2025 SPRING ECONOMIC FORECAST

WOODS CENTER FOR ECONOMIC ANALYSIS AND FORECASTING

CSUF | COLLEGE OF Business and Economics

2025 SPRING ECONOMIC FORECAST

TABLE OF CONTENTS

SHAKEN AND STIRRED:
TRUMPONOMICS, TAXES, TARIFFS, TRADE AND PROSPECTS FOR GROWTH

The Nation, Southern California, and Orange County

Anil Puri, Ph.D., and Mira Farka, Ph.D.

U.S. ECONOMIC OUTLOOK AND FORECASTS
Shaken and Stirred 3
Overview 3
Splendid Isolationism: The Art of the Tariff and the Radical Remaking of the Global Order.... 29

ORANGE COUNTY, SOUTHERN CALIFORNIA, AND CALIFORNIA
How Will California Be Affected by Trumponomics? 41
Assessing Fiscal Discipline: Does California Need a
Department of Government Efficiency (DOGE)? 43
Population and Immigration Dynamics 45
Are Southern California and Orange County Economies Already in Slowdown 48
Housing Market Trends 50
Orange County Business Sentiment 52
Employment Forecasts 56

SHAKEN AND STIRRED:
TRUMPONOMICS, TAXES, TARIFFS, TRADE AND PROSPECTS FOR GROWTH

The Nation, Southern California, and Orange County

Anil Puri, Ph.D.

Director, Woods Center for Economic Analysis and Forecasting
Provost Emeritus

Mira Farka, Ph.D.

Co-Director, Woods Center for Economic Analysis and Forecasting
Professor of Economics, College of Business and Economics

SHAKEN AND STIRRED

"If he was any cooler, he'd be frozen, baby!"
– *Austin Powers*

Overview

Basil Exposition: "Austin, the Cold War is over!"
Austin Powers: "Finally those capitalist pigs will pay for their crimes, eh? Eh, comrades? Eh?"
Basil Exposition: "Austin…we won."
Austin Powers: "Oh, smashing, groovy, yay, capitalism!"
– *Austin Powers*

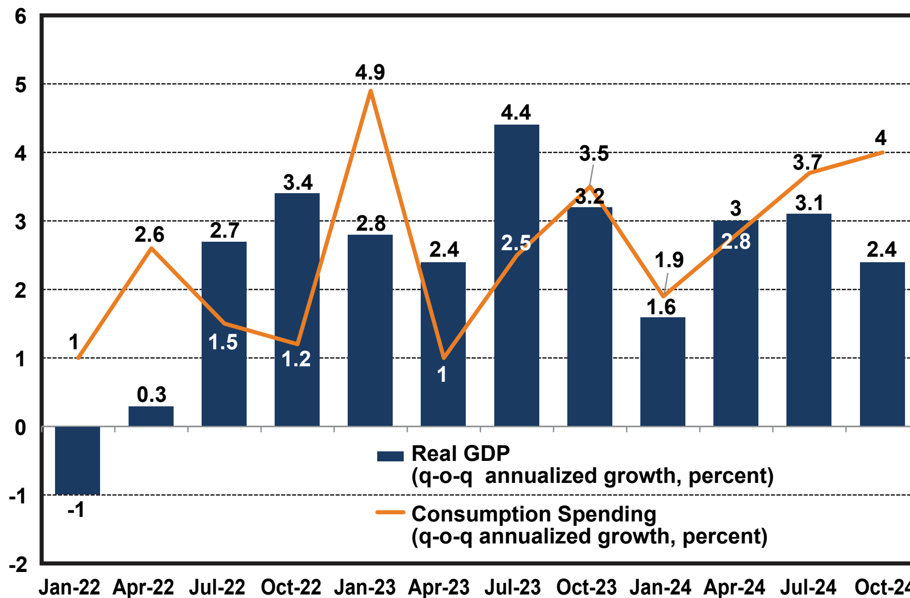
Oh, behave! The catchphrase to end all catchphrases, often purred by the bad-toothed, velvet-clad, cravat-laden British spy—Austin Powers—didn't just define the eponymous *Austin Powers* series set in the 1990s; it practically *was* the '90s. A gloriously unhinged romp through time, packed with silly spy gadgets, outrageously colorful '60s sets, and elaborate yet hilariously avoidable life-or-death scenarios, the films remain an escapist blast of swinging absurdity. At its heart is Austin ("*Powers* by name, *powers* by reputation")—a lovable spy equal parts endearing and unapologetically cringe-inducing, who lives for two things: free love and saving the world. Thawed from the groovy '60s and awkwardly transplanted into the far less groovy '90s, he is tasked with stopping his arch-nemesis: the pinky-wielding, cat-stroking Dr. Evil ("*I didn't spend six years in Evil Medical School to be called Mister, thank you very much*")—an incompetent megalomaniac with a flair for overcomplicated schemes of world domination…and, occasionally, moon destruction. Along the way, we meet a cavalcade of fantastical characters: Frau Farbissina ("*the founder of the militant wing of the Salvation Army*"), Dr. Evil's long-lost son, Scott ("*You're the Diet Coke of evil, just one calorie*"), Fat Bastard ("*Get in my belly!*"), Number Two ("*His name? Number Two*"), Mini-Me ("*you complete me*"), and the seductive yet lethal fembots ("*Care to have a little fun?*"). It's all "groovy, baby, yeah" even more than a quarter of a century later.

Much like the *Austin Powers* films, the U.S. economy is currently stewing in its own peculiar brew—part "grooviness," part "cringeworthiness," part Austin Powers and part Dr. Evil, part charm and part flawed, part "snake to my mongoose...or mongoose to my snake. Either way, it's bad."

It's genuinely befuddling: While hard data remains relatively robust, sentiment measures have plumbed depths typically seen in the shadow of a looming recession. Start with hard data first. The economy ended 2024 on strong footing, with real GDP up 2.8%—just shy of 2023's 2.9% pace (Figure 1). Growth did ease to 2.4% in the fourth quarter, down from 3%+ in the two prior quarters, but remained respectable. Consumers—the true engine of growth throughout this cycle—have powered on instead of scaling back, with spending accelerating from an average pace of 2.3% in the first half of the year, to 3.7% in the third quarter, and an impressive 4% in the fourth. Business investment also rebounded, growing at a 4% annual rate in 2024—a sharp reversal from just 0.1% the year before.

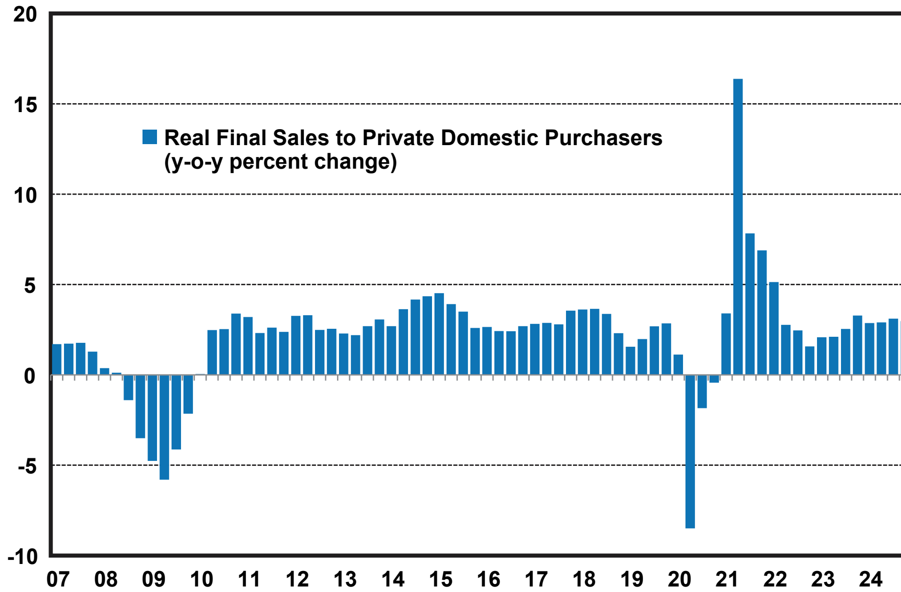
While hard data remains relatively robust, sentiment measures have plumbed depths typically seen in the shadow of a looming recession.

FIGURE 1
Real GDP and Consumption Ended the Year on Solid Footing (q-o-q annualized growth, percent)



If not for the drag from trade—where imports outpaced exports, subtracting a full 0.5 percentage points from real GDP—growth would have exceeded 3% in 2024. In fact, when stripping away the more volatile components—trade, government spending, and inventories—real final sales to domestic purchasers, a true measure of private sector demand, rose by a healthy 3% last year (Figure 2). That's the strongest showing since 2018 (excluding the post-pandemic surge in 2021). It's all "fab…switched on… a bit of alright," as Mr. Powers would put it.

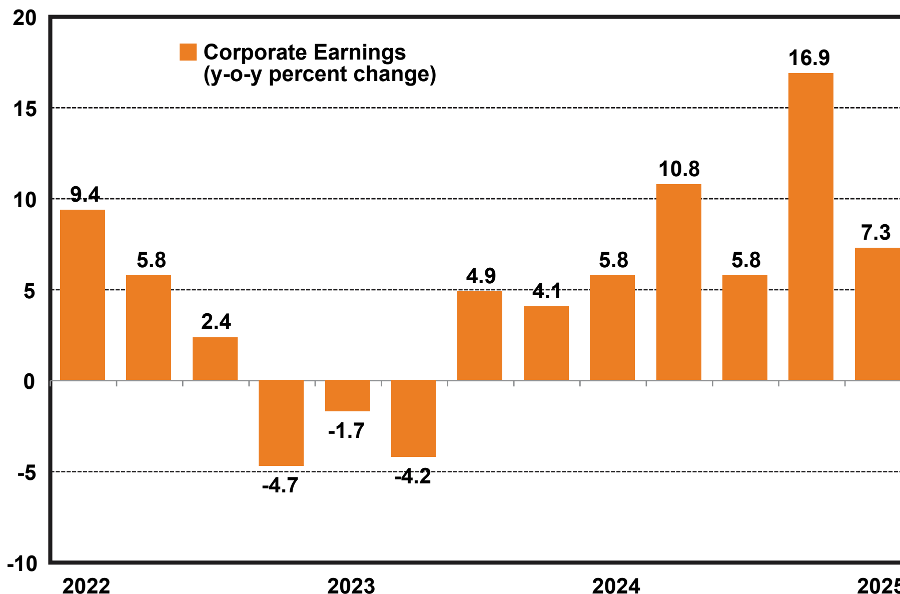
FIGURE 2
Private Sales Also Ended the Year Strong
(y-o-y percent change)



Other indicators were equally heartening. The labor market ended the year on solid ground, adding an average of 166,000 jobs per month in 2024, with the pace accelerating to 209,000 in the final quarter. Even the much-anticipated—and dreaded—downward payroll revisions, first signaled last summer, turned out to be less ominous than initially feared: a net revision of 589,000 jobs, rather than the projected 818,000. Corporate profits as a share of GDP ended the year near all-time highs. Corporate earnings rose 16.9% in the fourth quarter—the strongest quarterly gain since late 2021, when the economy was emerging from the pandemic. And though it's still early, first-quarter earnings for the companies that have reported so far are showing a solid 7.3% year-over-year growth (Figure 3).

The labor market ended the year on solid ground, adding an average of 166,000 jobs per month in 2024, with the pace accelerating to 209,000 in the final quarter.

FIGURE 3
Solid Corporate Earnings... Even in the First Quarter Marred by Trade Concerns
(y-o-y percent change)

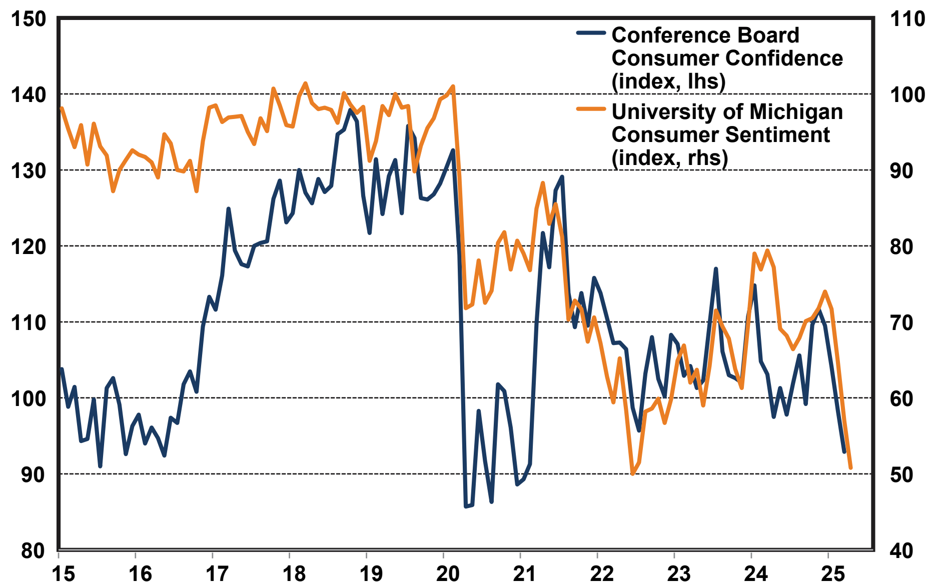


Even troubled corners of the economy were stabilizing. Green shoots in commercial real estate—first visible in mid-2024—have continued to take firmer root. As of the fourth quarter of 2024 (latest available data), property prices are leveling off, and transaction activity has surged, albeit from deeply depressed levels, fueled by lower interest rates and improved access to capital. Transaction volume (on a year-over-year basis) is up 64% for apartments, 32% for industrial space, and 8.1% for retail. Even the long-beleaguered office market is stirring, with activity up 35% year-over-year. This rebound, along with falling rates, has brightened the outlook for regional banks, which remain heavily exposed to commercial real estate. According to the FDIC, second-half losses totaled about $420 billion—nearly $100 billion less than in the first half and well below the $690 billion peak in the third quarter of 2022.

