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The U.S. Economic Outlook for 2025–2027

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Executive Summary

Shaky Growth, but Steadier Tariff Landscape

Seesaw movements of inventories and net exports over 2025H1 pushed the headline annualized real GDP growth pace to 3.0 percent in the second quarter, up from a negative 0.5 percent print in the first quarter. Under the hood, however, the economic growth engine is sputtering. The combined growth contribution of private consumption and fixed investment slid from 1.6 percentage points in 2025Q1 to 1.1 in 2025Q2, with both figures likely boosted at least marginally by tariff front-running.

While tariff news continues to roll in, broader trade uncertainty appears to be subsiding. Several major U.S. trade partners have agreed to tariff rates near 15 percent, and we now expect tariffs on non-USMCA compliant imports from Canada and possibly Mexico to ultimately come down to around that level as well. The final outcome of trade negotiations with China is still uncertain, but we now think that the eventual average level of tariffs on China's imports will settle around 50 percent, up by almost 40 percentage points since 2024.

Job Market Data Under Stress

The July jobs report brought an unexpected chill to the peak of summer. A modest headline reading of 73,000 jobs added and outsized downward revisions to May and June, totaling 258,000 jobs, pulled the three-month average job gains down to just 35,000 in July.

The headline unemployment rate has hovered in the 4.0–4.2 percent range since May 2024, but the household employment level is down nearly 800,000 since January 2025. Possibly reflecting the softening jobs market, the labor force participation rate has slid by 0.4 percentage points since April, preventing the unemployment rate from rising.

Overall, monthly and higher-frequency hard data and recent surveys of consumers and businesses paint a mixed, but generally downbeat, picture of the dynamics of the economy so far in the third quarter, suggesting further slowing of economic growth. A recession, however, is not in our baseline given that financial asset valuations are near new highs and risk spreads remain quite narrow.

Affordability Split in Housing

Existing home prices have edged down in recent months, but mortgage rates remain near 7.0 percent. Poor affordability, coupled with elevated economic uncertainty and a low-turnover jobs market weigh on the single-family home market. As inventory accumulated and buyers remained cautious, single-family housing starts and permits declined in the past quarter.

The multi-family housing market is holding up well after working off the post-pandemic oversupply. Most new multi-family units are built for rent, with the market likely benefiting from the poor affordability of homeownership.

Tariff Pass-Through Uncertain, Possibly Started

Year-over-year CPI core goods inflation has turned marginally positive since April after spending most of 2024 in deflation territory. While the pickup in inflation faced by consumers has been far less pronounced than many predicted, the July jump in the PPI to 3.3 percent year over year suggests that more measurable tariff pass-through could be starting. The eventual share of the tariff burden borne by consumers, domestic and foreign businesses is highly uncertain, yet very consequential to our economic outlook.

The Fed, Risks, Cuts

If the labor market weakens further while tariffs start showing up in prices, the Fed will be in an uncomfortable position this fall. The FOMC will have to weigh deteriorating hard data on its full employment mandate against the risk of tariff-driven price increases *turning into persistent inflation, with very little data on the latter. We think that softer labor market data will prevail, and the Fed will resume cutting rates.*

Still, we project the Fed to cut the target range for the fed funds rate in a measured manner, by 50 bps by the end of 2025. As extra inflation due to tariff policy begins to subside, we expect two more 25 bps cuts in the first half of 2026 and another one in the second half of 2026. This trajectory brings the fed funds rate range to 3–3.25 percent, the terminal range we project for this cycle.

GOP Reconciled

The enactment of the One Big Beautiful Bill Act in July cemented or extended much of the 2017 tax overhaul, while sprinkling some deferred spending cuts to select safety net programs to assure the bill's passage. Several new personal tax deductions were added to partially fulfill campaign promises. Major provisions on the business side restored the immediate R&D expense write-off and made the 100-percent bonus depreciation allowance on qualified investment permanent.

We anticipate robust growth in defense spending throughout our forecast, while non-defense spending pulls back in the near term before edging back up.

Revenue growth tracks closely with expenditure growth as tariff revenue balloons while faster inflation feeds tax revenues. As a result, the federal deficit settles around 6.0 percent of GDP, an unsustainably high level.

The 2025–2027 Outlook

As tariff headwinds dampen consumer spending and restrain real activity, we expect headline GDP growth to slow to 1.7 percent in 2025Q3. With the labor market weakening and tariff-induced price pressure materializing, growth slips further to 0.6 percent in 2025Q4. As looser monetary policy and lower taxes filter through the economy, we project the pace of growth to ramp back up to 2.0 percent by early 2027. Real GDP expands by 1.7 percent in calendar 2025. Calendar year growth edges down marginally in 2026, before rebounding to 2.1 percent in 2027.

We expect the labor market to soften over the next year, as economic growth remains slow. The unemployment rate rises from 4.2 percent in 2025Q3 to 4.6 percent in 2026Q3–Q4. Less restrictive monetary policy helps stabilize the unemployment rate by 2027. Average monthly private sector job gains will slow further and bottom at 60,000 per month in 2025Q3. We expect private job growth to pick back up slowly and exceed 100,000 per month by 2027. In 2025Q4, the removal of around 100,000 federal workers who took separation incentives from payrolls will push overall monthly job gains to just 26,000 per month.

PCE inflation picks up as tariffs filter through the economy. Year-over-year PCE inflation stays in the 2.6–2.8 percent range through 2027Q1 and then decelerates to 2.3 percent by 2027Q4.

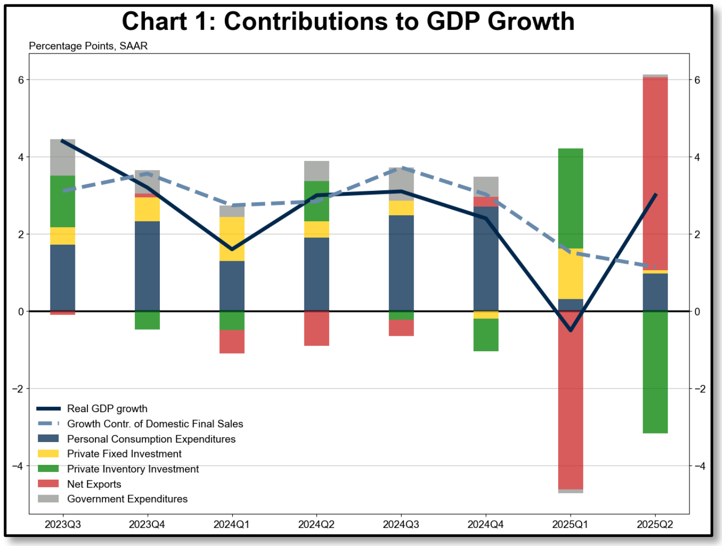
Total housing starts slow to 1,284,000 units in 2025Q4, stalled by tepid growth and lasting uncertainty. Over 2026–27, as the existing supply overhang clears, and mortgage rates decline, housing starts improve slowly to 1,412,000 units by the end of 2027.

With tariffs starting to show up in higher MSRPs and lower incentives, light vehicle sales are expected to drop substantially in 2025Q4, to a pace of 15.4 million units as the back side of the pull-forward effect arrives. The sales pace lingers around 15.4 million during 2026, with tariff-induced price increases still ongoing. The sales pace edges up to 15.6 million over 2027.

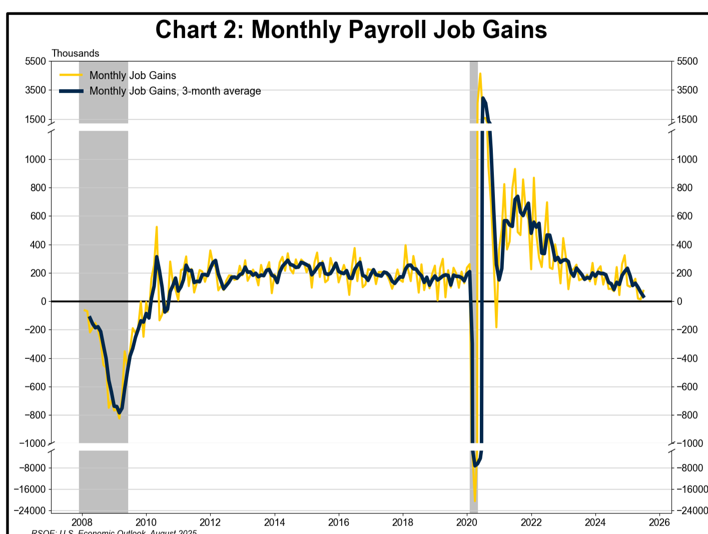
	Actual	**RSQE Forecast**		
	2024	2025	2026	2027
GDP (billions of current $)	29184.9	30451.8	31749.3	33237.0
Real GDP (billions of 2017 $)	23305.0	23700.4	24045.4	24542.0
% change: year-over-year	2.8	1.7	1.5	2.1
% change: 4th-qtr-to-4th-qtr	2.5	1.2	1.6	2.3
Nonfarm payroll employment (millions)	158.0	159.5	160.2	161.5
Civilian unemployment rate (%)	4.0	4.2	4.5	4.5
Capacity utilization, total industry (%)	77.6	77.6	77.5	77.7
Inflation (private nonfarm GDP deflator, % change)	2.4	2.6	2.8	2.6
Inflation (CPI-U, % change)	3.0	2.7	3.1	2.9
Inflation (core CPI, % change)	3.4	3.0	3.3	3.1
Light vehicle sales (millions)	15.8	16.0	15.4	15.5
Private housing starts (thousands)	1370.6	1327.9	1328.0	1393.2
3-month Treasury bill rate (%)	5.0	4.1	3.3	3.1
10-year Treasury note rate (%)	4.2	4.3	4.0	3.9
Conventional mortgage rate (%)	6.7	6.7	6.2	5.8
Real disposable income (billions of chained 2017 $)	17517.4	17848.5	18115.3	18427.1
% change	2.7	1.9	1.5	1.7
Corporate profits after tax (billions of current $)	3440.6	3287.1	3365.2	3629.7
Value of U.S. $ (FRB broad index), % appreciation	2.3	0.1	-1.4	0.0
Current account balance (NIPA basis, billions of current $)	-1087.6	-1142.3	-983.6	-969.1
Federal surplus (FY, NIPA basis, billions of current $)	-1789.5	-1846.3	-1847.1	-1891.2

The Current State of the Economy

Real GDP expanded at a 3.0 percent annualized rate in the second quarter. Chart 1 shows the contributions of the major components in the GDP statistics to the headline growth rate. After a historic drag of 4.6 percentage points in the first quarter, net exports' contribution bounced back to the also-unprecedented magnitude of 5.0 percentage points. The volatility in net exports in the first half of the year was primarily driven by imports of some goods responding violently to the threat of tariffs and then dropping off sharply. Exports moved in similar ways, but only with a fraction of the amplitude.



