25 questions for 2025

Avoiding complacency in a strong economy

BCG Center for Macroeconomics

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Executive summary: Avoiding complacency in a strong 2025 US economy

Since April 2022, our publications have argued for a soft landing (see here or here or here). Now that the narrative has swung from “inevitable recession” to “remarkable resilience” we ask: is undue pessimism giving way to undue complacency?

We approach the question of complacency by asking and answering 25 critical questions about the 2025 economy, most of which we hear articulated in boardrooms across all sectors:

- **Labor market:** We expect the labor market to hold up and the already well-advanced soft landing to complete, as inflation will remain in check and policy rates will return to near neutral.
- **Consumers:** The often-told story of the brittle consumer will continue to be wrong. Consumers are able to spend but unwilling to do so where they don't see value. Price competition has returned to convince buyers of value proposition.
- **Monetary policy:** Easier policy is not easy policy—it will remain restrictive in 2025. And long rates will not follow short rates sharply lower. But an economy that has digested restrictively high rates will take easier if still-high rates in stride.
- **Shocks:** Always have the potential to disrupt and large ones the ability to end the cycle. Yet for many shocks—stock market reset, a tariff surge, geopolitics, banking disruption, and more—the bar remains high to deliver a downturn.
- **Risk and opportunity:** Simple recession “indicators” will continue to perform poorly. Think about upside as creatively as downside. 2025 is shaping up to be an economy were consumers, firms, and policymakers all can win.

All told, though we’re reticent about consensus newly siding with our optimism, we find little fault with an economy that has both cyclical and structural strength. A continued expansion remains by far the most likely outcome in 2025.

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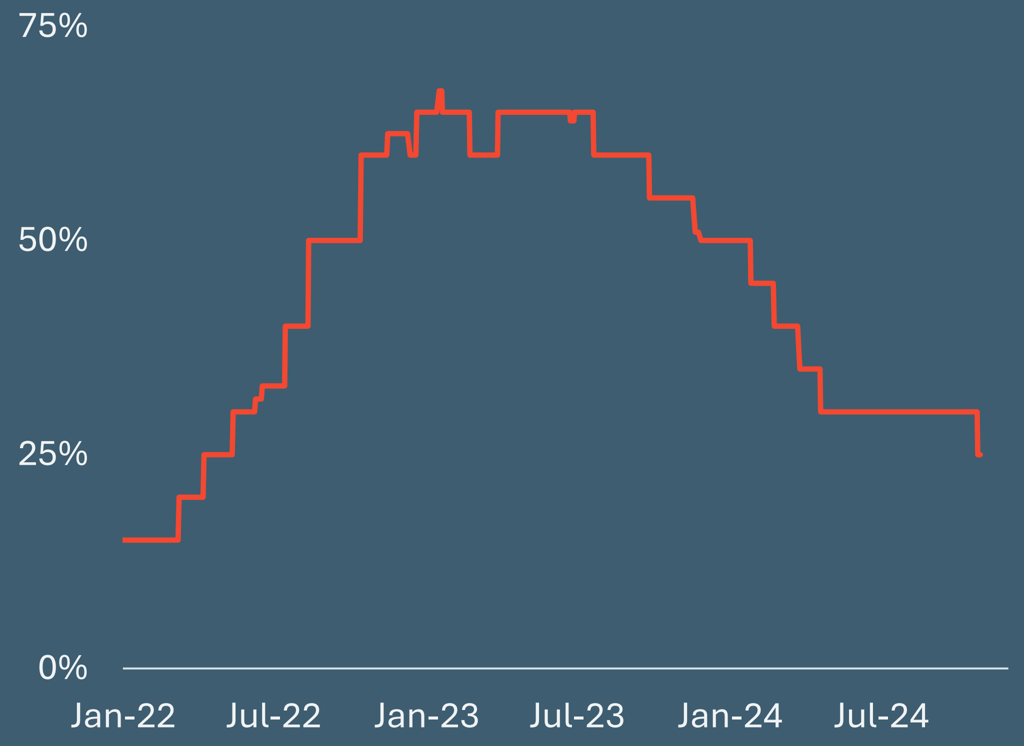
Has undue pessimism for an "inevitable" recession in 2024...

Consensus roundtrip to imaginary recession

Probability of recession (next 12 months)

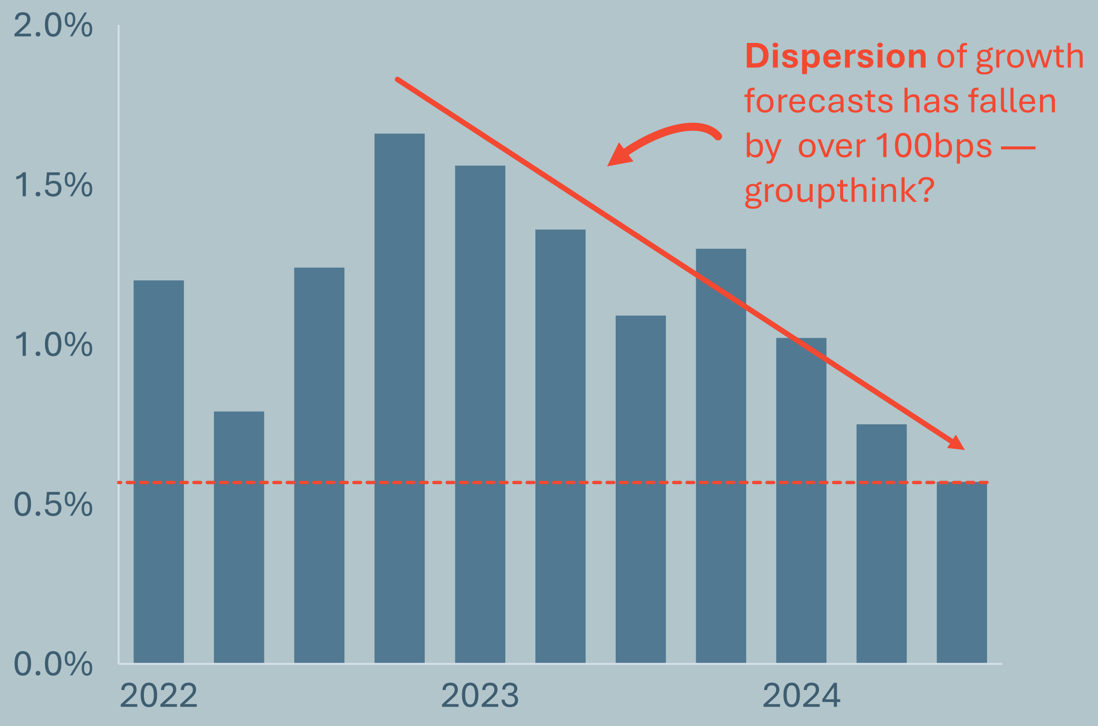


Note: Data through 10/28/2024. Median calculated from Bloomberg's survey of economists.
Source: Bloomberg, BCG Center for Macroeconomics

...given way to undue complacency for growth in 2025?

Now, narrowest dispersion of forecasts in years

Dispersion of one year ahead real GDP growth



Note: Data through Q3 2024. This dispersion measure is the percent difference between the 75th percentile and the 25th percentile of the projections in levels.
Source: Federal Reserve Bank of Philadelphia, BCG Center for Macroeconomics

Elections matter... so why does it get short shrift here?

Elections matter—full stop. Yet when we talk about the macroeconomy we need to be careful about assumptions often made in this regard.

The outcome of an election will have **myriad idiosyncratic and microeconomic impacts**—shifts in government spending and investment, different stances on M&A or regulation, and foreign policy decisions that can impact business and entire sectors.

But in aggregate, the macroeconomy is more likely to **shrug at the presidential election** than see wild gyrations. Most parts of the economy will be unaffected by the election outcome (think consumer spending) and where there is impact the net impact of change is likely to leave modest aggregate effects

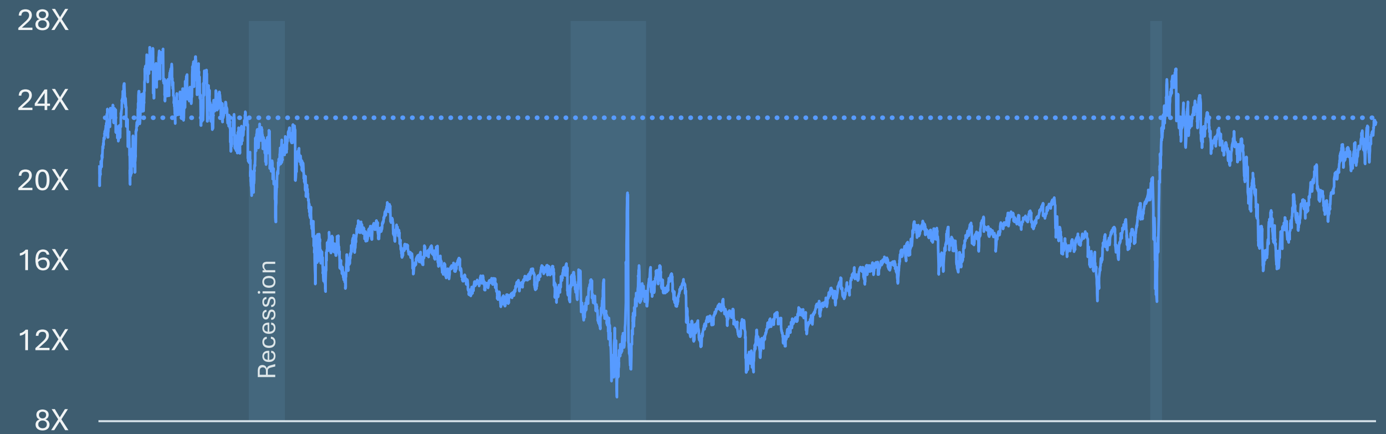
As shown on the right, **markets share this view**. 1-year forward equity valuations signal enormous confidence about the outlook—not despair—in the face of a close election. The same can be said about corporate spreads that do not signal election fears.

As we have argued before (and revisit in this document briefly), the **political system of the US is set up precisely to prevent wild gyrations**. It takes significant political capital to effect more than incremental change through legislation. The majorities required for big changes rarely come along and, if attained, are built over multiple electoral cycles.

Ours is a **macroeconomic (aggregate) view**. It is cognizant of the election, but it views the 2025 outlook as largely independent of it.

High equity valuations don't suggest big election downside

Price-to-earnings ratio for S&P 500 (1-year forward)



And low credit spreads show no pricing of election overhang

Corporate high yield bond option-adjusted spread (pct. pts.)

Note: Data through 10/28/2024. Spread is for average for Bloomberg Corporate High Yield Average Index.
Source: Bloomberg, BCG Center for Macroeconomics

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25 questions for 2025

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Labor Market
Gracefully cooling but fundamentally strong

Consumer
No signs of cracking and a continued tailwind to growth

Monetary Policy
Easing, not easy, with high rates here to stay

Shocks
Always lurking—but a high bar to deliver recession

Risk and opportunity
Consider recession risk, but also upside of tight economy

The labor market remains a critical proxy for the economy's health: if it holds, so will the cycle. The labor market has cooled successfully and at this point any more cooling is unwelcome. We see continued labor market health as possible and even likely as growth is still broad-based. With the labor market intact, and inflation contained, only the policy rate is left to return to near neutral for the soft landing to be completed. Meanwhile, higher wage growth can persist because better productivity growth makes it affordable. If this happens, the economy may deliver a win-win-win (for workers, firms, and policymakers) in 2025.

Q: Once the unemployment rate is rising, why would it stop?

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A: Recent rise is about supply

The rise in the unemployment rate has triggered the blinking lights of many recession dashboards. Historically, whenever the unemployment rate has risen as much as it has recently, it always rose further and delivered a recession.

Can today be different?

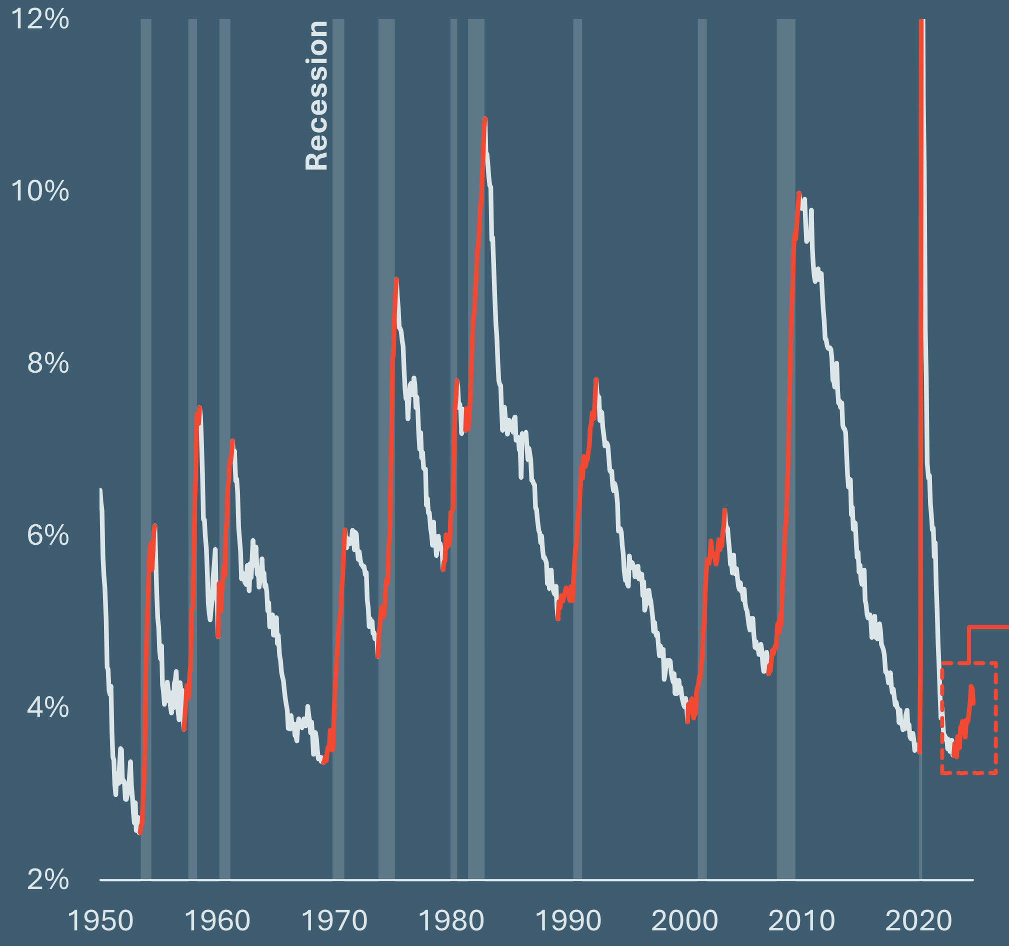
Yes. Consider that the recent rise in unemployment was driven entirely by supply, not demand.

- **Labor supply is the driver:** the number of people looking for work has increased, coming from immigration as well as strong participation. This accounts fully for the rise in unemployment rate.
- **Labor demand:** the number of new jobs continues to grow even if at a more modest pace.

A recessionary rise in the unemployment rate must be driven by net layoffs rather than solely greater labor supply.

