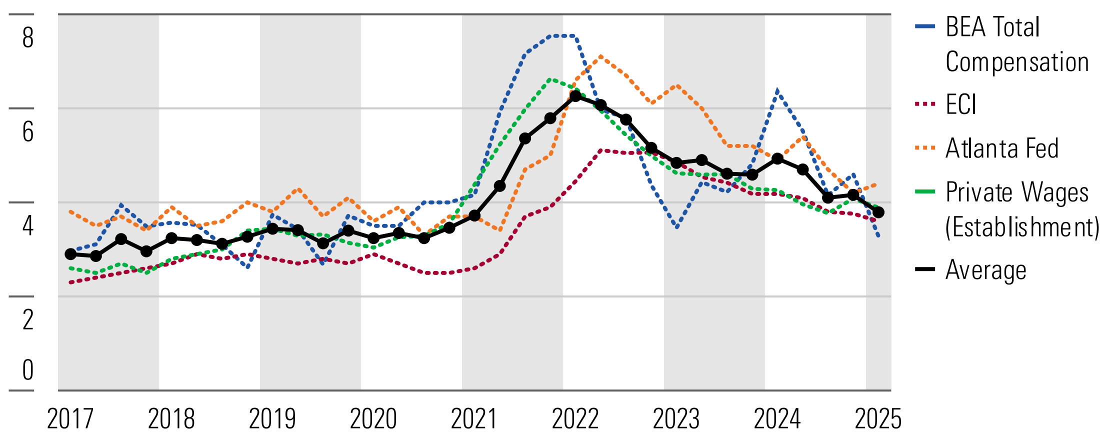
Total Hours Worked, % Growth Year over Year



Wage Growth Close to Returning to Normal

Our composite measure of wage growth dipped to 3.8% year over year as of the first quarter of 2025, down from an average of 4.5% in 2024 and a peak of 6.2% year over year in the first quarter of 2022. The current growth rate is not far from the 3.5% that would be consistent with 2% inflation. The further slowdown in job growth that we expect should be sufficient to bring wage growth fully back to normal.

Wage Growth Measures, % Year Over Year

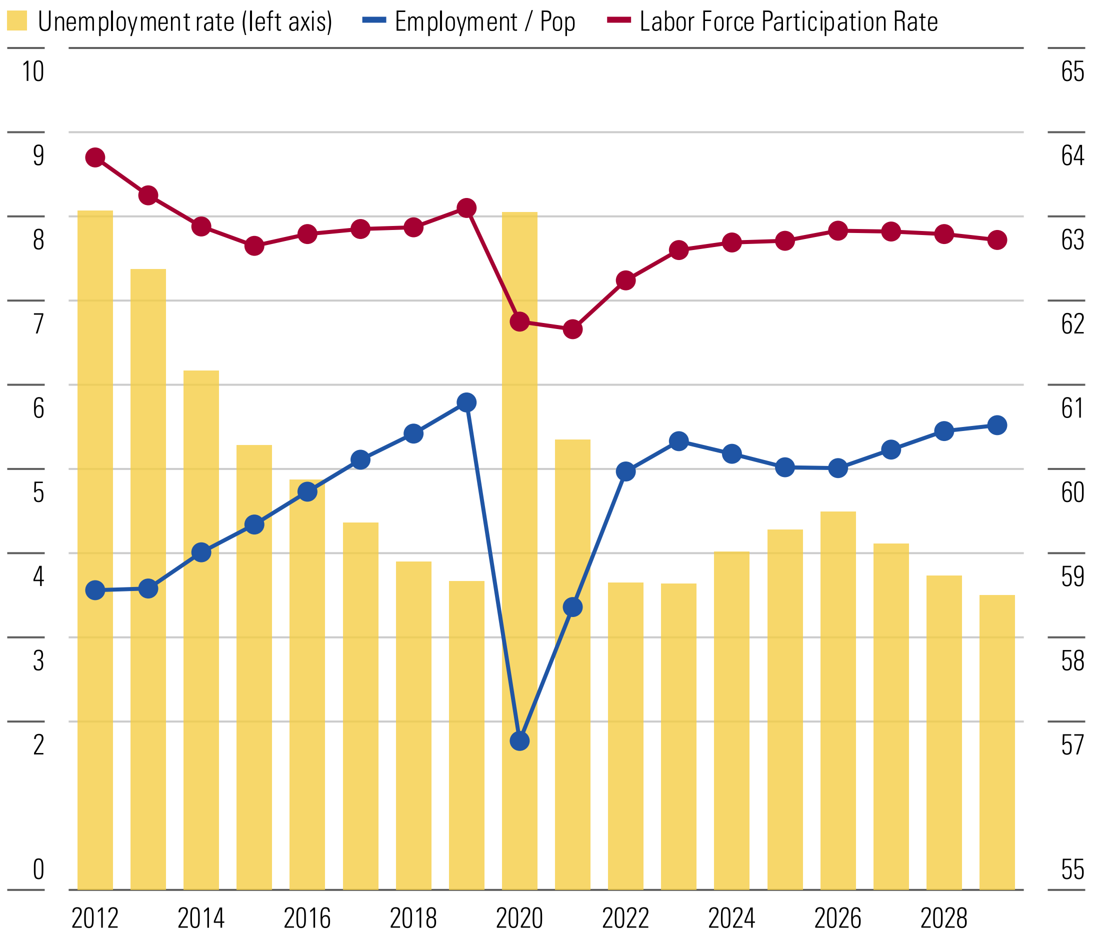


Labor Market Weakness Ahead, Followed by Rebound When Economic Growth Restarts

With employment growth slowing, we expect the unemployment rate to rise to 4.3% on average in 2025 and 4.5% in 2026, up from an average of 3.6% in 2023 and an average of 4.0% in 2024. This would be quite mild compared with US economic slowdowns in recent decades, which is consistent with our expectation that the US will avoid a recession. Nonetheless, this cooling of the labor market should be sufficient to return wage growth to normal.