Green shoots in commercial real estate—first visible in mid-2024—have continued to take firmer root. As of the fourth quarter of 2024 (latest available data), property prices are leveling off, and transaction activity has surged, albeit from deeply depressed levels, fueled by lower interest rates and improved access to capital.

All this points to an economy that started the year with the wind on its back. So far, so good...so far, so…"*shagadelic!*" Except, these upbeat figures stand in stark contrast to sentiment. Consumer confidence in particular has taken a beating: The Conference Board's index fell for a fourth straight month in March, hitting a four-year low—just above levels last seen during the pandemic (Figure 4). Even more troubling, its expectations component dropped to 65.2, its lowest level in 12 years and well below the key threshold of 80 historically associated with a recession. The University of Michigan's index—a perennially gloomier gauge—paints an even bleaker picture: in April, it fell to its second lowest level in history going back six decades. Business sentiment has also taken a turn for the worse. The National Federation of Independent Business (NFIB) index—a measure of small business optimism—has declined for two straight months. The Duke CFO Survey—tracking sentiment among large firms—is now nearly back to pre-election levels after an early post-election bump.

FIGURE 4
Consumer Confidence Has Collapsed
(index)



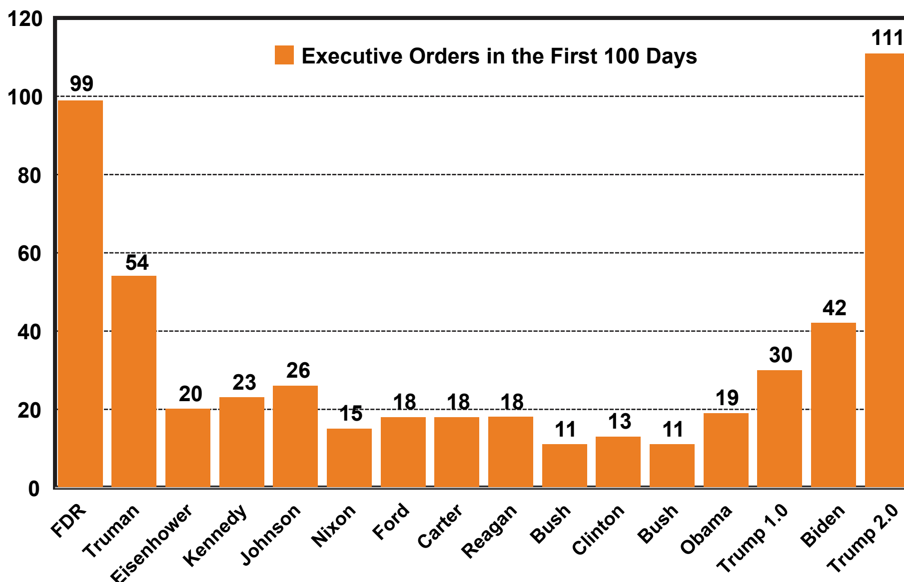
The worry is that sentiment may soon start bleeding into hard data. Some distressing signs are already cropping up. Retail sales slumped unexpectedly in January, dropping by an astounding 0.5%. They rose modestly the following month, but the 0.2% uptick was still far below expectations of 0.6%. The labor market has remained steady, but job growth has downshifted with just 125,000 jobs added in January and 151,000 in February—well under the 209,000 monthly clip we saw in late 2024. The unemployment rate edged up by 0.1 percentage points last month, and labor force participation slid to a two-year low. More ominously, the Atlanta Fed's high-frequency GDP tracker

is now flashing red, forecasting a steep -2.4% drop in first-quarter GDP—a jarring reversal from the 3.1% growth it estimated just a few weeks ago. Put it all together, and Austin Powers' signature freakout starts to sound pretty spot on: "Crikey! The U.S. economy has lost its mojo!" The swagger, it appears, is all but gone.

Rarely has sentiment and economic outlook swung so sharply outside of war, a pandemic, or some similar calamity. Mercifully, none of these disasters is to blame. Instead, the gloom stems from the policies enacted by the newly christened Trump administration, which has wasted no time in moving swiftly and unapologetically to reshape the economic and geopolitical landscape. In a sharp break from his first term—when his economic approach was largely pragmatic, transactional, and short-termist—President Trump's second coming is both far bolder and undeniably more sweeping (Figure 5). He is attempting nothing short of a radical remake—of both the post-war global order and the U.S. economy—moves that are at once ambitious and extraordinarily risky.

In a sharp break from his first term—when his economic approach was largely pragmatic, transactional, and short-termist—President Trump's second coming is both far bolder and undeniably more sweeping.

FIGURE 5
Move Fast and Break Things
Trump 2.0: The Highest Number of Executive Orders in History



It's not just the *Sturm und Drang* style with which the administration is charging ahead—though that alone is bound to break things. It's the agenda itself. Mr. Trump's platform reads like a patchwork of distinctly historical strains, infused with a heavy dose of Americana: "the bare-knuckle nationalism of Andrew Jackson, the tariff-loving protectionism of William McKinley, the small-government, pro-business policies of Calvin Coolidge, the deportation playbook of Dwight Eisenhower, the manifest destiny ambitions of James Polk, and the isolationism of Woodrow Wilson," as J.P. Morgan puts it. And it is—*Everything, Everywhere, All at Once*.

Mr. Trump's platform reads like a patchwork of distinctly historical strains, infused with a heavy dose of Americana: "the bare-knuckle nationalism of Andrew Jackson, the tariff-loving protectionism of William McKinley, the small-government, pro-business policies of Calvin Coolidge, the deportation playbook of Dwight Eisenhower, the manifest destiny ambitions of James Polk, and the isolationism of Woodrow Wilson."

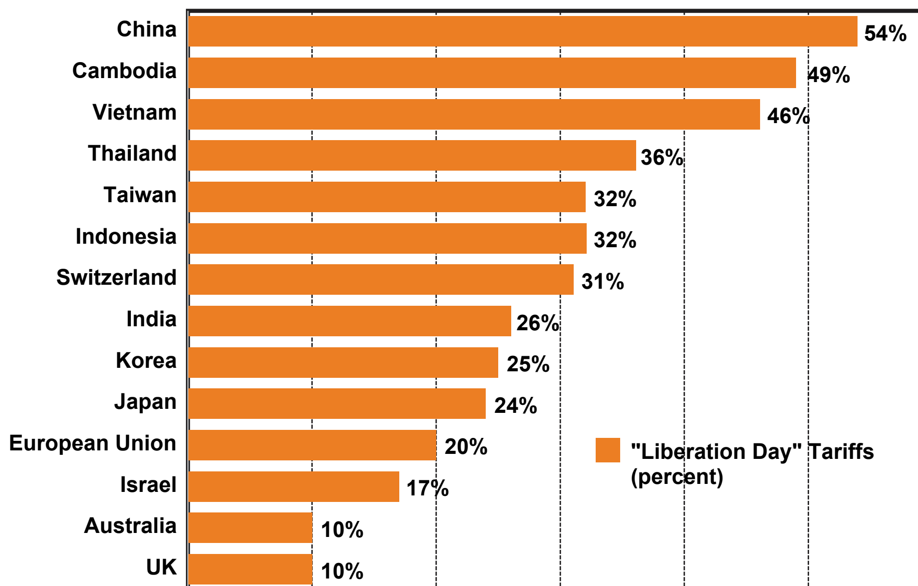
Some of these goals are worthy; others verge on the Quixotic. No matter. With this bold agenda, a fairly decent economy was expected to catch a second as Mr. Trump's pro-growth agenda—centered on tax cuts, deregulation, and a revival of domestic energy—promised to unleash the private sector, boost investments and power growth. Investors and businesses were promised "the dawn of a Golden Age," complete with Golden Visas for wealthy foreigners—and even a Golden Dome, a flashy new missile defense system, to match.

Alas, things have not quite worked out that way. "I 'vana' toilet made out of solid gold, but it's not in the cards now, is it?" Austin Powers quips in one of his rare moments of reflection on reality. Nearly 100 days into the new administration, the promise of a Golden Age doesn't appear to be in the cards—at least not yet. Instead of tax cuts and deregulation, the Trump administration has so far focused almost exclusively on two of the most headline-grabbing—but confidence-sapping—issues: tariffs and slashing the federal government. Both make for the worst kinds of news—they dent sentiment, increase uncertainty, crimp growth, and, in the case of tariffs, stoke inflation fears.

Instead of tax cuts and deregulation, the Trump administration has so far focused almost exclusively on two of the most headline-grabbing—but confidence-sapping—issues: tariffs and slashing the federal government.

By far, the most damaging are tariffs. In his April 2 unveiling—grandly dubbed "Liberation Day" by the president—the world received a clear message: the post-war global order, as we have come to know it, is over. The raft of tariffs was so sweeping, it went beyond even the worst-case scenarios the market had braced for. No country was spared. A universal 10% tariff was imposed on all imports to curb tariff avoidance, while reciprocal tariffs targeted countries with which the U.S. runs large trade deficits. Countries in Asia were hit hardest: India will now face tariffs of 26%, South Korea 25%, Japan 24%, Taiwan 32%, and Thailand 36%. Tariffs on Chinese goods will rise by an additional 34%, on top of the existing 20% imposed earlier this year (10% in February and another 10% in March) (Figure 6). Levies on EU imports will increase to 20%, while the UK and Australia—with which the U.S. runs trade surpluses—will be subject only to the baseline 10%. Even islands inhabited only by penguins and seals—like Heard Island and the McDonald Islands, a volcanic archipelago near Antarctica—weren't spared.

FIGURE 6
"Liberation Day": Eye-Watering Tariffs as Far as the Eye Could See



There were a few acts of mercy. Mexico and Canda were exempted from the universal 10% tariffs, but only because they are already subject to a 25% tariff on non-USMCA-compliant goods—covering roughly 50% of imports from Mexico and 62% from Canada. USMCA-compliant goods are still exempt from tariffs, offering some relief to our closest trading partners. Specific sectors already subject to some tariffs—such as steel, aluminum, and autos, all currently at 25%—were also spared from the reciprocal measures. Some sectors breathed a sigh of relief as well: the executive order exempted pharmaceuticals, semiconductors, copper, lumber, energy, bullions, and a handful of critical minerals from the new tariffs. Still, President Trump has signaled that additional duties on these products are coming at a later date.

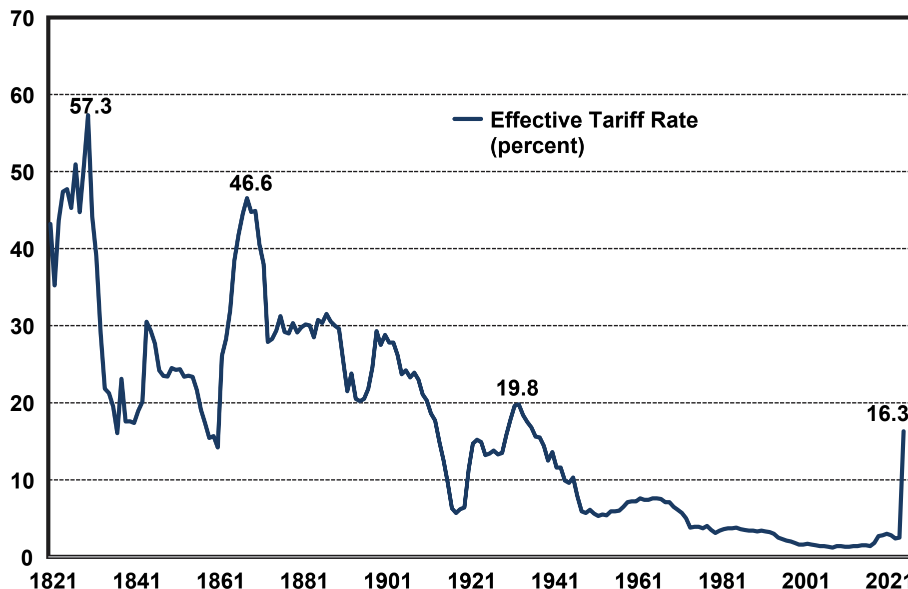
It's also far from clear how the administration arrived at the final tariff rates. Some of the figures were so shocking—verging on the nonsensical—you had to blink twice to make sure they weren't a mistake. While it pledged "reciprocal tariffs—no more, no less," and suggested a more sophisticated formula that would account for VATs, currency manipulation, and other trade distortions, the reality appears far more simplistic. It seems the administration merely took the U.S. bilateral trade deficit as a share of imports from each country and cut that figure roughly in half—an approach Mr. Trump described as an act of "great kindness." This is a remarkably crude way to go about it and one that does not quite reflect "reciprocity"—not even close.