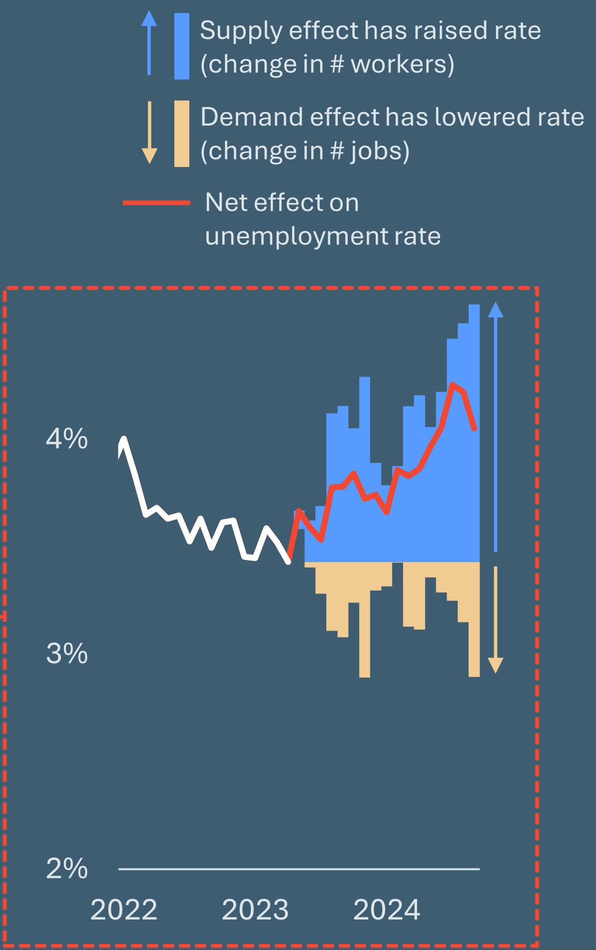
Historically, rising unemployment leads into recession

Red = cyclical uptick trough-to-peak



But the drivers matter

Red = uptick since April 2023 trough



Note: Data through 9/2024.
Source: BLS, BCG Center for Macroeconomics

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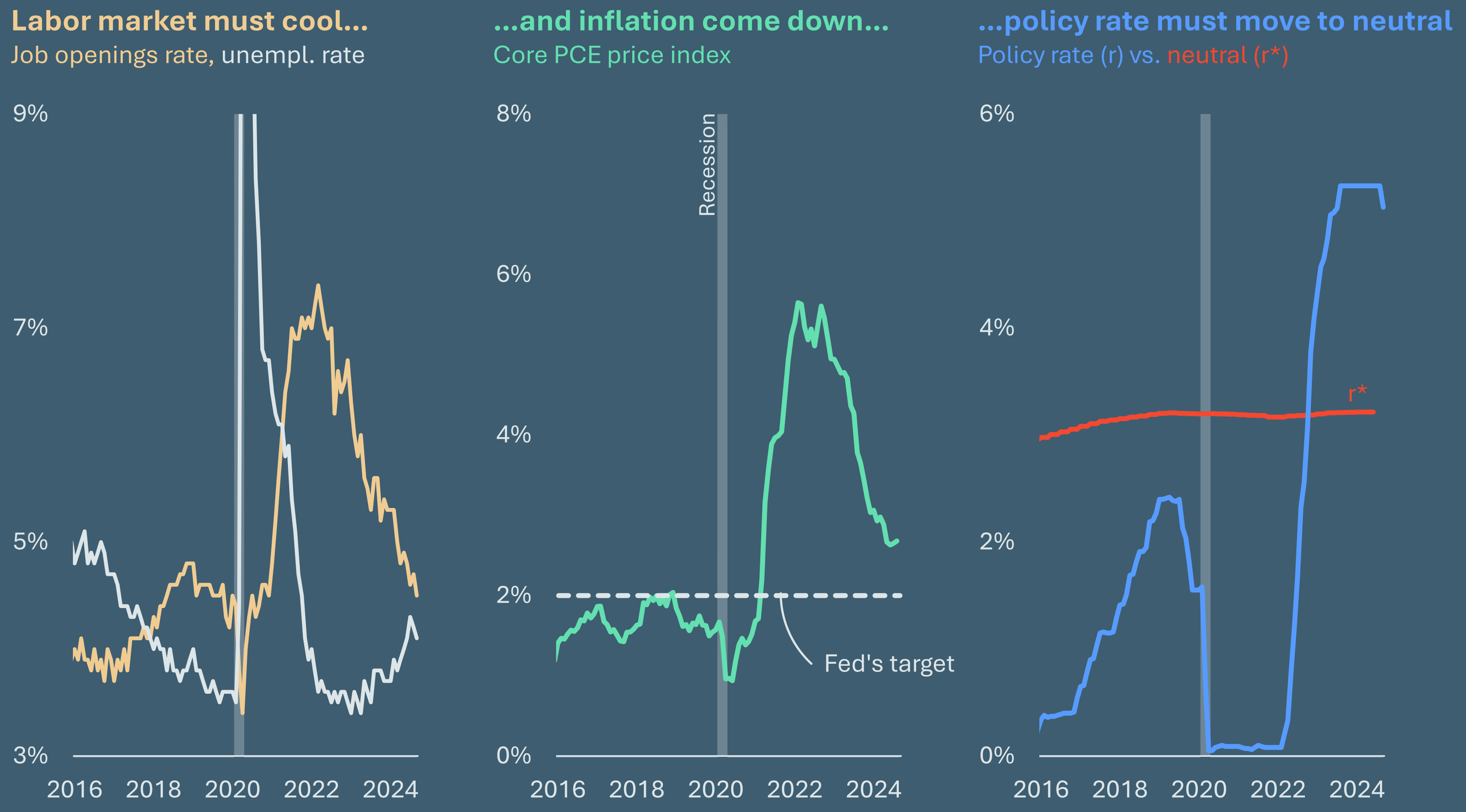
A: We're in the third, and final, stage

Debate over whether the US economy will have a soft landing continues unabated. In reality, the soft landing is well advanced, and the economy is in the third of three stages:

1) **Labor market must ease gracefully.** This has happened – the overheated labor market has cooled without a recessionary increase in the unemployment rate.
2) **Inflation must fall near policy target.** This has also happened – even if inflation remains somewhat above target. We don't need inflation to be downwardly biased like in the 2010s to achieve a soft landing.
3) **Policy rate must fall to near neutral.** This has just begun and looks likely to make a journey close enough to neutral that a soft landing should be seen as complete by the end of 2025.

We are well into what looks like a successful soft landing.

3 Stages of soft landing:



Note: Data through 9/2024 (inflation through 8/2024). r* = Laubach-Williams 2-sided smoothed model estimate + 2% (to put in nominal space).
Source: BLS, BEA, Federal Reserve, BCG Center for Macroeconomics

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Q: Are a few load-bearing sectors holding up the economy?

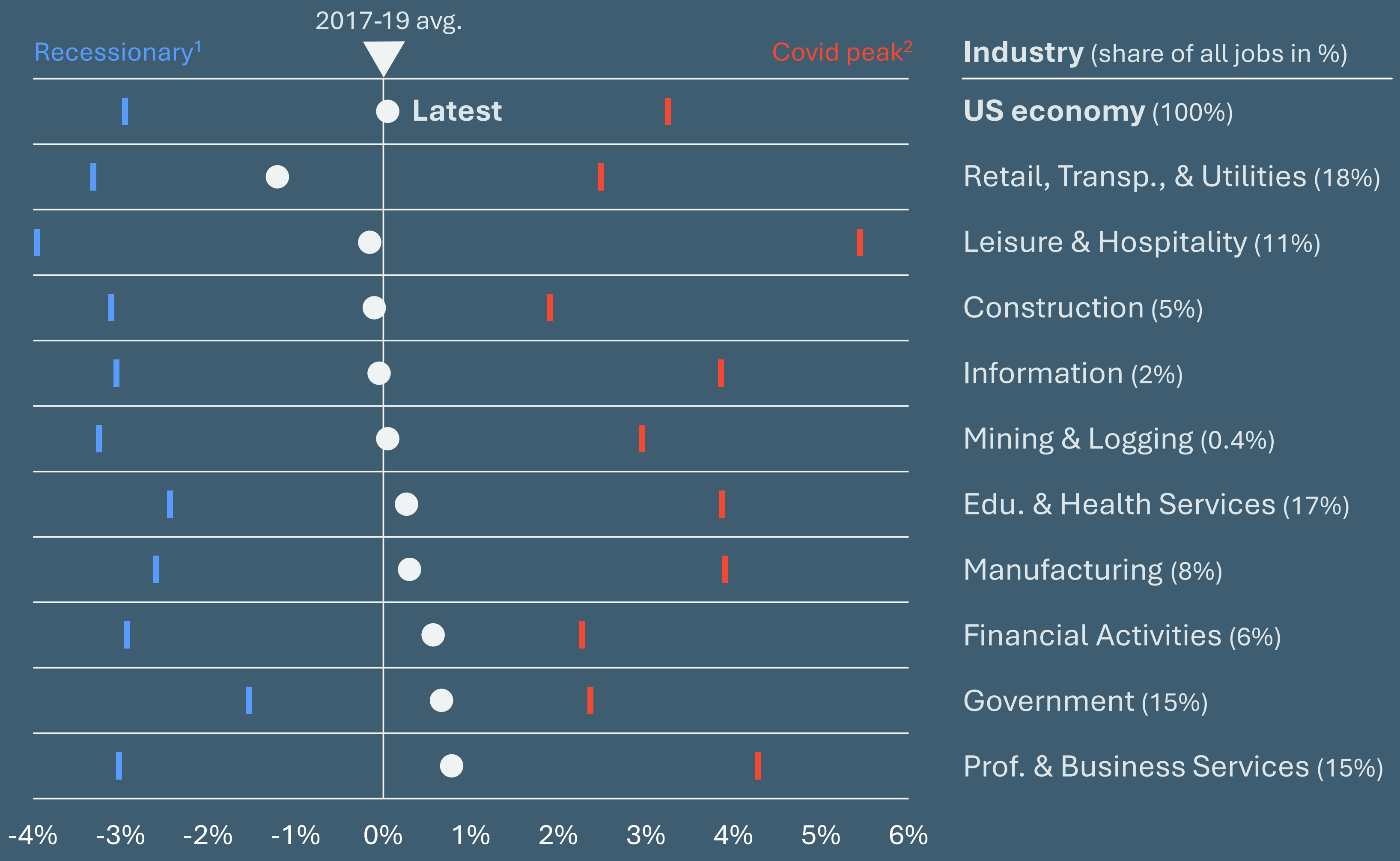
A: No, strength is broad-based

Fears about the economy are often expressed in terms of a "rolling recession" or the idea that strength in a few places is covering up many areas of weakness. Yet looking across the economy we see a consistent picture of a soft landing, not pockets of strength offsetting recessionary weakness:

- **Broad strength:** 6 out of 10 industries have more job openings than they did during 2017-19 – which was also a strong labor market.
- **Large sectors' strength:** While one large sector (retail, 18% of jobs) is weak – others including business services (15%), government (15%), and education and health (17%) are strong.
- **Nothing near recession:** And no sector is anywhere near recessionary levels.

Even as there are some areas of modest weakness, the breadth of labor market strength continues to be a reserve the economy can draw on.

Jobs openings remain strong across sectors (relative to 2017-19 average)



Note: Pct.-pt. differences. Latest is 9/2024. Sector employment shares do not sum to 100% due to rounding. 1) 2008-09 minimum. 2) Calculated between 2020-22.
Source: BLS, BCG Center for Macroeconomics

Q: Is still-high wage growth a risk to the economy?

A: No, it's sustainable

Though wage growth has fallen, it is still well above pre-pandemic levels, around 4%. Often cited as a major risk, the economy can in fact digest such higher wage levels.

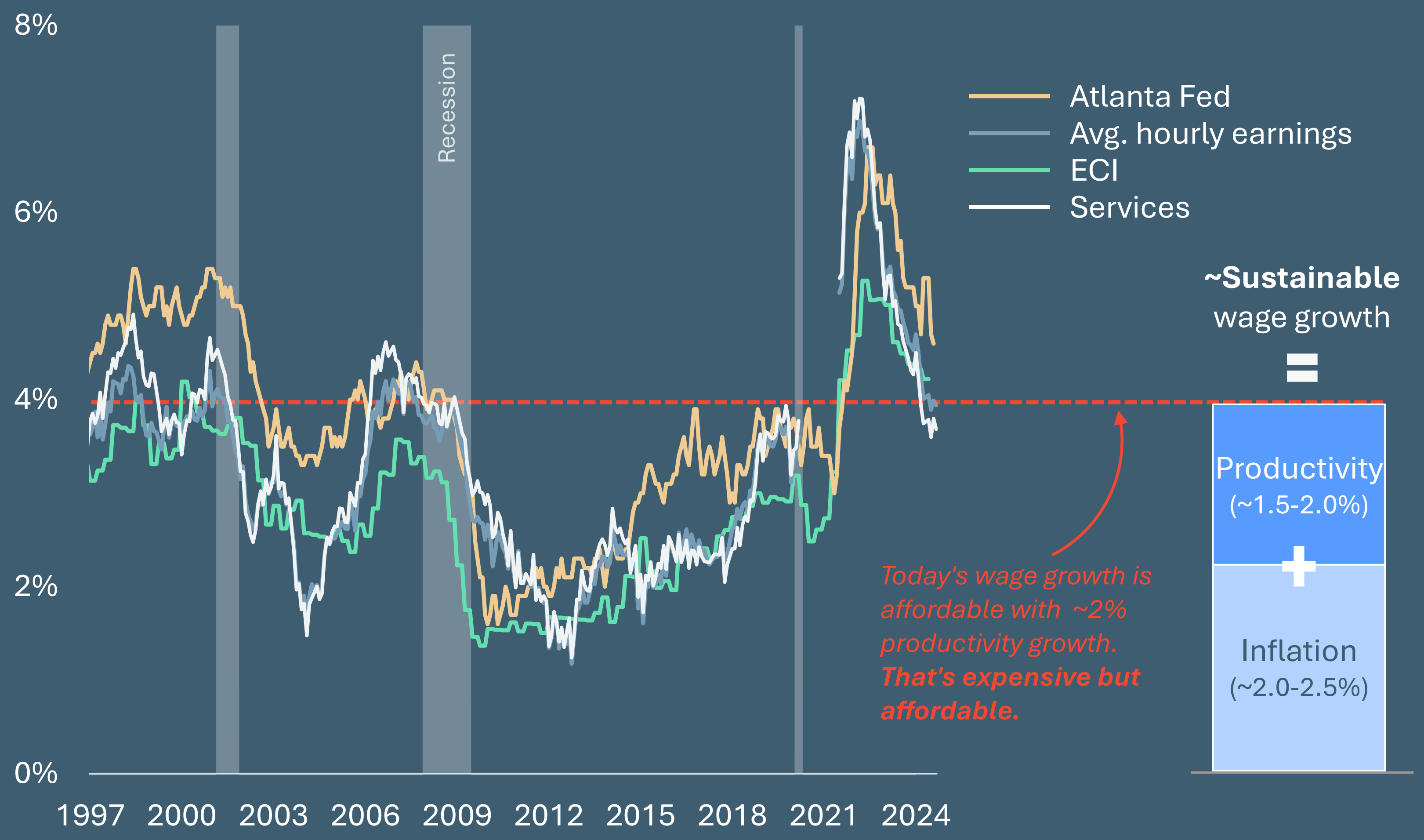
Two sources make wage growth around 4% sustainable for firms:

- **Price growth:** Some part of nominal wage growth can be passed on as price increases—in today's environment that could be around 2-2.5% inflation.
- **Labor productivity growth:** Some portion of nominal wage growth can be paid for through efficiencies—in today's environment around 1.5-2% is realistic

On net, this suggests that nominal wage growth near 4% is sustainable and doesn't threaten to drive an acceleration in inflation that would force monetary policy to once again throw on the economic brakes.

Wage growth has cooled enough to not threaten the economy with inflationary pressures

Nominal wage growth (year-over-year)



Note: Data through 9/2024 (Services and average hourly earnings); 8/2024 (Atlanta Fed, 3-month moving avg., as reported); Q2 2024 (Employed Cost Index). Excludes 4/2020-6/2021 for average hourly earnings due to base effects from Covid.
Source: BEA, BLS, FRB of Atlanta, BCG Center for Macroeconomics

Q: Is productivity higher—and why?

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A: Yes, thanks to labor tightness

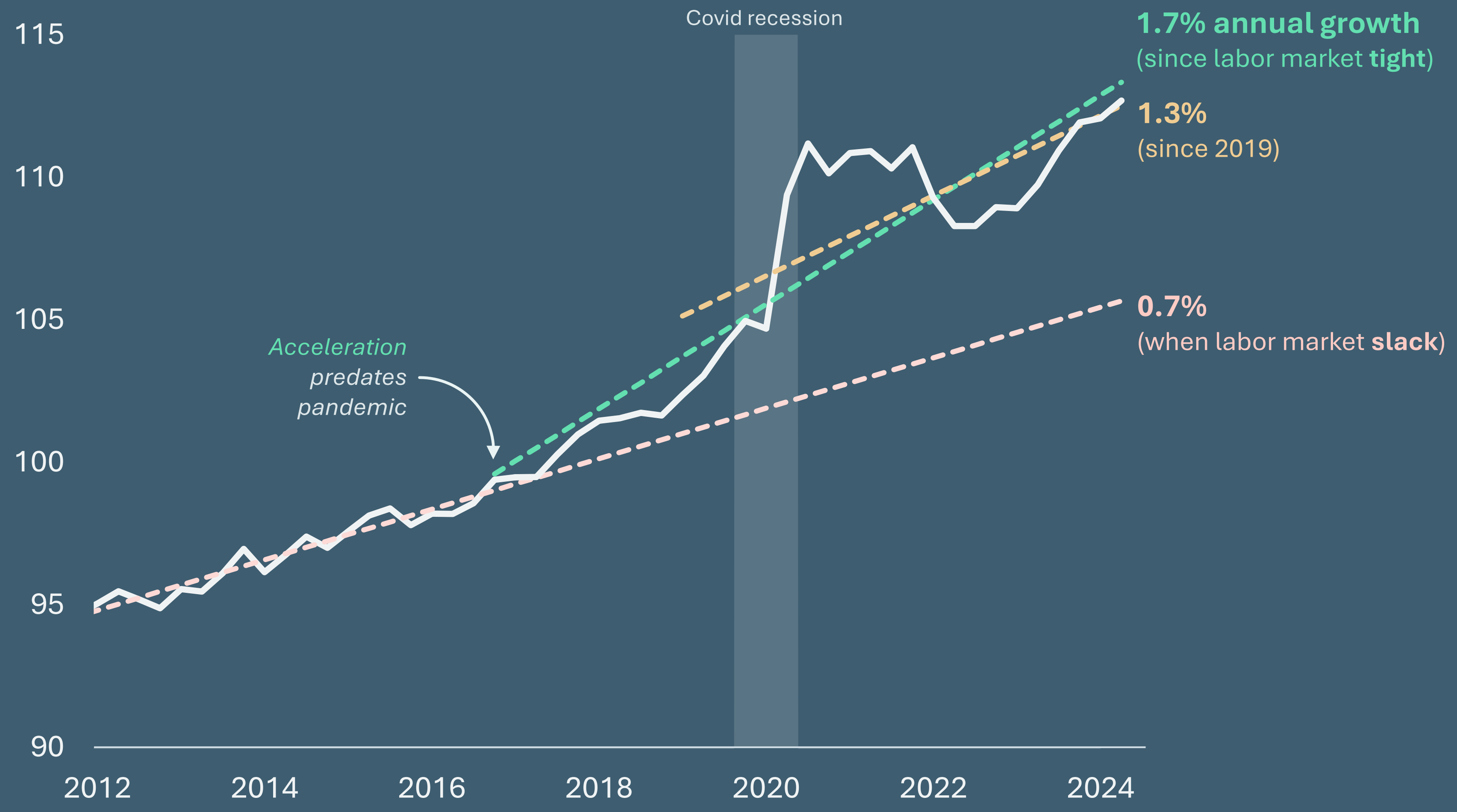
Productivity growth has accelerated but it's too simplistic to ascribe this to tech or Covid gyrations. In fact, it is driven by labor market tightness that started in 2017 – a structural not cyclical force that we expect to continue to underpin the economy.