We expect labor markets to recover as economic growth reaccelerates, with the unemployment rate hitting 3.5% (where it was before the pandemic) by 2029. We project a 2029 labor force participation rate of 62.7%, which is 170 basis points higher than the rate yielded by taking 2019 age-specific labor force participation rates and projecting forward with an aging population. Thus, our forecasts actually imply substantial labor force expansion. Our thesis was laid out in detail in our second-quarter 2021 US Economic Outlook (Page 18). As had been occurring over 2015-19, job availability is drawing formerly discouraged people back into the labor force. Furthermore, labor force participation rates should be boosted as new immigrants continue to be onboarded into the workforce. According to research drawing on BLS data, new cohorts of immigrants typically start with about a 50% labor force participation rate in the first year, but that typically rises well above 70% a few years afterward.

Labor Market Forecasts



Source: Bureau of Labor Statistics, Morningstar.

Inflation

Tariff hikes will eventually pass through to consumer prices.

Tariffs Will Breath New Life Into Inflation

Inflation to Average 2.5% Over 2025-29

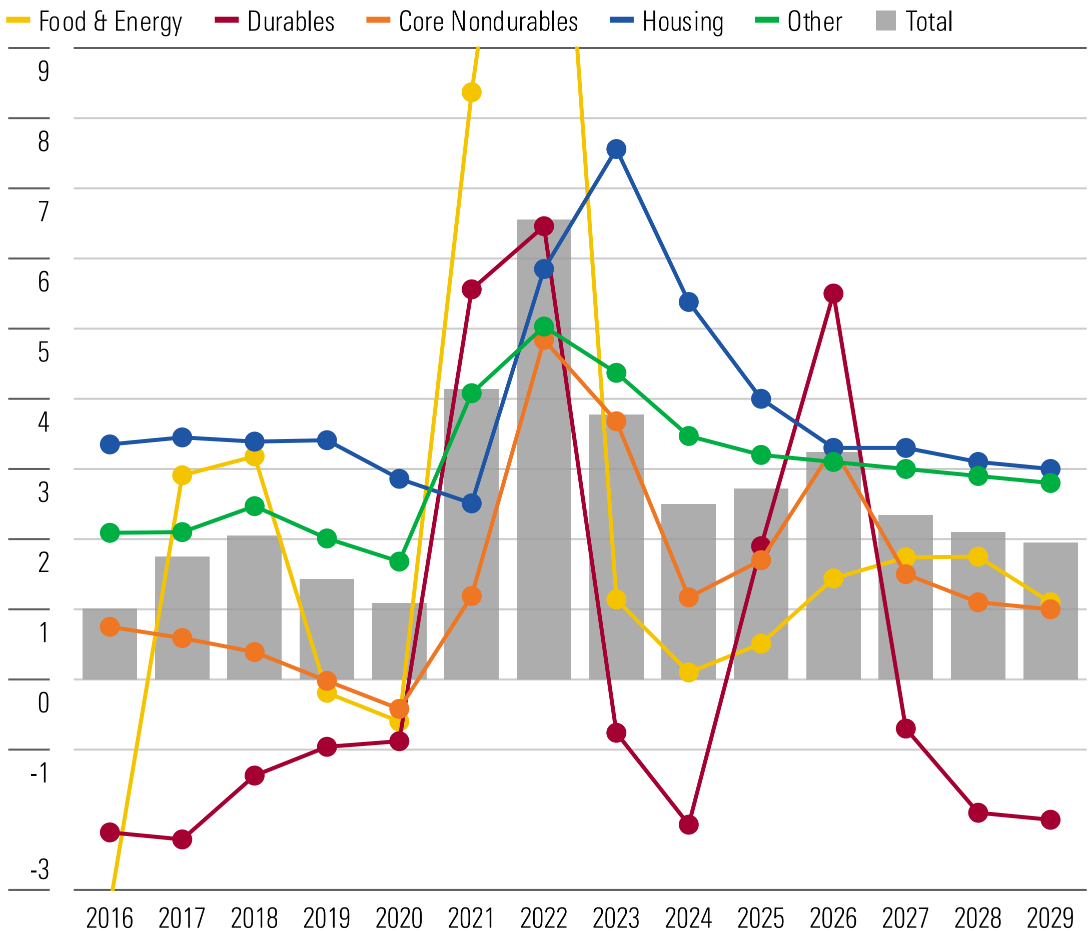
After soaring to 6.6% in 2022 (the highest since 1981), PCE inflation dropped to 3.8% in 2023 and 2.5% in 2024. Before the surge in announced tariffs during March and April 2025, we had expected inflation to average 2.0% over 2025-29, right in line with the Fed's target. Falling housing inflation, normalizing wage growth, and the ongoing impact from healed supply chains should've pushed inflation back to normal.

Tariffs will inject a renewed dose of higher-than-normal inflation into the economy. The direct impact will be on goods; we expect durables prices to rise a cumulative 7% over 2025-26 and nondurables to rise 5%. This is less than the runup in goods prices over 2021-23 (12% for durables, 10% for nondurables), but still a major inflationary impulse. Inflationary pressures will also spread elsewhere, keeping services inflation from falling more than it otherwise would have.

After 2026, the tariff shock will mostly have faded, and the slack in the economy created by slow GDP growth should push inflation down again.

PCE Inflation Forecast: Key Components (% Growth)

Other = core services excluding housing, aka "supercore"



Source: Bureau of Economic Analysis, Morningstar.