The growth contribution from inventory investment swung in the opposite direction from that of net exports. As producers tapped into their inventory stocks rather than relying on imports to meet demand, the contribution of private inventory investment subtracted 3.2 percentage points from growth in 2025Q2. While the growth contribution from consumption partially rebounded in the second quarter, the momentum in private fixed investment dissipated as likely tariff front-running in equipment investment ebbed. Final sales to domestic purchasers, which exclude the volatile GDP components of net exports and inventory investment, added 1.1 percentage points to headline GDP growth. That contribution edged down from 1.6 percentage points in 2025Q1 and fell notably below the 2022–24 average of roughly 2.2 percentage points.

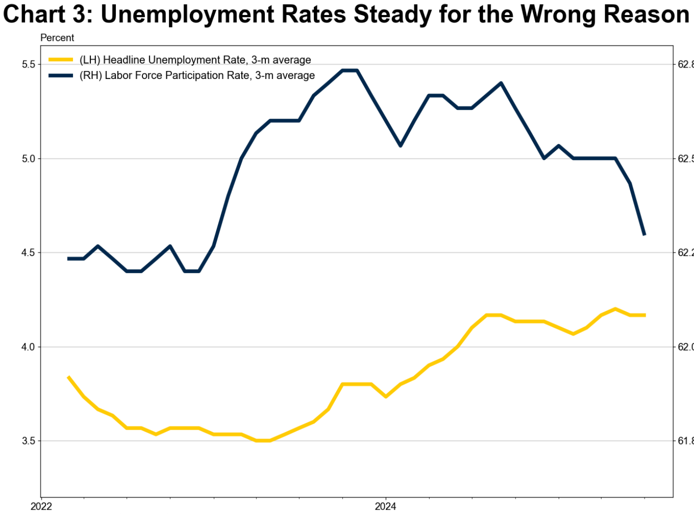


The July jobs report brought an unexpected chill to the peak of summer. Chart 2 shows monthly payroll job gains and the corresponding 3-month average. Modest headline reading of 73,000 jobs added and outsized downward revisions to May and June, totaling 258,000 jobs, pulled the three-month average down to just 35,000 in July. The hiring market is clearly showing signs of weakening. Although the downward revisions were broad-based, educational services under state and local government accounted for over 40 percent of the total. Even though the goods-producing and retail trade sectors have both shed jobs in recent months, we think it is still too early to conclude that employers have delayed hiring because of tariffs.

The data remain noisy and are subject to further revision during annual benchmarking, with the preliminary estimate due in September. As population growth slows, job gains closer to the July reading of 73,000 are likely to become more common going forward.

Despite significant downward revisions in the payroll data, the unemployment rate has hovered around 4.2 percent since March. This resilience is partially because the labor force participation rate has been declining. Chart 3 shows the 3-month moving average of the unemployment rate and the labor force participation rate. The latter has declined from a recent high of 62.8 percent in late 2023 to 62.3 percent—its lowest level since before 1980, excluding the pandemic and the recovery that followed in 2021–22. There are likely several factors behind this trend. First, as the labor market softens, job opportunities tend to dry up first for traditionally less advantaged workers. We have seen considerable declines recently in labor force participation for those under the age of 24, and for Black or African American workers. Second, the participation rate for highly educated workers, namely those who have at least a bachelor's degree, has also edged down notably in recent months. Finally, population aging will continue to exert downward pressure on the labor force participation trend.

Chart 3: Unemployment Rates Steady for the Wrong Reason

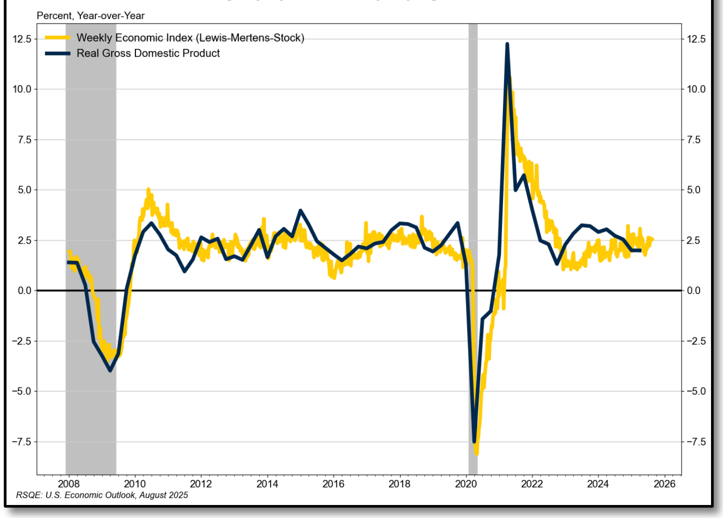


RSQE: U.S. Economic Outlook, August 2025

We believe the declining labor force participation rate, and resulting resilience in the unemployment rate, is masking some worrisome developments in the civilian employment-to-population ratio, which has dipped below 60.0 percent since May. Still, we judge that the labor market remains in balance, but it is certainly in a more precarious place than a year ago.

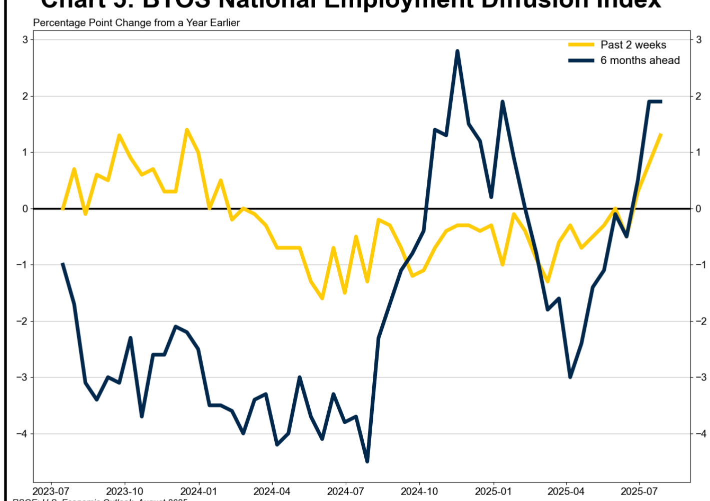
Higher-frequency indicators of economic activity with data through late July and early August suggest ongoing expansion. Chart 4 plots the Weekly Economic Index (WEI) published by the Federal Reserve Bank of Dallas. It summarizes ten daily and weekly economic indicators such as tax withholding, electricity consumption, and rail traffic.[1] The index is scaled to the four-quarter real GDP growth rate. The index dipped from a 2.4–2.5 percent year-over-year pace between December 2024 and April 2025 to about a 2.1 percent pace in May–June. However, it recovered in July and early August. The relatively steady level of growth indicated by WEI suggests that so far the economy is holding up to the tariff shock. That said, the available history since 2008 shows that official growth figures can diverge substantially from WEI-implied readings.

Chart 4: WEI and GDP



New initial unemployment claims remained low and steady in the weeks that followed the July employment report's reference week of July 10–16. The bi-weekly Census Bureau's Business Trends and Outlook Survey (BTOS) contains data on the share of respondents who have seen their number of paid employees increase, decrease, or stay flat over the survey period, which allows us to calculate a diffusion index. The year-over-year change of the

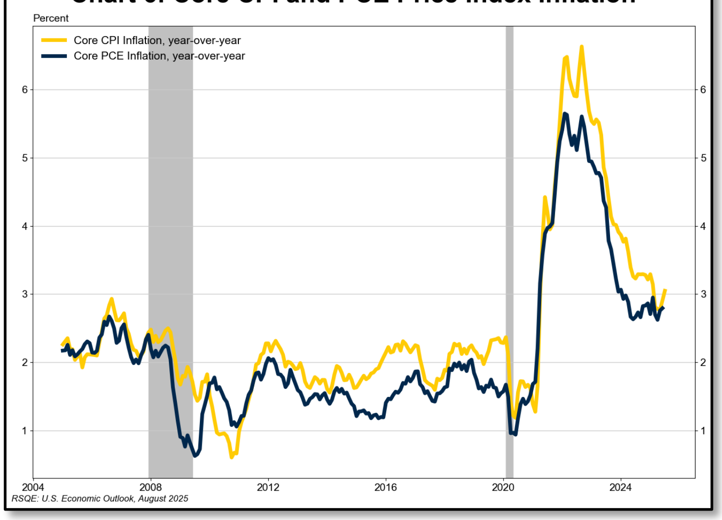
Chart 5: BTOS National Employment Diffusion Index



[1] The index uses Redbook same-store sales, Rasmussen Consumer Index, new claims for unemployment insurance, continued claims for unemployment insurance, adjusted income/employment tax withholdings, railroad traffic originated, the American Staffing Association Staffing Index, steel production, wholesale sales of gasoline, diesel, and jet fuel, and weekly average US electricity load.

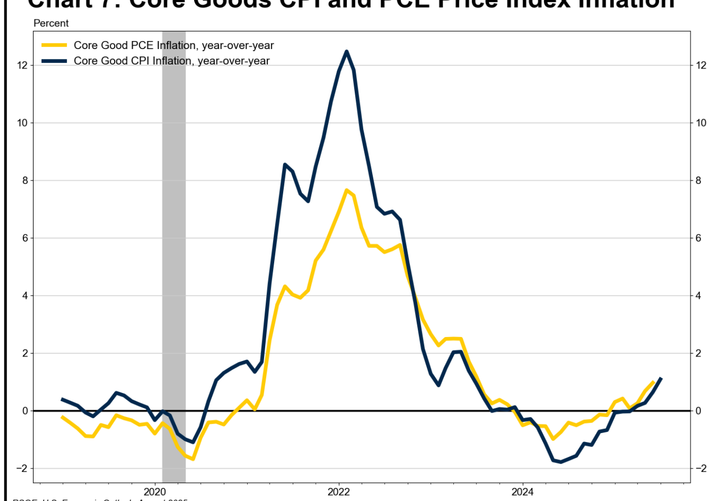
current employment diffusion index shows an uptick in the second half of July, with the July average improving considerably both compared to a year ago and compared to the recent trend of year-over-year readings.[2] It is worth stressing that July–August 2024 private payroll gains averaged under 40,000 a month, so the year-over-year improvement in the BTOS metric does not signal a strong labor market, but rather puts a floor under the pace of ongoing softening. We also construct a year-over-year change of the diffusion index for hiring plans six months into the future. This metric also improved in July, with the year-over-year change of the BTOS diffusion index for employment 6 months ahead rising to a level similar to those observed during the surge of job market optimism in late 2024 and early 2025. Overall, the available higher-frequency data suggests that the economy has likely continued to expand in the latest monthly and quarterly data.

