Capital Risk

USA ECONOMIC UPDATE

2025 April

The Misery of Mercantilism

Photo: Seaport at sunset (Claude Gelée, Louvre INV 4715)

A return to Renaissance thought appeals to artists and scientists, not so much to economists. That a country forged in a revolt *against tariffs* would endeavor to return to mercantilism highlights the extent of change in the global economic order. Multiplying this choice is the venture away from free markets and ideas to one of state-controlled regulation. Indeed, the reign of the US as the world's consumer of last resort is in peril, as rent-seeking dissuades consumption. The paradox is the incongruence of these policies with the global dominance of US companies, which extract monopolistic rents from foreign consumers. A return to mercantilism risks their profits and domestic consumption. Two hundred years of global growth may disappear at the whim of pen and paper.

"

The Smoot-Hawley Tariff Act in 1930 led to a global decline in trade and contributed to the onset of the Great Depression. Despite this evidence, the US seeks the logical fallacy of growth and reindustrialization through tariffs.

The decision overlooks competitors' strategic responses and the tactical limitations of replacing forgone goods and services. Commonsense should prevail less US growth is liberated.

Highlights

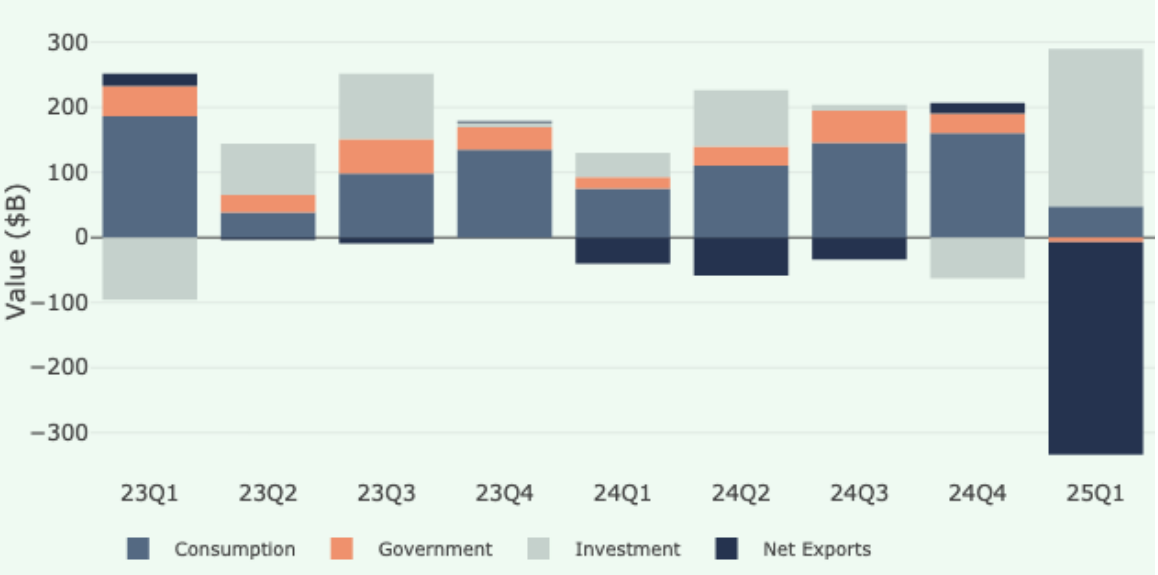
- **GDP** will continue to decline as tariff-avoiding actions impair future growth.
- **Inflation** above the target will persist as housing and healthcare pricing endure.
- **Deficit** reduction is critical, yet requires addressing taxes and spending.
- **Interest** on the Federal debt will eventually crowd out other spending.
- **Imports** are crucial to US consumption, yet tariffs significantly impair them.
- **Manufacturing** creates high-value-added goods that would suffer with tariffs.

The Macro View

A turning point. While the economy continues to grow, the impact of high interest rates is beginning to show (Exhibit 1). Investment declined for the first time in four years. The worrisome sign is that the decline was broad-based: all sub-categories declined except structures (both private and residential), which were only modestly positive. Indeed, high interest rates impair investment to some degree, and an investment slowdown in artificial intelligence further magnifies the impact. While an investment retrenchment preceded every recession in the last seventy years, many investment slowdowns have not resulted in a recession. It is only when other sectors are falling simultaneously that a recession is foretold.

Consumers lead while investment fades.

Exhibit 1. GDP Contribution by Component



Source: Federal Reserve Economic Database, CRM Calculations.

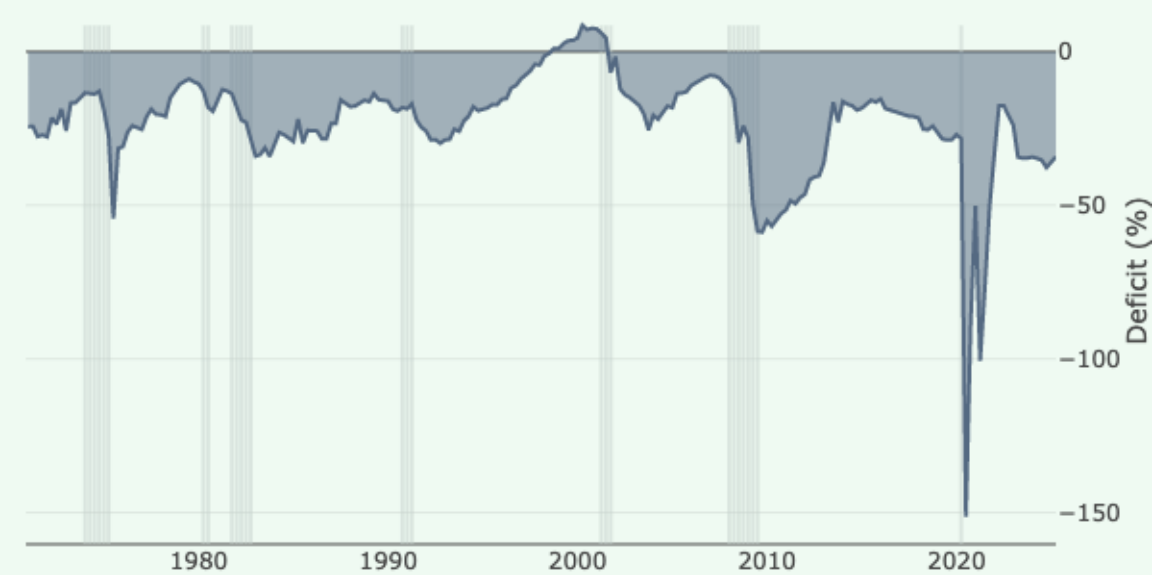
The Fed's challenge is to achieve a *soft landing* of the economy, where policy loosens before employment declines. Unequivocally, investment is slowing. The trouble is that monetary policy is only loosely linked to consumption. Indeed, higher financing costs reduce the marginal borrower, yet housing real estate investment continues apace. The Fed's concern is how inflation limits consumer spending and impacts employment. When consumer spending changes, the Fed's policy must change. The critical indicator is goods consumption, whether domestic or imported.

