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The U.S. Economic Outlook for 2025–2026

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Executive Summary

All Things Considered

As the Fed proceeds with its cutting cycle amid a cooling labor market, we expect real GDP to grow at an annualized pace of 2.3 percent and the unemployment rate to average 4.2 percent in 2024Q4. We project a modest deceleration of economic growth to accompany the less dynamic labor market over the near term. However, the solid momentum of real final sales to private domestic purchasers, helped by growth in real income, is likely to persist, supporting solid real GDP growth. As the stimulative effects of the expected tax cuts dominate the drag from the anticipated new tariffs, we project quarterly GDP growth to accelerate modestly during 2026, reaching a 2.5 percent annualized pace by 2026Q4.

Consumption Momentum: Revised and Reinforced

The recent large upward revision of personal income data since 2022 explains the resilience of consumption growth in the face of higher interest rates. Higher income and meaningful real wage gains going forward will likely support robust spending growth in the near term.

No Halloween Haunt for the Labor Market

The labor market is looking less worrisome after some jump scares in the third quarter. The unemployment rate dipped to 4.1 percent in September and held there in October, down from the recent high of 4.3 percent in July. However, the trend pace of job gains is likely still decelerating even after accounting for the negative impacts of recent hurricanes and strikes. Job openings have continued to soften. We expect private sector job gains to decelerate moderately through most of 2025, while government sector employment also grows at a slower pace.

Prelude to the Super Bowl of Tax

Many previously low-probability fiscal scenarios surfaced following the Republicans' trifecta victory in the November elections. We expect an extension of most expiring provisions of the Tax Cuts and Jobs Act of 2017, a lower corporate tax rate of 15 percent for domestic manufacturers, and a higher cap on the state and local tax deduction. We also anticipate sizable but incomplete tax cuts on Social Security benefits, tips, and overtime income. Consumer incentives for purchases of electric vehicles, on the other hand, are likely to be unplugged quickly.

Tariffs on China are very likely to surge. We project average tariff rates on Chinese goods to grow eventually to triple the size of those implemented during the first Trump Administration. We expect President-elect Trump's fiscal agenda to come into effect in 2026. With roughly 200 billion dollars in tax cuts against 85 billion dollars in new tariff revenue, the federal deficit climbs from 6.1 percent of GDP in fiscal 2024 to 6.8 percent of GDP by fiscal 2026. That level would be unprecedented outside of wars, the recent pandemic, and severe recessions.

Inflation Trends: Very Demure, Very Mindful

Progress on bringing inflation trends down has stumbled recently. The 3-month annualized core CPI inflation rate came down from 4.5 percent in March to 1.6 percent in July, but it has re-accelerated to 3.6 percent in October. Although the deceleration in inflation trends has cleared the way for the Fed to start easing, the recent uptick reduces the urgency to cut rates quickly in the forecast. We continue to believe that inflation remains on a path of gradual deceleration toward the Fed's target, largely because shelter inflation has plenty of room to decelerate further.

The Fed Stands Watch

The long-awaited Fed pivot to rate cuts has arrived. After sitting in a 23-year high range of 5.25–5.5 percent for 14 months, the fed funds rate was reduced by 50 basis points in September and by 25 basis points in November, bringing it to the 4.5–4.75 percent range. The pace of cuts to follow is likely to be data dependent. Provided that labor market conditions remain stable, we project another 25-basis point cut at the FOMC's December meeting before the pace of cuts slows next year. We anticipate four more cuts of 25 basis points in 2025, bringing the fed funds rate to its terminal range of 3.25–3.5 percent for this cycle by the end of the year.

In our view, the temporary uptick of inflation related to tariffs will not prompt the Fed to tighten policy in 2026. We believe that risk management concerns related to the potential negative growth effects of tariffs, which played a role in the 2019 rate cuts, will balance the upside risks from new tax cuts, prompting the Fed to stand pat.

The 2025–2026 Outlook

We project that real GDP growth will slow from a Q4-to Q4 pace of 2.4 percent in 2024 to 1.9 percent in 2025. Long-term interest rates have increased meaningfully in recent months, which will limit potential consumption growth in the near term by making financing for big-ticket purchases less affordable. We expect looser monetary policy to work through the economy sufficiently to lift quarterly growth to a 2.1 percent pace in the second half of 2025. As personal income tax cuts kick in, the quarterly pace of growth ramps up during 2026, reaching an annualized rate of 2.5 percent in 2026Q4. Calendar year real GDP growth picks up to 2.2 percent in 2026.

The unemployment rate ticks up from 4.2 percent in 2024Q4 to 4.3 percent in 2025Q1 and then stabilizes at 4.4 percent for the remainder of 2025 before declining back to 4.2 percent by 2026Q4. Monthly payroll job gains continue to slow, averaging 108,000 jobs from 2025Q2–Q4. As looser monetary policy works its way through the system, job gains ramp up slowly during 2026. The economy adds 1.3 million jobs in 2026.

We expect PCE inflation to continue its decline toward the Fed's 2.0 percent target, as shelter cost growth decelerates. Year-over-year PCE inflation settles around 2.1 percent in 2025. We expect the price effect of the new import tariffs to be modest, with 12-month PCE inflation ticking up to 2.3 percent by the end of 2026. The reacceleration is a bit larger for core PCE inflation.

With plenty of supply already for sale, new single-family home construction remains soft, averaging a pace of 991,000 units from 2024Q4 to 2025Q2 before climbing to a 1,080,000 unit pace by 2026Q4. The annual pace of multi-family starts bottoms at 350,000 in 2024Q4 before recovering to 449,000 units by 2026Q4 as financing costs drop.

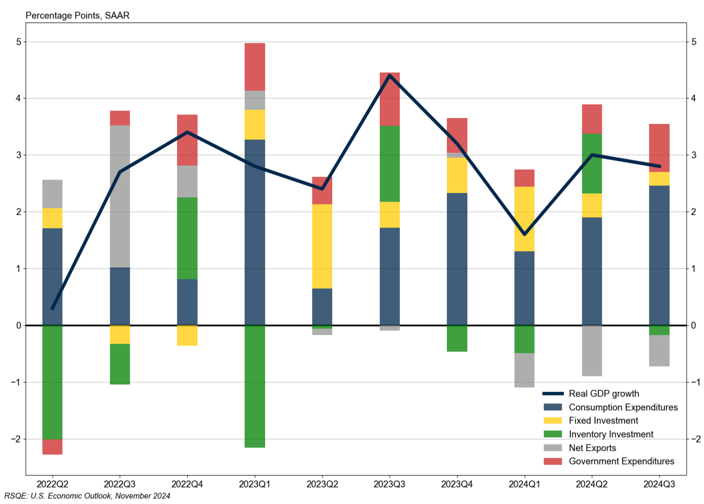
We expect auto loan rates to step down as long-term rates decline and auto delinquencies drop. As the CPI for new light vehicles continues to decrease, we think vehicle affordability will improve noticeably as measured by monthly payments and transaction prices relative to income. We project that the annualized pace of sales will edge up to 16.1 million in 2025. We expect the anticipated early phase-out of the electric vehicle credits to have minimal impact on total light vehicle sales, as consumers are likely to shift toward vehicles with other drivetrain types. As a result, vehicle sales total 16.2 million in 2026.

	Actual	**RSQE Forecast**		
	2023	2024	2025	2026
GDP (billions of current $)	27720.7	29170.2	30448.3	31774.3
Real GDP (billions of 2017 $)	22671.1	23295.8	23792.9	24305.8
% change: year-over-year	2.9	2.8	2.1	2.2
% change: 4th-qtr-to-4th-qtr	3.2	2.4	1.9	2.3
Nonfarm payroll employment (millions)	156.1	158.6	160.1	161.4
Civilian unemployment rate (%)	3.6	4.0	4.4	4.3
Capacity utilization, total industry (%)	79.0	77.7	76.8	76.7
Inflation (private nonfarm GDP deflator, % change)	3.6	2.4	2.2	2.2
Inflation (CPI-U, % change)	4.1	2.9	2.3	2.6
Inflation (core CPI, % change)	4.8	3.4	2.6	2.6
Light vehicle sales (millions)	15.5	15.7	16.1	16.2
Private housing starts (thousands)	1421.4	1355.8	1373.9	1495.1
3-month Treasury bill rate (%)	5.1	5.0	3.8	3.3
10-year Treasury note rate (%)	4.0	4.2	4.0	3.9
Conventional mortgage rate (%)	6.8	6.7	6.1	5.8
Real disposable income (billions of chained 2017 $)	17052.5	17581.4	17966.6	18540.5
% change	5.1	3.1	2.2	3.2
Corporate profits after tax (billions of current $)	3068.8	3400.7	3375.7	3469.5
Value of U.S. $ (FRB broad index), % appreciation	-0.2	1.9	1.3	0.0
Current account balance (NIPA basis, billions of current $)	-915.9	-1092.7	-1163.3	-1274.4
Federal surplus (FY, NIPA basis, billions of current $)	-1549.4	-1768.2	-1939.4	-2126.1

The Current State of the Economy

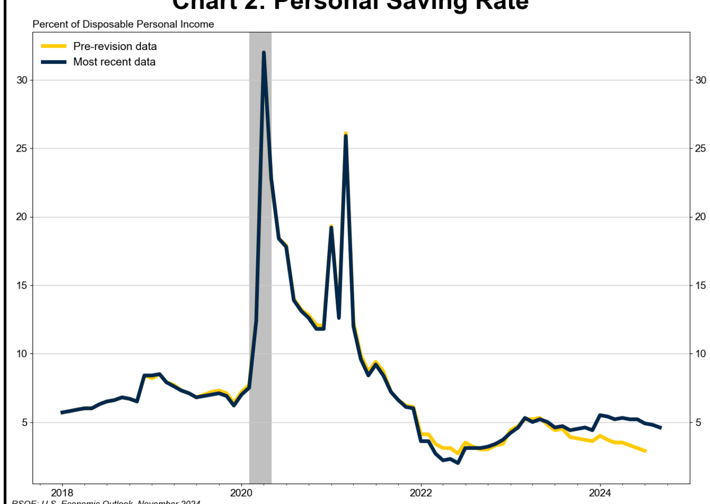
The U.S. economy continues to expand at a solid clip. Real GDP expanded at an annualized pace of 2.8 percent in the third quarter of 2024, a touch below the 3.0 percent pace in the prior quarter. Chart 1 shows the growth rate of real GDP and the growth contributions of its major components over recent quarters. The government sector's contribution rebounded to 0.9 percentage points in the third quarter on the strength of defense-related expenditures. Consumption expenditures' contribution to headline growth rose to 2.5 percentage points, benefiting from jumps in purchases of pharmaceutical products and election-related services. However, the contribution of private fixed investment slipped to only 0.2 percentage points. The sum of the latter two components—together known as the contribution of real final sales to private domestic purchasers—registered over 2.0 percentage points for the seventh quarter in a row.

Chart 1: Contributions to GDP Growth



The recent annual revisions to the National Product and Income Accounts (NIPAs) resulted in considerably higher estimates of Gross Domestic Income growth over the 2019–23 period, largely stemming from higher estimates of personal income. Chart 2 shows the current and pre-revision personal saving rates. With revised data showing a fairly steady reading of around 5 percent disposable personal income, the recent pace of consumption expenditure growth appears more sustainable than previously thought.

