GOVERNMENT PORTFOLIO ADVISORS

Weekly Economic Update—March 31st, 2025

Hurt feelings are running deeper, and they may be starting to pierce the economy's armor. To be sure, the chasm between soft and hard data remains exceptionally wide, and most indicators still portray an economy that is running comfortably above recessionary waters. But that sinking feeling is becoming more palpable and downward revisions to growth are spreading. Don't look now, but the first quarter is already treading perilously close to negative territory, given the tracking record of incoming data for January and February. One quarter does not make a recession, of course, and there is every reason to believe that a spring rebound is in the cards, one that will launch the economy onto a respectable growth trajectory for the remainder of the year.

But just as rising inflation expectations could become a self-fulfilling prophecy, it's possible to talk ourselves into a recession if the public's mood turns downbeat enough. At what point that threshold is passed ---i.e., when sentiment is bad enough to have a meaningful impact on behavior – is uncertain. The economy has turned in a respectable performance in the past when households were in the doldrums. But rarely has it occurred five years into an expansion, and coming off a year of solid growth, low unemployment and torrid wealth gains linked to eye-opening gains in stock prices and housing equity. While these tailwinds remain mostly in place, households are becoming firmly convinced they will fall by the wayside rapidly if not sooner.

A litany of reports in recent weeks highlights the downbeat mood of households and businesses. This week's data spotlight shone brightly on households, revealing not only a further downdrift in sentiment, but also hints that their growing pessimism may be influencing behavior. Reinforcing the gloomy reading by the University of Michigan, the Conference Board survey for March confirmed that households are turning ever-more pessimistic – expecting deteriorating job conditions, weaker incomes and even a poor stock market. Topping it off, they expect living costs to become more expensive, as inflationary expectations – echoing that of the University of Michigan survey – are moving decidedly higher.

The overall confidence index fell for the fourth consecutive month, landing at the lowest level since 2021. That's even lower than the depressed level in mid-2022, when households awoke to the inflationary spiral that was just gaining traction. Only a reasonable comfort with current labor conditions prevented the overall index from falling more steeply. But that too is on fragile ground, as the index of household expectations, which include job prospects, sank to the lowest level in 13 years. The link between household sentiment and behavior is loose, but it is worth noting that the current level of the overall index is lower than in the final month preceding the last four recessions.

While causality between surveys and behavior is hard to prove, the unceasing rollout of depressed readings on household sentiment has no doubt contributed to the subjective upgrades of recession odds in recent weeks. To be sure, those odds have yet to be confirmed in the hard data, but signs that people's feelings are seeping into their behavior are showing up. The key focus, understandably, is on consumers, as they are the main drivers of growth. With two months of the year now in the books, their contribution to the economy's performance in the first quarter has fizzled from the previous quarter,

when the sizzling 4.0 percent increase in personal consumption underpinned a solid 2.4 percent increase in GDP. Neither of those growth thresholds are likely to be remotely seen this quarter.

To be fair, it is difficult to separate the noise from the signal over the first two months of the year due to the vagaries of weather and the shape-shifting nature of Trump's tariff threats. Those threats have clearly contributed to the upsurge in inflationary expectations and are wreaking havoc with spending and investing plans of households and businesses. The January pullback in consumer spending was generally overlooked because of the depressing influence of harsh weather conditions. But forecasts for a solid rebound in February did not materialize, as the tepid 0.1 percent increase in real consumption from the downwardly revised 0.6 percent drop in January was far weaker than expected. Barring an exceptional jump in March, real consumer spending is on track for a subdued 0.6 percent increase in the first quarter, pointing to a significant drag on the GDP growth rate. Whether it stays above or below the zero boundary will depend on how the volatile components of trade and inventories play out.

The good news is that the foundation for a spring rebound in consumer spending is in place, as the income side of the ledger is still growing at a solid pace and outrunning inflation. Real disposable income staged a healthy 0.5 percent increase in February, the strongest since January 2024, and far above the 0.1 percent average monthly increase last year. The bad news is that a smaller percentage of income growth is coming from wages, which has the strongest influence on spending. Labor compensation accounted for less than 30 percent of the nominal income gain in February and less than 25 percent over the first two months of the year. Normally, the wage contribution is much higher, accounting for over 50 percent of income growth in 2024. A big part of the shortfall was taken up by interest and dividend receipts on financial assets, which are making a much bigger contribution to income growth this year.

That said, the sturdy income increase against the weakness in spending meant that households built up their savings rate, sending it to a 9-month high of 4.6 percent in February from 3.3 percent at the end of last year. Since a bigger boost to income is coming from financial assets, we suspect that the most, if not all, of the savings increase accrued to wealthier households This cohort has a lower propensity to spend out of incomes, so the increased savings buffer may not translate into as much spending firepower as would be the case if it landed in the bank accounts of lower income households. However, the savings cushion will likely be drawn down to absorb the higher prices on many of the goods that proposed tariffs will bring about.

It may well be that the anticipation of higher prices linked to tariffs is, in part, spurring the increase in savings. For sure, the March reading on inflation did not help dampen inflation expectations. The increase in the core personal consumption deflator, which is the Federal Reserve's preferred inflation gauge, ticked up to 0.4 percent in February from 0.3 percent in January, lifting the year-over-year increase to 2.8 percent from 2.7 percent. That pushes it further away from the Fed's 2 percent target and increases the odds that it will not resume the rate-cutting campaign until at least late this year.

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FINANCIAL INDICATORS

INTEREST RATES	March 28	Week Ago	Month Ago	Year Ago
3-month Treasury bill	4.29	4.29	4.30	5.23
6-month Treasury bill	4.22	4.23	4.29	5.13
2-year Treasury note	3.92	3.96	4.01	4.59
5-year Treasury note	3.99	4.01	4.03	4.21
10-year Treasury note	4.24	4.25	4.22	4.20
30-year Treasury bond	4.63	4.59	4.51	4.34
30-year fixed mortgage rate	6.65	6.67	6.76	6.79
15-year fixed mortgage rate	5.89	5.83	5.94	6.79
STOCK MARKET				
Dow Jones Industrial Index	41,583.90	41,985.35	43,840.91	42,052.19
S&P 500	5,580.94	5,667.56	5,954.50	5,728.80
NASDAQ	17,322.99	17,784.05	18,847.28	16,379.46
COMMODITIES				
Gold ($ per troy ounce)	3,117.90	3,026.50	2,867.30	2,254.80
Oil ($ per barrel) - Crude Futures (WTI)	69.00	68.28	69.95	82.73

ECONOMIC INDICATOR	Latest Month/Quarter	Previous Month/ Quarter	Two-Months/ Qtrs Ago	Average-Past Six Months or Quarters
New Home Sales (February) - 000s	676	664	713	680
Durable Goods Orders (February) - % change	0.9	3.3	-1.8	0.2
Personal Income (February) - % change	0.8	0.7	0.3	0.5
Personal Consumption (February) - % change	0.4	-0.3	0.9	0.4
Savings Rate (February) - Percent	4.6	4.3	3.3	4.0

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