The Macro View

Deficit Dilemma. The US is not unfamiliar with deficits: it has run one for over 50 years, except for a brief period in the late 1990s during the tech bubble (Exhibit 2). The choice for deficit reduction is one of two paths: reducing spending or increasing taxes. Since the infamous "Read my lips: No new taxes" mantra derailed a presidential re-election, the focus is on spending control. This focus did not preclude spending from increasing due to the complexity of budget accounting. While the US budget situation is in a perilous position in absolute terms, at approximately $2 trillion, the deficit relative to receipts does not appear extraordinary.

The deficit level is only seen during a recession.

Exhibit 2. Federal Deficit as a Percentage of Current Receipts



Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

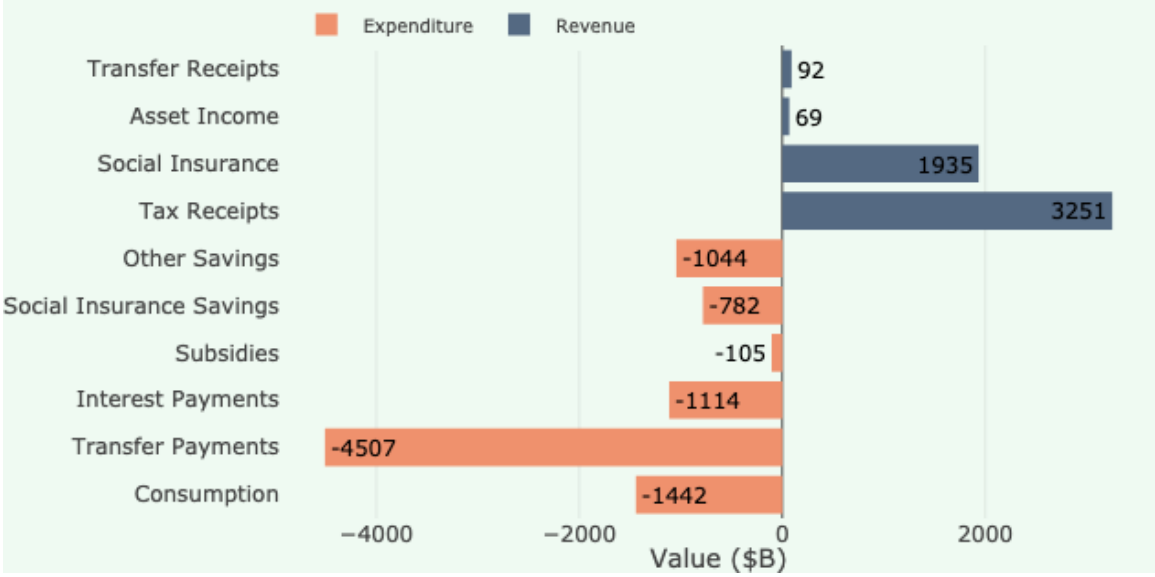
The challenges are the timing and starting point. First, a deficit of this magnitude is unprecedented during an expansion, which could limit the ability to respond should the economy face a recession. More critical is the level of debt, which stands at 120 percent of GDP. This level was only reached during World War II, while the period from 1970 to 2010 averaged about 50 percent. This level has two implications: the capacity to borrow may be limited, and the cost to service the debt may not only preclude further expenditures but *require reductions and tax increases*.

The Macro View

Unbalanced. As the Department of Government Efficiency (DOGE) attempts to eviscerate the Federal Government, it found that there are few limbs available for chopping. The largest single category is $4.5 trillion in transfer payments, including social security and payments to state and local governments (Exhibit 3). The challenge for DOGE to cut $2 trillion was that the Federal government's consumption accounts for a mere $1.4 trillion of the $7.4 trillion of expenditures. Over $6 trillion is effectively mandatory spending that can't be changed without losing political capital. One can't get there from here.

Transfer payments dominate spending.

Exhibit 3. Federal Government Revenue and Expenses



Source: U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis.

On the revenue side, it's become apparent where the overriding issue resides. Social insurance receipts total $1.9 trillion, yet expenditures amount to $3.4 trillion, and an additional $782 million was drawn from the social insurance savings account. The problem arises on two fronts: a pay-as-you-go system is in severe deficit, and they are borrowing from its balance to cover other expenditures. A related concern includes the issuance of more than $1 trillion of new debt (i.e., Other Savings) and the elephant in the room, interest payments. The continuation of deficits will result in higher debt payments, both from the amount of issuance and the rate of interest paid on the debt.

The Macro View

Financing the Past. Interest payment of federal debt tripled during the 1980s, despite the cost of debt dropping by more than half (Exhibit 4). The trouble with this prior period was that debt issuance was not necessarily funding an expanding government, but rather the result of reduced tax burden. In real terms, receipts on personal taxes were barely positive, and corporate taxes declined. Financing corporate profits with government debt produced stellar equity market returns. The current challenge is that rates are low by historical standards, and the debt level is materially higher. The starting point matters.

