KeyBank

Economic Outlook 1H 2025

U.S. economy weakens amid uncertainty around global trade policy, tariffs and inflation

After exceeding expectations in 2024, the U.S. economy was on strong footing at the start of 2025. But momentum has slowed during the first half of this year, and the first quarter saw growth of -0.3% as firms attempted to "front-load" the cost of tariffs by purchasing more imports.

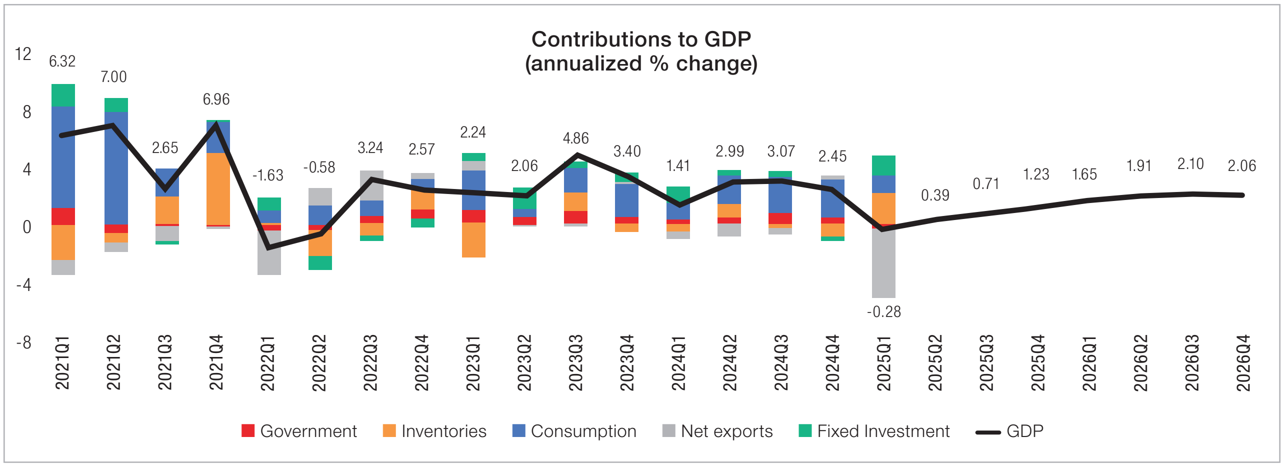
Risks to economic growth in 2025 include the new administration's aggressive and unpredictable trade and immigration policies, federal job cuts and restructuring, and federal budget cuts. Meanwhile, confidence among businesses and consumers has lowered amid fears that high tariffs on trade partners will cause inflation to surge and consumer demand to falter. While business leaders remain hopeful for tax cuts and deregulation, mounting uncertainty presents a variety of potential scenarios and challenges to navigate.

Overview: U.S. economic growth slowed in the first quarter of 2025

U.S. GDP declined at a rate of 0.3% during the first quarter of 2025. Contributing factors to the decrease in growth included a pullback in government spending, as well as a reduction in net exports. Specifically, in advance of the new tariffs the U.S. presidential administration announced going into effect on April 2 (and subsequently paused), businesses ramped up imports of goods, exceeding the amount of goods exported during the same period.

Among businesses and consumers alike, the primary concern about an increase in tariffs is the effect on the prices of goods, i.e. inflation. According to the Bureau of Labor Statistics, consumer prices rose 0.2% in April, bringing the annual inflation rate to 2.3% — a slight decrease from March's 2.4% reading, and a better result than economists expected. However, the data likely does not yet reflect the consequences of new tariffs. How soon inflation will respond depends on factors like the amount of inventory retailers had on hand before the tariffs went into effect, which input materials are impacted, and the ability of firms to pass costs on to consumers.

Businesses and consumers aren't the only ones keeping a close on eye on inflation: the Federal Open Market Committee (FOMC) has a dual mandate of promoting full



Source: Bureau of Economic Analysis (BEA), Moody's

employment and keeping inflation in check, and its primary policy tool for accomplishing those goals is the federal funds rate. On the employment front, total nonfarm payroll employment increased by 177,000 workers in April, and the unemployment rate held steady at a historically low 4.2%. For now, the labor market appears strong, and inflation is manageable. But the big question is which of these might deteriorate first, and what will the Fed do in response?