Gradual Progress in Bringing Inflation Back to Normal Had Been in Place

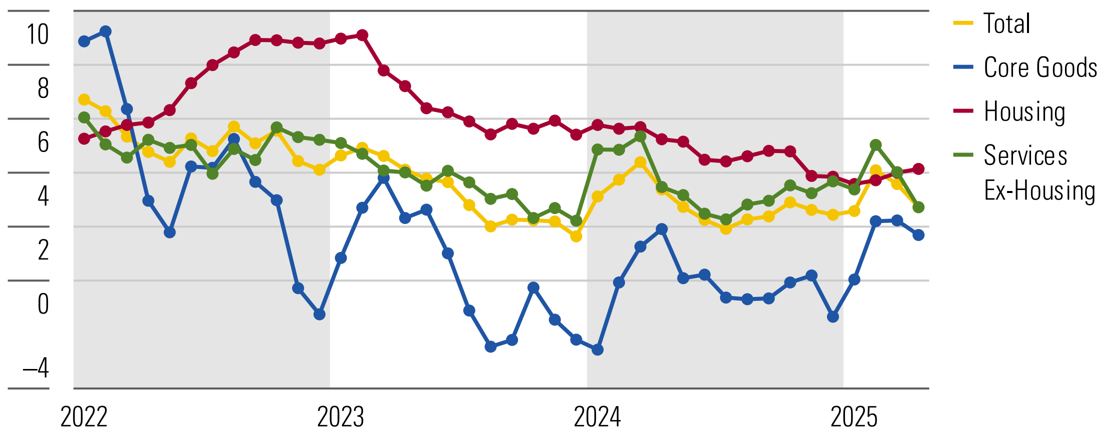
Core PCE Inflation Dropped to 2.5% in April 2025

The latest data shows that, heading into the tariff impact, inflation was still trending downward. Progress had slowed, mainly owing to very strong economic growth, but it was still in place. Core PCE inflation dropped to 2.5% year over year as of April 2025, versus an average rate of 2.8% in 2024.

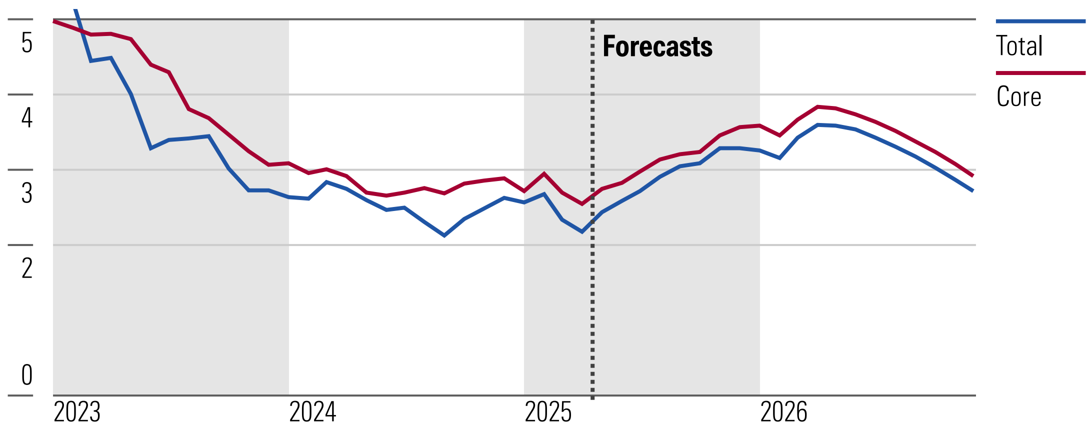
We did see the three-month growth rate of core PCE inflation jump to 4.4% annualized as of February 2025, but it dropped back to 2.1% as of April. That marked another round of beginning-of-year price hikes in core services excluding housing, similar to what we saw in 2024. With wage growth nearly converging back to levels consistent with 2% inflation (see Page 24), core services excluding housing has been on track for inflation to fully normalize.

While core goods inflation has ticked up over the beginning months of 2025, the bulk of that is probably not due to tariffs, yet. We expect the impact of tariffs to percolate gradually through the economy. Firms will move gingerly with price increases at first, but ultimately, the bulk of the higher costs from tariffs will have to be passed on to consumers.

Core PCE Components (Three-Month % Change, Annualized)



PCE Inflation Forecasts Monthly, % Growth Year over Year



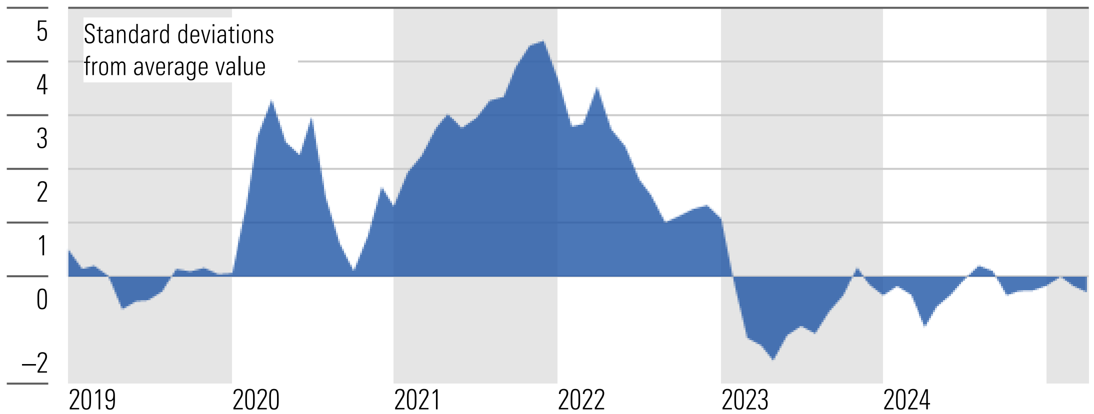
Source: Bureau of Economic Analysis, Bureau of Labor Statistics.
Correction: In a previous version of this report, the year was incorrect in the last paragraph. It is 2025.

Import Prices Holding Up, Suggesting Tariffs Will Be Passed On to US Consumers

Supply Chain Conditions Still Loose

The New York Fed's Global Supply Chain Pressure Index (which captures ocean shipping costs and delivery times, among other indicators) still shows supply chain conditions as loose as before the pandemic. Disruptions in the Red Sea and elsewhere (along with heightened shipping demand in anticipation of potential 2025 tariffs) have caused container freight rates to tick up, but it's not nearly as bad as the 2021-22 runup. Other types of freight costs or metrics like shipping backlogs show fairly loose supply chain conditions.

