1Q2025 U.S. Economic Outlook

Highlights

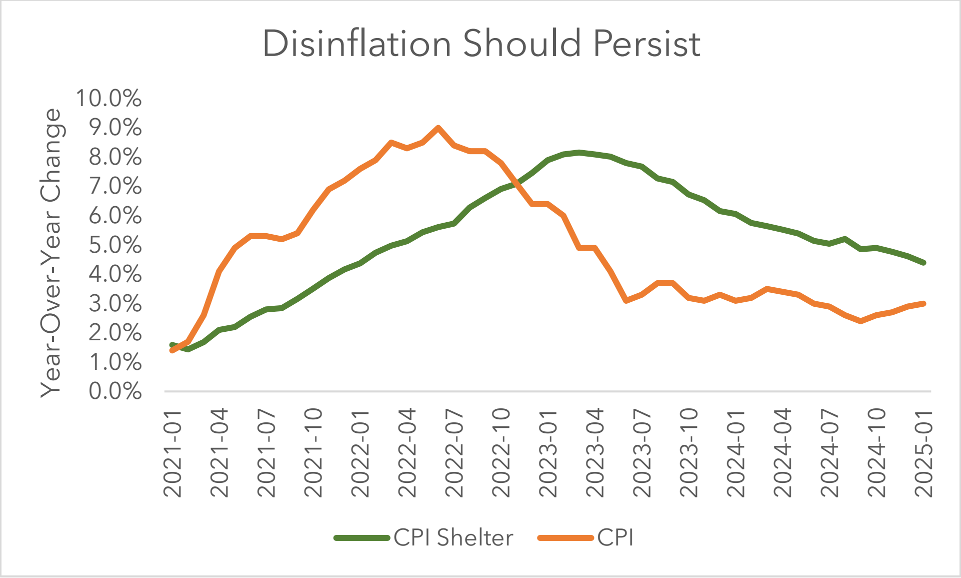
- Base case still positive
- Many facets of economy faring well
- CRE stands to benefit
- Risks are clear
- Outlook broadly unchanged, for now

"Should" is a modal verb that typically indicates that something is appropriate, reasonable, or best. The word proves incredibly valuable in economics where outcomes are never guaranteed. That maxim seems especially relevant this year, making "should" one of the most valuable words in our toolkit. As we look ahead to the balance of 2025, we see many things that should happen in the economy. Almost all look positive. But the massive uncertainty hanging over the US and global economies like the sword of Damocles forces us to temper our view. Unfortunately, this uncertainty stems predominantly from US government policy. While specific policy decisions could severely impact the economy, even the pure volatility and uncertainty of policy is already producing economic headwinds. Thus far, they are slight and manageable. But that provides us with little comfort. This environment requires critical thinking and analysis in order to make informed investment decisions. Therefore, we will address three key issues here. What are the largely positive developments in the economy that we should expect? What should those developments mean for commercial real estate (CRE)? But what specific risks could come to fruition and prevent these outcomes from occurring?

Base Case

The following lays out our base case for what should happen in the economy. Of course, that does not mean that it will, and we will address the key risks to this scenario toward the end.

Inflation – Although inflation has eased considerably since mid-2022, it still has room for further slowing. We will avoid beating our favorite dead horse, the mismeasurement of shelter inflation in the US, and simply say that in the official statistics, shelter inflation is lagging overall inflation by roughly 9-12 months. That means the shelter component should continue to slow for at least the next 6-9 months. And because shelter inflation represents such a large percentage of the major inflation indexes in the US, it has the ability to influence overall inflation. Throw in favorable base effects in the first half of this year, and inflation should continue to slow in 2025, albeit slightly, heading closer to the Fed's target rate of 2%.



Sources: BLS, BGO Economics and Research

Interest Rates – As we have previously written, we thought the Fed overreacted to noisy labor market data from last summer and started cutting too aggressively. The walking back of their forward guidance is a tacit admission of this. It has made this the worst easing cycle ever as measured by the difference between the 10-year Treasury yield and the fed funds rate. But interest rates still should come down more. Why? Because with inflation having slowed so significantly, real interest rates are now positive across the yield curve. That is restraining economic activity. The Fed knows and has acknowledged this. The Fed should bring rates down, even if the market is disappointed in the pace of rate cuts. And based on economic fundamentals, the 10-year yield should not stay so far above 4%. Rates should fall across the yield curve, but marginally.

