An Economic Update: What's Next?

Presented by: Dr. Amy Crews Cutts, CBE®
NACM Chief Economist
Date: May 19, 2025
Sessions: #37016 and #37026

The Outlook for 2025

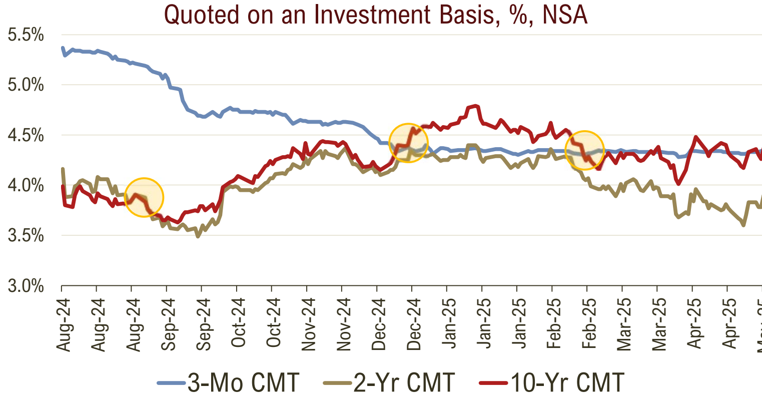
Economists are forecasting normalcy but "Liberation Day" tariffs could derail that

Hard data indicate there is no reason to worry
Soft data suggest that the months ahead will be rough

- All data that have been reported thus far – GDP, Inflation, Employment, Spending, Inventories, etc. are from the ***Before*** period, as in before tariffs became effective.
- Surveys and interviews with business owners and credit managers tell a different story as it is unfolding. This is a lot like when COVID shut things down and when 2019 tariffs went into effect.
- A pause is not a permanent fix

Interest rates had gone back to the natural order
The yield curve un-inverted then re-inverted

Market Yield on U.S. Treasury Securities at Constant Maturity, Quoted on an Investment Basis, %, NSA



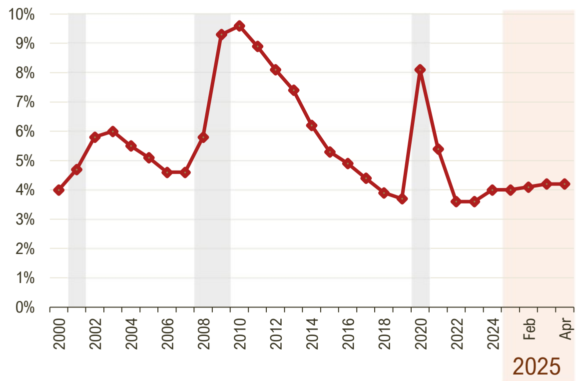
At the end of August, the 2-yr—10-yr portion of the yield curve un-inverted (10-yr yields exceeded 2-yr) but the 3-mo—10-yr relationship stayed inverted until mid-December. The market signals suggest higher inflation going forward, possibly with Fed policy reversal.

At the end of February, the 3-mo—10-yr curves inverted again, indicating a higher probability of recession over the next year.

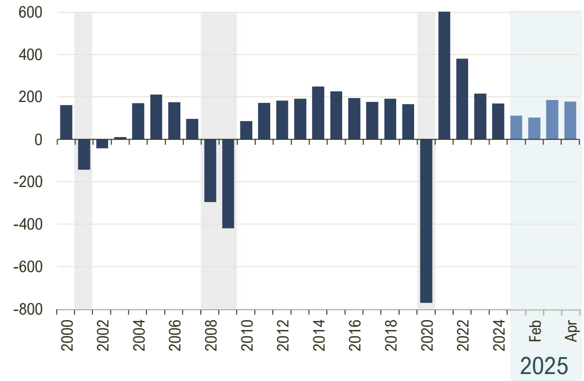
Source: AC Cutts & Associates, Board of Governors of the Federal Reserve System, Federal Reserve Bank of St Louis (FRED)

Labor market looks good so far

Monthly average unemployment rate, %, SA



Monthly average change in nonfarm payroll employment, 1000s, SA



Source: AC Cutts & Associates LLC, Federal Reserve Bank of St Louis (FRED), Bureau of Labor Statistics, National Bureau of Economic Research

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Layoff announcements have accelerated but those don't always translate into higher unemployment

More than 1250 companies have announced layoffs since the start of 2025, affecting 145,000 workers in the private sector and 150,000 federal workers

Source: AC Cutts & Associates LLC, Intellizence. Data through April 2025. Scale: blue icons represent 10 workers, red represent 150 workers

