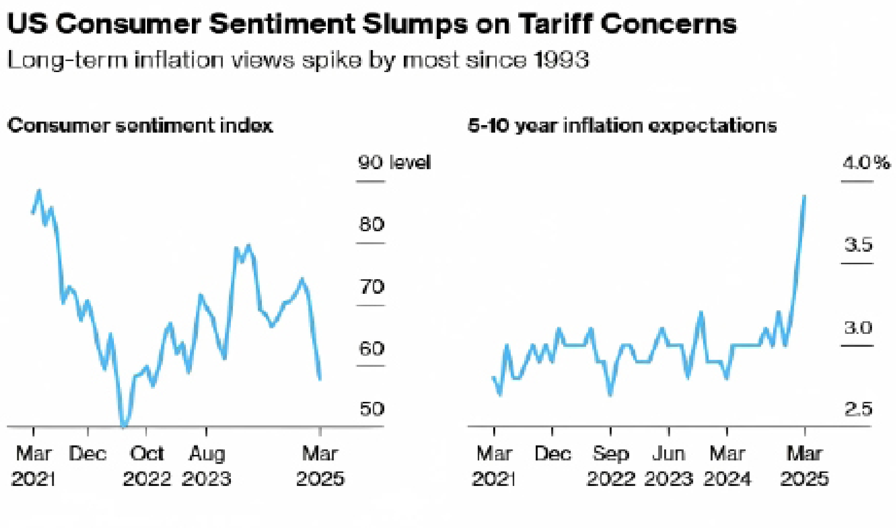
Tepp
Wealth Management

INSIDE

Today, Tomorrow and Beyond

The first 60 days of the Trump administration have been rather tumultuous, to say the least. Entering into 2025, as per my previous writings, I believed the US stock market to be broadly overvalued and emphasized that high income consumers were driving the economy. It now appears that Trump's trade policy, the Department of Government Efficiency ("DOGE") induced layoffs and geopolitical instability have soured consumer sentiment. There are now a variety of indicators that suggest a recession may be imminent. This writing is not quite a prediction but more of a warning of what might follow.