Labor Market – Things have cooled considerably in the labor market since the Great Resignation of 2021-2022. But the labor market has not stalled. Job growth persists, even at lower absolute levels, with companies hiring more selectively after a few frenzied years. With the ongoing labor shortage, layoffs also hover at low rates. This "don't hire, don't fire" labor market is keeping the unemployment rate near the best estimates of full employment. That in turn is producing healthy wage growth, well in excess of inflation, returning real spending power to consumers. The market should remain tight and less dynamic than in the recent past, but with real wage growth remaining positive.

Net Worth – Household balance sheets in the US remain the healthiest ever by many measures. Although debt levels continue to rise, the asset side of the ledger is rising faster. Net worth continues to hit record-high levels, driven by a healthy labor market, a rising equity market, and a structurally undersupplied housing market. Of those three, the equity market remains the most uncertain this year. The labor market is chronically undersupplied which supports ongoing real wage growth. The housing market is chronically undersupplied, which supports real price increases. Therefore, net worth should continue to increase in 2025. Additionally, because most households locked in debt (especially mortgage debt) at historically low rates before the Fed began tightening, debt service remains manageable for households. These should broadly keep finances healthy and support the wealth effect.

Productivity – Productivity growth accelerated post-pandemic in a way very few had anticipated. While we have been bullish about the future of productivity growth, it has outperformed even our expectations. But we remain positive about the outlook because its drivers will shift. In the initial stages of the pandemic recovery, productivity got a boost from the Great Resignation, as labor supply better matched labor demand. Second, new company formation hit record levels after the pandemic. New firms are very good at coming up with new and better ways of doing things. But moving forward, the new technology the economy has invested in over the last two business cycles - artificial intelligence, machine learning, automation – should boost productivity growth.

Consumption – The outlook for consumption this year remains favorable. The labor market continues to create net new jobs, albeit at a slower pace than in recent years. Meanwhile excess labor demand should keep unemployment low and continue to cause real wage growth to remain positive. That combination means more money to spend. Increasing net worth should further support spending via the wealth effect, even if it is not as pronounced as in recent years. And productivity growth should support the supply side of the economy, increasing output and further giving consumers real spending power. All of this should support consumption spending, keeping it relatively steady versus last year.

Private Investment – The outlook for private investment remains relatively positive but with two important caveats. First, the rift between the services sector and the interest-rate-sensitive-nonservices sector (including housing) should remain wide until interest rates decline more substantially. Second, the pace of growth should slow after a strong performance in 2024. While investment in capital, structures, and housing should remain relatively limited, services firms should continue to invest in equipment and intellectual property products, especially with the data science revolution underway. Generally, declining interest rates should help all categories of investment, even as short-term credit pressures emerge in some industries. Overall, private investment should grow at a healthy but slowing pace in 2025.

GDP – Consumption and investment represent the overwhelming majority of the macroeconomy. With both projected to perform well, they should provide the economy with a solid base of support. On the fiscal policy front, all the efforts of DOGE notwithstanding, government spending (especially by the federal government) should remain at elevated levels, producing a substantial deficit, likely near $2 trillion. Can more of that spending get pared back? That remains to be seen. Either way, GDP growth should slow in 2025 but remain above potential.

What Will It Mean For CRE?

If all of this unfolds roughly as it should, we foresee the two halves of the CRE market performing well. First, market fundamentals remain broadly healthy. While demand for space has slowed a bit over the last year, supply growth remains relatively muted, certainly by historical standards. Some pockets of excess supply growth remain, but the forward pipeline looks set to fall off quickly toward the end of this year and should remain benign for the foreseeable future. That should help maintain our positive outlook for fundamentals across most markets and property types, and consequently, income returns.

