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The U.S. Economic Outlook for 2025–2026

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Executive Summary

Solid Momentum Meets Trifecta of Uncertainties

The economy wrapped up 2024 on a firm footing, as real GDP expanded at an annualized pace of 2.3 percent in the final quarter. Personal consumption expenditures contributed 2.8 percentage points to growth, with other components subtracting on net. The unemployment rate declined to 4.0 percent in January, while payroll job gains were solid.

The start of President Trump's second term has introduced a great deal of uncertainty, which we see falling into three major areas: tariffs, the fiscal agenda, and aggressive efforts to reshape the role and the size of the federal government. We continue to believe that the path of economic policy will feature more "business as usual" than the headlines suggest. We do not envision sudden jumps in broad tariffs on our North American trade partners. Instead, we expect substantial additional tax cuts beginning in 2026 to dominate the policy agenda, if not the news. We believe the labor market is strong enough to absorb the shock of federal layoffs without too much deterioration.

Inflation Idiosyncratic, But Tariffs Are Coming

Progress on inflation has been bumpy recently. Month-to-month CPI inflation jumped above a 5.0 percent annualized rate in January due to likely one-time outsized runups in used car prices and motor vehicle insurance costs. We do not expect core PCE inflation for January to spike as much because of differences in index construction. We continue to expect meaningful disinflation in service prices ahead, driven by slowing rent growth and the moderating pace of wage increases.

We expect import tariffs to temporarily push goods inflation higher this year. Overall, though, we believe that the disinflationary trend in services will prevent overall inflation from reaccelerating.

Positive Downward Revisions

The labor market is in better balance now after the scare last summer and fall. The unemployment rate declined from 4.2 percent in November 2024 to 4.0 percent in January 2025, while last summer's reported unemployment rate peak was revised lower.

The recent benchmark revisions lowered the estimate of payroll job gains between April 2023 and March 2024 by roughly 550,000 jobs. While not a welcome development, this revision made the slowdown in job growth during 2024 look far less dramatic. The 6-month moving average of job gains stood at 197,000 jobs in March 2024 and bottomed out at 120,000 jobs in October 2024 before recovering to 178,000 in January 2025.

Housing Market in a Lull

It is increasingly likely for the 2025 housing market to look a lot like 2024's: mortgage rates remain elevated; housing supply could see a slight improvement with modest growth in new home construction and less restricted existing home inventories; and demand remains tepid with continued strength in rentals. The NAHB/Wells Fargo homebuilders' sentiment dropped deeper into the contractionary zone in February, reflecting lower expectations of both current and future sales.

One Agenda Two Bills

The Republican leadership in the House is trying to stuff the bulk of President Trump's legislative agenda into "one big beautiful bill." However, with a razor-thin

Republican majority in the House, crafting one monster bill that could pass Congress is likely to prove very difficult. We believe that a backup plan proposed by the Senate GOP will probably prevail. That plan splits off the TCJA extension and other tax cuts into a separate bill to be passed later this year, while giving precedence to funding immediate spending priorities. Hence, we expect about 200 billion dollars' worth of personal and business tax cuts per year starting in 2026. As a result, the federal deficit increases from 6.2 percent of GDP in fiscal 2024 to 6.5 percent by fiscal 2026.

Fed Not in a Rush, But Tariffs Are Coming

The FOMC cut the federal funds rate range at each of its last three meetings of 2024 by a combined percentage point before pausing in January. With the labor market deterioration seemingly now contained and inflation sticking above the Fed's objective, we expect the FOMC to wait for data on how the economy is adjusting to new Administration policies.

The Fed referenced economic uncertainty due to tariffs as supporting evidence for rate cuts in 2019. Hence, we believe that the potential for a retaliatory trade war will encourage the Fed not to turn hawkish in the face of tariff-induced price pressures. Given our outlook, we expect two 25 bps cuts in 2025, one in June and one in December, followed by two more in 2026.

The 2025–2026 Outlook

We project that the annualized pace of real GDP growth in 2025Q1 will stay on par with 2024Q4 at 2.3 percent. Rebuilding inventory after the burst of consumption growth last quarter will help sustain the pace of expansion. Growth slows marginally in 2025Q2–Q3 to the 1.9 percent pace, as higher tariffs keep inflation elevated. By 2026, lower taxes and interest rates help nudge the growth pace to around 2.2 percent. Calendar year GDP growth moderates from 2.8 percent in 2024 to 2.3 and 2.1 in 2025 and 2026, respectively.

The unemployment rate edges up from 4.0 percent in 2025Q1 to 4.1 in 2025Q2. As interest rates decline modestly and taxes come down, the labor market firms up marginally, and the unemployment rate slides to 4.0 percent in 2025Q4 and 3.9 percent by the end of 2026. Monthly payroll job gains perk up to 188,000 jobs in 2025Q1 then decelerate through 2025Q4 and settle around 130,000 jobs in 2026.

PCE inflation, the Fed's preferred measure, pokes up to 2.7 percent quarter-on-quarter annualized in 2025Q1 and then eases to a steady 2.2 percent from 2025Q4 to 2026Q4. In year-over-year terms, PCE inflation moderates to 2.2 percent in 2025Q2 and picks up to 2.4 percent in 2025Q3–Q4 due to new tariffs, before returning to 2.2–2.3 percent during 2026.

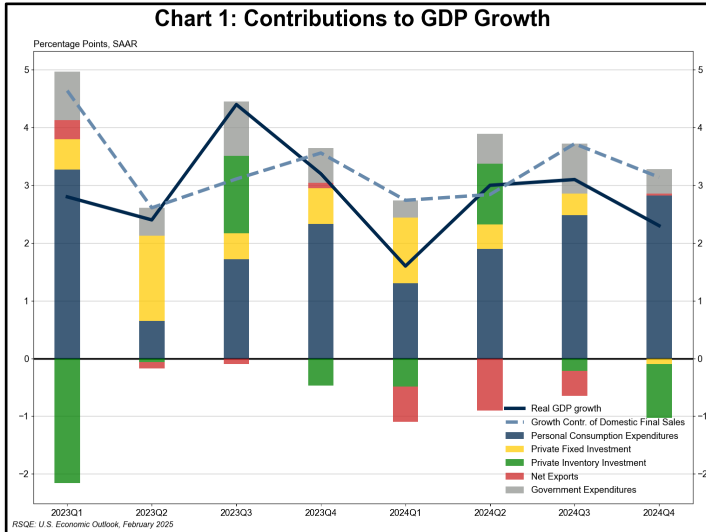
With plenty of supply for sale, new single-family home starts hover around 1,000,000 units, the 2024 level, in early 2025 before picking up gradually to 1,094,000 units by 2026Q4. Multi-family starts follow a similar pattern: the year begins soft with an average pace of 360,000 units in 2025H1, followed by a gradual increase to 420,000 units by 2026Q4.

The 16.5-million-unit light vehicle sales pace in 2024Q4 likely benefited from pull-forward sales. The sales pace dips to 15.9 million in 2025Q1 and then climbs slowly to around 16.3 million units by 2025H2 and 16.4 million by 2026Q4. We generally expect robust auto production and sales in the medium term, but uncertainty related to the tariffs is a substantial risk. Tariffs on cars made in Mexico and Canada, which make up almost 20 percent of U.S. light vehicle sales, could upend the North American economic geography.

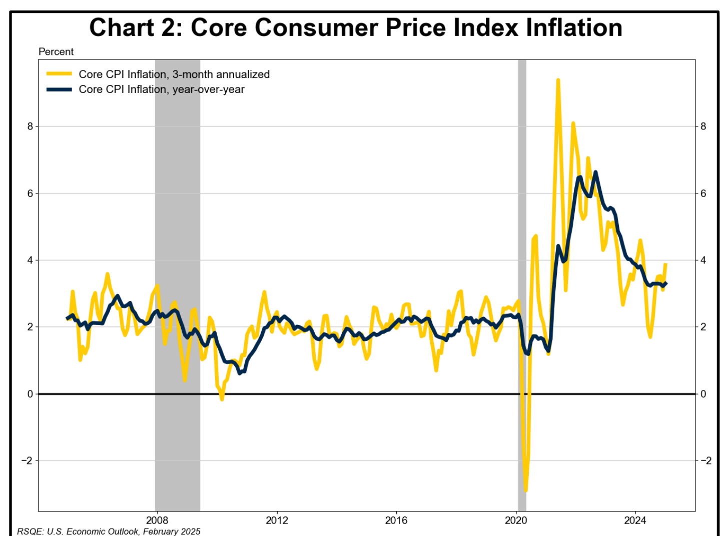
	Actual		**RSQE Forecast**	
	2023	2024	2025	2026
GDP (billions of current $)	27720.7	29179.1	30533.5	31920.5
Real GDP (billions of 2017 $)	22671.1	23302.2	23837.6	24349.5
% change: year-over-year	2.9	2.8	2.3	2.1
% change: 4th-qtr-to-4th-qtr	3.2	2.5	2.1	2.2
Nonfarm payroll employment (millions)	155.9	158.0	159.9	161.4
Civilian unemployment rate (%)	3.6	4.0	4.1	4.0
Capacity utilization, total industry (%)	79.0	77.6	76.8	76.6
Inflation (private nonfarm GDP deflator, % change)	3.6	2.4	2.3	2.3
Inflation (CPI-U, % change)	4.1	3.0	2.9	2.6
Inflation (core CPI, % change)	4.8	3.4	3.1	2.7
Light vehicle sales (millions)	15.5	15.8	16.2	16.4
Private housing starts (thousands)	1421.4	1364.6	1401.7	1491.5
3-month Treasury bill rate (%)	5.1	5.0	4.0	3.6
10-year Treasury note rate (%)	4.0	4.2	4.5	4.3
Conventional mortgage rate (%)	6.8	6.7	6.7	6.3
Real disposable income (billions of chained 2017 $)	17052.5	17540.3	17922.4	18474.5
% change	5.1	2.9	2.2	3.1
Corporate profits after tax (billions of current $)	3068.8	3372.1	3399.9	3492.1
Value of U.S. $ (FRB broad index), % appreciation	-0.2	2.3	4.3	0.0
Current account balance (NIPA basis, billions of current $)	-915.9	-1107.0	-1281.4	-1264.7
Federal surplus (FY, NIPA basis, billions of current $)	-1549.4	-1787.4	-1873.9	-2059.7

The Current State of the Economy

The economy wrapped up 2024 on a firm footing, as real GDP expanded at an annualized pace of 2.3 percent in the final quarter. The stacked color bars in Chart 1 show the growth contributions to real GDP of major components over recent quarters. Personal consumption expenditures added 2.8 percentage points to headline growth in 2024Q4, marking their strongest contribution in the past seven quarters. Government expenditures accounted for another 0.4 percentage points. Private inventory investment, which is historically very volatile, subtracted nearly a whole percentage point. In our view, the growth contribution of final sales to domestic purchasers (illustrated in the dashed line) provides a more stable snapshot of the economy's momentum.[1] This measure concluded 2024 on a high note, contributing a robust 3.1 percentage points.

