



THE CAVU COMPASS

Monthly macroeconomic insights and market commentary provided by CAVU Securities and Piedmont Crescent Capital.

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The Economy is Adjusting to Trump Time

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Tariffs Will Add to Stubborn Inflation Pressures in 2025

The Rapid Pace of Change Stokes Economic Uncertainty

- ▲ The world continues to grapple with the rapid policy shifts introduced by the Trump Administration. Wide-ranging tariffs have become a reality—some serving as short-term negotiating tools, while others aim to reinforce trade agreements and reshape the global trading structure. These tariffs will contribute modestly to inflation in 2025, though their impact will diminish the following year. U.S. manufacturing is expected to see modest growth this year.
- ▲ Economic growth fell short of expectations in Q4, with real GDP rising at a modest 2.3% annual rate. However, final domestic demand remains steady at around 3%, consistent with the past two years. The Q4 GDP shortfall was primarily driven by a surge in imports ahead of anticipated tariffs, a trend that may persist in the early months of this year.
- ▲ Job growth began the year slowly, with employers adding just 146,000 jobs in January. However, upward revisions to the previous two months lifted the three-month average to 237,000. Annual revisions showed 589,000 fewer jobs added between March 2023 and March 2024, in line with expectations. Growth remains heavily concentrated in health care and social services, leisure and hospitality and government.
- ▲ Inflation began the year on a surprisingly higher note, and annual data revisions showed slightly less progress has been made at returning inflation to the Fed's 2% target. With higher tariffs looming, inflation may prove more persistent than had been anticipated, likely delaying the Fed's next rate cut by at least a few months.
- ▲ President Trump has moved quickly to implement his campaign agenda, imposing tariffs, strengthening border security, expediting deportations of undocumented persons convicted of violent crimes, reducing government waste, and downsizing the federal workforce. The rapid pace has caught his opposition off guard, leading to some unexpected early progress. This month's *CAVU Compass* explores the prospects and implications of these actions.
- ▲ The administration has secured trade deals with Colombia, Panama, Canada, and Mexico and recently announced plans to launch peace talks between Russia and Ukraine. We estimate a 65% probability that the war will end this spring. Meanwhile, the fragile ceasefire between Israel and Hamas remains at risk, as Trump and Netanyahu have taken a more aggressive stance to secure the release of hostages from the October 7th attacks. Renewed conflict could push oil prices and shipping costs higher, while a ceasefire in Ukraine would help ease inflationary pressures and support economic growth, particularly in Europe.

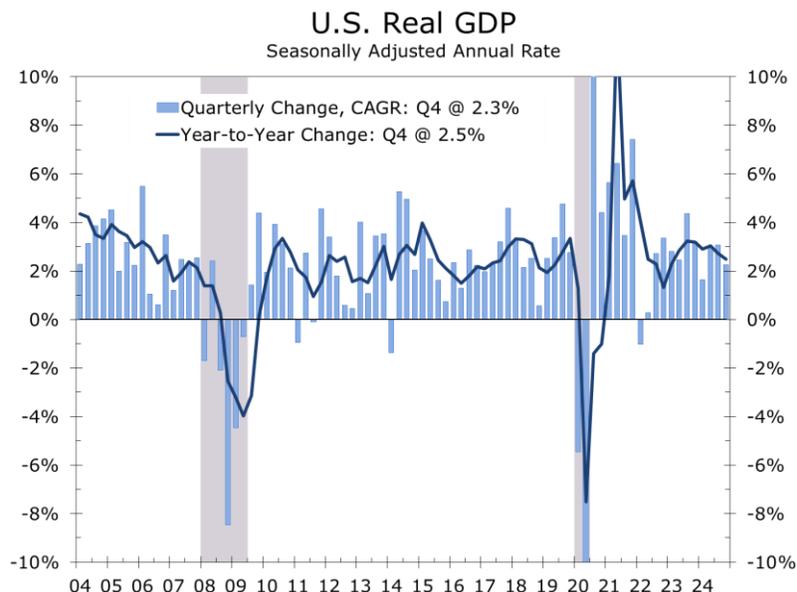
The world continues to grapple with the rapid policy shifts introduced by the Trump Administration, particularly in the area of trade. From steel and aluminum tariffs to broad-based reciprocal measures against countries that impose duties on U.S. goods, the Administration's aggressive stance threatens to disrupt global markets, reshape supply chains, and force businesses to alter the way they source and produce products. While some tariffs are intended as short-term negotiating tools, others reflect a broader strategy to reinforce existing trade agreements, such as NAFTA/USMCA, and others seek to restructure the global trading system.