Chart 6: Core CPI and PCE Price Index Inflation



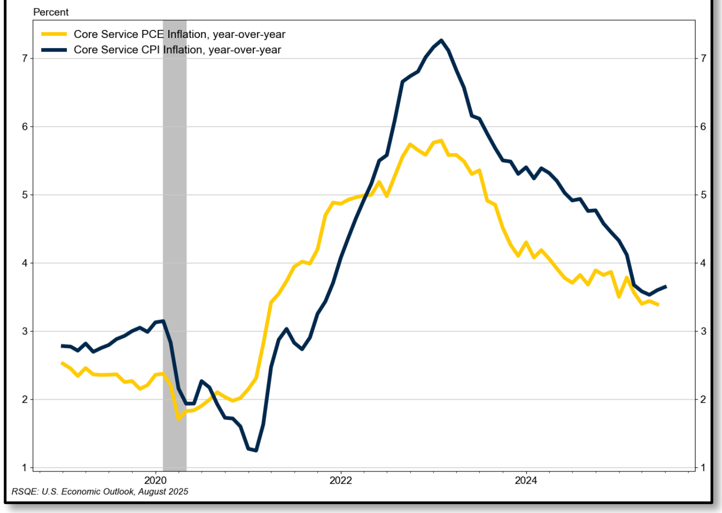
Incoming inflation data suggest tariffs may be starting to pass through to consumer prices. Year-over-year readings for core CPI and PCE inflation, which strip out the volatile food and energy components, have picked up slightly. In July, core CPI inflation edged up to 3.0 percent year over year, while core PCE inflation has been hovering around the 2.6–3.0 percent range for more than one year. Core goods inflation, which had been a deflationary force reining in the pace of headline inflation, has re-accelerated since April, although the upward trend began in mid-2024. While the pickup in inflation faced by consumers is less

Chart 7: Core Goods CPI and PCE Price Index Inflation



[2] The BTOS is a relatively new bi-weekly survey. The data starts in July 2022, and expanded coverage begins late September 2023, with the most recent data covering July 14 through July 27.

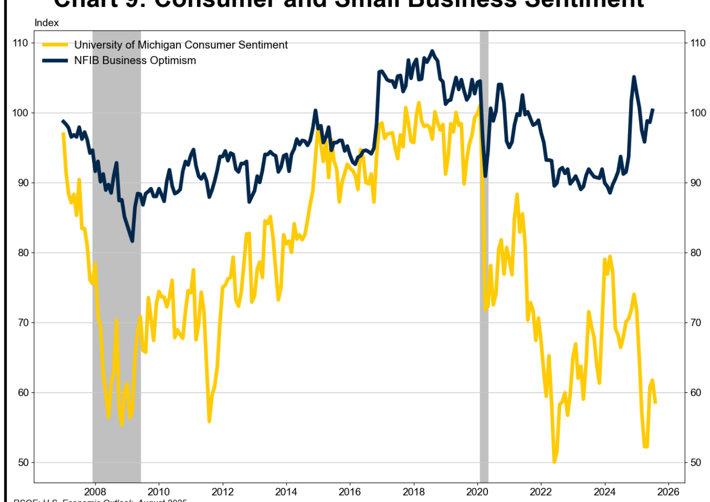
Chart 8: Core Services CPI and PCE Price Index Inflation



pronounced than many market observers had anticipated, the latest Producer Price Index (PPI) inflation rate of 3.3 percent year over year suggested that more tariff pass-through is probably still forthcoming. Meanwhile, core services inflation has yet to show meaningful progress toward normalization. Chart 8 shows the core services CPI and PCE inflation. Both metrics appear to have stalled above their pre-pandemic levels. We remain cautiously optimistic that continued shelter disinflation may provide some relief to core services inflation in the months ahead, as several rent cost metrics have shown renewed signs of easing.

The University of Michigan's index of consumer sentiment tanked between January and May, hammered by tariff-related developments. In June, as the tariff outlook stabilized and stock markets rebounded, all index subcomponents improved, and the overall index jumped. The July–August readings edged down again, however, largely due to deteriorating conditions for buying household durables. The composite sentiment index remains remarkably depressed, although the disconnect between the level of sentiment and growth of real consumption expenditures has narrowed as the latter has slowed.

Chart 9: Consumer and Small Business Sentiment



The National Federation of Independent Businesses (NFIB) Small Business Optimism index, on the other hand, is back over 100 for July, a level the index exceeded in November 2024–February 2025 before dipping to 95.8 in April. The bulk of the recent index dynamics could be explained by changes in expectations of future economic performance and businesses' own real sales. The recent improvement in the NFIB metric is even more remarkable given its historical sensitivity to the state of the residential single-family housing market, which is currently in the doldrums.

The Institute for Supply Management's (ISM's) Purchasing Manager Indices (PMIs) for manufacturing and services have weakened in recent months. The manufacturing sector PMI has edged down to 48 in July after a brief January–February spell above 50, with a concerning decline in the employment subindex. New orders and production subindices appear to be holding up, however. The services PMI July reading of 50.1 indicated stalling growth in the sector, with the May–July average at 50.3.

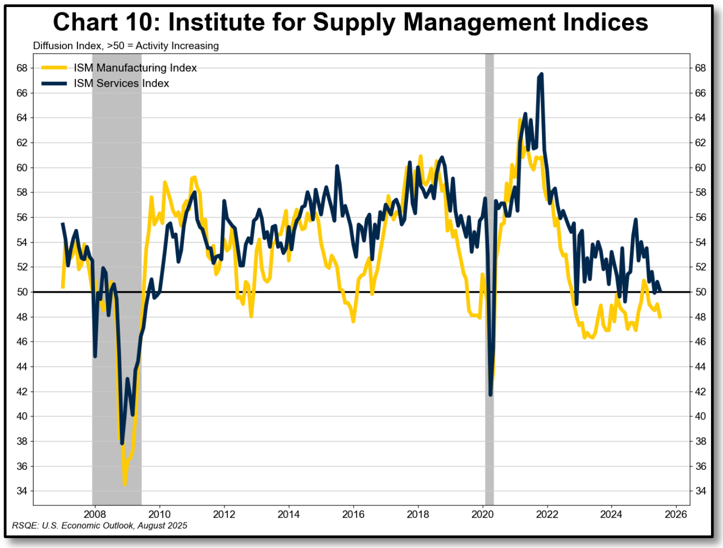


Chart 10: Institute for Supply Management Indices

Business activity, new orders, and employment subindices drove a concerning trend of slowing growth in the services sector, which covers about 84 percent of private sector jobs in the economy. Overall, consumer and business survey indices paint a somewhat mixed, but generally downbeat, picture that highlights the economy's perilous state.

The auto industry was one of the first to face sector-specific tariffs. Although sales volumes gyrated as buyers raced to front-run tariffs late last year and this spring, tariffs' impact on prices and production has been relatively muted. The annualized pace of vehicle sales averaged 16.1 million units in the second quarter, with a strong July print of 16.4 million units. The rush to qualify for the electric vehicle (EV) tax credit ahead of its accelerated September 30 expiration could support another above-trend sales reading this quarter. Meanwhile, the pace of production has remained steady through July. We have yet to see price hikes—in fact, inflation for both

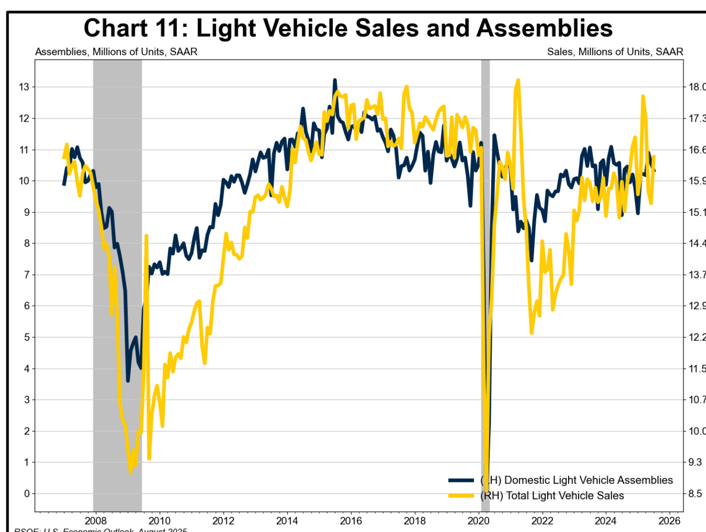


Chart 11: Light Vehicle Sales and Assemblies

used and new cars has mostly decelerated in recent months. Even as automakers ramp up deliveries of new model-year vehicles with higher MSRPs later this year, the impact will likely filter into consumer price readings gradually as those models gain market share. Moreover, recent and expected regulatory changes are likely to reduce automakers' production costs, potentially easing tariff-related price pressure.

Overall, we see the economy maintaining its footing, though its resilience may be fading. We expect softer readings on the labor market and real GDP growth in the second half of the year. Upcoming interest rate cuts should help preserve the economy's growth, preventing a downturn in the near future.

