Chaos Reigns

With the NASDAQ, and Russell 2000 already suffering Corrections, and the Magnificent Seven ETF now down over 16% from its 12/17 high, we felt it was important to share Thursday's Global Investment Strategy:

A Recession Is Imminent

The US Economy: Less Resilient Than Before

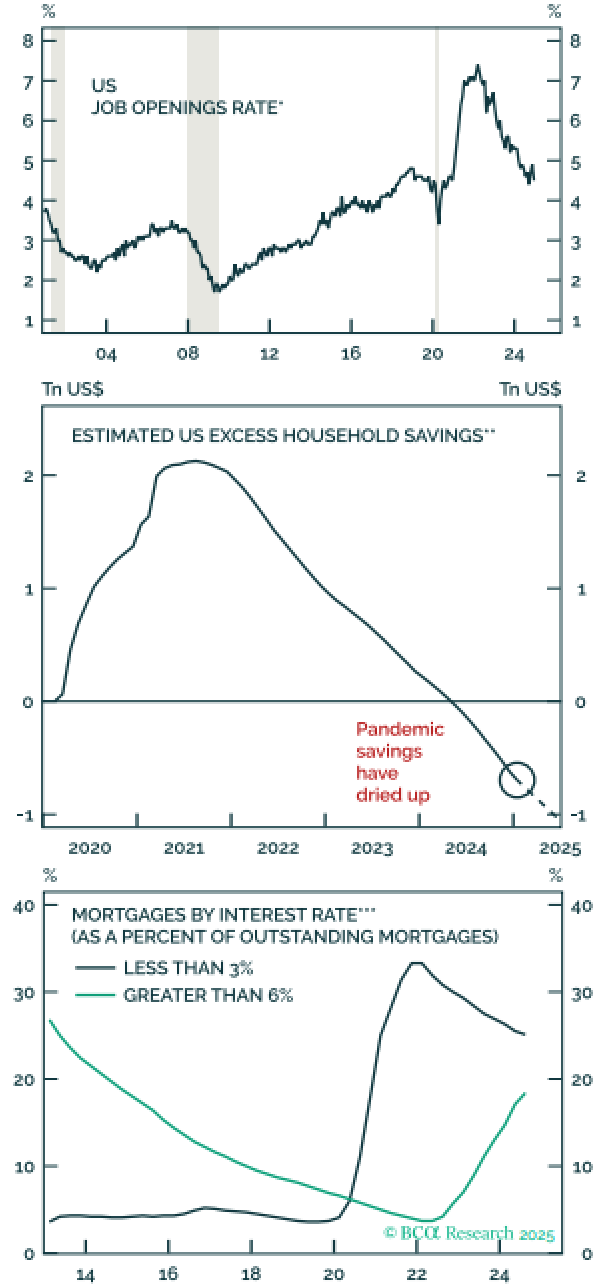
Recessions often begin when an economy becomes vulnerable to a downturn and is then hit by a shock. Once that happens, feedback loops typically emerge that reinforce the downward pressure on growth. Today, the US finds itself on the verge of such a cascade of bad economic news.

Contrary to popular perception, the US is at greater risk of a recession than it was in early 2022. Back then, when we were still optimistic on growth, the US economy had plenty of insulation around it: Job openings were plentiful; households held more than $2 trillion in excess savings; and many homeowners had refinanced their mortgages at very low rates.

Three years later, that insulation has worn thin: The job openings rate has returned to pre-pandemic levels; excess savings have been depleted; and 18% of mortgages carry a rate above 6%, up from 4% of mortgages in early 2022 (**Chart 1**). Meanwhile, credit card, auto loan, and commercial real estate delinquencies keep rising (**Chart 2 and Table 1**). Consumer confidence has nose-dived. Layoff announcements have spiked. New home inventories are at their highest level since August 2009 (**Chart 3**).