Chart 2: Personal Saving Rate



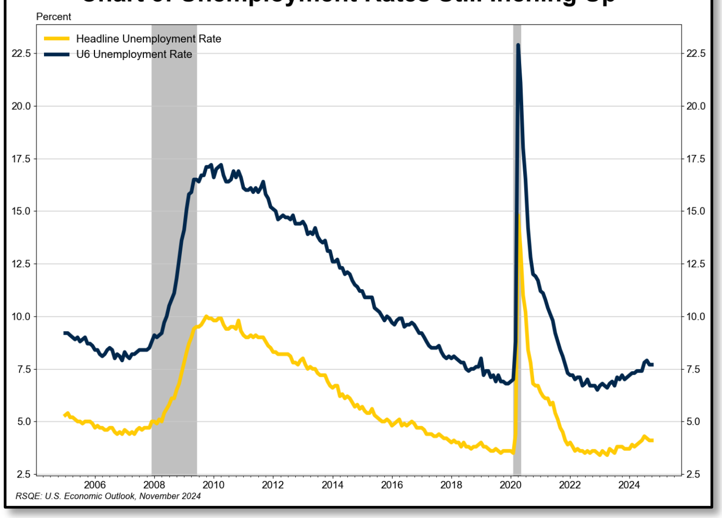


Chart 3: Unemployment Rates Still Inching Up

As of early September, the labor market situation was looking worrisome. The unemployment rate jumped by 0.4 percentage points between April and July to 4.3 percent, then barely edged down to 4.2 percent in August. Payroll job gains as reported on September 6 averaged only 116,000 per month from June to August. It was no wonder the Federal Reserve decided to cut the range for the fed funds rate by 50 basis points (bps) in mid-September. Subsequent data have been far less alarming. The unemployment rate dipped further to 4.1 percent in September and October. September payroll job gains came in initially at 254,000 along with a 72,000 combined upward revision to the July–August job gains. The October payroll job gains were only 12,000, but the job growth count was reduced by about 38,000 striking International Association of Machinists union workers and was further lowered temporarily by the disruptions that Hurricane Milton and Helene caused in parts of Florida and North Carolina.

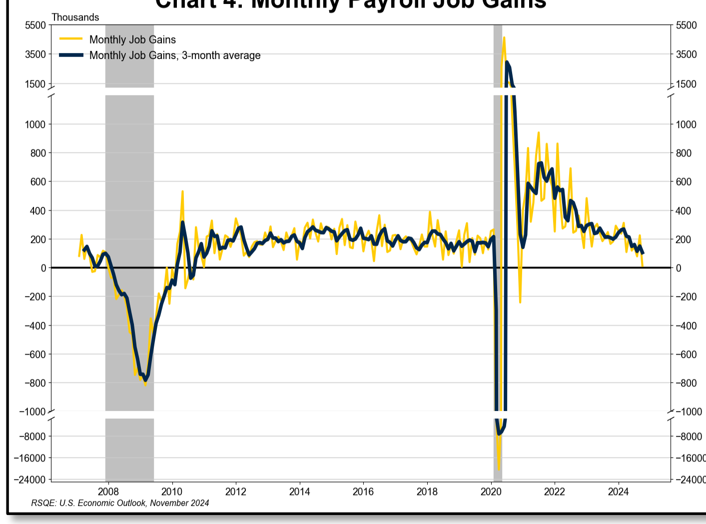
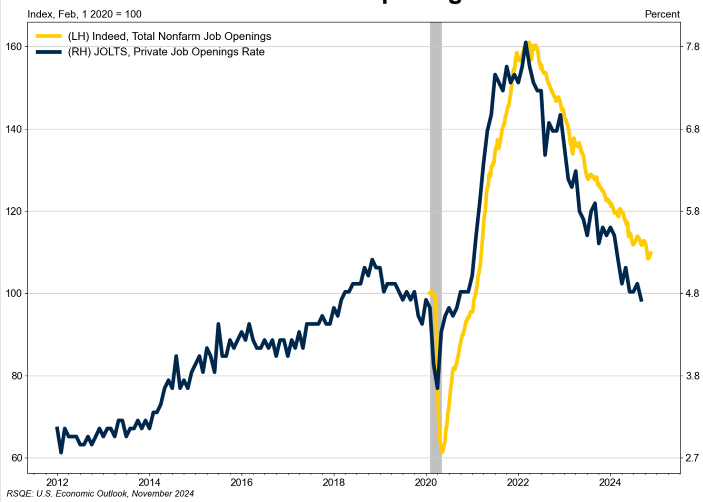


Chart 4: Monthly Payroll Job Gains

We are expecting a significant rebound in employment growth in November. Still, even factoring in the recent dip, both the headline unemployment rate and the broader measure of labor market slack known as the U6 unemployment rate appear to be following a slow upward trend.[1] We also think that payroll job gains are likely to continue slowing gradually. Based on the preliminary data, the annual benchmark revision of payroll employment is likely to lower payroll gains from April 2023 to March 2024

[1] In addition to the traditional measure of unemployment known as the U3 rate, the U6 unemployment rate includes people working part-time for economic reasons and those outside of the labor force who are willing and able to work and have looked for work at some point over the prior 12 months.

Chart 5: Job Openings



by 818,000, making the slowdown during this year look far less dramatic. The continued pace of labor market softening is well illustrated by Chart 5. The private sector job openings rate in the Bureau of Labor Statistics' (BLS's) Job Openings and Labor Turnover Survey (JOLTS) has been trending down since early 2022 and, as of the most recent data for September, has fallen back to the level observed at the end of January 2020. While the number of job openings in the Indeed.com data remains about 10 percent above its level on February 1, 2020, the readings in October and early November suggest job openings continue to soften. The 3-month average of private sector weekly hours has also declined from a peak of 35.0 in May 2021 to around its pre-pandemic level of 34.3 in October. As shown on Chart 6, however, aggregate private sector weekly hours have been holding up reasonably well, expanding at a pace of above 1.0 percent year-over-year for most of 2024. The measures of compensation shown in Chart 7 are continuing to moderate but remain high enough to sustain real compensation growth.

Chart 6: Aggregate Weekly Hours, Private Sector

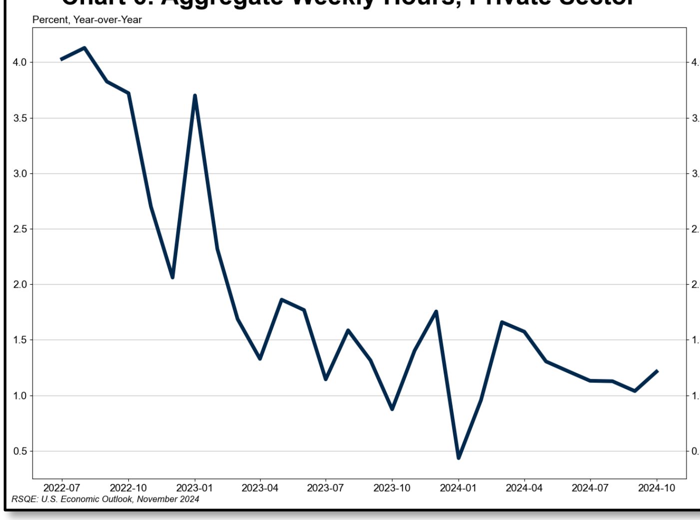
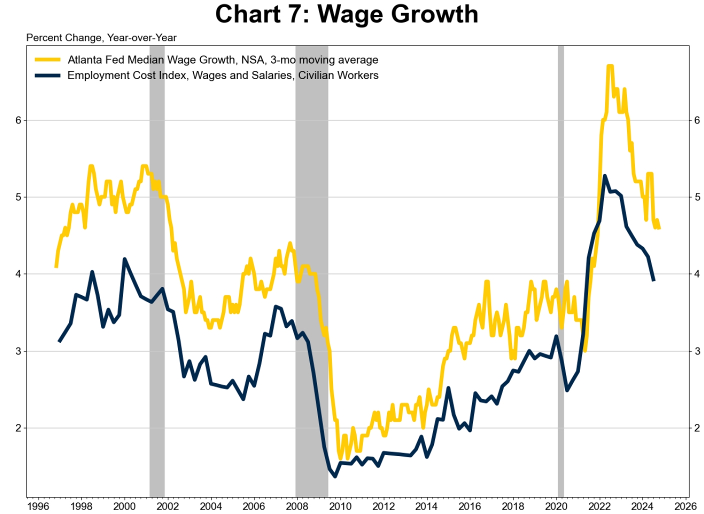


Chart 7: Wage Growth



Overall, labor market strength remains reasonable, with total payroll growth conducive of continued consumption growth in the near term.

Progress on bringing trend inflation down, very evident between late spring and mid-summer, has sputtered recently. The year-over-year core CPI inflation rate has remained around 3.3 percent since June. The 3-month annualized core inflation came down from 4.5 percent in March to 1.6 percent in July, but has re-accelerated to a 3.6 percent reading as of October. Personal Consumption Expenditures (PCE) price index inflation (only available through September as of the writing of this report) has exhibited a qualitatively similar dynamic. The annualized 3-month inflation rate of the highly-watched "supercore" metric—the PCE price index for core services excluding housing—improved from 5.3 percent in March to 2.3 percent in July but rebounded to 2.9 percent in September. PCE Housing inflation, however, continues to trend down, albeit slowly. Average PCE shelter costs had risen more than 5.0 percent year over year in September, despite measures of new tenant rent inflation that have long since moderated. Overall, we continue to believe that inflation remains on a path of gradual deceleration toward the Fed's target, largely because shelter inflation has plenty of room to decelerate further.

Chart 8: Core Consumer Price Index Inflation

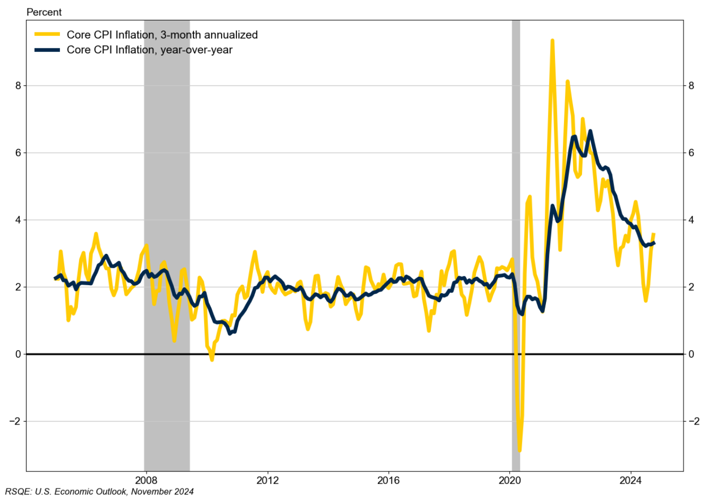
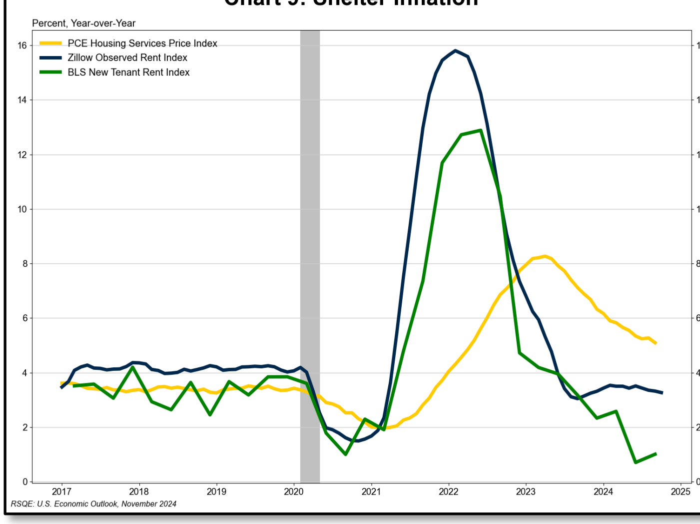


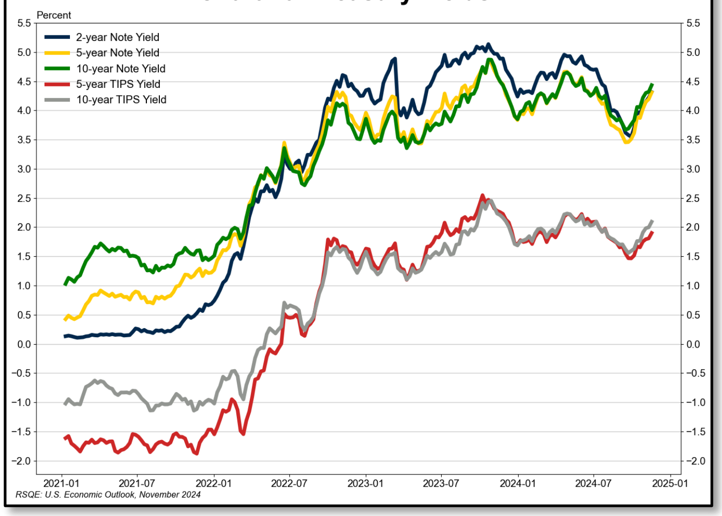
Chart 9: Shelter Inflation



The Fed cut the target range for the fed funds rate by 50 bps in mid-September and a further 25 bps in early November. Yet long-term Treasury interest rates have exploded higher since mid-September, returning to levels seen in July. The 10-year note yield rose by 60–70 bps through early November. About two-thirds of the run-up can be attributed to the increase in the 10-year Treasury Inflation-Protected

Security (TIPS) yield, with the rest due to higher inflation compensation. While it is tempting to attribute the run-up to shifts in election outcome probabilities and the increasingly more costly campaign promises in the lead-up to the November elections, the lack of a sharp bond market reaction upon learning the actual election outcome suggests that other forces are likely to have been at play as well. One possible explanation is the cooling and reheating pattern we have seen in the labor market and inflation data, coupled with the recent NIPA revision to personal income. Yet another explanation is a short-term overreaction to noisy information. We judge that there has been some overreaction, but near-term rate dynamics will largely depend on how markets assess the impact of President-elect Trump's second-term agenda.