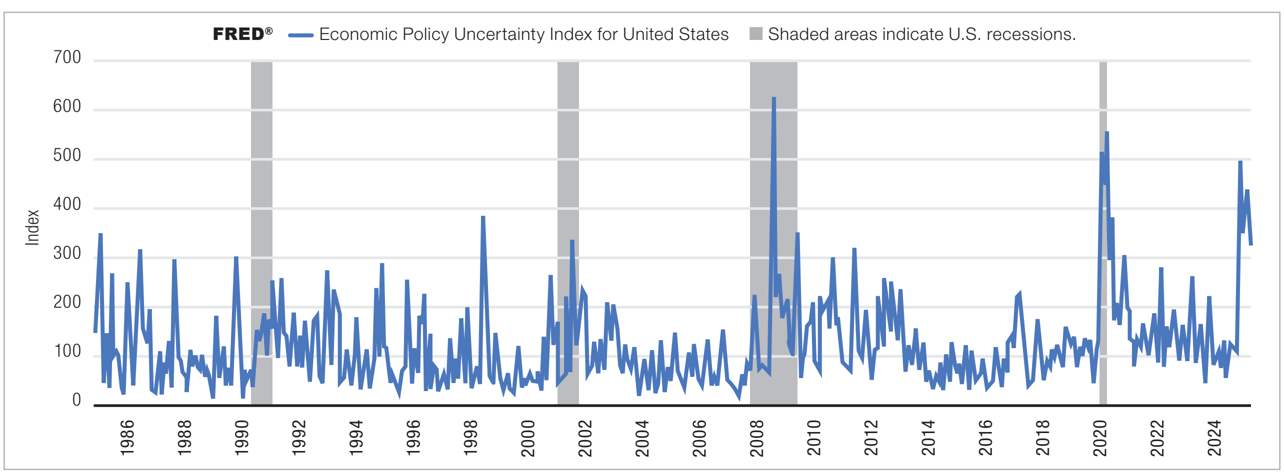
If job growth slows but inflation remains steady, the Fed may cut interest rates to promote investment in the labor market. If job growth remains strong but inflation begins to rise, the Fed is more likely to maintain the current interest rate so as not to cause layoffs. However, if inflation rises and employment decreases, the FOMC faces a dilemma. If it lowers interest rates to boost job growth, inflation could increase further, resulting in the undesirable outcome known as "stagflation."

With trade policy changing seemingly overnight, and the implications for the broader U.S. economy still largely a question mark, 2025 is shaping up to be a year of unprecedented uncertainty for U.S. businesses and consumers.

While both the step-back on tariffs with China and the U.K. deal are welcome developments, the global economy is still in a worse situation than before April 2. As of late May, a 30% U.S. tariff on China remains in place; so do 10% baseline tariffs on most other countries and 25% sectoral tariffs on steel, aluminum, autos and auto parts. While it is projected that this lowers the estimated effective tariff rate to 13.7% from 25.3%, this is still well above 2024's average rate of 2.4%. As of late May, the fate of President Trump's tariffs is increasingly uncertain, as a federal trade court ruled that imposing tariffs without congressional approval exceeds the administration's authority.

Economic uncertainty is on the rise

The Economic Policy Uncertainty index from researchers at Stanford University and Northwestern University uses an analysis of news reports, tax code data and economic forecast disagreement to gauge economic policy uncertainty in the U.S. In April 2025, the index spiked, reflecting a level of uncertainty reminiscent of the early days of the COVID-19 pandemic. While it has since retreated a bit, it remains at very high levels.



Sources: Baker, Scott R.; Bloom, Nick; Davis, Stephen J. via FRED®

Economic uncertainty can be a prelude to recession, and related instability inhibits decision-making among both business leaders and consumers. When uncertainty is high, businesses may delay investments or cut back on hiring. In turn, if consumers feel uncertain about their job prospects, they may tighten their belts — a troubling prospect in an economy driven heavily by consumer spending.

On the other hand, businesses that are prepared to respond swiftly to macroeconomic changes may be at an advantage in the current environment. "Readiness can turn volatility into a competitive opportunity. What I'm hearing from CEOs isn't panic about exact percentage hikes — it's a laser-focus on cycle time. How quickly can we push revised pricing to the field, reopen vendor contracts, and, if necessary, redesign a bill of materials," says Key Commercial Bank President Ken Gavrity.

"When a company has prepared well for rapid pivots, the moment a tariff hits, cross-functional teams already know who signs off on a price change, what clauses trigger renegotiation, and which engineering tweaks trim material usage. This field-readiness is made possible by leaders who are decisive and have prepared the company to make bold moves."