One of the most significant consequences of Trump’s tariffs is their impact on inflation and consumer spending. As tariffs raise the cost of imported goods, businesses often pass these costs on to consumers, driving prices higher. While the overall effect on U.S. inflation in 2025 is expected to be modest, it remains a concern for policymakers and the Federal Reserve, particularly as inflation has already proven more resilient than anticipated. Tariffs could also contribute to inflation by fueling inflation expectations, giving businesses greater flexibility to raise prices. The primary risk is a feedback loop—firms preemptively hike prices, households adjust expectations, and wage pressures build—potentially forcing the Fed to take a more restrictive stance.

We have slightly raised our inflation forecast, with tariffs now expected to add between 0.4 and 0.5 percentage points to core inflation this year. While this impact is expected to gradually diminish, the path back to the Fed’s 2% target will be longer. Higher inflation will also weigh on consumer spending, particularly among middle- and lower-income households. Recent consumer sentiment surveys indicate rising near-term inflation expectations and weaker overall sentiment, with middle- and lower-income households feeling the greatest strain.

U.S. manufacturing is expected to see modest gains this year as some businesses shift production to the U.S. to avoid tariffs. The steel industry is positioned to benefit from the 25% tariffs on all imported steel, while aluminum producers may see some upside as well, though the impact will be limited given the relatively small number of aluminum smelters operating in the U.S. The broader effects of tariffs, however, are more complex—higher input costs could offset some of these benefits, particularly for industries that rely heavily on steel and aluminum. Additionally, retaliatory tariffs from other nations could dampen U.S. exports. The economic burden of U.S. trade policy is expected to fall more heavily on Europe, Canada, and Mexico, though exemptions for critical imports such as aluminum, softwood lumber, and auto parts may help mitigate some of the impact.

We expect U.S. economic growth to slow to a 2% pace in the first half of this year. Imports are likely to exert a modest drag on GDP growth in Q1, as firms front-load shipments ahead of tariff increases. However, some of this impact will be offset by increased inventory building. Additionally, higher long-term interest rates will continue to weigh on home buying and overall spending on big-ticket items. Efforts to curb government spending will also likely lessen the tailwind from the IRA and CHIPS programs driving business fixed investment.