Interest expense rose more in the past 4 years than in the prior 40.

Exhibit 4. Federal Interest Expense ($, Billions)

Source: Bureau of Economic Analysis. Retrieved from FRED, Federal Reserve Bank of St. Louis.

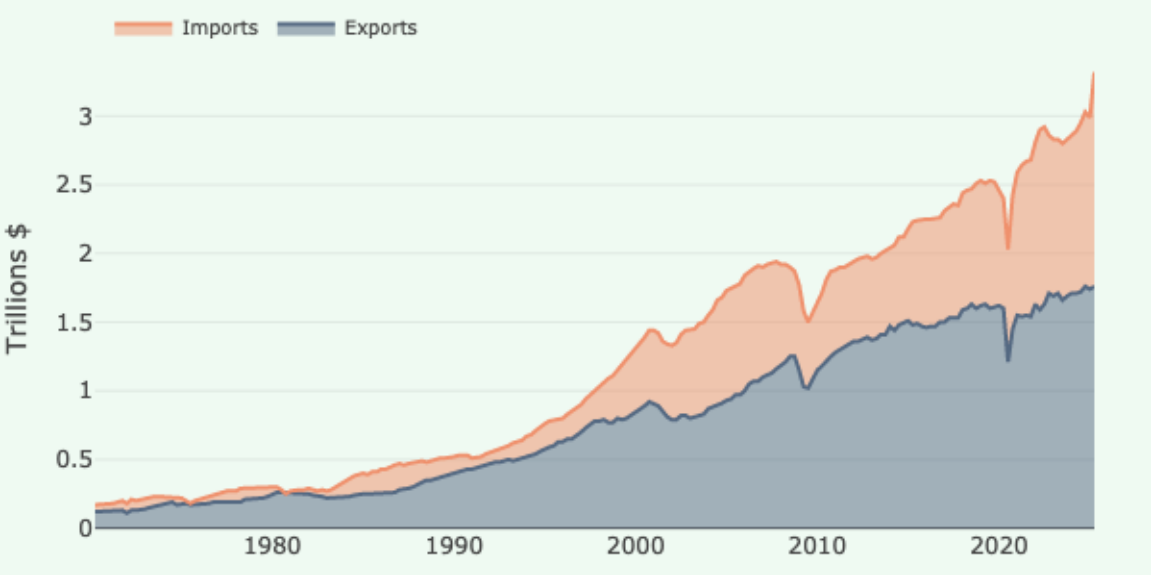
The recent doubling of interest expense in less than five years will crowd out future government expenditures or require higher taxes. Difficult decisions are ordained as the interest expense approaches the level of total government consumption. The difficulty in reducing the deficit through budget cuts alone is patently unrealistic, even with changes to Social Security. Addressing the revenue side is equally important. Yet, the mantra in Washington is tax cuts, which appears untenable in the current environment, even if tariffs offset some of the lost revenue.

The Macro View

Insufficient Imports. Since 1980, goods imports have outpaced exports, with the divergence increasing since China joined the World Trade Organization (WTO) in 2001. Certainly, taxing imports could provide some revenue. The challenge resides in the magnitude of imports. To close the current deficit, a 100 percent import tax rate is required. If tax cuts exceed program cuts, then a higher rate is needed. The reality is that the consumer would bear a material portion of the tariff, since even a highly profitable company could not afford to eat all the tariff. The result would be cost-push inflation for the US, the same voter concern that contributed to a switch of party control of government.

Imports are nearly double exports.

Exhibit 5. Goods Exports and Imports



Source: U.S. Bureau of Labor Statistics, retrieved from FRED, Federal Reserve Bank of St. Louis.

US exports face significant challenges during a trade war, as they remain at the same level as they were in 2018. While the US continues to export leading-edge technology, the recent exploits of China in electric cars, processors, and artificial intelligence serve as a warning. Europe and Japan also have products to offer. The outcome could result in lower US exports. The trade deficit could widen when combined with the difficulty of finding domestic substitutes for imports. US growth has led the world since the Pandemic: it's not evident that voters will appreciate higher prices and lower growth.

The Macro View

Productive Employees. America led the industrial world into the twentieth century, which significantly contributed to the Allied victory in World War II. Despite the talk of decline in manufacturing employment, industrial production per employee has varied around $350,000 since the 1970s (Exhibit 6). Capital and industrial goods are the most significant export sectors, reflecting their high value added. These sectors include semiconductors, telecom, and electric appliances. Critically, this production highlights that the US did lose some manufacturing employees, yet it continued to produce at a very high level, where it had a *comparative advantage*.

Industrial employees produce $300k each.

Exhibit 6. Industrial Production per Manufacturing Employee ($ 000)

Source: U.S. Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

Another critical dimension is the difference between the cost of labor production and the revenue generated. The average US manufacturing employee earns approximately $60,000 per year while producing over $300,000 worth of products. Other costs, including financing and capital investments, reduce the net difference of $270,000. Yet, these numbers highlight that the value added per employee remains exceedingly durable over time, even as the number of employees declines. US manufacturing continues to produce world-class goods, limited only when unexpected cost inflation (e.g., the 1970s and the Pandemic) occurs.

The Macro View

Durable Consumption. The American trade deficit is primarily a function of capital and consumer goods, the latter a prime export from China. Since 1980, durable goods consumption per manufacturing employee has increased *sixfold* (Exhibit 7). The level is consistent with the output per employee in industrial production at about $300,000. The implication is quite clear: the US consumer is availing itself to cheaper goods produced externally at the cost of losing those employment levels.

Durable spending is about $300K per employee.

Exhibit 7. Durable Consumption per US Durable Manufacturing Employee ($ 000)

Source: U.S. Federal Reserve Board, retrieved from FRED, Federal Reserve Bank of St. Louis. Consumption per employee is Real Consumption Durables / Manufacturing Durables Employment.