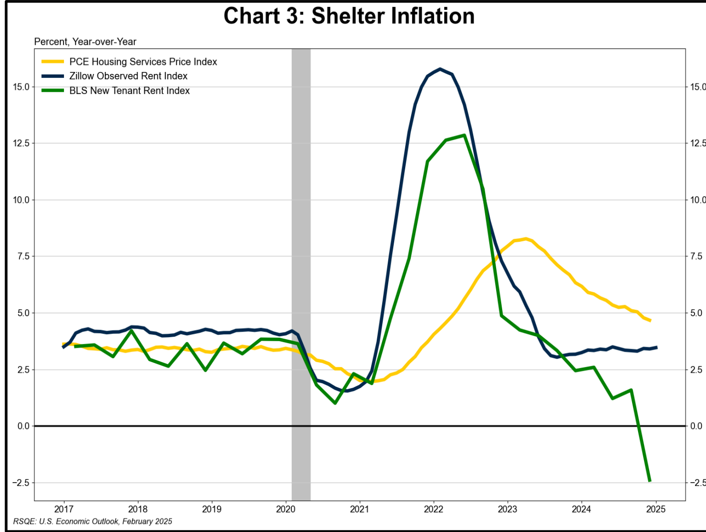


Progress on inflation has been bumpy recently. Food and energy prices have put upward pressure on the headline numbers, but the run-up in core inflation is more worrisome. After some meaningful deceleration, from 3.8 percent in March to 3.3 percent in June 2024, the year-over-year core CPI inflation rate has hovered around that pace since then. The 3-month annualized reading revved up from 3.1 percent in December to 3.8 percent in January 2025, due to runups in used car prices and motor vehicle insurance costs.[2] We expect the core PCE reading



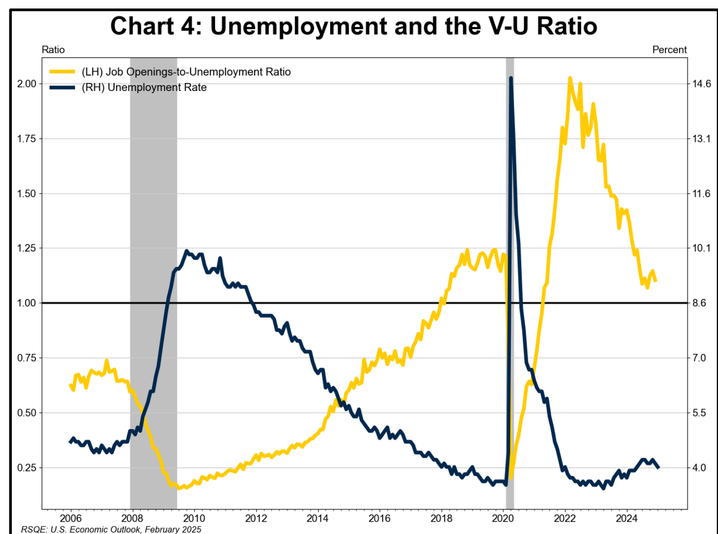
[1] Final sales to domestic purchasers comprise consumption, business fixed investment and government spending.
[2] December's reading was comparatively low, as it reflected October's muted inflation in new vehicles, medical services and transportation services, specifically motor vehicle insurance.

for January to show less inflation than the CPI reading did because the relative importance of the CPI components that ran hot is considerably lower in the PCE index. Moreover, we believe that used car prices are unlikely to show outsized increases in the near term, as wholesale price inflation for used vehicles has been slow since November.



Another reason to remain guardedly optimistic about further inflation progress is the likely continued slowing of shelter inflation. The year-over-year rate of PCE housing inflation, shown as the maize line in Chart 3, was trending down from 5.3 percent in August to 4.7 percent in December after remaining stagnant from June to August. Two indices that measure rent inflation for new tenants have shown encouraging signs. The Zillow observed rent index is growing below its pre-pandemic pace, while the Bureau of Labor Statistics' (BLS') experimental research index for new tenant rents has also been decelerating.

We therefore consider much of the recent uptick in CPI inflation to be idiosyncratic and short-lived and see a viable path to a return to disinflationary trends in 2025. On the other side of the ledger, we anticipate import tariffs to temporarily push goods inflation higher this year. Overall, though, we believe that the disinflationary trend in services will prevent overall inflation from reaccelerating.



The labor market is in better balance now after the scare last summer. The unemployment rate settled around 4.1 percent in the fourth quarter of 2024, with the latest reading for January 2025 nudging down to 4.0 percent. The ratio of job openings to the count of the unemployed, commonly known as the vacancy-to-unemployment (V-U) ratio, slid

from its all-time high of 2.0 in March 2022 to 1.1 in July 2024 and has been hovering around that level since. As the V-U ratio declines, the labor market becomes less tight. The latest readings of the unemployment rate and the V-U ratio suggest that the current labor market remains robust, though running a bit looser than the pre-pandemic economy.

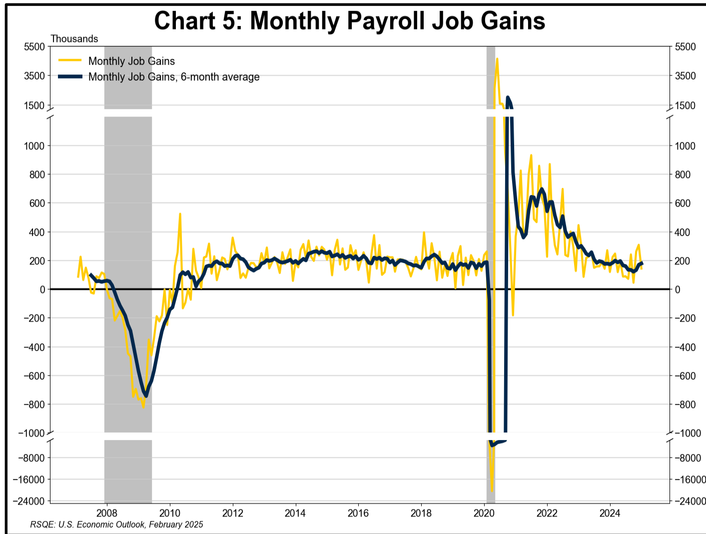
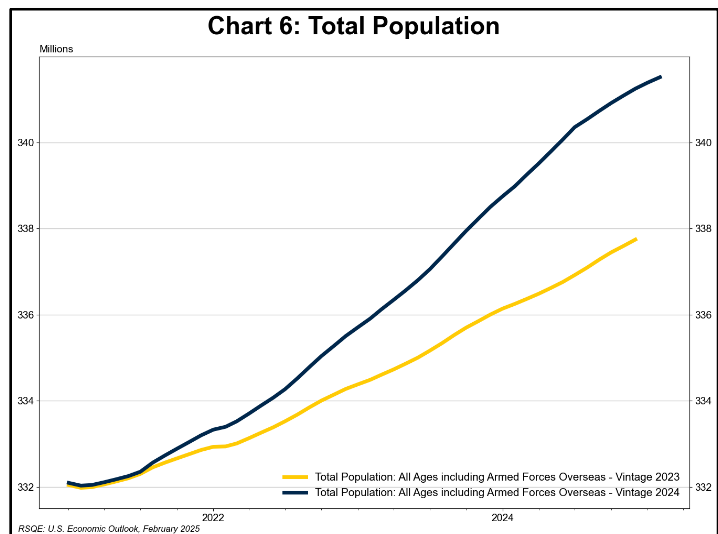


Chart 5 shows monthly payroll job gains alongside its 6-month average. The recent benchmark revisions lowered the estimate of job gains between April 2023 and March 2024 by roughly 550,000 jobs, not quite as many as the preliminary estimate of 818,000 jobs. While not a welcome development, this downward revision made the slowdown in job growth during 2024 look far less dramatic. The 6-month moving average bottomed at 120,000 jobs in October but recovered to 178,000 in January.

The labor market's surprising resilience despite the significant monetary policy tightening owes partially to an increase in net international migration since 2020. The Census Bureau recently released its new population estimates, and the updated monthly resident population plus armed forces overseas went up from 337.7 million to 341.2 million for December 2024. Consequently, we saw a jump of approximately 1.0 percent in the size of the civilian noninstitutional population 16 years and over in the population controls of the January household employment survey. However, as tighter border controls and enforcement under the current administration slow the pace of new arrivals, we have lowered our projection for population growth over the next several years



considerably. As a result, we also expect a moderation in the pace of payroll employment gains needed to sustain labor market stability going forward.

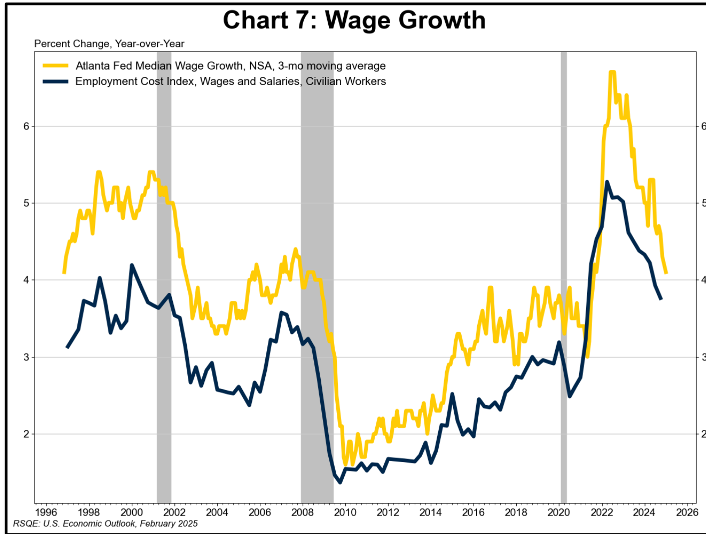


Chart 7 shows two employee compensation metrics. Both measures suggest that while wage growth is running ahead of inflation, it has decelerated considerably in recent months. We believe this development will continue to support progress on inflation while sustaining reasonable consumption growth. Combined with signs of returning stability in other data, we expect the improving balance in the labor market will help the Federal Reserve focus on the last phase of its battle to bring inflation back down to target.