CHART 1

The Job Openings Rate Has Returned To Pre-Pandemic Levels, Excess Savings Have Been Depleted, And Mortgages Are Expensive



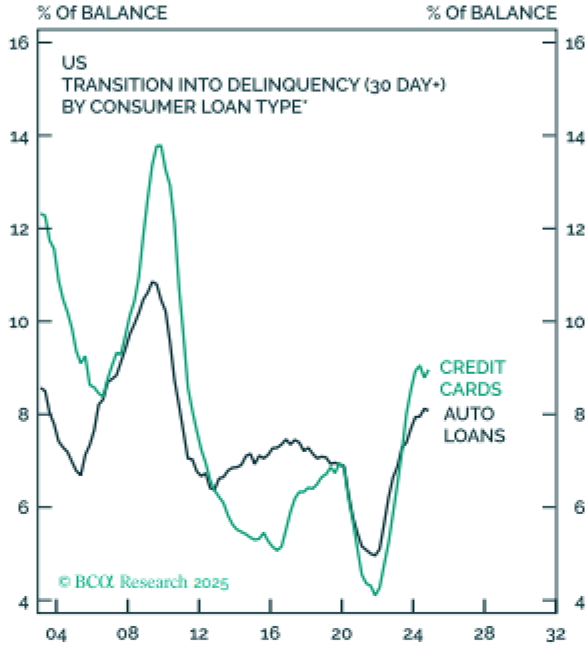
* SOURCE: JOB OPENINGS AND LABOR TURNOVER SURVEY (JOLTS), BLS. NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.
** SOURCE: "DATA REVISIONS AND PANDEMIC-ERA EXCESS SAVINGS", H. ABDELRAHMAN AND L. OLIVEIRA, FEDERAL RESERVE BANK OF SAN FRANCISCO, NOVEMBER 8, 2023.
*** SOURCE: FHFA NATIONAL MORTGAGE DATABASE, OUTSTANDING RESIDENTIAL MORTGAGE STATISTICS.

About That Atlanta Fed Estimate The Atlanta Fed's GDPNow model estimates that GDP is on track to decline by 2.4% in Q1 (**Chart 4**). This is almost certainly too pessimistic.

Imports jumped in January in anticipation of increased tariffs. Conceptually, higher imports should not reduce GDP if they also show up in consumption, investment, or inventories. Perhaps due to data limitations – especially in the case of inventories – the official statistics do not appear to fully capture the whereabouts of those imports. This is particularly true for gold imports, which have surged out of fear that Trump will levy a tariff on bullion shipments (as he has already done or is threatening to do for many other commodities).

CHART 2

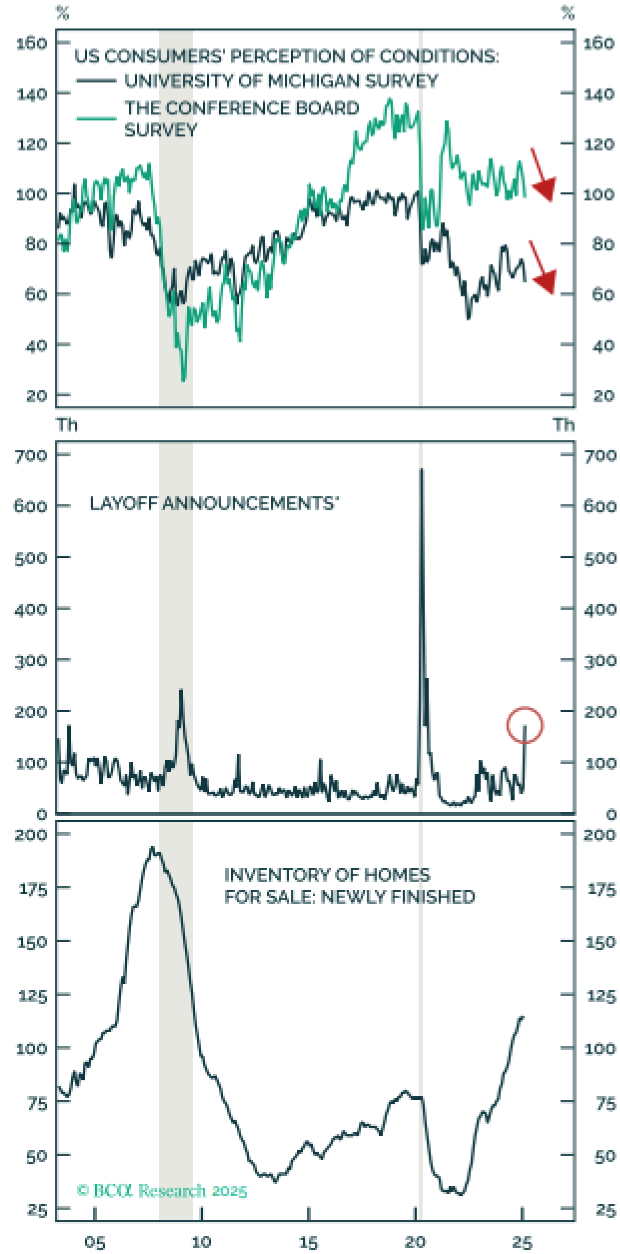
Delinquencies Are Rising For Credit Cards And Auto Loans...