In fact, these "reciprocal tariffs" were so eye-wateringly high, that as we anticipated upon their announcement, they could only be interpreted as an opening salvo in a broader negotiation strategy. And so it was. In what may come to be known as "Liberation from Liberation Day," just one week after imposing the tariffs and a mere 12 hours after they took full effect, President Trump paused all punitive reciprocal tariffs for 90 days, replacing them with a universal 10% baseline. At the same time, he doubled down on China, raising its tariff burden to a staggering 125%, and to a further 145% after China retaliated. The pause is intended to give the 75 countries that have come knocking time to carve out negotiated solutions.

This is certainly good news. While the average trade-weighted tariff rate remains high—driven largely by the vertiginous China tariffs—at 21.5%, that figure assumes no drop in import volumes (they will fall) and no import substitution (they will shift away from China), neither of which is realistic. Once these adjustments are factored in, the average effective tariff rate—the measure that truly matters—has settled at 16.3%. That's still well above the 2.5% rate at the start of the year, but meaningfully below the eye-popping 25.5% announced on April 2 (Figure 7). Had that rate held, it would have marked the highest tariff burden in over a century. The promised Golden Age would have arrived—draped in tariffs straight out of the Gilded Age.

The average effective tariff rate—the measure that truly matters—has settled at 16.3%. That's still well above the 2.5% rate at the start of the year, but meaningfully below the eye-popping 25.5% announced on April 2.

FIGURE 7
A Tariff Rate Almost Out of the Gilded Age
(average effective rate, percent)



But even with this remarkable de-escalation, tariffs are still higher than at any point since the 1930s. Tariffs also featured prominently in Mr. Trump's first term, but their scope was far narrower focused mainly on China and on steel and aluminum products, many of which were ultimately granted exemptions. The total value of tariffed goods then amounted to $384 billion, a fraction of today's near-universal coverage: roughly $2.6 trillion, or 82% of all U.S. imports, are now subject to a levy of at least 10% (Table 1). As Mark Twain famously quipped, "History doesn't repeat itself, but it often rhymes." Yes, history may rhyme—but this time, the Trump administration isn't merely humming an old tune. It's marching to a far more militant battle hymn, judging by the speed, scope, and depth of the tariffs it has enacted.

TABLE 1
Tariffs Are Far More Reaching Now Than in 2018-2019

	FIRST TRUMP ADMINISTRATION	SECOND TRUMP ADMINISTRATION
Value of Imports Tariffed	$380 billion	$2.6 trillion
Percent of Total U.S. Imports Tariffed	15%	82%
Average Effective Tariff Rate	2.7%	13.5%

Tariffs are now being used to address non-economic foreign policy issues—from immigration and fentanyl trafficking (Mexico, Canada, China) to broader geopolitical concerns (Greenland).

It does not help that Mr. Trump sees tariffs as a singularly effective tool for achieving multiple objectives. Some of these goals echo those of his first term, such as addressing unfair trade practices, correcting significant trade imbalances, shoring up national supply chains, reducing strategic vulnerabilities, rebuilding U.S. manufacturing, and gaining negotiating leverage. But two new goals have taken on greater significance. First, tariffs are now being used to address non-economic foreign policy issues—from immigration and fentanyl trafficking (Mexico, Canada, China) to broader geopolitical concerns (Greenland). Second, they appear to be used as a revenue-generating tool to help fund proposed tax cuts. It is perhaps this last objective, often overlooked, that may prove the most consequential, because it means that even in the best-case scenario, some version of these tariffs will remain in the long haul.

In our view, it is very likely that Mr. Trump is less committed to a particular fixed policy than he is to the broader conviction that tariffs, however deployed, yield a win-win outcome.

The problem is that with so many objectives at once, the administration often loses track of which goal it is prioritizing at any given moment. Some goals even contradict each other—such as trying to raise revenue and support domestic manufacturing (which assumes tariffs are permanent) while simultaneously using them as bargaining chips in trade talks (which assumes they'll eventually be lifted). That's why interpretations of its trade agenda vary so widely: it's never quite clear what the real aim is.

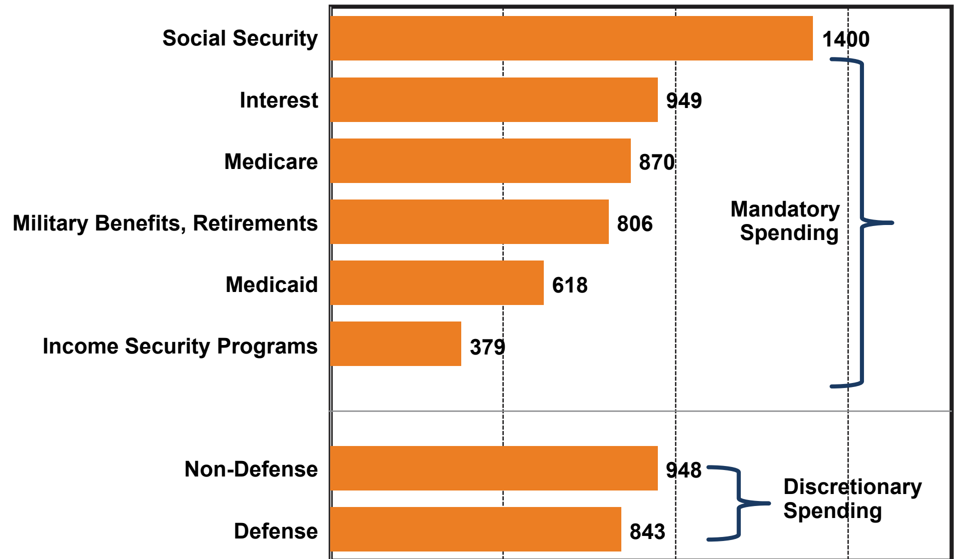
But that might be just as well, if you ask the administration. In fact, in our view, it is very likely that Mr. Trump is less committed to a particular fixed policy than he is to the broader conviction that tariffs, however deployed, yield a win-win outcome. If they stick, revenues rise and (ideally) some manufacturing returns home. If they are lowered in exchange for other countries reducing their own barriers, that's a win too—U.S. exports gain market access, and the administration gets to declare victory. Either way, "We have cards," as Mr. Trump would put it. And on that point, he's not wrong.

Reforming the bureaucratic state is both urgently needed and deeply resented. For decades, reports from the Government Accountability Office list failure after failure, with an estimated $250-$500 billion in fraud and abuse to boot.

The second plank of President Trump's agenda—reforming the administrative state—is also facing a myriad of challenges. The grandly named Department of Government Efficiency (DOGE) has drawn so many negative headlines that, just three months in, its most notable accomplishment may be slashing confidence rather than budgets. Charged with the daunting goals of modernizing federal technology, cutting government spending, and boosting transparency and accountability, its mission borders on the Herculean. That's because reforming the bureaucratic state is both urgently needed and deeply resented. For decades, reports from the Government Accountability Office list failure after failure, with an estimated $250-$500 billion in fraud and abuse to boot.

DOGE has promised $1 trillion in cuts—down from an initial $2 trillion—which is patently outlandish, especially given that its actual scope is far smaller than advertised, targeting only discretionary spending which accounts for a mere 15% of the budget ($1.8 trillion) (Figure 8). One can't help but recall Dr. Evil's words when describing his father: "He would make outrageous claims, like he invented the question mark." Yes, $1 trillion is far-fetched, but even a far more modest sum would be welcome in a world where the national debt has hit $36 trillion.

FIGURE 8
The Scope of DOGE is Only Limited to Discretionary Spending (billions of dollars)



So far, DOGE claims to have saved $160 billion—mostly through a mix of asset sales, contract and lease cancellations, elimination of fraud and improper payments, grant cancellations, interest savings, programmatic adjustments, and regulatory streamlining. However, independent estimates put the actual savings closer to a third of that figure. But most of the doom-mongering has come from its attempt to slash the federal workforce (Figure 9). Judging by the headlines, you'd be forgiven for thinking the number ran into the millions. In reality, the figure is far more modest: just 24,000 workers. Of those, roughly 16,000 had initially been reinstated by various lower courts after being deemed improperly terminated—only to have those rulings overturned by the Supreme Court. More layoffs—a hefty 280,000 according to the Challenger report—are still in the pipeline, suggesting that these numbers are likely to rise further over the course of the year (Figure 10).

More layoffs—a hefty 280,000 according to the Challenger report—are still in the pipeline, suggesting that these numbers are likely to rise further over the course of the year.

FIGURE 9
Federal Employment Cabinet-Level Agencies (thousands of employees)

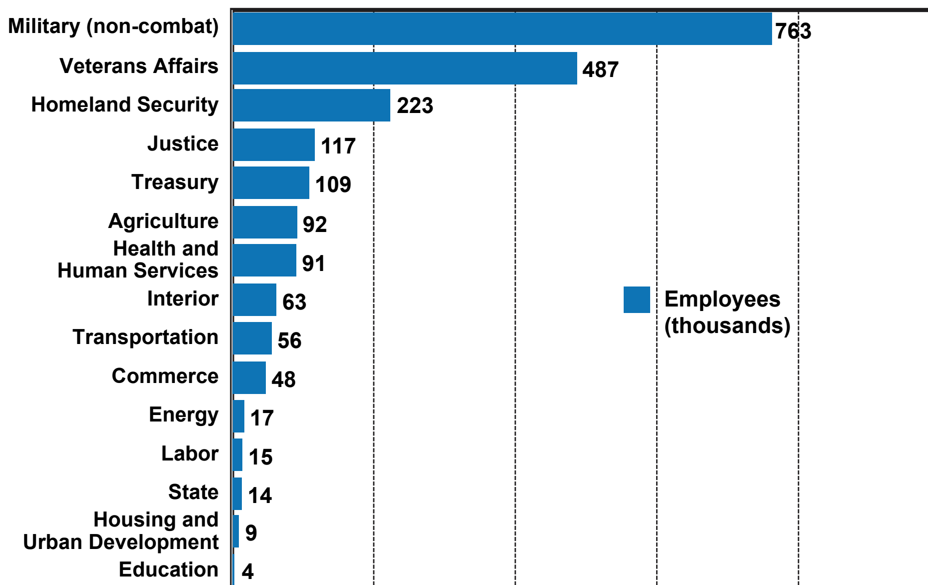
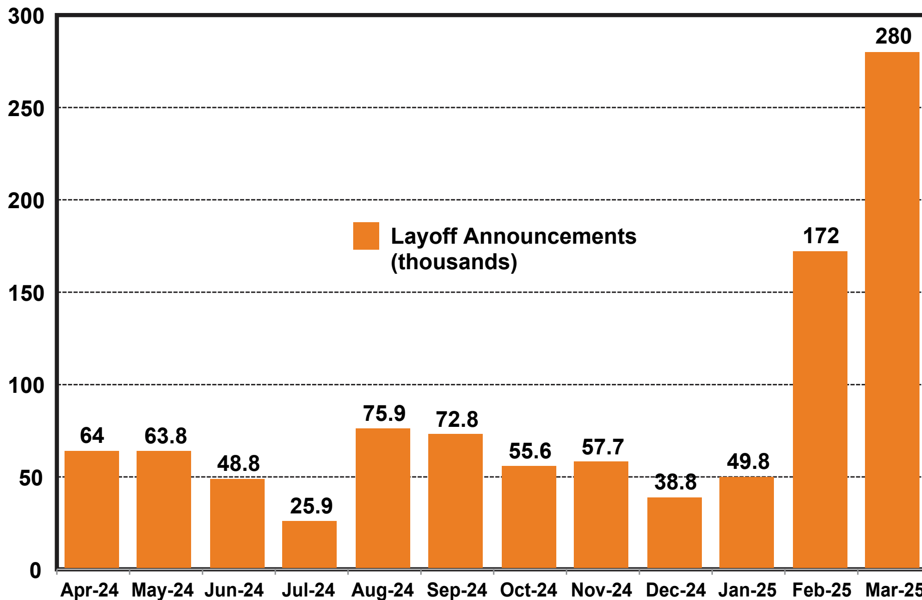


FIGURE 10
DOGE-Related Layoff Announcements Through the Roof (Challenger Report, thousands of employees)

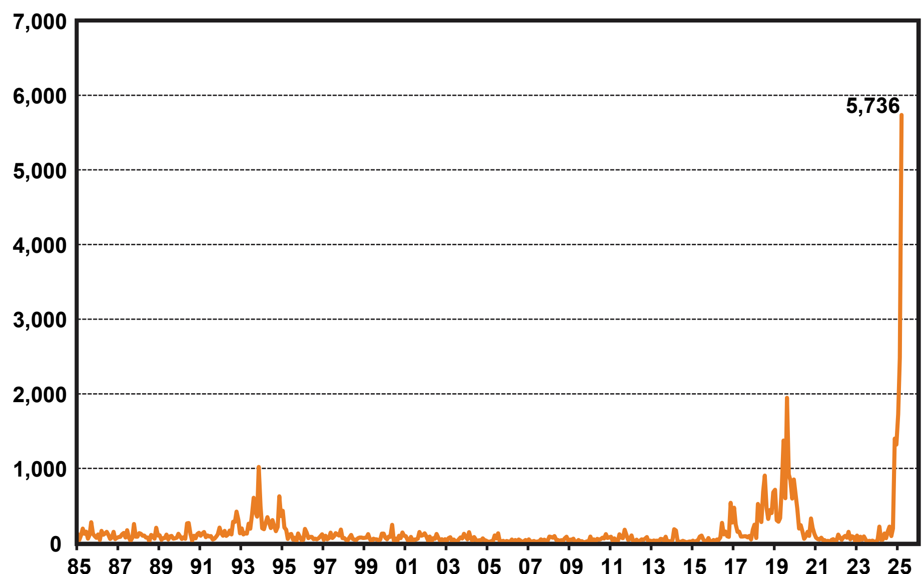


Perhaps just as concerning is the chaotic, disorienting, arbitrary, and at times mercurial manner in which these policies are being rolled out—even by the standards of an administration that seems to thrive on disorder.