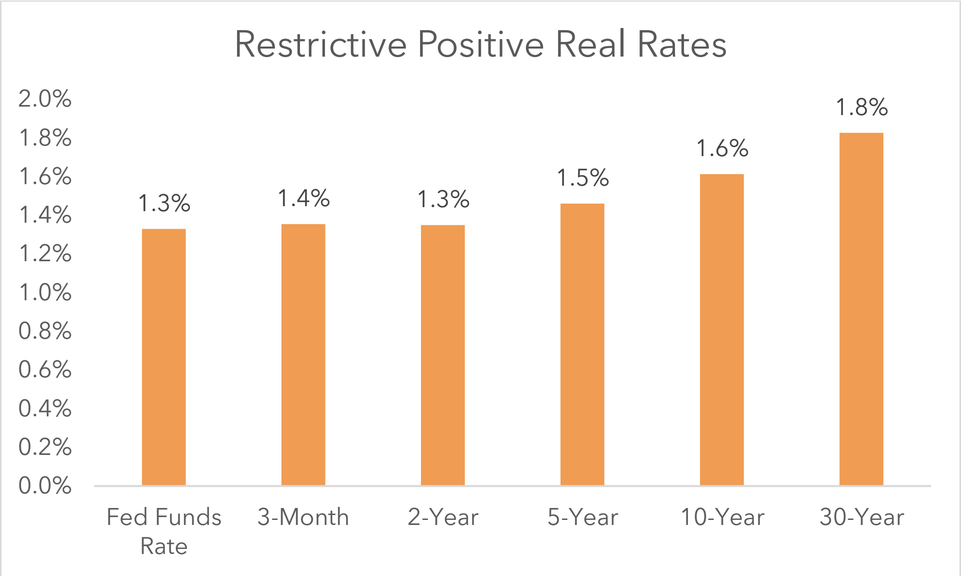
Second, the CRE capital market's recovery is clearly underway, even if it is moving in fits and starts right now. But the capital markets cycle, broadly measured by a variety of metrics including returns, has already bottomed out. Declining interest rates, even at a slower pace than many in the industry would prefer, should further support the recovery. While interest rates remain elevated, debt retains a relatively strong position. While equity's stance should firm as rates decline, that does not mean a bad environment for CRE debt. Quite the contrary, the market could become far more liquid and active. But relative positioning should shift. We will have more to say about the US CRE market in our quarterly CRE outlook next week.

Risks

Three key risks could upset this positive outlook. Two are clearly visible while one is not.

Trade Policy – We have already extensively modeled and remodeled the potential downsides of tariffs and a trade war. They are clear and unambiguous – higher inflation and slower economic growth. But even the threat and uncertainty of tariffs is producing negative economic consequences. Consumer confidence has fallen, investment is hesitating (risking industrial production) and the markets are volatile, with interest rates remaining relatively high amidst this uncertainty. If the economy can avoid the direst trade scenarios, then our base case should still largely unfold. But if the economy has to contend with an extreme trade environment, characterized by broad and high tariffs on key trade partners, then all bets are off. A trade war could be the easiest way to sabotage the current expansion in the economy.

Monetary Policy – Because real interest rates are still positive, they are restraining economic activity. And interest payments as a percentage of GDP recently hit its highest level since the 1990s. This situation does not have to end tomorrow. But the longer it remains true, the greater the risk of creating a recession. This proves especially true now because we know that inflation is being mismeasured in the US, which increases the probability of a policy mistake occurring at this stage of the cycle. If real interest rates remain too high, that will reduce the profits of interest-rate-sensitive industries, who in turn will respond by laying off employees in order to reduce costs. That typically sets off a downward spiral of aggregate demand in the economy until it bottoms out and stabilizes, causing a recession. The Fed knows this, but uncertain trade policy and inflation could stay its hand, increasing the risk of a monetary policy mistake. But the Fed will also have to balance the other half of its dual mandate, the labor market. If the economy does start to falter, the Fed could provide more support than we currently anticipate.



Sources: Federal Reserve, US Treasury, BGO Economics and

Random Shock – Exogenous shocks such as weather, pandemics, and politics and geopolitics are permanent but less visible and more unpredictable. Therefore, they prove difficult to discuss in detail ex ante. But with the momentum the economy brought into 2025, it would take something substantial to derail the current economic expansion.

Outlook

We have long held that a recession is not inevitable. That assertion remains true. If the economy can avoid the worst of the current risks, it should continue to fare well. And left to its own devices, there is no reason to think the economy cannot continue to expand well into the latter half of this decade. While the counterfactual is impossible to know in macroeconomics, our modeling strongly suggests that if the pandemic had not occurred, the expansion that began in mid-2009 would have continued until now. Either way, the economic fundamentals appear solid and without a serious policy mistake or exogenous shock, the economy should continue to expand. That could give the CRE market its best performance in decades. More to come on that next week.

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