* SHOWN AS A 4-QUARTER MOVING TOTAL.
SOURCE: FEDERAL RESERVE BANK OF NEW YORK.

CHART 3

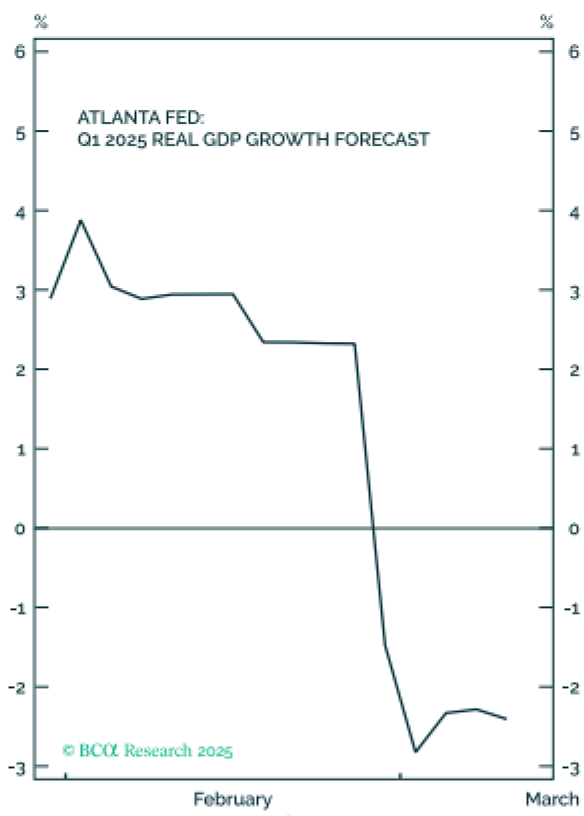
Consumer Confidence Has Nose-Dived, Job Layoffs Are Up, And New Home Inventories Are Elevated



* SOURCE: CHALLENGER, GRAY, AND CHRISTMAS.
NOTE: SHADED AREAS DENOTE NBER-DESIGNATED RECESSIONS.

CHART 4

The Atlanta Fed's GDPNow Model Estimates That GDP Is On Track To Decline By 2.4% In Q1



SOURCE: FEDERAL RESERVE BANK OF ATLANTA.