Chart 8 shows the National Association of Home Builders/Wells Fargo Housing Market Index (HMI) and the Mortgage Bankers Association's index of loan applications for purchases. The HMI, which measures builders' sentiment on concurrent and six-month forward single-family sales, as well as the traffic of prospective buyers, continues to suggest a moderate decline in activity. While homebuilders' sentiment held up last fall and into January despite the rebound in mortgage rates, it dropped in February. This drop paints a more depressed outlook for new residential construction, with both present and expected sales for the next six months down from the previous month. Mortgage loan applications remain at historically low levels as mortgage rates hover near the 7.0-percent level again.

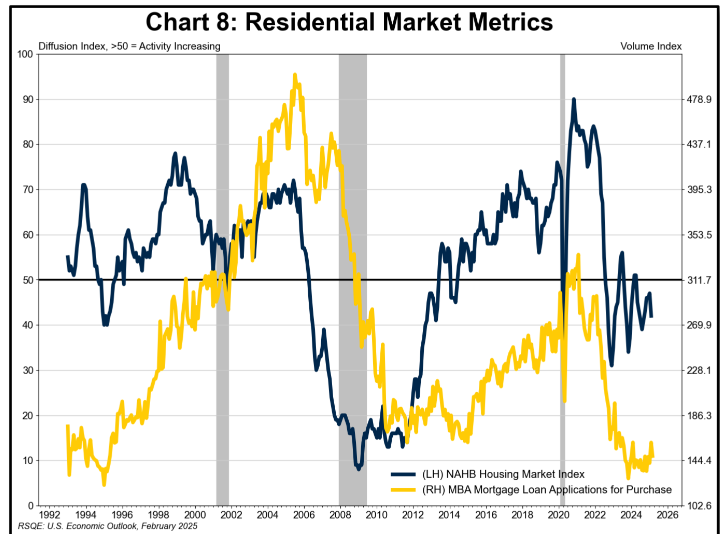
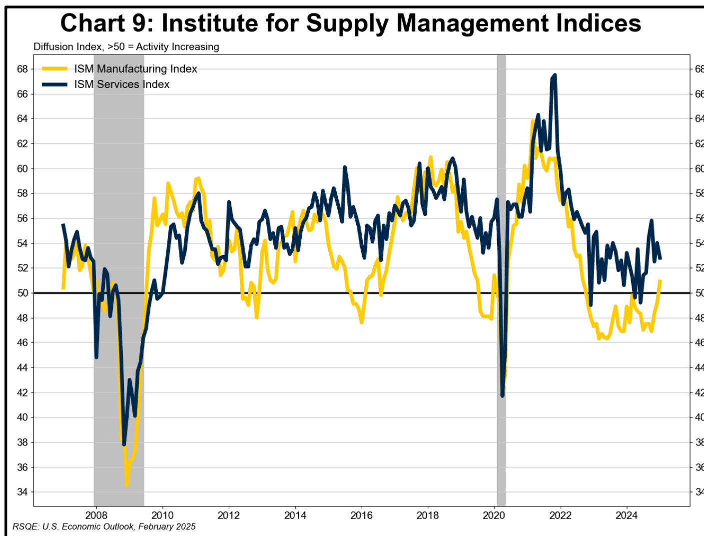
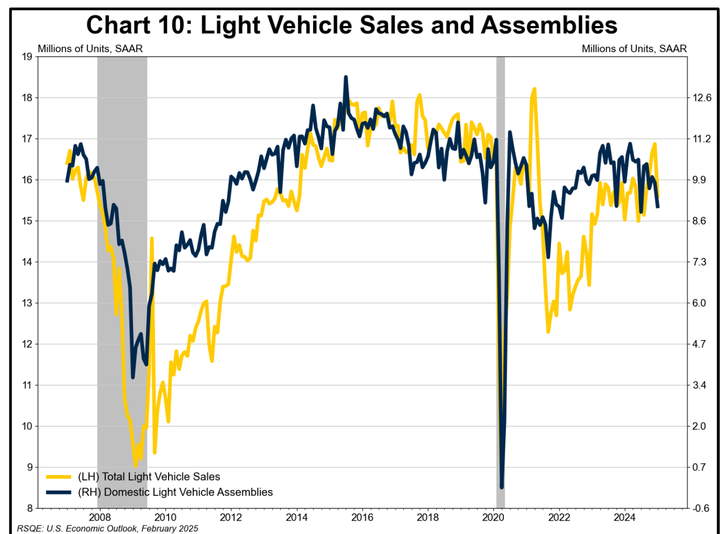


Chart 9 shows the Institute for Supply Management's (ISM's) Purchasing Manager Indices for manufacturing and services. Readings below 50 suggest slowing business activities in the respective

sectors. The manufacturing index climbed to 50.9 percent in January after 26 consecutive months of contraction, helped by improvements in production and employment. We are cautiously optimistic about the manufacturing sector's outlook despite uncertainty surrounding tariffs. This is partly because businesses may be better prepared for potential supply chain disruptions this time around. Moreover, most manufacturing surveys conducted by regional Federal Reserve banks in January suggested stable expectations for the next six months. The services index remains in the expansionary territory at 52.8 percent.



Unfortunately, the turnaround for vehicle assemblies has yet to arrive, despite recent signs of recovery in the manufacturing sector. The seasonally adjusted annualized pace of light vehicle assemblies has declined for two consecutive months after a short-lived rebound in November, struggling to climb back to its pre-pandemic level. The annualized light vehicle sales pace dropped from 16.9 million units in December to 15.6 million units in January 2025. While December's reading likely benefited from pull-ahead demand due to price uncertainty related to tariffs and fears of changes to electric vehicle (EV) tax credits, January still saw the fifth consecutive month of year-over-year improvement.



A new phase of tariff policy has begun. Effective February 4, an additional 10-percent tariff was imposed on all goods imported from China. Furthermore, a 25-percent tariff on steel and aluminum imports is set to take effect in March. We project that tariff rates on China will eventually triple to the size of those in place last year during our forecast horizon. We estimate that the additional tariffs on China

we have penciled in will result in a permanent 0.2 percentage-point increase in the price level. However, we do not expect a lasting imposition of broad tariffs on imports from Canada and Mexico. Instead, the threat of such tariffs is likely to be used as a bargaining chip in negotiations with our trade partners.

We believe that the Trump Administration's efforts to downsize the federal workforce will restrain the growth of total government employment, but we do not expect them to threaten the stability of the broader job market. Federal government job gains have on average accounted for only 10 to 20 percent of the total jobs added by the government sector post-pandemic, and only 3.3 percent of the total job gains over the prior 24 months. In 2024, local governments contributed more than 65 percent of total government employment growth.

Overall, the state of the economy remains challenging to interpret. We believe the labor market will remain in largely good health, while the slowdown in inflation should resume in the next few quarters despite the imposition of new tariffs. Although the tariffs are likely to cause inflation to linger above the Fed's comfort level in the near term, the economy's underlying disinflationary momentum should persist.

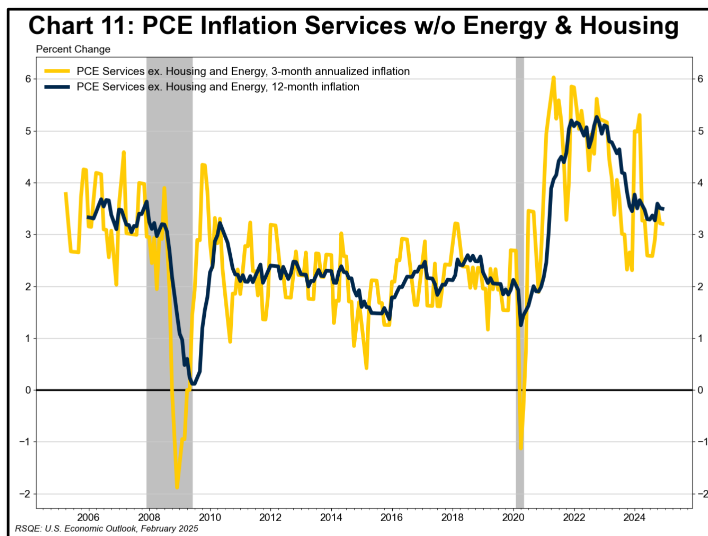
Next, we detail several key policy and economic assumptions underlying the forecast.

Monetary Policy

The Federal Open Market Committee (FOMC) remains committed to its dual mandate of bringing inflation down to its 2.0 percent objective while maintaining full employment. The FOMC cut the federal funds rate at each of its last three meetings of 2024, by 50 basis points (bps) in September and 25 bps in both November and December, before pausing at the 4.25–4.5 percent range in January. Looking forward, Committee members have made statements such as "Over the medium term, I continue to see a gradual reduction in the level of monetary policy restraint," signaling that cuts are still on the table in 2025 even if they may happen more slowly than previously expected.[3] With labor market data continuing to come in moderately strong and inflation sticking above the Committee's objective, we project just two more 25 bps cuts in 2025, one in June and one in December.

[3] Vice Chair Philip N. Jefferson, "U.S. Economic Outlook and Monetary Policy", Feb 4, 2025: https://www.federalreserve.gov/newsevents/speech/jefferson20250204a.htm.

The median economic projection for the federal funds rate among December FOMC meeting participants similarly envisioned two cuts in 2025, with another two in 2026. The Committee maintained its belief that inflation would continue to normalize toward the Fed's 2.0 percent target, although at a slower pace than in the September projections. The median projection also saw the unemployment rate rising to 4.3 percent in 2025 and staying there through the end of the 2026. The unemployment rate was reported as 4.2 percent at the time that the Committee met in December, rising from 3.7 percent earlier in the year. Since then, however, unemployment has decreased to 4.0 percent while the previous path was revised to show less dramatic deterioration over the past summer, likely further cementing the Fed's "go slow" monetary policy approach.



Core PCE inflation, a key metric for forecasting future inflation, stood at 2.8 percent year over year in December. This metric has been stuck between 2.6 and 2.8 percent since May 2024. The 3-month average (annualized) rate rose from 1.9 percent in July to 2.8 percent in October before declining to 2.2 percent in December. January's hot Core CPI inflation print likely points to another reacceleration in the PCE Core inflation print, although as noted above, we expect the rebound in PCE to be smaller. The stubborn behavior of inflation recently supports the slow pace of cuts to the federal funds rate we now foresee. Core non-housing services, also known as the "supercore" (roughly half of private consumption), was one of the final sectors to experience disinflation. As shown on Chart 11, it has been a significant driver of the lack of further progress.

