The Growing Risk of Stagflation

What is really happening to the Economy?

KEY HIGHLIGHTS:

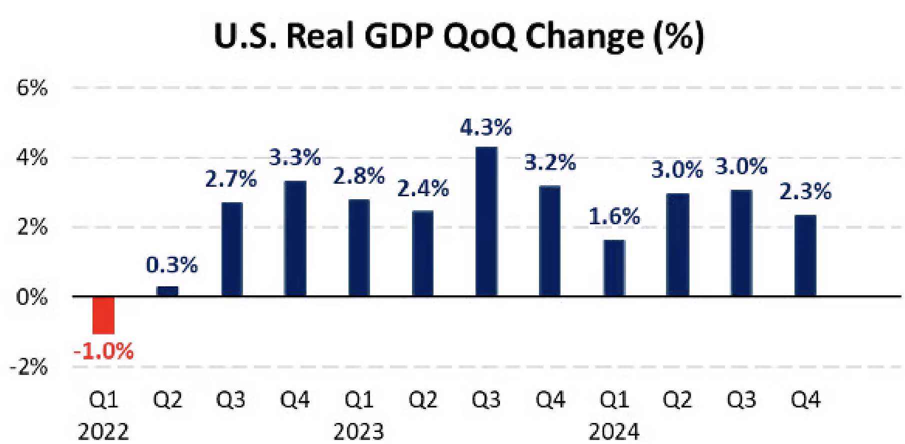
- **Record-setting stimulus packages during the pandemic allowed individuals to save in excess $2 trillion.**
- **These record liquidity levels fueled investment and consumption for consumers and businesses.**
- **Since mid-2021, excess savings has steadily declined and officially ran out at year-end.**
- **Personal Consumption Expenditures are currently $2 trillion above a normalized level using 2019 pre-pandemic trend lines.**

There has been well deserved euphoria since President Trump won the election in November. The animal spirits of the economy were unleashed as consumers, business owners and investors had newfound optimism with a tax friendly, pro-business and America first government. This was validated by nearly every market and economic metric that was released in the months following the election until March. This economic and market optimism has begun creating a surge in month-over-month (MoM) inflation data and concerns are rising that inflation may reaccelerate.

At the same time, President Trump is delivering on his commitments to the American people. These include the Department of Government Efficiency (DOGE) aggressively cutting the country's annual deficit and mounting debt, an America First economic policy including tariffs, and deportation of illegal immigrants. All of these policies will be important to our country over the medium to long-term, but risk near-term negative impacts on the overall economy.

Stagnating Growth and Hangover from Government Stimulus over the Last Four Years

The overall economy is slowing in the first quarter of 2025 based on a struggling consumer lowering spending, economic uncertainty from economic policy impacting business decisions, an uncertain interest rate outlook, government spending and employment cuts. The economy was largely propped up by massive government spending over the last four years, with spending over the last two years largely concentrated in infrastructure spending across the nation.

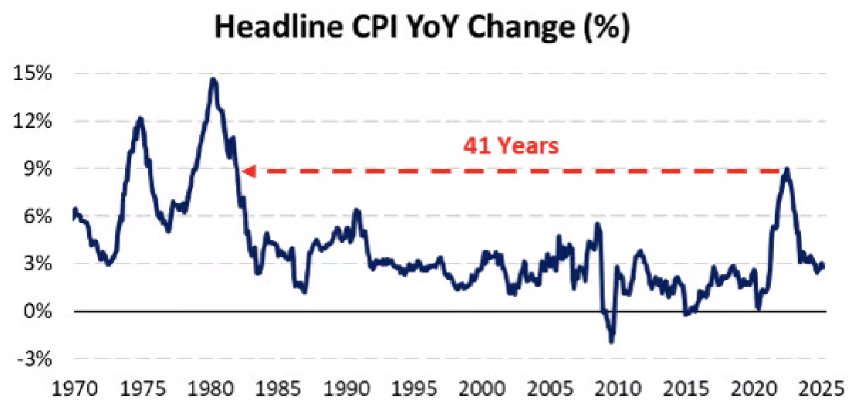


This spending has largely worn off as we have entered 2025 and is creating a slowdown in jobs supporting those projects both directly and indirectly. Additionally, over the past four years, between 10 and 15 million illegal immigrants entered the United States, this would equate to an almost 5% increase in the overall population of our country. All these individuals required housing, transportation, food and other services, much of which was paid for by either government programs or wages they earned through undocumented employment. All of this was highly stimulative to many business sectors as well as the overall economy. With the mass deportation process underway and likely increasing throughout this administration, there will be a reversal in the contribution of illegal immigrants and related government programs to the U.S. economy. The combination of these factors will likely result in lower GDP for the first half of 2025.