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

Trade Policy

After an unrelenting barrage of tariff-related news this spring, summer brought some relief both in the frequency and the content of tariff news. There were still plenty of tariff increases: steel and aluminum tariffs rose to 50 percent for many countries, with copper joining the list; the *de minimis* exemption for packages valued under 800 dollars is set to be eliminated on August 29; reciprocal tariffs on many countries took effect in August; and Brazil and India saw their tariff rates jump for reasons not directly related to their trade with the United States. However, there were several deals announced that likely signal the general future direction of the Trump Administration's trade policy. Starting with the United Kingdom in June, and followed by Vietnam, Indonesia, Japan, the European Union, and South Korea in July, announced deals generally offered lower tariffs compared to those threatened earlier. We think that Japan, Korea, and the EU, all countries with large exports of high value-added goods into the United States, getting tariff rates around 15 percent is a strong signal about the future direction of the U.S. trade policy with respect to geopolitical allies. Hence, we expect tariffs on non-USMCA compliant imports from Canada and possibly Mexico to come down to around 15 percent eventually as well.

It is harder to assess the long-term level of tariffs on China. The pause in further escalation was recently extended through early November. Negotiations are ongoing, but the final outcome is still uncertain. We now think that the eventual average level of tariffs on China's imports will settle around 50 percent, up by almost 40 percentage points since 2024. Global retaliation has been very muted, with only China and Canada implementing significant tariffs on selected U.S. exports.

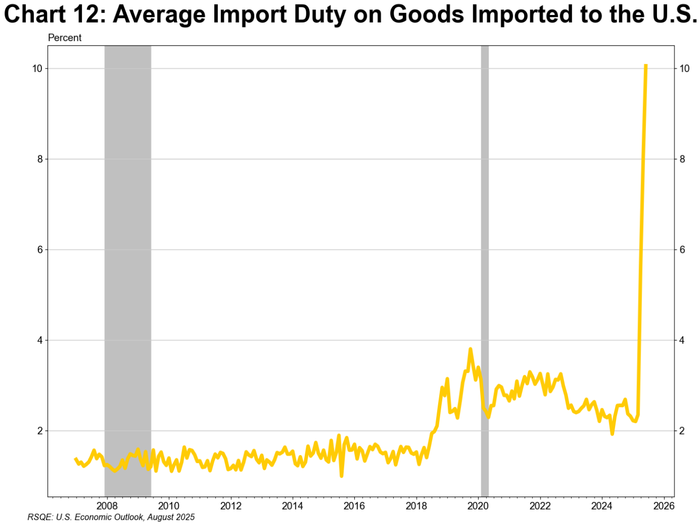
We are not out of the woods on new tariffs yet, though. There are ongoing Section 232 national security investigations into imports of semiconductors and pharmaceuticals. President Trump has also threatened significant "secondary" tariffs on countries helping Russia evade Western sanctions and additional tariffs on BRICS countries if they try to reduce their dependence on the U.S. dollar for international trade.

All in all, our assumptions result in an average tariff rate of around 15 percent (based on recent country import shares) to persist throughout our forecast horizon. The post-substitution effective tariff rate is likely to be lower, as consumers shift away from imported goods whose prices increase more due to tariffs, while businesses reoptimize their supply chains to minimize import duty bills. Nonetheless, we penciled in a significant and persistent increase in annual tariff revenues, ramping up from about 80 billion dollars in 2024 to over 360 billion dollars in 2026.

While the ultimate levels of tariffs we expect over the forecast horizon are lower than previously anticipated, we still expect considerable upward pressures on consumer prices to weigh on near-term growth.

Incoming hard data has shown very limited impacts from tariffs so far outside of front-running effects on imports and inventories. Consumer price inflation through July has yet to show a break from its 2024 trend, with only a few isolated sub-categories showing spikes that could be linked to tariffs. Producer prices did jump in July but are only up marginally for the year so far. As shown on Chart 12, tariff bills only began to accumulate in April, reaching an average rate of 10 percent in June, and likely inching up in July. We expect the average tariff to rise further through fall, but

Chart 12: Average Import Duty on Goods Imported to the U.S.



then to stabilize and to start declining as trade flows adjust and consumption and production substitution takes hold.

The ultimate impact on consumer prices is uncertain. With tariffs already generating about 30 billion dollars per month for the Treasury, it currently appears that U.S. businesses are bearing the full tariff burden since neither consumer prices nor import prices have changed much yet. But that outcome is not likely to sustain. There are several reasons to think we are still at the beginning of the passthrough into consumer prices. First, producers had a chance to stock up on some goods in advance of tariffs, placing some post-tariff imports into bonded warehouses where tariffs are not due until the goods are withdrawn for use in production or to be sold. Second, some academic literature also suggests that real effects of tariffs may take a while to show up.[3] Finally, some price increases have already been scheduled. For example, many vehicle manufacturers announced increases in their MSRP pricing for 2026 model year vehicles by 2–3 percent on average, with deliveries set to ramp up this fall.

On the other hand, there are several reasons to expect that foreign suppliers will also bear a meaningful share of the tariffs' costs. The voluminous academic literature on the passthrough of large exchange rate changes into import and consumer prices typically places the U.S. economy near the bottom in terms of price sensitivity, implying that historically, foreign producers routinely took large hits to profits in cases of significant dollar depreciation.[4] We believe that this scenario remains plausible despite muted import price decline thus far.

Furthermore, recent fiscal and regulatory policy actions may offset some revenue losses for several domestic sectors, which would allow them to preserve their profit margin without passing tariff-induced costs to consumers.

We expect tariffs to exert cumulative upward pressure of about 2.5 percent on goods prices between 2025 to 2027. Overall year-over-year CPI inflation is expected to re-accelerate meaningfully through the middle of next year, from 2.5 percent in 2025Q2 to 3.2 percent in 2026Q3, before beginning

[3] Davide Furceri, Swarnali A Hannan, Jonathan David Ostry, and Andrew K. Rose "Macroeconomic Consequences of Tariffs", IMF Working Papers 2019, 009 (2019), accessed August 15, 2025, https://doi.org/10.5089/9781484390061.001

[4] See José Manuel Campa and Linda S. Goldberg, "The Sensitivity of the CPI to Exchange Rates: Distribution Margins, Imported Inputs, and Trade Exposure," Review of Economics and Statistics 92, no. 2 (May 2010): 392-407.

to gradually slow again. Although temporary, this surge pushes overall inflation higher, delaying the path back to inflation normalization. Compared to the pre-tariff trend, the price level rises by over 1.0 percent, while real GDP declines by a similar amount.

Monetary Policy

The Federal Open Market Committee (FOMC) currently appears poised to recalibrate its policy stance as threats to full employment start to outweigh inflation risks. The FOMC has held short-term interest rates steady in the 4.25–4.5 percent range since the start of 2025, despite political pressures for rate cuts. With tariffs expected to have one-time effects on inflation, the Committee is increasingly concerned about signals of labor market weakness in recent data releases. Therefore, we project the Fed to implement a 25 basis points (bps) cut at its upcoming September meeting and again in December, followed by three more 25 bps cuts in March, June, and September 2026.

The Fed remains attentive to potential inflationary effects from tariffs and the surrounding uncertainty, but so far, movements in headline and core inflation readings have been limited amid evolving tariff negotiations. Several FOMC members, including Chair Jerome Powell, have expressed that "a reasonable base case is that the effects on inflation could be short lived—reflecting a one-time shift in the price level."[5] This suggests that temporary tariff-induced inflation would not automatically trigger tighter policy.

Although the FOMC maintained rates in July, several members have shared their preference for lower rates as the economy, particularly the labor market, began to appear more vulnerable. Vice Chair for Supervision Michelle Bowman and Governor Christopher Waller broke from the majority's decision to hold steady and voted for 25 bps cuts in July, marking the first dual dissent among Federal Reserve Governors since 1993. The July jobs report, released after the FOMC meeting, sparked more concerns about labor market conditions, pushing more members toward a dovish stance.[6]

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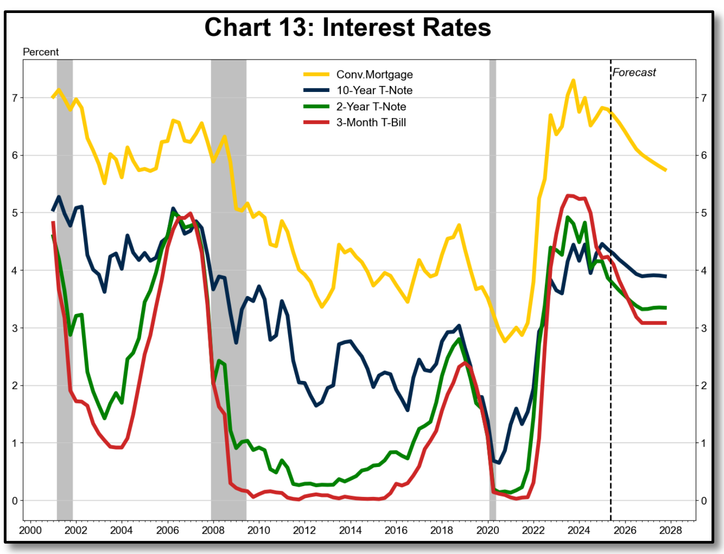
[5] Federal Reserve, "Transcript of Chair Powell's Press Conference," July 30, 2025. Board of Governors of the Federal Reserve System. https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20250730.pdf.
[6] "Markets are near certain of a September rate cut as more Fed presidents turn dovish overnight," Fortune, August 7, 2025. https://fortune.com/2025/08/07/markets-fed-september-rate-cut-kashkari-daly-cook-dovish/.

In addition to giving markets another opportunity to gauge signals ahead of September's rate decision, Chair Powell will deliver the Fed's monetary policy framework review in his likely final speech as Fed Chair at the Jackson Hole Symposium. With this year's theme being "Labor Markets in Transition: Demographics, Productivity, and Macroeconomic Policy," he is expected to address how policy might need to adapt to slower population growth and potential productivity shifts.

We believe that our forecast is consistent with a Fed that is recalibrating toward a less restrictive policy stance based on recent labor market data. Still, we project the Fed to cut the target range for the fed funds rate in a measured manner, by 50 bps by the end of 2025. As extra inflation due to tariff policy begins to subside, we expect two more 25 bps cuts in the first half of 2026 and another in the second half of 2026. This trajectory brings the fed funds rate range to 3–3.25 percent, the terminal range we project for this cycle. A change at the helm due in May 2026 is a notable wildcard in our projections, but we believe the ultimate choice of the new Fed chair will not have as much of an impact on the interest rate path as some expect.