The Fed's statutory dual mandate requires a balanced approach to promoting maximum employment alongside price stability. The labor market has shown signs of stabilizing recently, with the 6-month average of payroll job gains improving from around 130,000 jobs in August–November to 178,000 in January, the highest this metric has been since May 2024. However, the annual benchmark process and updated seasonal factors revised the level of establishment employment downwards, with

December 2024 revised down by 610,000 jobs. Still, the overall resilience gives the Fed yet another reason to move slowly on the rate cutting cycle.

The Fed will probably be wary of possible adverse effects on output arising from new tariffs, both potential and already implemented. The Fed referenced economic uncertainty—partially stemming from tariffs on Chinese goods—as supporting evidence for rate cuts in 2019. Although the Fed was not as concerned with inflation then as it is today, we believe that the potential for a retaliatory trade war will encourage the Fed not to turn hawkish in the face of tariff-induced price pressure.

The Fed has been reducing the size of its balance sheet since May 2022. At that time, the Fed announced a 95 billion dollar-per-month redemption cap for its securities holdings, and it has been shrinking its balance sheet by around 80 billion dollars per month since then. On May 1 of last year, the Fed announced that it would slow the pace of decline by establishing a new redemption cap of 60 billion dollars per month beginning on June 1. We expect the Fed to take small steps toward a more accommodative policy by further slowing the pace of balance sheet reductions, bringing its holdings of Treasury debt to 12 percent of GDP by the end of 2026, a level similar to the 2018Q1 reading.

We believe that our forecast is consistent with a Fed that has entered a more patient phase of its ongoing rate-cutting cycle. As noted, we project the Fed to cut the target range for the fed funds rate by only 50 basis points by the end of 2025. We expect the unemployment rate to rise slightly to 4.1 percent in 2025Q2 but to settle at 4.0 percent by the end of 2025. At the same time, we expect the annualized pace of core PCE inflation to moderate to 2.2 percent in 2025Q4, down from 2.7 percent in the first quarter.

We project PCE inflation to hold steady near a 2.2 percent annualized rate from 2025Q4–2026Q4. Even so, we expect two more 25 basis point cuts in 2026, bringing the fed funds rate to 3.25–3.5 percent by the end of 2026, the terminal range for this cycle. The implied short-term real interest rate of about 1.1 percent will be very close to the FOMC's median projected 1.0 percent real "neutral" rate, which we calculate as the median projection for longer run federal funds rate, 3.0 percent, minus the unanimous 2.0 projection for longer run PCE inflation from the FOMC's December projection materials.

Chart 12 shows our projections for selected key interest rates. The 3-month Treasury bill rate steadily falls from 4.2 percent in 2025Q1 to 3.8 percent in 2025Q4 and 3.4 percent in 2026Q4. The 10-year Treasury rate rises to 4.6 percent in 2025Q1 and then declines gradually to 4.4 percent in 2025Q4 and 4.2 percent by the end of 2026. Mortgage rates decline more quickly than longer-term government bond yields as the excess spread between them shrinks in the face of subsiding risks related to the paths of the policy rate and inflation. The 30-year conventional fixed-rate mortgage rate falls from 6.9 percent in 2025Q1 to 6.5 percent in 2025Q4 and 6.1 percent by 2026Q4.

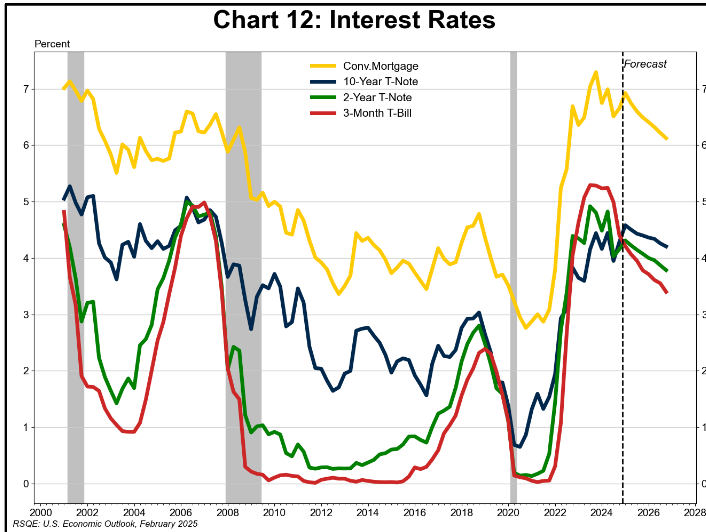


Chart 12: Interest Rates

Trade and Fiscal Policy

President Trump's second term kicked off with an avalanche of executive action covering a wide range of policy issues. Various executive orders have instituted a federal hiring freeze, repurposed the United States Digital Service as the Department of Government Efficiency (DOGE), paused foreign aid spending, raised some import tariffs, and more. Legal challenges to some of the orders have temporarily halted their implementation, however. Other orders have been rescinded or had their starts delayed.

Announcements of new tariffs and their partial postponements have taken center stage in recent weeks. Late in January, tariffs were announced on all goods imported from Colombia and subsequently withdrawn after the latter agreed to accept inbound flights with deportees. An additional 10-percent tariff on all goods imported from China took effect on February 4, while the 25-percent tariff on Canadian and Mexican imports originally scheduled to start on the same day was delayed until March 3. Tariffs of 25 percent on steel and aluminum are currently set for March 12. More announcements are likely coming.

A sudden jump in tariffs on Canadian and Mexican goods could scramble many North American supply chains. Automotive manufacturers are likely to be hit particularly hard, leading to price hikes, lower

output, and market share losses by those more reliant on Mexico and Canada. The disruption to production would likely inflict measurable pain on President Trump's electoral base. As a result, we expect such a sudden shock to be avoided. Tariffs on Canada and Mexico, if any, will likely be phased in gradually (thus delaying and diminishing their economic impact) and/or feature significant carve-outs for key sectors of the U.S. economy.

While the uncertainty over tariffs is quite high at this early stage, it appears plausible that the U.S. tariff policy—a tool under direct control of the executive branch—will be used to force negotiations with our trading partners over a broad set of issues potentially not directly related to trade itself. Hence, we expect more tariff threats on the likes of the European Union, India, Japan, Korea, and several other countries with a positive trade balance with the United States. President Trump's recent announcement directed the U.S. Trade Representative's Office and the Department of Commerce to study tariff and non-tariff barriers around the world in connection with reciprocal tariffs. The inclusion of value added taxes used by many countries on the list of non-tariff barriers opens the door to threats of significant reciprocal import tariffs. Whether those tariffs will actually kick in will depend on country-specific circumstances. For example, the EU may be asked to commit to purchasing more U.S. defense exports. We are, however, expecting further tariffs to be levied on imports from China, with several rounds of escalation spanning our outlook period and the ultimate average tariff reaching about three times as high as at the end of 2024.

While DOGE has captured a large share of news headlines, we believe its key spending recommendations will ultimately have to go through the 119th Congress. While the Senate has been busy confirming cabinet position nominees, the Republican leadership in the House has been trying to get President Trump's legislative agenda going by attempting to stuff most policy promises into "one big beautiful bill." The ultimate bill could attempt to fund upgrades to border infrastructure, add defense spending toward President Trump's promises, extend the Tax Cuts and Jobs Act (TCJA), lower corporate tax rates for domestic manufacturing, lower taxes on social security, overtime, and tip income, and more.

It is highly unlikely that this agenda will gather any support from the Democratic side of the aisle. As a result, the budget reconciliation process is the only way forward. It took about a month to refine the

initial step of the fiscal 2025 budget process—the budget resolution that sets topline spending and revenue targets—to the point that it could pass out of the House Budget Committee. The House budget resolution for fiscal 2025 aims to lower revenues by 4.5 trillion dollars over fiscal years 2025 through 2034, as well as adding about 300 billion dollars for President Trump's immediate priorities in defense and border funding, partially offsetting the deficit with about 2.0 trillion dollars in spending cuts (with a 1.5 trillion dollar floor). However, the Republican majority in the House is set to shrink to just two votes through at least April due to cabinet appointments. So, significant concessions had to be promised to the fiscal conservative faction of the Republican House GOP. On the other hand, the successful Senate confirmation of several unorthodox cabinet position nominees likely signals that the Senate is more in-tune with President Trump's agenda compared to his first term, when the high-stakes effort to repeal the Affordable Care Act (ACA) died in the Senate. The budget resolution, however, is just the first step. Crafting the actual bill, passing it through the House, the Senate, and likely again in the House would be a monumental task. We do not believe that a bill cutting 1.0–2.0 trillion dollars from discretionary spending can pass the House anytime soon, since some Republican districts will likely lose significant amounts of federal funds.

As a backup, the Senate is also working on its own budget resolution, which only reshuffles about 300 billion dollars of spending toward defense and border spending mentioned above, with the rest of the tax-cutting agenda delayed until later in the year, likely until the start of fiscal 2026. While the reconciliation process allows up to three separate bills per fiscal year—each one dealing separately with taxes, spending, and the debt ceiling—revisiting spending or taxes for a second time is not allowed. Hence, passing a quick bill dealing with some spending would make it difficult to pass just the tax portion within the same fiscal year, because such a bill could not feature any spending changes and would likely lose the support of the fiscal conservatives in the House. As a result, we expect that the Senate approach will win in the short term, meaning that the TCJA extension and other tax-cutting action will be dealt with in the fourth quarter of 2025, when the looming expiration of personal tax cuts should facilitate intra-GOP bargaining.

To add a couple of extra pieces to the short-term fiscal puzzle, the current continuing resolution (CR) funding the government will expire on March 14, while the debt limit suspension ended on January 2, 2025, with the Treasury employing its regular "extraordinary measures" since. With the ongoing seasonal inflow of cash, the Treasury is unlikely to run out of cash until sometime this summer. Consequently, funding the government past mid-March is the next important flash point. We are not expecting a shutdown, as we think party discipline will prevail on this issue and allow a short-term CR to pass the House. We do not expect the Senate to block it either. Another short-term CR, however, is likely to run into penalties prescribed by the Fiscal Responsibility Act of 2023, which will trigger about a 45 billion dollar cut to discretionary defense appropriations for fiscal 2025 if no full-year budget is in place by April 30. A standalone reconciliation bill lifting the debt ceiling is plausible this summer if the issue is not dealt with before then.