Perhaps just as concerning is the chaotic, disorienting, arbitrary, and at times mercurial manner in which these policies are being rolled out—even by the standards of an administration that seems to thrive on disorder. Federal workers are fired, rehired, and then fired again. "Liberation Day" tariffs were first touted, then imposed with a heavy hand, then paused. Tariffs on Mexican and Canadian goods were announced, postponed, reimposed, and then partially rolled back in piecemeal fashion. Auto tariffs followed a similar script—imposed, then delayed by a month. The *de minimis* waiver, which exempts imports under $800 from duties, was revoked in February, hastily reinstated after customs systems were overwhelmed by a flood of parcels and will be revoked again in early May. So, while the tariff wall has now come down from its prohibitively high levels, the saga is far from over—as countries haggle with the administration for carve-outs and concessions.

This means uncertainty will remain elevated. In fact, a trade uncertainty index compiled by the Fed—which tracks media mentions of "trade" or "tariff" alongside "uncertainty"—had already surged to its highest level since the series began in 1960, even before the dramatic events of "Liberation Day" and its swift reversal (Figure 11). A broader policy uncertainty index has also spiked, reaching levels last seen during the pandemic. We expect both to remain elevated, given that the administration appears to regard strategic ambiguity as a source of strength in negotiating

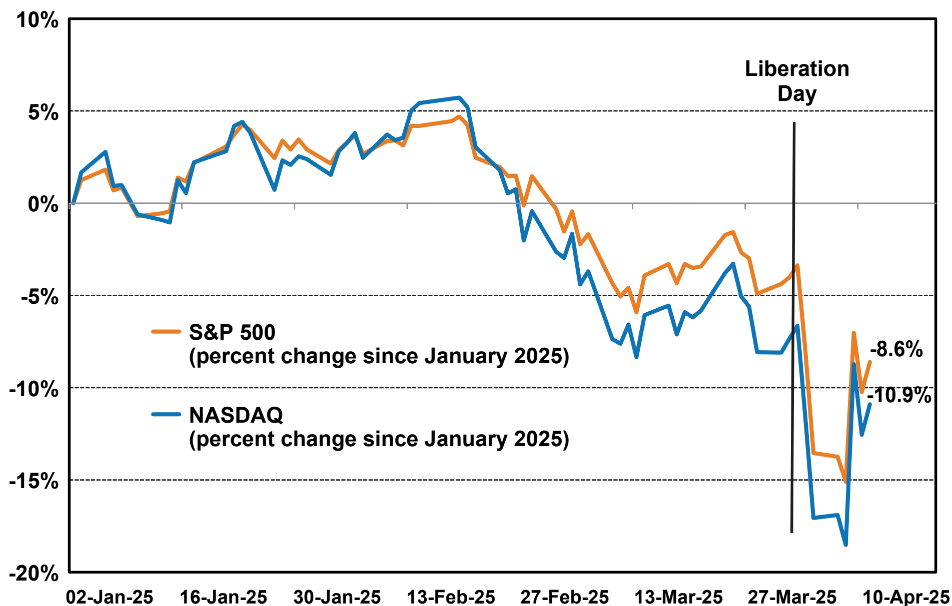
FIGURE 11
Off the Chart: Trade Policy Uncertainty Index at Record Levels (index)



leverage. Thus, uncertainty will continue to complicate business plans—and the work of your two favorite economists: This report (and its forecasts) went through more revisions than we care to admit, just to keep up with the head-spinning pace of policy shifts. But that's a minor inconvenience. What matters is the impact on the economic outlook.

The tariff whipsaw has well and truly whipsawed the market. "They're after me lucky charms!" is the paranoid refrain of one of Dr. Evil's henchmen. Ditto for the market, which—until the recent reversal—seemed increasingly convinced the administration's policies were after its own lucky charms. In the four terrifying trading days following "Liberation Day," the S&P 500 shed a jaw-dropping 12.5%—wiping out $6.6 trillion in market value in less than a week (Figure 12). The NASDAQ—already battling other structural headwinds—tumbled into bear market territory. The VIX index—a gauge of market fear—surged to levels consistent with peak-recessions. Then came April 9, and with it, a 90-day tariff reprieve—one that may as well have been a reprieve from all the carnage. The market soared, with the S&P 500 leaping 9.5% in a single day—its strongest performance since 2008. The NASDAQ notched its second-best day on record. While the rally was welcome, it laid bare a deeper fragility: that the market's fate can hinge on a single tweet. That's hardly the foundation of a stable business environment.

FIGURE 12
Whipsawed: The Market Hangs on a Whim of a Tweet
(percent change since January 2025)



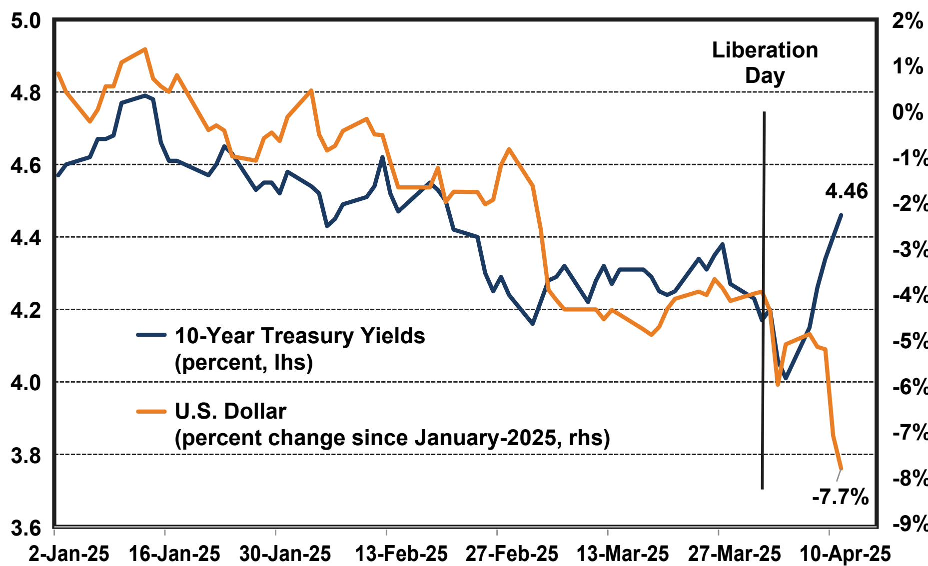
In fact, even prior to the recent convulsions, the administration had been extraordinarily blasé about the fate of the stock markets—a sharp contrast to its first term, when it treated it as a barometer of success. Treasury Secretary Scott Bessent spoke of an economy in need of "detoxing" (from excessive fiscal spending). President Trump had referred to a "little disturbance" and a "period of transition" (from rebalancing global trade)—and notably, declined to rule out the possibility of a recession. The "Trump put" appeared to have vanished: instead of a reassuring embrace, markets were met with a cold shoulder. "'Stead of treated, we get tricked, 'stead of kisses, we get kicked," as Mini-Me and Dr. Evil memorably rapped in It's a Hard-Knock Life—a line that perfectly seems to capture the market sentiment.

In fact, even prior to the recent convulsions, the administration had been extraordinarily blasé about the fate of the stock markets—a sharp contrast to its first term, when it treated it as a barometer of success.

But there is one market the administration seems to heed: the bond market. The U-turn on tariffs came after a two-day rout in Treasuries that sent 10-year yields soaring from 3.8% to nearly 4.5%—a dramatic spike seen only in times of acute stress (Figure 13). This is the opposite of what the administration wants: it has made no secret of its desire to push down long-term yields to revive the housing market and ease debt servicing costs. Part of the surge was tied to the unraveling of the "basis trade"—a highly leveraged strategy commonly used by hedge funds that exploits the (small) gap in pricing between cash Treasuries and futures. As margin calls mounted, hedge funds were forced to liquidate, pushing yields higher. Rumors also swirled of massive bond offloading by foreign holders—possibly Japan, though many assumed China. But no matter the cause, the bond market's revolt likely played a decisive role in the administration's policy reversal. As James Carville once put it: "I used to think that if there was reincarnation, I wanted to come back as the president or the pope or as a .400 baseball hitter. But now I would like to come back as the bond market. You can intimidate everybody." Truer words have rarely been spoken.

The U-turn on tariffs came after a two-day rout in Treasuries that sent 10-year yields soaring from 3.8% to nearly 4.5%—a dramatic spike seen only in times of acute stress.

FIGURE 13
An Unwelcome Development: Bond Yields Up; Dollar Down
(percent)



Despite the pause, the tariff wall remains higher than it was at the start of the year—and may yet grow taller. Higher tariffs—and, to a lesser extent, spending cuts—have stirred fears of both slower growth and a fresh inflation flare. "I started working on my mojo to counter their mojo, we got cross-mojulation and their heads started exploding," as Mr. Powers would say. The cross-mojulation of tariffs and DOGE is beginning to exact a real toll on the outlook. And unlike in the first term, when the carrot—tax cuts and deregulation—came before the stick, this time, it seems, it's all stick, at least so far. The tariff pause has helped calm frayed nerves and soothe sentiment, but uncertainty lingers, and markets remain jittery. Doom predictions—though dialed back from their apocalyptic peaks on "Liberation Day"—continue to loom. Soft-landing dreams have evaporated. There's continued chatter of a "growth scare." Stagflation worries haunt every forecast. Wall Street remains on recession watch. American exceptionalism—so ubiquitous just five minutes ago—appears to be on its deathbed. The swagger is gone.

There's continued chatter of a "growth scare." Stagflation worries haunt every forecast. Wall Street remains on recession watch. American exceptionalism—so ubiquitous just five minutes ago—appears to be on its deathbed.

Color us skeptical. In times like these, we urge a collective deep breath, a clear-eyed resolve, and a steely endurance. Yes, the economic outlook is softening—not only because of the administration's policies, which are delivering their own shocks, but also because the U.S. economy was already poised to slow after years of above-trend growth. But that doesn't mean that worst-case scenarios will materialize. In fact, our view is that none of the anticipated scenarios—a full-blown stagflation, a proper recession, or worse, the death of American exceptionalism—are in the cards, at least not over the forecast horizon.

Our view is that none of the anticipated scenarios—a full-blown stagflation, a proper recession, or worse, the death of American exceptionalism—are in the cards, at least not over the forecast horizon.

Instead, the outlook is simultaneously both less frightening and more complex than each of these scenarios in isolation imply, split into two distinct phases: a bumpier, more uncertain short term, followed by a more resilient and robust long-term trajectory. While odds of a downturn have risen appreciably, we still expect the U.S. economy to skirt a recession, even as growth slows and inflation ticks higher. Thus, our outlook for the remainder of the year calls for a period of heightened volatility marked by moderate stagflationary dynamics—stagflationar-ish, if you will. We expect inflation to edge up to the high 3s, unemployment to rise to the high 4s, and growth to slow to the low 1s. This is more painful than it sounds especially since we do not expect the Fed to ease the pain, not by much, anyway. If it is any consolation, the stagflationary features are likely to be more moderate than the full-blown variety of the 70s when the unemployment rate averaged 6% and inflation 7%. Longer-term, the outlook is brighter as tax cuts and an ambitious deregulatory agenda are expected to boost growth and buoy investments.

The outlook is simultaneously both less frightening and more complex than each of these scenarios in isolation imply, split into two distinct phases: a bumpier, more uncertain short term, followed by a more resilient and robust long-term trajectory.