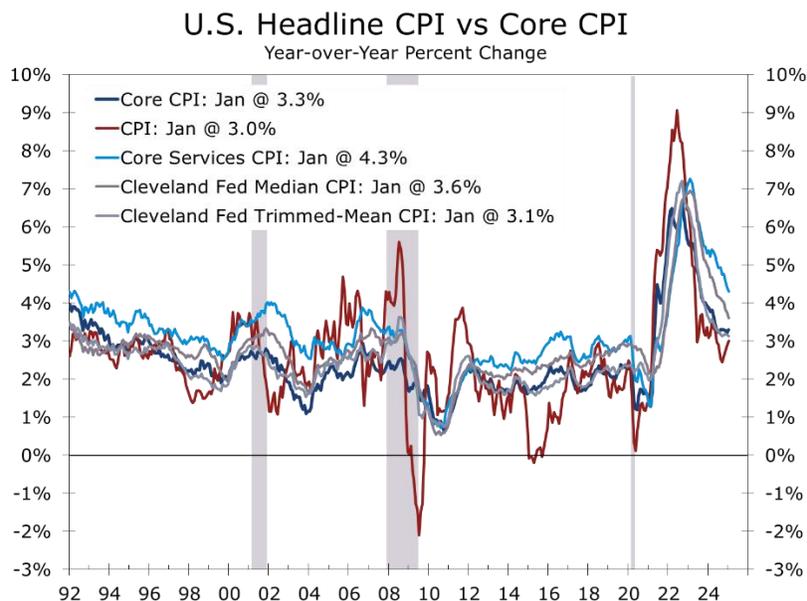
Source: Bureau of Economic Analysis

Inflation started the year on a hotter-than-expected note, with both consumer and wholesale prices rising more than anticipated in January. The Consumer Price Index (CPI) increased by 0.5%—its largest monthly gain since August 2023—while core CPI rose 0.4%. The Producer Price Index (PPI) also exceeded expectations, with the headline number up 0.4%. Additionally, annual data revisions revealed that inflation has not eased as much as previously estimated, adding to concerns that the Federal Reserve will keep rates higher for longer.

Market expectations have shifted accordingly, with no rate cuts expected through this spring and summer and only a slim chance of one by year-end. Some former Fed officials have even floated the possibility of a rate hike, though we see this as unlikely. In his February congressional testimony, Fed Chair Jerome Powell reaffirmed that the central bank is in “no hurry” to cut rates, reinforcing the view that the federal funds rate will remain above its neutral level well into next year.

The market’s initial reaction to January’s inflation data may be overstated. While inflation is still trending lower, the final stretch from 3% to 2% will likely take longer than the sharp drop from 9.1% to 3%. The post-pandemic unwinding of price spikes—particularly in used cars and gasoline—exaggerated the earlier progress. Additionally, looming tariff increases could put upward pressure on prices, though consumer resistance to price hikes may temper the impact, weighing on sales and forcing some companies to adjust pricing. Stronger productivity and moderating wage growth should also help ease inflation later in the year, creating a more stable environment for businesses and consumers.

While the sharp gains in CPI and PPI raised concerns, they may overstate the inflation threat. Seasonal distortions likely boosted the January data, as price adjustments for items with infrequent changes tend to cluster at the start of the year. Similar patterns have occurred in past years, driven by one-off factors such as insurance premium resets and wage negotiations from the prior year. These distortions suggest that progress on reducing inflation is slowing but not stalling or reversing, as some fear. Importantly, the underlying data in the PPI report suggest the personal consumption expenditures (PCE) deflator—the Fed’s preferred inflation gauge—is unlikely to run as hot as CPI and PPI. Moreover, both median and trimmed-mean CPI continue to trend lower, as do similar measures for the PCE deflator.