Intra-GOP tensions between cutting taxes versus cutting spending will still be there for fiscal 2026, perhaps even more prominently. The revenue-cutting prescription of 4.5 trillion dollars in the fiscal 2025 House budget resolution is likely to be insufficient to enact President Trump's tax-related campaign promises. The 10-year extension of the TCJA alone would lower revenues by over 4.0 trillion dollars relative to the current law baseline. Some lawmakers are advocating the use of the current policy fiscal baseline, under which extending the TCJA would not lower revenue projections at all. But the House budget resolution appears to have already committed to the use of the current law baseline. Similarly, making the TCJA permanent, as requested by President Trump, would be extremely challenging under the usual budget reconciliation process. Lowering (but not eliminating) taxes on overtime, tip, and social security income is likely to cost a few more trillion dollars over a ten-year span. Cutting spending significantly with a narrow vote margin in the House is going to be just as problematic, although reports of large-scale inefficiencies from future DOGE announcements may make it more palatable to some. Undoing all tax incentives contained in the Inflation Reduction Act (IRA) would only increase revenue by about 500–600 billion dollars through 2035. Finally, even the potential revenue from significant and broad import tariffs, which we consider unlikely, will not make the bill budget-neutral.

These objections aside, reconciliation bills are not required to lower projected deficits, nor do we expect the tax bill that ultimately passes to do so. Yet a very large deficit impact may jeopardize the bill's passage. On several occasions over the past two decades, Congress has effectively prescribed that the Joint Committee on Taxation (JCT, the agency that scores the revenue side of bills) use a specific set of assumptions arguably aimed at limiting the estimated deficit impact. We expect more of the same this time. All in all, we are expecting a 10-year extension of the TCJA, coupled with about 2.0 trillion dollars' worth of new business and personal tax cuts (again spread over a decade) starting in calendar year 2026, except for the reinstatement of 100 percent bonus depreciation, which we expect to be applied to capital placed in service starting in 2025Q3.

Over 30 percent of federal government current expenditures and gross investment in the National Income and Product Accounts (NIPAs) is spent on employee compensation. Hence, federal workforce growth is important for the federal government's contribution to GDP growth. President Trump has committed to bringing down the size of the federal administrative state, targeting about a 5–10 percent reduction in the federal workforce, or up to 240,000 civilian non-Postal Service jobs. Generally, firing federal government employees beyond the one-to-two-year probationary period is difficult and time-consuming. But many thousands of people still under probation could be let go more easily. As of May 2024, Office of Personnel Management FedScope data showed agencies employed more than 200,000 employees hired within the prior 12 months. The Trump administration has recently offered a buy-out option to most federal employees, with about 75,000 reportedly accepting, although many were likely expecting to leave soon anyway. Layoffs of employees on probation have also started. Additionally, the hiring freeze is still in effect, and once it ends agencies will likely be restricted to hire a fraction of the people retiring, leaving, or being laid off. Some of these actions are being challenged in courts, which may drag out the process and pare down job losses. We are currently projecting the size of the federal workforce to flatline after expanding by about 140,000 since January 2023. We nonetheless expect modest growth of total government employment to continue, with some localities expanding their agencies to fill in the shoes left by the federal retreat.

Table 1 shows the data and our projections for the federal budget on a NIPA basis for fiscal years 2023 to 2026, broken down by receipts and major expenditure categories. The pace of nominal revenue growth is set to pick up to 6.4 percent in fiscal 2025, as inflation remains elevated and rising tariffs on Chinese imports bring in some revenue. We expect the fiscal 2026 budget to reduce income tax revenues, but the still-rising tariff revenue helps revenues post a modest 2.6 percent increase in fiscal 2026.

Table 1
Federal Budget, NIPA Basis
(Billions of Dollars)

			FY Forecast	
	2023	2024	2025	2026
Current receipts	4875.4	5039.9	5362.0	5504.1
% change	-2.8	3.4	6.4	2.6
Current expenditures	6424.7	6827.3	7236.0	7563.8
% change	5.0	6.3	6.0	4.5
Consumption	1300.2	1380.9	1466.3	1525.2
% change	6.4	6.2	6.2	4.0
Transfer payments	4131.1	4273.3	4532.1	4731.4
% change	2.7	3.4	6.1	4.4
Federal subsidies	105.1	95.2	91.5	92.6
% change	-48.2	-9.4	-3.9	1.2
Interest payments	888.3	1078.0	1146.1	1214.6
% change	32.2	21.3	6.3	6.0
Surplus (+) or deficit (-)	-1549.4	-1787.4	-1873.9	-2059.7
Percent of GDP	-5.7	-6.2	-6.2	-6.5

RSQE: U.S. Economic Outlook, February 2025

We expect federal current expenditures to grow by 6.0 percent this fiscal year as previously appropriated funds continue to filter into NIPA outlays. We project that growth will moderate to 4.5 percent in fiscal 2026, reflecting some cuts implemented as a part of the fiscal 2026 budget, but will remain supported by robust defense spending. Transfer payment growth slows from 6.1 percent in fiscal 2025 to 4.4 percent in 2026, due in part to the expiration of the IRA's boost to ACA tax credits by the end of 2025. Federal subsidies bottom in fiscal 2025 and edge up in 2026 after four years of declines. Interest rates remain elevated relative to the 2010s, but the growth rate of interest payments on the federal debt decelerates from a 21.3 percent pace in fiscal 2024 to a 6.0–6.3 percent pace in fiscal 2025–26, as deficits continue adding to the debt.

As revenue growth lags expenditure growth over fiscal 2025–26, the federal deficit continues to expand, from 6.2 percent of GDP in fiscal 2024 to 6.5 percent by fiscal 2026. Federal debt held by private investors increases from 82.6 percent of GDP in 2024Q4 to 89.5 percent in 2026Q4. Even as the Fed tapers the pace of its rundown of Treasury security holdings, a large amount of Treasury debt remains on the Fed's balance sheet rather than in the hands of the public.

The Housing Market

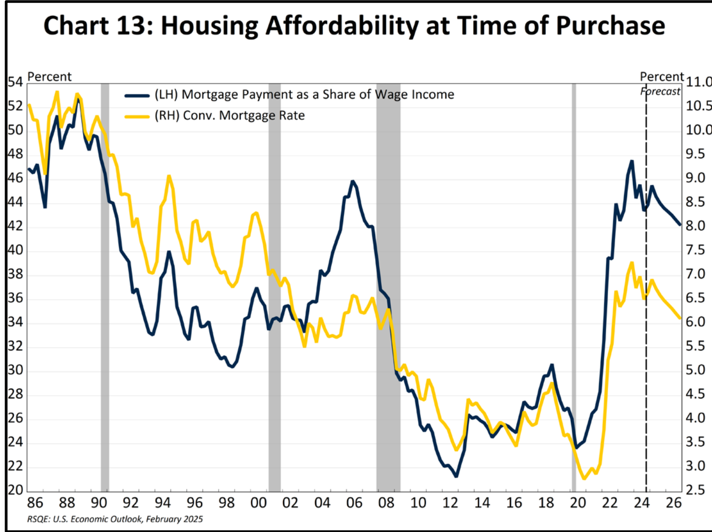
It is increasingly likely for the 2025 housing market to look a lot like 2024's: mortgage rates remain elevated; housing supply could see a slight improvement with modest growth in new home construction and less restricted existing home inventories; and demand remains tepid with continued strength in rentals. The upsides for home sales stem from less uncertainty about home prices and mortgage rates, pushing buyers on the fence to make a move. However, the upsides are limited by worsening affordability. After brief improvements in late 2024, housing affordability has deteriorated as the 30-year conventional fixed rate mortgage rates have rebounded to around 6.9 percent in mid-February 2025.

Home prices showed slower growth in 2024Q4, yet they are expected to appreciate faster than consumer price indices. Our preferred measure of home prices, the seasonally adjusted S&P CoreLogic Case-Shiller National Home Price Index, decelerated to 3.6 percent year over year in October 2024, and ticked up modestly to 3.8 percent in November. Over the next two years, we expect housing affordability to improve gradually, but the extent of the improvement will likely be underwhelming due to the slow dissipation of the lock-in effect of previously low mortgage rates.

The University of Michigan Survey of Consumers' sentiment index of home buying conditions picked up slightly in 2024Q4, but it remained near its historic low. Despite homebuyers' continued pessimism, homebuilders generally remained optimistic about the economic growth outlook and regulatory environment. The sub-component for expected new single-family home sales in the next six months of the NAHB housing market index has shown above-50 readings (more builders indicating expected sales conditions as good than poor) in all months since September 2024 with the exception of the most recent one for February. However, construction delays and higher building costs are expected in the current environment, because of continued wage pressures amid the challenging labor market and the tariff rollout, which curbs the recovery of supply in single-family homes.

The development of housing affordability continues to be dictated by changes in the mortgage rate as home price growth remains relatively stable. Chart 13 plots our preferred measure of affordability, the ratio between a typical mortgage payment on a newly bought home and the average wage income

per worker, alongside the 30-year conventional mortgage rate.[4] As mortgage rates ticked up from 6.5 percent in 2024Q3 to 6.7 percent in 2024Q4, this ratio rose from 43.4 percent to 43.9 percent. We project the affordability ratio to worsen in 2025Q1 with the conventional 30-year mortgage rate climbing to 6.9 percent, and then to ease gradually to a level comparable to that observed in late 2022. Even though homes are not projected to become much more affordable in the next two years, home sales are likely to recover as the scenario of a swift and substantial improvement in affordability due to sharply lower mortgage rates is seemingly off the table, pushing potential buyers to accept the prevailing prices.

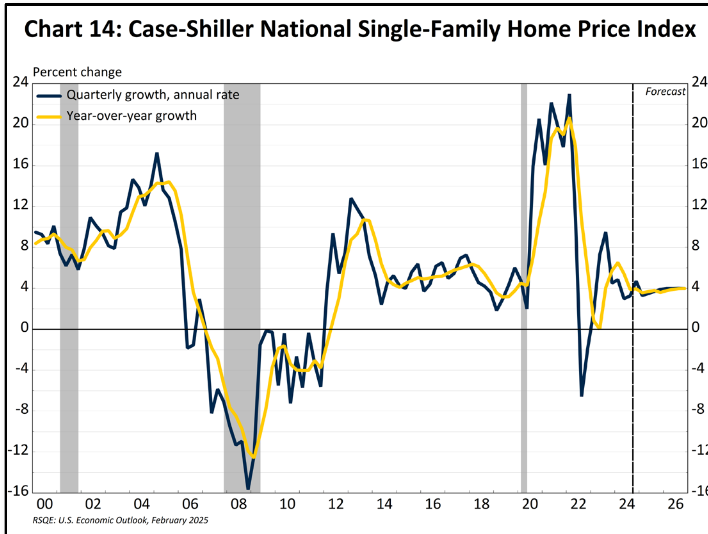


We expect a gradual uptick in new single-family home sales in the near term, as supply increases under stable levels of housing starts and permits, while downward price pressures linger with elevated mortgage rates. Annualized sales of new single-family homes moderated to 662,000 in 2024Q4, down from 708,000 in 2024Q3. Single-family housing starts climbed to an annualized pace above 1,000,000 units in 2024Q4. Months' supply of new single-family homes for sale averaged 8.9 in the fourth quarter of 2024, still suggesting an excess of inventory compared with a balanced market featuring around 6 months' worth of supply. Despite the supply overhang, single-family residential construction is expected to benefit from rising demand. We are still cautiously optimistic about the new single-family home market in 2025 given that the existing single-family home market has tightened.