Business leaders are concerned about the impact of tariffs

For businesses of all shapes and sizes, tariffs have been a prominent concern throughout the first half of 2025. The unpredictable nature of the current administration's approach to trade policy has a destabilizing effect on business leaders, who worry about future demand for their goods, as well as whether they'll be able to pass the increased costs of products subject to tariffs onto their customers. Tariffs may affect some industries more severely than others: for example, while imported cars (and the materials to make them domestically) are subject to tariffs, many auto dealers believe they can raise prices to make up for their increase in costs — and many also have maintenance departments to generate revenue if sales decline. But without a clear picture of what to expect in the coming months, many business owners are feeling apprehensive about their companies' current and future prospects.

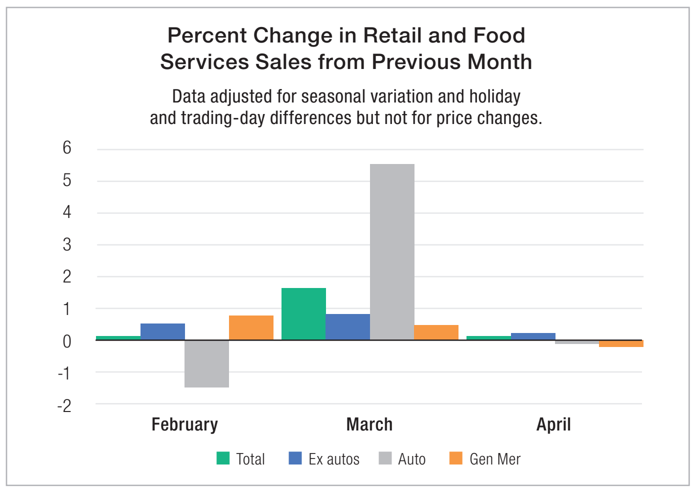
Uncertainty and the looming threat of tariffs are taking a toll on small business owners' confidence: the Small Business Optimism Index published by the National Federation of Independent Business (NFIB) fell 3.3 points to 97.4 in March, then declined by 1.6 points in April to 95.8, marking its second consecutive month below the 51-year average of 98. Among these business owners, real sales expectations declined, and fewer plan to make inventory investments in the coming months. Small businesses' relatively smaller economies of scale and tighter margins heighten the degree to which they are impacted by tariffs, as it's more difficult for them than for larger enterprises to pivot to new domestic suppliers or bear cost increases.

Meanwhile, Chief Executive's CEO Confidence Index improved slightly in May after declining in April. The publication attributed the increase in optimism to "hopes the tariff situation could resolve with limited impact on the U.S. economy." Yet in April's survey only one month earlier, two-thirds of CEOs and business owners (67%) said they did not approve of the tariffs, and 76% said that tariffs would negatively or very negatively impact their businesses this year.

In addition, the latest data from the Institute for Supply Management's (ISM) Manufacturing Purchasing Managers' Index illustrates a divergence between manufacturing and services businesses. The Manufacturing PMI® fell 0.3 percentage points in April, with companies reporting decreased demand and production due to economic uncertainty. At the same time, economic activity in the services sector expanded for the 10th consecutive month, with the U.S. service sector set to outperform both manufacturing and the overall U.S. economy in 2025.

Finally, retail sales grew by 0.1% in April, at a markedly slower rate than the previous month's increase of 1.7%. Gains in March were dominated by consumer auto purchases ahead of presumed tariff-generated price increases. This suggests that consumers' anxiety about the economy is starting to impact their spending.

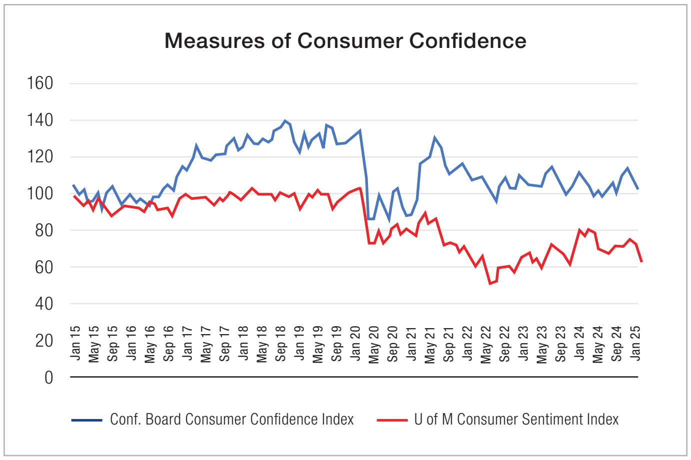
Consumer confidence has trended downward