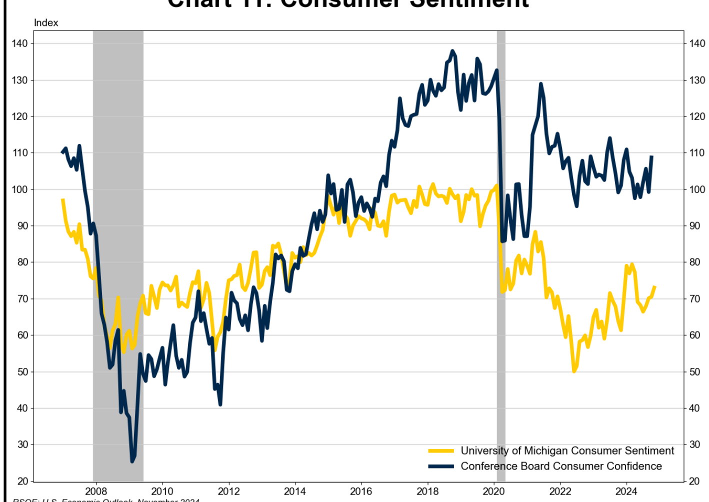
Chart 10: Treasury Yields



To briefly summarize our assumptions about the first two years of the second Trump Administration: we expect moderately wider fiscal deficits due to lower tax revenues that stimulate the economy, while higher tariffs undo some of the stimulus. This relatively benign outlook means that we do not anticipate large shifts in long-run neutral policy rate. As a result, we continue to project long-term Treasury yields to moderate.

Chart 11 shows the recent dynamics of consumer sentiment in the economy. While the Conference Board metric has generally moved sideways, the University of Michigan Consumer Sentiment index took a large dive in 2022 amid high inflation. Since then, the index has been on an upward trajectory with a few setbacks. Both indices remain far below pre-pandemic levels. It remains unclear whether and how the apparent disconnect between the levels of confidence and growth of consumer spending will be resolved.

Chart 11: Consumer Sentiment



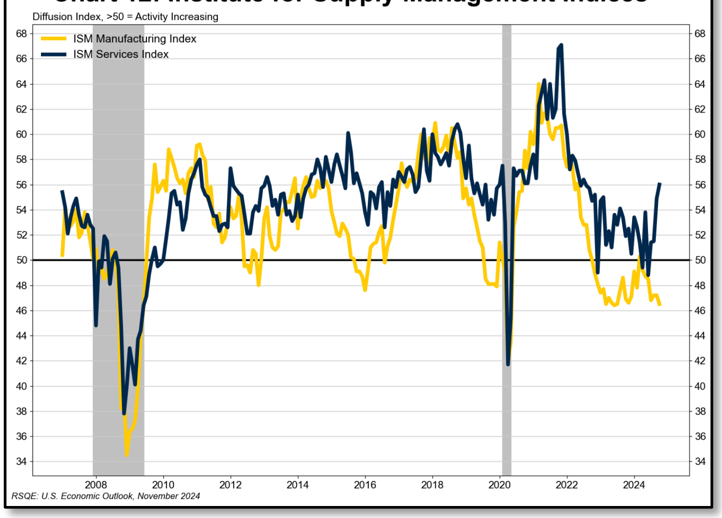


Chart 12: Institute for Supply Management Indices

Chart 12 shows the Institute for Supply Management's (ISM's) Purchasing Manager diffusion Indices for manufacturing and services. The services index jumped to 56.0 in October, propped up by the new orders and employment sub-indices, suggesting strong service sector momentum to start the fourth quarter. The manufacturing sector continues to struggle, with the ISM index indicating contraction in all but one of the past 24 months. We are hopeful that this manufacturing downturn will end soon. Most manufacturing outlook surveys conducted by regional Federal Reserve banks show a marked improvement in 6-month ahead expectations.

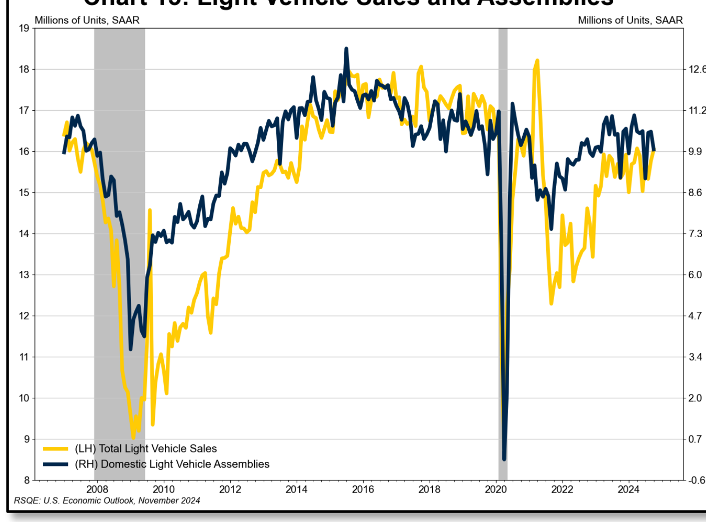


Chart 13: Light Vehicle Sales and Assemblies

Stagnant light vehicle sales are one reason behind the weakness in manufacturing. The seasonally adjusted annualized pace of light vehicle sales topped 16 million units for the second time this year in October, but the average for this year so far stands at a disappointing 15.6 million. Poor affordability due to high vehicle finance interest rates is likely holding back vehicle sales. Chart 14 shows light truck and car transaction prices relative to average monthly wages on the left axis. Both the maize and blue lines are at or below their 2019 levels. The green and red dashed lines (displayed on the right axis) show hypothetical monthly

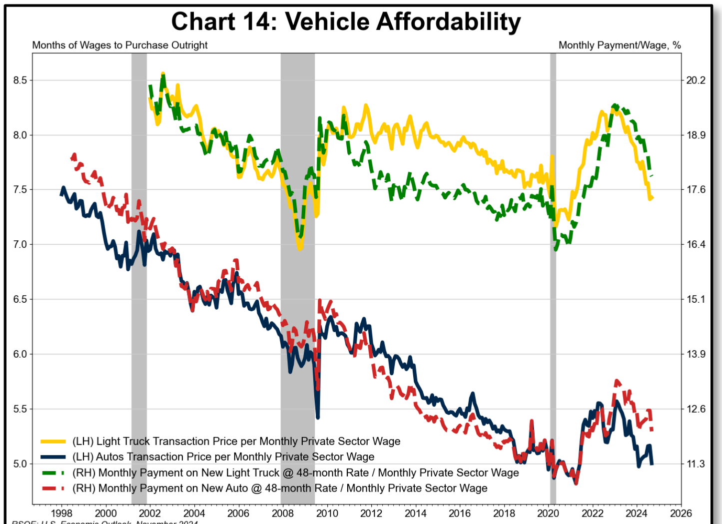
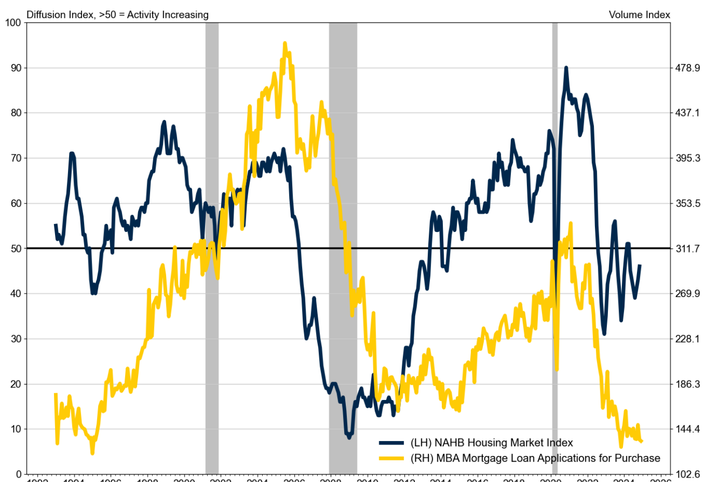


Chart 14: Vehicle Affordability

payments as a share of the monthly average wage for a new car or truck purchased at the respective average transaction price and financed over 48 months at the new vehicle finance interest rate reported by the Wall Street Journal. Both metrics show that affordability has deteriorated noticeably since 2021, to levels more in line with 2014–15 levels for cars and 2012 for trucks, respectively. The good news is that vehicle loan delinquency rates may peak soon, which could bring about lower risk spreads for vehicle finance and improving affordability.

With 30-year fixed mortgage rates pushing up toward the 7.0 percent mark again, the housing market is likely to get another swing of the seesaw. Chart 15 shows the National Association of Home Builders' (NAHB's) Housing Market Index alongside the Mortgage Bankers Association's (MBA's) volume index of loan applications for purchases. The NAHB's index, which measures builders' sentiment on concurrent and six-month forward single-family sales as well as the traffic of prospective buyers, has barely begun to improve this fall after its summer slump. With mortgage rates shooting up again, we do not expect much optimism from homebuilders. The number of new mortgage applications also appear destined to scrape along the bottom of their historical volumes over the near term.

Chart 15: Residential Market Metrics



RSQE: U.S. Economic Outlook, November 2024

Overall, the state of the economy remains challenging to interpret. We believe that the dynamics of the labor market support continued solid consumption expenditure growth in the current quarter. High interest rates and post-election policy uncertainty could weigh on some sectors. Although we forecast the labor market to continue gradually cooling off through the first half of next year, we believe that the Fed's pivot to looser near-term monetary policy will filter through the economy over time, helping to sustain the ongoing business expansion over the next two years.

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

Key Policy Implications of the Federal Elections

Donald Trump has won the presidency once more, and the Republican Party has won control of both houses of Congress for 2025–26. The House majority will remain very narrow, but party discipline could become easier to enforce with a Republican President and Senate. Still, the slim seat margin will likely limit the size and scope of policies Congress can implement, with most legislative action likely centered on tax policy. We now expect an extension of most expiring provisions of the Tax Cuts and Jobs Act of 2017 (TCJA), reinstatement of 100-percent bonus depreciation, and a reduction of the corporate income tax rate for domestic manufacturing to 15 percent. We think that a full exemption of tips, overtime pay, and Social Security benefit payment from income taxation is unlikely, but a partial exemption is likely. We also expect the cap on the state and local tax (SALT) deductions to be relaxed, fulfilling a campaign commitment. A large portion of Inflation Reduction Act (IRA) funds devoted to renewable energy has gone to Republican districts, so we do not expect a wholesale early phase-out of "green energy" provisions. However, the highly visible consumer incentives for purchases of electric vehicles (EVs) are likely to get zapped.