Chart 13 shows our projections for selected key interest rates. The 3-month Treasury bill rate declines from 4.1 percent in 2025Q3 to 3.8 percent in 2025Q4 and to 3.1 percent in 2026Q4, stabilizing thereafter. The 10-year Treasury rate averaged 4.3 percent in 2025Q3, before sliding to 4.2 percent in 2025Q4, and settles at 3.9 percent from 2026Q3 onward. The 10-to-2-year spread continues widening through 2026. Mortgage rates decline more quickly than longer-term government bond yields, narrowing the excess spread between them. This path reflects subsiding risks around the paths of three issues: the monetary policy rate, inflation, and the exit of GSEs from conservatorship. The 30-year conventional fixed-rate mortgage rate falls from 6.7 percent in 2025Q3 to 6.6 percent in 2025Q4, 6.0 percent in 2026Q4, and 5.7 percent by the end of 2027.



Fiscal Policy

The enactment of the One Big Beautiful Bill Act (OBBBA) in July cemented or extended much of the 2017 tax overhaul while layering on spending cuts to some safety net programs. The result is a fiscal package that sustains near-term deficits, shifts more costs to states, and leaves longer-term federal budget pressures unresolved.

Several high-profile revenue-reducing provisions were included in the bill. The state and local tax deduction (SALT) cap was lifted to 40,000 dollars through 2029, before it snaps back to the current cap of 10,000 dollars in 2030. A new deduction of up to 6,000 dollars was created for seniors beginning in 2025, standing in for the more costly campaign proposal of "No Tax on Social Security." On the business side, the OBBBA restored the immediate R&D expense write-off and made the qualified business income deduction and 100-percent bonus depreciation permanent. The Child Tax Credit was also extended permanently with a modest expansion. We believe that some of the officially temporary provisions in the OBBBA, such as the new SALT cap and senior deduction, are likely to be extended in the future.

The OBBBA moved up the sunset date for the EV credit to September 30, 2025, and for many energy-efficiency credits to the end of 2025. However, most safety net cuts are not scheduled to occur until 2027. The bill introduces work requirements and more frequent eligibility reviews for safety net programs. For example, able-bodied adults in the Medicaid expansion population, unless exempt, will have to complete at least 80 hours of work or community engagement per month to stay on Medicaid, although waivers may extend the timeline in some states beyond 2027. The bill also shifts a larger share of the administrative costs of the Supplemental Nutrition Assistance Program (SNAP) to states and restricts their ability to finance Medicaid through provider taxes, with tax rate caps scheduled to decrease from fiscal 2028.

All in all, the OBBBA is set to increase the total deficit by 3.4 trillion dollars through fiscal 2034 relative to the traditional current law baseline, as estimated by the Congressional Budget Office (CBO).[7] Relative to a current policy baseline, the increase is far less, 366 billion dollars.[8] With revenue-reduction

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[7] See the Summary Table in the document at https://www.cbo.gov/publication/61570.
[8] See the Summary Table in the document at https://www.cbo.gov/publication/61569.

provisions frontloaded and spending cuts pushed into later years, the federal budget deficit rises moderately through fiscal 2029 even compared to the current policy baseline. In response to the nation hitting the debt ceiling early in January, the OBBBA also raised the debt ceiling by 5 trillion dollars, which will likely last through mid-2027 if current deficits sustain.

The reduction in the federal workforce and its treatment by the Bureau of Economic Analysis (BEA) is partly responsible for the decline in the federal government's real output in the first half of this year. Official payroll data does include workers who took the Deferred Resignation Program (DRP), as they will remain on the payroll until the end of September. However, the BEA has adjusted the real value of government employee compensation to reflect the decline in services provided, as those on DRP are not expected to work. The latest National Income and Product Accounts (NIPA) reading suggests that the downsizing effort has contributed to more than half of the decline in federal government’s output so far, after accounting for federal employees currently in the DRP. With at least 77,000 employees reportedly signing up for the DRP in the first round and layoff plans already announced, we project a decline of around 100,000 government employees to show up in payroll data in the fourth quarter of 2025.[9]

As the dust from the OBBBA’s passage settles, we anticipate robust growth in defense spending throughout our forecast horizon, because virtually all of the additional defense spending appropriated in the OBBBA is estimated to be spent by fiscal 2030. As the spending cuts outlined in the OBBBA are primarily on healthcare and SNAP, we expect the pace of growth in transfer payments to individuals and state and local governments to moderate.

Table 1 shows the data and our projections for the federal budget on a NIPA basis for fiscal years 2024 to 2027 by receipts and expenditure categories. Nominal revenue expands at a brisk 7.3 percent pace in fiscal 2025 owing to rising tariff revenue. As modest tax cuts work their way through the economy but inflation re-accelerates, revenue growth remains strong in 2026, at 5.1 percent. Slowing inflation results in revenue growth sliding to 4.4 percent in fiscal 2027.

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[9] This estimate comes from the Federal Government Layoffs tab under https://layoffs.fyi/, which tracks data through news reports.

We project that federal current expenditures growth will moderate from 6.2 percent this fiscal year to below 4.0 percent afterwards, driven by sliding Medicaid enrollment and reduced transfer spending to individuals and state and local governments prescribed in the OBBBA. Federal consumption growth decelerates to 2.0 percent in fiscal 2026 before picking up again in fiscal 2027, as non-defense spending pulls back while defense spending growth remains robust. Transfer payment growth decelerates from 6.8 percent in fiscal 2025 to 3.8 percent in fiscal 2027 as tighter eligibility requirements for Medicaid and SNAP begin to take effect. Federal subsidies expand by 13.2 percent in fiscal 2025 owing to agricultural subsidies appropriated by the American Relief Act. Finally, the growth rate of interest payments decelerates from 21.3 percent in fiscal 2024 to 4.7 percent in fiscal 2027 as interest rates decline, but debt continues to grow and longer-term debt issued during 2010s is refinanced at higher rates.

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

		FY Forecast		
	2024	2025	2026	2027
Current receipts	5037.8	5405.8	5682.6	5929.9
% change	3.3	7.3	5.1	4.4
Current expenditures	6827.3	7252.1	7529.6	7821.1
% change	6.3	6.2	3.8	3.9
Consumption	1380.9	1449.8	1478.1	1540.1
% change	6.2	5.0	2.0	4.2
Transfer payments	4273.3	4564.5	4754.1	4933.7
% change	3.4	6.8	4.2	3.8
Federal subsidies	95.2	107.8	106.0	100.5
% change	-9.4	13.2	-1.6	-5.2
Interest payments	1078.0	1130.0	1191.4	1246.8
% change	21.3	4.8	5.4	4.7
Surplus (+) or deficit (-)	-1789.5	-1846.3	-1847.1	-1891.2
Percent of GDP	-6.2	-6.1	-5.9	-5.8

RSQE: U.S. Economic Outlook, August 2025

As revenue growth tracks closely with expenditure growth over fiscal 2025–27, the federal deficit settles around 6.0 percent of GDP. Federal debt held by private investors increases from 81.6 percent of GDP in 2025Q2 to 88.9 percent in 2027Q4. 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.

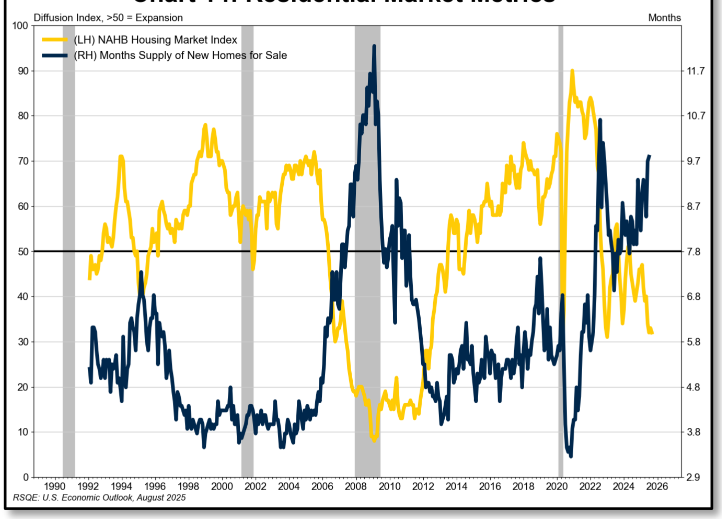
The Housing Market

Macroeconomic uncertainty and a low-turnover jobs market are both weighing on the housing market. Demand for single-family housing softened in the second quarter, with new and existing home sales remaining near the recent lows in 2024Q4. As inventory accumulated and buyers remained cautious, single-family housing starts and permits declined in the past quarter. Home prices edged down, but home affordability stayed stretched with mortgage rates hovering around 6.8 percent in 2025Q2.

Despite these challenges, the multi-family market remains resilient, as unaffordable homeownership may be helping sustain demand for rentals.

Single-family housing activity declined in the second quarter. Starts slowed to an annualized 937,000 units, and new home sales dropped to 652,000 units, both the lowest levels since 2023Q1.[10] The inventory of new single-family homes available for sale climbed further to 511,000 units at the end of 2025Q2, a level last seen in 2007. Correspondingly, the months' supply of new homes for sale metric shown in Chart 14 has averaged an uncomfortable 9.4 months in April–June, well above the long-run average of 6 and the highest level since 2022Q3.

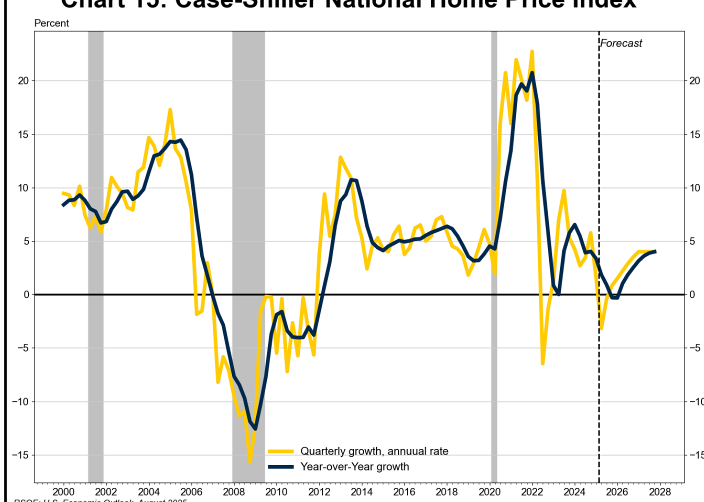
Chart 14: Residential Market Metrics



Housing-related sentiment remained very soft amid persistent uncertainty and stretched affordability. Chart 14 also shows the National Association of Home Builders/Wells Fargo Housing Market Index (HMI). The HMI hit its lowest points in June and August since December 2022, with only a modest improvement in the sub-index for sales expectations in the next six months in July–August. The University of Michigan Survey of Consumers indicated persistent caution, with the home selling conditions index falling to levels similar to 2021, and the home buying conditions index lingering near its historic lows. The housing market is expected to remain relatively anemic throughout 2025 before improving in 2026 with the help of lower mortgage rates.