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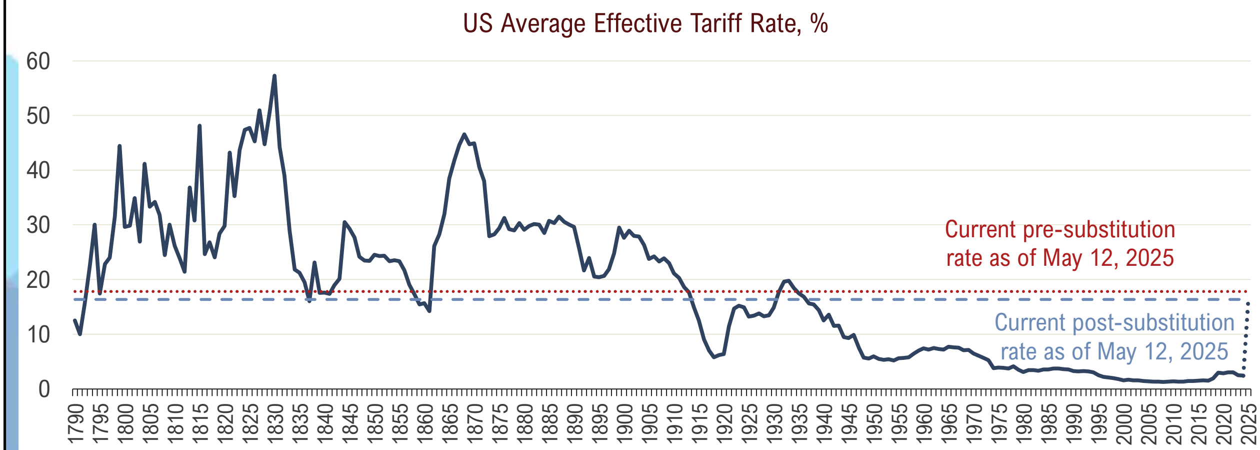
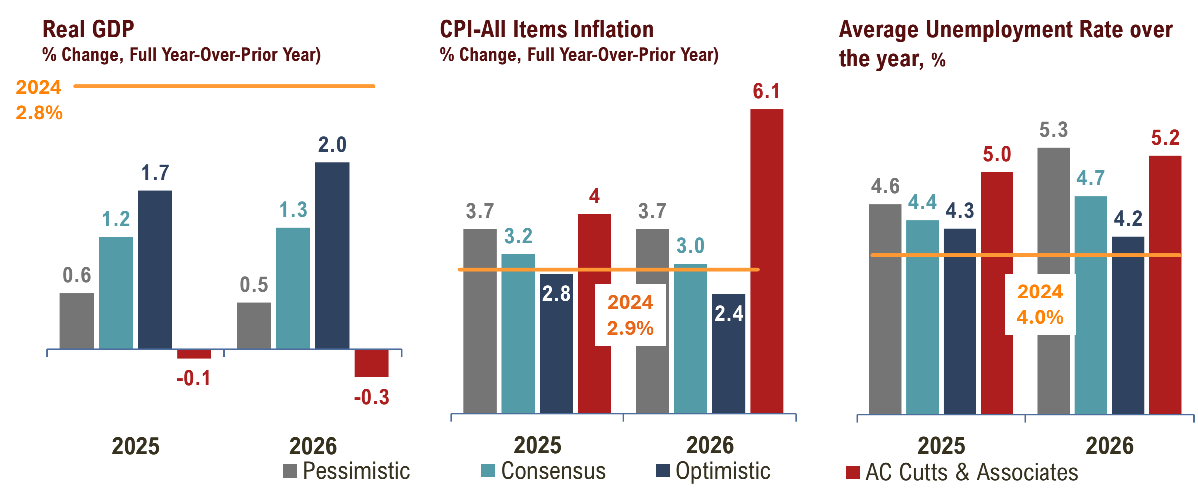
Even with the new China-U.S. tariff adjustments and the U.K.-U.S. deal, tariffs remain very high



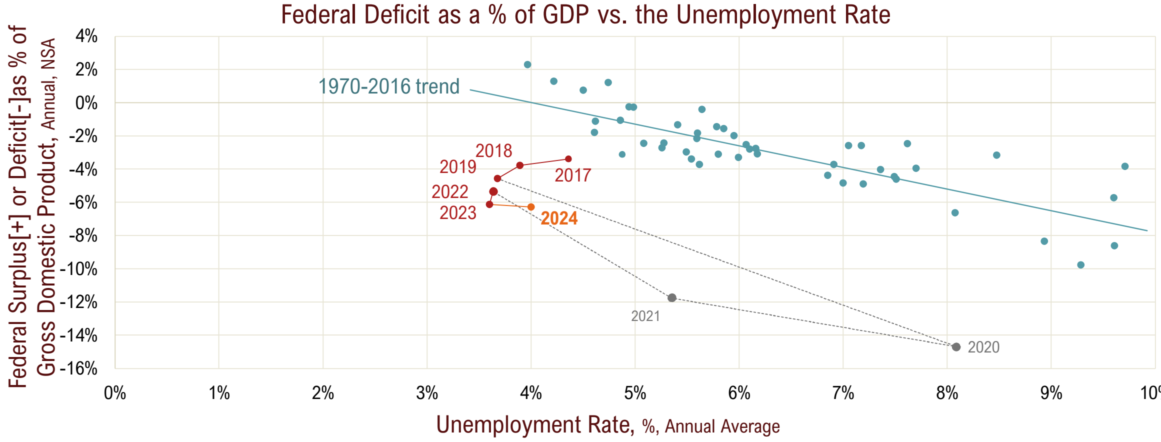
Source: AC Cutts & Associates LLC, Yale Budget Lab

Economist *consensus* forecasts do not indicate a recession in the next 12 months, but they expect slowing



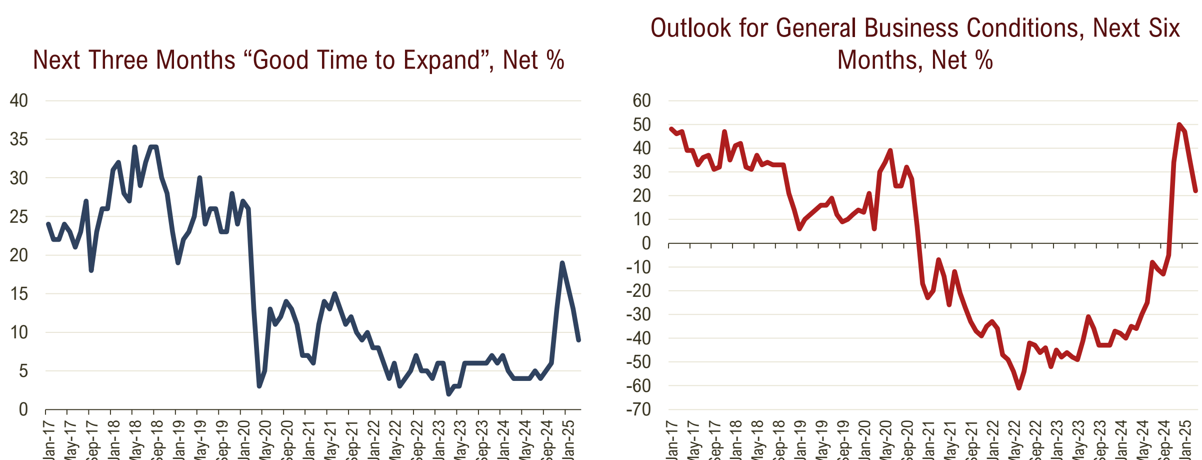
Source: Blue Chip Economic Indicators®. Note: Pessimistic values are the average of the 10 most pessimistic responses, Optimistic are the average of the 10 most optimistic responses. AC Cutts & Associates' forecasts are far outliers on the pessimistic end.