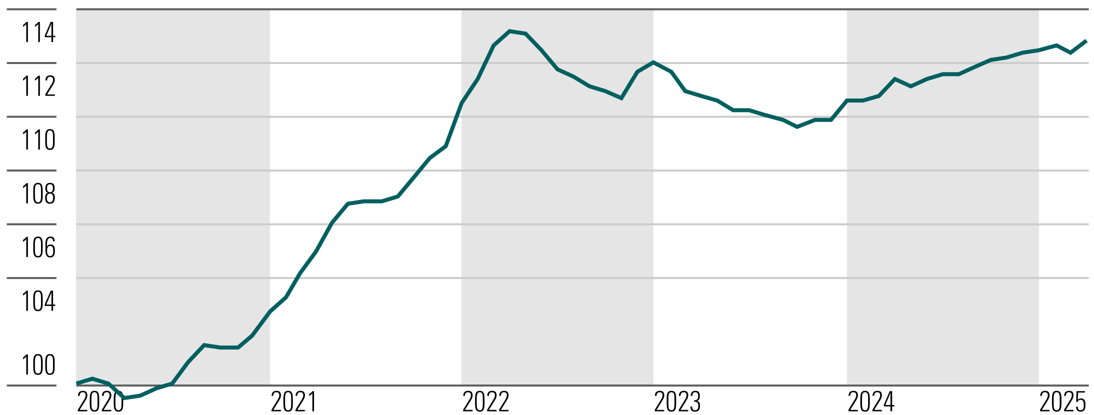
Global Supply Chain Pressure Index (New York Fed)



Import Prices Up 1.3% Year Over Year in April

Prices for all US imports excluding petroleum were up 1.3% year over year as of April 2025, as prices continued to creep up in the early months of 2025. Importantly, these prices *don't* include the tariff bill; thus, import prices would have to fall if foreign importers were picking up the tab on tariffs. The US dollar has depreciated in the last several months, also suggesting that tariffs won't be passed on to foreigners.

Import Price Index (Excluding Petroleum)



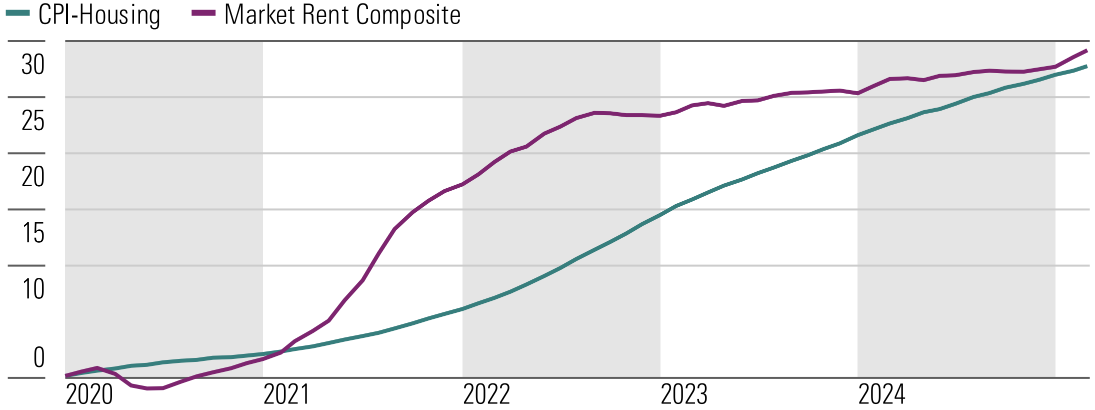
Source: Federal Reserve Bank of New York (top), Bureau of Labor Statistics (bottom).

Housing Inflation Should Continue to Drop

Overall Rents Have Converged to Market Rents

The housing component of the main price indexes (CPI and PCE), representing the average rent paid by all tenants, responds with a substantial lag with respect to the market rate. Because of this lag and the runup in market rents over 2021-22, official housing inflation was still high in 2024 at 5.4%.[1] But market rent growth has decelerated sharply in response to falling housing demand and expanding supply, standing at about 2.0% year over year as of March 2025. The accumulated gap between market rents and the housing inflation index has basically closed. Housing inflation is now trending down, having dropped to 4.2% year over year as of April 2025.

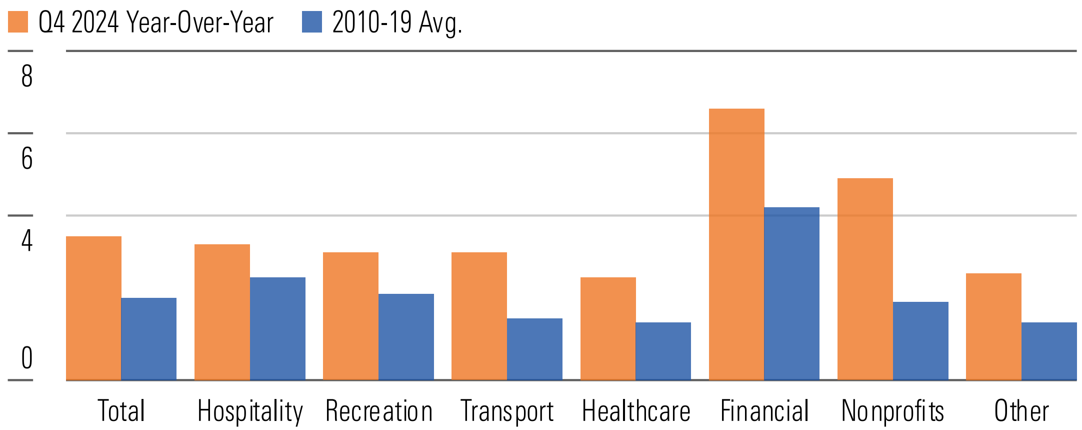
Rent Inflation Measures, % Cumulative Change vs. January 2020



Excess Core Services Inflation Spread Across All Components

Core services inflation excluding housing was 3.3% year over year in the first quarter of 2025, still significantly above the 2010-19 average of 2.0%. Overall PCE inflation was 1.5% over 2010-19, so we should probably be shooting for core services excluding housing at around 2.5% to be consistent with 2.0% inflation. The remaining excess is spread about evenly among all the subcomponents.

Core Services Ex-Housing Detail (% Growth)



[1] Our market rent composite measure includes the Zillow Observed Rent Index, CoreLogic Single-Family Rent Index, and Apartment List rent indexes.

