GENERALI ASSET MANAGEMENT

FOCAL POINT

The US economy after the election: strong growth now, uncertainties later.

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Our Focal Point series explores topical issues on macro, markets and investment

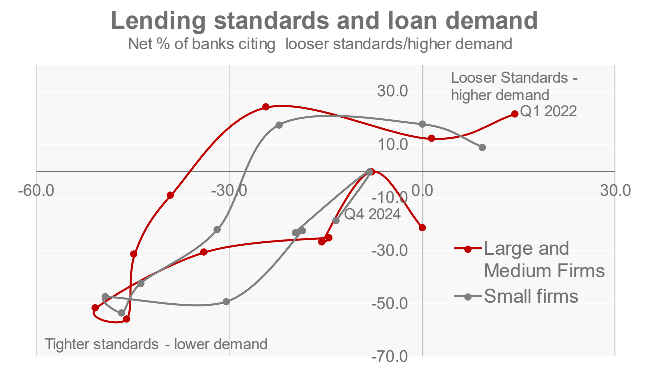
- **President Trump will take over a strong economy with high productivity gains. We now expect 2.4% growth in 2025 and a small acceleration in 2026 before tariffs take their toll from 2027.**
- **The Republican win will bring about substantial changes in economic policy. Tax and immigration cuts may be more important than tariffs, which may be phased in more gradually than feared. Uncertainty is big on the timing of policies. Risks are titled towards a quicker and more harmful implementation of tariffs.**
- **Higher growth will limit disinflation next year, but core inflation can still hit 2% by Q1 2026. In our scenario tariffs will affect inflation, but after 2026.**
- **The new political setting will not stop the Fed from cutting rates, though we now expect only another 100bp in quarterly steps from here, implying a landing rate at 3.5%-3.75% because of stronger growth and a worse fiscal outlook. Political pressure on the Fed will rise, but not eliminate its independence.**

The Republican sweep victory in the presidential and congressional elections has prompted speculation about a significant shift in economic policy, which could have a notable impact on inflation and growth. Some “shockers,” in terms of appointments and draft legislation, have already been announced, and the full package of measures will be displayed gradually. Meanwhile, the US economy will continue to benefit from the growth momentum of the past two years.

Sustained growth in 2025, supported by productivity gains.

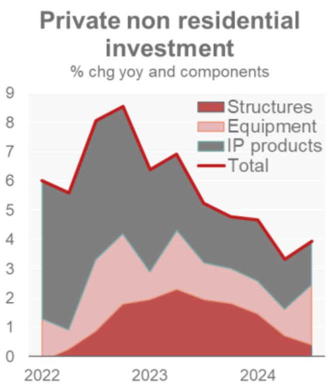
President Trump inherits a strong economy, with growth likely to exceed 2% annualised in Q4 and in H1 2025. Despite the less optimistic surveys and recurring concerns about inflation (one of the factors that contributed to the Trump victory), consumption has remained robust and is unlikely to decelerate significantly, given the continued strength of real income. The recent revision to income data has led to a notable increase in the saving rate. We anticipate that it will rise from its current level of 4.6% to 5.3% by the end of 2026 and subsequently reach the pre-pandemic average of 6% by the following year. But the low level of household leverage should prevent a faster accumulation of precautionary savings. Slower economic activity will result in moderate job losses, with the unemployment rate likely to reach 4.4% in Q2 2025 from 4.1% now. Data on sentiment and orders indicate a potential rebound in capital expenditure, both for residential and non-residential, which we believe will be a significant driver of growth over the next couple of years.

Firstly, there are now more favourable conditions capex financing. This is due to several factors, including strong corporate profitability and liquidity, lower borrowing costs and the peak in lending standards having passed.