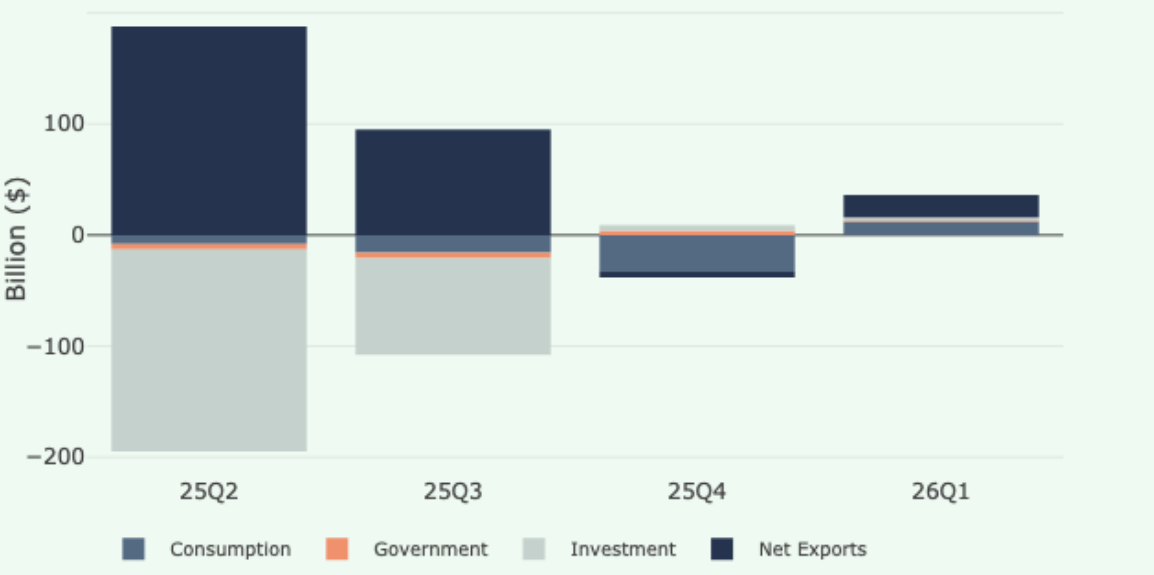
The US must choose between cheaper and more plentiful durable goods and restoring employment in the industrial sector. If it decides to burden its trading partners by taxing imports, it will also harm the US consumer, who relies on these goods. The cost will be a higher price that will erode the value of their wages and could lead to spiraling cost-push inflation. Much like the United Kingdom imposed mercantilism and made its colonies serfs, the US risks a similar outcome. The difference this time is that a duly elected president wishes to impose the suffering, not an indifferent and faraway monarch. Indeed, the terms of trade need improvement, yet not at the cost of impoverishing generations of Americans. E pluribus unum.

The Macro View

Systemic Shock. It is hard to overstate the shock that occurred in the first quarter. Imports jumped three times higher than the previous high, while investment set a non-pandemic growth record. These unprecedented and rational actions were taken to import and invest goods in advance of tariffs taking effect. The immediate effect was to create a negative growth in the first quarter. The impact will decelerate investment growth over the next year, while mitigating the import drag on growth late in the year. The net result is a complete reevaluation of the expected growth composition over the year.

Contraction could occur throughout the year.

Exhibit 8. Forecast for US GDP Growth



Source: CRM estimates for each component.

The expectation is for a decline of 0.4% in 2025, below the consensus estimate of 1.5%.[1] This level of growth will pose a dilemma for the Fed, as inflation persists in housing and higher import prices. The latter highlights the key risk: the durability of employment as higher prices persist. The uncertainty surrounding tariffs will likely force the Fed to act, despite persistent inflation. As the Fed's focus switches to employment from inflation, the prospect of *stagflation* will emerge, a politically dire conundrum indeed.

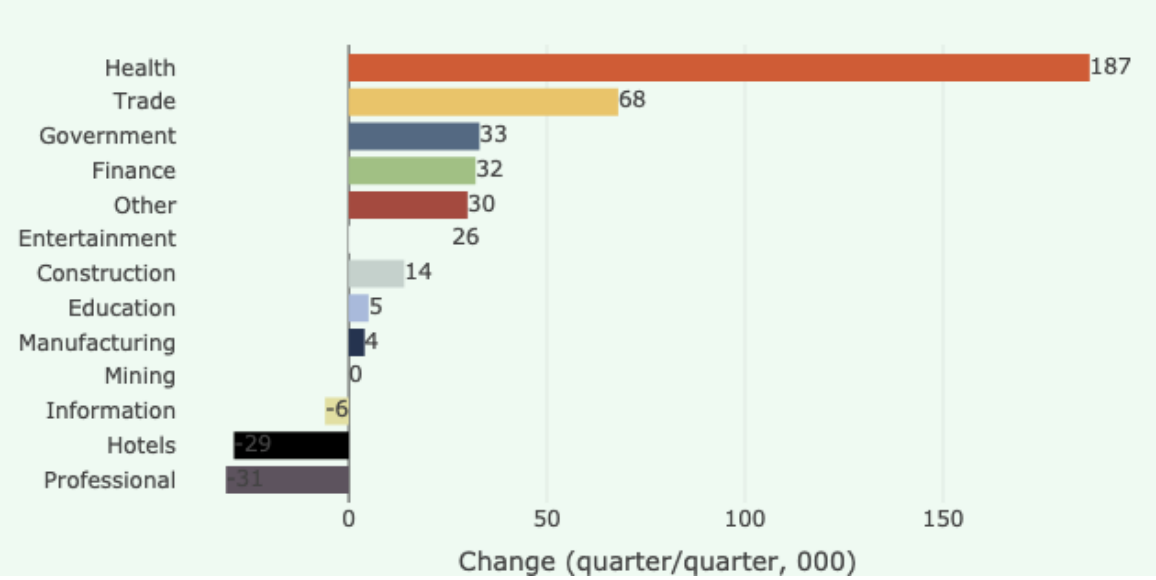
[1] Federal Reserve Bank Philadelphia, *Survey of Professional Forecasters*, First Quarter 2025.