As of January, with the exception of real consumer spending – which may have been distorted by bad weather – the series tracked by the NBER did not yet point to an outright recession. That said, growth appeared to have slowed further in February, as evidenced by the deceleration in Goldman's Current Activity Indicator. And with the full impact of the double-shock of the trade war and DOGE cuts yet to come, it is highly likely that growth will slow even more. This will translate into falling

TABLE 1

...And In The Commercial Real Estate Sector

CRED iQ OVERALL DISTRESSED RATES BY PROPERTY TYPE* *DELINQUENT AND / OR SPECIALLY SERVICED LOANS*						
MONTH	OFFICE	MULTIFAMILY	RETAIL	HOTEL	INDUSTRIAL	SELF STORAGE
Aug-23	9.4%	5.0%	10.7%	7.7%	0.4%	0.0%
Sep-23	10.8%	4.7%	11.2%	8.3%	0.7%	0.1%
Oct-23	10.5%	5.1%	9.5%	8.9%	1.8%	1.3%
Nov-23	6.8%	2.9%	6.6%	6.4%	4.4%	1.3%
Dec-23	9.9%	4.0%	8.4%	8.0%	0.6%	1.1%
Jan-24	10.5%	2.6%	8.0%	6.7%	0.3%	14.4%
Feb-24	11.0%	3.4%	8.4%	6.9%	1.3%	0.1%
Mar-24	11.4%	3.7%	9.5%	7.7%	0.6%	0.1%
Apr-24	11.7%	7.2%	11.9%	8.7%	0.4%	0.1%
May-24	11.1%	7.1%	11.3%	9.4%	0.5%	0.1%
Jun-24	11.5%	7.4%	11.7%	8.1%	1.0%	0.1%
Jul-24	12.2%	8.4%	11.8%	7.8%	0.8%	0.2%
Aug-24	13.0%	11.0%	10.6%	8.4%	4.6%	0.1%
Sep-24	14.8%	11.2%	11.4%	8.6%	0.6%	2.4%
Oct-24	14.8%	11.0%	11.7%	9.0%	1.2%	3.6%
Nov-24	15.5%	11.2%	11.5%	8.6%	0.6%	1.7%
Dec-24	17.2%	12.5%	10.9%	9.9%	0.8%	1.6%
Jan-25	17.7%	12.9%	10.8%	10.4%	1.6%	14.2%
Feb-25	19.3%	13.0%	10.7%	10.2%	0.5%	2.0%

* AS OF FEBRUARY 28, 2025.
SOURCE: CRED iQ.

payrolls and rising unemployment during the second quarter of this year.

In our Annual Outlook, we postulated that the recession would begin in May 2025. That still feels right to us.

Just A Little Disruption?

Most conventional estimates find that higher tariffs will have only a modest contractionary effect on US growth. This is not surprising, given that the US is a fairly closed economy – goods exports and imports account for only 6.9% and 11.1% of GDP, respectively.

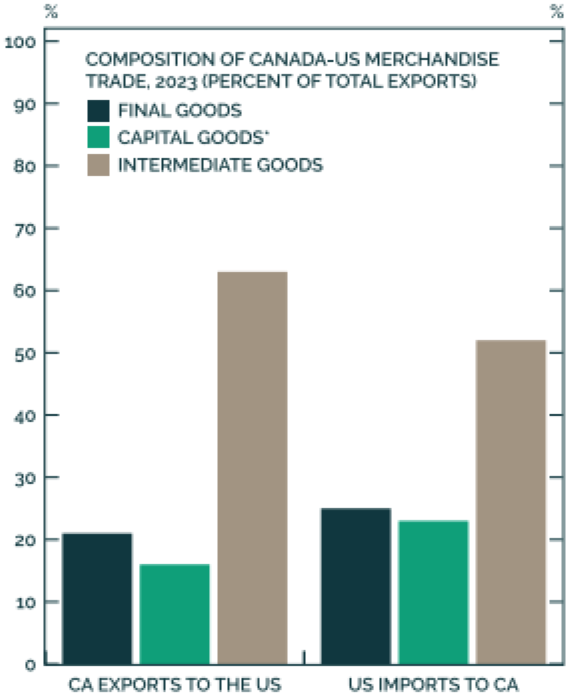
Nevertheless, we strongly suspect that conventional estimates understate the likely growth hit to the US from higher tariffs. There are three main reasons for this.