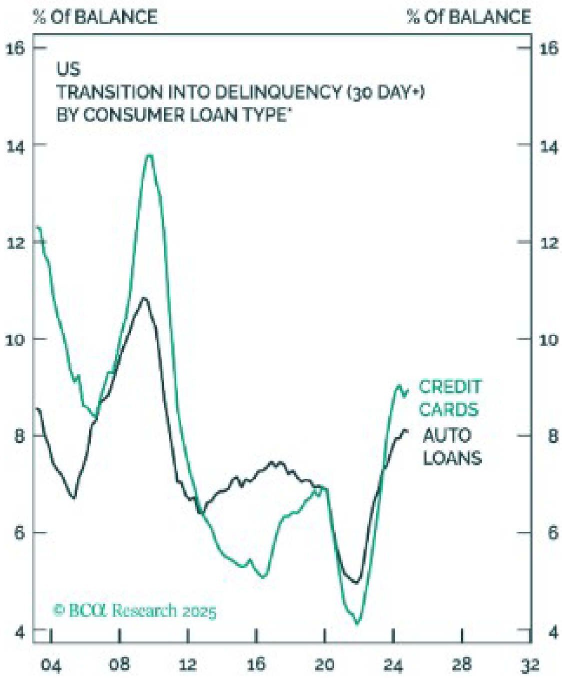


Source: University of Michigan, Bloomberg News

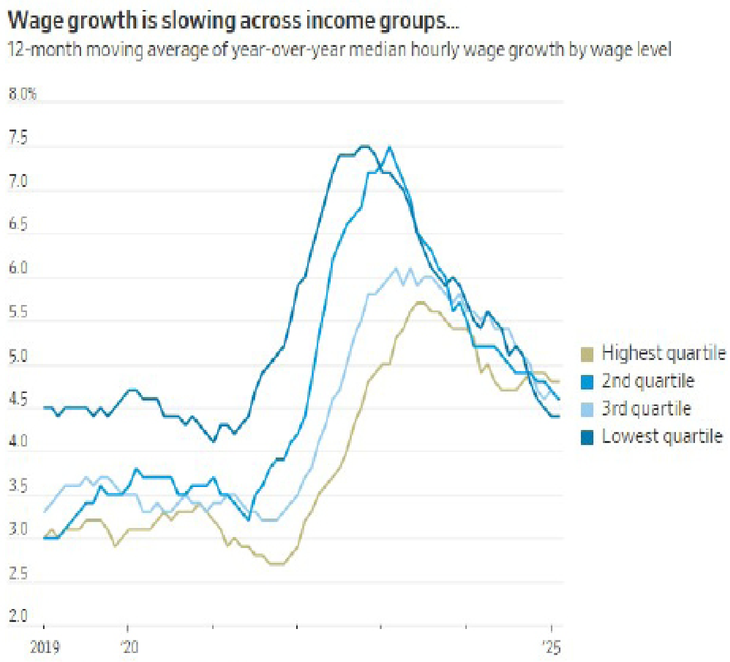
I. IMMEDIATE RISK: POSSIBLE RECESSION

Recessions rarely happen overnight. Instead, they typically emerge when an economy becomes vulnerable over time and then encounters a shock. Right now, several key factors are signaling that the US economy is reaching a breaking point:

1. **Consumer spending is running out of steam:** Lower income consumers have already reduced their spending and now higher income consumers are limiting their expenses as well. According to the Wall Street Journal, luxury retail spending dropped 5.9% in January and 9.3% in February. Credit card and auto loan delinquencies are rising, and mortgage rates remain at multi-decade highs. Further, wage growth rates are falling for all income levels.



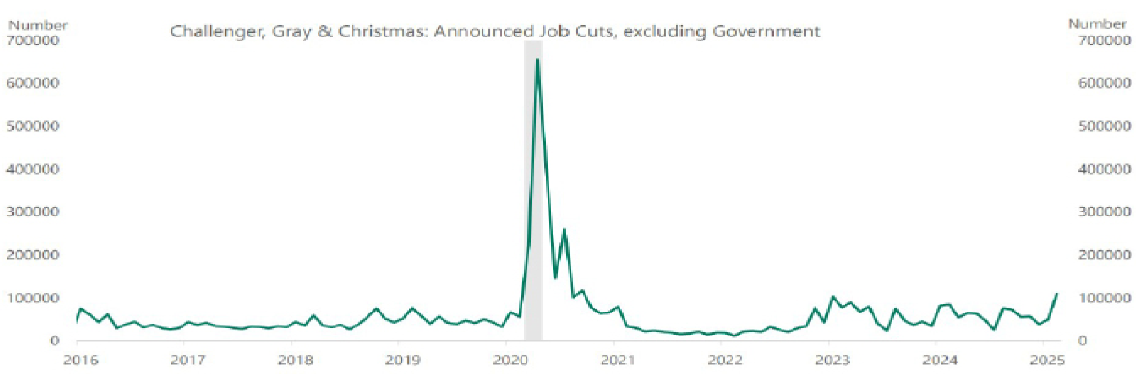
Shown as a 4-quarter moving total.
Source: Federal Reserve Bank of New York.



Source: Federal Reserve Bank of Atlanta

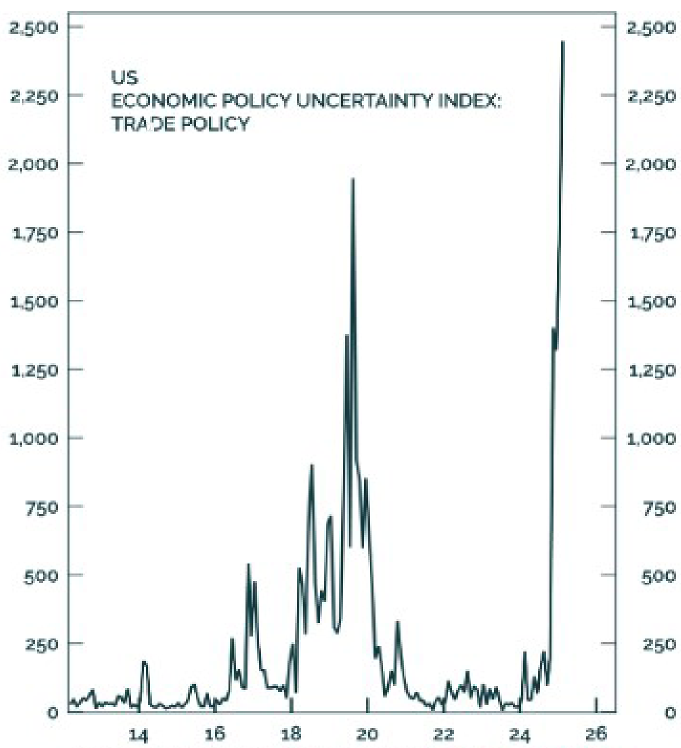
2. **Labor signals are weakening:** The red-hot labor market of 2021-2024 is cooling, with layoffs picking up. Announced private sector job cuts are the highest since the COVID era. Further, the unemployment rate ticked up to 4.1%.