Federal deficit as a share of GDP remains disconnected from pre2016 trend



Source: AC Cutts & Associates, Federal Reserve Bank of St. Louis; U.S. Bureau of Labor Statistics; U.S. Office of Management and Budget via FRED®

Small business owners have become less optimistic



Sources: AC Cutts & Associates LLC, National Federation of Independent Businesses, Small Business Economic Trends Survey, Macrobond. Used under License. Data through March 2025.

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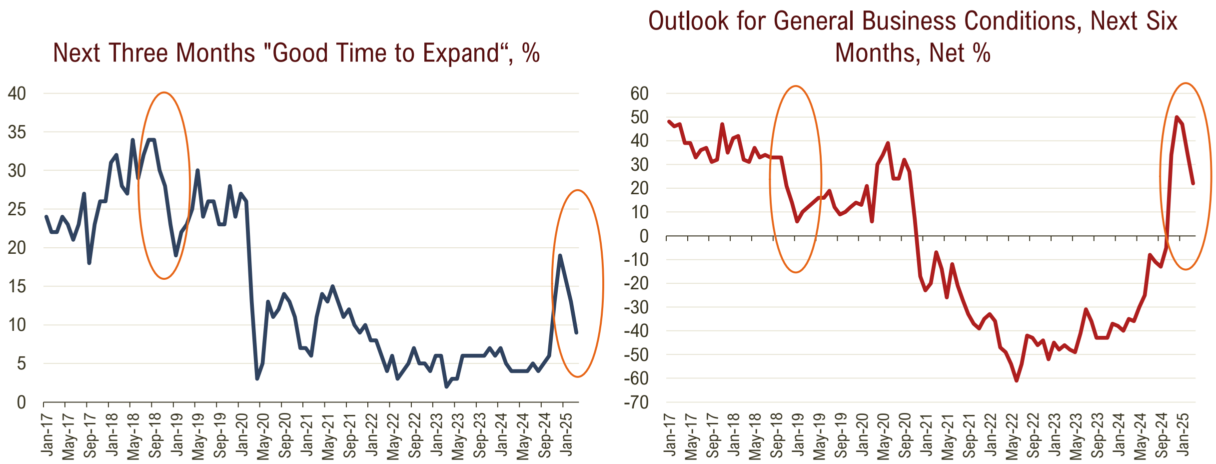
Small business owners have become less optimistic Tariffs are on their minds



Sources: AC Cutts & Associates LLC, National Federation of Independent Businesses, Small Business Economic Trends Survey, Macrobond. Used under License. Data through March 2025.

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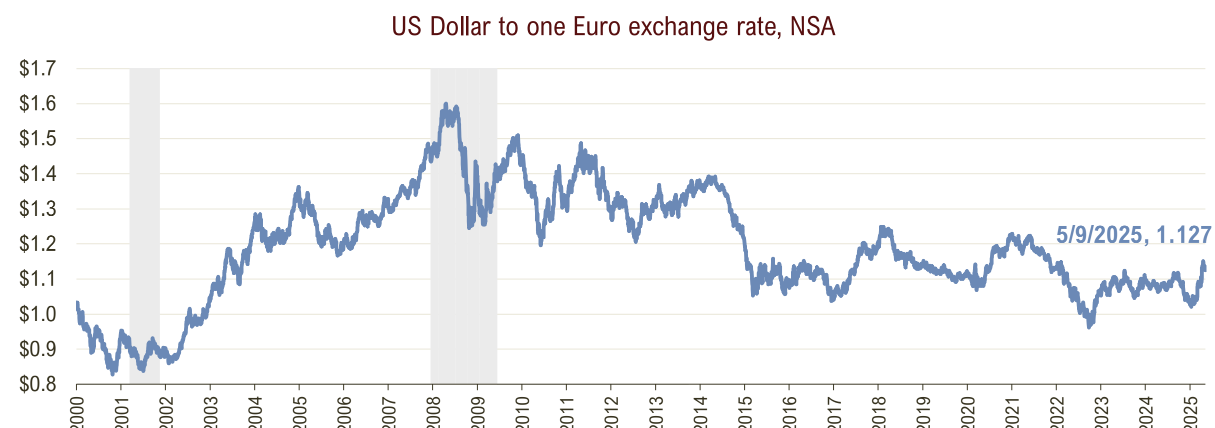
The Dollar has weakened recently but is still historically strong – Good for importers, not for exporters



Source: AC Cutts & Associates LLC, Board of Governors of the Federal Reserve System (US); Federal Reserve Bank of St. Louis via FRED®

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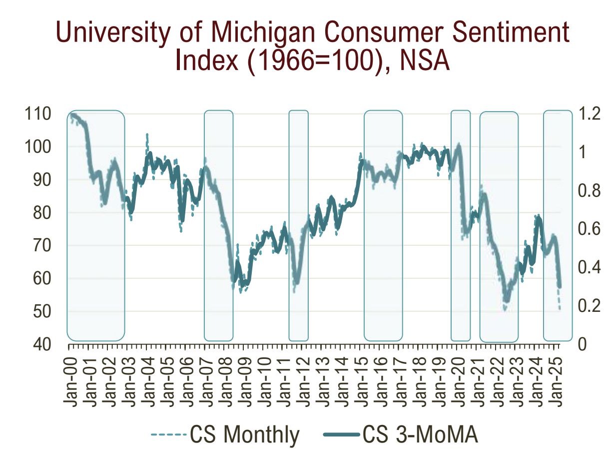
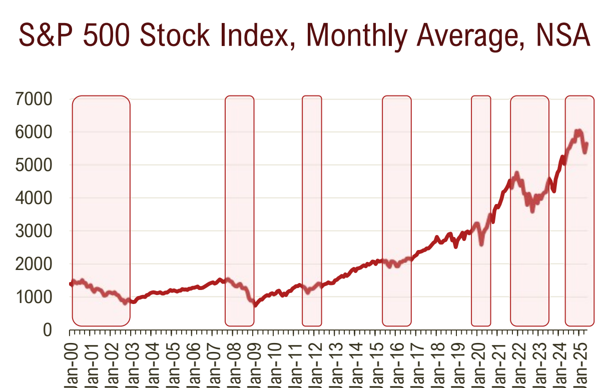
Wealth Effect will likely be important