Source: Bureau of Labor Statistics, Zillow, CoreLogic, Apartment List (top); Bureau of Economic Analysis (bottom).

Monetary, Fiscal, and Financial

Fed will cut rates gradually to balance risks.

Fed Still Needs to Push Interest Rates Lower to Support Economic Growth

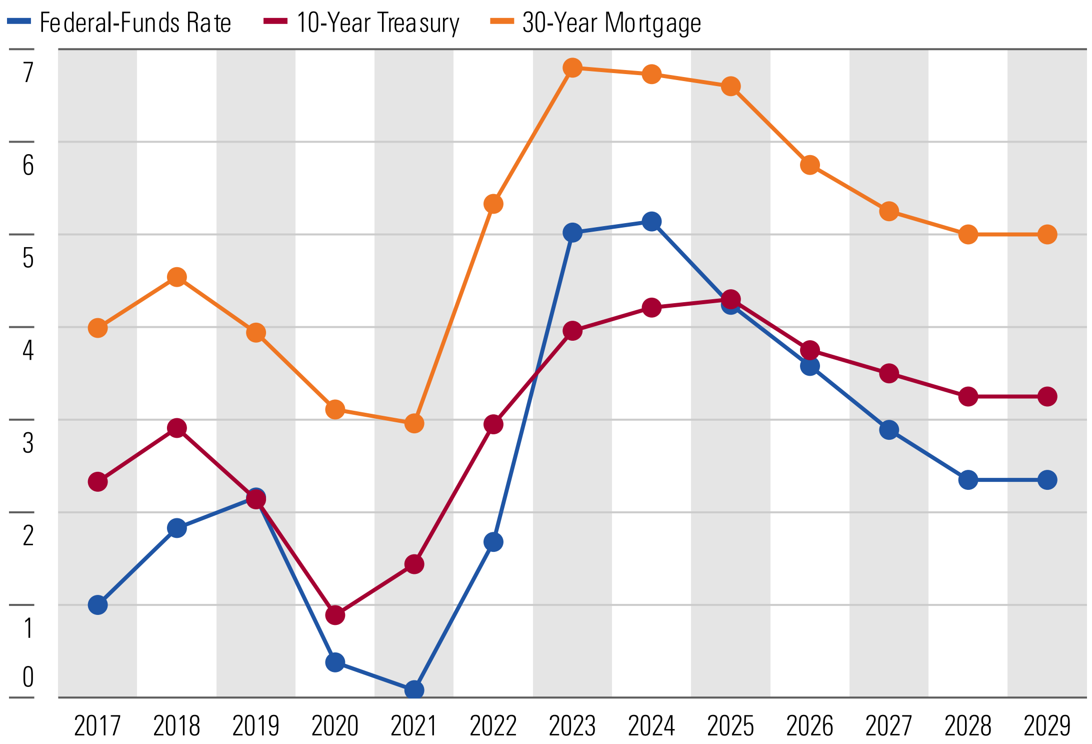
We Project 10-Year Treasury Yield of 3.25% in 2028 and Later Years

The federal-funds rate has been cut by 100 basis points since September 2024, but longer-term bond yields have risen since then, owing greatly to concerns about the US federal debt load. We expect the 10-year Treasury yield to average 4.3% in 2025, slightly above its 4.2% in 2024. In our view, this is too high to support continued robust economic growth. Interest burden is still rising as borrowers refinance at prevailing market rates. New homebuyers are putting up with exorbitant mortgage costs for now, but that won't last forever.

The Fed will have to cut much further to drive longer-term yields lower—we expect another 200 basis points of cuts through late 2027. This should drive the 10-year yield to an average 3.25% by 2028, which is our long-run expectation. In turn, this should drive the 30-year mortgage rate down from an average 6.7% in 2024 and 6.6% in 2025 to 5.00% by 2028.

While the path of interest rates over the next couple of years is mainly contingent upon the cyclical status of the economy, our long-term interest-rate projections are driven by secular trends. Factors such as aging demographics, slowing productivity growth, and increasing inequality have acted to push down real interest rates for decades, and these forces haven't gone away. The low-interest-rate regime will resume once the dust settles from the pandemic economic volatility. Our long-term views and monetary policy framework are detailed in our US Outlook for Interest Rates, Inflation, and Monetary Policy.

Interest-Rate Forecasts (Annual Average)



(%)	2024	2025	2026	2027	2028	2029
Fed-Funds Rate	5.14	4.24	3.58	2.89	2.35	2.35
10-Year Treasury	4.21	4.30	3.75	3.50	3.25	3.25
30-Year Mortgage	6.73	6.60	5.75	5.25	5.00	5.00

Source: Federal Reserve, Morningstar.

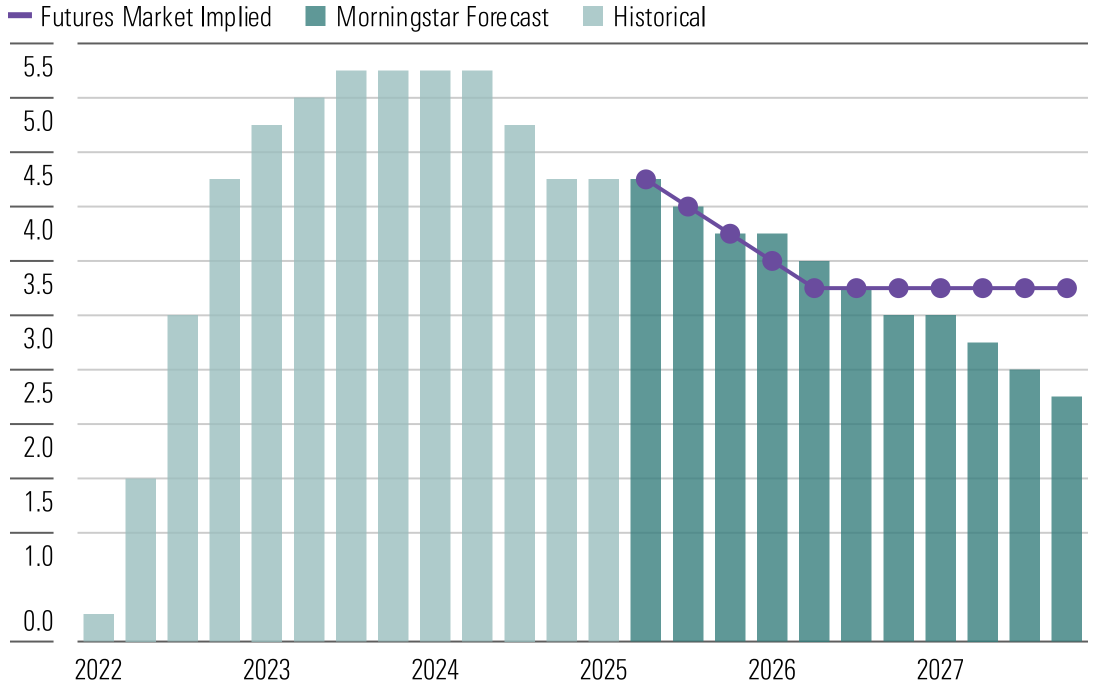
The Fed Still Has Much More Cutting to Do