Existing single-family home sales recovered to the 3.8-million-unit annualized pace in 2024Q4 from the 3.6-million-unit pace in 2024Q3. Looking ahead, existing single-family home sales in 2025 are expected to be similar to sales in 2024, with improved demand limited by elevated mortgage rates.

[4] The mortgage payment is computed assuming no down payment using the contemporaneous average conventional mortgage rate. As a proxy for mortgage size, we index the median home price in 2012 to cumulative house price growth since that time as measured by the Case-Shiller Home Prices Index. Average wage is computed by dividing total wage income by employment level in the BLS' household survey.

Multi-family housing starts further improved to 372,000 in the fourth quarter of 2024, compared with an average pace of 361,000 in the third quarter. Multi-family permits moderated as the rental vacancy rate crept up in the second half of 2024 to 6.9 percent, after consecutive 6.6 percent readings in 2023Q3–4. However, potential single-family home buyers who continue to rent before saving enough to afford a single-family home, combined with sustained growth in jobs and wages, support demand in the multi-family market.



Home price growth has slowed in the second half of 2024. Chart 14 shows the historical and forecast paths of year-over-year and quarterly annualized rates of home price growth, measured by the seasonally adjusted Case-Shiller Home Price Index. The latest release for November 2024 showed a modest rebound to 3.8 percent growth year over year, following a 14-month low of 3.6 percent year-over-year for October. We expect the annualized quarterly pace of price appreciation to dip below 4.0 percent during 2025, before stabilizing at 4.0 percent throughout 2026.

Energy Markets

The price of West Texas Intermediate (WTI) crude oil averaged roughly 75 dollars per barrel during January 2025. Prices experienced a sharp but short-lived surge to 80 dollars per barrel in mid-January, driven by new sanctions on Russia and colder winter weather in North America. Prices later stabilized around 73 dollars per barrel in the final week of the month, as increased U.S. production, demand concerns stemming from tariffs, and fears of oversupply weighed on the market. Prices continued to hover around 71–73 dollars per barrel during the first week of February. While an impending trade war could drive oil prices higher, energy markets have yet to react too strongly, focusing instead on rising U.S. crude oil inventories.

Despite China's efforts to bolster demand, its crude oil imports fell nearly 2.0 percent in 2024. Consequently, India surpassed China as the world's largest source of oil demand growth in 2024, according to the U.S. Energy Information Administration (EIA) projections. The EIA anticipates this emerging trend to continue over the next two years, driven by India's rising demand for transportation fuels and faster overall economic growth forecasts. India is among the few places where energy demand is expected to overtake its pre-pandemic trend. Overall, in its February Short-Term Energy Outlook, the EIA continued to predict that global energy demand growth will remain below the pre-pandemic trend.

In early February, the Organization of the Petroleum Exporting Countries and its allies (OPEC+) decided to stick to its schedule of raising oil output in April. The EIA also forecasts OPEC+ to ramp up production in 2025Q2 through 2026, though it expects output will likely remain below target. Without a substantial increase in supply from OPEC+ countries in the near term though, global inventories will likely continue to draw down until production ramps up to meet global demand. The EIA estimates that increased production in the United States, Guyana, Brazil, and Canada, alongside output from OPEC+, will be sufficient to exceed global demand in the second half of 2025, allowing global inventories to rebuild through 2026.

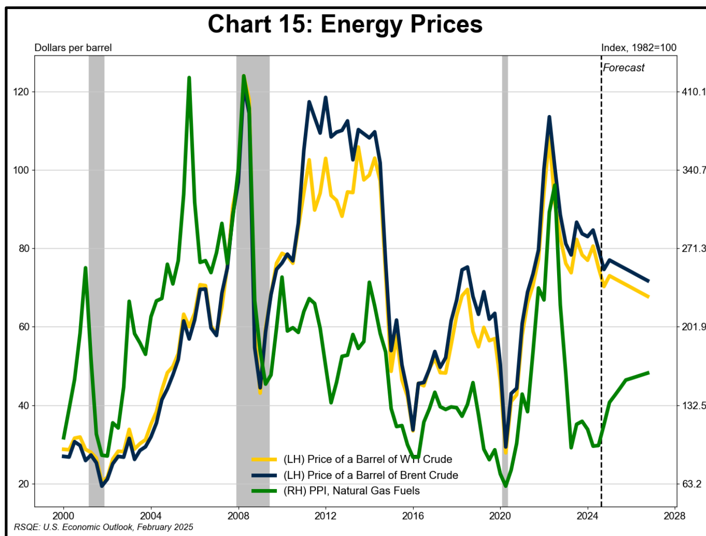


Chart 15 shows our forecast for WTI and Brent crude prices in maize and blue alongside the Producer Price Index (PPI) for natural gas fuels in green. We expect the price of WTI to average 73 dollars per barrel in 2025Q1 and to tick down to roughly 68 dollars by the end of 2026, as global tensions keep oil prices from falling much further. We forecast the Brent–WTI spread to remain relatively stable at 4.0 dollars per barrel through 2026.

Natural gas prices, as measured by the PPI for natural gas fuels, surged 21 percent in the fourth quarter of 2024 due to a cold snap and heightened demand for liquefied natural gas (LNG). Prices climbed further in January 2025, reaching 19.5 percent above year-ago levels following sharp gains in

December and January. Despite high natural gas production in 2023 and 2024, we expect prices to keep rising during our forecast as strong global appetite for LNG remains intact. While China's tariffs on U.S. LNG could dampen its purchases, we expect that robust global demand will help shipments find alternative buyers. As a result, we forecast natural gas prices to increase by 19.2 percent from the first quarter of 2025 to the end of 2026—significantly outpacing the cumulative projected CPI inflation of 4.7 percent over the same period.

The Forecast for 2025–2026

The start of a new Presidential term usually features significant policy uncertainty, especially when coupled with same-party control of Congress, as observers decipher which campaign promises will get high priority and which may fall by the wayside. The start of President Trump's second term has followed suit, but more so. The "flood the zone" executive strategy appears aimed at altering national policies in as many areas as possible simultaneously to spread the opposition thin. As such, it is very hard to predict where the new administration will achieve the most success once the dust settles, with a large range of plausible economic outcomes. We continue to believe that a sharp sudden increase in import tariffs against countries highly integrated into domestic supply chains would be significantly detrimental to the economy and will be avoided. The level of uncertainty associated with tariff threats will likely stay high, however, perhaps in an attempt to reshape supply chains without tariffs. Import duties against China, on the other hand, will continue to rise. How the effort to reshape the federal government will play out is an even bigger wildcard. The traditional GOP agenda of tax cuts and lower spending is our baseline. However, a large-scale firing of federal public servants and dried-up government funding for numerous non-profit entities could upend the recently restored stability in the labor market. On the flip side, a successful re-industrialization of the U.S. economy could boost productive capacity.

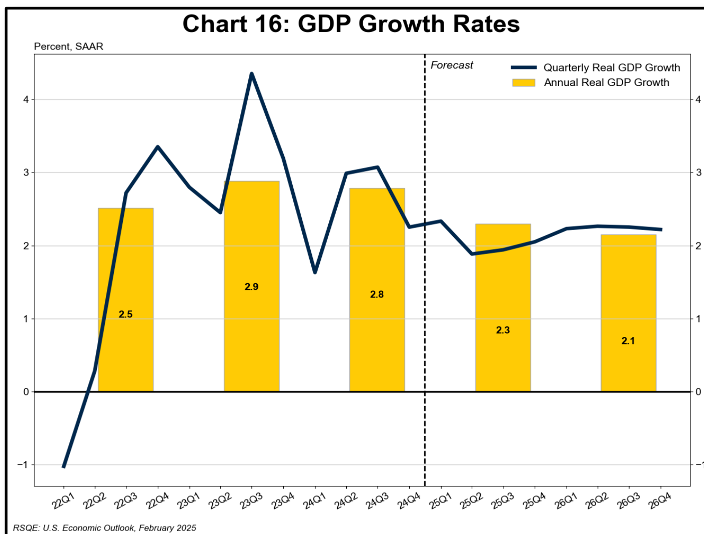


Table 2

Contributions to the Growth of Real GDP

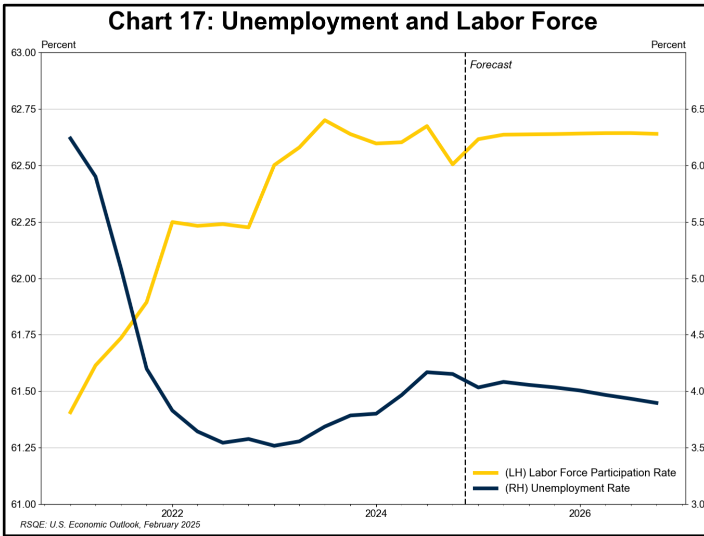
(Average quarterly contributions, percentage points at annual rate)

	'24Q4	'25Q1	'25Q2	'25H2	'26
Real GDP (% change, AR)	2.3	2.3	1.9	2.0	2.2
Contributions to real GDP growth					
Final sales to domestic purchasers	3.2	1.9	2.1	2.2	2.3
Consumption	2.8	1.4	1.4	1.3	1.4
Nonresidential fixed investment	-0.3	0.2	0.5	0.5	0.5
Residential investment	0.2	0.1	-0.0	0.1	0.2
Government purchases	0.4	0.2	0.2	0.2	0.2
Net exports	0.0	-0.6	-0.4	-0.1	-0.0
Inventory investment	-0.9	1.1	0.2	-0.1	-0.0