Every dollar of increased (decreased) stock market wealth leads to an increase (decrease) in consumer spending of 2.8 cents

Consumer sentiment (& spending) is closely tied to changes in the stock market (wealth)





Source: AC Cutts & Associates LLC, Macrobond, University of Michigan, S&P Dow Jones Indices LLC. Used under license. Shaded areas denote periods of sustained monthly losses in the S&P index

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3 things affecting aggregate demand today

Decline Start Month	Decline End Month	Change in Value of HH Assets: Equities and MFs
Aug 2000	**Sep 2002**	**-41.4%**
Oct 2007	**Feb 2009**	**-49.1%**
Apr 2011	Sep 2011	-15.4%
Dec 2019	**Mar 2020**	**-23.1%**
Dec 2021	Sep 2022	-24.2%
Jan 2025	Apr 2025	-19.6%*

- **Income effect of prices** – prices rise, I have to make cuts to stay on budget
- **Wealth effect** – If my assets lose value I have less to fall back on, so I cut spending (YTD down $10+ Trillion)
- **Savings effect** – When I am not confident in the economy, I save more, which means I have less to spend

➔Consumers & businesses are likely to spend less in coming months

Bold values in the table correspond to periods in recession. Sources: AC Cutts & Associates LLC, Siblis Research, Board of Governors of the Federal Reserve System, Federal Reserve Bank of St Louis (FRED)

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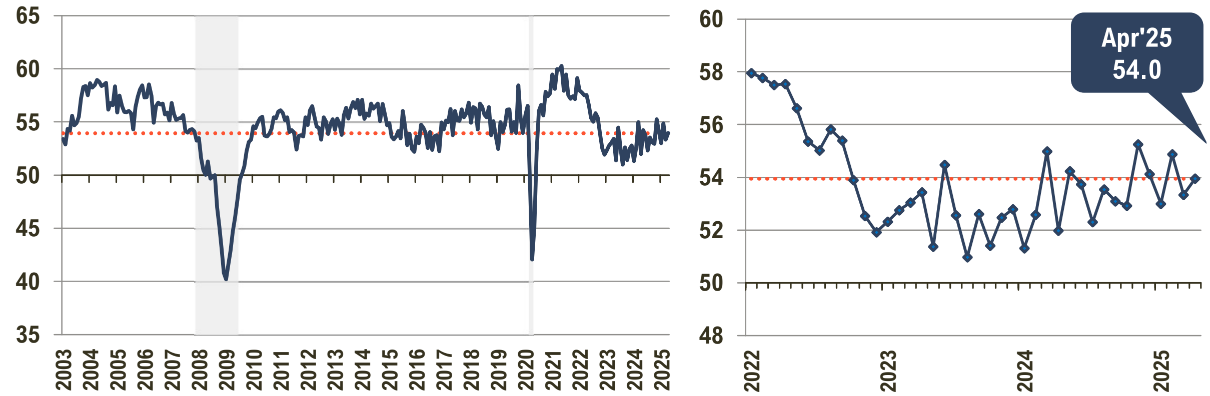
What the NACM Credit Manager's Index tell us

NACM CMI CREDIT MANAGERS' INDEX

April survey is about March activity…
so pre-tariff times

NACM Combined CMI is showing economic expansion April survey reflects March activity

NACM Credit Managers' Index, Combined Manufacturing and Services
SA (>50 = Expansion, <50 = Contraction)



Source: National Association of Credit Management. Regarding accounts receivables, favorable factors are sales, new credit applications, dollar collections, and amount of credit extended. Unfavorable factors are rejections of credit applications, accounts placed for collection, disputes, dollar amount of receivables beyond terms, dollar amount of customer deductions, and filings for bankruptcies. Unfavorable factors are included on an inverse scale so that a rise in an unfavorable factor causes a decline in the CMI index.

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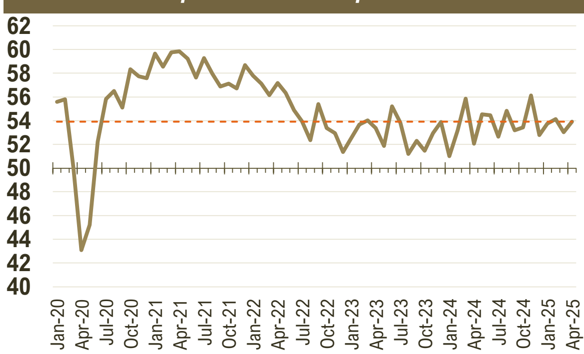
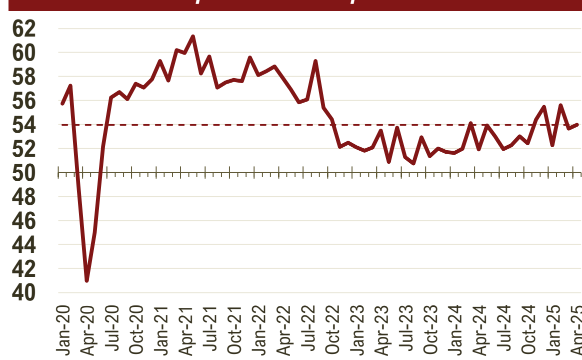
The Service Sector CMI is trending up and Manufacturing CMI is trending level(ish) – both indicate expansion

NACM Credit Managers' Index, SA (>50 = Expansion, <50 = Contraction)

Credit Managers' Index - Manufacturing Sector
April'25: 53.9 In Expansion



Credit Managers' Index - Service Sector
April'25: 54 In Expansion



Source: National Association of Credit Management.