By End of 2027, Our Projections Are 100 Basis Points Below Market Expectations
The federal-funds rate was at a lofty plateau of 5.25%-5.50% from July 2023 to September 2024. From September to December 2024, the Fed cut by 100 basis points, bringing the federal-funds rate down to a target range of 4.25%-4.50%. That's still well above the prepandemic 2017-19 average of 1.7%.

Tariffs have complicated the Fed's job. On net, the inflationary considerations from tariffs slightly outweigh the recessionary risk, so we've delayed our rate cut expectations slightly compared with our pretariff forecast. We expect 0.50 percentage points in cuts in 2025, 0.75 points in 2026, and 0.75 points in 2027.

We still think the market is projecting a terminal rate that's a bit too high, reflecting an overestimation of the natural rate of interest. We wrote about the dangers of keeping rates too high for too long in our 2024 US Financial Health Report.

Federal-Funds Rate Expectations, %
Bottom of Target Range



Federal-Funds Rate (%) Year-End, Bottom of Target Range	2025	2026	2027
Morningstar	**3.75**	**3.00**	**2.25**
Market-Implied	**3.75**	**3.25**	**3.50**

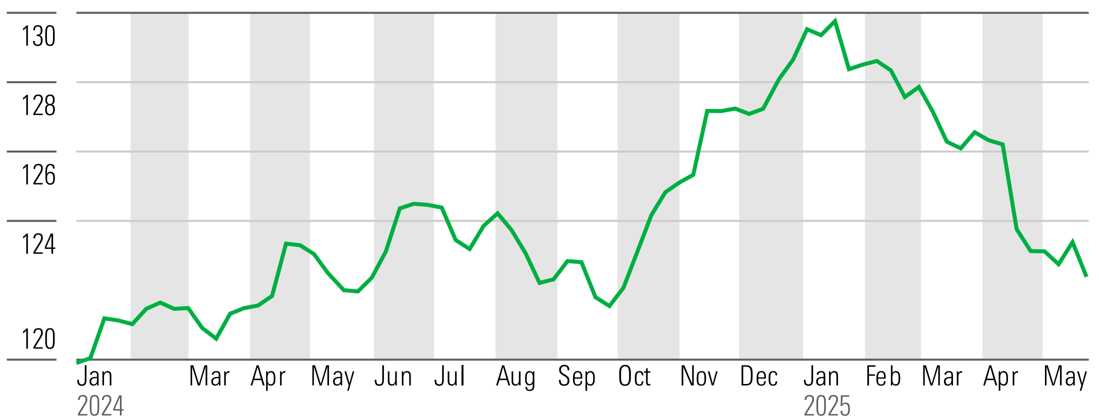
Source: Chicago Mercantile Exchange, Morningstar.

Exchange Rate Depreciation Is Ominous Sign

Dollar's Depreciation Could Represent Diminishing Confidence

The Fed's nominal broad US dollar index has fallen about 6% since the recent peak in January 2025. This leaves it about in line with levels averaged throughout 2024—not so concerning at first glance. But the puzzle is that economic theory suggests that an increase in average tariff rates of over 15% should've generated an exchange rate appreciation of about half that (7.5%), given fairly muted foreign tariff retaliation so far. The fact that the dollar has instead depreciated suggests that a significant offsetting shock is taking place. Very plausibly, that offsetting shock is a diminishing confidence in US assets among foreign investors, a worrying sign.

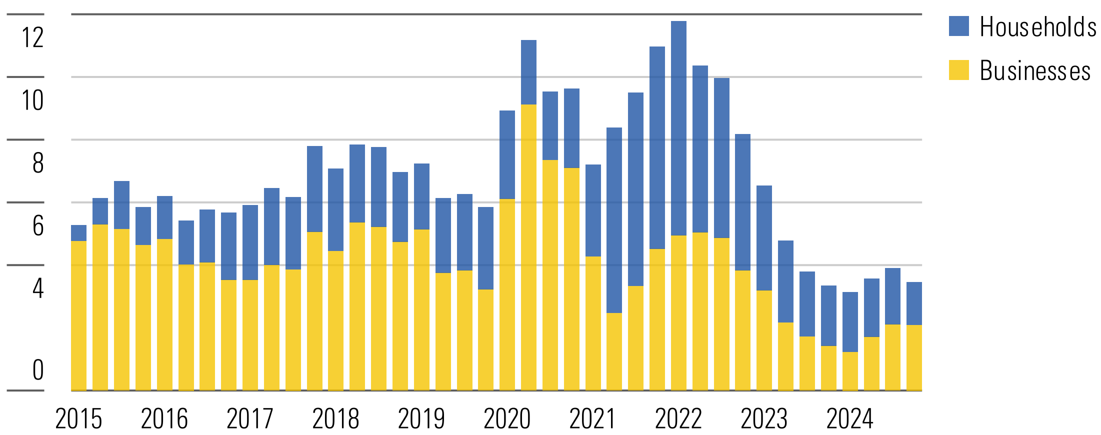
US Dollar Index (Federal Reserve Nominal Broad)



Credit Contraction Has Bottomed Out for Now

Credit issuance to the private nonfinancial sector decelerated sharply from a peak of 11.8% in the first quarter of 2022 to a low of 3.2% in the first quarter of 2024. Historically, we've never seen a credit contraction that large occur without a recession. This credit contraction is still somewhat worrying, but we have seen credit issuance stabilize since then without dipping into negative territory. Credit issuance has typically been a lagging indicator, so this may mean that the economy has gotten off scot-free. Still, tightened availability of credit is a cause of pain in certain areas of the economy (like commercial real estate), which will likely drag on growth over 2025-26.