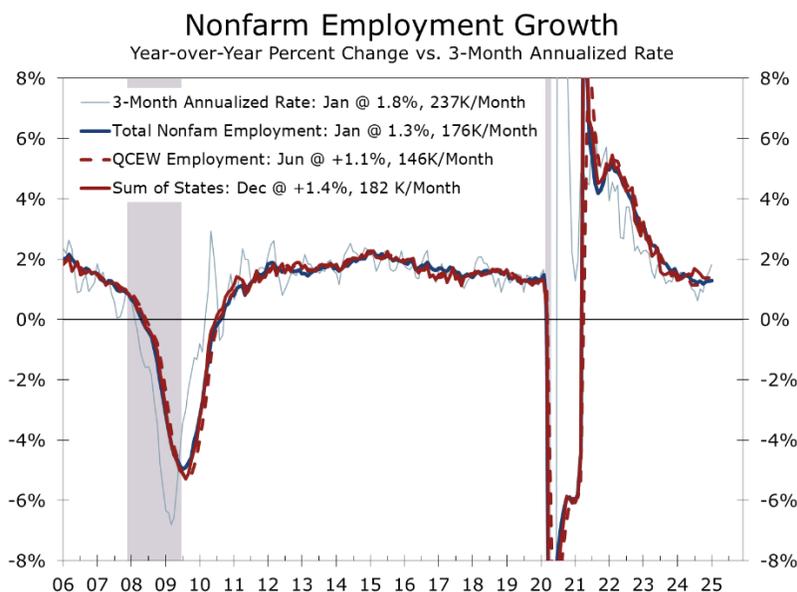
Source: The Bureau of Labor Statistics

The Federal Reserve’s dual mandate—price stability and full employment—guides its shifting priorities. Last September, the Fed was more focused on supporting the labor market, but today, the risks are balanced or slightly tilted toward fighting inflation. This shift has pushed bond yields higher and delayed expectations for rate cuts. However, we expect the balance of risks to move back to neutral in the coming months as inflation concerns ease and labor market risks grow.

January’s employment report reflected a solid but cooling labor market. Nonfarm payrolls rose by 143,000, below expectations and down from December’s upwardly revised 307,000 job gain. Still, the three-month average remained strong at 237,000. Job gains were concentrated in health care, social services, retail trade, and government, which accounted for 93% of new hires. The unemployment rate unexpectedly dipped to 4.0%, while the underemployment rate held steady at 7.5%. Labor force participation edged up to 62.6%, and wage growth remained firm at 4.2% year-over-year. Full employment is largely thought to be between 4% and 4.5%.

Annual benchmark revisions lowered job estimates by 620,000 through the end of 2024, aligning employment data with our prior expectations. While this suggests a weaker labor market than initially reported, the revision was in line with forecasts and does not add additional urgency for rate cuts. Rising wage growth and inflation expectations reinforce the Fed’s cautious stance, likely keeping rates steady unless clear signs of economic deterioration emerge. Markets initially reacted with a risk-on sentiment, pushing equities and bond yields higher on confidence in economic resilience—a response we view as somewhat overdone.

Despite recent labor market strength, job growth is expected to slow further as consumer spending moderates and trade uncertainty weighs on investment. Immigration restrictions could tighten labor supply, increasing the risk of wage-driven inflation. If employment slows too much, unemployment may rise, while a rebound in job growth could reignite inflation concerns. This fragile equilibrium keeps the Fed in a wait-and-see mode. Long-term yields should remain firm, with nonfarm payrolls serving as the key swing indicator—persistent job growth could push yields higher and delay rate cuts, while a convincing hiring slowdown would likely pull them forward. We feel the risk is currently slightly more heavily weighted toward the latter, with the narrowing breadth of job gains being a reliable harbinger of slower nonfarm payroll growth.



Source: Bureau of Economic Analysis

January retail sales fell sharply, with the headline number contracting by 0.9% and a broad-based pullback across key categories. While adverse weather and seasonal adjustment factors contributed to the decline, the weakness was widespread, suggesting a softer start to Q1 consumer spending. Auto sales were a major drag, while discretionary categories—such as sporting goods, furniture, and building materials—saw the steepest declines. Non-store retail sales, primarily online, also dropped, raising questions about the extent to which weather alone drove January’s weakness.