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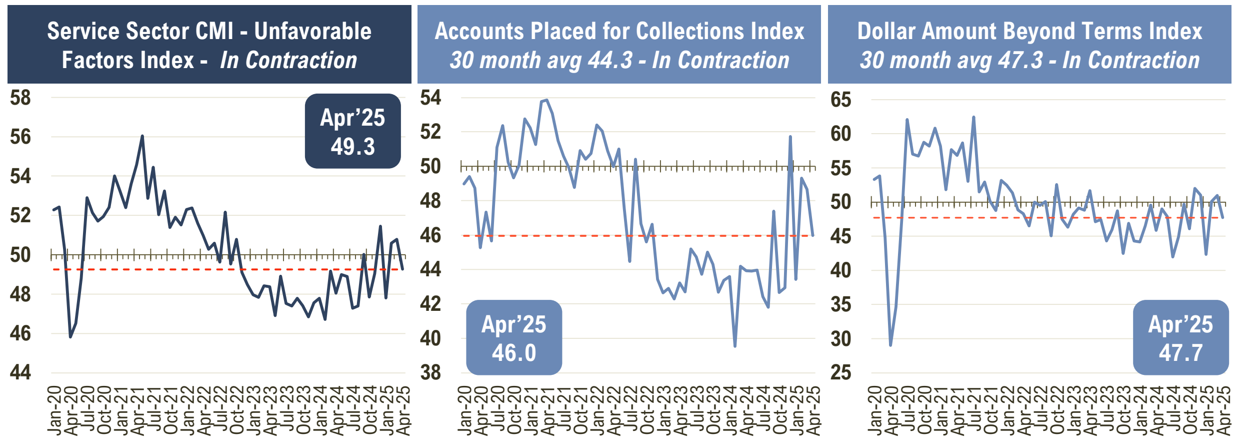
NACM Services Sector unfavorable factor index has been in contraction since November 2022



Source: National Association of Credit Management. Index values >50 = Expansion, <50 = Contraction. Indexes are seasonally adjusted.

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The Impact of monetary tightening

The Fed's recent inflation fight wasn't like all the others but it is useful in thinking through what might happen next

What causes *Inflation*?

Textbook definition is that there is too much money chasing too few goods – that is, the supply of money is too high and the supply of things to buy is too low.

Another way to think of it is that there is too much aggregate demand for too little aggregate supply, money being one of the things affecting aggregate demand.

Supply shocks can lead to inflation even when demand is not much changed – this was 2022-2023 cause – Tariffs levied in 2019, COVID pandemic, Avian Flu…

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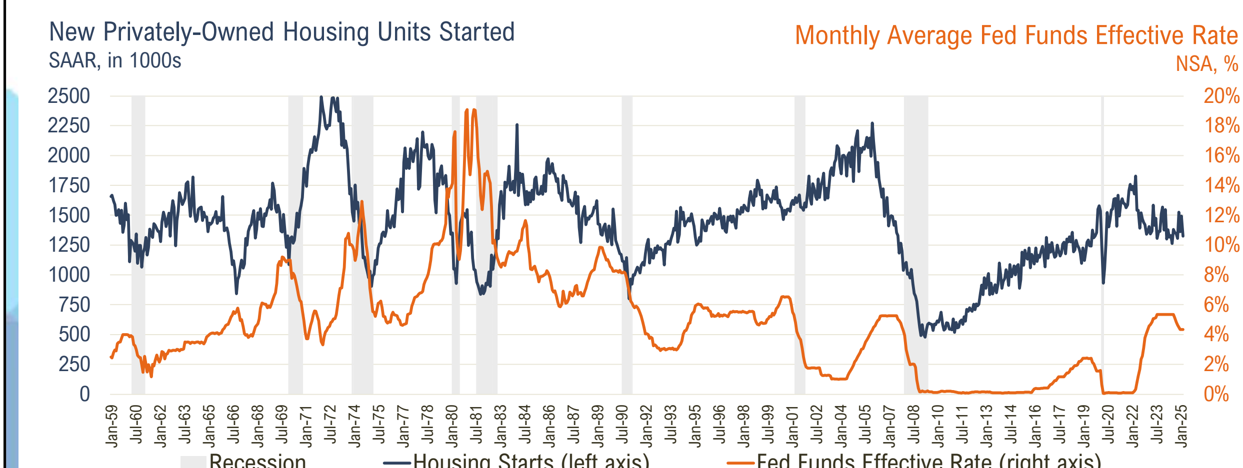
The Fed fights inflation through demand destruction

Raising interest rates affects sectors that rely on loans, esp. home construction



Source: AC Cutts & Associates LLC, Board of Governors of the Federal Reserve System, U.S. Census Bureau, U.S. Dept of Housing and Urban Development, St. Louis Federal Reserve Bank (FRED).

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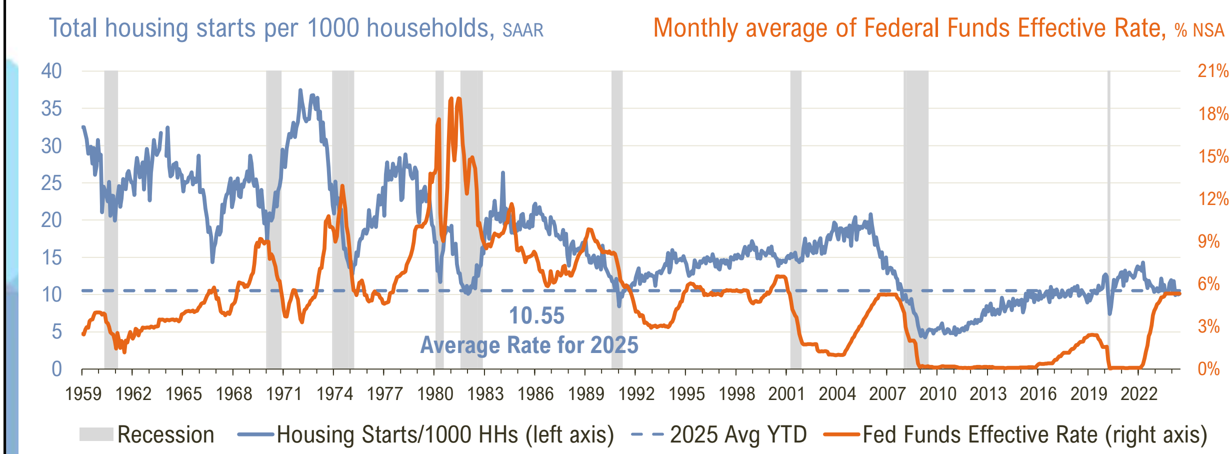
Changing perspective: home building per capita shows that Fed policy is having very little effect