We would be the first to acknowledge that risks to our baseline are firmly tilted to the downside, given that much can go wrong. In fact, should "Liberation Day" tariffs be reinstated again, which is not our base case, it is hard to see how the U.S. or the global economy avoids a recession. In fact, our nuanced—and arguably more benign—outlook rests uncomfortably on a set of assumptions that have less to do with economic fundamentals and more with the nature of policy initiatives and the likelihood of their success. This makes the outlook especially vulnerable: a few incorrect assumptions about where Mr. Trump ultimately lands on a broad set of issues—tariffs, DOGE, deregulation, immigration—or about Congress's ability to deliver on tax cuts, could easily knock it off course. Nonetheless, even if policy errors exceed our baseline expectations—a real possibility—a few key fundamentals, such as relatively low financial leverage in the private sector, should help limit the likelihood of worse outcomes.

We would be the first to acknowledge that risks to our baseline are firmly tilted to the downside, given that much can go wrong.

The case for no recession—though more challenging than just a few weeks ago—is still alive, if you look closely. Perhaps the most straightforward reason is that similar to the pandemic, when a sharp recession was triggered by government-imposed shutdowns, much of today's turbulence is rooted not in economic fundamentals, but in policy choices. "I'm going to place them in an easily escapable situation involving an overly elaborate and exotic death," Dr. Evil crows. Tariffs may well bring an overly elaborate and exotic death to the U.S. economy—but this is a man-made predicament, not destiny. Adjust a few tariff rates here, renegotiate some trade deals there, as we assume in our baseline, and odds that a recession is avoided improve dramatically.

The case for no recession—though more challenging than just a few weeks ago—is still alive, if you look closely.

Importantly, the over-the-top doom and gloom blanketing the airwaves must be resisted—especially in moments of extreme uncertainty like the present. Nothing is more dangerous than the belief that "this time is different." Yes, we are navigating waters last charted a century ago, amid rising trade tensions and a potential reconfiguration of global trade—but there's a higher risk that apocalyptic predictions will far outpace reality. We've been here before. In fact, much of today's rhetoric echoes the not-so-distant past. At the onset of COVID-19, we were warned that up to 50 million people might perish, that vaccines would take years to develop, and that lockdowns could last not months, but potentially years. After Russia invaded Ukraine, headlines warned of an imminent World War III and a global recession triggered by energy shocks and the massive disruption to global trade. The list goes on. "Once-in-a-century" events have a way of evoking the darkest predictions precisely because they are extraordinary events.

Importantly, the over-the-top doom and gloom blanketing the airwaves must be resisted—especially in moments of extreme uncertainty like the present.

In fact, when stripping away the noise, economic fundamentals, though weaker than at the start of the year, are holding up relatively well even as the economy cools. Financial conditions continue to remain easy as of this writing (early April). The number of banks tightening lending standards—a key indicator of how difficult it is to obtain business loans—has returned to normal levels after spiking during the banking panic two years ago (Figure 14). Credit spreads—the gap between high-yield (below investment grade) corporate bonds and 10-year Treasuries—widened by 60 basis points on "Liberation Day", the highest in 17 months, but are still below levels consistent with a recession (Figure 15). The Chicago Fed Financial Conditions Index—a broader gauge of market tightness—continues to signal an environment of easy financial conditions and ample credit availability.

In fact, when stripping away the noise, economic fundamentals, though weaker than at the start of the year, are holding up relatively well even as the economy cools.

FIGURE 14
Bank Lending Standards Have Eased Since the 2023 Mini-Panic
(net percent of banks)

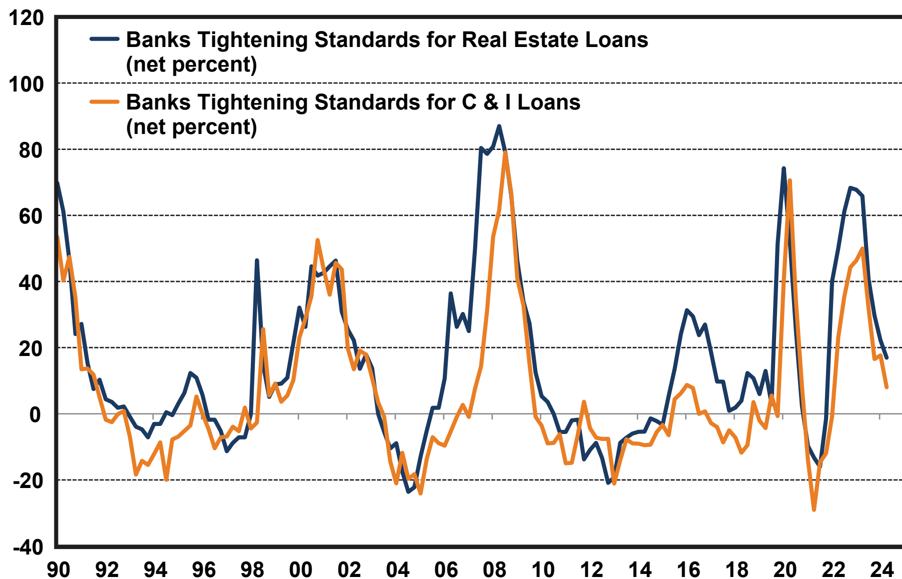
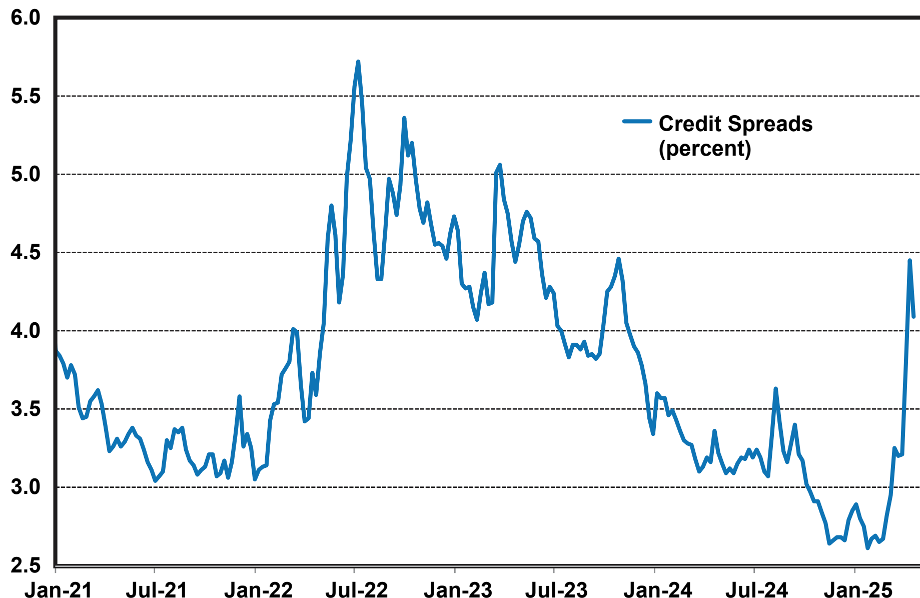
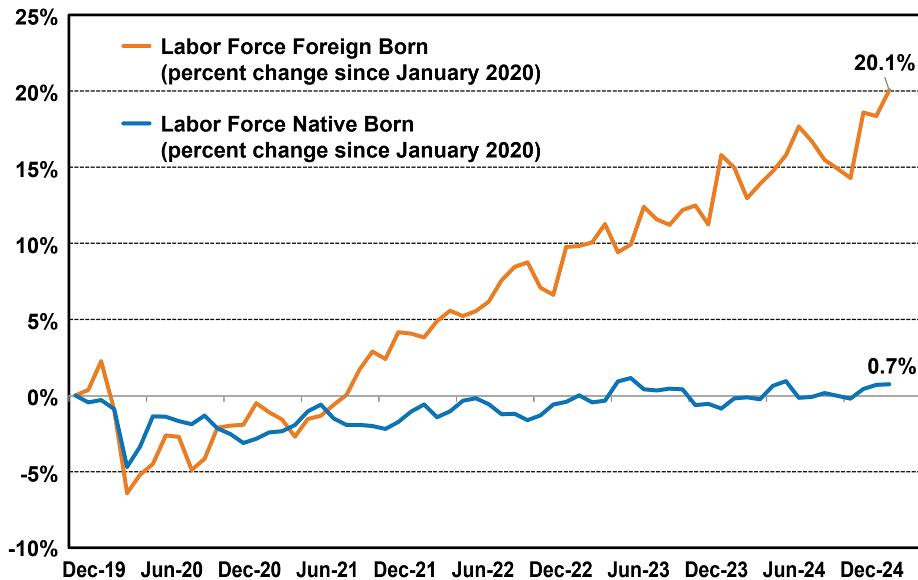


FIGURE 15
Credit Spreads Have Widened but Are Still Below Crisis-Levels
(percent)



The labor market remains robust. Job growth slowed to an average of 152,000 per month in the first quarter—down from 166,000 last year—but March brought a sharp upside surprise, with 228,000 jobs added, well above the 140,000 expected. In its annual benchmark, the Bureau of Labor Statistics also carried out revisions to the household survey—which were unusually large, driven in part by a surge in immigration over the past few years (Figure 16). But unlike the payroll data, these were *upward* adjustments. The new estimates added nearly 3 million people to the civilian non-institutionalized population (ages 16 and over), 2.1 million to the labor force, and 2 million to total employment.

FIGURE 16
Foreign Born Population: a Huge Boost to Labor Supply (percent change since January 2020)



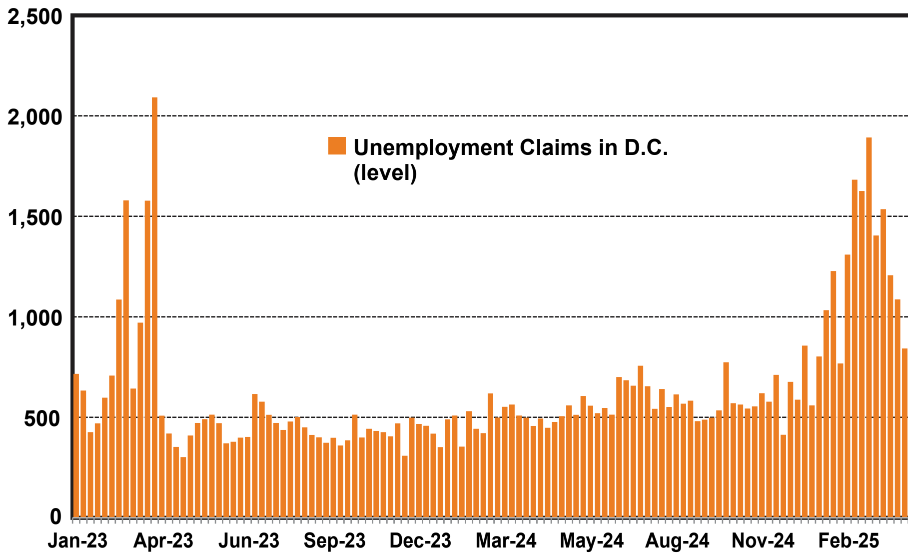
The outlook for hiring has unquestionably turned more cautious, especially in the wake of policy-induced shocks. Still, the latest data points more to a holding pattern rather than to an outright collapse. Job openings—as measured by the JOLTS survey—weakened slightly in February (the latest available data), falling by 194,000, but remain above pre-pandemic levels. Job postings on Indeed have actually edged higher since the start of the year, rising 2.4% through the end of March. The March NFIB index shows that the net share of small firms planning to increase employment versus those planning to cut remained at 12%—a bit lower than after the election, but roughly where it has held for the past twelve months. Meanwhile, tariff policy appears to have had little immediate impact on hiring among large firms: in the Duke CFO Survey, 70% of respondents said they had made no changes to hiring plans, while 24% reported a reduction.

The outlook for hiring has unquestionably turned more cautious, especially in the wake of policy-induced shocks. Still, the latest data points more to a holding pattern rather than to an outright collapse.

Layoffs and separations remain low. Weekly initial jobless claims have actually declined over the past three weeks, reaching 223,000—well below the 350,000 level typically associated with a recession. Even unemployment claims from federal workers—tracked separately through the Unemployment Compensation for Federal Employees (UCFE) program—have returned to historical norms after spiking to 1,600 in February. The same is true for unemployment claims in the DC area, which is where most layoffs are occurring (Figure 17). That said, we do expect these numbers to climb as DOGE and the administration press forward with efforts to downsize the federal workforce and notch more legal wins. Challenger, which tracks announced job cuts, reported 280,253 planned layoffs of federal employees and contractors over the past two months, affecting 27 agencies.

Challenger, which tracks announced job cuts, reported 280,253 planned layoffs of federal employees and contractors over the past two months, affecting 27 agencies.