Consumption

As travel and professional services slow in the private sector, healthcare employment and its unionized sibling, government, continue to grow at a rapid pace. The healthcare sector is experiencing employment growth that exceeds that *of all other sectors combined* (Exhibit 9). The average monthly job growth rate is approximately 160,000; without healthcare, it is only *80,000*. This situation presents two challenges: the durability of the healthcare sector's growth and the leisure sector's sensitivity to a slowing of foreign travel. If they falter, then recession follows.

Healthcare leads employment growth.

Exhibit 9. U.S. Private Employment Change by Sector (Thousands)



Source: Federal Reserve Economic Database. Change from Dec 2024 to Mar 2025.

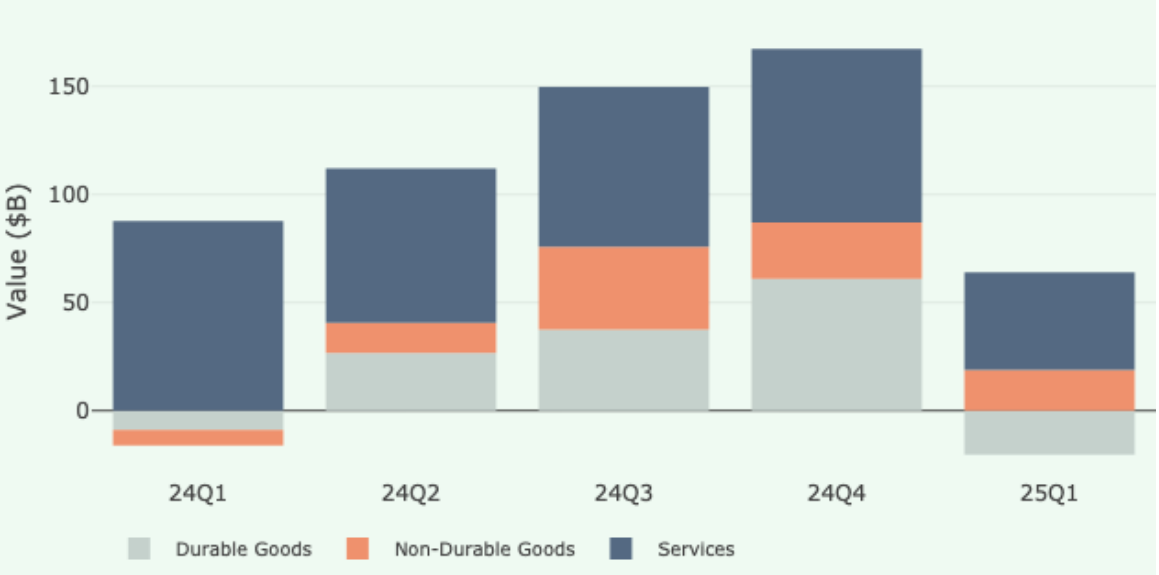
The trouble arises with home health care and hospitals. The former is at 160 thousand and the latter at 200 thousand, *four times their average rate.* This excess growth is approximately 270,000 jobs per year. An aging workforce with increased health care requirements may contribute to excess growth; however, the lingering impact of pandemic contractions in these sectors is more likely. If this effect is mean-reverting, then employment growth will slow. While unlikely to cause a recession itself, healthcare can contribute to a broader economic contraction by aligning with other declining sectors.

Consumption

Not So Durable. All the major components of consumption slowed in the first quarter (Exhibit 10). While non-durable goods and services continued to contribute to growth, durables faltered in the face of trade uncertainty. This outcome is not a surprise due to their lack of sensitivity to trade: services are domestically based, and non-durables include food and gasoline, staples of everyday consumption. This outcome, however, highlights a risk: a simultaneous slowdown of all components, which may show consumer stress.

All major components slowed.

Exhibit 10. Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

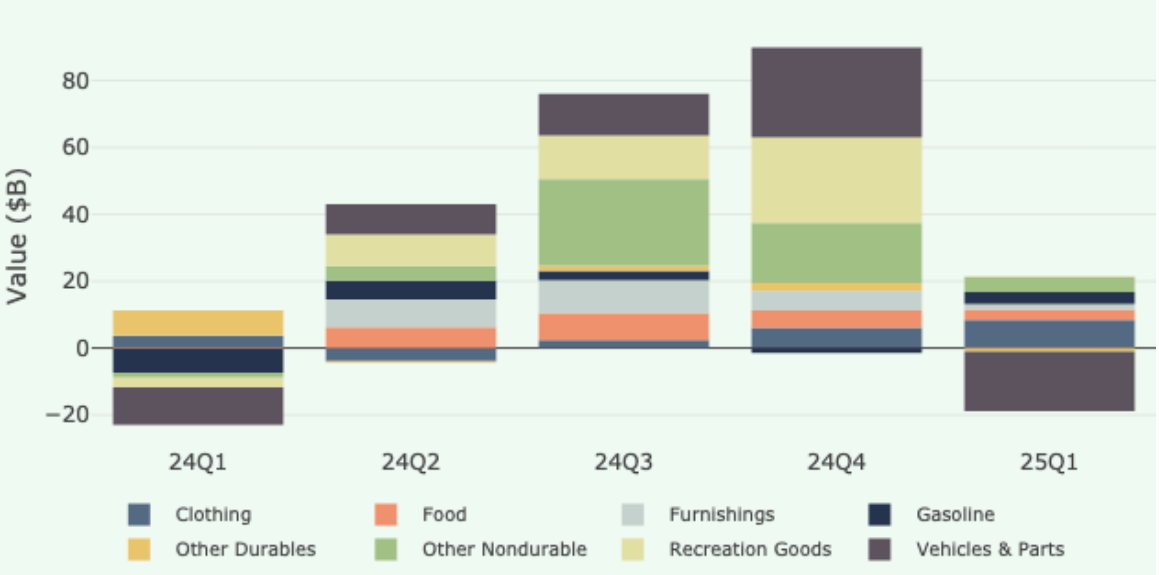
Goods are broadly segmented into two types. *Nondurable goods* (e.g., food, drugs, gasoline, etc.), which are consumed on use and are constant in their application (e.g., eating and driving). In contrast, *durable goods* are purchased once and used repeatedly over time (e.g., cars, televisions, computers). The latter category comprises two key performance indicators: consumers can time the purchase of durable items to align with their employment situation, and they are more sensitive to trade fluctuations. Employment uncertainty from reduced trade and higher prices from imports could negatively impact their consumption.