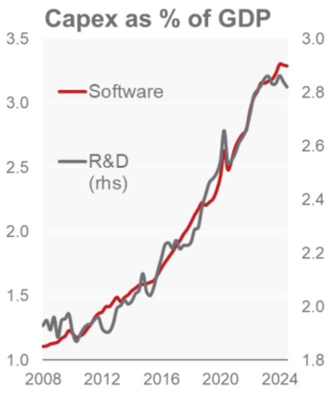


Source: Federal Reserve SLOOS survey, GenAM

Secondly, the sharp increase in structure investment in the computer and electronics sector that followed the introduction of the Biden administration's policies should be followed by higher equipment spending as factories start production. It is likely that AI will provide an additional boost, although this is difficult to quantify as national accounts do not yet provide sufficiently detailed information.



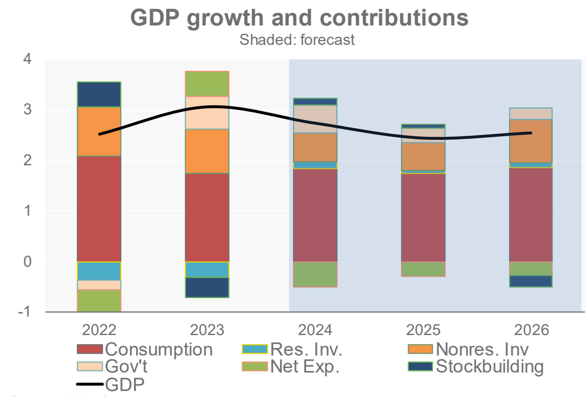
Source: BEA, GenAM



Source: BEA, GenAM

Political uncertainty on trade remains the biggest downside, as it can interfere with manufacturers' planning. As we detail below, we do not have much information and for the time being we assume the swift announcement of some measures aimed at the whole of import from China and some selected EU products (cars), which will set the stage for negotiations. The actual timing and size of the measure will result from this bargaining.

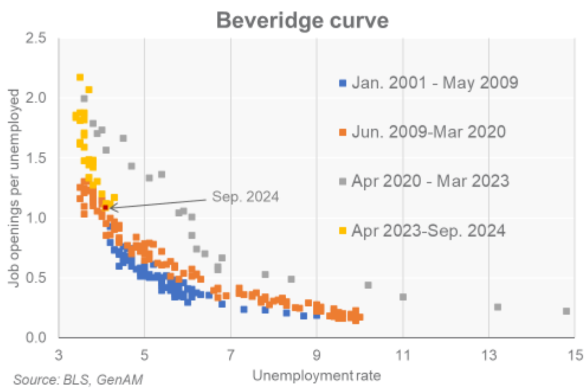
Further investment would facilitate the continuation of one of the most interesting trends observed in recent quarters. The latest data revisions have revealed an even stronger rate of labour productivity. Some of this is likely to be cyclical, a reaction to a tight labour market that will likely dissipate. However, the substantial increase in R&D and software expenditure in the post-pandemic period is likely to provide a more sustainable boost. This, along with the delayed effect of the surge in immigration, is likely to have pushed up the trend growth rate of the economy to around 2%, according to the CBO projections. This indicates that, prior to considering the influence of the revised economic policy, domestic demand can grow at a consistent rate without endangering disinflation. We anticipate GDP to expand by a robust 2.4% in 2025 (up from the 2.2% observed in October), with an acceleration to 2.5% in 2026, in part due to the Trump administration tax and deregulation policies.



Source: BEA, GenAM

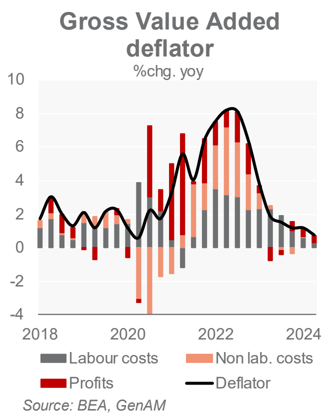
Gradual disinflation with upside risks.

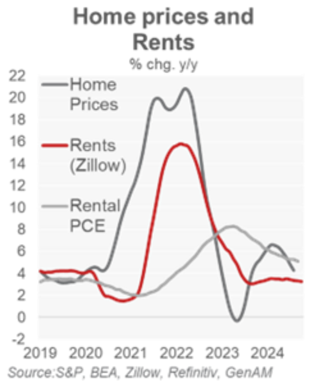
Core PCE inflation should reach 2% by early 2026, before upside risks from trade policy will likely kick in. Next year's inflation outlook will depend on how the labour market and other parts of the economy perform. The labour market has weakened, with fewer job openings. It should start moving along the pre-Covid Beveridge curve (see chart), with a mild increase in the unemployment rate. This would help disinflation in the labour-intensive services industry.



