Are tariffs starting to take a toll on the US economy?

The US economy started the year with another quarter of above-3% GDP growth—the third such gain in the last four. Details were less than stellar, however, with domestic spending rising just 1.5%, one of the slowest increases in the past five years. We’re looking for a better composition of growth in the second quarter. Government spending will provide a boost as shutdown-related declines in the past two quarters are reversed. And while April was a flat month for consumers, solid momentum toward the end of last quarter leaves household spending tracking a firm increase in Q2. Resurgent consumer confidence (May’s reading was the best this year and not far from 2018’s multi-decade highs) and a solid labour market point to continued strength in the sector, which represents 2/3 of the US economy.

While that key engine of growth still looks to be in high gear, other areas of the economy are showing signs of stalling. US manufacturing output fell by 1/2% or more in three of the first four months of 2019. Activity in the sector is now flat relative to a year ago—a first since 2015-16 when a pullback in the energy industry took its toll. The ISM manufacturing survey showed business sentiment continuing to soften in May. The new export orders index, in particular, has declined in each of the last five quarters, and half of respondents quoted in the report said tariffs were driving up costs or impacting their supply chains. Trade uncertainty might also be negatively impacting capital spending plans. After rebounding to start the year, capex orders unexpectedly fell in April and shipments are down so far in the second quarter. Business investment got a boost from corporate tax cuts and investment incentives last year, but slower growth in Q1 could be a sign of things to come if trade issues are unresolved.

Latest threats could deepen the impact

Optimism that the US and China were close to a trade agreement faded quickly in May when the Trump administration announced an increase in tariff rates from 10% to 25% on nearly $200 billion of Chinese imports. That increase, which had been threatened last year but was put off amid ongoing negotiations, amounts to a significant escalation in the two countries’ trade spat. For scale, the average US import tariff increased by 1 percentage point over the last year, largely due to the new levies on China. We think this latest tariff hike will add another 3/4 ppt. And the Trump administration might not be done there, threatening to add tariffs on all remaining Chinese imports that have yet to be targeted. China responded by announcing retaliatory tariff hikes on a list of $60 billion of US imports. All eyes are now on the G20 summit in Japan in late-June when it is hoped that a face-to-face meeting between Presidents Xi and Trump might help ease tensions and allow negotiators to clear the current impasse.

With the Trump administration’s trade ire seemingly focused on China, Mexico was caught off-guard by Trump’s threat to apply across-the-board tariffs on Mexican imports (starting at 5% and potentially rising to 25% by October) if the country doesn’t do more to stem the flow of illegal immigrants. The move was particularly surprising given the current push to ratifyCUSMA. US trade relations are clearly in a state of flux—even more so than over the past year. Our working assumption is that threats against Mexico will not lead to sustained action, and that some form of de-escalation between the US and China will be agreed in the coming months. Still, we think the latest tariff hikes and increased uncertainty for businesses will weigh on the US industrial sector and business investment through the middle of the year. As a result, we are looking for growth to slow to just less than 2% in the coming quarters, though that forecast remains subject to considerable uncertainty on the trade outlook.

At this stage, we don’t think the moderate slowing in US GDP growth assumed in our forecast is enough for the Fed to reverse course and begin lowering interest rates. But further escalation of trade tensions, or a greater hit from recent actions than we’re assuming (particularly if the impact spreads more significantly to the consumer sector) could see policymakers moving in that direction. Rates markets are currently discounting almost 75 basis points of easing from the Fed by next January.