Consumption

Stalling Autos. As trade rhetoric intensified, tradeable durable goods acted as expected, falling (Exhibit 11). Some of this movement was the stockpiling of goods in the fourth quarter as the intent of the new regime became apparent. Yet, the decline in motor vehicles and parts is disconcerting, as buying in advance to avoid higher prices would seem to be the natural strategy. Yet, the opposite happened, and this is where trouble arises. If the consumer is not spending despite the possibility of higher prices, then uncertainty about employment may be the culprit.

All durable goods categories slowed.

Exhibit 11. Goods Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values annualized rates.

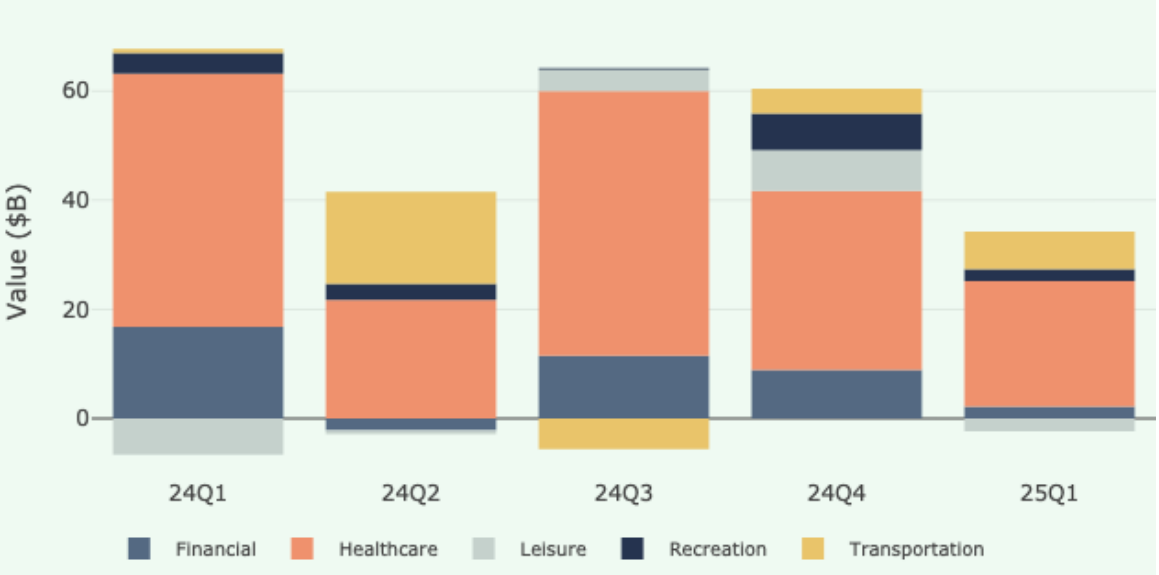
A related story unfolds in non-durable goods, with clothing and footwear emerging at a rate not seen since the end of the Pandemic. While a rush to grab the new spring fashions may be a catalyst, the most likely explanation is that consumers acted in advance to buy goods that would be subject to increased tariffs. If the consumer has brought forward consumption, then future consumption will be diminished, not merely because of higher prices. A trade shock caused by higher tariffs may limit domestic consumption and exports of goods. The rational US consumer may behave as expected in the present, albeit at the expense of their future consumption.

Consumption

Caring for Growth. The United States economy is primarily service-based. Unlike most other industrialized countries, healthcare is not a government expenditure, but a personal consumption item (Exhibit 12). It is 12% of GDP, 17% of consumption, and 27% of services. It exceeds broader categories of total exports, durable goods, the Federal government, and state and local governments. While an aging population foreshadows increased health spending, the risk is that its consumption patterns change, as they account for *about half of the growth in services.*

The healthcare sector dominates services.

Exhibit 12. Service Consumption Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate. Leisure = Dining & Hotels.

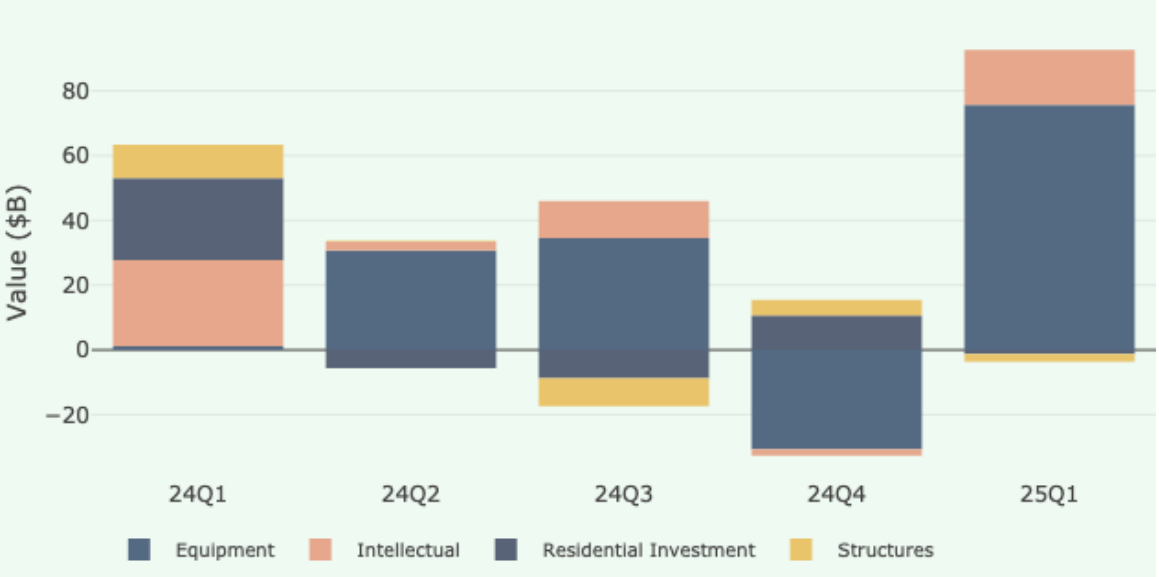
The challenge is that finance is the next leading contributor to service consumption growth. Yet, it's not apparent what innovation might drive this higher consumption. While financial security products for an aging workforce are a plausible reason, it seems unlikely when the growth spurt occurred post-pandemic. Thus, the key performance indicator for service consumption lies within these sectors. A service-dominated economy surely is more resilient than a goods-driven economy during trade turbulence, yet it would seem unlikely that higher prices for goods would not reduce healthcare and financial consumption. Absent growth, the pie is the same no matter the slices.