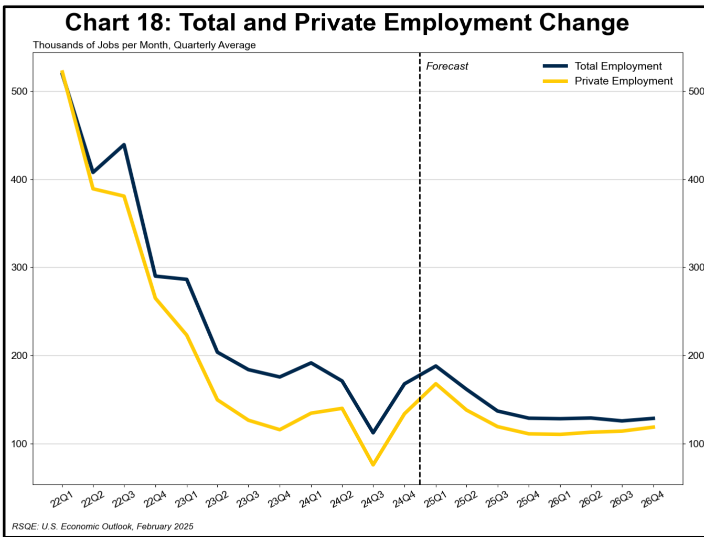
RSQE: U.S. Economic Outlook, February 2025

- We project that the annualized pace of real GDP growth in 2025Q1, at 2.3 percent, will match that of 2024Q4. Rebuilding inventory after the burst of consumption growth last quarter will help sustain the pace of expansion.
- The pace of quarterly real GDP growth then stays in the narrow band of 1.9–2.3 percent annualized for the rest of the forecast.
- Growth slows marginally in 2025Q2–Q3 to the 1.9 percent pace, as higher tariffs keep inflation elevated. By 2026, lower taxes and interest rates help nudge the growth pace to around 2.2 percent.
- Calendar year GDP growth registered 2.8 percent in 2024, but we project it to moderate to 2.3 percent and 2.1 percent in 2025 and 2026, respectively.

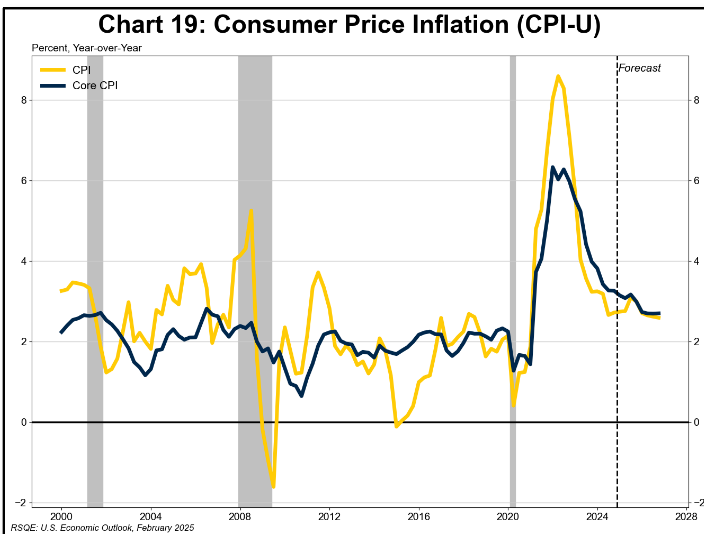
- Election-related spending and the post-election surge in consumption, possibly to front-run tariffs or higher prices, drove consumption's outsized contribution to GDP growth in 2024Q4. In the forecast, consumption growth moderates to provide a steady contribution that averages 1.4 percentage points over 2025–26.
- Investment in intellectual property supplies about two-thirds of the contribution of nonresidential fixed investment to GDP over the forecast window. Equipment investment sputters in 2025Q1, held back by tariff uncertainty and a dip in vehicle sales. Nonresidential construction largely stagnates, following a spike in 2022–24 driven by groundbreaking on multiple new microchip factories.
- Residential investment does not start adding to growth until 2025H2, as mortgage rates remain high and housing affordability improves only marginally.
- Government purchases' contribution to growth drops to 0.2 percentage points, after averaging 0.6 percentage points over 2023Q1–24Q4.
- Net exports' drag on growth shrinks from 0.6 percentage points in 2025Q1 to approximately zero in 2026, as higher tariffs take a larger bite out of imports.



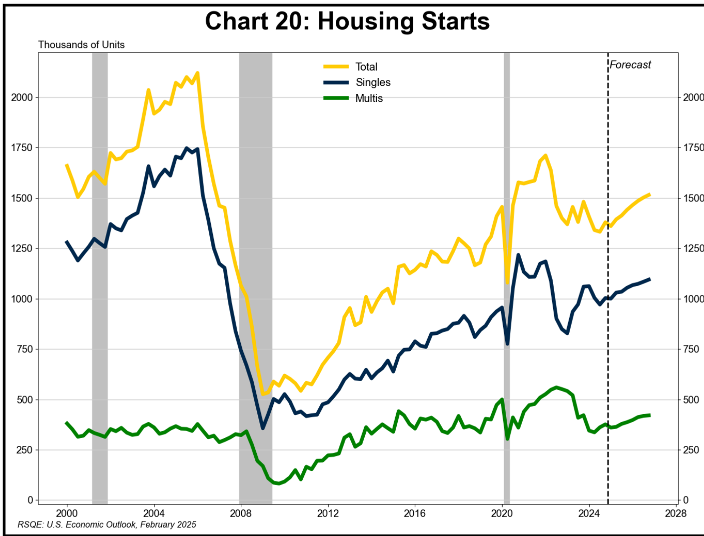
- The labor market is showing some signs of renewed strength. The headline unemployment rate dipped to 4.0 percent in January after reaching 4.2 in November.
- The labor force participation rate has held relatively steady between 62.5 and 62.8 percent since February 2023, with the January reading at 62.6 percent. We expect it to generally stay in this range during our forecast window, as the baby boom generation continues to retire while the share of recent immigrants working and seeking employment edges up.
- As interest rates decline modestly and taxes come down, the labor market firms up marginally. The unemployment rate briefly rises to 4.1 percent in 2025Q2 before sliding back to 4.0 percent in 2025Q4 and 3.9 percent by the end of 2026. Slowing population growth contributes to the tightening of the labor market.

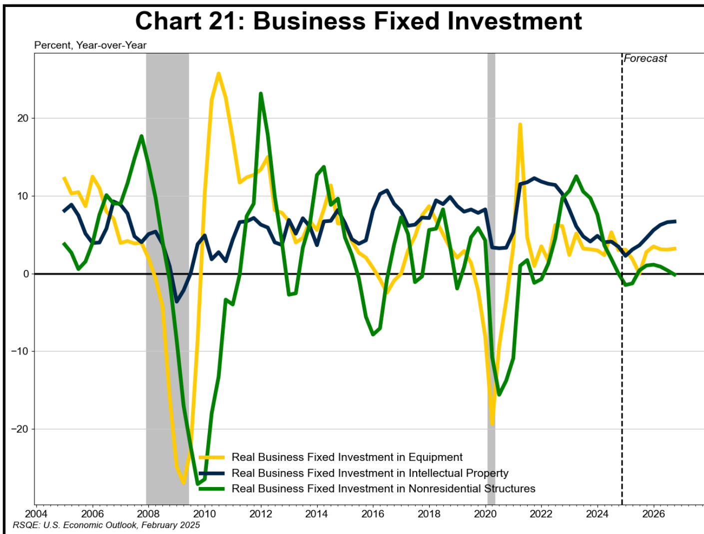


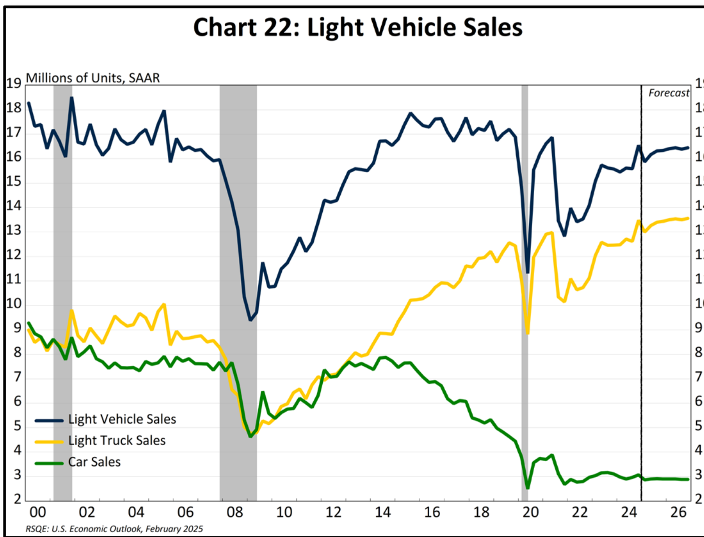
- January's payroll employment showed solid gains of 143,000 jobs after blowout months in November and December of 261,000 and 307,000 respectively.
- The trend pace of job gains has rebounded some after a long deceleration streak. The six-month average pace of gains reached 178,000 in January, the strongest pace since last May.
- Private sector job gains perk up in 2025Q1 but then resume decelerating through 2025Q4. We expect job growth to pick up very slightly in 2026.
- The government sector continues to slow the pace at which it adds jobs from the heights of 2023, as local government employment tops its pre-pandemic count and federal civilian government employment flatlines under the new administration.



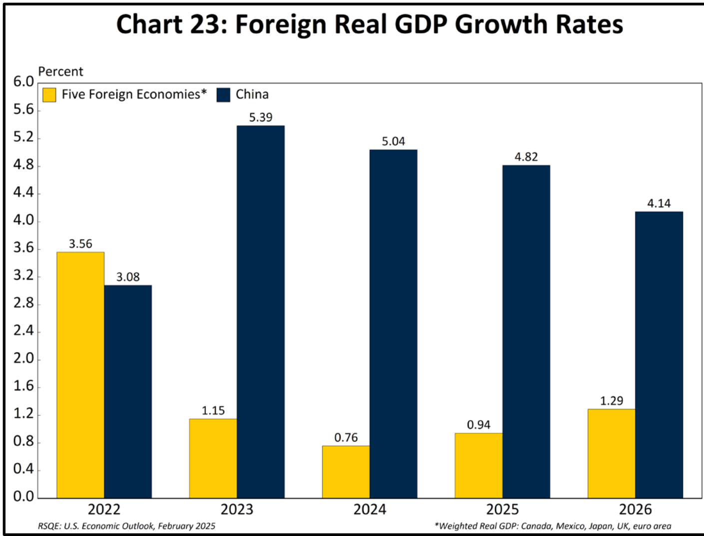
- All-items CPI inflation edged higher to 2.7 percent year over year in 2024Q4, as energy prices rebounded in December. Core CPI inflation stabilized around 3.3 percent in 2024H2, with slower price increases in shelter and other services compared to 2024H1.
- Year-over-year core CPI inflation slows marginally to 3.1 percent in 2025Q1, and lingers around that rate through 2025Q3, as new tariffs on China filter into consumer prices. Core inflation steps down to around 2.7 percent in 2026. Headline CPI inflation runs behind core until the end of 2025, with gasoline and food inflation largely subdued.
- PCE inflation, the Fed's preferred measure, pokes up to 2.7 percent quarter-on-quarter annualized in 2025Q1 and then eases to 2.2 percent from 2025Q4 to 2026Q4. In year-over-year terms, PCE inflation moderates to 2.2 percent in 2025Q2 and briefly picks up to 2.4 percent in 2025Q3–Q4 due to new tariffs, before returning to 2.2–2.3 percent during 2026.