Change in Private Nonfinancial Debt, % GDP Trailing 12-Month



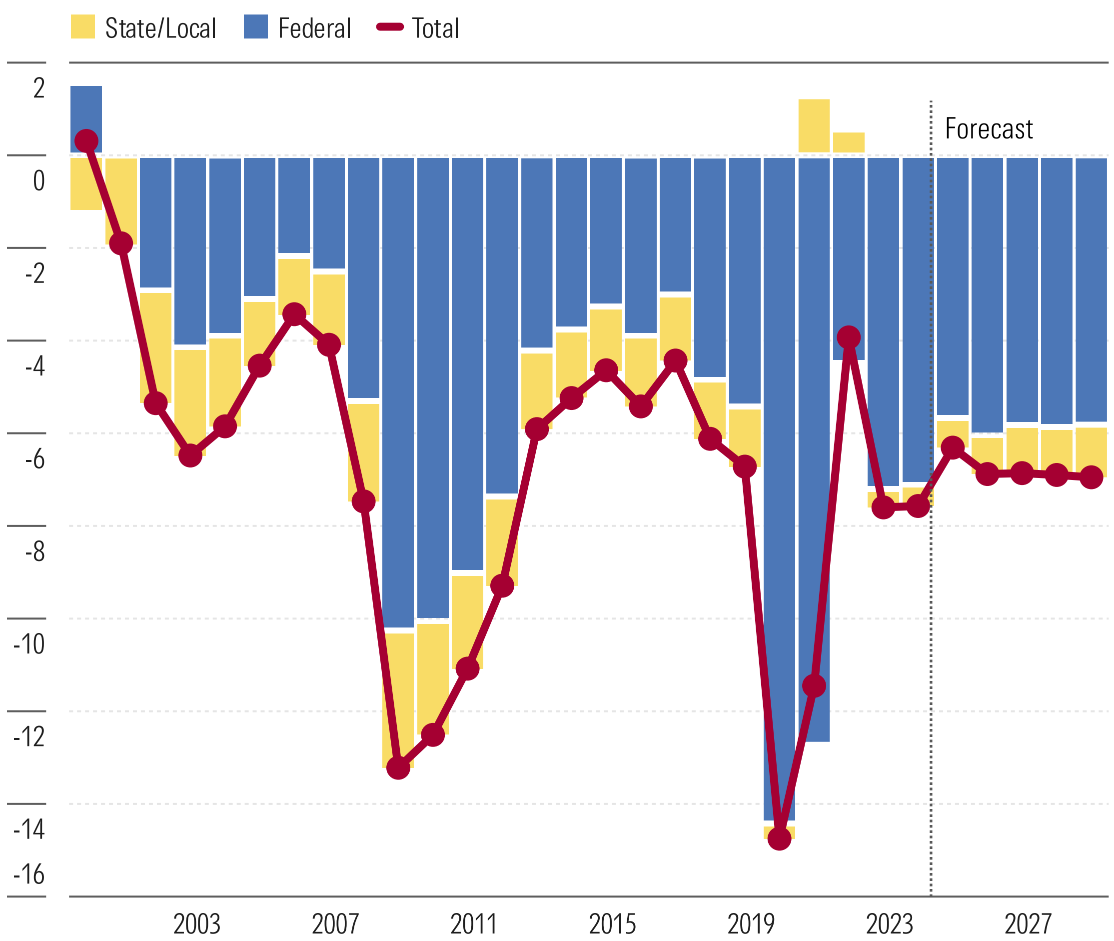
Source: Federal Reserve.

Government Deficits to Remain a Step Above Prepandemic Level

We project the combined US government deficit as a share of GDP to average 6.8% over 2025-29.[1] That's moderately larger than the prepandemic (2018-19) average of 6.4%. We expect the federal deficit to be about 0.7 percentage points higher, while the state and local deficit contracts by 0.3 percentage points. The higher federal deficit is driven entirely by higher interest costs, owing to a higher debt/GDP ratio and a higher average interest rate on debt.

Our expectations for the federal deficit over 2025-29 have contracted by about 0.3% of GDP on average since our pretariff forecast. We expect tariffs to generate increased federal revenue amounting to about 1.1% of GDP on average over 2025-29. On the other hand, the Republican Party's major tax and spending bill is adding more to the deficit than we previously anticipated. We had thought that the Tax Cuts and Jobs Act tax cuts due to expire in 2026 would be only partially extended. Instead, not only are we getting a full extension, but the GOP bill is adding a number of tax cuts, with only minor spending cuts to offset over the next few years.

US Government Budget Balance (% GDP)



[1] Our estimates are based on the Congressional Budget Office's forecasts. The CBO assumes no new legislation, so we add the estimated impact of future legislation. We also plug in different interest-rate assumptions than the CBO.

Source: Bureau of Economic Analysis, Morningstar.