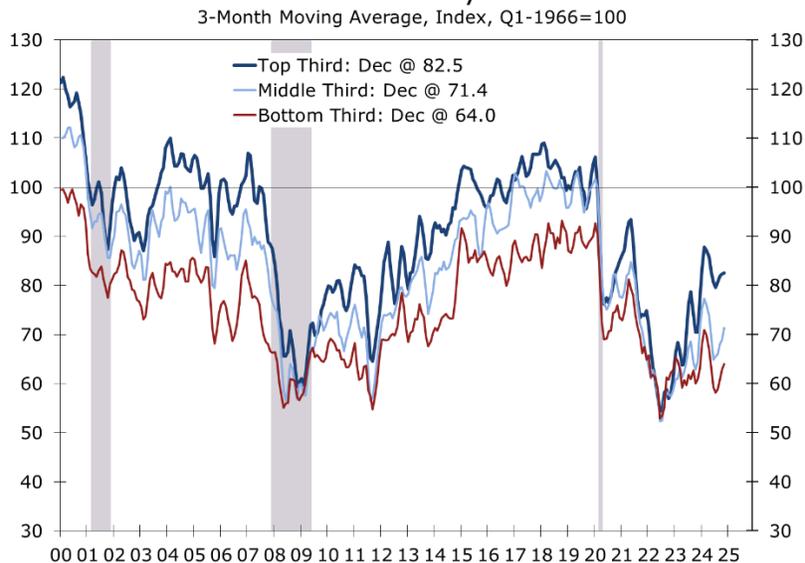
Consumer sentiment has continued to weaken in early February, reflecting growing policy uncertainty. With excess savings largely depleted, spending now relies more on employment and income growth. Higher grocery prices and rising insurance costs are likely key contributors to the pullback in sentiment. Consumers’ assessment of current conditions has declined 6.4 points since December to 68.7, while expectations for future economic conditions—more closely linked to actual spending—have fallen 6.0 points to 67.3.

The University of Michigan’s consumer sentiment survey highlights particular weakness among lower-income households. Sentiment for the lowest income tercile has dropped to 64, matching levels seen at the depths of the Global Financial Crisis. Middle-income households are only slightly more optimistic, with sentiment at 71.3. These figures suggest that economic uncertainty and rising costs are weighing disproportionately on consumers with tighter budgets, posing a potential headwind to discretionary spending.

The underlying fundamentals support consumer spending in 2025. The unemployment rate remains low at 4%, and weekly jobless claims hover near historic lows. Wage growth is solid, and household balance sheets—along with slightly lower interest rates than a year ago—should provide support. Low-rate financing incentives are expected to sustain light vehicle sales and big-ticket spending.

However, financial strength is not evenly distributed across income groups. Rising costs for necessities are disproportionately impacting lower- and middle-income households, putting pressure on discretionary spending. Given these dynamics, we have slightly reduced our estimate for Q1 consumer spending and continue to expect a below-consensus gain of just under a 2% annual rate.

Consumer Sentiment By Income Tercile



Source: Census Bureau

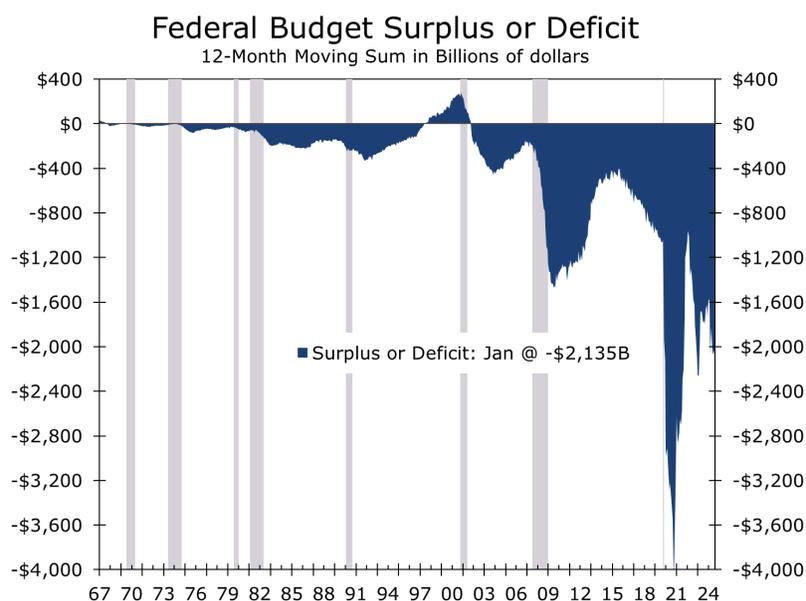
An old axiom in economic analysis advises distinguishing between what you think the Fed *will* do and what you think it *should* do. In today’s hyperpolarized political climate, this principle is just as relevant when assessing the Trump administration. It is more constructive to focus on what the administration *will* do rather than what one believes it *should* do. Another key rule to apply—take Trump seriously, but not literally—meaning the most hyperbolic rhetoric from both Trump and his opposition should be ignored or at least downplayed.