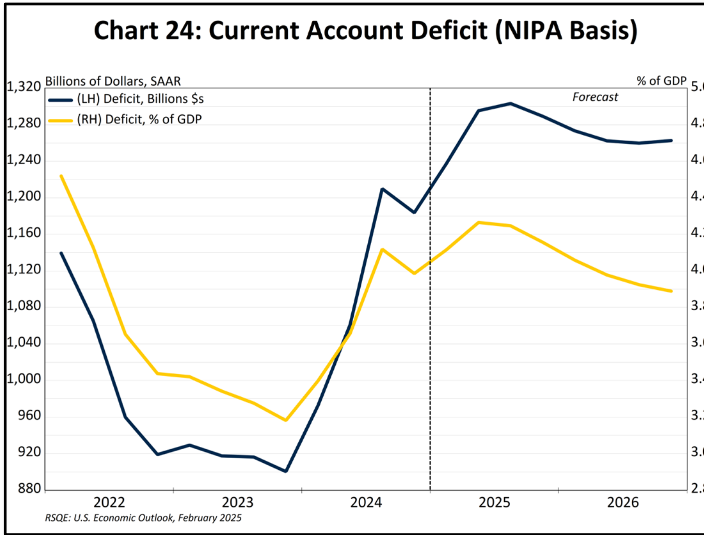




- With plenty of supply for sale, new single-family home construction remained soft in 2024, hovering around an annualized pace of 1,000,000 units. It stays near that pace in early 2025 before picking up gradually to 1,094,000 units by 2026Q4.
- Multi-family starts edged higher to an annualized pace of 372,000 units in 2024Q4. However, we expect multi-family starts to soften in 2025H1 with the still-significant level of construction completions hitting the market amid higher rental vacancies. They climb to a pace of 420,000 units by 2026Q4.
- The annualized pace of total housing starts stood at 1,388,000 in 2024Q4. It is projected to exceed the 2019Q4 level by 2025H2 and reach 1,515,000 in 2026Q4.
- We remain optimistic about new construction, despite a delayed rebound due to elevated mortgage rates. In the medium term, housing starts should benefit from low existing home supply and poor affordability.
- The growth pace of real investment in equipment held steady at 3.0 percent year over year in the final quarter of 2024. Tariffs and subsequent retaliation measures will likely weigh on information processing equipment investment in the near term, with year-over-year growth declining to zero in 2025Q3. We expect growth to resume in 2025Q4, reaching a year-over-year growth rate of 3.2 percent by 2026Q4.
- Intellectual property investment expanded by 3.5 percent year over year in 2024Q4. Despite the uncertainty regarding federal health and science funding, we project that healthy growth in intellectual property persists throughout our forecast window, accelerating to 6.7 percent year over year by 2026Q4.
- As the microchip factories' construction activity likely has already peaked, the level of nonresidential structure investment declined in 2024Q3-Q4. Going forward, we expect that mining construction will instead support modest expansion in nonresidential structure investment.
- The annualized pace of light vehicle sales posted a promising 16.5 million units in 2024Q4, the fastest since 2021Q2. The strong sales were supported by a dip in interest rates, more ample inventory, rising retail incentives, and likely some pull-ahead volume in anticipation of tariffs and an end to the EV tax credit. After a correction in 2025Q1, auto sales are expected to continue rising gradually as vehicle purchases become more affordable relative to incomes.
- The light vehicle sales pace dips to 15.9 million in 2025Q1 and then climbs slowly to around 16.3 million units by 2025H2 and 16.4 million by 2026Q4. The increase in sales gains is primarily driven by the light truck category, which includes pickups, SUVs, and crossovers.
- We generally expect robust auto production and sales in the medium term, but uncertainty related to the tariffs is a substantial risk. Tariffs on cars made in Mexico and Canada, which make up almost 20 percent of U.S. light vehicle sales, could significantly reshape the North American economic geography.



- To forecast demand for U.S. exports, we construct a trade-weighted index of real GDP for five of our major export markets: Canada, Mexico, Japan, the United Kingdom, and the euro area. We also track China's economy, but we show it separately because it tends to grow more quickly.
- China's economic growth responded well to policy stimulus in the second half of 2024, but the annual growth rate still decelerated to 5.0 percent. This burst of growth late in 2024 will boost 2025 calendar average, even though the quarterly pace will settle around 4.0 percent soon due to rising tariffs on China's exports.
- The five-economy composite calendar year growth rate is projected to have slowed to just 0.8 percent in 2024, dragged down by slower growth in Japan and Mexico. Average calendar year growth over 2025–26 improves in all countries but Mexico, which would likely be damaged the most by the more aggressive U.S. trade policy. The five-economy aggregate growth rate improves to only 1.3 percent by 2026.



- The current account deficit has rebounded during 2024 owing to strong growth in imports. The current account deficit stood at 4.0 percent as a share of GDP in 2024Q4, taking a pause from the recent run-up.
- We forecast import tariffs, primarily targeting Chinese goods, to ramp up in 2025Q2. In anticipation of foreign retaliation and perhaps higher tariffs, we expect businesses to accelerate both imports and exports of goods. The deficit-to-GDP ratio peaks at 4.3 percent in 2025Q2 as the frontloading of imports temporarily outpaces export growth.
- The current account deficit narrows marginally in 2026. A sizable domestic tax cut would likely fuel extra demand for goods, offsetting some restrictions on import growth due to tariffs.
- In nominal terms, the current account deficit registers an annualized pace of 1.2 trillion dollars in 2025Q1, then widens by about 66 billion dollars more through 2025Q3, before declining by roughly 40 billion dollars by 2026Q2 and flatlining in the second half of the year.

Risks to the Forecast

Economic uncertainty remains highly elevated. Noisy and delayed data, coupled with policy ambiguity in Washington D.C., allow for a wider-than-usual range of near-term scenarios. Tariff policy continues to be a wildcard throughout our forecast horizon.

The labor market has shown encouraging resilience since last summer, but its health could be overstated by noisy data. For example, employment in the Quarterly Census of Employment and Wages (QCEW), the primary source for the annual benchmark of the payroll employment level, showed a much

weaker growth for 2024Q2 than the establishment survey job count. The gap between year-over-year readings of QCEW and the more timely measure of payroll employment averaged 0.3 percentage points for 2024Q2-Q3. While not unprecedented, a further increase in this disparity would be concerning, suggesting that another downward revision to the payroll job count is coming and the labor market is looser than we currently believe.

We are relatively optimistic about the direction of the upcoming inflation readings despite the limited recent progress. However, inflation could re-accelerate due to factors such as a surprise in the shelter component. In particular, continued high mortgage rates could keep potential homebuyers away from purchasing, resulting in some upward pressure on rents. The run-up in home prices since 2020 has been much more pronounced compared to rents, leaving the price-to-rent ratio close to mid-2000s level highs. With no housing price correction in sight, a persistently high rent inflation could be the mechanism to bring the relative costs of home ownership toward historical norms. Meanwhile, the administration's focus on increasing domestic fossil fuel production could lead to lower energy prices.

The new administration has adopted a "flooding the zone" approach to pushing its agenda. This makes predicting which policies will ultimately be implemented, to what extent, and on what timeline they will filter through the economy significantly more challenging. The current budget negotiations in Congress are one of many near-term uncertainties in the fiscal environment. Our forecast does not feature a government shutdown, but the risk of an intra-party clash that could lead to one in March is non-negligible. While unlikely, a lengthy shutdown could lead to a significant level of immediate fiscal consolidation, which will dampen our economic outlook considerably.

Our forecast assumes that Congressional Republicans succeed in extending the TCJA and enacting about 200 billion dollars of extra tax cuts per year. However, should intra-GOP unity fracture, the razor-thin margin in the House of Representatives may threaten the passage of many elements of the GOP's fiscal agenda. This scenario would likely result in weaker growth in 2026 and a somewhat narrower budget deficit. On the other hand, if the House GOP's one-bill strategy proves successful, significant tax cuts may be backdated to the start of calendar year 2025, with an immediate impact on withholding, disposable incomes, corporate profits, and the economy.

The extent of government downsizing remains an open question. Large reductions in the federal workforce would have a meaningful impact on our near- and medium-term outlook for federal spending, which typically accounts for around 6.5 percent to GDP in real terms. Our forecast foresees headwinds to the federal headcount in the near term given the hiring freeze and ongoing layoffs of probationary employees. We believe that some displaced workers may transition to state and local government. However, with the state and local government hiring rate returning to its pre-pandemic level, the extent to which this sector can absorb additional workers is uncertain, posing a potential risk to the labor market. Furthermore, federal layoffs could severely undermine the quality of survey data provided by federal statistical agencies by delaying data collection modernization and discouraging talented personnel. Any deterioration in the accuracy and timeliness of key economic statistics would pose a persistent challenge to interpreting an already complex economy. On the other hand, the Administration's efforts to reduce the federal workforce may be constrained by the courts, reducing their eventual impact.

Finally, the evolving fine print and implementation of tariff policy are likely to create continuing risks throughout our forecast horizon. The ramp-up of tariffs on goods from China has begun already. We expect the tariffs on steel and aluminum imports to stick, but so far we do not anticipate lasting and broad-based tariffs on imports from the rest of the world. We believe that the latter will be used to provide negotiating leverage with our trading partners, although they may be implemented temporarily in pursuit of a deal. However, if broad tariffs are imposed on Canada and Mexico, they would probably trigger a sizable retaliatory response. The disruption to North American supply chains would be especially severe if such tariffs were imposed with no significant lead time.

Overall, we judge that the balance of risks to our outlook is tilted toward slower real economic growth than our point forecast, although we believe that the Federal Reserve should be able to offset many of the potential negative shocks we have described. The wide range of potential scenarios may prevent the Fed from delivering the necessary response in time.