Appendix

Morningstar - US Economics Dashboard

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025 E	2026 E	2027 E	2028 E	2029 E	CAGR: 2014-19	CAGR: 2019-24	CAGR: 2024-29
U.S. Real GDP by Expenditure (% Growth)																					
Personal Consumption	1.4%	1.7%	2.8%	3.4%	2.5%	2.6%	2.7%	2.1%	-2.5%	8.8%	3.0%	2.5%	2.8%	2.2%	1.7%	2.1%	2.5%	2.2%	2.7%	2.9%	2.1%
Residential Investment	13.0%	12.7%	4.3%	10.6%	7.1%	4.3%	-0.7%	-0.9%	7.7%	10.9%	-8.6%	-8.3%	4.2%	-2.2%	4.9%	7.6%	6.9%	5.5%	4.0%	0.9%	4.5%
Business Investment	10.6%	6.2%	7.0%	5.0%	-2.1%	4.5%	7.6%	4.3%	-7.9%	7.6%	10.5%	3.2%	3.8%	2.3%	1.0%	3.4%	4.1%	3.7%	3.8%	3.2%	2.9%
Government Spending	-2.1%	-2.4%	-0.9%	2.0%	2.0%	0.6%	2.0%	3.9%	3.4%	-0.3%	-1.1%	3.9%	3.4%	1.2%	1.0%	1.2%	1.4%	1.4%	2.1%	1.8%	1.2%
Exports	4.0%	3.0%	3.9%	0.3%	0.5%	4.1%	2.9%	0.5%	-13.1%	6.5%	7.5%	2.8%	3.2%	2.5%	2.8%	2.8%	2.8%	2.5%	1.6%	1.1%	2.6%
Imports	2.4%	1.2%	5.2%	5.2%	1.5%	4.7%	4.0%	1.2%	-9.0%	14.7%	8.6%	-1.2%	5.4%	1.8%	1.8%	1.5%	1.5%	1.5%	3.3%	3.4%	1.6%
GDP Growth %	**2.3%**	**2.1%**	**2.5%**	**2.9%**	**1.8%**	**2.5%**	**3.0%**	**2.6%**	**-2.2%**	**6.1%**	**2.5%**	**2.9%**	**2.8%**	**2.0%**	**1.7%**	**2.5%**	**2.9%**	**2.6%**	**2.6%**	**2.4%**	**2.3%**
Nominal GDP - $ Trillion	**16.3**	**16.9**	**17.6**	**18.3**	**18.8**	**19.6**	**20.7**	**21.5**	**21.4**	**23.7**	**26.0**	**27.7**	**29.2**	**30.3**	**31.3**	**32.6**	**34.2**	**35.7**	**4.1%**	**6.3%**	**4.1%**
% Growth	4.2%	3.9%	4.3%	3.9%	2.8%	4.3%	5.3%	4.3%	-0.9%	10.9%	9.8%	6.6%	5.3%	3.9%	3.3%	4.2%	4.7%	4.4%			
Inflation (% Growth)																					
GDP Deflator	1.9%	1.7%	1.7%	0.9%	1.0%	1.8%	2.3%	1.7%	1.3%	4.6%	7.1%	3.6%	2.4%	1.8%	1.6%	1.7%	1.8%	1.8%	1.5%	3.8%	1.8%
PCE	1.9%	1.3%	1.4%	0.2%	1.0%	1.7%	2.0%	1.4%	1.1%	4.1%	6.6%	3.8%	2.5%	2.2%	1.8%	1.9%	2.0%	2.0%	1.3%	3.6%	2.0%
PCE - Core	1.9%	1.5%	1.5%	1.2%	1.6%	1.6%	1.9%	1.6%	1.3%	3.6%	5.4%	4.1%	2.8%	2.4%	2.1%	2.0%	2.1%	2.1%	1.6%	3.4%	2.1%
Labor Market																					
Unemployment Rate (%)	8.1%	7.4%	6.2%	5.3%	4.9%	4.4%	3.9%	3.7%	8.1%	5.3%	3.6%	3.6%	4.0%	4.3%	4.5%	4.1%	3.7%	3.5%			
Labor Force Participation (%)	63.7%	63.2%	62.9%	62.7%	62.8%	62.9%	62.9%	63.1%	61.7%	61.7%	62.2%	62.6%	62.6%	62.7%	62.8%	62.8%	62.8%	62.7%			
LFP % - Prime Age	81.4%	81.0%	80.9%	80.9%	81.3%	81.7%	82.1%	82.5%	81.4%	81.6%	82.4%	83.3%	83.4%	83.3%	83.6%	83.8%	83.9%	84.0%			
Supply Side (% Growth)																					
Total Hours Worked	1.9%	1.3%	2.0%	2.1%	1.2%	1.2%	1.9%	1.0%	-6.5%	4.4%	3.2%	1.4%	1.0%	0.9%	0.5%	1.0%	1.1%	0.9%	1.5%	0.5%	0.9%
Labor Productivity	0.4%	0.8%	0.6%	0.8%	0.6%	1.3%	1.1%	1.5%	4.7%	1.6%	-0.6%	1.5%	1.8%	1.0%	1.2%	1.5%	1.8%	1.7%	1.1%	1.8%	1.4%
Output Gap (% Potent. GDP)	**-5.2%**	**-5.1%**	**-4.5%**	**-3.8%**	**-4.0%**	**-3.1%**	**-2.1%**	**-1.8%**	**-4.9%**	**-0.8%**	**-1.2%**	**-1.1%**	**-0.4%**	**-1.7%**	**-1.8%**	**-1.2%**	**-0.4%**	**0.0%**			
Other																					
Govt Budget Balance (% GDP)	-9.3%	-5.9%	-5.2%	-4.6%	-5.4%	-4.4%	-6.1%	-6.7%	-15.0%	-11.8%	-3.7%	-7.6%	-7.6%	-7.4%	-7.6%	-7.1%	-7.4%	-7.2%			
Net Exports (% GDP)	-3.4%	-2.8%	-2.9%	-2.9%	-2.7%	-2.8%	-2.9%	-2.7%	-2.9%	-3.6%	-3.7%	-2.9%	-3.1%	-3.2%	-3.2%	-3.2%	-3.1%	-3.1%			
Market (Year Avg)																					
Fed Funds Rate	0.14%	0.11%	0.09%	0.13%	0.40%	1.00%	1.83%	2.16%	0.38%	0.08%	1.68%	5.02%	5.14%	4.17%	3.25%	2.48%	2.38%	2.38%			
10-Year Treasury Yield	1.80%	2.35%	2.54%	2.14%	1.84%	2.33%	2.91%	2.14%	0.89%	1.44%	2.95%	3.96%	4.21%	4.30%	3.60%	3.25%	3.25%	3.25%			

Source: Bureau of Economic Analysis, Morningstar.

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