Affordability has improved marginally, with mortgage rates moderating to an average of 6.7 percent in July. The 30-year conventional rate is expected to decline slowly,

Chart 15: Case-Shiller National Home Price Index



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10 The number of single-family housing starts was revised up from 919,000 units after our forecast was completed.

staying above 6.0 percent through the end of 2026 before dropping to 5.9 percent in early 2027. Chart 15 shows the historical and forecast paths of year-over-year and quarterly annualized rates of home price growth, measured by the seasonally adjusted S&P Cotality Case-Shiller Home Price Index. With buyer hesitation in a relatively loose housing market, home prices are estimated to have declined at a 3.2 percent annualized rate in 2025Q2. In 2025Q3, home prices edge down slightly before resuming growth and gradually ramping up to the long-run 4.0 percent pace by 2027Q1.

Energy Markets

The price of West Texas Intermediate (WTI) crude oil has eased from its mid-June rally, when Iran threatened to close the Strait of Hormuz, falling from 75 dollars per barrel to an average of 67 dollars per barrel in July 2025. In early August, WTI prices declined further after the Organization of the Petroleum Exporting Countries and its allies (OPEC+) announced plans to increase oil production by 547,000 barrels per day in September. This additional supply could be absorbed if it offsets potential disruptions from pressure on India to halt Russian oil purchases. Yet by mid-August, WTI prices softened further to 63–64 dollars per barrel, as concerns about oversupply and slowing demand took center stage.

The U.S. has been a net total energy exporter since 2019, and the Trump Administration aims to maintain that status. In a flurry of trade deals in late July, the U.S. secured agreements, in principle at least, from the EU, South Korea, and Japan to expand their U.S. energy imports. While we do not expect all of those purchases to materialize, the agreements could help preserve the U.S. energy export position as U.S. crude oil production remains near record highs and liquified natural gas (LNG) takeaway capacity increases in the coming years. However, in its August Short-Term Energy Outlook, the U.S. Energy Information Administration (EIA) projects only modest global demand growth for liquid fuels, averaging 1.1 million barrels per day (roughly 1.0 percent per year) in both 2025 and 2026. This sluggish demand growth and long time-to-build lags for new LNG export infrastructure will likely limit the full realization of these trade agreements within the announced time frames, even as the U.S. seeks to replace Russian energy in key markets around the globe.

Global oil supply is projected to outpace demand in the coming years, driven by production growth from OPEC+. The EIA expects total liquid fuels production to rise by 2.3 million barrels per day in 2025 and 1.0 million barrels per day in 2026, with OPEC+ contributing 27 percent of the growth and the United States accounting for 17 percent. However, U.S. production gains could be at risk if WTI crude oil prices fall significantly below 61 dollars per barrel—the lower end of the average breakeven range for new wells, according to the Federal Reserve Bank of Dallas.[11] Such a price drop would also give OPEC+ an opportunity to gain market share, as it can produce oil profitably at a much lower price.

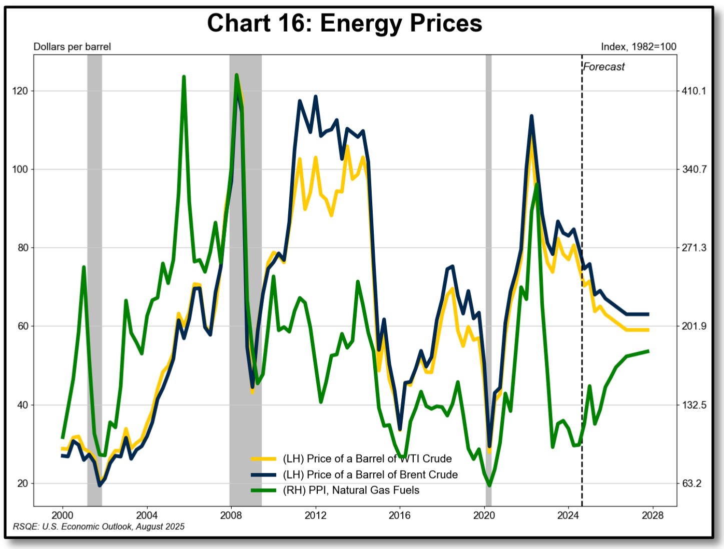

Chart 16 shows our forecast for WTI and Brent crude prices in maize and blue, alongside the PPI for natural gas fuels in green. We expect the price of WTI to average 65 dollars per barrel in the third quarter of 2025 before declining to 59 dollars per barrel in the final quarter of 2026, as persistent oversupply during the next year is likely to keep downward pressure on prices, even amid continued geopolitical tensions. By late 2026, as the market moves closer to balance, prices are expected to level off and remain at 59 dollars per barrel through the end of our forecast. We also project that the Brent–WTI spread will remain relatively stable at 4 dollars per barrel through 2027.

Natural gas prices, measured by the PPI for natural gas fuels, surged in late 2024 and early 2025. A cold snap and stronger LNG demand pushed prices up nearly 54 percent from the third quarter of 2024 to the first quarter of 2025. Prices then fell about 20 percent in the second quarter of 2025 as spring proved warmer than expected. Although a warm spring was nice while it lasted, we expect prices to resume their upward march over the next two years as global LNG demand remains strong. That demand should help U.S. shipments find buyers, even as LNG takeaway capacity expands significantly during

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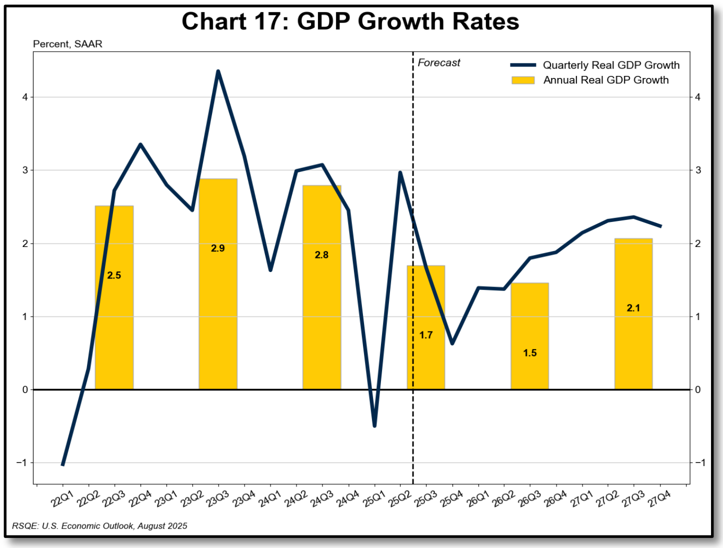
[11] Federal Reserve Bank of Dallas. (2025, March 26). Dallas Fed Energy Survey. https://www.dallasfed.org/research/surveys/des/2025/2501#tab-questions

the forecast. As a result, we project natural gas prices will increase by 20.6 percent from the first quarter of 2025 to the end of 2027, growing 2.5 times more quickly than cumulative inflation over the same period.

The Forecast for 2025–2027

The sweeping tariffs imposed in the first half of 2025 have thus far had only muted effects on real economic activity. Uncertainty has eased somewhat since spring, as the tariff landscape appears more settled. While firms may have absorbed much of the cost so far, we anticipate seeing more visible tariff pass-through to consumer prices in the coming quarters. Recent payroll employment data looks concerning after a weak July report that also brought large downward revisions to May and June figures. Sharply slower population growth, however, implies that fewer new jobs are needed to hold the unemployment rate steady. Therefore, we view the labor market as moving toward a slower-growth equilibrium rather than tipping into an outright recession. This backdrop should give the Federal Reserve room to gradually ease its policy restraint, preventing excess labor market cooling while managing the risk of tariff-driven inflation persisting. Nevertheless, we anticipate the economy to experience some near-term weakness as inflation picks up and the labor market continues to soften. While the OBBBA will provide near-term relief to consumers and businesses, the long-term fiscal outlook remains uncertain, with the debt-to-GDP ratio rising even after accounting for tariff revenues. As population growth slows, real GDP growth near 2.0 percent is insufficient to stabilize the debt without a major fiscal adjustment or above-trend inflation.



- As tariff headwinds dampen consumer spending and restrain real activity, we expect the headline GDP growth rate to slow to 1.7 percent in 2025Q3. With the labor market weakening and tariff-induced price pressure materializing, growth slips further to 0.6 percent in 2025Q4.
- This slowdown is likely to be short-lived. As looser monetary policy and lower taxes filter through the economy, we project the pace of growth to ramp back up to 2.0 percent by the second half of 2026. Growth accelerates further into the 2.1–2.4 percent range in 2027.
- In 2025, annual real GDP expands by 1.7 percent. Calendar year growth edges down marginally in 2026 before rebounding to 2.1 percent in 2027.
- Consumption growth in early 2025 appears weaker after the recent revisions. As tariff pressures build, we expect further slowing in the second half of the year. With new tax relief taking effect, consumption's growth contribution rebounds to 1.0 percentage point in 2026 and 1.3 percentage points in 2027.
- The 0.8 percentage-point boost to real GDP growth from nonresidential fixed investment in early 2025 reflects tariff front-running of information processing equipment and a jump in aircraft deliveries, but we expect the contribution to flatline over the remainder of the year. As tax incentives resume, nonresidential fixed investment adds 0.4 percentage points to growth in 2026 and 0.6 in 2027.
- Residential investment weighs on growth this year, as elevated inventories of new homes for sale lead builders to scale back new construction starts. In 2026–27, residential investment contributes marginally to growth.
- Government purchases add little to growth over our forecast, as cuts to federal non-defense and state and local spending offset rising federal defense expenditures.
- The volatile 2025H1 contributions of net exports and inventory investment cool off by 2026.