- **Tightness spurred productivity upshift:** Productivity accelerated by 100bps since 2017 when the labor market became tight. When firms are unable to simply hire more workers and they become more expensive, they invest and transform production – and that has delivered productivity.
- **Missing tech and Covid productivity boost:** Too often productivity is ascribed to the adoption of new technologies. Yet the gyrations of Covid have coincided with slower productivity growth than the 2017 trend when labor turned tight.

Expect stronger productivity growth – remember, technology is just the fuel; labor market tightness is the spark

Productivity growth accelerated with tight labor market, not Covid

Business sector real output per hour (2017 = 100)



Note: Labor market "tight" defined as unemployment rate (u) <= estimated neutral/noncyclical rate of unemployment (u*). Based on these measures, the labor market became tight in 2017. Data through Q2 2024.
Source: BLS, BCG Center for Macroeconomics

25 questions for 2025

Labor Market
Gracefully cooling but fundamentally strong

Consumer

No signs of cracking and a continued tailwind to growth

A strong labor market has underpinned strong consumption, but many consumers feel strained. This was in large part driven by broad real wage cuts that hit household budgets as inflation ran ahead of wages. But today consumers have made up that ground as wages grow faster than prices – and wages have now risen by more than prices since 2019. Consumers self-report significant strain but their spending behavior suggests continued strength; where they are hesitant is more about willingness than ability to spend. They will spend where they see value-for-money, and they are supported by strong balance sheets. Expect the consumer to keep fueling growth in 2025.

Monetary Policy
Easing, not easy, with high rates here to stay

Shocks
Always lurking—but a high bar to deliver recession

Risk and opportunity
Consider recession risk, but also upside of tight economy

Q: Is the consumer still spending?

A: Yes, robustly so

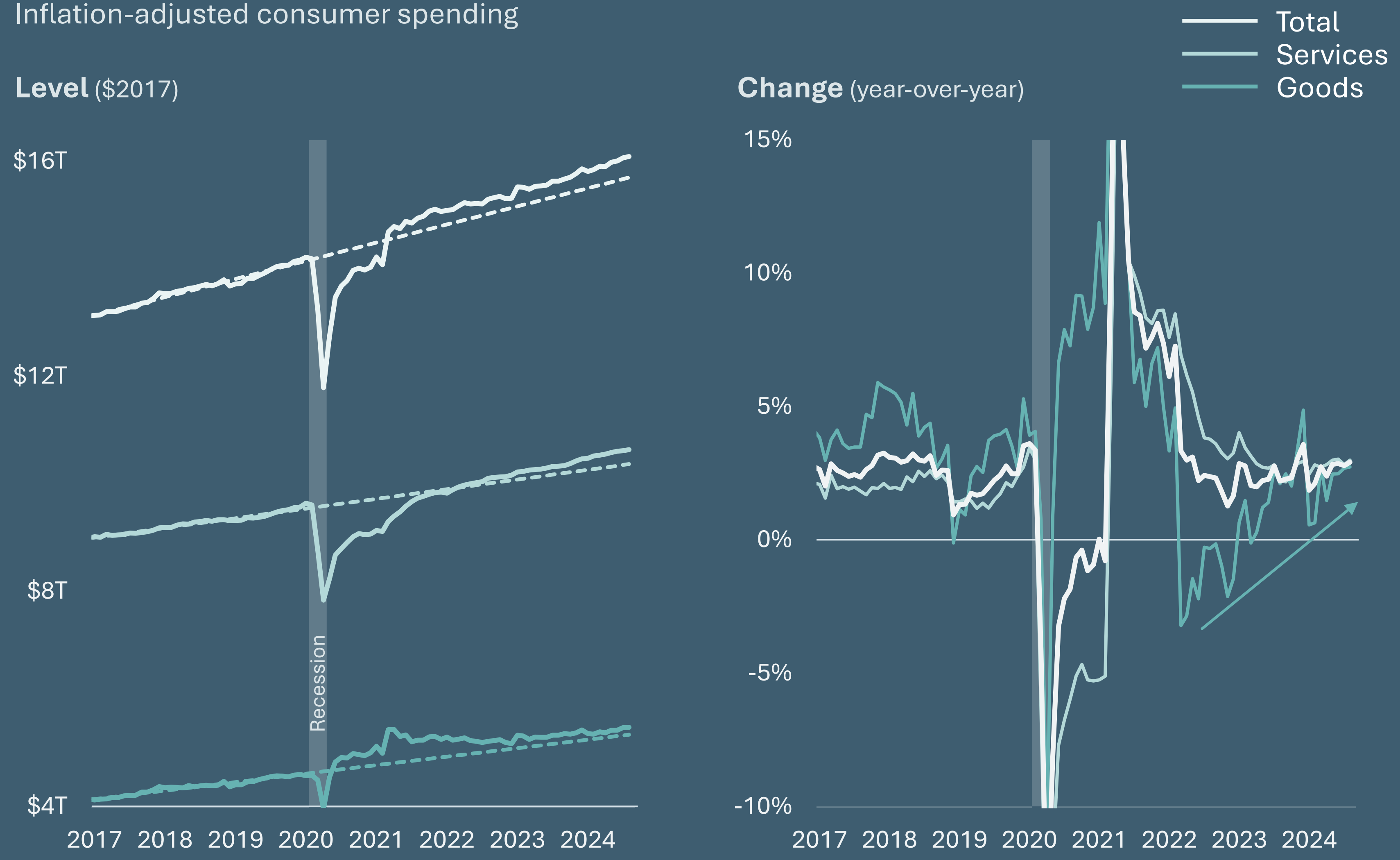
Despite headlines of consumers that are weak and near a breaking point, the evidence from real spending suggests that consumers are willing and able to spend. Not only did they deliver a full and rapid recovery after the shock of Covid, but they also drove an overshoot that has persisted with strong growth over the past few years.

- **Total**: Consumption's full and fast recovery has persisted, delivering demand at a stronger level than implied by its pre-Covid trend.
- **Goods**: Goods demand fueled a faster recovery, but then softened as the overshoot was digested – yet today growth has clearly resumed.
- **Services**: Service demand recovered slowly but sustained, strong growth has pushed it comfortably above trend.

Today there are few signs the consumer is slowing down – and given its weight it suggests the economy will continue to grow.

First goods, then services drove consumer spending – now both

Inflation-adjusted consumer spending



Note: For personal consumption expenditures. Data through 8/2024. Trendlines = 2016-19 linear regression.
Source: BEA, BCG Center for Macroeconomics

Q: Why should we trust that the consumer won't fold?

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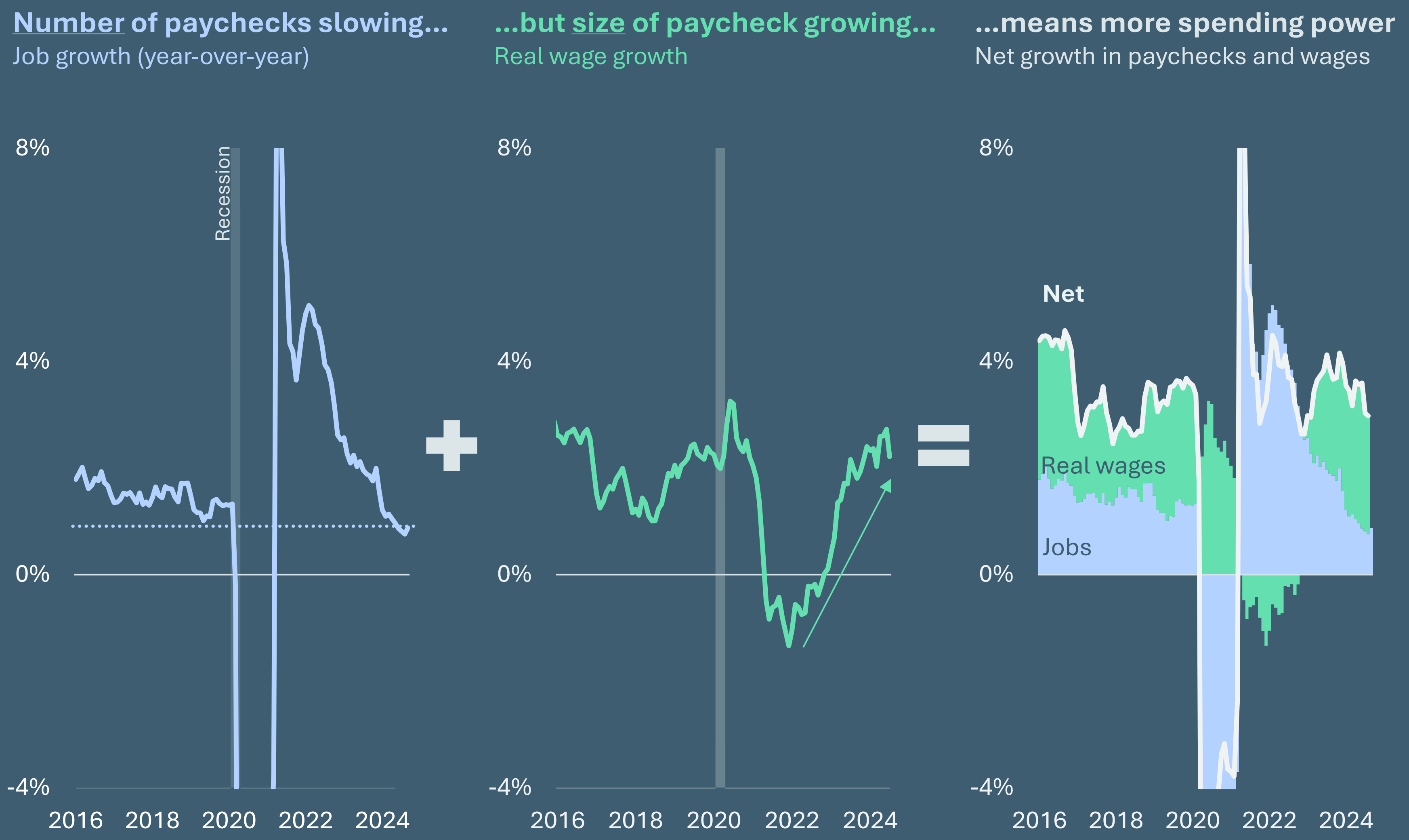
A: Strong real wage growth

Aggregate spending power continues to grow at a healthy pace – but the composition of that spending power has shifted in significant ways. The main source of spending power has passed from new job creation to real wage growth:

- **Number of paychecks:** job creation accounted for the entirety of the increase in spending power in 2022. That pace of hiring was not sustainable and has cooled since.
- **Size of paycheck:** The return of real wage growth has taken over from job creation as a driver of spending power. As inflation dropped below wage growth, real wages have surged.

While the growth rate of spending power has remained constant, the composition of spending power has improved by shifting to real wage growth. **It provides a comfortable backdrop to consumption.**



Note: Data through 8/2024 (9/2024 for jobs). Job growth is average of Household and Establishment surveys' growth, due to recent divergence.
Source: BEA, BCG Center for Macroeconomics

Q: Aren't consumers underwater from higher prices?

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A: No, price afforda-bility is up

Public discourse on the consumer has been too one-sided, focusing only on the rise in prices and resulting in far too-negative portrayals of price affordability. A sober look at the evidence differentiates between three angles:

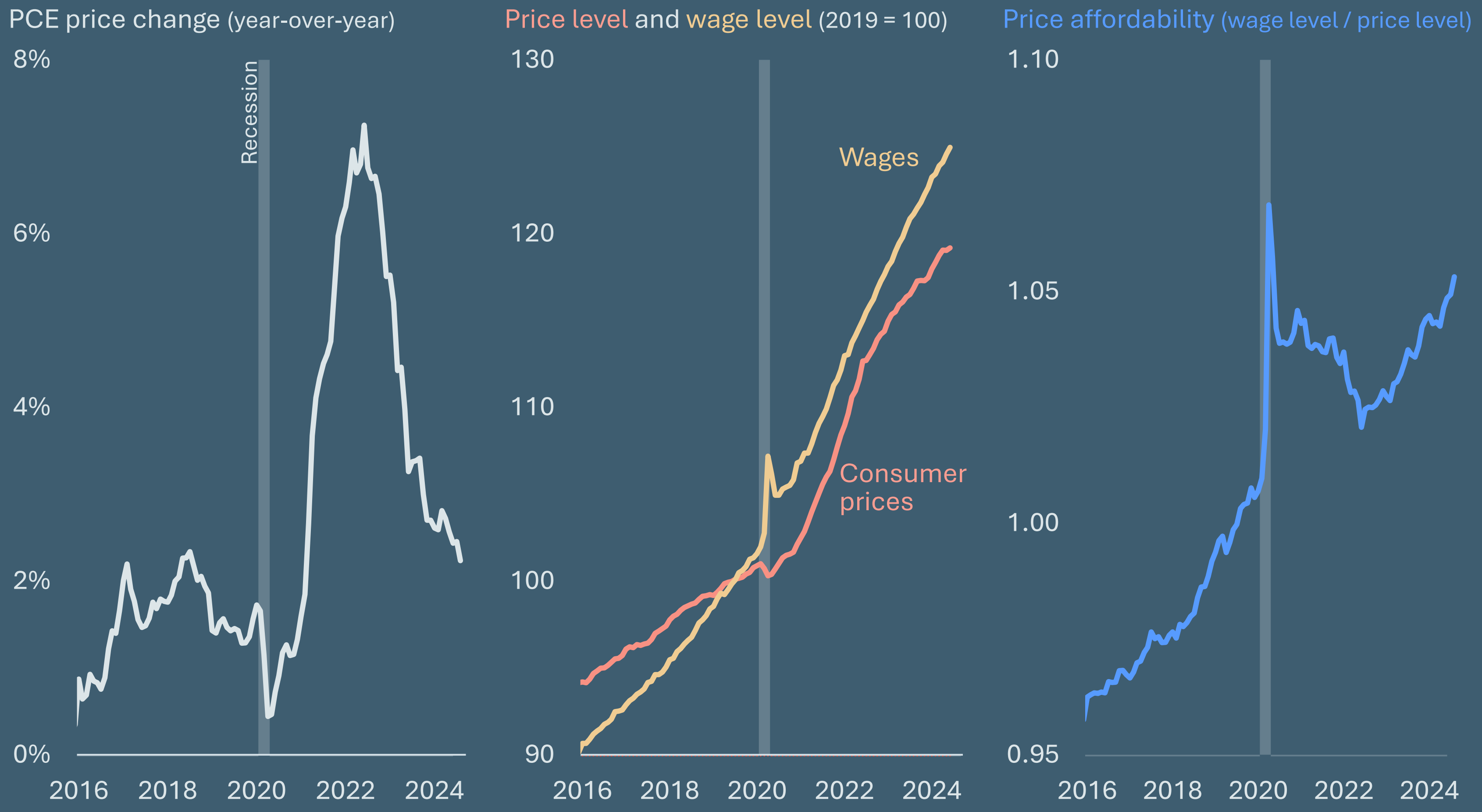
- **Price change (aka inflation):** Inflation is a rate of change that has slowed significantly.
- **Price level and wage level:** Slower inflation means prices rise more slowly; it does not mean they fall. But the affordability of higher prices is a matter of the wage level—which has increased by more than the price level since 2019 (25% vs. 20%).
- **Price affordability:** Real spending power has grown materially: it's about 5% higher than 2019, which helps explains why consumption has remained robust.

It is worth noting that beneath the aggregate there will be **those who have seen weaker wage growth than shown and those with faster wage growth**.