It also seems very likely that tariffs on imports from China will rise sharply. We project average tariff rates on Chinese imports to grow to eventually be triple the size of those implemented during the first Trump Administration. We project the new tariffs to come into effect early in 2026 and ramp up over the following year as rounds of mutual retaliation follow. We expect about a 0.2 percent permanent increase in consumer prices due to the new China tariffs. On the other hand, and contrary to many observers, we do not project the lasting imposition of broad tariffs on imports from the rest of the world over the next two years. We instead expect the threat of such tariffs (or a short-lived imposition) to be used as a bargaining chip in negotiations with our trade partners.

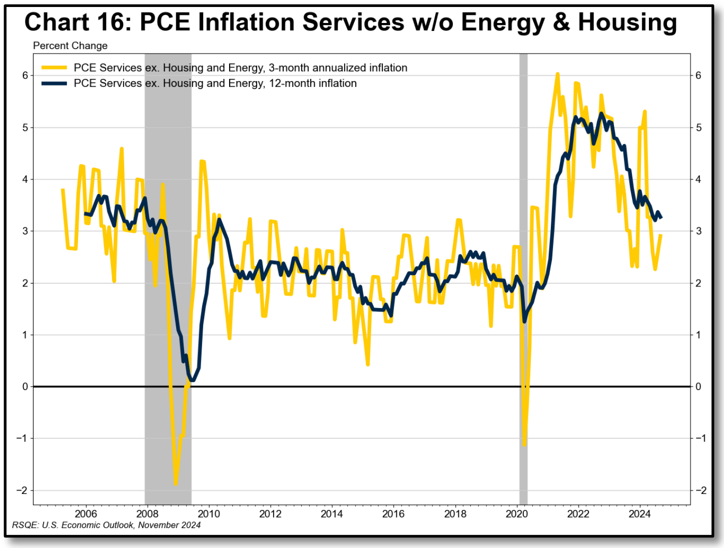
The path of future population growth is highly uncertain, but it is very relevant for our outlook. We think poor economic conditions in several Central American countries will continue to be the key driving force behind the flow of migrants across the U.S. southern border. Tighter border controls and enforcement under the second Trump Administration will deter some and slow the pace of new arrivals. We have lowered our projections for population growth considerably compared to our recent outlooks, which relied on Congressional Budget Office projections released in January 2024.[2] The campaign promise of mass deportations of unauthorized immigrants is a major wildcard. The removal of a significant portion of the working-age population could push interest rates and inflation higher, while also slowing the economy. A large-scale deportation program has not been attempted since the Eisenhower Administration in 1953. While it is likely that a deportation program will be put in place, we are skeptical that it will ultimately result in the permanent removal a significant portion of unauthorized immigrants.

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 has cut the federal funds rate at each of the last two meetings, by 50 basis points in September and by 25 bps in November, bringing it to the 4.5–4.75 percent range. Committee members have noted that they are "strongly committed to supporting maximum employment" and that "labor market conditions have generally eased" in their recent statements, signaling that they are open to further rate cuts if the labor market shows further signs of weakening. On the other hand, Federal Reserve Chair Jerome Powell stated on November 14, "The economy is not sending any signals that we need to be in a hurry to lower rates. The strength we are currently seeing in the economy gives us the ability to approach our decisions carefully." We project another 25 bps cut in the Committee's December meeting before the pace of cuts moderates next year absent a rapid deterioration of labor market conditions.

The median economic projection for the federal funds rate among September FOMC meeting participants envisioned one additional cut in 2024 from the current range and four more in 2025. The Committee maintained its belief that inflation would continue to normalize toward the Fed's 2.0 percent target. The median projection foresaw the unemployment rate rising to 4.4 percent in 2024Q4 and staying there in 2025Q4. The actual unemployment rate entered the fourth quarter at 4.1 percent in October, likely allowing the Fed to move gradually toward a more neutral monetary policy.

[2] Congressional Budget Office's report, "The Demographic Outlook: 2024 to 2054", Jan 18, 2024: https://www.cbo.gov/publication/59697.



Core PCE inflation, a key metric for forecasting future inflation, stood at 2.7 percent year over year in September. This metric has been slowing consistently since the September 2022 reading of 5.6 percent, but progress has slowed in 2024. The 3-month average (annualized) rate spiked to 4.4 percent in March and declined to 1.9 percent as of July, but it has since rebounded to 2.3 percent in September. Another hot Core CPI print in October likely means another incoming above-trend PCE Core inflation print. The decline in inflation in the middle of this year cleared the way for the Fed to begin cutting rates, but the recent reacceleration adds credence to a slower path down. 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 16, it was a significant driver of the recent spike, the subsequent decline, and the recent firming-up. Its year-over-year level remains stubbornly high as well.

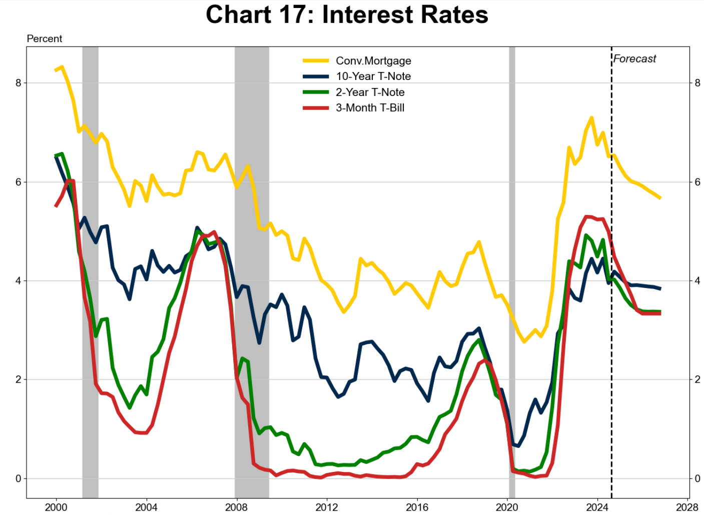
The Fed's statutory dual mandate requires a balanced approach to promoting maximum employment alongside price stability. The labor market is still near full employment, but it is showing definite signs of further cooling. The topline payroll job gains reading of 12,000 in October came in below expectations, adding to fears that the labor market slowdown has accelerated. While the monthly reading was likely impacted by inclement weather and strikes, the average over the three months before October was 148,000, a meaningful step down from the 2024Q1 monthly average of 267,000 (or 196,000 after adjusting for the preliminary estimate of the benchmark revision). The continued slowdown in the labor market alongside close-to-target inflation gives the Fed room to move rates lower.

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 this 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, a small step towards a more accommodative policy. We expect the pace of balance sheet reduction to slow to 30 billion dollars per month by the end of 2025.

We believe that our forecast is consistent with a Fed that is preparing to enter 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 25 basis points at the December FOMC meeting. By that time, we expect the unemployment rate to stand at 4.2 percent and the annualized pace of core PCE inflation to be around 2.4 percent, up from 2.2 percent in the third quarter. With the fed funds rate around 4.6 percent, the implied short-term real interest rate of nearly 2.2 percent will still appear slightly restrictive, especially given the softening labor market.

We project PCE inflation to reaccelerate from a 2.1 percent annualized rate in 2025Q3–Q4 to 2.3 percent by the end of 2026 as President-elect Trump's proposed tariffs make their way through to domestic prices. Even so, we expect four further 25-basis point cuts in 2025, bringing the fed funds rate range to 3.25–3.5 percent by the end of 2025, the terminal range for this cycle. The inflation related to the tariffs will likely be temporary as markets adjust to the new normal. In addition, the Fed will probably be attentive to the potential adverse effects on output arising from a possible trade war. 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 raise rates in 2026 in the face of tariff-induced price pressure.

Chart 17: Interest Rates



RSQE: U.S. Economic Outlook, November 2024

Chart 17 shows our projections for selected key interest rates. The 3-month Treasury bill rate steadily falls from 4.5 percent in 2024Q4 to 3.4 percent in 2025Q4 and 3.3 percent in 2026Q1, before holding around that level throughout the rest of the forecast. The 10-year Treasury rate rises to 4.2 percent in 2024Q4 and then declines gradually to 3.9 percent in 2025Q4 and 3.8 percent by the end of 2026. Measured by the quarterly 10-year-to-2-year spread, the yield curve un-inverts this quarter after two years of negative values. 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 6.5 percent in 2024Q3–Q4 to 6.0 percent in 2025Q4 and 5.7 percent by 2026Q4.

Fiscal Policy

As many provisions in the TCJA are set to expire by the end of 2025, several observers are calling this year the "Super Bowl of Tax". Given that the Republicans won undivided control of the federal government in the November elections, they will be calling most of the plays. With the slim majority in the House, significant spending cuts would be very difficult to push through; hence, we expect the 119th Congress to largely focus on reducing taxes.

We expect easy agreement on extending several individual components of the TCJA that are currently set to expire. A permanent doubling of the maximum child tax credit (CTC), for instance, is likely to garner bipartisan support. Similarly, we believe that the reinstatement of the immediate write-off on research expenditures and an extension of the 100-percent bonus depreciation will face minimal opposition. On the other hand, the tax incentives on clean energy and EVs introduced by the Inflation Reduction Act (IRA) of 2022 will probably get unplugged sooner than the current end year of 2032.

We were already expecting most personal provisions in the TCJA to survive regardless of the election outcome, so the TCJA's personal income tax cuts are virtually guaranteed to stick around. The fiscal cost of extending these cuts is formidable, however. The Joint Committee on Taxation estimated that an extension of the TCJA's personal income tax rates, combined with CTC provisions, would add a cumulative 3.3 trillion dollars to the primary deficit from 2025 to 2034 on top of an estimated baseline in which they expire of 7.4 trillion dollars.[3]

[3] This estimate is available in the Congressional Budget Office's report, "Budgetary Outcomes Under Alternative Assumptions About Spending and Revenues", May 8, 2024, https://www.cbo.gov/publication/60114.

President-elect Trump has also floated several other tax-cutting proposals which could lead to significant further revenue declines if enacted. The SALT deduction cap, currently set at 10,000 dollars, is anticipated to be under scrutiny because it is disfavored by some Republican representatives in "deep blue" states in addition to most Democrats. President-elect Trump vowed to eliminate the SALT cap less than two months before the election, but the extent of the adjustment could hinge on the size of the Republicans' ultimate majority in the House. According to multiple estimates, the full expiration of the SALT cap would reduce revenue by more than 1.1 trillion dollars over a 10-year budget window.[4] The size of the SALT cap could become a key battleground for fiscal hawks if the majority ends up slim. We have currently factored in a relaxation of the cap to 15,000 dollars for single taxpayers and 30,000 dollars for couples. Under this assumption, it comes with a yearly price tag of 50 billion dollars.[5] In addition, we anticipate that Congress will follow through on President-elect Trump's promise to cut the corporate tax rate to 15 percent for domestic manufacturers, which will lead to an additional annual revenue loss of 20 billion dollars.[6]

We expect contentious discussions on ending taxation of Social Security benefits and exempting overtime and tip income from tax. Despite being favored by both presidential candidates, tax exemptions for tip income would be challenging to enact because compensation structures would likely be adjusted to take advantage of this policy. The possibility of ending taxation of Social Security benefits, tips, and overtime income also appears uncertain, because the revenue cost could be 3.6 trillion dollars or more over a 10-year budget window.[7] If, as expected, the Republicans hold a thin majority in the House, any pushback from GOP fiscal hardliners could pose a serious challenge to the passage of these proposals. We assume a scaled-down version of these policies will take full effect by 2026, with a revenue loss of about 120 billion dollars per year.