First, most estimates ignore the supply-side effects of higher tariffs, focusing instead on the demand-side implications of rising import prices on real incomes. The supply-side impact of higher tariffs could turn out to be quite large. More than half of trade in North America is in intermediate goods (**Chart 6**). The auto industry is well known for its complex supply chain which spans Mexico, Canada, and the US. However, there are many lesser-known examples. For instance, about 80% of semiconductors manufactured in the US undergo advanced testing and assembly at IBM's facility in Bromont, Quebec.

Second, the haphazard way that the tariffs are being rolled out has created significant uncertainty among the public and the business community. The Trade Policy Uncertainty Index has surged to the highest level on record (**Chart 7**). The IMF has documented that uncertainty over tariff policy can have as damaging an effect on growth as the tariffs themselves.

CHART 6

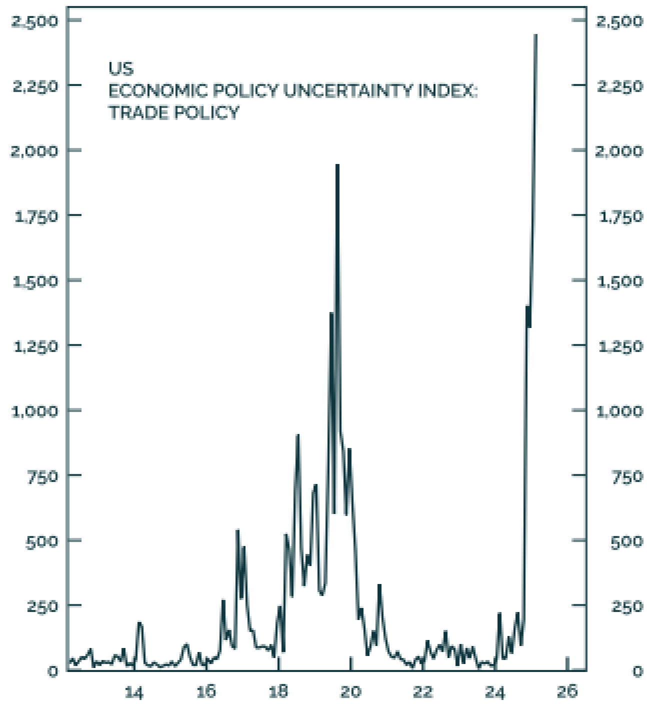
Intermediate Goods Constitute The Lion's Share Of North American Trade



* E.G., MACHINERY AND EQUIPMENT.
SOURCE: CANADIAN CHAMBER OF COMMERCE, DATA LAB (2023).