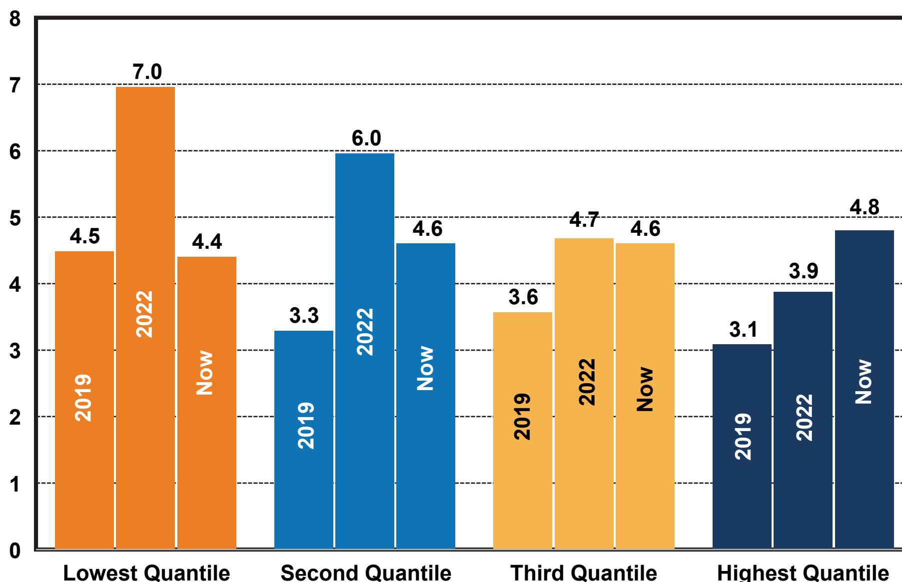
FIGURE 17
Unemployment Claims in Washington, D.C. Rose in February, But Have Declined Recently (level)



All this means that while no longer red-hot, the labor market is holding steady, at least for now. This has boosted wage and income growth. Except for the bottom quintile—where wage growth has largely reverted to its historical norm after a post-pandemic surge—wage gains across all other segments remain 1.5 to 2 percentage points above pre-pandemic levels (Figure 18). Real disposable income rose by 1.7% on a year-over-year basis in February, up from 1.3% in January. This is below the 2.6% average historical pace, but this is not surprising given that inflation has remained sticky. Most notably, as of the fourth quarter of last year (latest available data), household wealth had surged by nearly $50 trillion since the pandemic—$15.3 trillion from housing equity and the rest from financial assets. Admittedly, the recent market correction has taken a toll: since the February peak, roughly $6 trillion has been wiped out from the stock market. Even so, U.S. households remain more than $44 trillion wealthier than they were before the pandemic.

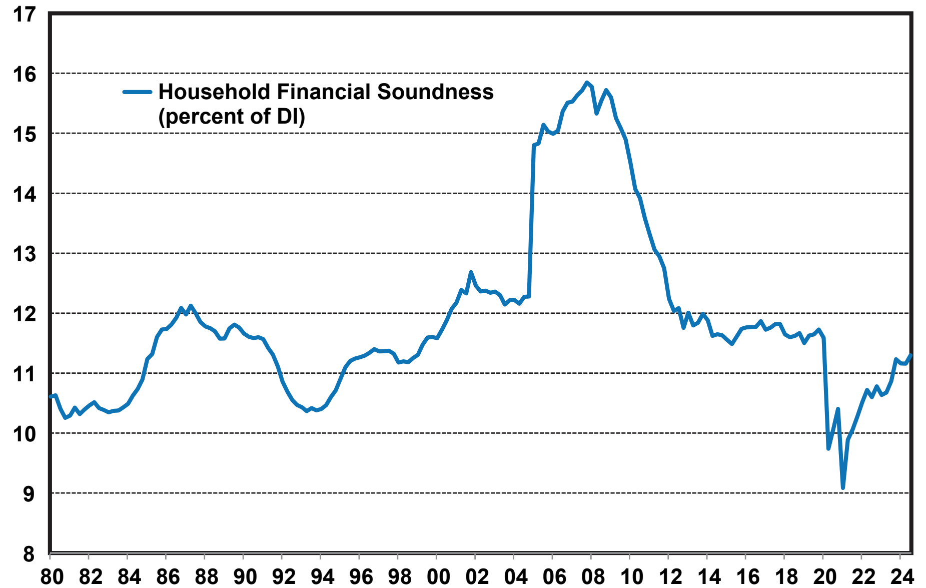
Except for the bottom quintile—where wage growth has largely reverted to its historical norm after a post-pandemic surge—wage gains across all other segments remain 1.5 to 2 percentage points above pre-pandemic levels.

FIGURE 18
Wage Growth is Higher than Pre-Pandemic, Except for Lowest Quintile Earners (y-o-y percent change)



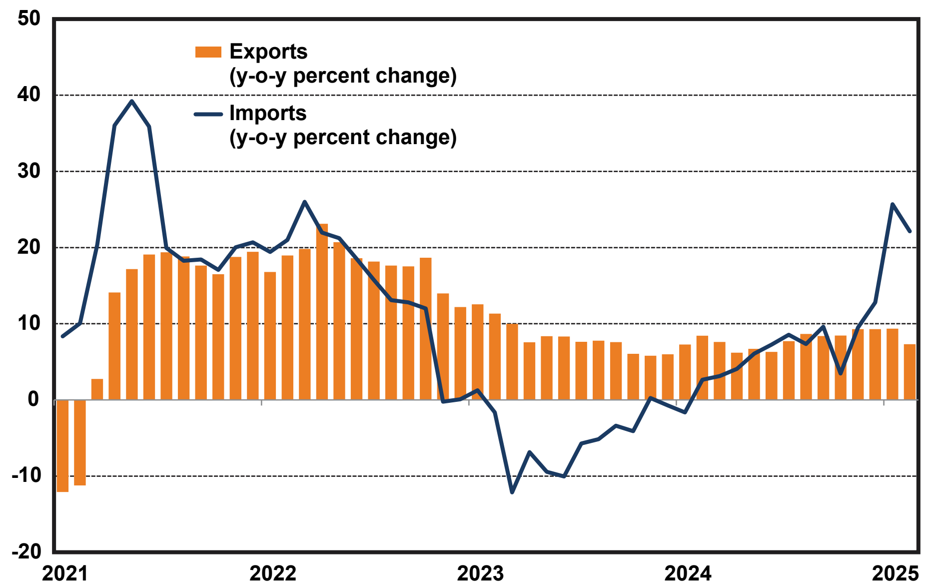
Perhaps most importantly, private sector balance sheets—across households, corporations, and banks—remain in solid shape. Household debt service payments as share of disposable income, while up slightly from historical low levels recording during the pandemic, continue to remain at decades-lows (Figure 19). Overall household debt as a share of GDP is at its lowest level in 25 years. And it's not just households: liabilities relative to GDP are also at historically low levels for both corporations and banks. The corporate debt maturity wall is also less daunting now than it appeared a couple of years ago, when many commercial real estate (CRE) loans—originated at ultra-low pandemic-era rates—were expected to reset at much higher ones. Nearly $900 billion in CRE loans matured last year, but the pipeline ahead is more manageable: $580 billion will mature in 2025, $430 billion in 2026, and $380 billion in 2027. Another piece of good news: The maturity schedule for other corporate debt – leveraged loans, high-yield, and investment-grade – is spread out over time. Most firms that locked in low rates during the pandemic won't need to refinance any time soon—a comforting thought, even if rates stay higher for longer.

FIGURE 19
Household Balance Sheets are in Good Shape
(debt service plus principal payments as percent of disposable income)



Some of the recent economic softening also appears to be temporary rather than structural. An unusually cold January dampened consumer spending. The dire first quarter GDP forecast from the Atlanta Fed seems to be driven primarily by a widening trade deficit as firms front-loaded imports ahead of impending tariffs (Figure 20). A major contributor was a surge in non-monetary gold imports, which jumped from $13.2 billion in December to $32.6 billion in January—accounting for nearly 60% of the trade gap's expansion. However, since the Bureau of Economic Analysis excludes gold transactions from GDP calculations, adjusting for this quirk would lift the Atlanta Fed's tracker from -2.4% to a more modest -0.4%. Perhaps most telling, other high-frequency indicators—like the Dallas Fed's activity index—continue to point to solid growth, registering 2.3% at the end of March.

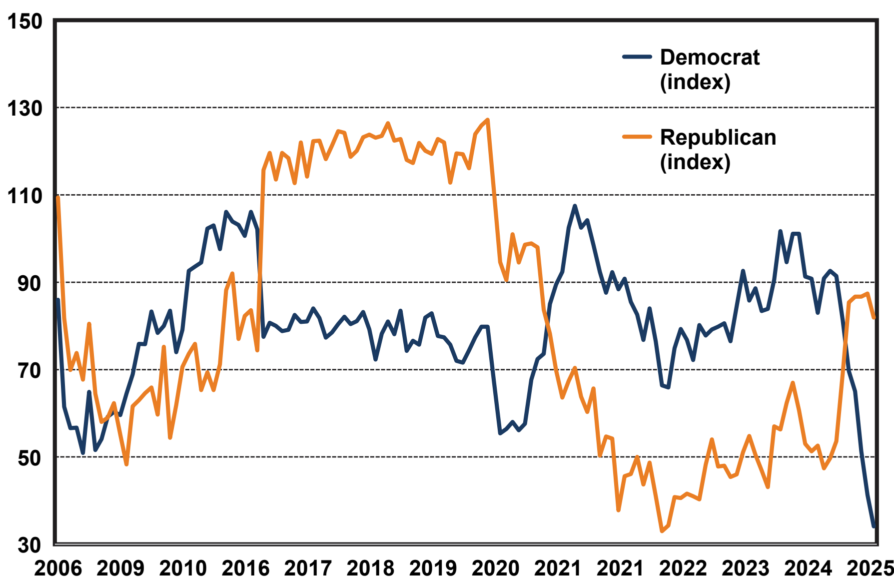
FIGURE 20
A Surge in Imports due to Impending Tariffs Has Distorted Q1 Growth
(y-o-y percent change)



Consumer sentiment has collapsed, but as has been the case since the pandemic, there is a gulf of separation between sentiment and actual consumer behavior. While as of this writing the full impact of the tariff whipsaw has yet to show up in the data, high-frequency indicators are holding up so far. Foot traffic at airports continues to remain strong according to TSA data, OpenTable reservations are currently 1% ahead of last year's pace, and Redbook retail sales—a gauge of same-store sales at major retailers—are growing at a 7% rate, the highest so far this year. Besides, so deeply embedded appears to be the partisan divide that sentiment is increasingly shaped more by how consumers voted in the last election than by their perceptions on the economy. According to the University of Michigan survey, Democrats are now more pessimistic than during the depths of the Great Recession, while Republicans are more upbeat than at any point since before the pandemic (Figure 21).

Consumer sentiment has collapsed, but as has been the case since the pandemic, there is a gulf of separation between sentiment and actual consumer behavior.

FIGURE 21
A Partisan Divide: Consumer Sentiment is Now More Political than Ever
(University of Michigan consumer sentiment, index)

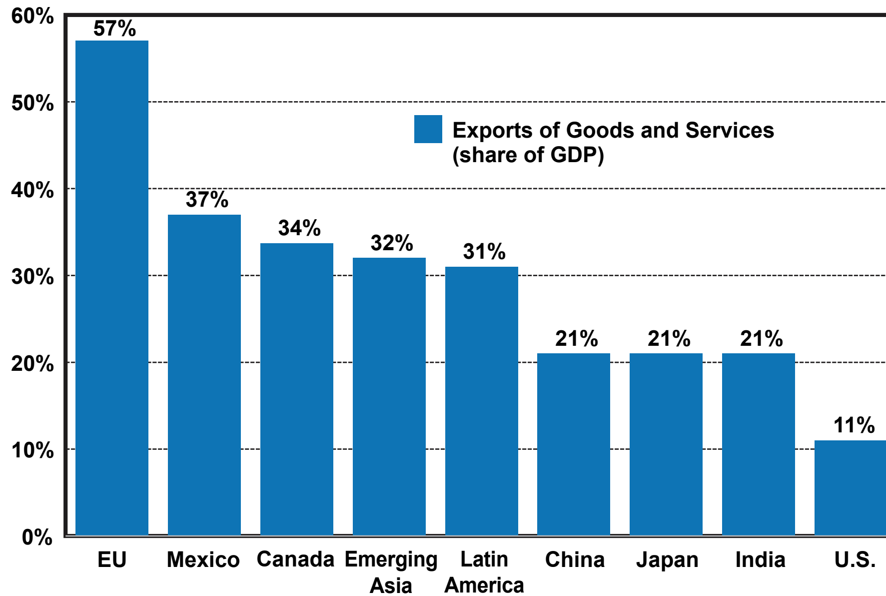


According to the University of Michigan survey, Democrats are now more pessimistic than during the depths of the Great Recession, while Republicans are more upbeat than at any point since before the pandemic.