Source: AC Cutts & Associates, US Census Bureau, National Bureau of Economic Research, National Association of Realtors, Federal Reserve Bank of St. Louis (FRED). Data through February 2025

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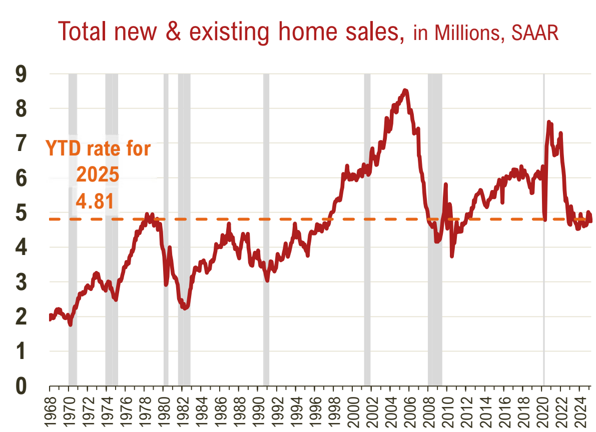
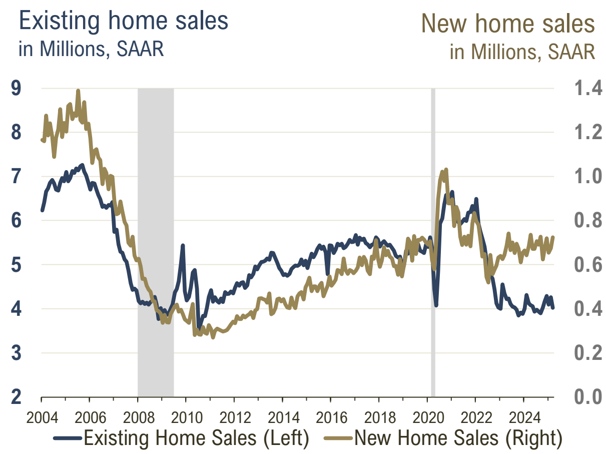
Low inventories of homes for sale are slowing home sales more than high interest rates





Source: AC Cutts & Associates, U.S. Census Bureau, U.S. Department of Housing and Urban Development, NBER, Federal Reserve Bank of St. Louis (FRED), National Association of Realtors, used with permission.

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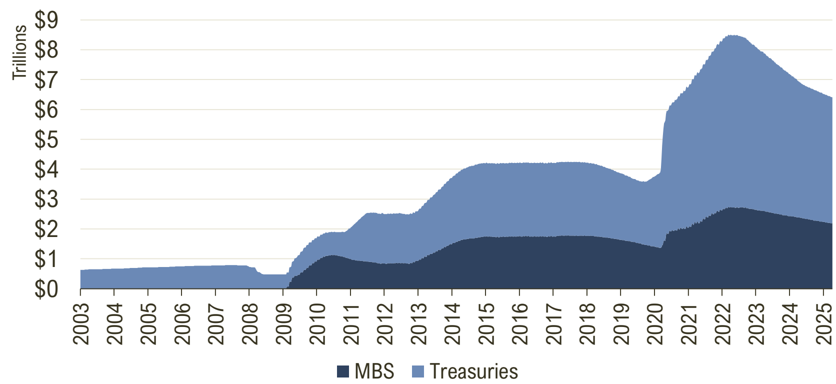
Fed holdings of MBS and Treasuries are in gradual decline, meaning mild "Quantitative Tightening"

The total face value of U.S. Treasury & GSE Mortgage-Backed Securities held by the Federal Reserve, $Trillions, NSA



Source: AC Cutts & Associates LLC, Macrobond, Federal Reserve Bank of New York

In Q1 2025, the average monthly decline in the MBS portfolio was $4.2 billion on a total portfolio of $2.23 trillion at the start of the year, a runoff rate of 0.19%. In 2024 the runoff rate was slightly lower, at 0.15%.
For Treasury holdings, the average monthly decline was $5.4 billion on a total portfolio of $4.29 trillion as of the start of the year. The Q1 2025 monthly runoff rate was 0.13%, down from an average 0.20% in 2024.

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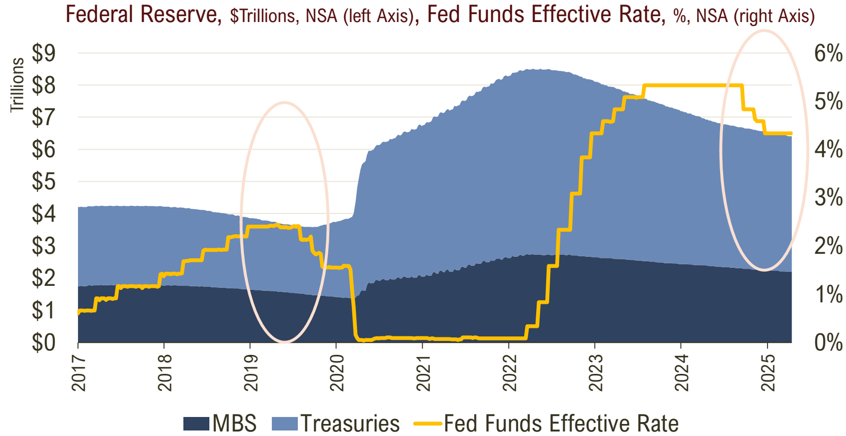
Fed Monetary Policy can seem contradictory

The total face value of U.S. Treasury & GSE Mortgage-Backed Securities held by the Federal Reserve, $Trillions, NSA (left Axis), Fed Funds Effective Rate, %, NSA (right Axis)



Source: AC Cutts & Associates LLC, Macrobond, Federal Reserve Bank of New York

It is possible and plausible that the Fed will engage in active Monetary Policy (directly targeting the Federal Funds Rate) that contradicts its passive actions through its portfolio holdings.