CHART 7

US Trade Policy Uncertainty Has Surged To The Highest Level On Record

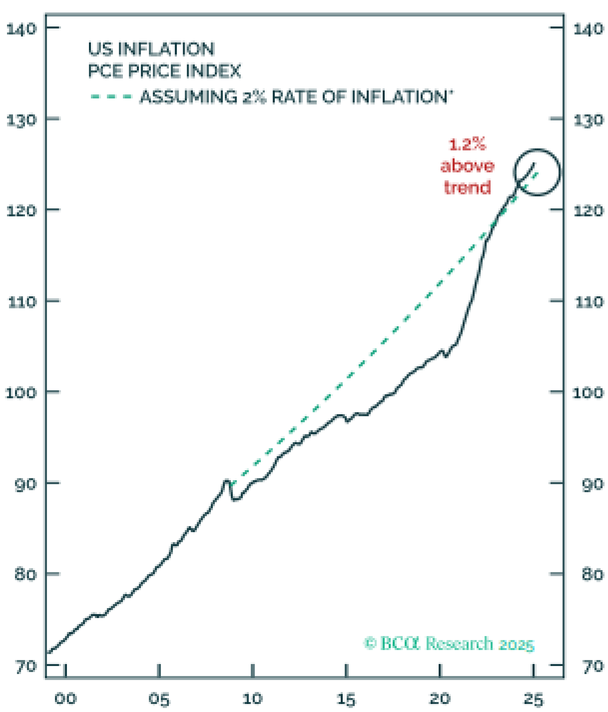


SOURCE: ECONOMIC POLICY UNCERTAINTY. © BCA Research 2025

Third, higher tariffs will temporarily push up inflation, making the Fed less willing to cut rates. In 2018, when Trump launched the first trade war, the PCE deflator was 6% below where it would have been if inflation had averaged 2% since 2008 (**Chart 8**). Today, the PCE deflator is 1.2% above its long-term trendline. This means

CHART 8

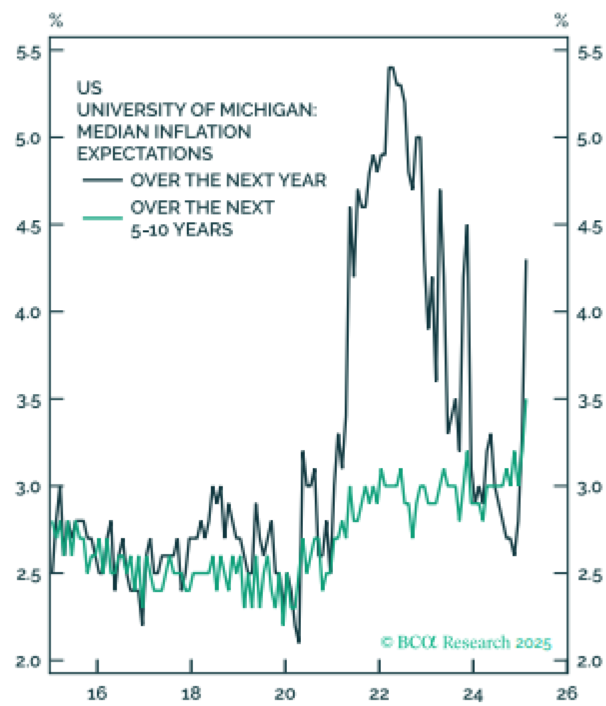
The Fed Has Less Scope To Permit Another Inflation Overshoot…



* SINCE OCTOBER 2008.
SOURCE: BUREAU OF ECONOMIC ANALYSIS (BEA).

CHART 9

…Especially If Survey-Based Inflation Expectations Rise Further



SOURCE: UNIVERSITY OF MICHIGAN.

that the Fed has less scope to permit another inflation overshoot, especially if survey-based inflation expectations rise further, as they already have in the University of Michigan survey (**Chart 9**).

Dogeball

As with trade, conventional estimates understate DOGE's likely impact on the US economy. The typical estimate involves taking the income lost by someone fired from their government job and computing the knock-on effects on aggregate demand.

As an example of how these conventional estimates work, suppose a fired worker receives a salary of $100,000 and is subject to a 30% income tax rate while spending 90% of their after-tax income. For every dollar of income lost, that worker's spending would drop by 0.7*0.90, or 63 cents. Since one person's spending is another person's income, for the economy as a whole, the total loss in demand would be $100,000*(0.63/1- 0.63) or roughly $170,000.

CHART 14
The S&P 500 Is Expensive

* SOURCE: REFINITIV / IBES.
** SOURCE: BLOOMBERG FINANCE L.P.

Notice that this estimate implicitly assumes that DOGE's actions do not have any effect on savings behavior. This is almost certainly false. The capricious nature of DOGE's decision-making has sent a chill through the 10 million or so workers who rely on the government for their livelihoods. If these actions cause workers to lift precautionary savings, the impact on aggregate demand could be far larger than typically assumed. ...

In situations where precautionary savings rise in response to a softening labor market, a $1 decline in income could lead to a greater than $1 decrease in aggregate demand. This could produce an outsized hit to GDP. Indeed, it is possible for aggregate demand to fall permanently even if the shock to income is temporary.