Announced job cuts in private sector

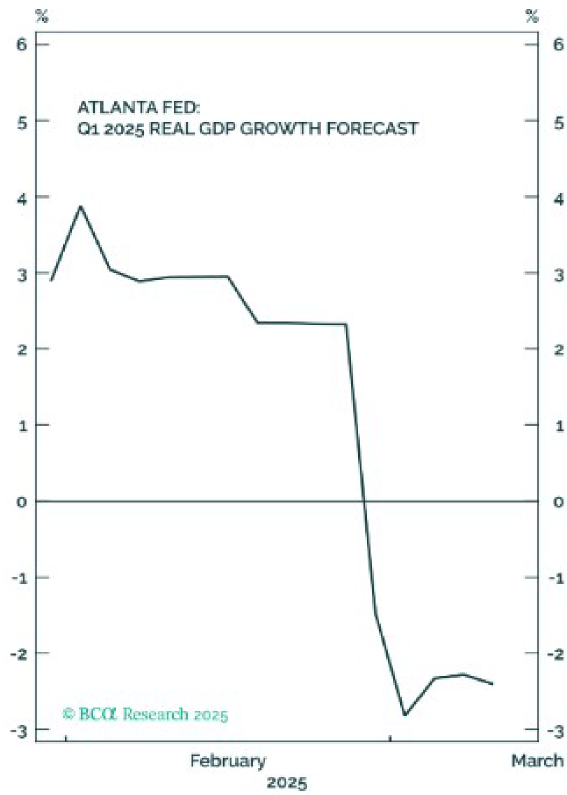


Source: Challenger, Gray and Christmas, Haver Analytics, Apollo Chief Economist

3. **<u>The trade war is escalating:</u>** President Trump's aggressive tariff policies are disrupting supply chains and raising costs, further squeezing businesses and consumers. The economic policy uncertainty index has reached its highest levels in decades. Even the Atlanta Federal Reserve ("Fed") is anticipating a sharp reduction of economic activity in the 1stQ of 2025.



Source: Economic Policy Uncertainty.



Source: Federal Reserve Bank of Atlanta.