Source: U.S. Census Bureau, Advanced Monthly Retail Trade Survey, May 15, 2025

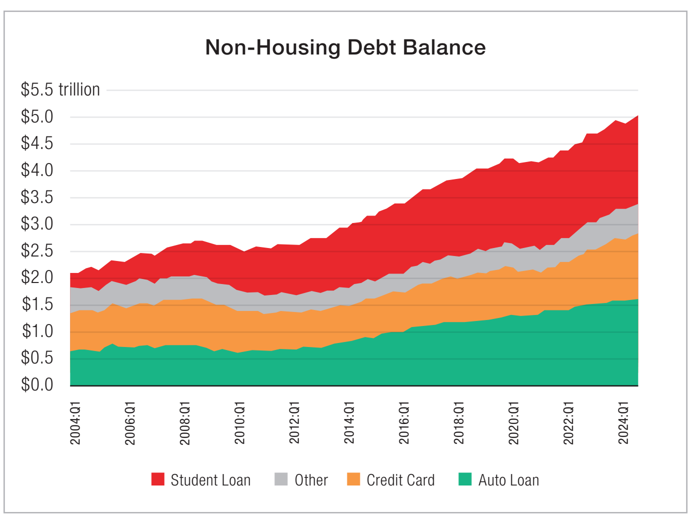
Economic uncertainty is diminishing consumer confidence. In May, the University of Michigan Consumer Sentiment Index declined for the fifth straight month to 50.8. Sentiment is now down almost 30% since January of 2025. At the same time, consumers' inflation expectations have reached their highest reading since 1981. According to

Surveys of Consumers Director Joanne Hsu, "Tariffs were spontaneously mentioned by nearly three-quarters of consumers, up from almost 60% in April; uncertainty over trade policy continues to dominate consumers' thinking about the economy."



The Conference Board Consumer Confidence Index® has also plummeted. It fell from 100.1 in February, to 93.9 in March, to 85.7 in April, before rebounding in May to 98. The sizable increase in May was led by a 17.4-point surge in the expectations index, which registered 72.8, still below the threshold of 80 that has historically signaled an imminent recession.

Given that it seems consumers' confidence in the economy is strongly linked to policy shifts in Washington, a sudden diversion from the current trend of de-escalation would likely send confidence tumbling once again. With that said, the rebound in confidence in May is welcome.



Additionally, emerging trends around consumer debt, and particularly student loan debt, could also present risks to the health of the economy. The U.S. administration has announced that it will not continue the previous administration's pause on some loan repayments, and by summer, borrowers in default could see automatic deductions from their paychecks. More than 42 million people hold student loans from the federal government, and more than five million of those borrowers have not made a repayment in the past year. Given the extended pause, many borrowers' budgets no longer account for loan repayments. The shock created by this additional expense imposed on so many consumers could be severe.

Meanwhile, according to data from the Federal Reserve Bank of Philadelphia, percentages of past-due credit card accounts increased at the end of 2024, and the percentage of accounts making the minimum payment reached a new 12-year high. At the same time, banks are extending more credit to borrowers who qualify for large credit lines. Together, these trends indicate that consumers are taking on more debt, and a slowdown in job growth could quickly heighten financial stress in this segment of the economy.

Forecasters predict slower growth in 2025, but no recession

Despite a tumultuous few months, forecasters are not convinced the U.S. economy is headed for recession. The Moody's Consensus Outlook for May predicts slower growth in 2025 but stops short of predicting a recession. At the time of this publication, the most likely outlook for the economy appears to be that the Trump administration's economic policies will diminish the U.S. economy but not derail it. In this scenario, the president will pivot on his policies in time to avoid recession. It has become increasingly clear that without a change in policy course, stock prices will decline further, and the economy will suffer a downturn.

It's also important to note that while the U.S. economy is fundamentally sound, abrupt shifts in policy, especially where global trade is concerned, can rapidly transform the U.S. economic environment. On the other hand, if the Trump administration shifts its policy focus away from tariffs and prioritizes deregulation or lowering taxes, business sentiment could shift quickly in a more positive direction. But for now, uncertainty is causing angst for consumers and businesses alike, and if the administration maintains its commitment to tariffs, forecasters expect that economic growth will continue to slow.

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About Benjamin E. Demko

Ben Demko manages the economic research and analytics team focused on macroeconomic, industry, and market risks that impact KeyBank's varied loan portfolios. He is responsible for proprietary, forward-looking perspectives on the economy and real estate markets that are used across the bank for stress testing, loss estimation, asset management, resource allocation, and profit planning. Ben joined KeyBank in 2005 and has nearly 20 years of business analytics, economic research, and risk management experience.

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