Price growth (aka inflation is down)

Price level up—but so are wages

Price affordability is strong and rising



Note: Data through 8/2024 (through 9/2024 for wages).
Source: BLS, BEA, BCG Center for Macroeconomics

Q: How brittle are the consumer's finances?

A: Not brittle, but strong

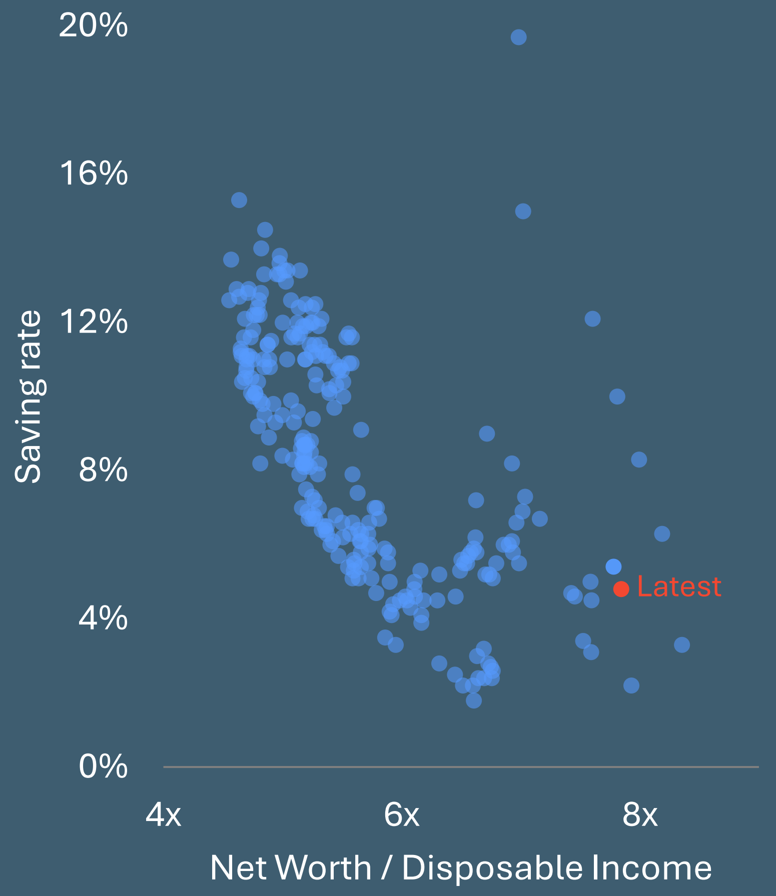
Low savings rates are often taken to indicate that consumers are unable to save or that they are living profligately. Either way, many see low rates as a sign of consumer brittleness that will soon reveal itself in the macroeconomy. Yet neither is true – the consumer is strong.

- **Balance sheets** have rarely been healthier in aggregate. Fueled by soaring home prices and lofty equity valuations, net worth to income ratios are near record highs. It is not that households are unable to save; rather, they don't think they need to as they are comfortable with their wealth.
- **Distributional perspective:** Even if it were true that the weakest consumers are unusually strained (we don't agree), their collective consumption footprint is too small to shape the cycle.

Consumer finances will continue to underpin economic strength.

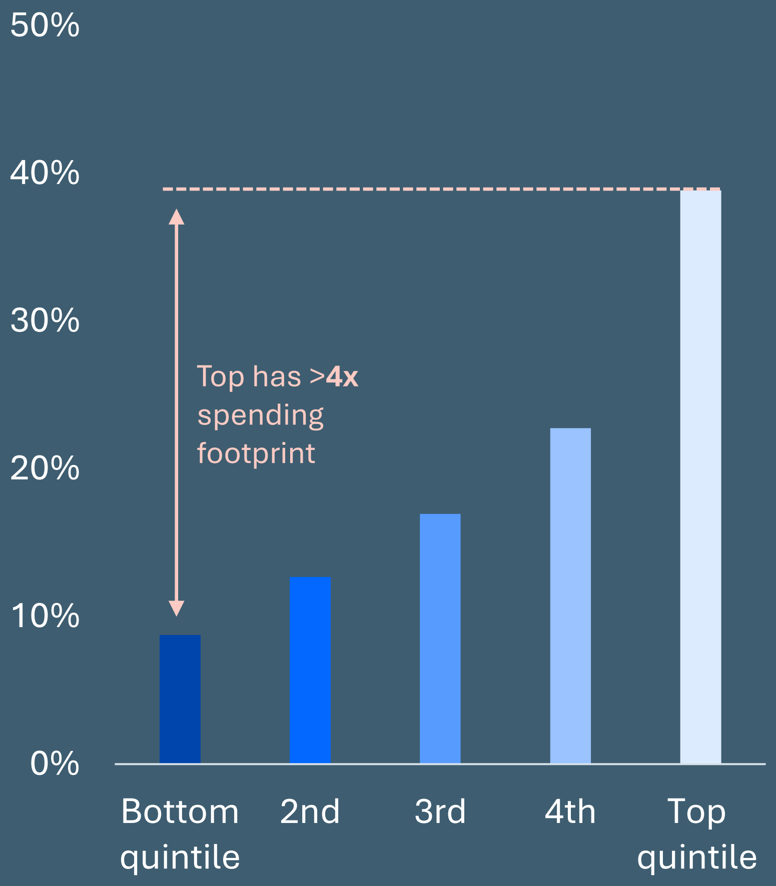
Savings rate may be low, but it's strong when put in context of wealth

Saving rate (y-axis) vs. Household wealth (x-axis)



Macroeconomic impact of bottom quintile limited by its smaller consumption footprint

Share of total U.S. consumer spending



Note: Data (left) from 1960 through Q2 2024 (uses latest—8/2024—savings rate). Shares (right) are for 2023.
Source: BEA, Federal Reserve, BLS, BCG Center for Macroeconomics.

Q: What are consumers looking for?

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A: Good value-for-money

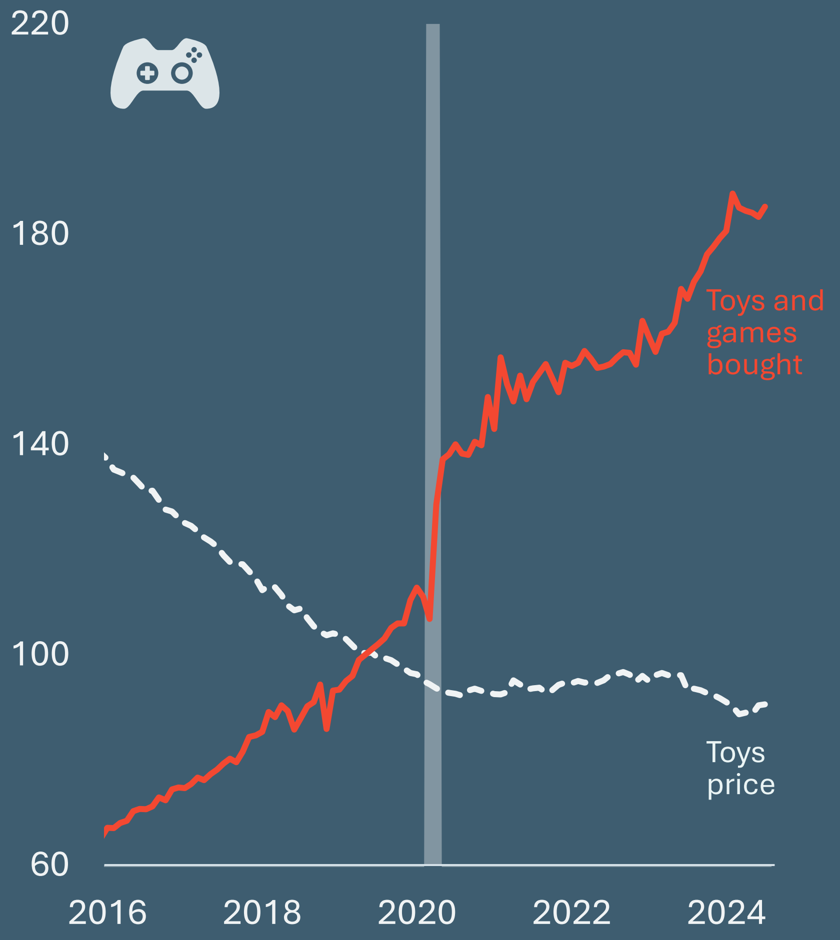
Public discourse continues to conflate consumer ability and willingness to spend. Put simply, too much price was taken, and now consumers want to see value-for-money. When they do, they spend, and when they don't, they pull back:

- **Groceries:** When grocery prices surged, consumers pulled in their spending and shifted it to food away from home or substituted down in value (e.g., generics). But when price growth stabilized (and when prices looked more attractive relative to eating out), grocery demand grew again.
- **Toys and games:** In contrast, toy demand never slumped as prices never rose materially. And even after a large pandemic upshift, when prices started to fall again, consumers saw more value and demand surged even more.

Consumers are not unable but often unwilling to spend where they don't see value-for-money.

When value deteriorated so did demand
Grocery prices and real spending (2019 = 100)

Good value-for-money has seen sustained growth
Toys and games prices and real spending (2019 = 100)



Note: Data through 8/2024. Prices and spending are personal consumption expenditures (PCE).
Source: BEA, BCG Center for Macroeconomics

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No signs of cracking and a continued tailwind to growth

Monetary Policy

Easing, not easy, with high rates here to stay

Monetary policy will ease but will not be easy in 2025 as the policy rate will stay above the neutral rate of interest. This will continue to exert a headwind on the economy. Neither do falling policy rates imply that long rates will fall: that is unlikely, as high long rates are consistent with underlying strength. This relatively tight stance of monetary policy is driven by a change in the underlying inflation bias, which is now upward rather than downward (pre-Covid). The real economy took restrictive rates in stride in recent years and will continue to do so as policy rates fall. The rate-sensitive housing market will not be undermined by structurally higher rates owing to low inventories.

Shocks
Always lurking—but a high bar to deliver recession

Risk and opportunity
Consider recession risk, but also upside of tight economy

Q: How much will monetary policy ease?

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A: Expect easier, but not easy, policy

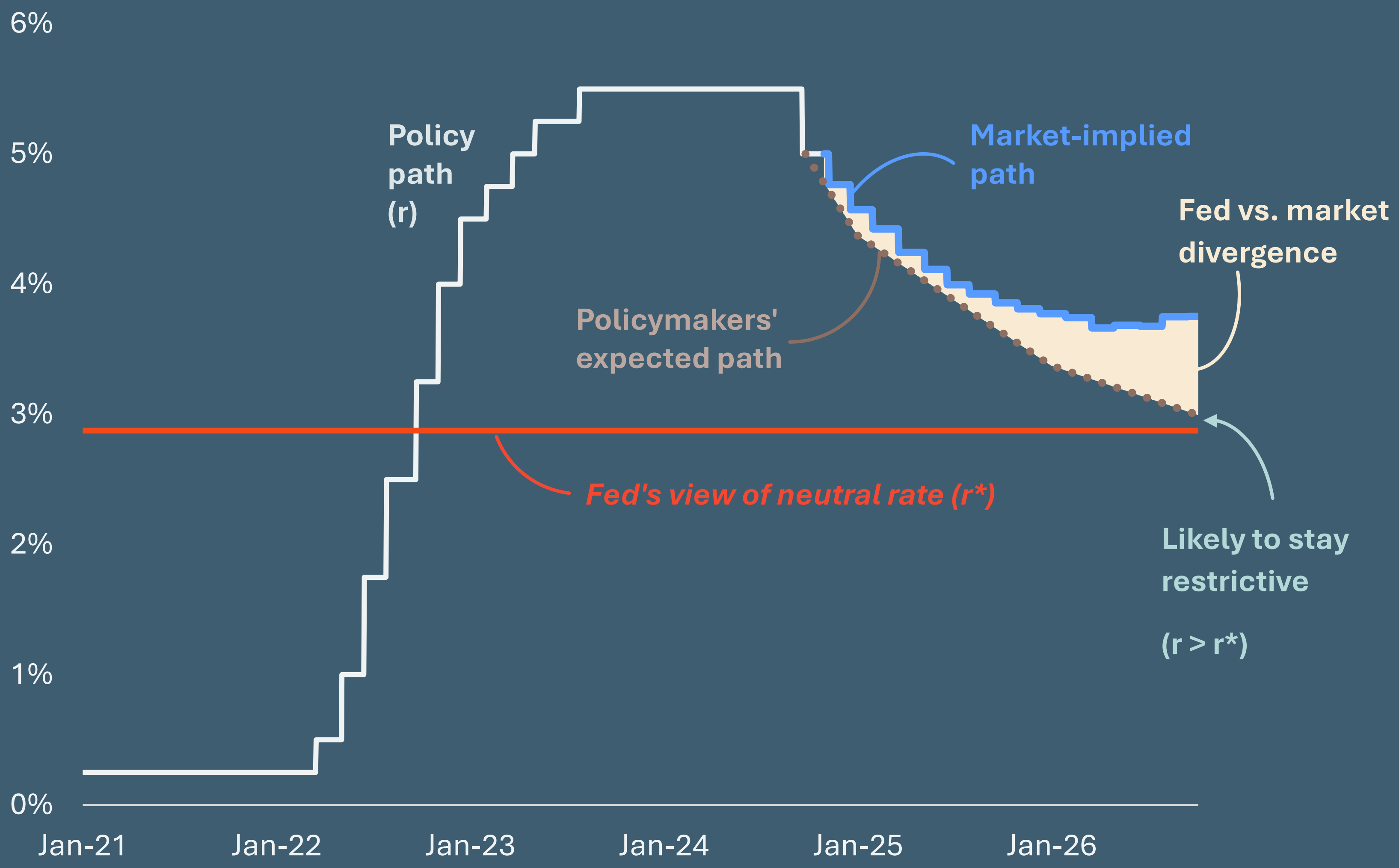
After rapidly moving higher to sharply restrictive territory, policy rates have started to fall. But don't conflate easier policy with easy policy. The direction of travel doesn't reveal the true policy stance:

- **Policy rate remains above r*:** Though falling, the policy rate will likely remain above r* (the "neutral" rate of interest) in 2025, meaning monetary policy continues to slow the economy. Easier is not the same as easy (below r*).
- **Uncertainty about r*:** Because r* can only be estimated, and only with difficulty, its precise level is uncertain. That means policymakers will move gradually, and if the economy remains strong, they will be hesitant to approach r* in 2025

Monetary policy is easing—but staying tight.

Monetary policy set to ease, but don't expect it to get easy

Monetary policy path and expectations going forward – relative to neutral rate (r*)



Note: Market estimate as of 10/30/2024 through 1/2027. Market-implied path takes into account a wide range of possibilities inside its 'average' – whereas policymakers' path is a modal expectation of the likeliest appropriate path.
Source: Bloomberg, BCG Center for Macroeconomics

Q: Will long rates follow short rates down?

A: Not likely

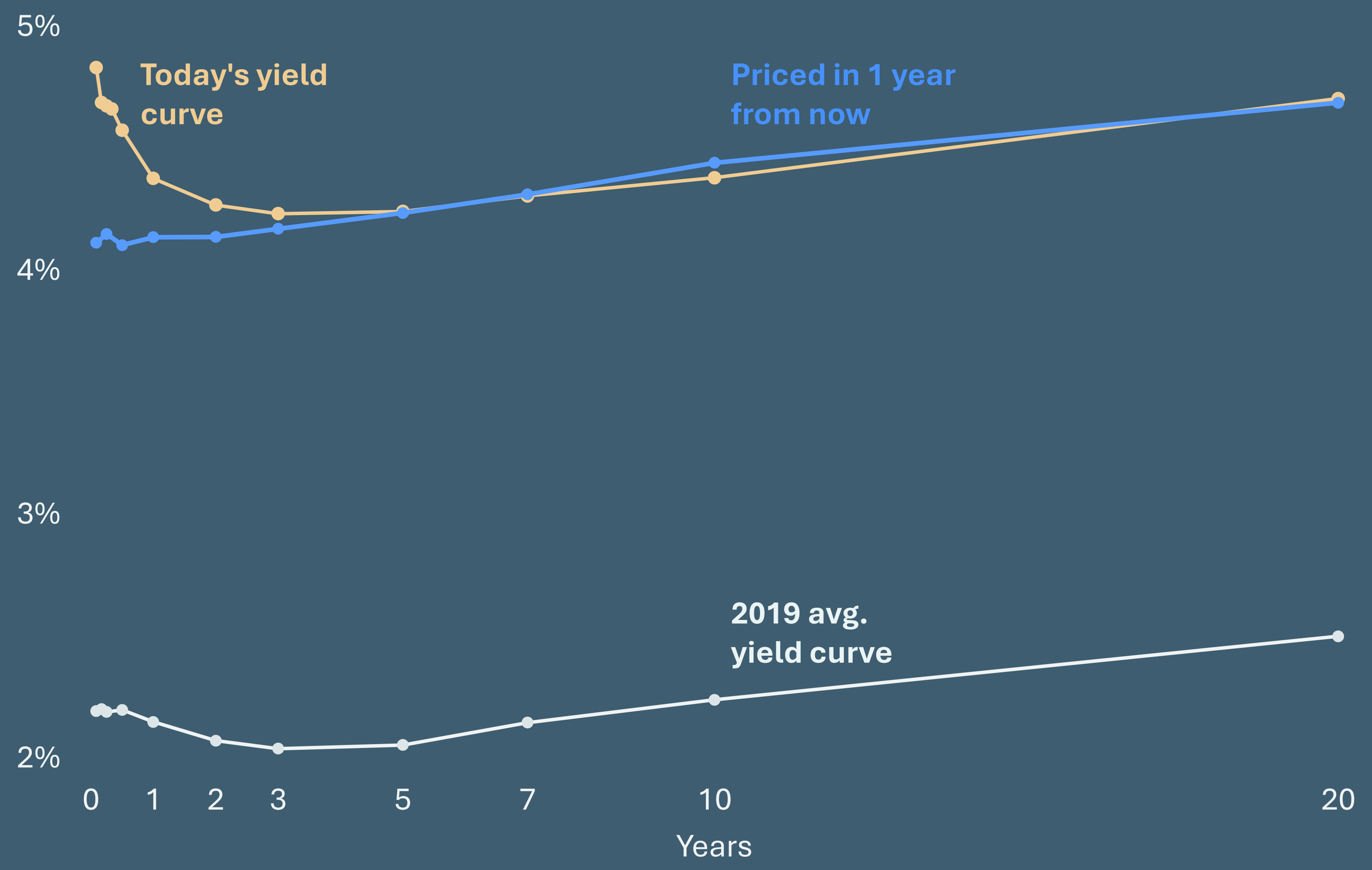
It is often assumed that when monetary policymakers lower interest rates, rates for longer-term debts such as mortgages will fall as well. But this is not always the case – and seems unlikely to be the case today.