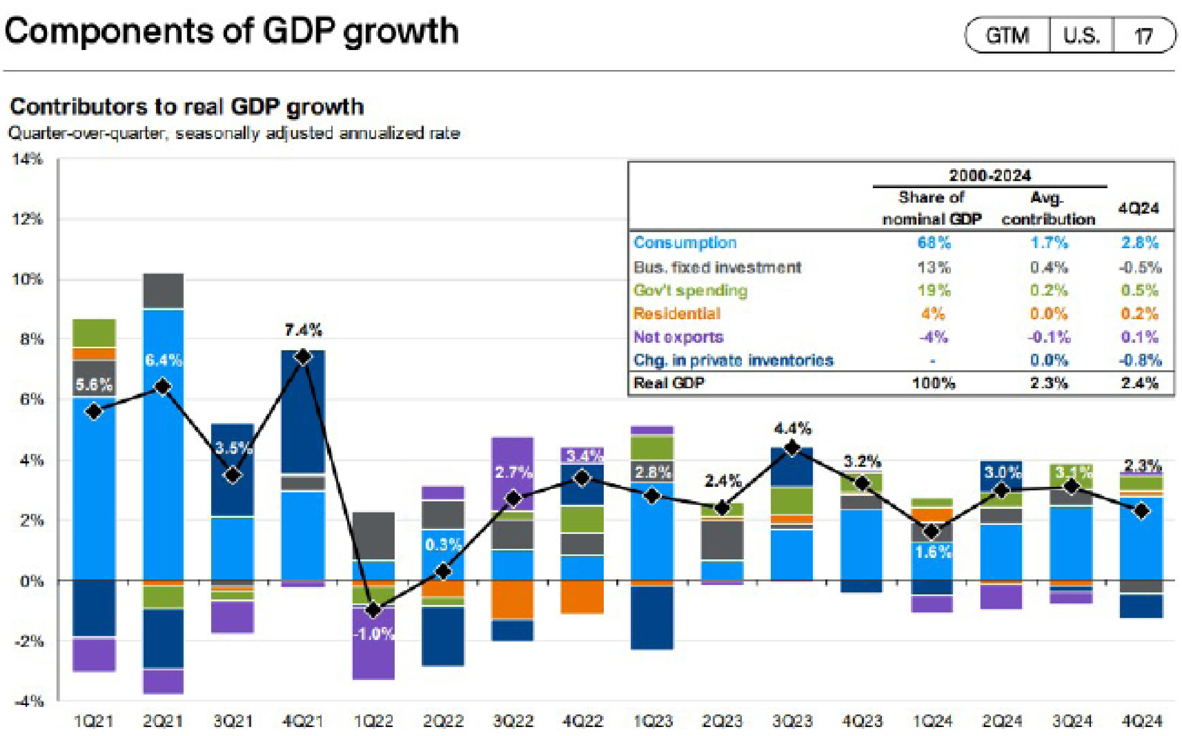
4. These risks filtered through to the US stock market during the week of March 10th. At the end of trading on Thursday, March 13th, both the S&P 500 index and NASDAQ index had entered correction territory. Scott Bessent, the US Treasury Secretary, appeared on Meet the Press and displayed no concern about the pullback: "…corrections are healthy. They're normal." This indicates that the Trump administration will follow through with this tariff plan irrespective of the economic or financial market consequences.

No one can predict the exact timing of a recession, but the case for a near-term slowdown is strengthening. If current trends continue, a contraction may already be underway, with rising unemployment, reduced wages and falling stock prices may follow.

II. NEAR TO MID TERM OPPORTUNITY: RECOVERY AND EXPANSION

One of Trump's key economic strategies is extending and expanding tax cuts, particularly those from the 2017 Tax Cuts and Jobs Act (TCJA). While the TCJA primarily benefited corporations, the new round of tax cuts aims to lower income taxes further, reduce capital gains taxes, and provide additional business incentives. The short-term impact of tax cuts is usually positive, stimulating growth as long as businesses reinvest their gains productively:

1. **Lower personal income taxes** increase take-home pay, boosting consumer spending, which accounts for roughly the largest share of GDP. Households in higher-income brackets, who tend to save or invest tax cuts, may channel funds into the stock market or real estate, driving asset appreciation.



	2000-2024 Share of nominal GDP	2000-2024 Avg. contribution	4Q24
Consumption	68%	1.7%	2.8%
Bus. fixed investment	13%	0.4%	-0.5%
Gov't spending	19%	0.2%	0.5%
Residential	4%	0.0%	0.2%
Net exports	-4%	-0.1%	0.1%
Chg. in private inventories	-	0.0%	-0.8%
Real GDP	100%	2.3%	2.4%

Source: BEA, FactSet, J.P. Morgan Asset Management. Guide to the Markets – U.S. Data are as of March 12, 2025.

2. **Cutting corporate tax rates** can encourage companies to expand, hire, and raise wages although past evidence suggests much of the benefit goes toward share buybacks and dividends. Buybacks, in particular, can be a significant catalyst for growth as businesses reinvest in their own companies. Further, if paired with accelerated depreciation incentives, businesses may invest more in machinery, technology, and infrastructure, boosting productivity.

3. **Reducing capital gains taxes** makes it more attractive to invest in equities, leading to a stronger stock market. Retirement accounts and pension funds benefit from rising markets, potentially increasing consumer confidence.