Source: BLS, GenAM

Upside risks to inflation arise from sustained strong demand, which could maintain high margins, and, although less probable, from a rebound in labour costs. In terms of components, the behaviour of the rent components deserves attention. Following a period of deceleration, house prices have moderated the rental component of PCE, although the cooling has been less pronounced than suggested by new rental data. Meanwhile, house price inflation has risen once more, which could result in some reheating and volatility in a significant component of core PCE inflation, which the Fed has some control over. This could lead to a flattening of the path of Fed easing in the second half of 2025.





Policies: a small bite after a loud bark?

How, when and to what extent the Republican policy agenda is implemented shape our forecast from H2 2025 onwards. The new administration is still in the initial stages of preparation, but we anticipate a significant attenuation of the most extreme economic measures announced by Trump during his campaign. Furthermore, the administration will prioritise the most visible items of the programme (tax cuts and immigration curb) over those that are more controversial and likely to cause rapid inflationary pressures, such as tariffs. On this front we clearly expect some announcement and possibly limited action soon after the Jan. 20 inauguration, but implementation will take time and depend on the outcome of the negotiation with the main trade partners. There are two main reasons for this sequencing:

- The Republicans enjoy a 5-seat majority in the Senate and a provisional one of 10 in the House of Representatives1: this means that any change involving tax revenue and expenditure will have to be legislated using the lengthy and complex reconciliation process. In the very first day, the new Congress will have to deal on how to secure Federal funding after the suspension of the debt ceiling that ends at the beginning of January. This will require time and effort. Moreover, centrist senators and those living in rural areas will likely push back against too punitive tariffs that would trigger Chinese/ EU retaliation on farm products: Trump could clearly resort to executive orders as he did in his first term, but this will limit the scope for action to specific products and exporting countries. Similarly, they may be reluctant to implement strict immigration policies, which could result in labour shortages in their constituencies.
- Despite the rhetoric, we think that Republican leaders are aware of the inflationary impact of too harsh tariffs and recognise that the ruling party is likely lose seats in the mid-term election, which will take place in November 2026. Therefore, they will be cautious about taking any action that could lead to an inflationary surge in the period leading up to the election.

We then think tax cuts and immigration restrictions will come first, followed by trade measures. In this case it is hard to predict the timing: the announcement will be fast; the speed of implementation will depend on several factors. In our projection we expect them to start affecting the economy at the end of 2025 and have a gradual impact. This is very uncertain, and risks are tilted to an early and more harmful implementation, so we will update our forecasts and run some alternative scenarios.

Our assumptions on the policy settings are the following:

- In terms of fiscal policy, we anticipate a net increase in the deficit of approximately US$ 3tn between FY 2026 and 2033: we expect the deficit to shrink marginally from 6.2% of GDP in calendar year 2024 to 6.1% next year. In addition to the extension of the Tax Cuts and Jobs Act (TCJA) provisions set to expire in 2025, the administration will cut taxes for households, ease the fiscal burden to firms by cutting the tax rate on profits from 21% to 18% and providing a more favourable treatment of deductions for firms and increase defence expenditure. It is probable that most of these revenue reductions will be unfunded, which would serve to further boost activity and debt. The potential removal of the IRA-mandated funding or tax benefits will have to consider the fact that these measures are currently popular in many Republican-leaning states, such as Texas. Most savings are likely to be achieved by reducing subsidies for electric vehicles, although this may prove challenging given the role of Elon Musk, the owner of Tesla, in the administration. Secondly, Mr. Musk has been assigned the task of restructuring the functioning of the federal administration. However, it is not yet clear what the savings will be and when they would materialise. It is important to note that 70% of federal non-interest expenses are mandatory. Furthermore, 12% of total expenditure is allocated to defence, which the new administration plans to increase. Most mandatory expenses finance popular programs such as Medicare and Medicaid, which have broad bipartisan support. Reducing these entitlements could have adverse political consequences.
- Immigration: we expect tough talks to be followed quickly (by mid-2025) by actions aimed at restricting the inflows of humanitarian migrants which have constitutes the bulk of the recent rise in immigration, mostly via tighter administrative requirements which do not require changes to the legislation. This should trim inflows from the 1.25mn per year seen in