- **Already priced in:** The path lower for short rates is already priced-in to long rates. So, unless rates move lower or faster than expected, they will not pull down long rates. This can be seen in the yield curve "Priced in 1 year from now" (blue line): short rates are much lower, but long rates are not.
- **Higher, but healthy:** That policy rates are falling reflects that inflation is down significantly. But as a healthy economy continues to deliver an upward bias for inflation and lowers the risk of recession, rates will remain far higher than in the past (white line, 2019 yield curve).

Long rates are unlikely to fall. **In fact, a strong economy is consistent with higher but healthy rates**

Short rates may be coming down, but don't expect long rates to follow

US Treasury yield curve today, a year ago, and in 2019



Note: Data as of 10/30/2024

Source: Bloomberg, Federal Reserve, BCG Center for Macroeconomics

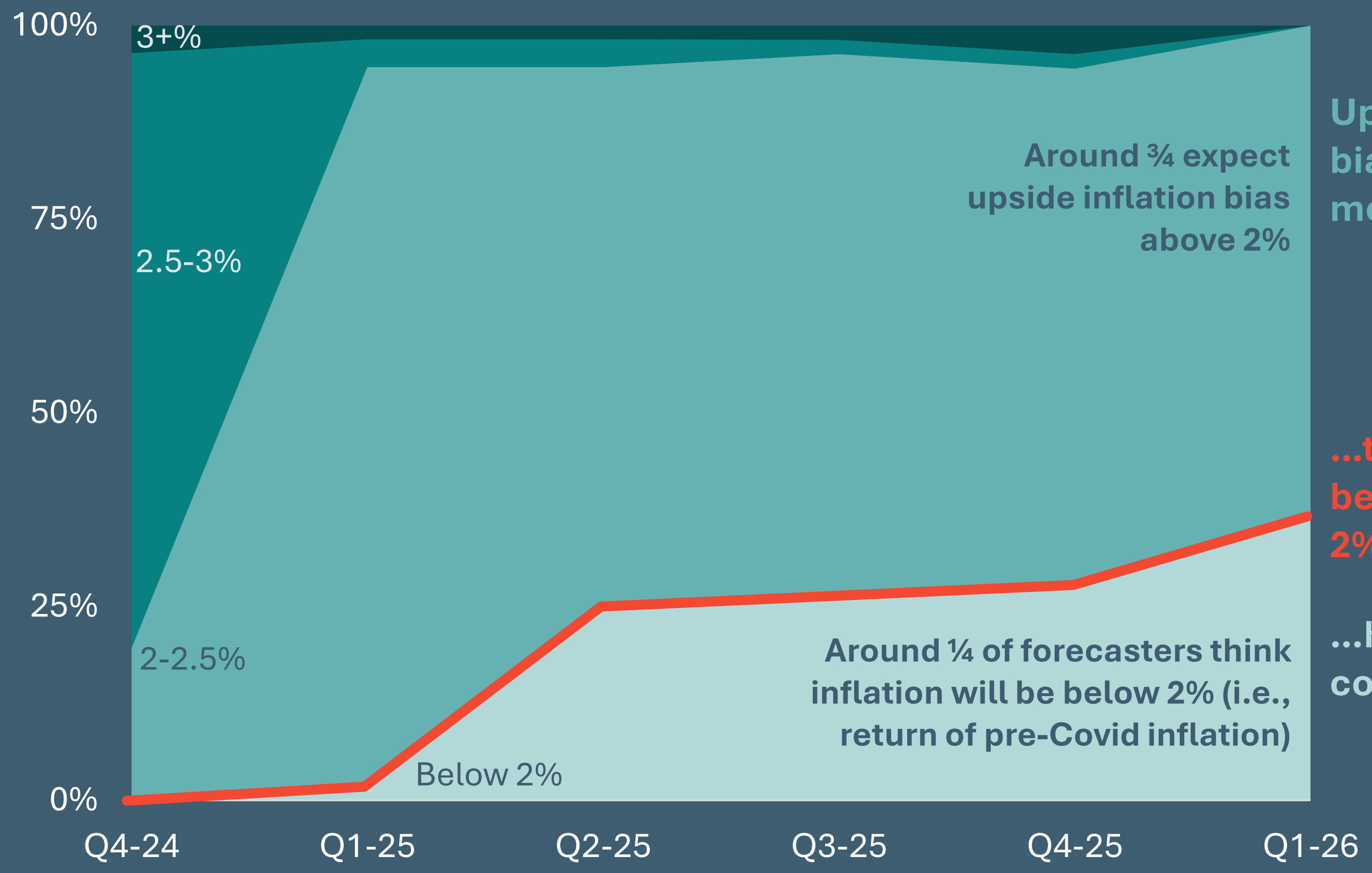
A: Yes, but nuance matters

Inflation has retreated from a multidecade high – enough that policymakers and markets have become more sanguine about inflation risk. More than 1 in 4 forecasters see inflation on a path below the policy target; the rest see it slightly above. This may seem like a small disagreement, but the consequences are significant.

- **Expect an upside bias**: Continued labor market tightness, structural investment demand, and higher inflation expectations all contribute to inflation that is more likely to remain above the policy target of 2% rather than living below as it did for much of the 2010s.
- **Upward bias forces more restrictive policy:** An upward bias matters for policymakers as they will need to be more vigilant against inflation. This implies that policy will be less quick to ease and more frequently a headwind to the economy. A stark difference from the 2010s.

Above or below 2%: small differences come with big consequences

Distribution of inflation forecasts across coming 6 quarters (Core PCE inflation)



Upside inflation bias may be modest, but...

...the divide between above 2% and below...

...has big consequences

Note: Results of up to 55 economists surveyed by Bloomberg. Last updated 10/16/2024.
Source: Bloomberg, Federal Reserve, BCG Center for Macroeconomics

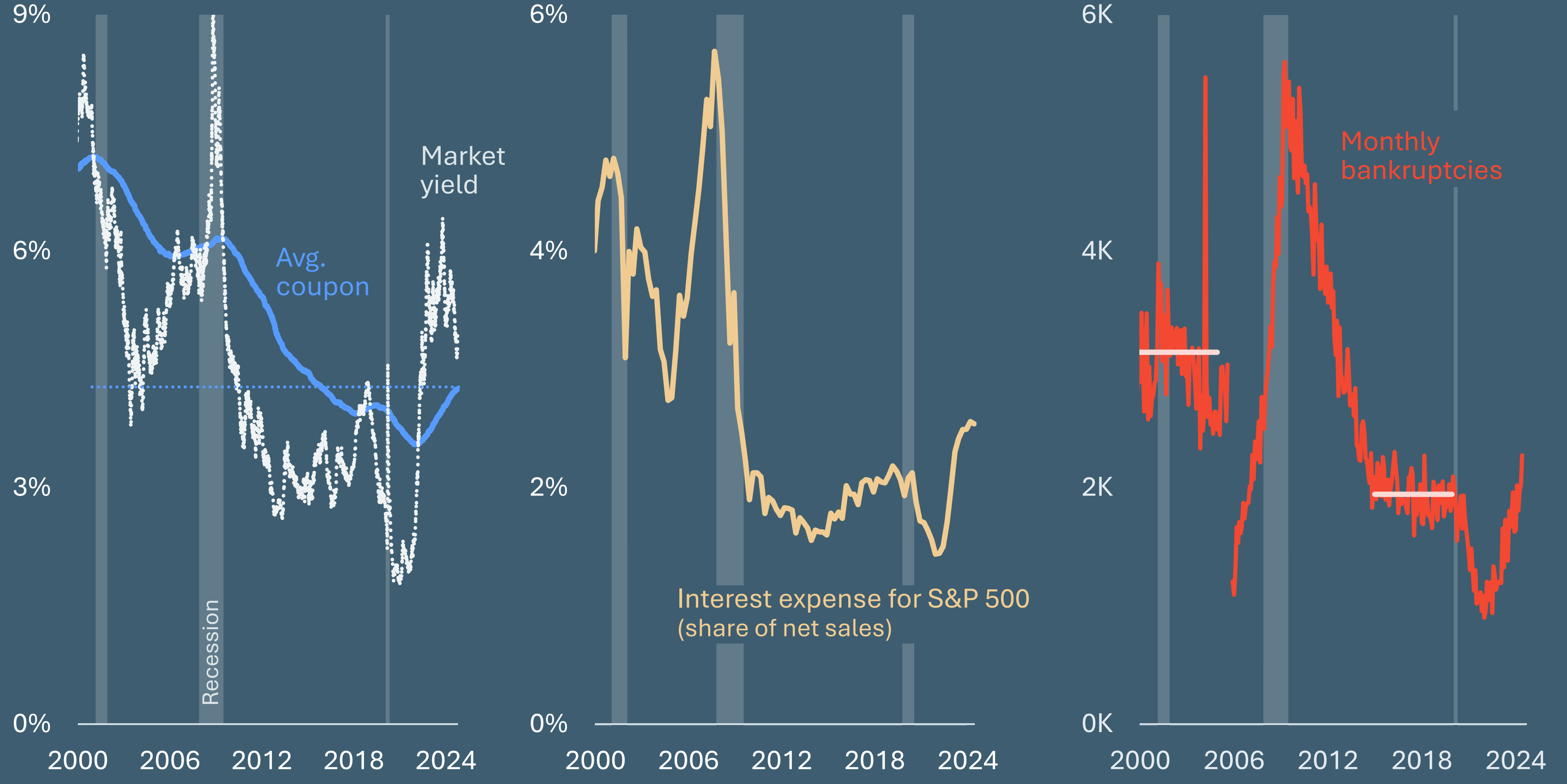
Q: If monetary policy works with a lag, won't higher rates still do harm?

A: For some, but not systemically

Many have pointed to lagged effects of higher rates, implying the economic damage from higher rates is not missing, it's just delayed. While some effects are lagged, they are unlikely to be a systemic risk.

- **Roll-over risk is real**: Many firms will continue to see their interest rate bill rise because their older debts with even lower coupons will roll over into higher coupon debt, even as rates fall.
- **Aggregate interest burdens are still modest:** While interest burdens will rise, they will remain modest compared to history.
- **Rising bankruptcies should be seen as healthy:** For some, higher rates will be too much to bear and bankruptcy will result – but bankruptcies, while up significantly from the extraordinary lows of Covid, remain at levels that are not threatening. And many bankruptcies can be healthy in a strong economy where capital and labor should be reallocated to more productive uses.

Higher rates trickle through to higher costs… …**firms absorb** higher fin. costs though they remain modest… …which helps **force out weakest firms**, which is probably good



Note: Rates are for Bloomberg Corporate Investment Grade Index. Data through 10/15/2024 (left), Q2 2024 (center), and 6/2024 (right). Bankruptcies includes chapter 7, 11, and 13 filings. Data excludes 3 months in 2005 which saw spike in filings due to legislative changes.
Source: Bloomberg, S&P, Administrative Office of U.S. Courts, BCG Center for Macroeconomics

Q: Will higher-for-longer rates hurt the housing market?

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A: Headwind, not problem

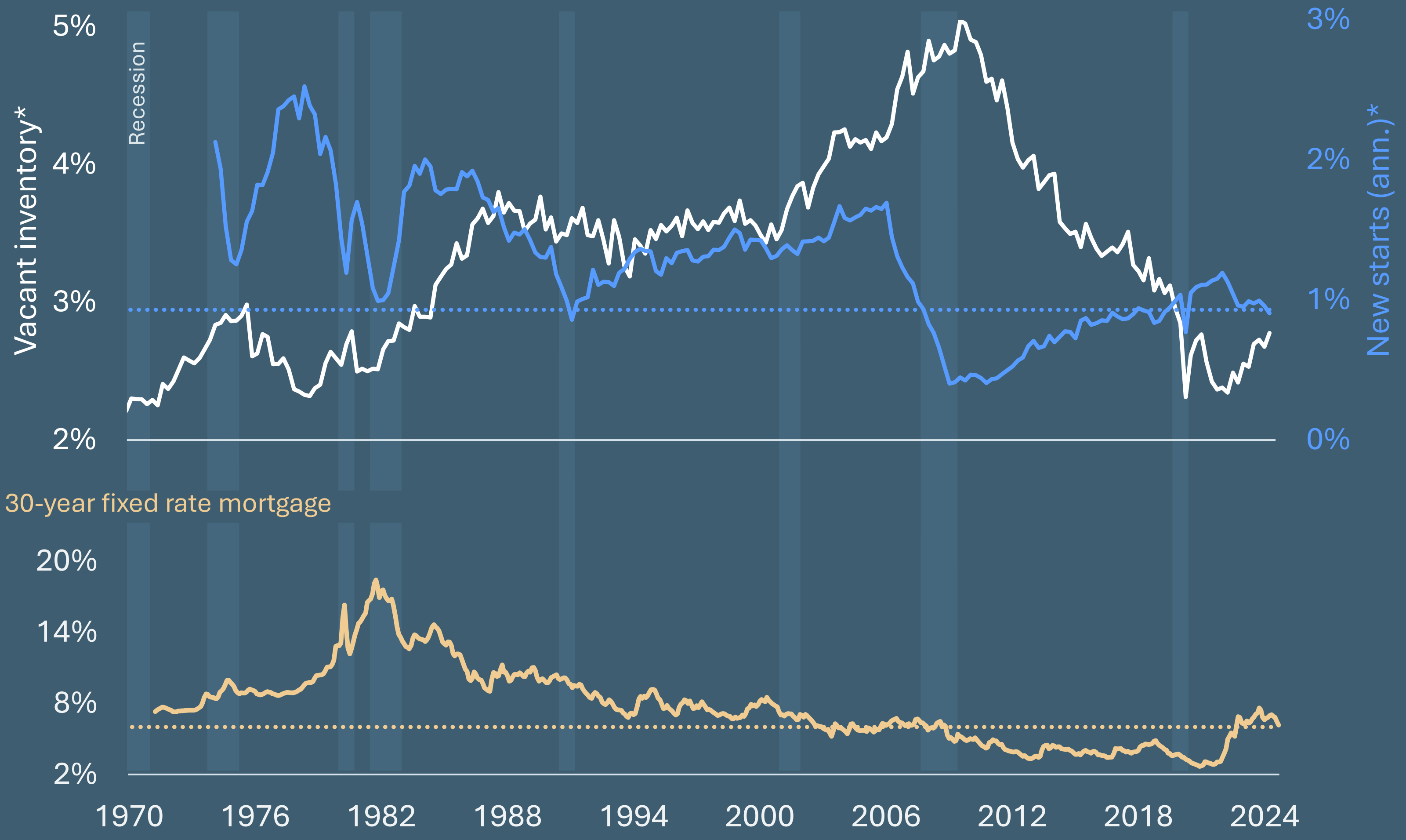
Borrowing rates do influence the cost of home ownership, yet rates prove less influential on homebuilding, where the supply of homes plays an even more important role.

- **Not rates, but inventories**: Rather than rates, it is the level of inventories that plays the most important role in prices and building activity. If inventories are high, as they were in the early 2010s, builds and prices will be weak – if low, as today, building and prices will be strong.
- **Rates do matter, but for what**: That is not to say rates don't matter. Higher rates will be a headwind to price and to building – and in some areas, such as sales or refinancing, they can be particularly influential.

With low inventories and higher rates than in the past, we'd expect prices to remain elevated (with more modest further appreciation), activity/builds to continue at a healthy pace (particularly compared to 2010s), and sales to remain more modest. Overall, the housing market will remain strong.