Trump's second major economic lever is deregulation, particularly in energy, finance, and healthcare. Loosening restrictions on oil & gas drilling, pipelines, and mining encourages domestic production, potentially lowering energy costs. Faster environmental permitting for factories, infrastructure projects, and housing developments could spur investment and job creation.

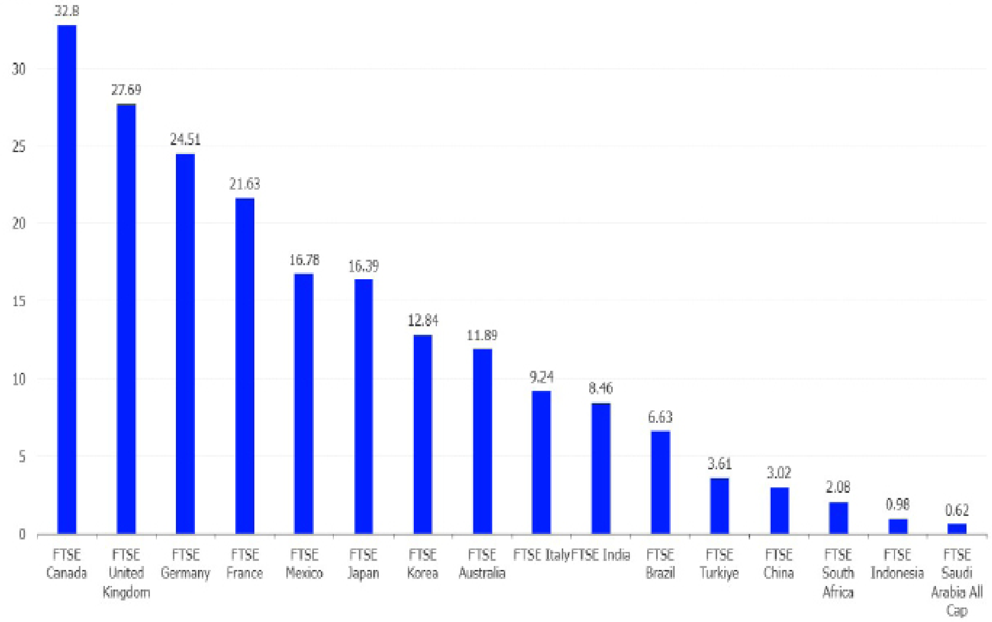
Scaling back banking regulations could lead to easier access to credit for small businesses and consumers. Lower compliance costs for banks could increase lending capacity, potentially driving housing and commercial real estate growth. Easing restrictions on drug approvals and telemedicine could spur innovation and investment in biotech and healthcare startups.

III. MID-TERM RISK: INFLATION

While tax cuts and deregulation may provide a short-term economic boost, an expansionist stance on tariffs and immigration restrictions could fuel long-term inflation. These policies, designed to protect American industries and workers, often entail unintended economic consequence primarily higher consumer prices, supply chain disruptions, and labor shortages.

Trump's tariff hikes on China, Canada, and Europe are causing disruptions that are larger than many analysts initially expected. Over half of North American trade consists of intermediate goods, meaning tariffs raise costs for domestic production rather than just imports.

Many US industries rely on foreign materials and components, meaning that tariffs increase production costs. For example, tariffs on steel and aluminum raise costs for automakers, appliance manufacturers, and construction firms, which then pass those costs onto consumers. When tariffs restrict imports, businesses must find alternative suppliers, often at higher costs. US trading partners, especially China and the EU, retaliate by imposing their own tariffs, making American goods more expensive abroad.



Source: FTSE Russell, Corporate Announcements, I/B/E/S Data as of January 31, 2025

Unfortunately for the US, a shortage of labor may further exacerbate inflation. Trump's restrictive immigration policies are likely to intensify labor shortages, particularly in low-wage, high-demand industries such as agriculture, construction and hospitality. Industries like construction, agriculture, hospitality, and healthcare rely heavily on immigrant labor. Restricting immigration shrinks the available workforce, forcing businesses to increase wages to attract and retain workers. When wages rise sharply due to labor shortages, businesses pass those costs onto consumers in the form of higher prices for goods and services.

While Trump's policies may stimulate short-term growth, the combination of tariff-induced price increases and labor-driven wage inflation creates the perfect conditions for persistent inflation with slowing economic momentum. With supply-side pressures mounting and monetary policy constraints tightening, the question isn't just whether inflation will stick around, but whether the U.S. economy is now marching toward full-fledged stagflation.