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[4] The Penn Wharton Budget Model estimated a 1.1 trillion-dollar revenue decline if the SALT cap were eliminated starting in 2024: https://budgetmodel.wharton.upenn.edu/issues/2024/2/8/lifting-the-salt-cap-budget-effect. The Committee for a Responsible Federal Budget (CRFB) estimated a 1.2 trillion-dollar revenue loss from 2026–2035 if cap were eliminated in 2025: https://www.crfb.org/blogs/salt-cap-expiration-could-be-costly-mistake.

[5] We calculated this estimate using the CRFB's "build your own tax extensions" tool: https://www.crfb.org/build-your-own-tax-extensions.

[6] The central-cost estimate for corporate tax rate cut for domestic manufacturers is 200 billion-dollar revenue loss from 2026–2035: https://www.crfb.org/papers/fiscal-impact-harris-and-trump-campaign-plans.

[7] The central-cost estimate for ending taxation of Social Security benefits, tips, and overtime income totals 3.6 trillion dollars from 2026–2035 by CRFB: https://www.crfb.org/papers/fiscal-impact-harris-and-trump-campaign-plans.

On the other hand, import tariffs could offer some relief for federal revenues. Tariff revenue accruals surged by 50 billion dollars from 2017Q4 to 2018Q4 at the start of the trade war with China, marking a 37 percent year-over-year increase—the largest jump in 35 years. Throughout the campaign, President-elect Trump frequently proposed imposing tariffs of 60 percent on all goods imported from China and 10 or 20 percent tariffs on goods imported from the rest of the world. If implemented, these tariffs could bring substantially larger revenue than in 2018–19, when tariffs were levied on about two-thirds of Chinese imports at an average effective rate of about 19 percent.[8] However, given the scale of the proposed new tariffs, the subsequent repercussions could pose a drag on near-term growth, reducing the potential tax revenues. For this forecast, we have penciled in higher tariffs duties on China's imports coming on over the course of 2026, which will ultimately rise to a level about three times higher than in 2024–25. While some tariff threats may be used as bargaining tools against some other countries, we do not anticipate any meaningful non-China tariffs to take effect for any significant amount of time through 2026. As a result, we expect to see the annualized tariff-driven revenue increase to ramp up to 85 billion dollars by the end of 2026.

The Fiscal Responsibility Act of 2023 suspended the U.S. debt ceiling through January 1, 2025, after which the U.S. Treasury will start using extraordinary measures to keep the government open temporarily. With the fiscal 2025 budget unlikely to be finalized during the lame-duck session, we are reminded again that the nation continues to struggle to come up with a clear plan to address both its short-term and long-term fiscal challenges. For a change, we expect this round of debt ceiling theater to go down largely unnoticed given single-party control of the Congress and Presidency.

Table 1 shows the data and our projections for the federal budget on a National Income and Product Accounts (NIPA) basis for fiscal years 2023 to 2026, broken down by receipts and major expenditure categories. The pace of revenue growth is set to pick up to 4.5 percent in fiscal 2025. We assume that the projected tax cuts will be working their way through the economy in fiscal 2026, when

[8] The Budget Lab at Yale estimated that a 10 percent universal tariff on goods imports with a 60 percent tariff on Chinese imports would raise at least 2 trillion dollars from 2025 through 2034: https://budgetlab.yale.edu/research/fiscal-macroeconomic-and-price-estimates-tariffs-under-both-non-retaliation-and-retaliation. The Tax Foundation estimated that the trade war with China resulted in a nearly 80 billion dollar tax increase: https://taxfoundation.org/research/all/federal/trump-tariffs-biden-tariff. The Peterson Institute for International Economics estimates for average China import tariffs can be found here: https://www.piie.com/research/piie-charts/2019/us-china-trade-war-tariffs-date-chart.

higher import tariffs will also be coming online. However, we judge that the revenue increase from tariffs is unlikely to fully offset the cost of the tax reductions we project. Therefore, revenue growth is expected to slow to a 2.7 percent pace in fiscal 2026.

We expect federal expenditures growth to outpace receipts growth over the next two years, averaging a 5.2 percent annual pace throughout our forecast window. We estimate that federal consumption growth accelerated to 6.3 percent in fiscal 2024 and will moderate to 4.5 percent in fiscal 2026 but will remain supported by robust defense spending. Transfer payments account for more than 60 percent of the overall expenditure growth, as Social Security and the federal share of Medicaid spending settle into a steady post-pandemic trajectory, while expanded Affordable Care Act (ACA) credits from the IRA expire as scheduled by the end of 2025. Federal subsidies are on track to retreat to near their pre-pandemic levels before resuming growth in fiscal 2026. Interest payments on the federal debt rose by nearly one-third in fiscal 2023 due to sharply higher interest rates. As the Fed continues its rate-cutting cycle, the growth rate of interest payments decelerates from a 21.3 percent pace in fiscal 2024 to a 5.2 percent pace by fiscal 2026.

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

			FY Forecast	
	2023	2024	2025	2026
Current receipts	4875.4	5058.2	5284.7	5425.9
% change	-2.8	3.8	4.5	2.7
Current expenditures	6424.7	6826.4	7224.1	7552.0
% change	5.0	6.3	5.8	4.5
Consumption	1300.2	1381.1	1456.3	1518.6
% change	6.4	6.2	5.4	4.3
Transfer payments	4131.1	4272.1	4529.9	4734.9
% change	2.7	3.4	6.0	4.5
Federal subsidies	105.1	95.2	85.5	86.5
% change	-48.2	-9.4	-10.2	1.2
Interest payments	888.3	1078.0	1152.5	1212.1
% change	32.2	21.3	6.9	5.2
Surplus (+) or deficit (-)	-1549.4	-1768.2	-1939.4	-2126.1
Percent of GDP	-5.7	-6.1	-6.4	-6.8

RSQE: U.S. Economic Outlook, November 2024

As revenue growth lags expenditure growth, the federal deficit continues to expand, from 6.1 percent of GDP in fiscal 2024 to 6.8 percent of GDP by fiscal 2026. Federal debt held by private investors increases from 79.9 percent of GDP in fiscal 2024 to 87.4 percent of GDP in fiscal 2026. 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

Affordability in the housing market improved marginally in the third quarter of the year, as the 30-year conventional fixed mortgage rate declined from 7.0 percent in early June to 6.1 percent in late September. However, mortgage rates reversed course early in October, climbing back to 6.8 percent as of mid-November. With listing prices mostly holding up, this fall's improvement in housing affordability may prove fleeting, limiting the prospects for recovery in single-family home sales. Inventory of single-family housing available for sale has continued to accumulate as buyers have stayed on the sidelines hoping for lower rates and prices.

Our preferred measure of home prices, the seasonally adjusted S&P CoreLogic Case-Shiller National Home Price Index, has decelerated on a year-over-year basis, from above 6.0 percent in January–April to 4.2 percent in August. Although we expect mortgage rates to resume their decline over the next two years, there is substantial uncertainty around their path stemming from large projected deficits, likely increases in tariffs, the resulting pressure on inflation, and potential changes to the mortgage finance system such as the possible reprivatization of Fannie Mae and Freddie Mac. We project housing affordability to improve gradually over the next two years. The extent of the improvement is projected to be underwhelming, however, due to elevated uncertainty and the lock-in effect of the previous surge in mortgage rates preventing many potential sellers from listing their homes for sale.

Measures of housing-related sentiment have been mixed recently. Homebuilders' sentiment has improved, likely due to expectations that lower financing costs will return in earnest going forward. In the NAHB housing market index, the component for single family sales in the next six months showed consecutive above-50 readings in September and October, with more builders expecting sales conditions to be good than poor. Still, most builders were pessimistic about the present situation and traffic of prospective buyers. On the homebuyers' side, the University of Michigan Survey of Consumers' sentiment index of home buying conditions inched lower in November after ticking up slightly in October. It remains near a historic low.

Existing single-family home sales fell below the 3.5-million-unit pace in August and September, possibly related to expectations of further declines in mortgage rates heading into the Federal Reserve's easing cycle. The seasonally adjusted months' supply of existing single-family homes climbed to 4.1 in September, compared with an average of 3.6 in the second quarter and 3.2 a year ago. Rising months' supply is usually a signal of slower home price appreciation ahead.

Chart 18: Housing Affordability at Time of Purchase

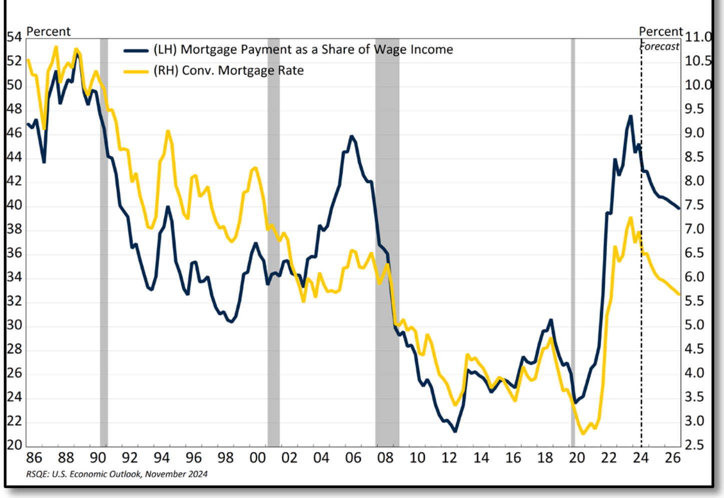


Chart 18 plots our preferred measure of affordability, the ratio between a mortgage payment on a newly bought home and the average wage income per worker.[9] We estimate that this ratio decreased to 43.0 percent in the third quarter of 2024 as mortgage rates fell, the lowest since the first quarter of 2023. Looking ahead, we project the affordability ratio to stay flat in 2024Q4 and then to ease gradually to 40.8 percent in the second half of 2025 and 39.9 percent by the end of 2026. Although this improvement in affordability will bring some relief to prospective homebuyers, housing will remain much less affordable than during the years prior to the pandemic, when our affordability metric generally moved within the range of 20–30 percent.

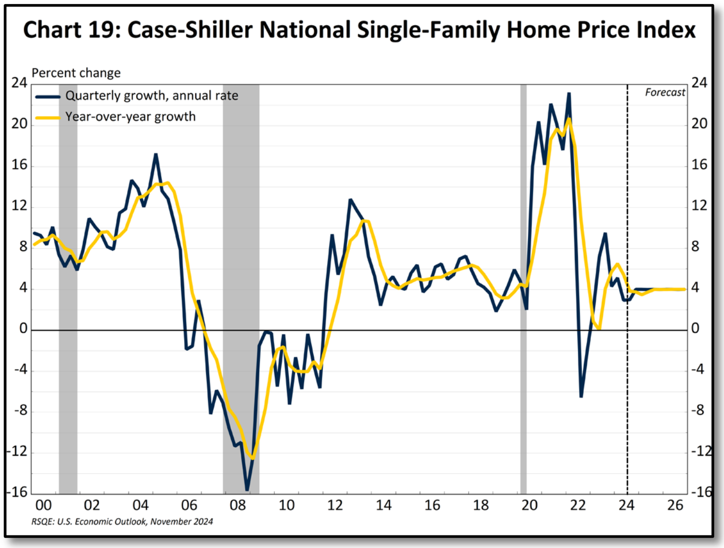
Annualized sales of new single-family homes rebounded to 724,000 in the third quarter, up from 693,000 in the second quarter. With somewhat cheaper mortgages ahead and still-rising existing home prices, we expect a slow pick-up in new home sales to continue in the near term. Single-family housing starts saw a large dip in July, potentially due in part to Hurricane Beryl, but recovered to an annualized pace of 1,000,000 units in August. Months' supply of new single-family homes for sale moderated to 7.6 in September from 8.7 in February, but still suggests an excess in inventory compared with a balanced market featuring under 6 months' worth of supply. Single-family residential construction remains restrained as the market works through the supply overhang that has developed since 2022, but we are

[9] 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.

cautiously optimistic about this market in the long term given that it should benefit from the expected decline in mortgage rates.