While there is no guarantee that such an outcome will occur this time around, it is a credible risk. As evidence, note that the savings rate jumped from 3.5% to 4.6% in January, the last month of available data.

The Risk of an FCI Doom Loop

The risk that falling spending leads to less income, resulting in even lower spending, is one example of a feedback loop that usually emerges during economic downturns. But there is another feedback loop to worry about – one that is particularly pertinent today: a feedback loop involving financial conditions.

US financial conditions have tightened since last September, mainly because of the increase in bond yields. As a result, the impulse from financial conditions to GDP growth has moved from a tailwind to a modest headwind.

Looking out, the risk is that financial conditions tighten further. Despite the recent decline in stock prices, the S&P 500 is still trading at elevated levels relative to earnings, sales, and book value (**Chart 14**). Credit spreads are also near historic lows, even though default rates have risen.

A further decline in equity prices alongside a widening in credit spreads would lead to a tightening in financial conditions. Tighter financial conditions, in turn, would lead to slower growth, thereby causing equity prices to fall and credit spreads to widen further.

Europe: Curb Your Enthusiasm

Investors have gotten bulled up on European stocks. The MSCI euro area index is up 11.9% in local-currency terms and 16.3% in US dollar terms since the start of the year.

Two forces have driven the rebound. First, recent data on European manufacturing activity have come in stronger than expected. Second, Trump's isolationist policies have galvanized Europe into increasing fiscal spending, especially on defense.

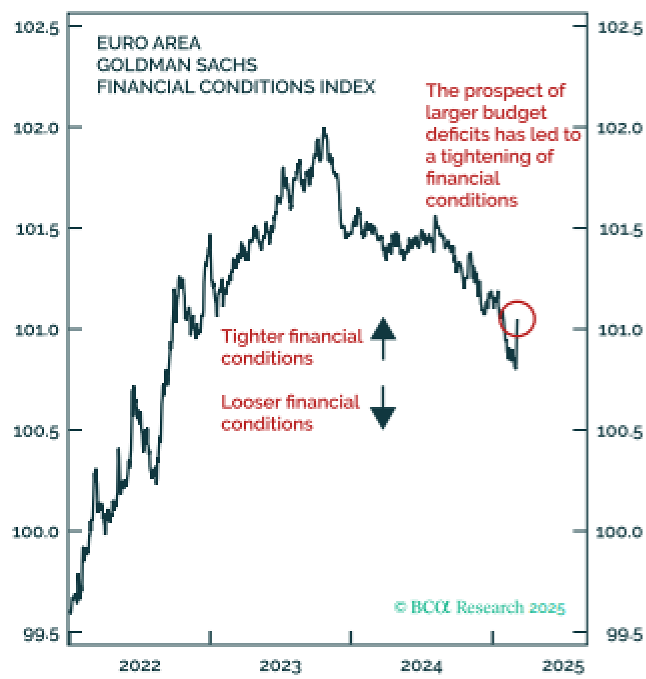
With respect to better European manufacturing data, our strong suspicion is that much of the improvement has been driven by tariff front-running. Domestic demand remains anemic, as evidenced by the surprising drop in retail sales across the euro area in January.

As far as fiscal spending is concerned, one can debate whether it will boost growth over the medium-to-long term. Increased infrastructure spending will certainly help. However, higher defense spending, while important for national security, will not augment the economy's supply-side capacity.

Debt sustainability is also a concern. Although Germany has the ability to spend more, government debt is already over 100% of GDP in France, Italy, Spain, and the UK.

In any case, in the near term, the prospect of larger budget deficits has led to a tightening of financial conditions via higher bond yields and a stronger currency (**Chart 16**). This is likely to weigh on growth.

CHART 16
European Financial Conditions Have Tightened In Recent Days



SOURCE: GOLDMAN SACHS VIA BLOOMBERG FINANCE L.P.