Of course, all this could shift quickly—we're still in the first inning of the global trade reconfiguration, and trade tensions, especially with China, seem far more likely to escalate than ease in the near future. But even here, the outlook may not be as dire as it seems at first brush. First, if protectionism is here to stay—as it appears to be—no country is better positioned to withstand it than the United States. In truth, America's self-sustained, continent-sized economy, has always been more closed than open, with trade being more of a residual activity than its driving force. Last year, exports of goods and services made up just 11% of U.S. real GDP, a fraction of the EU's 57%, Mexico's 37%, Canada's 33.7%, and even China, Japan, and India's 21% (Figure 22). Mexico and Canada, in particular, remain heavily dependent on U.S. trade, with over 75% of their exports bound for the U.S., making up 30% and 20% of their GDP, respectively, leaving them vulnerable in a tit-for-tat trade war. By contrast, U.S. exports to its top three trading partners—Mexico, Canada, and China—account for just 3% of its GDP, underscoring America's comparative insulation from trade disruptions.

America's self-sustained, continent-sized economy, has always been more closed than open, with trade being more of a residual activity than its driving force.

FIGURE 22
Trade Accounts for a Small Share of U.S. Economy, Unlike Other Countries (exports, percent of GDP)



Second—and perhaps even more importantly—while we believe tariffs are here to stay for the duration of the current administration, the current 16.2% average likely marks a ceiling, leaving ample room for negotiation. We expect a number of broader trade deals to emerge, in which tariffs—and potentially other trade barriers—could be rolled back on both sides. Several countries—Israel, Vietnam, Taiwan, and Zimbabwe—have already offered to cut their tariffs on U.S. goods to zero, while the EU has proposed eliminating tariffs on industrial goods. We wouldn't be surprised if more follow suit. According to the White House, 130 countries have already reached out in hopes of striking a deal.

While we believe tariffs are here to stay for the duration of the current administration, the current 16.2% average likely marks a ceiling, leaving ample room for negotiation.

As we outline below, we see the current tariff landscape falling broadly into five categories: (a) USMCA countries; (b) reciprocal tariff countries—typically those with which the U.S. runs large trade deficits; (c) sector-specific tariffs; (d) China; and (e) the universal 10% group. With the exception of the last category, where tariff reductions appear least likely, we expect trade negotiations to yield tariff cuts—and potentially dismantle some trade barriers—in the remaining four, though to varying degrees. The greatest potential for tariff reduction lies in the first three categories, where we expect the current U.S. tariff wall to come down meaningfully—with more limited, though still significant, reductions likely in the case of China.

All this will take time—especially if negotiations expand to include haggling over non-tariff trade barriers. The administration has even signaled it would consider commitments on future U.S. investments as part of broader deals. We wouldn't be surprised if the 90-day pause is extended—perhaps repeatedly—before any meaningful frameworks with dozens of trading partners take shape. This means the current tariff structure is likely to remain in place for the foreseeable future.

We wouldn't be surprised if the 90-day pause is extended—perhaps repeatedly—before any meaningful frameworks with dozens of trading partners take shape.

This is the main reason why our outlook in the short term is for a bumpy ride with stagflationary dynamic. Tariffs, after all, are the ultimate stagflationary shock—akin to an oil price shock. They fuel inflation and throttle growth, and even the U.S.—with its "splendid isolationism"— is not immune. But it is perhaps the drag on growth rather than inflationary pressures that are more concerning, given current dynamics of the American economy. That's because this radical remake of global trade is coming at a time when the U.S. economy was already poised to slow. The post-

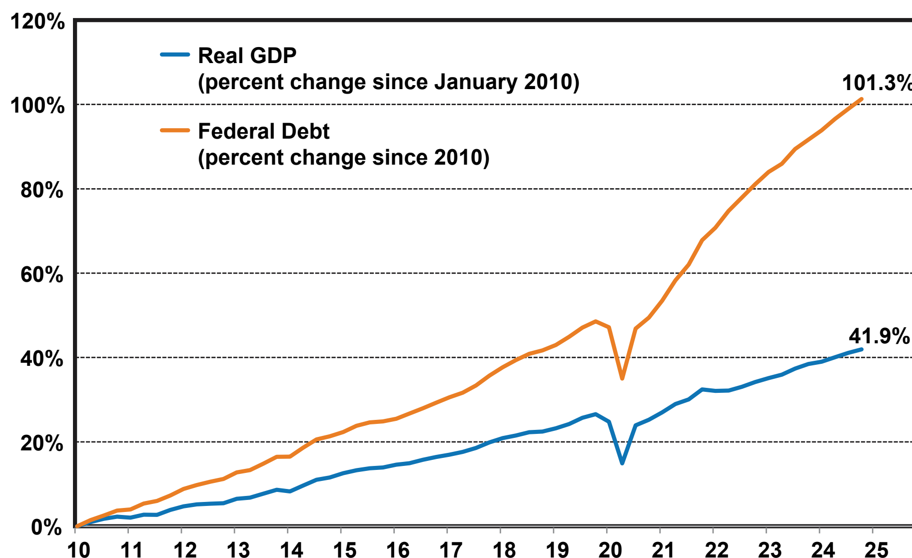
pandemic spending spree is fading, excess savings (squirreled away during lockdowns) are drying up, and job growth will likely soften as supply chains are reshuffled yet again under the weight of the new tariffs. "There's nothing more pathetic than an aging hipster," Dr. Evil cruelly quips about Austin Powers. Indeed. An aging expansion is just as troubling.

Importantly, the three main engines that powered the U.S. economy's exceptional performance over the past three years—fiscal support, advances in AI, and the strength of high-income consumers—are less likely to drive growth going forward.

Importantly, the three main engines that powered the U.S. economy's exceptional performance over the past three years—fiscal support, advances in AI, and the strength of high-income consumers—are less likely to drive growth going forward.

Take fiscal support first. The deficit stood at 6.4% of GDP last year, which is rather bewildering given the economy grew nearly 3%. An extra $600 billion in federal spending across 2022 and 2023 helped the U.S. sidestep a recession amid aggressive Fed rate hikes. Government hiring played a major role too: 28% of all jobs created in 2023 and 23% in 2024 were in the public sector—well above the historical average of 8%. federal debt has surged by a staggering 100%, while U.S. GDP has grown by a far more modest 42% (Figure 23).

FIGURE 23
Not so Exceptional: Debt Has By Far Outpaced Real GDP Growth (percent change since January 2010)



The current administration is intent on reversing these trends by slashing public-sector employment—and, presumably, spending—though outlays in the first five months of this year have already outpaced last year's by a significant $318 billion, largely due to the carryover from the previous budget. The pivot from public- to private-led growth is a welcome shift. The challenge, however, is that while the benefits of such structural changes unfold over time, the pain is immediate.

The pivot from public- to private-led growth is a welcome shift. The challenge, however, is that while the benefits of such structural changes unfold over time, the pain is immediate.

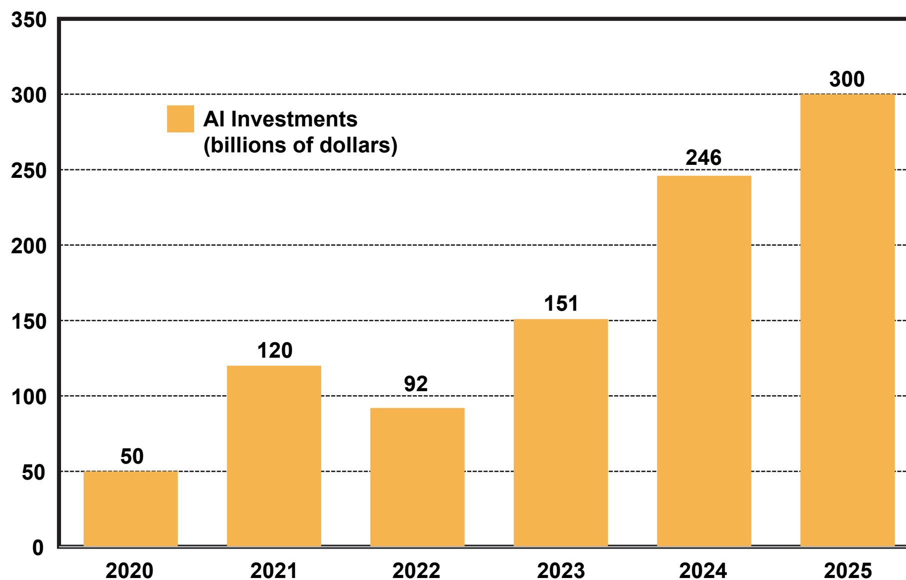
The second factor that propelled growth over the past two years—artificial intelligence (AI)—is now unwinding. The high-tech sector had already started the year on shaky ground, even before the tariff-saga fueled uncertainty. Some of that weakness stemmed from the fading frenzy for "everything AI," which had previously sent the stocks of the Magnificent Seven to stratospheric levels. But the real shock came at the end of January, when the world learned that DeepSeek, an obscure Chinese firm, had managed to develop an AI model rivaling top American counterparts—but without the astronomical costs or cutting-edge U.S. chips. The news landed with a thud.

It is a close to a "Sputnik moment" as America has seen in over a generation underscoring an uncomfortable truth—that China may be further ahead in the AI revolution than many had assumed, and that AI breakthroughs are no longer a U.S.-centric domain.

But it's not just geostrategic concerns: the promise of AI has been a key engine of U.S. growth over the past three years, contributing 0.5 percentage points to GDP in 2022, 0.3 points in 2023, and 0.2 points in 2024, as investments in data centers and AI infrastructure surged. The five major tech firms—Alphabet, Amazon, Apple, Meta, and Microsoft—collectively spent an estimated $246 billion on capital expenditures in 2024, much of it directed toward AI-related hardware and R&D (Figure 24). Overall spending in AI was projected to reach $1.4 trillion between 2024 and 2027.

It is a close to a "Sputnik moment" as America has seen in over a generation underscoring an uncomfortable truth—that China may be further ahead in the AI revolution than many had assumed, and that AI breakthroughs are no longer a U.S.-centric domain.

FIGURE 24
Investments in AI Were A Huge Boost for the Economy (billions of dollars)



All this is now in question. The emergence of DeepSeek has sparked fears that U.S. tech giants may have overinvested in the AI promise. For now, Big Tech remains publicly committed to ramping up AI-related investments, which are estimated to reach $320 billion in 2025. But this was before the current market rout: as of this writing, the Magnificent Seven have lost a staggering $1.57 trillion in market capitalization. More turbulence may lie ahead, particularly if other countries—such as the EU—retaliate against America's new tariffs by targeting services. Signs of a pullback are already emerging. Microsoft has recently scaled back several data center projects both globally and in the U.S., even as it maintains that it will spend $80 billion on infrastructure this year.

The emergence of DeepSeek has sparked fears that U.S. tech giants may have overinvested in the AI promise.

The third cause for concern is the outlook for high-income consumers. Perhaps the most enduring trend of the recent expansion—and its most glaring vulnerability—is that consumption growth has become increasingly reliant on households at the top of the income distribution. While 58% of U.S. households own stock, the top 10% hold a staggering 88% of total equity wealth, with the top 1% alone owning 38%. Housing wealth is somewhat more broadly distributed, yet even here, the top 40% of income earners control 74% of it. The sharp rise in both financial and housing wealth over the past three years has powered consumption at the top, with the wealthiest 10% now accounting for nearly half of all consumer spending—up from a historical average of around 38%.

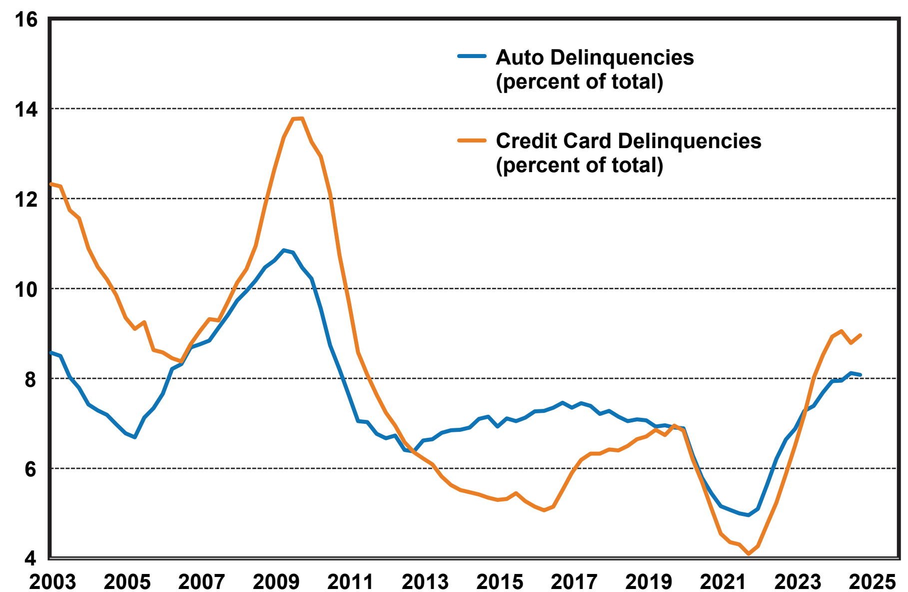
Perhaps the most enduring trend of the recent expansion—and its most glaring vulnerability—is that consumption growth has become increasingly reliant on households at the top of the income distribution.