Multi-family housing starts recovered slightly to 363,000 in the third quarter compared with an average pace of 340,700 units in the first half of the year, but the multi-family market remained loose as previously started projects were completed, boosting inventory. However, easing financial conditions in the near term and extra demand from recent immigrants as they ramp up their labor force participation should help sustain demand for multi-family units in 2025–26.

Chart 19 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 in August showed a continued deceleration of home price appreciation to 4.2 percent year over year. We expect the year-over-year pace of price appreciation to dip below 4.0 percent through 2025Q2 before stabilizing at a 4.0 percent level over the remainder of our forecast period.



Energy Markets

The price of West Texas Intermediate (WTI) crude oil hovered around 70–75 dollars per barrel during the first couple weeks of October, as tensions in the Middle East remained high. On October 26, Israel conducted targeted strikes on military sites in Iran. Its decision to spare oil production facilities alleviated emerging energy market concerns about supply. The price of WTI fell below 70 dollars per barrel shortly after the attack but rebounded to 72 dollars in early November as energy markets shifted focus to the U.S. presidential election and another FOMC meeting, in addition to the ongoing tensions in the Middle East.

Another major risk to our energy outlook is China's demand for oil. Chinese demand has slowed significantly in recent quarters, even contracting in mid-2024. In its October Short-Term Energy Outlook, the Energy Information Administration (EIA) forecasts that China's liquid fuel consumption will increase by only 0.1 million barrels per day (bpd) in 2024 and 0.3 million bpd in 2025. These modest increases represent just 10 and 20 percent of the projected global growth in consumption—a significant slowdown from the pre-pandemic pace in 2018 and 2019, when China accounted for 40 and 50 percent of the world's increase in consumption.

The Organization of the Petroleum Exporting Countries and its allies (OPEC+) once again decided to delay their planned oil production increase to early next year, citing concerns about weak oil demand and increasing supply from outside of the group. The EIA, however, expects OPEC+ to ramp up production in mid-2025, though output will likely remain below target for the year. Without a substantial increase in supply from OPEC+ countries in the near term though, global inventories will likely continue to draw down until production growth ramps up to meet global demand. The EIA estimates that increased production in the United States, Guyana, Brazil, and Canada, along with output from OPEC+, will be sufficient to exceed global demand in the second half of 2025, allowing global inventories to rebuild.

Chart 20 shows our forecast for WTI and Brent crude prices in maize and blue as well as the Producer Price Index (PPI) for natural gas fuels in green. We expect the price of WTI to tick down from 78 dollars in mid-2024 to a little under 72 dollars by the end of 2026, as tensions in the Middle East 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, as the inclusion of U.S. WTI-Midland crude in the Brent index appears to have reduced the spread's volatility.

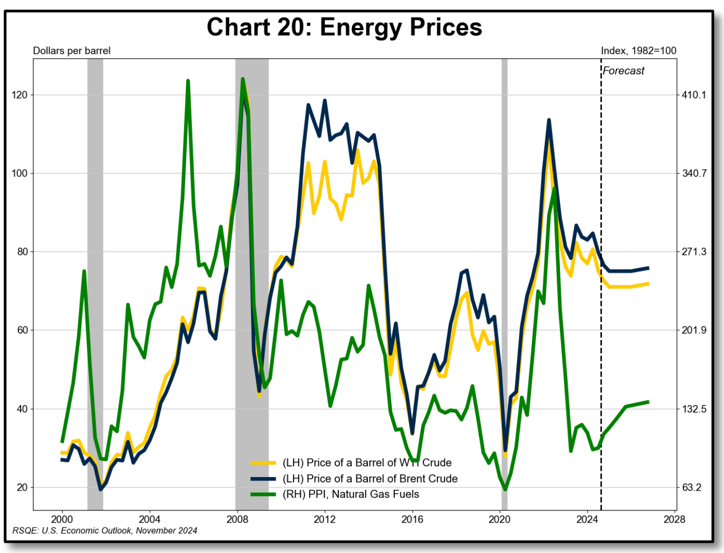


Chart 20: Energy Prices

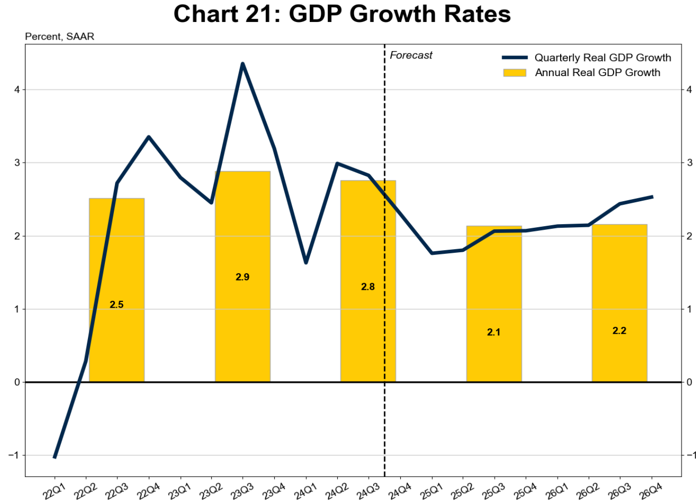
Natural gas prices, as measured by the PPI for natural gas fuels, rose by 1.4 percent in the third quarter of 2024. However, prices remain 15.5 percent below year-ago levels due to record U.S. natural gas production in 2023 and a mild winter that reduced demand for space heating. High production and low prices led to inventories being restocked to nearly 40 percent above the five-year average (2019–2023) by March 2024. As production declined moderately over the year in response to lower prices, inventories were drawn down to just 5 percent above the five-year average by September 2024.

Over the next few years, we anticipate heating seasons in our forecast to be slightly warmer than the previous 10-year average, with production remaining flat but at record-high levels. At the same time, we expect domestic consumption to stay relatively stable, placing minimal upward pressure on prices. International demand paints a different picture. We anticipate that liquefied natural gas (LNG) exports will increase due to strong international demand, driving up domestic prices. As a result, we forecast natural gas prices to increase by 11.8 percent from 2023 to 2026, outpacing the cumulative projected CPI inflation of 8.0 percent over the same period.

The Forecast for 2025–2026

The recent comprehensive NIPA revision has resolved the apparent disconnect between real GDP and real Gross Domestic Income growth rates over recent years. With a significant upward revision to past personal income, and the still-healthy labor market producing meaningful real wage gains, the average consumer's budget appears consistent with continued healthy spending growth. Long-term interest rates have risen meaningfully in recent months, however, limiting potential consumption growth. Recent immigrants will likely continue ramping up their labor force participation, assuming that the anticipated deportation policy is limited in scale. As a result, working-age population and, hence, potential GDP growth will likely remain above trend. By 2026, we project the key policies of President-elect Trump's agenda to take shape. We expect about 200 billion dollars in tax cuts in 2026, split between persons and corporations, to be partly counteracted by about 85 billion dollars in new tariff revenue. We project that the stimulative effects of the tax cuts will dominate the drag from the tariffs over the next two years, as domestic importers and foreign producers share some of the tariff incidence with U.S. consumers. As a result, we project GDP growth to accelerate in 2026, but at the cost of a wider federal fiscal deficit. At 6.8 percent of GDP for fiscal 2026, the level of the federal deficit would be unprecedented outside of wars, the recent pandemic, and severe recessions.

Chart 21: GDP Growth Rates



RSQE: U.S. Economic Outlook, November 2024

- We project that real GDP growth will slow from its 2.8 percent annualized pace in 2024Q3 to 2.3 percent in 2024Q4 and 1.8 percent in 2025H1. Consumption's contribution lags in 2025Q1, as the campaign- and election-related boost in 2024H2 wanes.
- Looser monetary policy filters through the economy over the next few quarters, stabilizing the labor market by 2025H2. Strong labor force growth nudges real GDP growth up.
- The pace of growth ramps up above 2.4 percent by mid-2026, as personal income tax cuts kick in, overpowering the negative growth impacts of deportations and the new China tariffs that take effect early in 2026.
- Calendar year GDP growth registers 2.8 percent in 2024, then moderates to 2.1 percent in 2025, and ticks up to 2.2 percent in 2026.

Table 2

Contributions to the Growth of Real GDP

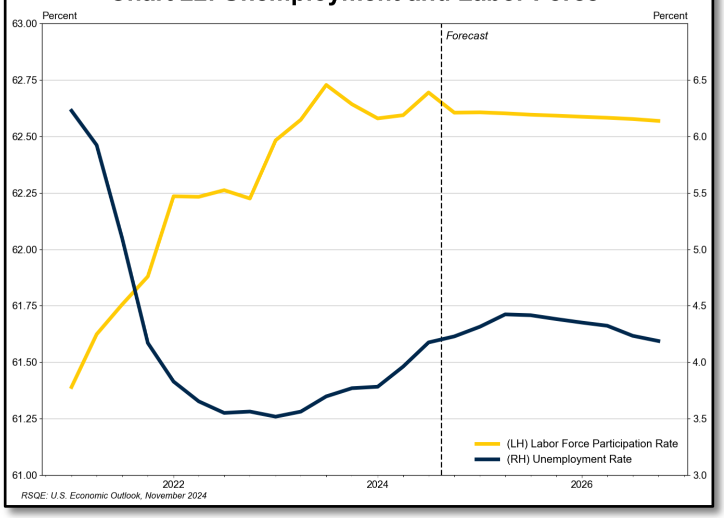
(Average quarterly contributions, percentage points at annual rate)

	'24Q3	'24Q4	'25H1	'25H2	'26
Real GDP (% change, AR)	2.8	2.3	1.8	2.1	2.3
Contributions to real GDP growth					
Final sales to domestic purchasers	3.6	2.3	2.0	2.4	2.5
Consumption	2.5	2.0	1.3	1.5	1.6
Nonresidential fixed investment	0.5	-0.0	0.3	0.6	0.5
Residential investment	-0.2	0.1	-0.0	0.1	0.2
Government purchases	0.9	0.2	0.4	0.3	0.2
Net exports	-0.6	0.2	-0.2	-0.3	-0.3
Inventory investment	-0.2	-0.2	0.0	-0.0	0.0

RSQE: U.S. Economic Outlook, November 2024

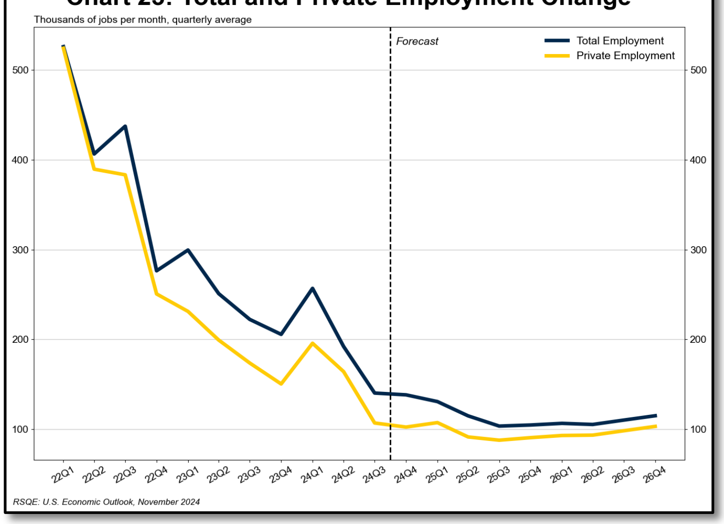
- After the near-term slowdown, consumption expenditures' contribution to growth hovers in the 1.4–1.7 percentage point range from mid-2025 through 2026, as real earnings growth decelerates in a slightly looser labor market.
- The forecast growth contribution of nonresidential fixed investment is largely driven by spending on equipment and intellectual property, as nonresidential construction flatlines following a spike driven by the early stages of construction at 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 from its unusually high 2024Q3 level, averaging about 0.3 percentage points over 2024Q4–26Q4.
- Net exports are a drag on growth in 2025, as businesses attempt to front-run forthcoming tariffs. In 2026, tariffs and retaliation affect both imports and exports, with no change to their net growth contribution.