Higher Inflation

In the last quarter of 2024, inflation began re-accelerating, with a peak of 3.0% in January 2025. These increases have manifested in nearly every key category of CPI, from food and energy to shelter and transportation costs. The reacceleration of the economy in 2024 due to the overwhelming government stimulus, capital markets rally and mass immigration have meaningfully contributed to stubborn and increasing inflation. Inflation is more money chasing the same number of products, and the excessive government spending and handouts reignited this issue.

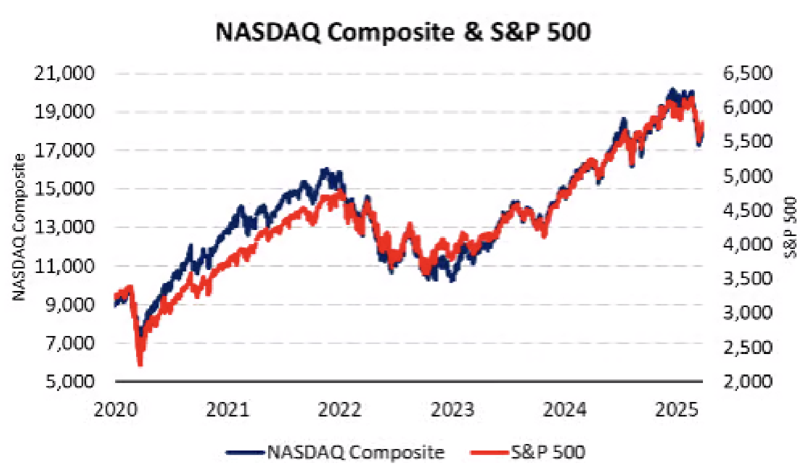
On March 12, 2025, the Consumer Price Index for All Urban Consumers (Headline CPI) posted a year-



over-year (YoY) increase of 2.8% for February, down 0.2% from the previous month but still 0.4% higher than its recent low of 2.4% in September 2024. Only time will tell if this trend continues, but the economic policies being enacted introduce a significant risk of inflation reigniting due to tariffs/trade war increasing product costs and mass deportation of illegal immigrants increasing the cost of labor.

Capital Markets Activity

The capital markets, particularly the equity markets, experienced a significant recovery in 2024 because of the economic resiliency from government stimulus, debt fueled consumer spending and Federal Reserve policy. This capital markets activity experienced the "Trump Bump" in November that pushed equity values to all-time highs and extreme earnings multiples. This felt unsustainable at the time, but animal spirits and FOMO took over as equity values continued to rise. This bubble popped in March and there has been a sizable correction since as the S&P 500 has decreased 6.3% through the first three weeks of March and is down 4.9% year-to-date. Additionally, the NASDAQ has decreased 8.1% through the first three weeks of March and is down 10.2% year-to-date, particularly in the high flying momentum names. The equity market boom created a significant wealth effect for higher end consumers, and its reversal could reduce consumer spending, housing purchases, and overall economic activity from the middle and upper classes in the United States.



Weaker Employment Markets

The third key component that contributes to stagflation is weaker employment markets. The employment market is starting to weaken both because of expense management from corporations and the impacts of mass deportations. As you can see in February's employment report, the number of employed people declined MoM and at the same time, a similar number left the labor force. Because of how the unemployment calculation works, the unemployment rate only increased 0.1% to 4.1%; however, the overall number of employed individuals decreased by 588,000 people. At the same time, the number of part-time employees increased 460,000 MoM in February. This is likely the first month of a consistent trend for the remainder of the year as illegal immigrants are deported or self-deport and are no longer in the employment statistics. Additionally, you are beginning to see expense management by corporations, and there is a growing risk that artificial intelligence (AI) begins reducing the number of white-collar workers resulting in elevated unemployment of very good paying jobs. We will talk about AI in depth during next month's newsletter as this is a trend to watch over the remainder of 2025 and into 2026.

Where do we go from here?

This is a problematic combination of key economic components that could create stagflation in the United States. As we have discussed, the hangover from excessive government stimulus dissipating in 2025, and economic drag caused by reduced consumption from the reversal of illegal immigration as well as increased tariffs, are collectively weakening the consumer and overall U.S. economy. The

additional hangover from accommodative monetary policy has left inflation lingering, enabling tariffs and rising labor costs to create another surge in inflation, as we saw in the beginning of 2025. And finally, the weakening employee picture for white-collar workers and middle management, as corporations become leaner and leverage AI for greater automation is causing a further weakening of the middle-class labor market. The negative trend lines in all three of these areas are flashing the warning signs of stagflation, which is one of the most difficult economic periods to navigate. Consumers face the dual burden of rising living costs and fewer job opportunities, making the path to recovery more complex and painful compared to a standard recession. High inflation (or the risk of it) restricts policy options available to government and monetary policy authorities because stimulating the economy further exacerbates inflation. As a result, traditional economic tools are ineffective, leading to prolonged economic stagnation and persistently higher prices.

"I worry that the economy looks more like the 1970s than we've seen before."

– Jamie Dimon