Despite rates being a focus for homebuyers, they are a poor guide to activity – look to inventories

Housing vacant inventory* (left axis) and housing starts (right axis)*



Note: *as a share of total housing stock. Data through Q2 2024 (top) and 9/2024 (bottom).
Source: Census Bureau, Federal Home Loan Mortgage Corporation, BCG Center for Macroeconomics

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Risk and opportunity
Consider recession risk, but also upside of tight economy

Shocks always have the potential to disrupt the economic cycle, as Covid dramatically proved in 2020. But do the most common worries have that potential? Generally, we think the bar is assumed to be too low; delivering a recession is not easy. And most often, we think the effects of these shocks are considered too big. An isolated equity market correction won't end the recovery. The bar for the election to shape the economy is exceptionally high. Tariffs would add to inflation, but it is difficult to change its medium run course or for knock-on consequences to end the expansion. Geopolitics will make headlines but will struggle to break the global cycle. And financial hiccups can and will happen but are most likely contained by willing and able policymakers.

Q: Will an equity bear market deliver a downturn?

BCG

A: Unlikely

With the equity market near record levels, a frequent concern is that a correction or bear market could deliver a recession.

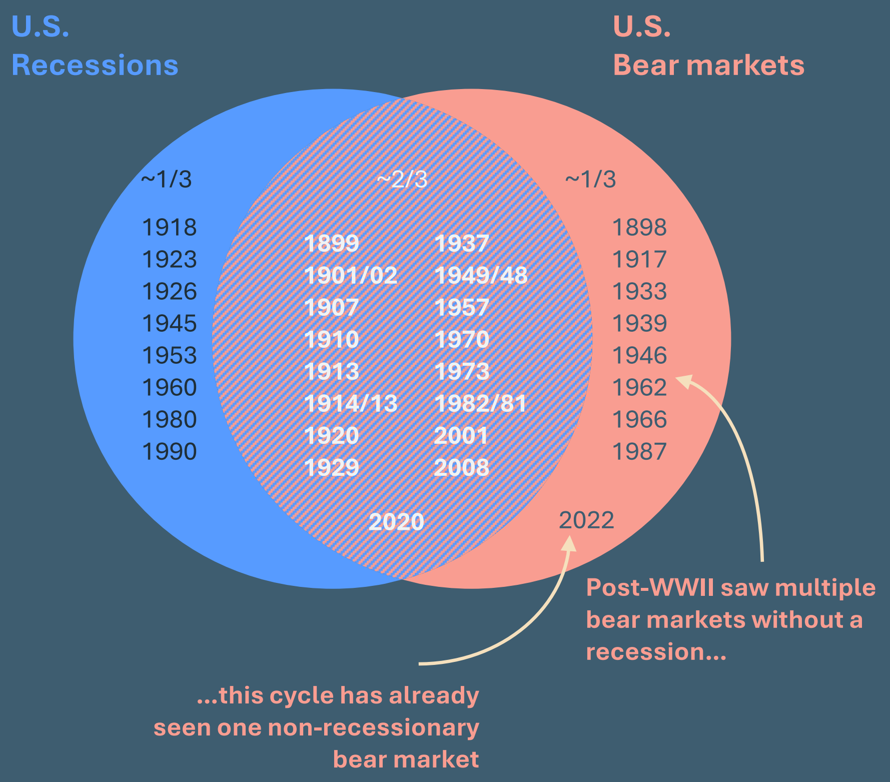
Though historically the overlap between recession and bear markets is high, bear markets can and do occur in isolation—such as in 2022.

We think the bar is quite high for the market to deliver a recession. Yet episodic volatility should be expected:

- **Elevated valuations,** relative to history, suggest strong assumptions about earnings growth. Lofty expectations are easier to disappoint.
- **Modern Volatility:** Today's stock market is prone to more periods of lower volatility and more periods of higher volatility than in the past. When volatility arrives, it is also associated with faster drawdowns.

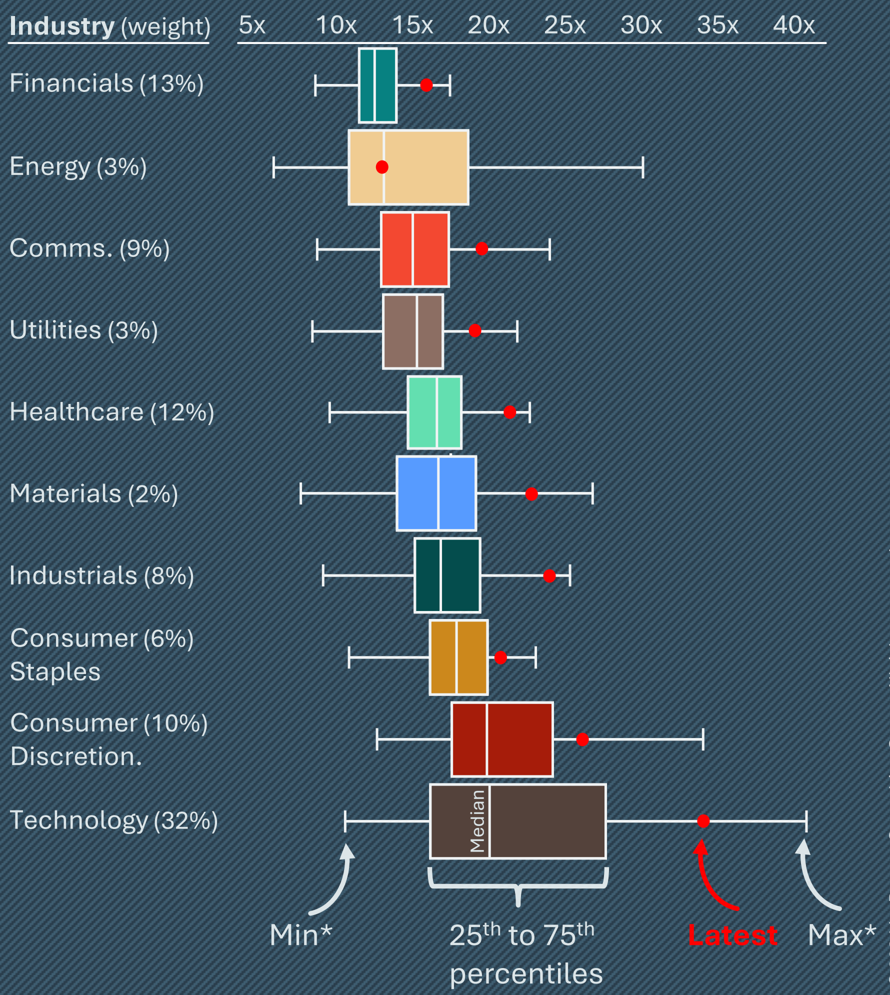
While a bear market is possible, if driven by internal market dynamics rather than a weakening economy, it won't drive a recession.

Bear markets and recessions overlap but not as frequently as often assumed



Valuations remain high across nearly all sectors

S&P 500 1-year forward p/e ratio (since 2000)



Note: *Excludes outliers. Latest market data as of 10/15/2024. Valuations are monthly from 2000 to 9/2024. Index weights do not sum to 100% due to exclusion of real estate (data unavailable in parts due to sector reclassification).
Source: Bloomberg, NBER, BCG Center for Macroeconomics

Q: Will the election shape the macroeconomy?

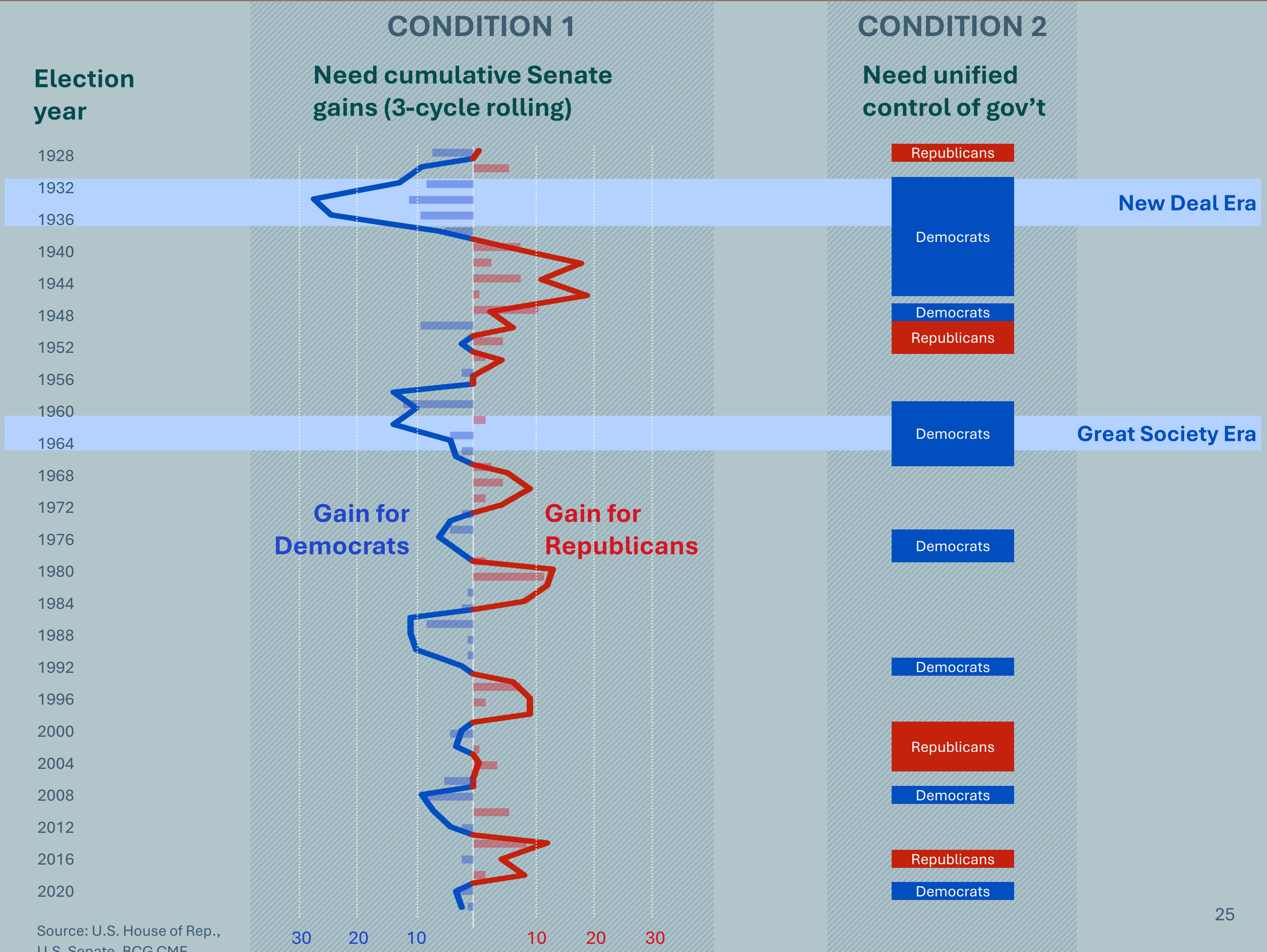
A: Unlikely

Elections matter – but do they shape the macroeconomy and the economic cycle? The bar is exceptionally high for politics to transform the big picture. One reason is that the political power required to pass significant legislation requires two conditions:

- **Cumulative Senate gains needed:** Gaining a legislative majority in the Senate (60 votes) would require a string of electoral victories to accumulate power. A high bar.
- **Unified control**: Collective control of both the House of Representatives, the Senate, and the Presidency is required to have the control to move polices without striking deals with the other side. While not as high a bar, this condition is one that also has the potential to be constraining.

If these two conditions aren't met, big economic legislation only really occurs around big crises.

Elections matter more idiosyncratically: M&A, regulation, foreign policy—areas where presidents have more discretionary power.



Source: U.S. House of Rep., U.S. Senate, BCG CME

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Q: Would tariffs drive inflation?

BCG

A: Yes, but not durably

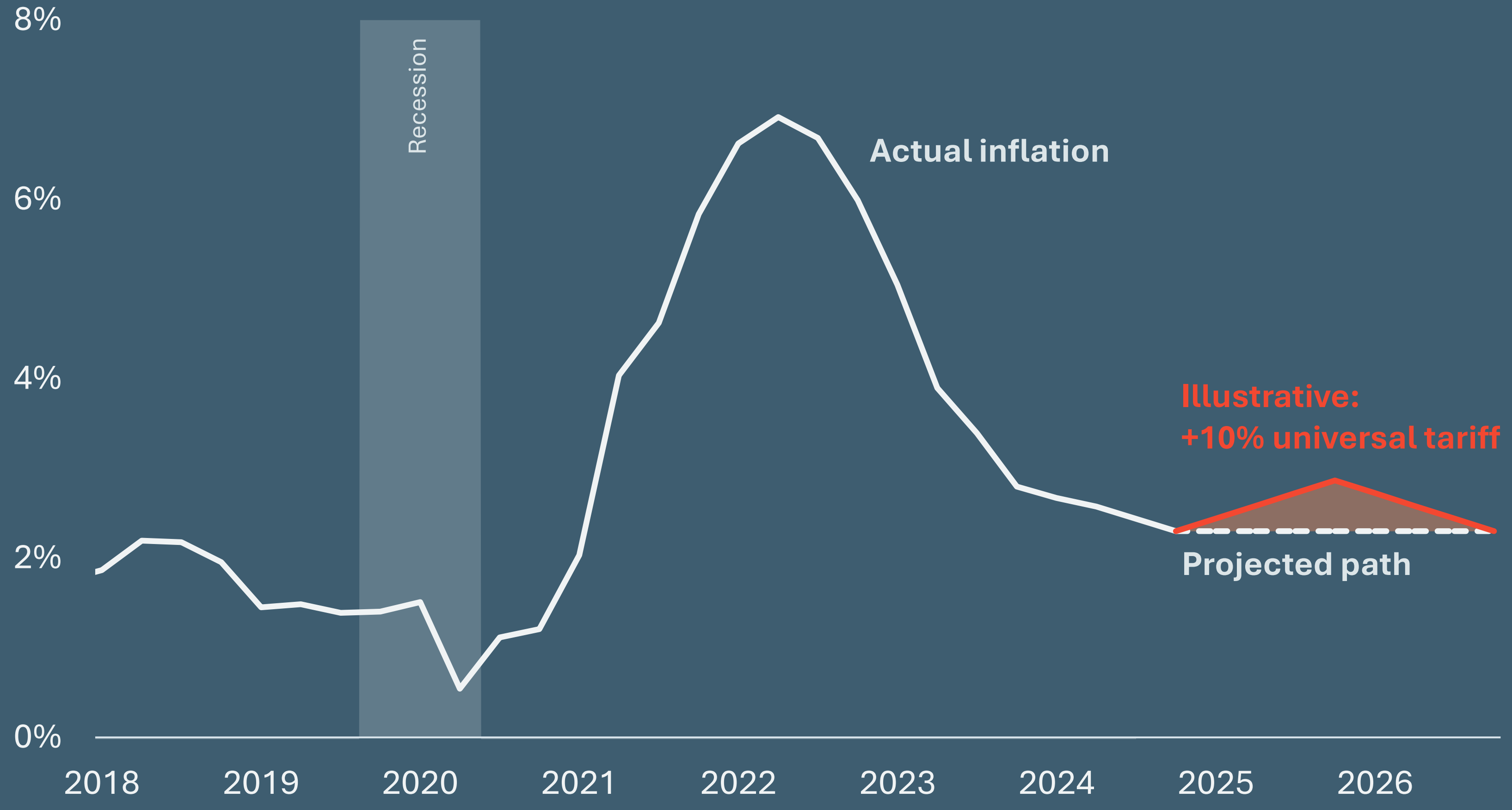
Many are concerned that former President Trump, if elected, would institute a 10% (or higher) universal tariff. Would it push inflation?

- **Cyclical inflation, for a time:** A 10% tariff would add about 0.6% to headline inflation – cutting into the spending power of households – for about a year. To be sustained, tariffs would again have to rise again 10% the following year, and the year after...
- **No change to structural inflation:** Tariffs are unlikely to have significant impact on expectations for inflation in the long run because of their one-off nature.
- **Secondary and micro effects:** Inflation isn't the only story; monetary policy would move more cautiously (leading to higher rates), and retaliatory tariffs would be likely.

While tariffs would struggle to derail the expansion, they would have material impacts on some firms as they work to reorganize themselves in a world with ever-changing rules.

Tariffs have the power to move inflation substantially, but not durably

Inflation with illustrative 10% universal import tariff if added today



Note: Historical inflation (PCE price index) is shown quarterly. Assumes perfect passthrough from tariff to consumer prices, amortized across 2 years. Here, inflation arises from a 10% increase in goods prices, weighted by goods imports as a share of total consumer spending. This amounts to a peak of ~0.6% one-time added inflation. Inflation's projected path is 2.3%, in-line with today's consensus.
Source: BEA, Bloomberg, BCG Center for Macroeconomics

Q: Will geopolitical conflict break the cycle?