In 2019, the Fed paused active monetary policy actions but allowed passive tightening.
In 2024, the FOMC was actively loosening while passively tightening.

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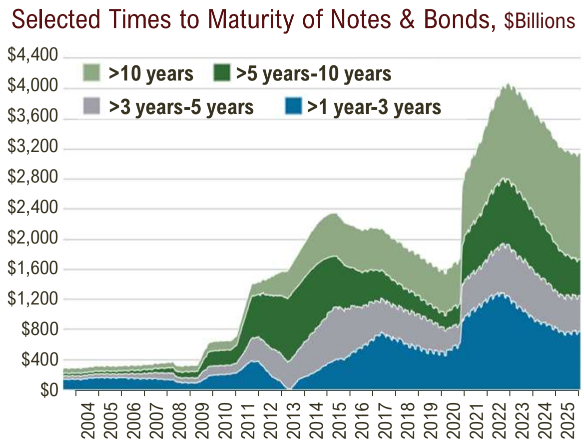
Fed holdings vs Treasury Issuance and the Market



Source: Efficient and effective central bank balance sheets - Dallasfed.org

The Fed's Treasury holdings, and the interest earned from them, is just netted out on the US Government Balance Sheet so is not inherently distortionary. However, the term distribution of the Fed's holdings can have an impact.

If the Fed buys across Treasury issuance, its purchases are neutral w.r.t. to Treasury intent. However, if the market is looking for particular terms, then buying into less liquid parts of the curve could mitigate immediate dislocations. But over time, without active management, the Fed could create inefficiencies or dislocations perhaps affecting trading markets. This is neither QT or QE necessarily – instruments could be reallocated without changing the total.

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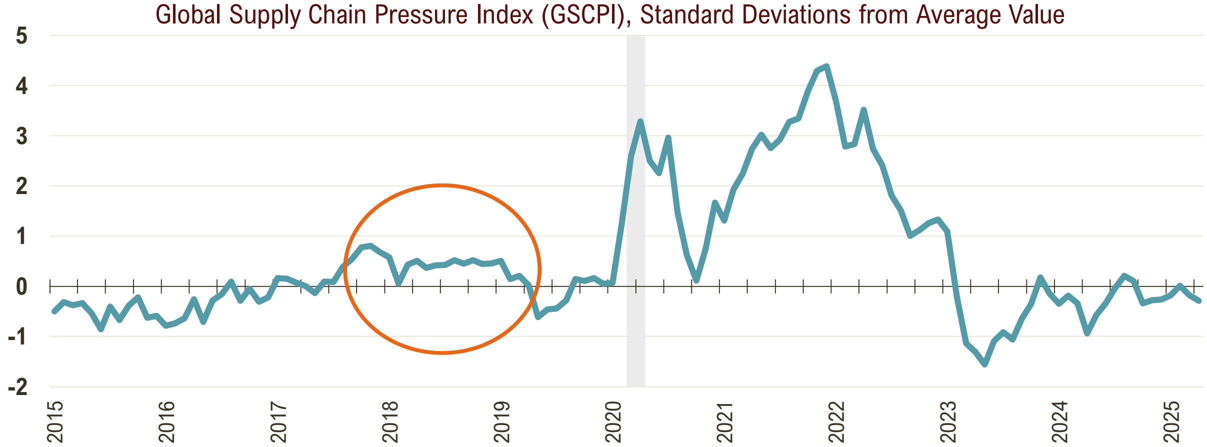
Supply chains and inflation

Tumultuous times

Global supply chain pressures are rising but just to mean levels through April

Global Supply Chain Pressure Index (GSCPI), Standard Deviations from Average Value



Source: AC Cutts & Associates LLC, National Bureau of Economic Research, Federal Reserve Bank of New York. Data through April 2025

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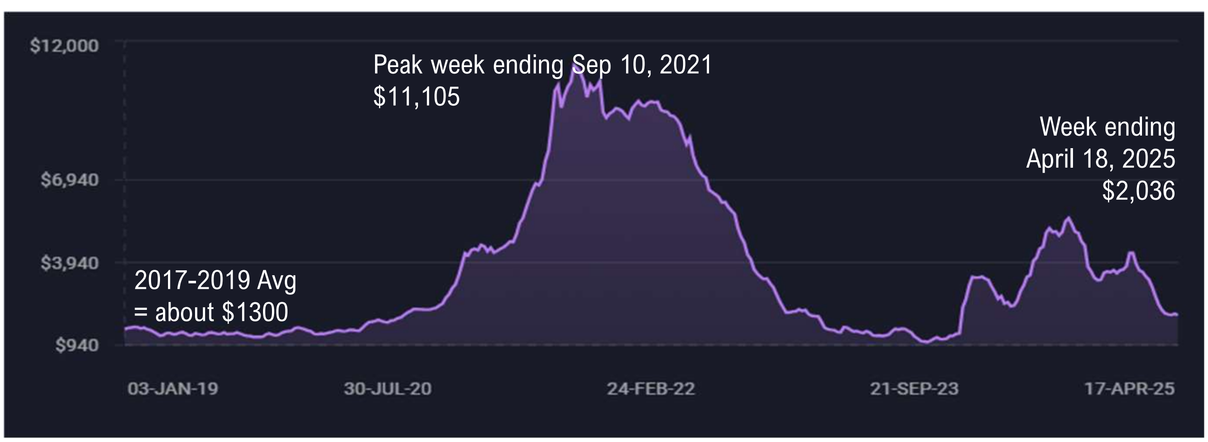
Shipping spot prices have come down but remain higher than normal

Freightos Baltic Index (FBX): Global Container Freight Index (NSA)



Source: Freightos (https://fbx.freightos.com/)