IV. MID TO LONG TERM RISK: STAGFLATION

Stagflation is best defined as an economy mired in a period of high inflation and sluggish economic growth. The last major bout of stagflation in the US occurred in the 1970s, when the OPEC oil embargo sent energy prices soaring which stymied economic growth. The Fed, under Chair Paul Volcker, pushed interest rates above 15% to finally crush inflation, leading to a painful recession.

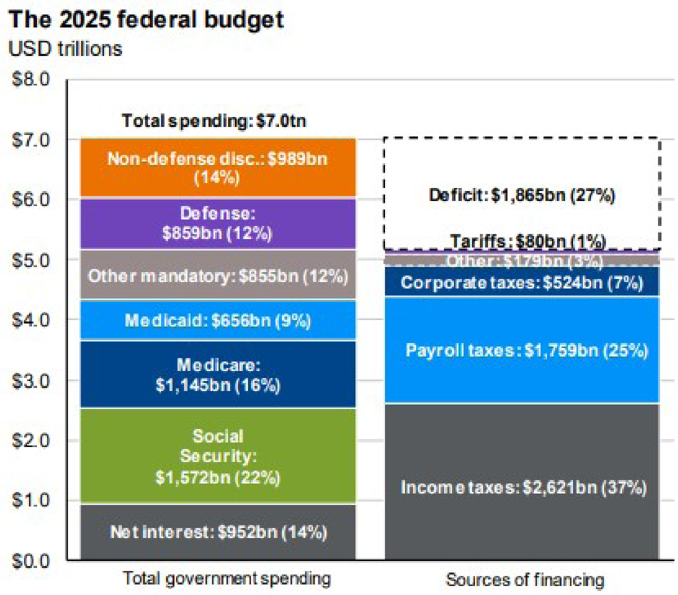
Today, US inflation is already slightly elevated, but labor market and supply chains pose stagflationary risks. A structural labor shortage fuels persistent wage pressures, particularly in high-skilled sectors where businesses are struggling to find workers. Additionally, trade disruptions and tariffs are pushing prices higher.

At its core, the US labor shortage is a structural problem. The three primary factors are: a) roughly 10,000 workers retire each day, exiting the workforce faster than younger workers can replace them, b) lower US birth rates mean fewer workers will enter the labor force in the coming decades, and c) restrictions on immigration which would ordinarily fill labor shortages in various industries.

With labor supply tight, businesses are being forced to compete aggressively for workers which pushes up wages, resulting in higher prices. Some economists argue that AI and automation will eventually boost productivity, but so far, significant productivity gains haven't yet materialized.

Since early 2022, the Fed has been aggressively raising interest rates to combat inflation. But after nearly two years of tightening, inflation is still elevated, and the labor market remains tight. This leaves the Fed with two options: a) keep interest rates high to fight inflation and risk a prolonged recession, or b) cut interest rates to avoid a recession and risk a resurgence of inflation. Bond markets are watching closely—if the Fed signals a pivot too soon, investors could sell US bonds, pushing long-term borrowing costs even higher. Bond holders with this intent are sometimes referred to as “bond vigilantes”.

If monetary policy seems tricky, fiscal policy isn't any easier. The US national debt has surpassed $36 trillion and rising interest rates are making it more expensive to service that debt. The government is still spending aggressively on infrastructure, defense, and social programs, further increasing borrowing needs. If the US issues even more debt, the bond vigilantes will almost certainly push rates higher costing taxpayers even more in interest expense.



Source: JP Morgan Guide to the Markets

CONCLUSION:

President Trump can certainly be unpredictable but, so far, he is following the economic plan he outlined during the 2024 Presidential campaign. His primary four policies (restricted immigration, heavy tariffs, tax cuts and deregulation) are all being implemented at varying paces. Economic warning signs are flashing and I would not be surprised if the US stock market pulls back further in the near term. However, Trump's policies are ultimately stimulative so I am hopeful there will be a prompt recovery. Unfortunately, that may also lead to fifty-year high inflation and stagnant economic growth. Watch this space for continuous updates and guidance.

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