BCG

A: Unlikely

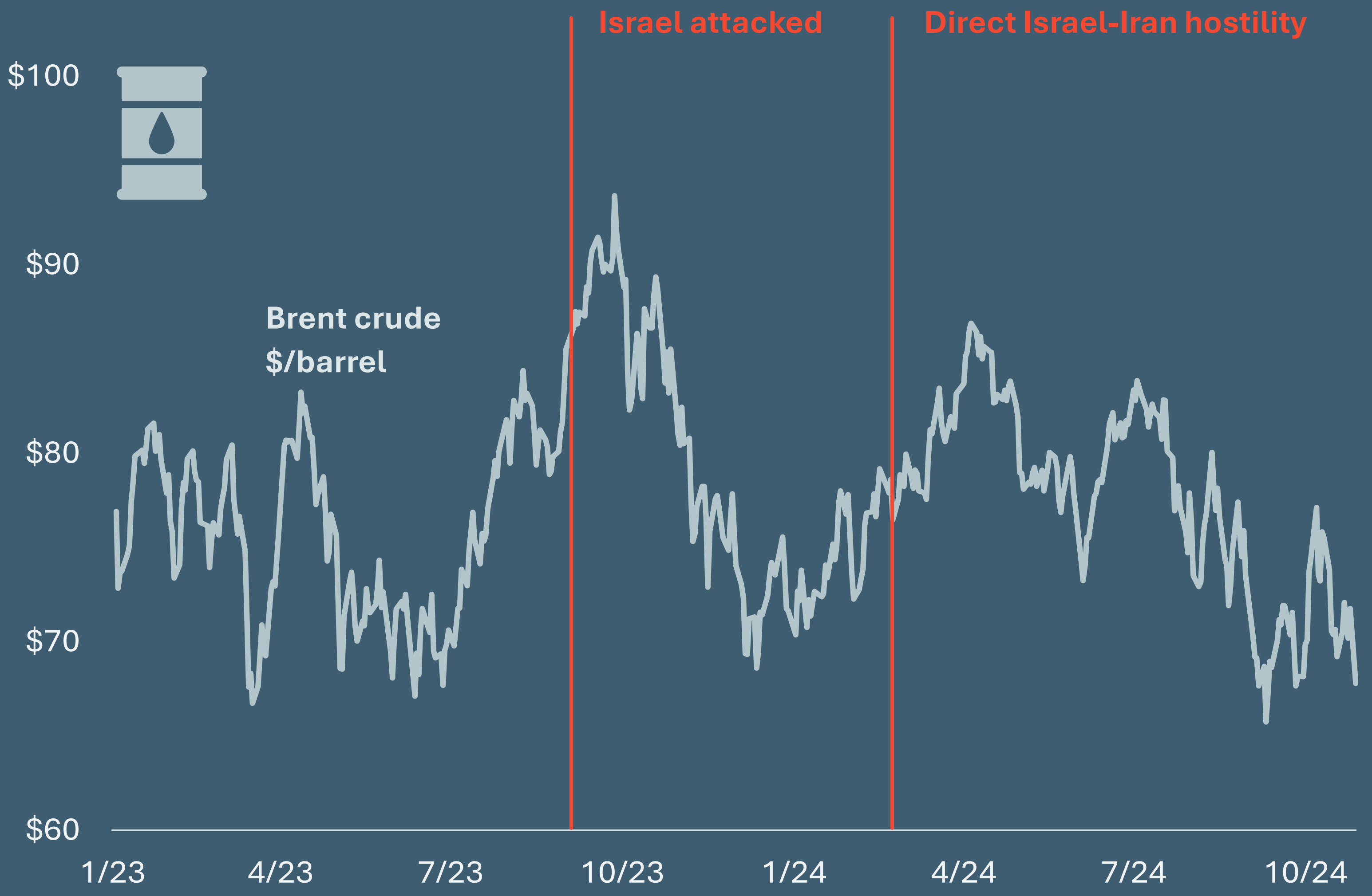
Geopolitical strains and conflicts naturally lead in headlines, but that's not the same as having macroeconomic impact. The example of oil prices over the last year, unimpressed by the escalating conflict in the Middle East, are not an isolated example.

- **Transmission channels:** To have economic impact, the geopolitical shock must transmit through (1) real linkages such as consumption and investment, (2) financial linkages such as the banking system, or (3) institutional linkages. That is often a much higher bar than assumed.
- **Shock and response:** Geopolitical risk is mostly assessed through the initial shock. Yet, the political consequences (reactions) can be more impactful than the initial shock – think greater fiscal demand and investment that shape economic activity.

The hurdles for geopolitics to be the main economic driver remain high, though not impossible to reach.

Despite war in the Middle East, oil prices are lower than they were

Brent crude oil price ($/barrel)



Note: Oil prices through 10/28/2024. Direct Israel-Iran hostilities began when Israel bombed the Iranian consulate in Damascus, Iran retaliated with direct missile and drone strike on Israel and Israel responded with an attack in Iran.

Source: Bloomberg, Eurostat, BCG Center for Macroeconomics

Q: Will a financial system crisis disrupt the economy?

BCG

A: Unlikely

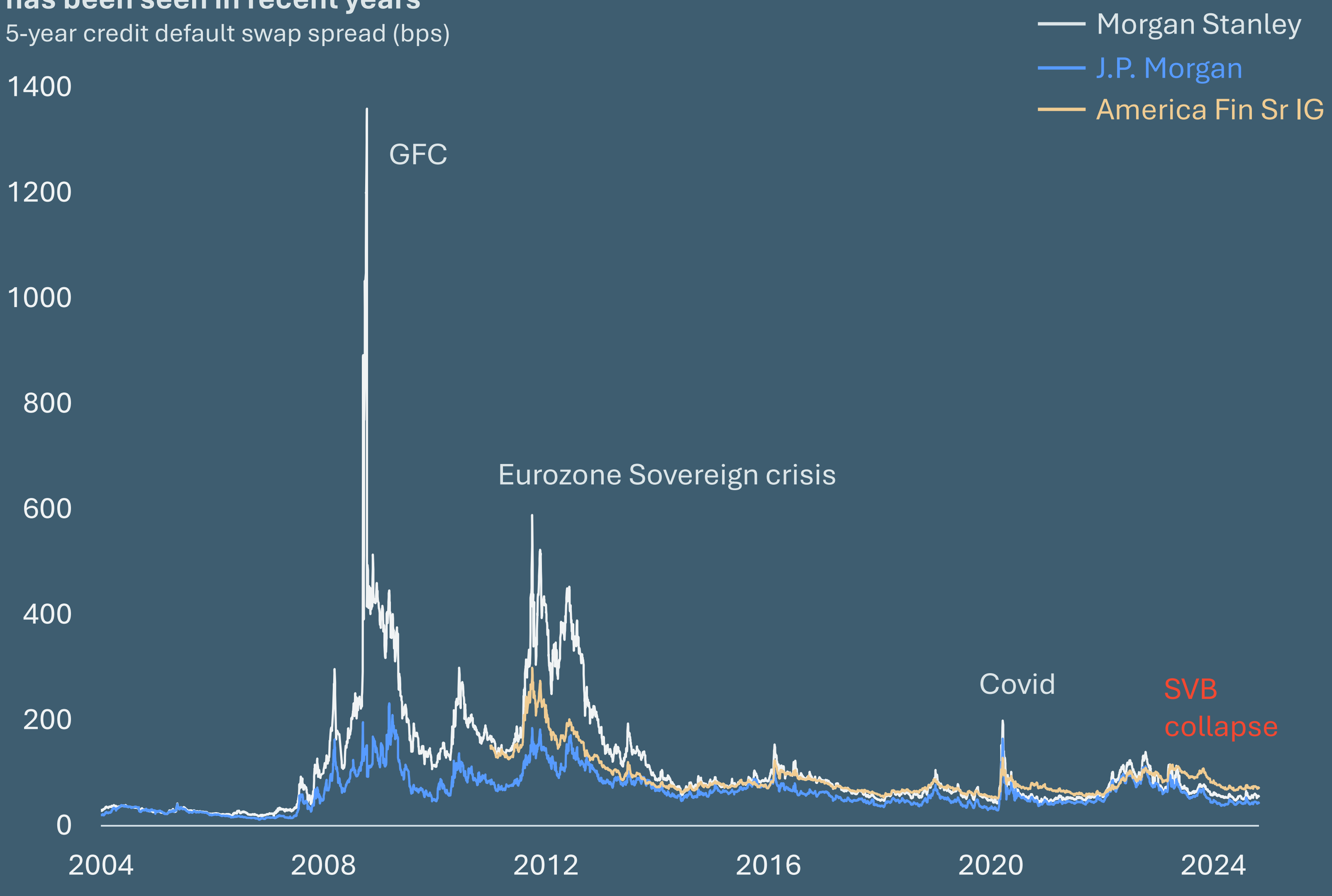
In the first half of 2023, a series of bank failures (most significantly Silicon Valley Bank and First Republic) spread fears that a new financial crisis was just around the corner. And while more financial disorder can never be ruled out, two reasons point to why it is not likely to disrupt economic activity:

- **Policymakers' significant ability to handle liquidity stress:** Central banks – and the Federal Reserve in particular – are well equipped to respond to liquidity crises and have shown repeatedly that they are willing and able to do so.
- **Systemic risk matters most**: It is not any bank failure that threatens the system – some level of bank failure is a regularity – but rather systemic failure. Today the banks at the core of the system are very well capitalized and reasonably profitable.

Financial disorder can always surprise, but it also takes a lot to undermine the system of credit intermediation – and there are no signs this is likely in the near future.

Systemic financial crisis requires far high levels of stress than what has been seen in recent years

5-year credit default swap spread (bps)



Note: Data through 10/28/2024

Source: Bloomberg, BCG Center for Macroeconomics

BCG

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Risk and opportunity
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Despite the economy's strength, a recession remains a key concern for many leaders. Many popular recession "indicators" have failed spectacularly in recent years. Instead, we should look for coherent narratives across three recession types (real, policy, and financial). Today, we don't see a likely path to recession in 2025 in any of the three. Instead, we see a tight labor market likely delivering a win-win-win economy where households receive real wage gains, firms protect their profits with productivity growth, and policymakers see strong growth without problematic inflation. We view this not as a cyclical fluke but a consequence of a structurally tight labor market that won't prevent – but will also likely survive – the next recession.

Q: Should we pay attention to flashing recession indicators?

BCG

A: Better to focus on their flaws

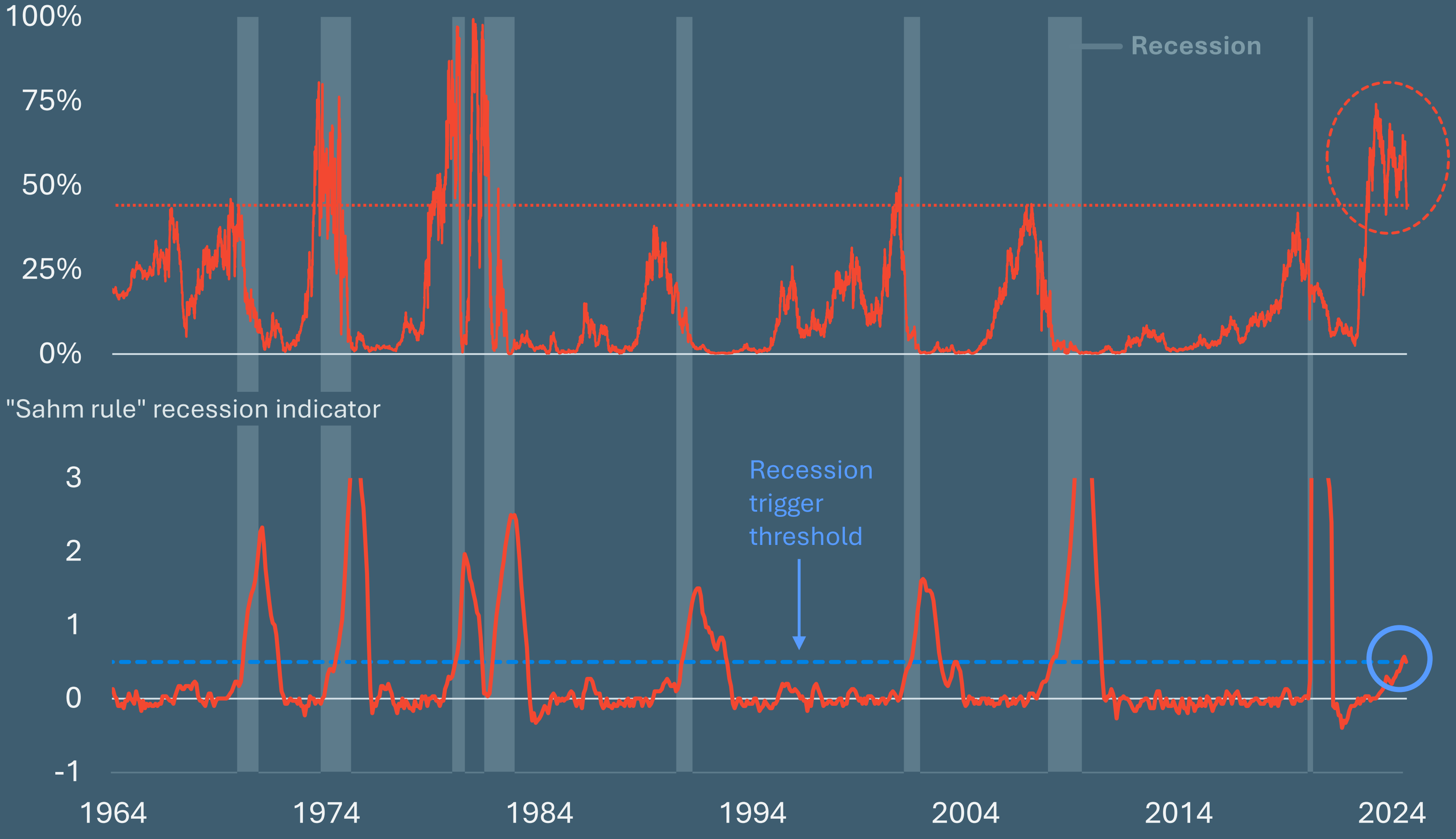
When everyone is straining to see around the economic bend, blinking dashboards offer an alluring proposition – simple rules that will tell you when a recession is coming or that it has arrived. Yet the problem is they don't work.

- **Yield Curve:** The difference between short rates and long rates is often pointed at as a leading indicator of recession, if short rates exceed long rates. Yet this signal has been calling for a recession for well over a year.
- **Sahm rule:** An uptick in the unemployment rate of 0.5% compared to a low over the prior year (see footnote) shows an economy entering recession. Yet when driven higher by strong supply rather than demand (as today), this indicator misses the mark.

While indicators can be useful signals, they can not be deferred to when assessing recession risk – judgement is required.

Dashboards' flashing lights must be understood for what they are – imperfect guides

Yield Curve indicator: Probability of recession in next 12 months (predicted by 3M-10Y Treasury spread)



Note: Sahm rule = difference between the current 3-month m.a. of the unemployment rate and the lowest 3-month avg. in the preceding 12 months (where .5 = recession). Data through 10/15/2024 (top) and 9/2024 (bottom).
Source: Haver, BCG Center for Macroeconomics

Q: How can recession risk be monitored then?

BCG

A: Think in types

Rather than thinking in odds and indicators, look across the landscape of recession risk to search for coherent narratives by three recession types:

- **Real economy recession:** Are there exogenous shocks that could undermine growth? How strong is growth to absorb normal surprises? Are there any real investment imbalances which if they unwound would deliver a recession?
- **Policy-induced recession:** What is the balance of risks between inflation and unemployment? Is policy restraint a serious challenge, and will it need to tighten or ease over the coming year?
- **Financial recession:** Are there any financial bubbles that could pop and threaten the cycle? What are the pathways to a disorderly crimping of credit intermediation? Is the banking system, particularly systemic banks, well capitalized and well funded?

There is no crystal ball to see the next recession, but we do not see a coherent and likely recession narrative for 2025.

Our recession risk framework

Type	1 Real economy recession	2 Policy-induced recession	3 Financial recession
Typical drivers	▪ Exogenous shocks (e.g.. Covid) ▪ Unwinding imbalances (e.g., investment boom-bust) ▪ Slowdown leading to economic stall	▪ Monetary policy tightening or restraint ▪ Policy can be too far ahead (fears of inflation) ▪ Or too far behind (need to bring inflation down)	▪ Popping financial bubbles ▪ Weakens or cripples balance sheets ▪ Banking system stress that cripples credit intermediation
Typical severity	▪ Shorter recession ▪ Few overhangs ▪ Strong recovery	▪ When inflation is anchored, more mild severity ▪ When inflation in unanchored, severe	▪ Severe when banking system crippled ▪ Long overhang ▪ Weak recovery

Q: What should we expect in a tight economy?

BCG

A: Strong real wage growth

A tight economy is one where labor markets are strong – particularly characterized by unemployment rates that are below the neutral level of unemployment (u*).