Chart 22: Unemployment and Labor Force



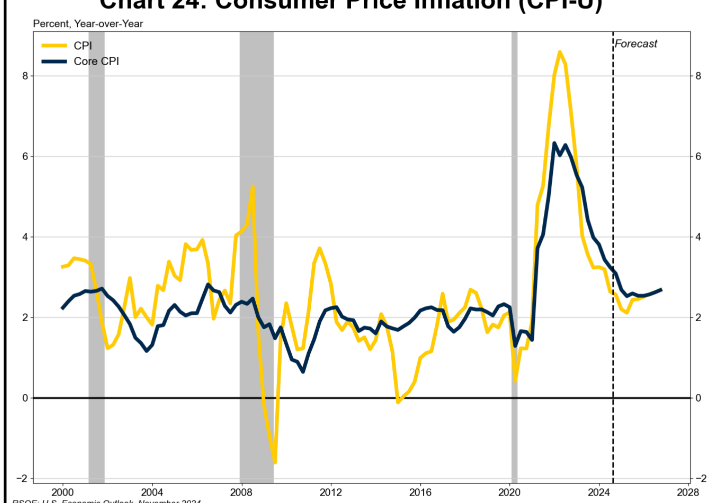
- The labor market is staying afloat for now. The headline unemployment rate hovered at 4.1 percent over the past two months after edging down from the recent high of 4.3 percent in July. The decline de-triggered a well-known recession indicator—the so-called "Sahm rule."
- The labor force participation rate has held relatively steady between 62.5 and 62.8 percent since February 2023, with the October reading at 62.6 percent. We expect it to slip marginally from this level 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 remain relatively high, the cumulative effects of previous monetary tightening continue to work their way through the labor market. The unemployment rate rises modestly to 4.4 percent in 2025Q2 before sliding back to 4.2 percent in 2026Q4 as monetary policy becomes more accommodative.

Chart 23: Total and Private Employment Change



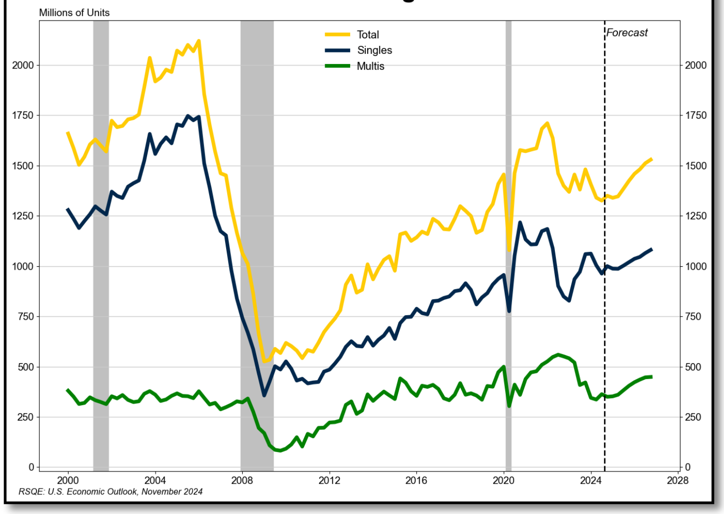
- Hurricanes and strike activity had a significant negative impact on October's payroll employment gains of only 12,000. Private job gains were reduced by 38,000 due to Boeing's machinists' strike. However, the pace of government hiring remains steady.
- Nevertheless, the trend pace of job gains is clearly decelerating. Despite an upbeat report in September, the three-month average pace of gains registered 148,000 prior to October's report, weaker than the 166,000 annual average pace in 2019.
- Private sector job gains continue to decelerate through 2025Q3. Several years of a tight labor market are likely to spur faster productivity growth over the next two years. We expect job growth to pick up again in 2026.
- The government sector adds jobs throughout the forecast, albeit at a much slower pace compared to 2023, as local government employment tops its pre-pandemic count.

Chart 24: Consumer Price Inflation (CPI-U)



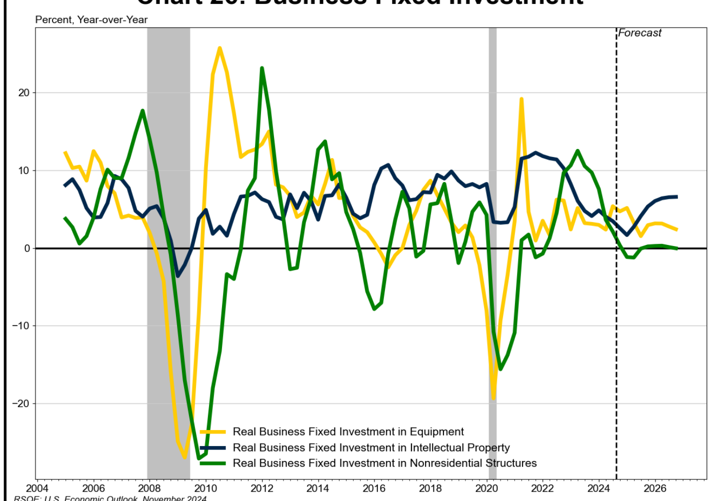
- All-items CPI inflation decelerated to 2.6 percent year over year in 2024Q3, as energy prices continued to decline. Core CPI inflation dipped to 3.2 percent with slower price increases in shelter and other services but ticked up to 3.3 percent in October.
- Core CPI inflation slightly outpaces the headline rate throughout 2024 and 2025, as gasoline price increases remain largely subdued and food inflation slows. Year-over-year core CPI inflation slows to 3.1 percent in 2024Q4, eases further to 2.5 percent in 2025Q4, and then rebounds to 2.7 percent in 2026Q4.
- We expect inflation in the PCE price index, the Fed's preferred measure, to pick up briefly to 2.4 percent year over year in 2024Q4 as energy price decreases slow. PCE inflation then resumes its downward trend toward 2.1 percent in 2025Q4. We expect year-over-year PCE inflation to accelerate to 2.3 percent by 2026Q4 as the projected tariffs work their way through domestic prices.

Chart 25: Housing Starts



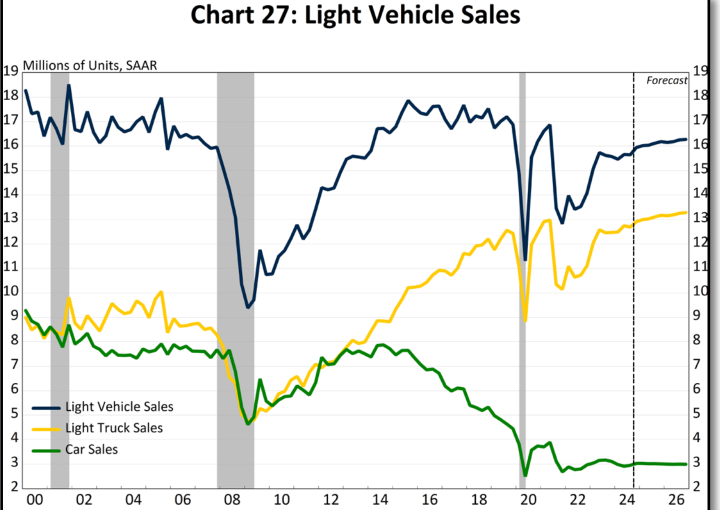
- With plenty of supply for sale, new single-family home construction remains soft, hovering around an annualized pace of 1,000,000 units in 2024 and early 2025, before picking up gradually to 1,081,000 units by 2026Q4.
- Multi-family starts edged up to an annualized pace of 363,000 units in 2024Q3 following lower prints earlier in the year. We expect multi-family starts to remain soft in 2025H1 due to elevated inventories and completions, but to climb to a pace of 449,000 by 2026Q4 with cheaper financing options.
- The annualized pace of total housing starts stands at 1,350,000 in 2024Q4 and recovers to the pre-pandemic level by 2025Q4, reaching 1,529,000 in 2026Q4.
- We remain optimistic about new construction, despite a delayed rebound due to near-term uncertainty related to mortgage rates and home prices. Housing starts should benefit from lower mortgage rates ahead and the recent influx in new immigrants, assuming no blanket mass deportations.

Chart 26: Business Fixed Investment

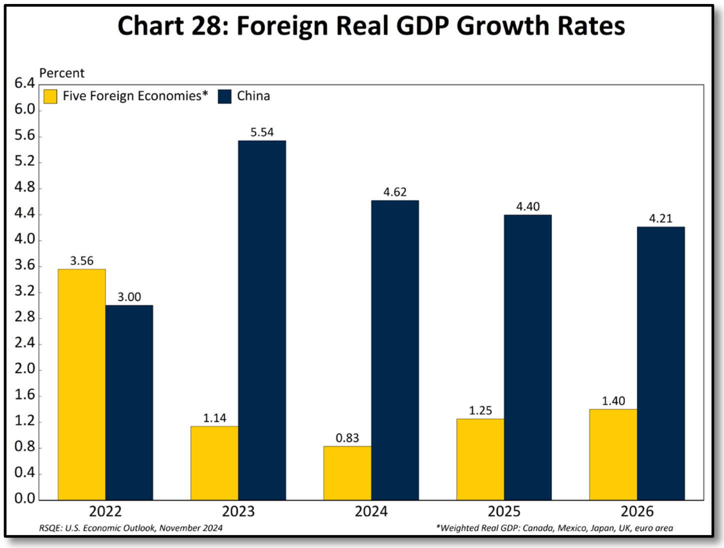


- Growth in real investment in equipment accelerated to 5.4 percent year over year in 2024Q3, reflecting a continued ramp-up in information processing equipment investment and a spike in aircraft deliveries. We expect its growth to hold roughly steady through 2025Q1, then decelerate to about 2.4 percent year over year by 2026Q4.
- Intellectual property investment expanded by 3.5 percent year over year in 2024Q3. We project that robust growth in intellectual property will persist throughout our forecast window, with the year-over-year pace accelerating to 6.6 percent by 2026Q4.
- Year-over-year growth in nonresidential structure investment slowed from 10.6 percent in 2023Q3 to 2.1 percent in 2024Q3, as the microchip factory construction boom appears to have crested. Even with a potential uptick in mining construction, overall investment in nonresidential structures will likely flatline over the next two years.

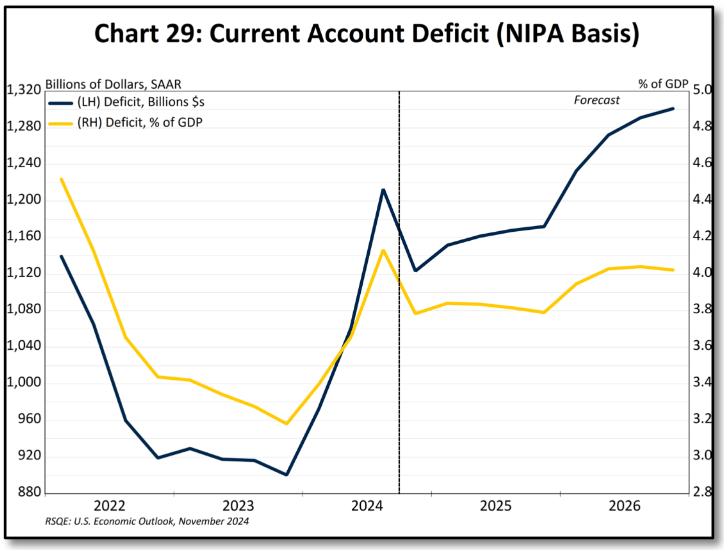
Chart 27: Light Vehicle Sales



- The annualized pace of light vehicle sales posted a solid 16.0 million units in October, the fastest since April. We also expect interest rates on auto loans to decline amid the Fed's cutting cycle and the CPI for new light vehicles to extend its recent declines. Auto sales are expected to continue rising gradually as vehicle purchases become more affordable relative to incomes.
- The light vehicle sales pace softens from October's rate to 15.9 million units in 2024Q4 and climbs slowly to 16.3 million by 2026Q4. The sales gains are mainly in 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 EVs is a substantial risk. We expect the current EV tax credit to be slashed, but with little hit to total light vehicle sales as consumers substitute to vehicles with other drivetrains.



