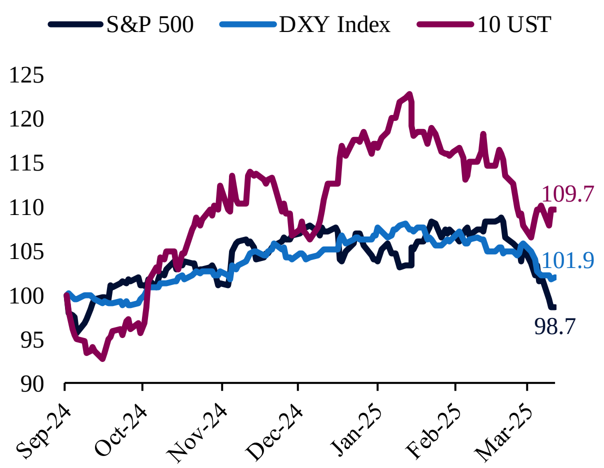
# US policy uncertainty drives fears of a recession

Earlier this year, we highlighted that the global growth outlook for 2025 would be largely determined by what happens in the US. This was not a controversial argument as the US accounts for around 1/4 of the global economy and was responsible for 32% of all the nominal growth globally since the pandemic in 2020. Moreover, the beginning of the Trump administration, starting with a strong mandate as well as the willingness to shake policy and support a pro-business agenda, suggested an end to "business as usual" decision making.

Initially, political change was met with investor optimism, given expectations for further tax breaks and deep de-regulation. This positive backdrop, which prevailed from the late part of the election until January, was also reflected by key markets. A rally in US equities (S&P 500) and the USD (DXY Index), alongside a pickup in long-term yields (10-year UST), all pointed to higher US growth expectations and US global outperformance.

**Major US asset classes**
(normalized, September 2024 = 100)

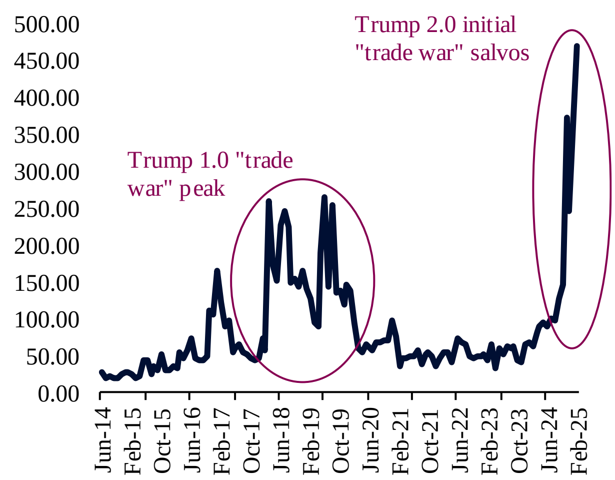



Sources: Bloomberg, QNB analysis

However, a sudden reversal of market sentiment started in February, as the new US administration launched some of its new policy initiatives. In a matter of a few weeks, the Trump "high growth trade" faded, with all major market moves reversing back to pre-election levels. Throughout late February and early March, the growth narrative also changed from a "no landing" scenario and fears of overheating and inflation to discussions about an imminent recession. In fact, a forecasting model by the Atlanta Federal Reserve, currently points to a deep contraction of 2.4% in Q1 2025 US GDP, a sharp deterioration from a 2.3% expansion in the previous quarter.

But what changed so drastically to justify such deterioration in activity and market expectations? In our view, two main factors explain the reversal in US economic momentum.

**Trade policy uncertainty index**
(100 = 1% share of articles, 2014-2025)




Sources: Haver, US Federal Reserve, QNB analysis

First, trade tariffs became a much bigger policy priority for the government than previously expected. Discussions so far include 25% tariffs on Canada and Mexico, 20% tariffs on China, 25% tariffs on all imports of steel and aluminium, and "universal tariffs" and "reciprocal tariffs" against all countries and products. Taken together, these discussions amounted to a significant increase of trade policy uncertainty. According to the trade policy uncertainty index, which measures the monthly frequency of articles discussing trade policy uncertainty as a share of the total number of news articles across major US newspapers, trade uncertainty is already higher than during the height of the "trade war" with China during Trump 1.0 (2017-2021). Trade uncertainty is disrupting

CAPEX planning by large companies and foreign direct investors, as supply chains need to be re-designed and cost structures re-estimated. Tariffs are also an indirect form of taxation that negatively affect household disposable income, placing pressure on overall consumption. Hence, tariffs are dampening market optimism, leading to lower investment, consumption and growth.

Second, the sudden shift in fiscal priorities is also negatively affecting demand and growth expectations. In recent years, the US has been aggressive in applying expansionary fiscal policies, pushing its deficit to around 7% of GDP and bolstering its economic performance. Currently, as the new US economic team prepares a significant fiscal consolidation to bring the deficit closer to 3%, US growth could slow significantly. Importantly, some of the policy initiatives extended by the government to promote savings and optimization, such as those carried out by the Department of Government Efficiency (DOGE), have been considered overly abrasive, generating significant uncertainty, anxiety and opposition. Threats of mass layoffs of US public employees are triggering a negative sign for consumer confidence, as the US government is by far the single largest employer in the country – the government employs around 3 million civilians and mobilizes around 1.3 million active-duty military personnel. Fiscal retrenchment and DOGE-sponsored initiatives are therefore negatively affecting consumption and overall aggregate demand, likely weighing on growth.

All in all, severe policy uncertainty on the trade and fiscal fronts is driving market volatility and a deterioration of investor and consumer sentiment. This is causing a significant change in expectations for growth. We have downgraded our US GDP growth projection for the US in 2025 to 1.5%, down from 2.2% earlier in the year.

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