Investment

The residential housing market continues to exhibit zero growth, remaining at 2017 levels. In a similar vein, commercial structures plateaued at 2019 highs. The saving grace is information technology, which had its highest dollar value increase on record at over $75 billion (Exhibit 13). Some of this was driven by the rush into artificial intelligence data centers, while some of it aimed to avoid the prospect of higher tariffs, as most chips are sourced from Taiwan, a prime target of the administration. Yet, the critical question is whether persistently high interest rates will deter further real estate investment.

Equipment is falling with no substitute.

Exhibit 13. Investment Contribution by Component



Source: Federal Reserve Economic Database. Values are an annualized rate.

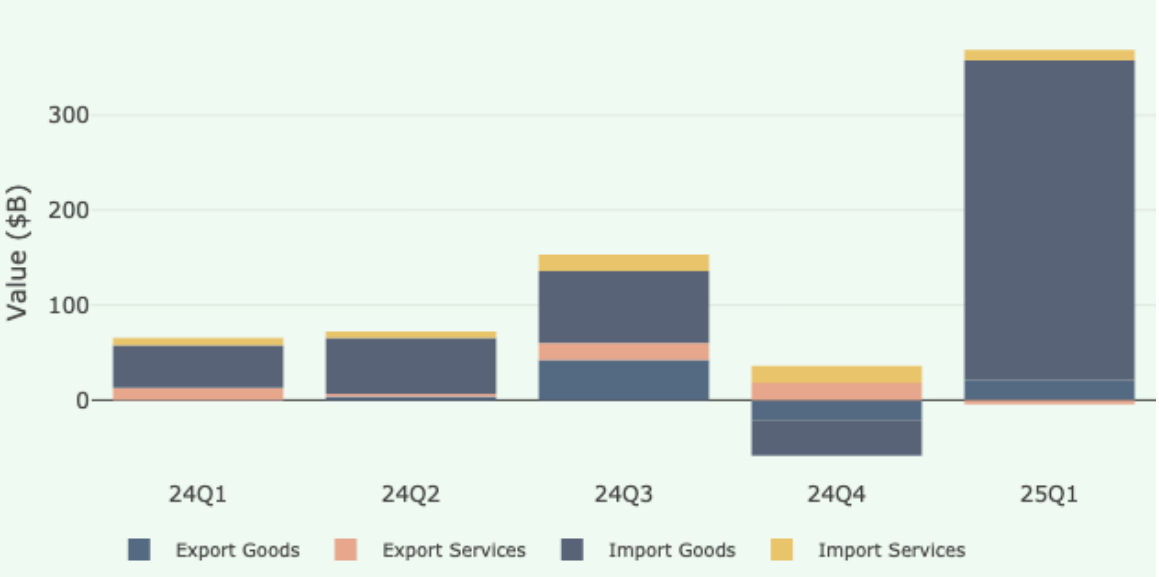
Higher interest rates are a material hurdle for investment, particularly so when combined with volatile federal policy. Businesses can handle higher interest rates alone, yet the uncertainty of future tax regimes and demand makes discounting future cash flows more of a gamble than an investment. Paradoxically, the government's focus on sectors (e.g., oil extraction) with an uncertain future, rather than alternative energy sources and artificial intelligence, appears to be strategic malfeasance if the goal is to maximize employment. The critical question is what investment will produce *incremental growth*.

Exports & Imports

The U.S. consumer earns its moniker, the consumer of last resort, from its voracious appetite for imported goods. Yet, what occurred in the first quarter is unparalleled in the data: a $335 billion jump in imports (Exhibit 14). The nature of national accounting led to the first quarter's negative growth, primarily driven by this data point. If tariffs are a weapon to wield, then rational consumers will act to avoid them in advance, particularly when capital and consumer goods account for nearly two-thirds of imported goods at $1.7 trillion. If import prices were to increase and no close substitute were available, then the *trade deficit would expand.*

Export and import goods are declining.

Exhibit 14. Net Exports



Source: Federal Reserve Economic Database. Values are an annualized rate.