- 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.
- Despite recent policy stimulus, China's economic growth is projected to slow from 5.5 percent last year to 4.6 percent in 2024, due to geopolitical pressures, challenges in its real estate market, and low consumer confidence. In 2025–26, we expect further deceleration, as new tariffs on China's exports kick in.
- The five-economy composite calendar-year growth rate is projected to slow to just 0.8 percent in 2024, largely due to weak growth in Japan and Mexico. In 2025–26, growth accelerates meaningfully in Japan and Canada, pushing the two-year average growth of the five-country aggregate GDP to 1.3 percent.



- The current account deficit declined from its pandemic-era high point of 4.5 percent to about 3.2 percent of GDP in 2023Q4, as consumption of goods moderated. Strong growth of imports in 2024H2 pushed the current account deficit back up to 4.1 percent of GDP. We project it to dip to 3.8 percent of GDP in 2024Q4.
- We expect new tariffs on imports from China to take effect starting in 2026, with several rounds of retaliation to follow. During 2025, we expect elevated levels of both imports and exports in anticipation of new tariffs, with the current account deficit holding largely flat relative to nominal GDP.
- The current account deficit is projected to widen despite new tariffs in 2026, thanks to a large domestic tax cut that is expected to fuel extra demand for goods.
- In nominal terms, the current account deficit registers an annualized pace of about 1.1 trillion dollars in 2024Q4, then widens by about 50 billion dollars more through 2025Q4 and a further 130 billion dollars through 2026Q4.

Risks to the Forecast

Economic uncertainty is highly elevated. The outcome of November's federal elections, delivering a Republican trifecta, has brought to the forefront many previously low-probability scenarios to the forefront. We will broadly group the risks we see by time horizon: those affecting near-term outcomes and those likely to influence our medium-run outlook. There are also large risks to the longer-run economic outlook, but we will not discuss them in detail here.

The most prominent near-term risks comprise noisy data leading to deviations of monetary policy from our assumed path, sudden changes in key economic trends, global commodity price volatility, and the paths of the wars ongoing abroad. Hurricane Helene likely led to a drop in job gains in October, but the magnitude of the drop is currently uncertain. With the initial establishment survey response rate lower than 50 percent for the month, sizeable subsequent revisions are likely. Given the elevated core month-on-month inflation prints over the past three months, a strong November jobs report that brings large revisions to prior data would likely place further fed funds rate cuts on hold at least temporarily. With year-over-year core CPI inflation having held stubbornly flat since June, any further acceleration of inflation trends would likely derail the Fed's rate-cutting plans absent a further cooldown in the labor market, sending policy rate expectations and longer-term Treasury yields higher.

Consumption expenditure growth, the largest driver of economic growth, has remained resilient in the face of low consumer confidence readings and high interest rates. A sudden deceleration in the face of rising delinquencies and financial strain, however, cannot be ruled out. On the other hand, if wage growth persists at higher levels for longer than we anticipate, consumption growth could lift real GDP growth higher than we project.

With the incoming Trump Administration's attitudes towards the wars in Ukraine and the Middle East likely to stand in stark contrast to those of the Biden Administration, the conflicts have a high risk of significant near-term developments with potential implications at least for global commodity prices and near-term U.S. defense spending. A ceasefire and the start of political negotiations in either conflict would likely lower escalation premiums embedded in market prices for global commodities produced around the affected region such as oil, natural gas, grains, metals, etc., but also reopen the currently curtailed shipping and travel routes. Such developments would help lower global inflation further and likely lift real incomes. Further escalation would likely lead to additional disruption to global commodity markets, spurring further increases in U.S. defense expenditures. The net effects on the U.S. economy would likely be ambiguous, however.

The list of medium-term risks is a lot longer. We can group them broadly into several, non-mutually exclusive, categories: those affecting the productive capacity of the economy, fiscal trajectory risks, factors affecting the neutral monetary policy rate, and foreign policy issues.

Two first-order drivers of the economy's productive capacity are the working-age population and total factor productivity (TFP). Population growth could change quite dramatically over the coming years. With immigration accounting for a substantial portion of U.S. population growth, border policies and their enforcement could have a disproportionate impact on GDP growth over the medium term. The range of plausible scenarios for immigration is wide. On one end is the prospect of large-scale deportations of unauthorized immigrants already in the country, coupled with significant curbs to inflows of new immigrants. On the other end is the prospect of policy actions that are largely for show but that do not have a large practical effect; in that scenario, we could even see an acceleration of new immigration due to economic and political disruptions in other parts of the world. The range of possible economic outcomes is equally wide, with several key sectors of the U.S. economy (such as construction and agriculture) currently relying on the labor of unauthorized immigrants most at risk. TFP is hard to measure and even harder to shift via policy. However, another key goal of the incoming Trump Administration, rebuilding the U.S. industrial base through a combination of tax incentives, tariffs, and federal spending, has the potential to alter medium-run TFP. Unfortunately, the TFP effects could go either way, depending on the policy's implementation. A reinvigorated industrial base could result in faster productivity growth going forward, while a failed policy would still see massive shifts of capital and labor away from a more efficient allocation, lowering TFP.

We project that the federal deficit is set to grow from an already high level over the first two years of the second Trump Administration. The set of fiscal policies we project is largely derived from campaign promises. The narrow House majority and other political calculations may limit their scope and delay their timing. In such an event, deficits would likely be slightly narrower, with a bit slower economic growth over the next two years. On the other hand, with no re-election concerns hanging over him, President Trump may choose to pursue a larger set of fiscal issues, such as attempting once more to repeal the ACA, reforming the immigration system, privatizing government-sponsored enterprises such as Fannie Mae and Freddie Mac, or significantly ramping up defense spending relative to GDP. While some of these policies may raise some revenue, the overall outcome is likely to produce considerably wider deficits, raising the probability of an adverse bond market reaction.

Many of the potential scenarios outlined above would also have implications for equilibrium medium-run real interest rates, and, hence, for the neutral monetary policy rate. As the neutral rate shifts due to policy action, the real-time effective monetary policy stance may evolve even without explicit action from the Fed. In the event that the neutral policy rate shifts substantially, it will take time for the Fed to observe enough data to correct course, raising the possibility of persistent deviations from its dual mandate over the medium term.

Finally, foreign policy is likely to stay in the headlines throughout our forecast window. We have projected a significant jump in import tariffs on Chinese goods during 2026, but no broad tariffs on imports from the rest of the world. We think the latter will likely be used as a threat in negotiations with our other key trading partners but will not actually be implemented. However, these assumptions are tentative, and a broad-based tariff on imports is certainly plausible. Such broad tariffs would probably trigger a significant retaliatory response, leading to a reshuffling of trade flows and realignment of exchange rates. The economic ramifications would likely be orders of magnitude larger than those of tariffs targeting only China. Beyond tariffs, a further escalation of current wars and the breakout of new conflicts is certainly possible given the current state and the trajectory of the geopolitical affairs.

Overall, we consider the most prominent risks to the 2025–26 U.S. economic outlook to be fairly balanced, but the range of potential outcomes to be quite wide, primarily because the Federal Reserve may not be able to react quickly enough to shocks that shift the medium-term neutral policy rate. A list of predominantly downside tail risks, which we do not describe here, also appears larger than usual.

Appendix 1: Brief Review of the Previous Year's Forecast

In line with our longstanding tradition, Table 3 shows RSQE's forecast record for real GDP/GNP growth.[10] The final row illustrates the evolution of our real GDP growth forecast for calendar year 2024.

Our November 2023 forecast had anticipated a pullback in consumer spending in the first half of 2024, leading us to underestimate the strength of the economy this year.

[10] Our real GNP level forecast record spanning 1953 to 1990 is available on our webpage.

Table 3
Review of Past Real GNP/GDP Forecasts
(Figures represent % change over the preceding year in real GNP from 1971 through 1991 and in real GDP beginning with 1992.)

	RSQE Forecast			
	Preceding November	February/March	August/September	Observed*
1971	3.3	3.8	2.9	3.3
1972	5.7	5.4	6.3	5.3
1973	7.1	7.2	6.2	5.9
1974	2.3	0.5	−1.1	−0.4
1975	1.1	−2.3	−3.5	−0.4
1976	5.9	6.7†	6.2	5.5
1977	4.3	4.9	5.2	4.7
1978	3.6	4.1	3.5	5.5
1979	2.0	2.8	1.5	3.5
1980	−0.3	0.3†	−1.4	−0.3
1981	1.4	1.6	1.8	2.4
1982	1.1	−0.1	−1.3	−1.7
1983	3.4	3.2	3.2	4.5
1984	6.5	6.2	7.2	7.1
1985	3.8	4.6	2.5	3.8
1986	2.9	3.3	2.4	3.2
1987	3.3	3.2	2.5	3.4
1988	2.9	2.3	3.8	4.2
1989	2.9	2.5	2.6	3.7
1990	2.7	2.5	1.1	2.0
1991	1.5	0.4	−0.1	−0.2
1992	2.2	1.6	1.7	3.5
1993	2.7	3.2	2.3	2.8
1994	2.4	3.9	3.5	4.0
1995	2.4	3.3	3.0	2.7
1996	2.6	1.7	2.2	3.8
1997	2.4	3.2	3.3	4.4
1998	2.6	2.9	3.1	4.5
1999	1.5	3.5	3.7	4.8
2000	3.1	4.1	5.1	4.1
2001	3.6	1.6	1.6	1.0
2002	0.4	2.5	2.2	1.7
2003	2.5	2.4	2.4	2.8
2004	5.1	4.7	4.3	3.8
2005	3.5	3.5	3.7	3.5
2006	3.4	3.6	3.3	2.8
2007	2.4	2.4	1.8	2.0
2008	2.4	1.0	1.4	0.1
2009	−1.0	−3.7	−2.5	−2.6
2010	2.3	2.9	2.6	2.7
2011	2.1	3.1	1.6	1.6
2012	2.4	2.2	2.2	2.3
2013	2.0	1.9	1.6	2.1
2014	2.7	2.6	2.1	2.5
2015	3.1	2.9	2.6	2.9
2016	2.6	2.3	1.5	1.8
2017	2.3	2.1	2.2	2.5
2018	2.5	2.6	2.9	3.0
2019	2.7	2.4	2.3	2.6
2020	1.7	2.1	−4.9	−2.2
2021	4.2	4.8	5.8	6.1
2022	4.0	4.1	1.5	2.5
2023	0.5	1.2	2.1	2.9
2024	1.7	2.5	2.6	2.8**

* Observed refers to the chained real growth rates as currently published.
† Forecasts published in June 1976 and April 1980.
** Estimated by RSQE as of November 2024.

Despite uneven progress in controlling inflation in the first quarter and rising signs of weaknesses in the labor market, we judged that broader economic momentum had remained solid, prompting us to raise our forecast in February and again slightly in August. Currently, we have cautiously nudged up our growth projection relative to our August estimate, as the labor market has not deteriorated further while the Fed has recalibrated its policy. The 2.8 percent real GDP growth we now expect for 2024 translates into an absolute forecast error of 1.1 percentage points compared to our previous November forecast.