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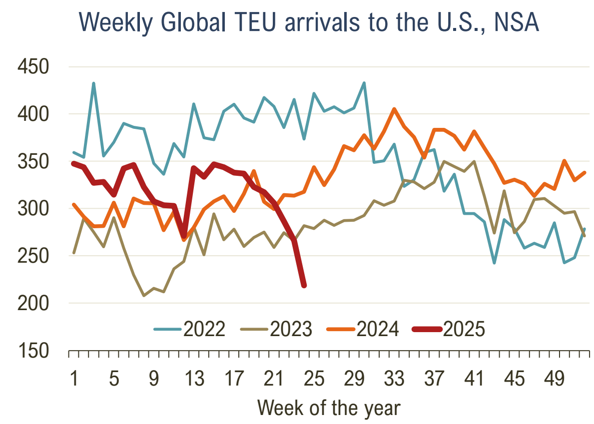
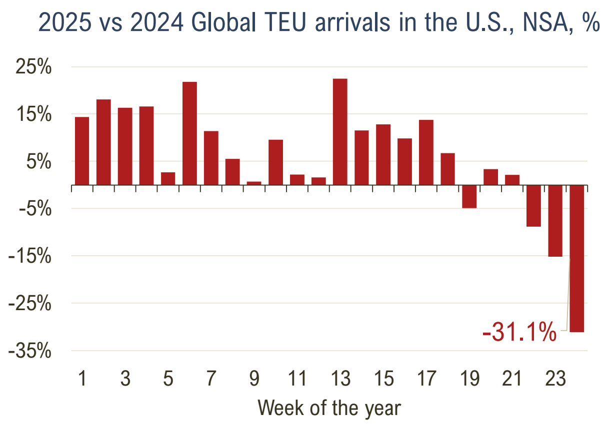
A dramatic decline in the total number of containers arriving in the US as a result of tariff policies





Source: AC Cutts & Associates LLC, Vizion. TEU are twenty-foot equivalent unit containers.

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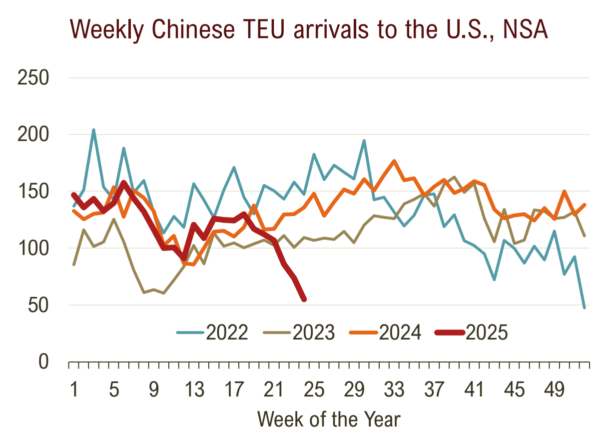
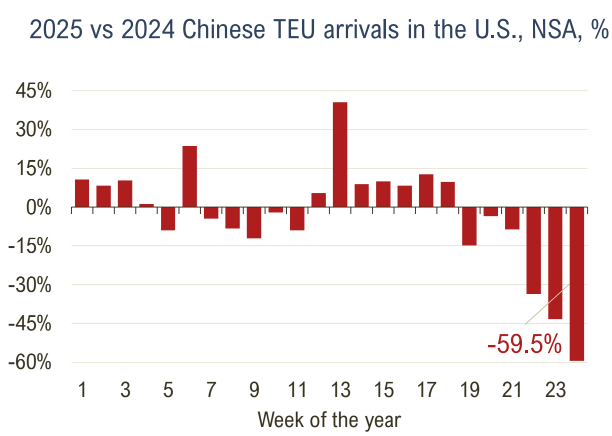
An even more dramatic decline has happened in the number of containers arriving in the US from China





Source: AC Cutts & Associates LLC, Vizion. TEU are twenty-foot equivalent unit containers.

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The LMI is showing a decline in March but remains in expansion, ahead of tariff impacts

The Logistics Managers' Index, NSA (>50 = Expansion, <50 = Contraction)

Sources: AC Cutts & Associates LLC, Apollo Chief Economist, the Logistics Managers' Index.

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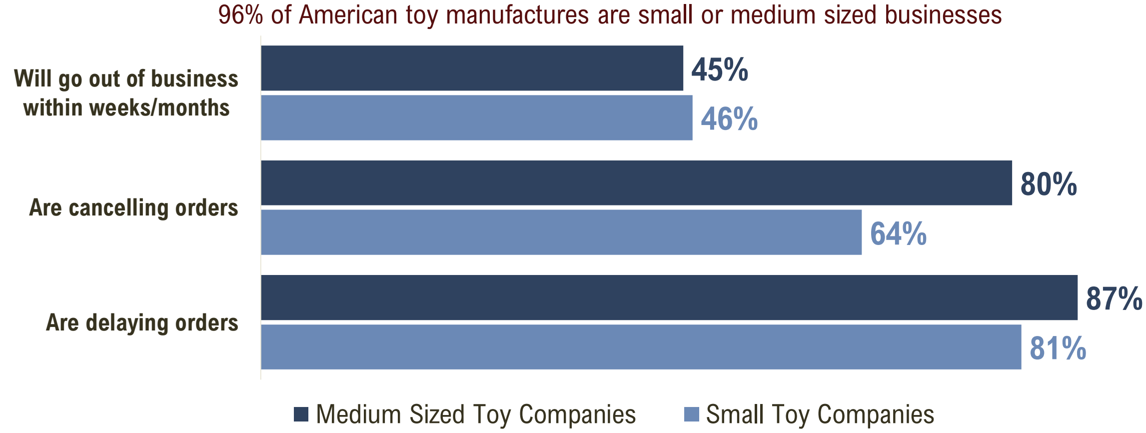
Christmas 2025 is at risk – US tariffs on Chinese imports is affecting toy manufacturers

96% of American toy manufactures are small or medium sized businesses



Sources: AC Cutts & Associates LLC, The Toy Association Member Survey (April 2025). Small toy manufacturers' annual revenues are < $10 million; Medium-sized toy manufacturers' annual revenues are < $100 million. 410 SME respondents.

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Contact

Amy@ACCutts.com (703)786-3089