Rising Uncertainty in the US Economy: Growth Slows & Inflation Risks Increase

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The US economy contracted in Q1 2025. Early Q2 data has been mixed - while hard data (e.g. employment) shows resilience, soft data (e.g. consumer and business sentiment) suggests potential weakness that could impact future growth. Inflation remains above the Fed's target, with tariffs posing upside risks. With the US growth and inflation outlook moving in opposite directions, the Fed's policy response will be closely watched, though much will depend on the outcome of the trade negotiations.

FOMC Keeps Rates Unchanged Amidst Increased Uncertainty

As expected, the FOMC kept the benchmark interest rates unchanged at 4.25-4.50% in May, acknowledging increased uncertainty around the US economic outlook. The FOMC statement highlighted that the risks to both sides of its dual mandate - price stability and maximum employment - have risen.

With US inflation still elevated and growth concerns rising, the Fed's policy response will be closely watched. Much will depend on the outcome of ongoing trade negotiations. Talks between the US and China are expected to begin soon, which has lifted market sentiments. Similarly, trade discussions with other countries are underway. However, until more clarity emerges, the full implications for US growth and inflation remain uncertain.

Currently, markets are pricing in three Fed rate cuts in 2025 - fewer than the four rate cuts expected a week ago but more than the two rate cuts indicated in the Fed's March dot plot. A more pronounced weakening in the labour market could lead to deeper monetary easing by the Fed.

The weaker dollar and expected Fed rate cuts also open room for further monetary easing in India. We expect the RBI to cut rates by another 50bps in FY26. In contrast to the US, India's inflation outlook remains favourable, with global commodity prices softening and the IMD forecasting surplus rainfall during the upcoming southwest monsoon season. There is also scope for deeper RBI rate cuts if global trade conditions worsen.

US Economy Faces Growth Concerns and Inflation Challenges

The US economy contracted in the first quarter of 2025, with GDP shrinking by an annualised 0.3% (QoQ) - the first decline since 2022. Notably, this contraction came even before new US tariffs were implemented. The contraction was largely driven by a sharp increase in imports, as businesses front-loaded shipments ahead of expected trade barriers. Imports surged by 41.3%, while exports increased by just 1.8%.

Government spending also weighed on growth, falling by 1.4% - its first contraction since 2022. Meanwhile, consumer spending growth slowed to 1.8% - its slowest pace since 2023. However, private domestic investment increased by 21.9%, the strongest increase since 2021.

It is important to note this is only the first estimate of GDP and may be revised in the future. So far, hard data for Q2 has not shown any signs of weakness. For example, in April, the US added 177,000 jobs - well above market expectations of 130,000 and last year's monthly average. The unemployment rate held steady at 4.2%, comfortably below the pre-Covid average of 6.2%.

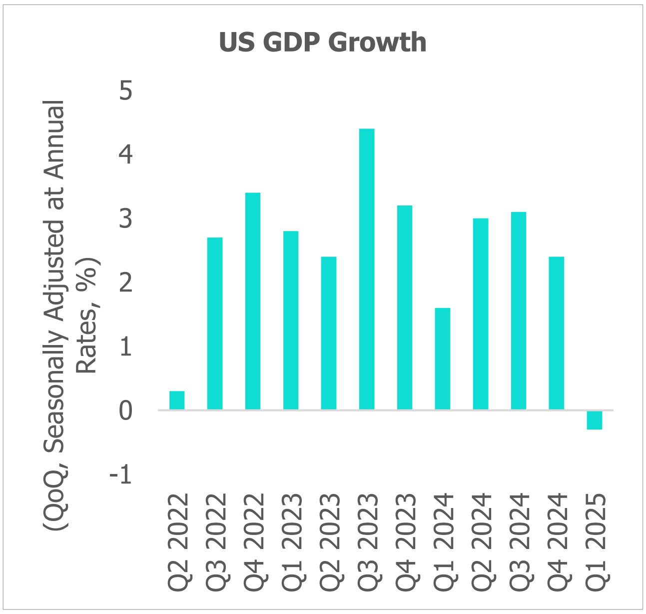
However, soft data is showing some signs of weakness. The ISM Services Employment Index remained in the contraction zone for a second consecutive month in April. Similarly, the ISM Manufacturing Employment Index has been below 50 for three consecutive months. The University of Michigan Consumer Sentiment Index has also declined for four straight months, reaching its lowest level since 2022.

Concerns about US growth have increased amidst heightened trade policy uncertainty. The IMF recently slashed its US GDP growth forecast by nearly one percentage point to 1.8% for 2025, marking a significant downward revision over just four months. It also raised the probability of a US recession to 37% from 25%.

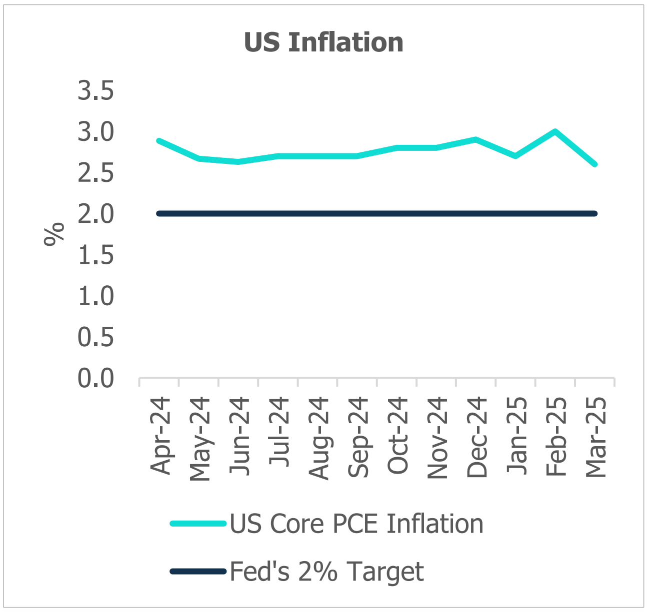
Inflation pressures remain. Core PCE inflation, the Fed's preferred gauge, is at 2.6%, still above the Fed's 2% target, and tariffs are adding to upside risks. US tariffs on Chinese goods remain high at 145%, and a baseline 10% tariff on imports from other countries has been maintained. Inflation expectations are also elevated. One-year ahead inflation expectations, as measured by the University of Michigan survey, stood at 6.5% in April – the highest level in four decades. Meanwhile, the five-year inflation expectations stood at 4.4% - the highest since 1991.

The 10Y UST yield jumped by 50bps to around 4.5% in April, driven by inflation fears, weak auctions, foreign investment outflows, and the unwinding of basis trades. However, yields have moderated since then to around 4.3%. At the same time, the US dollar index has fallen to a near three-year low as investors have moved to other safe-haven assets amidst US growth worries.

Going ahead, US trade policies will be key in shaping the direction of US growth and inflation. The outcomes of the ongoing negotiations could significantly influence domestic demand, price pressures and in turn the Fed's response. Financial markets are likely to remain sensitive to trade-related developments.



Source: US Bureau of Economic Analysis



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