The administration's priorities include strengthening border security, deporting undocumented migrants convicted of violent crimes, and using tariffs as a policy tool, revenue enhancement and a means to leverage U.S. market power. It also aims to reduce government waste to curb the deficit and build credibility for any possible future entitlement reform. In foreign affairs, securing strategic shipping chokepoints such as the Panama Canal and Northwest Passage is a focus, alongside recalibrating NATO to reflect post-Cold War realities. Trump has also expressed a desire to broker lasting peace in the Israel-Hamas and Russia-Ukraine conflicts.

The administration's agenda is advancing rapidly, catching opponents off guard. Tariffs have been implemented faster and more decisively than expected. While Mexico and Canada secured an extension, comprehensive tariffs are set to take effect on March 4 and are expected to remain in place, along with a 25% tariff on steel and aluminum imports. A primary objective is curbing the transshipment of Chinese steel via Canada and Mexico.

Legal challenges against DOGE are likely to prove fleeting, as the administration has utilized the U.S. Digital Service—an agency created under Obama—to execute its plans. DOGE also remains popular with the public. Total savings from DOGE are likely to fall well short of solving the government’s spending crisis and persistent deficits, although DOGE has already proven more effective at uncovering savings than most previous efforts.

Securing peace between Israel and Hamas remains difficult. The Trump administration has resumed arms shipments to Israel, hoping to pressure Hamas into submission. In contrast, a Russia-Ukraine ceasefire appears more plausible. While Ukraine will not join NATO, an increased European military presence would deter renewed Russian aggression. A ceasefire could ease inflationary pressures in Europe and the U.S. and would support economic growth in Europe.



Source: Office of Management and Budget

The weaker-than-expected January employment data, higher-than-expected inflation, and a sharp drop in retail sales align well with our below-consensus call for Q1 GDP growth. We previously noted that the Los Angeles wildfires would weigh more heavily on Q1 growth than early consensus estimates suggested. Recoveries from fires and floods tend to take longer than those from hurricanes or earthquakes, delaying any lift from rebuilding. Given the size of Los Angeles' economy, the disruption is significant enough to impact national data.

Beyond natural disasters, the uneven distribution of economic strength remains a key concern. Upper-income households are largely insulated from inflation due to rising asset prices, while lower-income, asset-light households face increasing pressure from higher costs of essentials like groceries, housing, and transportation. This divergence is contributing to weaker discretionary spending and broader economic uncertainty.

Technical factors will also restrain Q1 growth. Accounting for housing losses will weigh on consumer spending, while inventory building ahead of potential tariffs will boost imports and temporarily inflate inventory levels. Despite slower Q1 growth, the Fed is unlikely to cut rates with unemployment near 4%. However, inflation should continue to decelerate gradually, potentially paving the way for a 25-basis-point cut in late spring or early summer. While we still expect two quarter-point cuts this year, the case for a second cut is less certain.

Policy uncertainty will also impact business investment. Concerns over tariffs, the Inflation Reduction Act, and the CHIPS Act will weigh on capital spending in the first half of the year. However, as more clarity emerges on trade, taxes, and regulations, we expect growth to strengthen in the second half of this year.