Table 2
Contributions to the Growth of Real GDP
(Average quarterly contributions, percentage points at annual rate)

	'25H1	'25Q3	'25Q4	'26	'27
Real GDP (% change, AR)	1.2	1.7	0.6	1.6	2.3
Contributions to real GDP growth					
Final sales to domestic purchasers	1.3	0.5	0.4	1.6	2.3
Consumption	0.7	0.6	0.4	1.0	1.3
Nonresidential fixed investment	0.8	0.1	0.0	0.4	0.6
Residential investment	-0.1	-0.3	-0.1	0.1	0.2
Government purchases	-0.0	0.1	0.2	0.1	0.2
Net exports	0.2	-0.0	0.3	-0.0	-0.1
Inventory investment	-0.3	1.2	-0.1	0.0	0.1

RSQE: U.S. Economic Outlook, August 2025

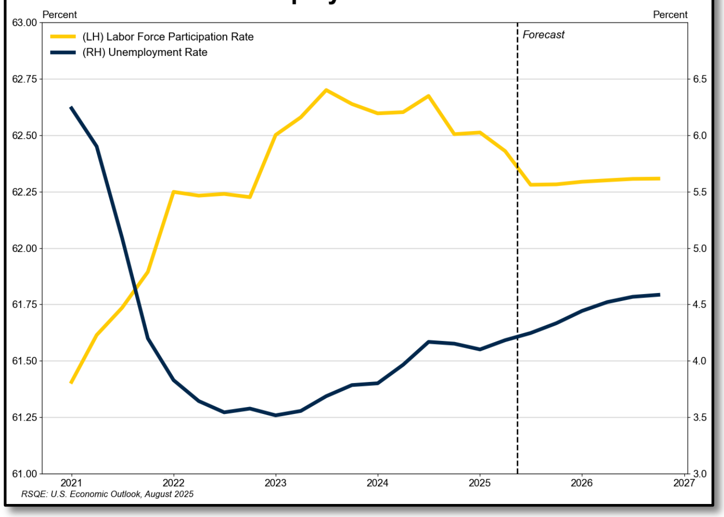


Chart 18: Unemployment and Labor Force

- The labor market is starting to show signs of stress after holding up earlier in the year. The headline unemployment rate has hovered in the 4.0–4.2 percent range since May 2024, but the household employment level has declined nearly 800,000 since January 2025.
- Possibly reflecting the softening jobs market, the labor force participation rate has slid by 0.4 percentage points since April, preventing the unemployment rate from rising.
- We expect the labor market to display additional vulnerability ahead, as the pace of economic growth slows. The unemployment rate rises from 4.2 percent in 2025Q3 to 4.6 percent in 2026Q3–Q4.
- Less restrictive monetary policy helps stabilize the unemployment rate by 2027. Slowing population growth contributes to the tightening of the labor market later in the forecast, and the unemployment rate edges down to 4.4 percent by the end of 2027. We expect the participation rate to hold relatively flat in our forecast.

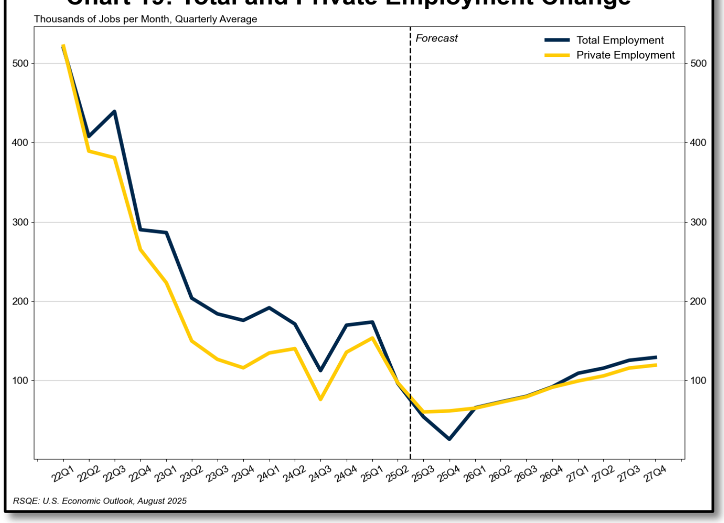


Chart 19: Total and Private Employment Change

- Payroll employment growth held up in early 2025 before slowing more recently. The July jobs report disappointed. The six-month average pace of job gains dropped from 179,000 in April to 81,000 in July.
- We expect private sector jobs to ease further in 2025H2, but then to slowly improve through 2027, as the economy adjusts to higher tariffs. Average monthly private sector job gains bottom at 60,000 per month in 2025Q3. We expect private job growth to pick back up slowly and exceed 100,000 per month by 2027.
- The pace of government job gains will generally slow to a crawl over the forecast horizon as local government employment tops its pre-pandemic count and federal civilian government employment remains flat due to layoffs. In 2025Q4, around 100,000 federal workers who took separation incentives will be removed from the payrolls, pushing overall monthly job gains to just 26,000 per month.

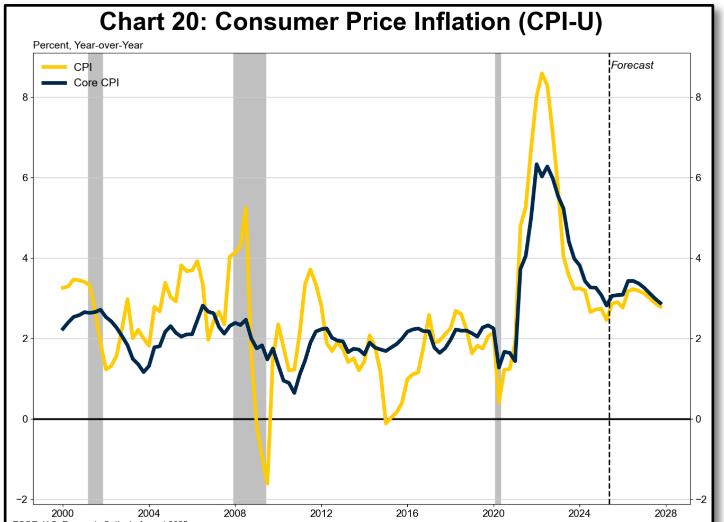
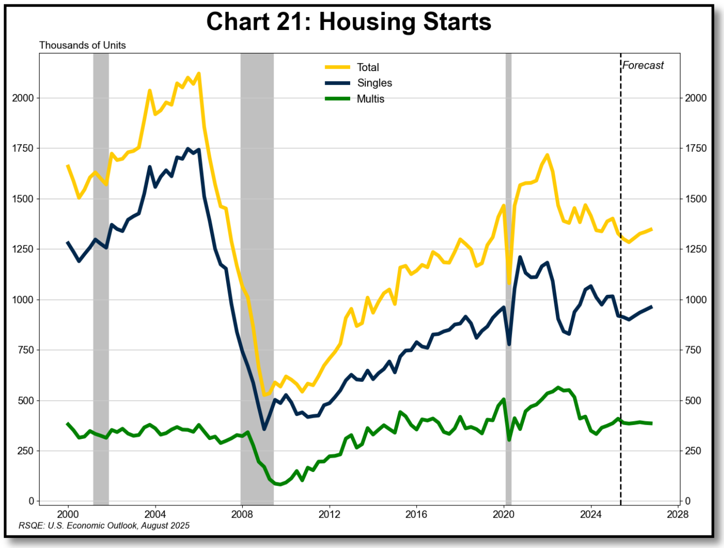
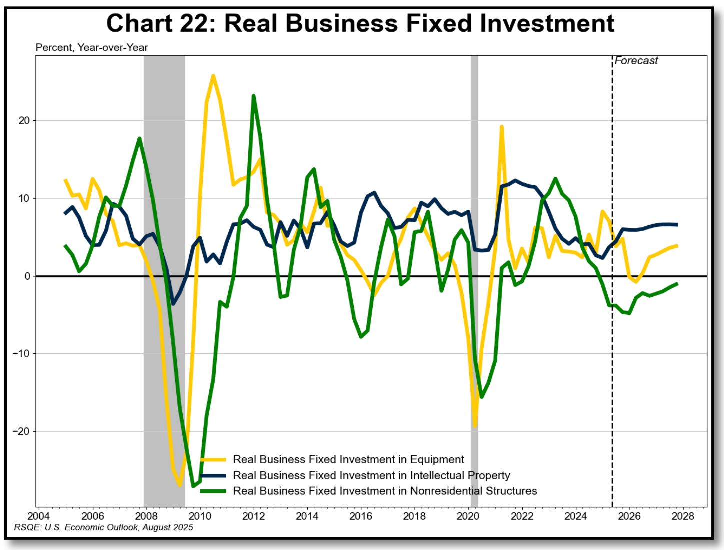


Chart 20: Consumer Price Inflation (CPI-U)

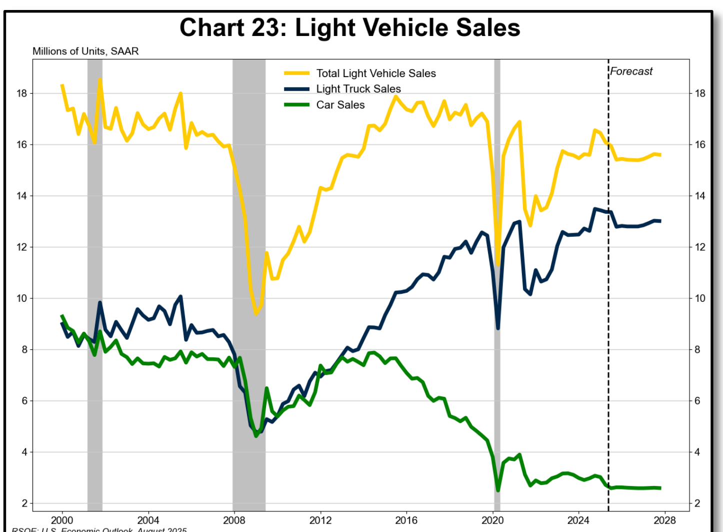
- Year-over-year CPI inflation stayed in the 2.3–2.4 percent range in March to May, before edging up in recent months. The broad trend of slowing service inflation continued, but core goods inflation has turned positive since April after spending most of 2024 in deflation territory. Headline inflation held at 2.7 percent in July with the core accelerating to 3.0 percent.
- The tariffs are expected to drive up inflation from here. The annualized quarterly pace of core inflation peaks in 2026Q1 at 3.5 percent and then gradually settles down through the rest of the forecast horizon. Headline CPI inflation runs consistently behind the core, with energy and food inflation subdued.
- PCE inflation picks up as tariffs filter through the economy. After holding at 2.4 percent in 2025Q2, year-over-year PCE inflation temporarily rises to the 2.6–2.8 percent range through 2027Q1, before decelerating to 2.3 percent by 2027Q4.