In this environment workers will feel more confident about pushing for wage increases – and are more likely to receive them.

- **Not a new environment:** Tightness is not new – it started years before Covid struck and returned quickly after the Covid recession.
- **Productivity can pay for it:** While real wage growth has returned to its strong pre-Covid levels, productivity growth is even stronger, helping pay for potentially all of the wage gains.
- **Potential for win-win-win economy:** If productivity can continue to run ahead of wage gains, 2025 can be a win-win-win economy.

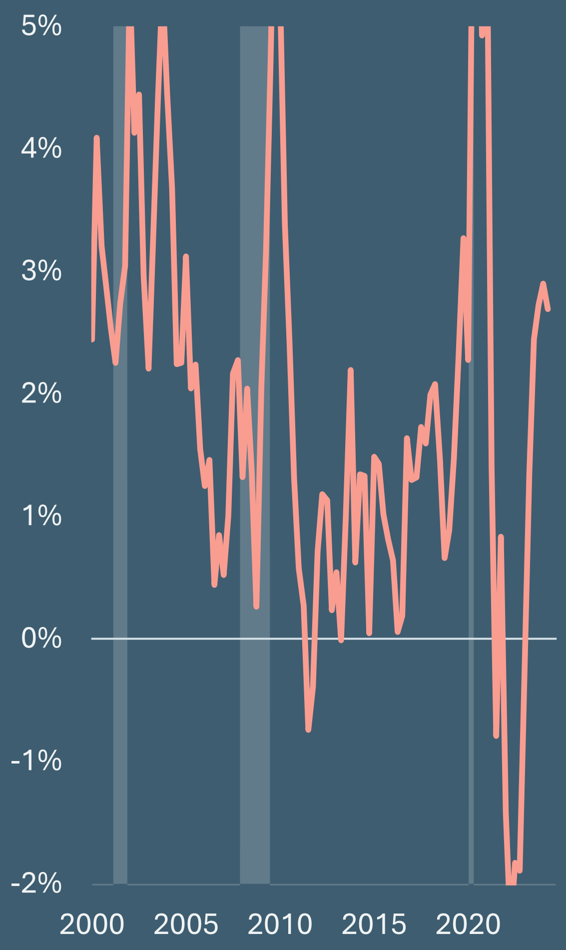
What is a win-win-win economy?

Real wage growth returns to strong pre-Covid levels

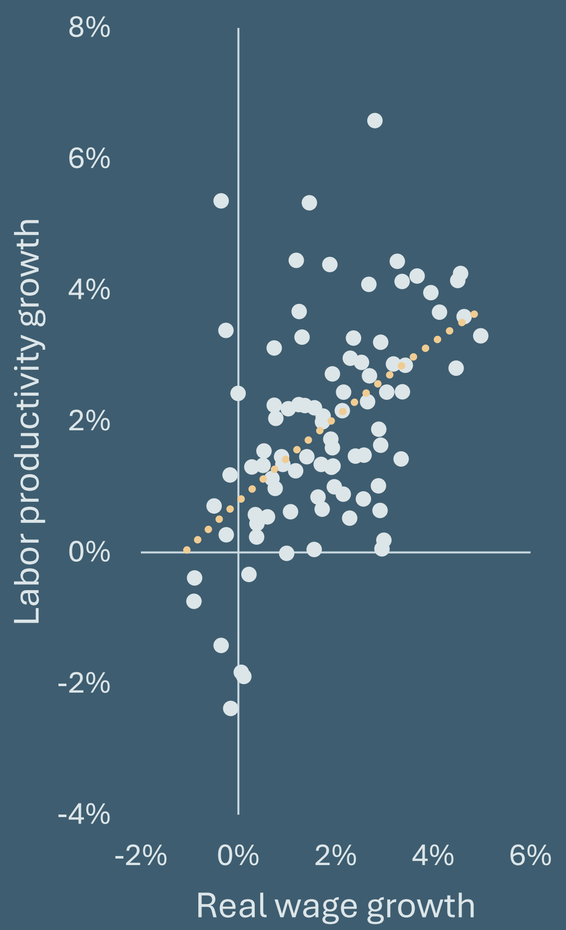
Real wage growth (Atlanta Fed – PCE)

Productivity growth even stronger today

(Y/Y change in real output/hour)



Productivity growth will help pay for real wage growth



Note: Data through 8/2024 (left) and Q2 2024 (center, right). Wage growth in 3-month mov. averages. Scatter based on data since 1985 when the period does not overlap with recession.

Source: HBR, BCG Center for Macroeconomics

Q: Who wins and loses in a tight economy?

BCG

A: Potential for a win-win-win

In a tight economy there must be a release valve for the cost pressures that come from high wage growth. Three possible places these pressures can go:

- **Absorbed in profit margins:** Firms can absorb wage growth into profit margins. If this is the key force, in the medium run it's a win for workers, obviously a loser for firms, and policy makers see it as a qualified success as it is not ultimately sustainable even if it can persist for a long time.
- **Passed through to inflation:** Firms can pass on the costs, but this means inflation which policymakers will push back upon. If high inflation persists, a recession is likely. No one comes out a winner.
- **Offset by productivity growth:** If firms can offset cost with productivity growth – workers receive wage gains, firms keep their profit margins, and policymakers get strong growth with little inflation.

Today the prospects that productivity growth can be the release valve are good—a win-win-win economy.

Release valve	Outcomes for...		
Tightness (cost pressures) is ...	Firms (capital)	Workers (labor)	Policymakers
...**absorbed** in profit margins	Lose	Win	Qualified success
...**passed through** driving inflation (and recession risk)	Lose	Lose	Risks tactical failure (policy recession), or strategic failure (inflation regime break)
...**offset** by productivity growth	Win	Win	Success

Source: HBR, BCG Center for Macroeconomics

Q: Is labor market tightness cyclical?

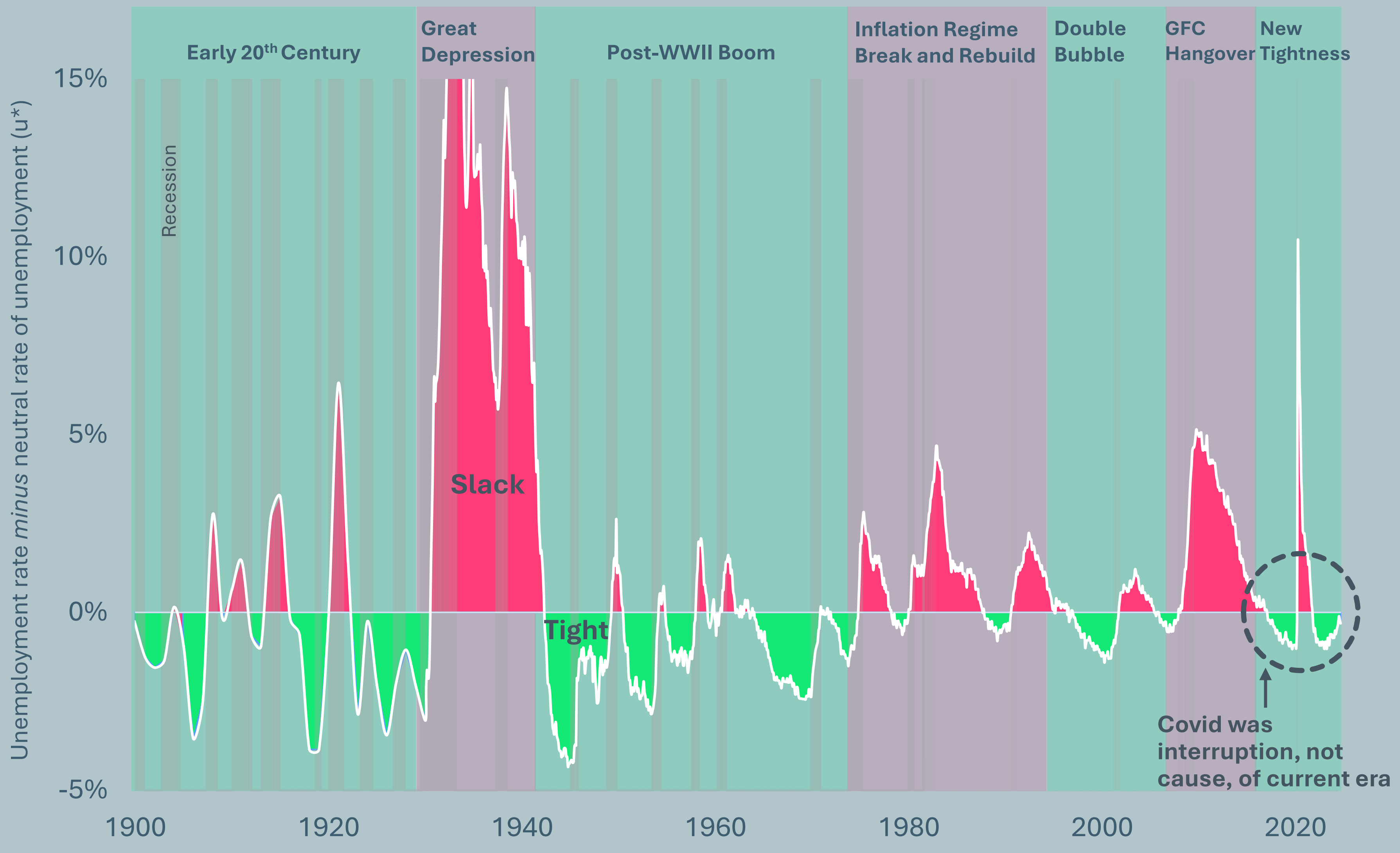
BCG

A: Structural; began before Covid

Tightness – the backdrop of a tight labor market – has happened before even if it hasn't been seen in many years. And it tends to last, meaning it is more than just a cyclical phenomenon – it is a structural one.

- **Boosted by structural factors:** Today a tight labor market is boosted by structural investment narratives from the energy transition to derisked supply chains.
- **Doesn't mean no recession:** Just because tightness is structural doesn't mean there won't be a recession. Just as the tight 1950s and 60s saw recessions, today's era of tightness is likely to see them as well.
- **Takes a structural recession to end it:** To end era of tightness requires a structural recession – either a inflation regime break (1970s) or systemic financial crisis (GD or GFC).

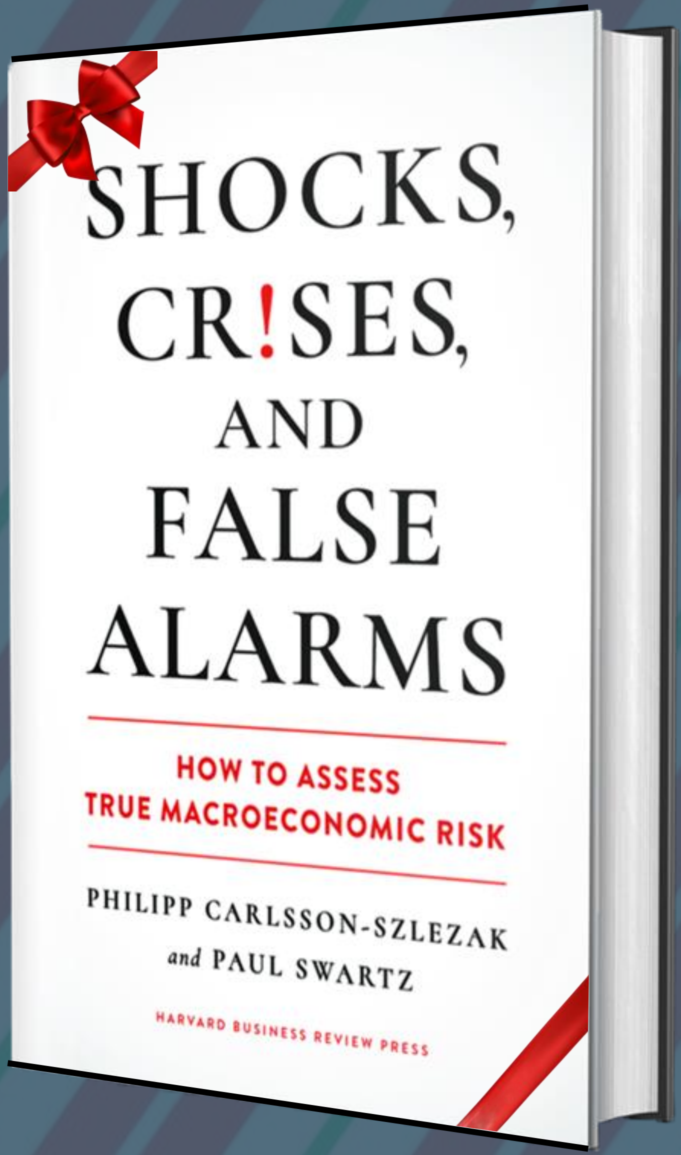
Today the prospects that we are living in a sustained era of tightness are too often overlooked – even as it is the defining feature of the structural environment.



Note: Data through 9/2024. 1900-1948 uses U* from 1/1949 (earliest available).
Source: BLS, CBO, Stanley Lebergott, BCG Center for Macroeconomics

BONUS Q: What would make a great holiday gift?

A: *SHOCKS, CRISES, AND FALSE ALARMS*



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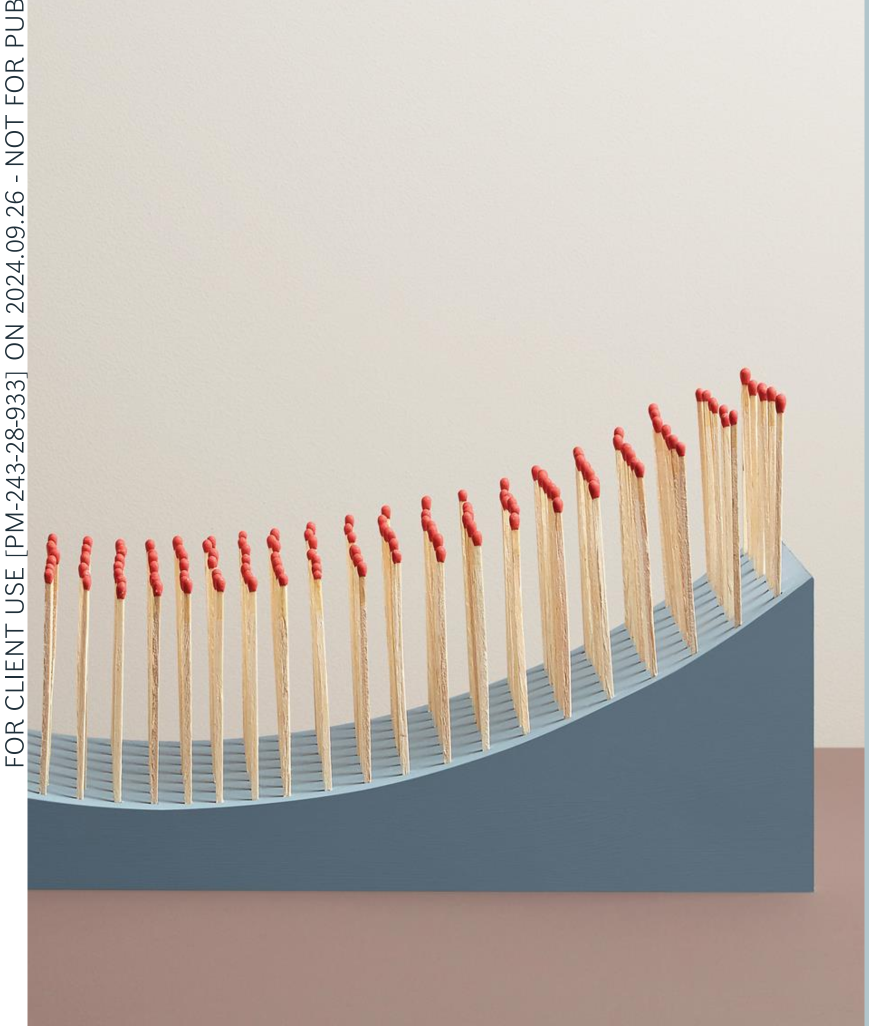

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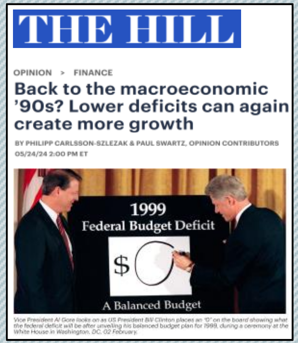

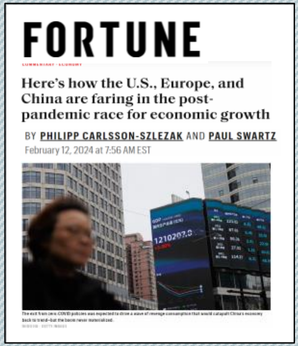

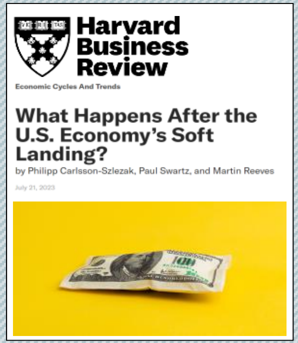

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