[1] At the time of writing vote counting was not finished

2023/24 to around 800k. Mass deportation is unlikely as difficult to implement and potentially harmful to labour supply in some industries.

- Tariffs: we assume that calls for across-the-board tariffs are just signalling the beginning of a tough negotiation. Still, and as shown by the possible re-appointment of trade-hawk Robert Lighthizer as US trade representative, some measures will follow through. In a somehow benign scenario, we expect a few, limited tariffs to be implemented rather soon by executive order and the bulk of them to be legislated in the second half of 2025, to leave some room for negotiation with the trade partners and being gradually implemented from 2026. They will not be across the board but target sectors/countries in which the US trade deficit is higher. So, as a working assumption, we pencil in by 2027 a 25% tariff on EU export of steel aluminium and vehicles and on Chinese sales of machinery, electronic equipment, and chemicals. A 10% tariff could be imposed on Mexican industrial metal exports and on Chinese EVs. We expect less than full retaliation, as the EU needs the US help on Ukraine and China has other levers to remain competitive, e.g. currency depreciation.
- Deregulation: during the electoral campaign, the Republican party has promised a wave of deregulation ranging from environmental regulation to banks. Most of it is feasible given the full control of the Congress but is at present the timeline I snot clear.

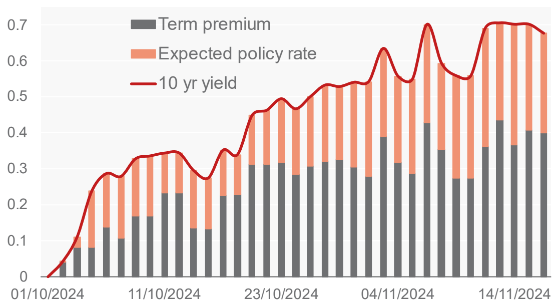
These measures entail a positive demand shock from the fiscal side and two adverse ones, the first from immigration cutting labour supply followed by tariffs, with a positive supply shocks form regulation, whose timing is uncertain. Given the timing we have assumed, we expect a frontloaded boost to GDP (in late 2025 and 2026) followed with a substantial lag by stronger inflation starting to materialise in 2026 and finally the recessionary impact of tariff, from 2027 onwards. This is an optimistic view on how the new administration proceed; a change in the timing, sequencing and size of the measure can have a substantial impact on growth and inflation already in the second half of 2025. A cautious stance by the Fed in cutting rates may prove a drag on growth.

Fed easing constrained by demand strength.

Given our assumption of moderating growth with gradually easing wage cost pressures, the Fed should continue to normalise its monetary policy, even if at a much more prudent speed and extent than what seemed likely before the US election outcome. We still expect another 25bp cut in December, but we trimmed the extent of accommodation for next year to 75bps. We see a cut in March with the other two spread out throughout the year: this will result in a landing rate in the 3.5% - 3.75% range. As shown in the appendix, such a path is broadly consistent with what prescribed by a few policy rules. The recent price data show that inflation remains bumpy, calling for caution in easing policy as growth does not seem at risk. A spaced-off pace of cuts will provide the Fed with more leeway for recalibration in case of surprises, which we think are skewed upwards for inflation. As repeated by Powell in the November meeting the Fed can and must act based on hard data and not on the hypothesised effect of economic policy. Thus, the adjustment of the policy rate to the consequences of the new administration policies will occur with some delay. Meanwhile financial markets will discount the effect on growth and inflation. The recent rise in US long rates owes in roughly the same amount to upward revision to the policy rate and to the net supply of bonds, proxied by the term premium. The disconnect between market expectations about the deficit, pushing up yields and monetary policy, reacting with a lag could lead to a steepening of the curve and a tightening in financial conditions.