US Economic and Financial Outlook

(% change on previous period, annualized, except where noted)

	2023				2024				2025				2022	2023	2024	2025	2026
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Actual	Actual	Actual	Forecast	Forecast
Output																	
Real GDP	2.8	2.5	4.4	3.2	1.6	3.0	3.1	2.3	1.8	2.2	2.5	2.7	2.5	2.9	2.8	2.4	2.8
Consumer Spending	4.9	1.0	2.5	3.5	1.9	2.8	3.7	4.2	1.9	2.2	2.5	2.6	3.0	2.5	2.8	2.6	2.6
Nonresidential Fixed Investment	5.3	9.9	1.1	3.8	4.5	3.9	4.0	(2.2)	1.8	2.2	2.8	3.5	3.8	4.9	3.5	1.5	3.8
Light Vehicle Sales	15.1	15.7	15.6	15.6	15.5	15.6	15.6	16.5	15.8	16.0	16.2	16.1	13.8	15.5	15.8	16.0	16.4
Industrial Production, Manufacturing	0.5	0.3	(0.4)	(1.4)	(0.9)	1.4	(0.7)	(1.3)	4.0	2.6	2.4	2.6	2.7	(0.4)	(0.4)	2.9	3.5
Unemployment Rate (Qtrly Avg)	3.5	3.5	3.7	3.8	3.8	4.0	4.2	4.1	4.2	4.3	4.3	4.2	3.6	3.6	4.0	4.3	4.2
Housing Market																	
Housing Starts (Units, thous)	1,369	1,455	1,380	1,481	1,407	1,340	1,332	1,379	1,350	1,380	1,410	1,420	1,552	1,421	1,365	1,390	1,480
New Home Sales	636	682	682	646	663	693	708	662	670	700	710	730	637	666	682	703	760
Existing Home Sales	4,317	4,187	4,020	3,880	4,200	4,050	3,890	4,117	4,020	4,070	4,120	4,170	5,030	4,090	4,060	4,095	4,230
S&P/Case-Shiller Natl Home Prices (Yr/Yr % Change)	2.3	(0.1)	2.6	5.2	6.4	6.0	4.4	3.7	3.9	4.0	4.1	4.1	14.8	2.5	5.1	4.0	4.3
Inflation (Year-to-Year % Change)																	
Consumer Price Index (CPI)	5.7	4.0	3.6	3.2	3.2	3.2	2.7	2.7	2.9	2.8	2.7	2.6	8.0	4.1	3.0	2.8	2.4
Core CPI	5.5	5.2	4.4	4.0	3.8	3.4	3.3	3.3	3.2	3.1	3.0	2.9	6.2	4.8	3.4	3.1	2.4
Personal Consumption Deflator	5.0	3.9	3.4	2.8	2.7	2.6	2.3	2.4	2.4	2.3	2.3	2.2	5.2	3.2	2.8	2.3	2.2
Core PCE Deflator	4.9	4.6	3.9	3.2	3.0	2.7	2.7	2.8	2.7	2.6	2.6	2.5	5.4	4.1	2.8	2.6	2.1
Employment Cost Index	4.9	4.5	4.4	4.2	4.2	4.1	3.9	3.8	3.9	3.8	3.8	3.8	4.9	4.5	4.0	3.8	3.7
Interest Rates (Quarter End and Ann Avg)																	
Fed Funds Target Range	4.75-5.00	5-5.25	5.25-5.50	5.25-5.50	5.25-5.50	5.25-5.50	4.75-5.00	4.25-4.50	4.25-4.5	4.00-4.25	3.75-4.00	3.75-4.00	1.68	5.02	5.14	3.90	4.10
10-Year Treasury Note	3.48	3.84	4.59	3.88	4.21	4.33	3.81	4.58	4.60	4.65	4.70	4.75	2.95	3.96	4.21	4.68	5.00
Conventional Mortgage Rate (Freddie Mac)	6.32	6.71	7.31	6.61	6.79	6.86	6.08	6.85	6.85	6.85	6.85	6.85	5.34	6.81	6.72	6.85	6.90

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