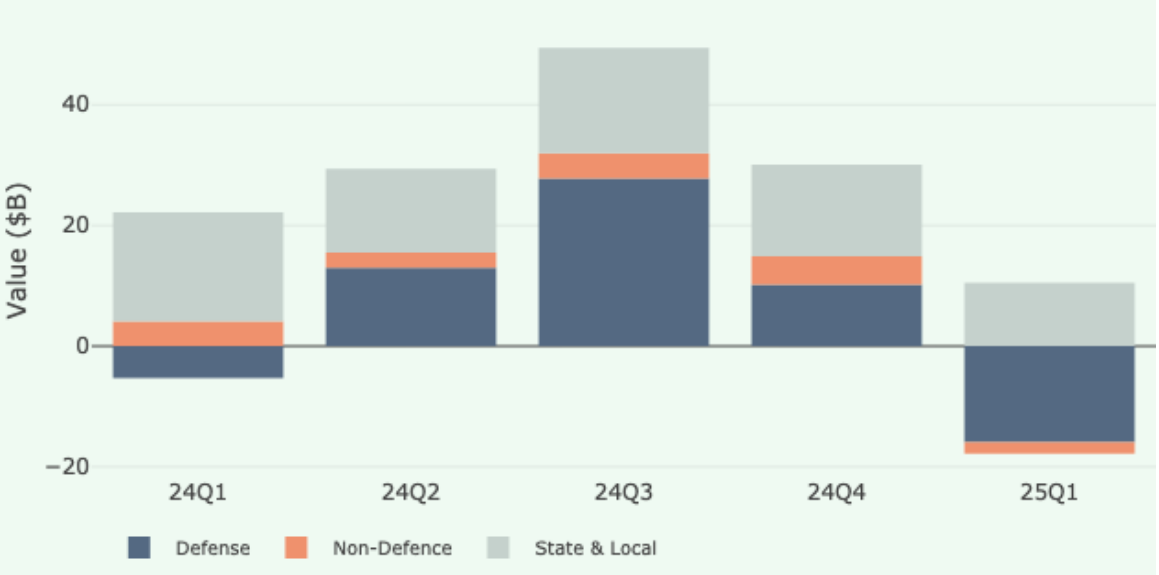
As witnessed, a response to US tariffs was inevitable. The challenge lies in the breadth of US imports because other nations don't need to impose universal tariffs. Instead, they can strategically choose their targets. Tactically, there are more imports to tax. Strategically, the US could potentially lose more of its $2.7 trillion in exports than it sees in the reduction of its $3.7 trillion in imports. The disconnect between expectation and reality may lead to suboptimal outcomes for US consumers and businesses. Strategy may trump tactics, but it can also undermine the US economy.

Government

Federal expenditures cratered as the Department of Government Efficiency (DOGE) ransacked the federal bureaucracy (Exhibit 15). The surprise was that the spending was centered on the defense component, rather than the non-defense component. Yet, the more significant component, state and local government, remained positive. Two factors are driving the slowdown of this component: the reduction of pandemic-era transfers and a slowing housing market, the lifeblood of local tax collections. This predicament highlights the risk: government expenditure growth is usually countercyclical; however, it is faltering at the same time as the other components.

State & Local government lead growth.

Exhibit 15. Federal and State Government



Source: Federal Reserve Economic Database.

The issue at the Federal level is the expansion of the deficit, which would lead to higher debt service and reductions in expenditures. This outcome could lead to reduced transfers to the lower government levels, which then would need to cut their costs. As tariffs impair trade, higher prices reduce consumption, and investment slows, fiscal policy stabilization is critical. Yet, DOGE seeks to *reduce spending*. Indeed, the US may face an economic fallout not seen in a century. There is a price for greatness: whether the US wants to bear the cost is less certain.

Forecast

The GDP forecast for *2025 is a decline of 0.4%*, with a consensus estimate of 1.5%.[2] Consumption is expected to slow as tariffs impact spending, with goods as the main detractor. The path forward for investment is uncertain as real estate faces high financing costs and a weakening consumer. Equipment investment may help as artificial intelligence expands, yet the frontloading of imports to avoid tariffs may obviate further expansion this year. The critical challenges are the expected spending cuts and the trade uncertainty.

Lower growth and higher inflation forecast.

The expected headline CPI Inflation for *2024 is 3.2%, and core CPI is 3.0%*, and is unchanged from the prior forecast. The consensus revised their forecast upwards to 3.3% and 3.5% from the previous rates of 2.8% and 2.9%, respectively. The primary driver of the consensus convergence is a slower moderation of housing prices. This trajectory will give the Fed pause, as the levels will remain higher than the two percent target, yet employment will fade. This dilemma will guide the Fed in making incremental reductions, gradually lowering the rate over the year with a *start date in the third quarter.*

Exhibit 15. Annual Forecast Versus Actual (%, y/y)

	2025	2024	2023	2022
Real GDP				
Forecast	***(0.4)***	*2.1*	*1.9*	*0.2*
Actual		2.5	3.1	0.7
Consensus	**1.5**	2.4	1.3	3.7
CPI				
Forecast	*3.2*	*2.6*	*2.9*	*4.6*
Actual		2.9	3.3	6.4
Consensus	**3.3**	2.5	3.1	3.8
Core CPI				
Forecast	***3.0***	*3.0*	*3.4*	*4.4*
Actual		3.2	3.9	5.7
Consensus	**3.5**	2.7	3.4	3.6

Note: All rates are percent changes 4Q/4Q. The consensus is the first-quarter Survey of Professional Forecasters.

[2] Survey of Professional Forecasters, *Second Quarter 2025*. https://www.philadelphiafed.org/research-and-data/real-time-center/survey-of-professional-forecasters/

Exhibit 16. GDP Component Summary Data

Component	Value ($B)	Q/Q (%)	Y/Y (%)
Gross Domestic Product	23,528	-0.1	2.1
Personal Consumption Expenditures	16,321	0.3	2.9
Services	10,782	0.4	2.6
Goods	5,561	0.0	3.7
Durable Goods	2,100	-1.0	5.2
Non-Durable Goods	3,472	0.5	2.9
Investment	4,557	5.6	6.4
Fixed Investment	4,347	1.9	2.7
Non-Residential Fixed Investment	3,600	2.5	3.7
Residential Investment	796	-0.1	-0.6
Federal	1,517	-1.2	3.0
State & Local	2,471	0.4	2.4
Defense	860	-1.8	4.2
Non-Defence	657	-0.3	1.5
Research	862	-0.6	-0.3
Exports	2,653	0.6	3.2
Imports	4,032	9.3	13.6

Source: Bureau of Economic Analysis, retrieved from FRED, Federal Reserve Bank of St. Louis.

Capital Risk

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