Evolution of the 10 year yield

Cumulated change. Based on the ACM decomposition



Source: NY Fed, GenAM

During the campaign, Trump criticised the Fed choices on rates and hinted at a politicisation of the Fed. We do not think that deeds will follow words.

First, the calendar prevents a sizeable reshuffling of the FOMC. The terms of only two members will expire during the President Trump's mandate, the other five can stay until 2030 or later. Secondly, it is true that Powell will end his term as Fed chair in 2026 but could in principle stay in the board for two more years. The same applies to Governor Barr, whose term will expire as Vice chair for regulation in 2026, but he can stay on the board until 2032. If they step down from the board the President could choose more friendly appointments. Yet decisions on rates are taken with a majority vote, which includes the five rotating members picked from the regional Fed banks, who are appointed by the local boards. The Trump's choices could then be overruled. Finally, any suspect of a weaker commitment to fight inflation would most likely trigger a sharp rise in interest rates. In theory the majority in the Congress could enable the administration to change the Federal Reserve Act and reduce independence, but fears of the almost inevitable pushback from the bond market will prevent any such move.

APPENDIX: Our Fed Fund Rates forecast versus policy rules

As the effect of the pandemic and the exceptions policy response fade, policy rules would become a less rough guide to forecast the path for the policy rate. We then assess how our own projections and those from futures stack up with what rules prescribe. Following the literature and what is known of FOMC thinking we plugged in our unemployment and core PCE inflation forecast into five different rules. We consider the following set up:

1) To account for the graduality of rate changes we use inertial rule, whereby the actual rate is a weighted average of the past period's rate and what prescribed by the policy rule, with a very high degree of persistence[2]:

$$FFR_t = \alpha FFR_{t-1} + (1-\alpha)FFR_t^{Rule} \quad \alpha = 0.85$$

2) We employed the following rules.

- Taylor Rule

$$FFR_t^{Rule} = r^* + \pi_t + 0.5(\pi_t - \pi_t^*) - (U^* - U_t) \; with \; r^* = 0.9, \pi_t^* = 2\%, U^* = 4.1\%$$

- Balanced Rule

$$FFR_t^{Rule} = r^* + \pi_t + 0.5(\pi_t - \pi_t^*) - 2(U^* - U_t)$$

- Inertial Rule

$$FFR_t^{Rule} = r^* + \pi_t + 0.5(\pi_t - \pi_t^*) - 1.2(U^* - U_t)$$

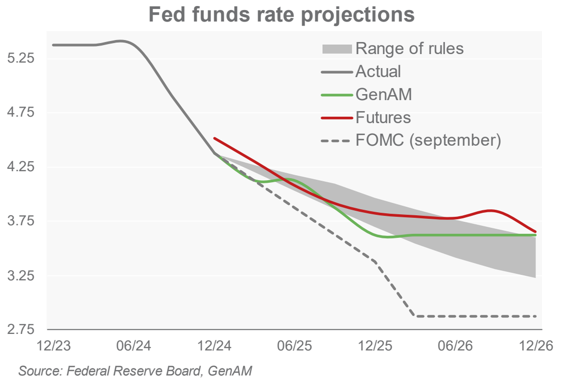
- Inertial Rule, lower weigh on the unemployment gap

$$FFR_t^{Rule} = r^* + \pi_t + 1.6(\pi_t - \pi_t^*) - 0.16(U^* - U_t)$$

- Inertial Rule, higher r*

$$FFR_t^{Rule} = r^* + \pi_t + 0.5(\pi_t - \pi_t^*) - 1.2(U^* - U_t), with \; r^* = 1.1,$$

The chart below compares the range of implied path for the policy rates with our assumption, the dots of the September meeting and the latest values of the Fed fund rates futures, for the 2025/2026 horizon.



[2] The value of the persistency parameter has been chosen looking at the literature on optimal monetary policy. See here for more details.

Imprint

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