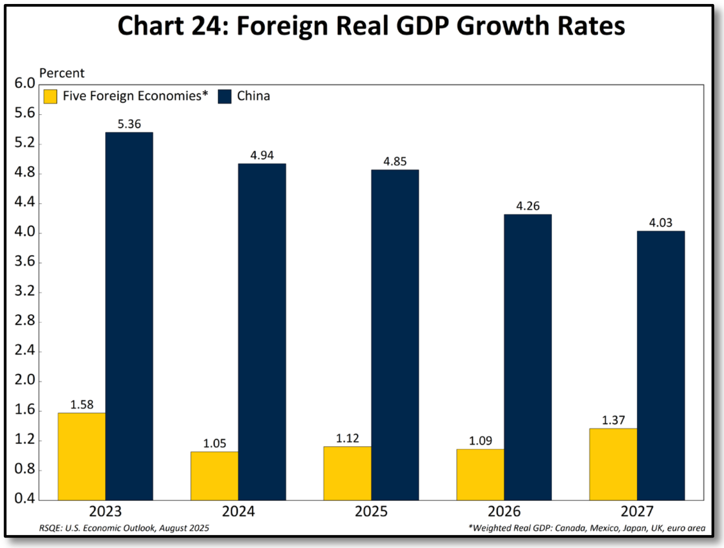
- New single-family housing starts slid to an annualized pace of 919,000 units in 2025Q2. Starts dip further to 900,000 units by 2025Q4 amid soft homebuying demand and an elevated supply of new homes for sale. Lower mortgage rates help starts recover to 1,029,000 units by 2027Q4.
- Multi-family starts accelerated to an annualized pace of 408,000 units in 2025Q2. We expect them to remain steady with the support of rental demand and lower mortgage rates. Starts stabilize around 390,000 units for the rest of our forecast period.
- In the short term, total housing starts slow to 1,284,000 units in 2025Q4, stalled by tepid growth and lasting uncertainty. In the medium term, as the existing supply overhang clears, improvements in affordability with lower mortgage rates should help lift total starts gradually. We expect housing starts to rebound slowly to 1,412,000 units by the end of 2027.



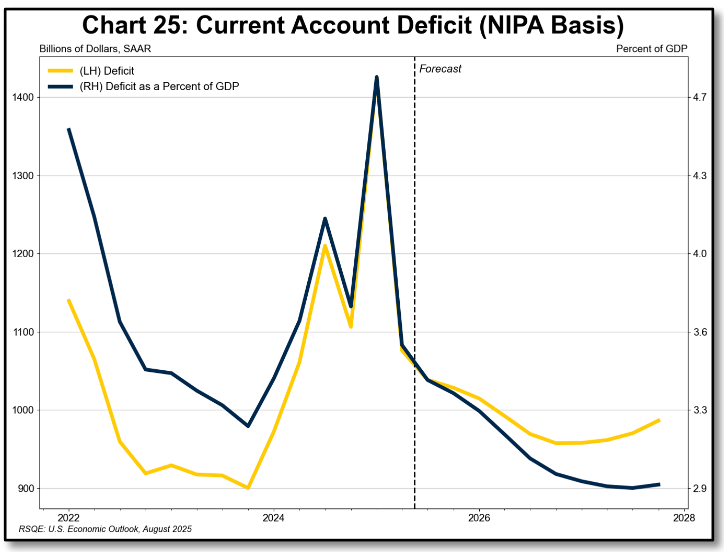
- Front-loading of information processing equipment ahead of tariffs and a jump in airplane production accounted for most of the gains in real investment in equipment in 2025H1. After a brief dip below zero, year-over-year growth recovers to above 3.0 percent by 2027Q2.
- Intellectual property investment remains an area of strength throughout our forecast window, with growth generally above 6.0 percent year over year from 2025Q4 onward. Despite potential headwinds to research and development from federal funding uncertainty, we expect software investment to hold up well. The reinstated R&D tax deduction helps too.
- Investment in nonresidential structures subtracts from growth throughout our forecast horizon, as the surge in construction activity tied to microchip factories turns into a slump once projects near completion. Given the subdued oil price outlook, mining and well drilling are expected to remain sluggish.



- The annualized pace of light vehicle sales posted a solid 16.1 million units reading in 2025Q2, possibly due to front-running of future tariff-induced price hikes. Monthly sales came in at 16.4 million units in July, perhaps supported by stronger EV sales ahead of the EV tax credit expiration at the end of September.
- With tariffs starting to show up in higher MSRPs and lower incentives, sales are expected to drop substantially in 2025Q4, to a pace of 15.4 million units as the back side of the pull-forward effect arrives. Most of the lost sales are in cars, while light trucks maintain their pre-tariff level of sales.
- Despite the recently announced reductions in tariffs, we expect considerable adjustments within the North American auto industry as a result of tariffs. As automakers adjust prices in response to the tariff-driven cost pressures, light vehicle sales linger around 15.4–15.6 million units in 2026–27.



- 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 in the first half of 2025 has held up well in the face of higher U.S. tariffs; the quarterly annualized pace has averaged 4.7 percent. As exports to the U.S. slow, while stress in the housing market continues, economic growth slows in 2025H2. The annual pace of real GDP growth still averages a respectable 4.8 percent in 2025 before coming down to around 4.0 percent by 2027, according to survey projections from the IMF and Bloomberg.
- The composite five-economy calendar year growth rate holds roughly steady around 1.1 percent in 2025, thanks to solid readings in 2025Q1. Second-quarter growth appears to have slowed, weighed down by trade disruptions and associated uncertainty. Calendar year growth stays muted in 2026, before an acceleration in Canada, Mexico, and the euro area lifts the composite growth rate to 1.4 percent in 2027.



- The trade balance widened considerably over the course of 2024, driven by rising goods imports.
- Imports of several narrow categories of goods, such as pharmaceuticals, spiked in 2025Q1 on fears of sectoral tariffs. As a result, the current account balance as a share of GDP ballooned to 4.8 percent, beyond the 4.5 percent recent peak in 2022Q1 following the stimulus-driven consumption boom and West coast port congestion.
- The trade-deficit-to-GDP ratio retreated back to 3.5 percent in 2025Q2 as tariffs started to kick in.
- We expect tariffs to bring the current account deficit below 1.0 trillion dollars by early 2026Q2. The deficit is projected to start widening again by early 2027. As a share of GDP, the trade deficit is expected to shrink to about 2.9 percent by late 2027. That level would be the narrowest since 2020Q2, but still considerably larger than the average of about 2.1 percent in 2015–19.

Risks to the Forecast

We strive to strike a balance between major quantifiable upside and downside risks to the economy in our forecasts. Sometimes, significant developments occur during the writing of the forecast narrative, skewing the balance of risks one way or another. Hard-to-quantify risks can at times be large, but tilt in an identifiable direction, as well. Currently, the key positive and negative risks to our outlook appear broadly balanced.

Trade policy is still at the top of the list of near-term risks to our outlook. Several recent deals with large trading partners and another pause in escalation of tariffs on China's imports likely signal that global trade flows will be subject to a relatively modest realignment instead of a more pronounced re-formatting. Risks exist on both sides of our assumed tariff path, however. Another escalation that either reneges on the already agreed-to deals, ramps up tariffs on China, or introduces meaningful secondary tariffs on countries helping Russia evade sanctions, could extend the tariff shock to the U.S. economy. On the other hand, further decreases in tariffs on major trading partners tied to significant reduction in barriers to U.S. exports to those markets could boost the outlook.

It is also quite uncertain to what extent our trade policy assumptions will affect the domestic economy. Economic effects directly attributable to higher tariffs have been difficult to spot in statistics so far. We have seen some isolated consumer and producer price increases of limited magnitude compared to tariff costs. Effects on quantities are even harder to assess, as the significant tariff front-running that began late in 2024 is still skewing the published data. It is plausible that foreign suppliers will end up bearing a substantially larger share of the tariff burden than we assumed, lifting the domestic outlook. On the other hand, large tariff-related price hikes in some sectors could diminish the stigma of price increases by less affected businesses and result in wider price-level increases.

The uncertainty surrounding the effects of the tariffs also turns near-term monetary policy into a risk. If our outlook is correct at least qualitatively, the Fed will face a tough call this fall: a softening labor market, rising inflation, and the need for 5–6 more months of data to judge whether price hikes will trigger persistently higher inflation. The state of the labor market is also quite confusing, with many conflicting data points. As a result, actual policy is likely to deviate from our assumed monetary policy path, depending on how the next several employment reports stack up.

Given the remarkable unity shown by the thin Republican majority in Congress, it is possible that further major legislation could pass via the reconciliation process for the next two fiscal years. The recent precedent of using current policy as a baseline for assessing bills' fiscal impacts could open up possibilities for reforms previously considered too costly to pass.

There are several economic developments that could turn into significant risks. Many financial asset valuations have rocketed higher after the tariff-induced scare this spring, at the same time many metrics measuring financial risk have turned lower in recent months. It is possible that financial markets reflect significant future profitability gains, perhaps due to higher AI-driven productivity. But it is also possible that these signal that significant financial excesses are building, which could threaten the trajectory of the economy.

The residential single-family housing construction sector appears to be under significant stress. The overhang of inventory of unsold homes is large. Our forecast hinges on monetary policy delivering some relief on mortgage rates and helping to gradually alleviate the imbalance. But adverse economic developments in other sectors of the economy, or the lack of monetary easing, could trigger a more disorderly market adjustment with large declines in new housing starts. Over the medium term, however, the housing sector is a strong candidate source of an upside risk, as many upbeat estimates of unmet housing demand could materialize.

Finally, our own and monetary policymakers' assessment of the economy is only as good as the data. Cutbacks in federal funding have already placed growing strains on the official economic statistics. Further degradation in the quality and/or frequency of government data would make assessing the state of the economy harder and raise the probability of economic policy and business planning errors.