This trend now appears increasingly fragile. With the recent stock market rout wiping out nearly $6 trillion in market capitalization, it's easy to see why growth fueled by this top cohort may be in jeopardy. Although overall wealth levels remain high even after the current correction, it wouldn't be surprising to see upper-income households begin to pull back. Anecdotal evidence already points to signs of strain: luxury retailers are reporting weaker sales, travel demand is softening, and credit card delinquencies—once concentrated among lower-income households—are now ticking up among wealthier borrowers.

With the recent stock market rout wiping out nearly $6 trillion in market capitalization, it's easy to see why growth fueled by this top cohort may be in jeopardy.

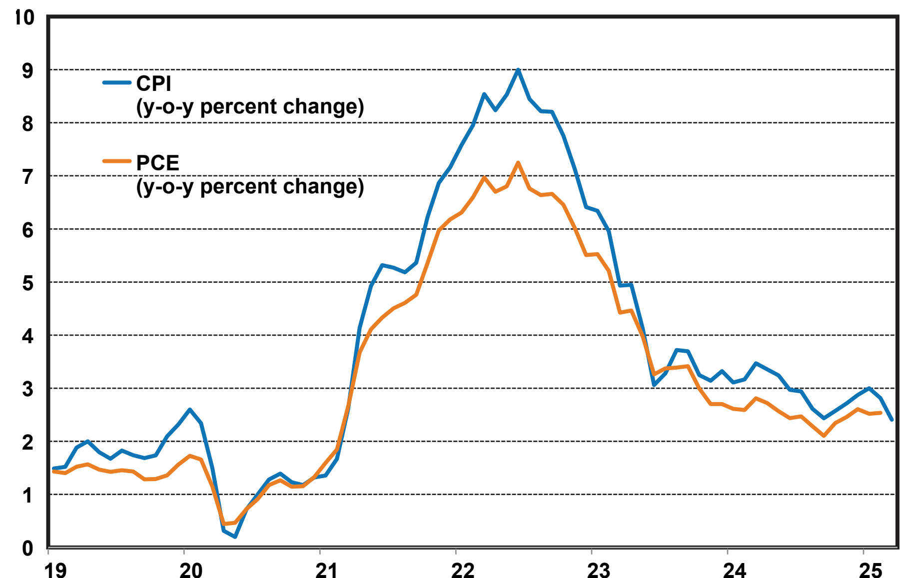
This comes at a time when households in the bottom half of the income distribution have already retrenched. Pandemic-era excess savings for the bottom 40% have been fully depleted. This segment of the population is now leaning heavily on credit cards, with outstanding balances exceeding $1 trillion—even as interest rates on revolving debt hover at a staggering 21.6%. Signs of financial strain are becoming increasingly visible: 33% of U.S. consumers now carry more credit card debt than they have in emergency savings. Auto loan delinquencies have climbed to their highest levels since 2010, and credit card delinquencies are now at their highest point since before the pandemic, according to the New York Fed (Figure 25). Meanwhile, wage growth at the lower end of the income spectrum has cooled notably. For the bottom quintile of earners, pay is now growing at just 4.4%—a marked slowdown from the 7%+ gains seen in the immediate aftermath of the pandemic.

FIGURE 25
Highest Delinquencies since the 2008 Financial Crisis (percent of total)



Slowing growth—now dramatically amplified by tariffs—is only one side of the stagflationary dynamics we expect in the short term. The other is persistent, sticky inflation, which was proving hard to dislodge well before tariffs were announced. Inflationary pressures—though still persistent—had eased considerably by the fall of 2024. The Consumer Price Index (CPI) fell to 2.4% in September, just a smidge above the Fed's 2% target, —a broader measure and Fed's preferred gauge—came in at a near-target 2.1% (Figure 26). But since then, both have drifted upward: CPI has averaged 2.7%, and PCE at 2.5%. Stickier measures of inflation, such as core CPI and core PCE, have proven even more stubborn, remaining stuck in the upper twos and low threes for more than a year.

FIGURE 26
Range-Bound: Inflation Was Sticky Even Before Tariffs (y-o-y percent change)



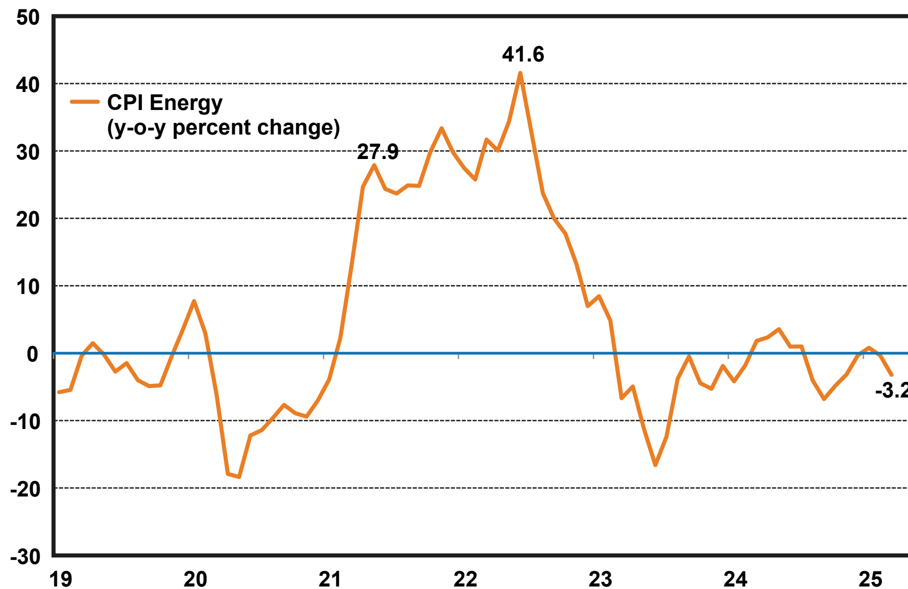
Much of this reversal can be laid squarely at the feet of the Fed. As we warned at the time—and as has become painfully clear in hindsight—the 50-basis-point rate cut in September, followed by two additional 25-basis-point cuts, was not just premature; it was a baffling and costly misstep that reversed the disinflationary process which, though painfully slow, was edging toward the Fed's 2% goal.

The 50-basis-point rate cut in September, followed by two additional 25-basis-point cuts, was not just premature; it was a baffling and costly misstep that reversed the disinflationary process which, though painfully slow, was edging toward the Fed's 2% goal.

Tariffs will only add fuel to these already adverse dynamics. Instead of settling into a "two-handle" range—running above 2% but below 3%—U.S. inflation is now projected to shift into a far more concerning "three-handle," with an uncomfortably high number behind the decimal point—a high three-handle, if you will. It would not be a surprise to see inflation drift even higher—except that tariffs are generally a one-off price-level shock. For inflation to become an entrenched problem, not just a one-time bump in price level, consumer demand would have to remain buoyant—something that's not part of our near-term baseline. Moreover, goods—where most tariff impacts will land—make up just 43% of the CPI basket and only 35% of the PCE index. The rest is services, which are largely insulated from trade shocks. And this is before accounting for energy and commodities, which make up around 7% of each index and have recently collapsed on expectations of a global slowdown (Figure 27).

Goods—where most tariff impacts will land—make up just 43% of the CPI basket and only 35% of the PCE index. The rest is services, which are largely insulated from trade shocks.

FIGURE 27
The Decline in Energy Prices Bodes Well for Inflation (y-o-y percent change)



The outlook beyond the current year, though more muddled than usual given extreme uncertainty, appears to be more promising. Chief among the tailwinds are tax cuts: Mr. Trump's "big, beautiful bill." As of this writing, both the House of Representatives and Senate have passed a broad framework enabling $5.3 trillion in deficit-financed tax cuts. This includes the extension of the 2017 TCJA provisions ($3.8 trillion)—which is baked into the baseline and doesn't count as additional deficit—and an added $1.5 trillion in new deficit spending. Additionally, $521 billion in spending will be allocated toward defense and immigration. But this is far from the final word. The Senate bill—adopted by both chambers—includes just $4 billion in spending cuts, whereas the earlier House version proposed $1.5 trillion in cuts, $880 billion of which would come from Medicaid—a rather touchy subject.

The outlook beyond the current year, though more muddled than usual given extreme uncertainty, appears to be more promising. Chief among the tailwinds are tax cuts: Mr. Trump's "big, beautiful bill."

It's hard to say what the final bill will look like, as many of its details are still being hammered out, but we do expect it to go well beyond a mere extension of the 2017 TCJA provisions. The final bill will likely reduce the corporate tax rate to 15 percent for domestic manufacturing as well as revive business provisions for research deductions, interest expenses, and capital costs—which have either expired or phased out under the 2017 law. On the individual side, President Trump has campaigned on eliminating taxes on tips, Social Security income, and overtime pay—and has since added a few more popular giveaways, such as expanding the SALT deduction and allowing taxpayers to deduct interest on car loans. The Senate, for its part, has introduced its own sweeteners, including an increase in the nonrefundable portion of the child tax credit from $2,000 to $2,500.

Given limited fiscal space, not every provision will survive reconciliation. Still, we expect the final package to include the removal of taxes on tips, an increase in the SALT deduction cap to $25,000 (from the current $10,000), an expanded child tax credit, and at least partial deductibility of car loan interest. Some targeted relief for lower-income households—whether through exemptions on overtime or Social Security income—also remains in play.

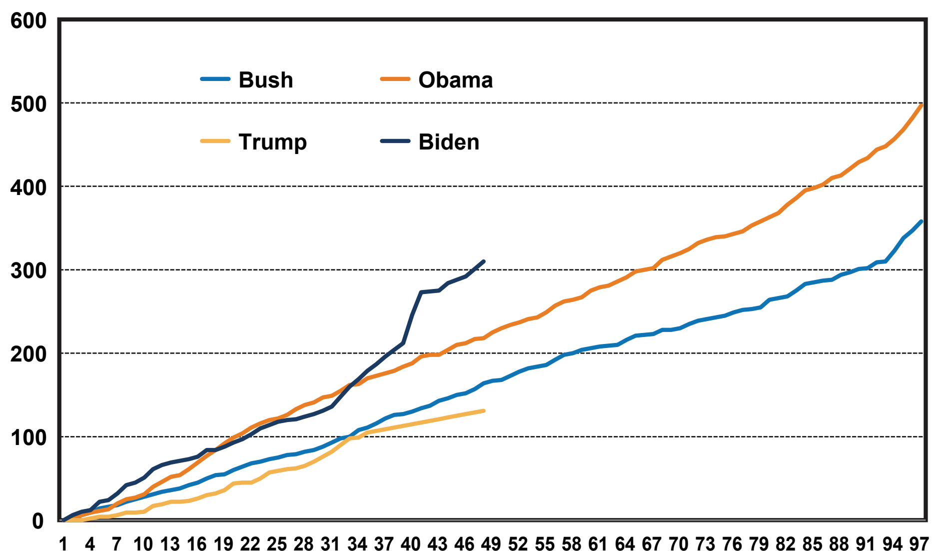
Of course, all this far exceeds the $1.5 trillion in additional deficit spending authorized over the ten-year horizon. The total cost of additional tax carveouts is estimated to fall somewhere between $3.2 and $4 trillion in new spending. To help bridge the gap, Congress and the administration could pursue savings by rolling back key Biden-era executive actions—particularly in green energy, healthcare, and student loans—which could generate roughly $1 trillion over the decade. Tariffs are also expected to shoulder a significant share of the burden, potentially bringing in an additional $2.8 trillion over 10 years, assuming, as we do, that some form of the tariff regime remains intact throughout the current administration.

It's hard to say what the final bill will look like, as many of its details are still being hammered out, but we do expect it to go well beyond a mere extension of the 2017 TCJA provisions.

Another central plank of the administration's pro-growth agenda is deregulation. The first Trump administration had a commendable track record on this front—though more because it resisted introducing new regulations than because it managed to rescind existing ones.

Another central plank of the administration's pro-growth agenda is deregulation. The first Trump administration had a commendable track record on this front—though more because it resisted introducing new regulations than because it managed to rescind existing ones (Figure 28). This is not an accident: Undoing existing regulation is often far more difficult than refraining from new rulemaking. Most deregulatory actions must follow the same procedural steps as new regulations—including a notice-and-comment process—and are generally subject to judicial review, where the administration's success rate stood at just 23 percent. Still, the numbers tell a compelling story. Based on regulatory impact analysis, the first Trump administration imposed an average annual net regulatory cost of just $10 billion, a fraction of the $111 billion under President Obama and well below the $43 billion under President Bush. Even the Code of Federal Regulations, now a behemoth at 198,000 pages, grew by only 1,500 pages during Trump's first term—the slowest pace on record.

FIGURE 28
Regulatory Touch: Number of Economically Significant Regulations (cumulative number of regulations, months in office)



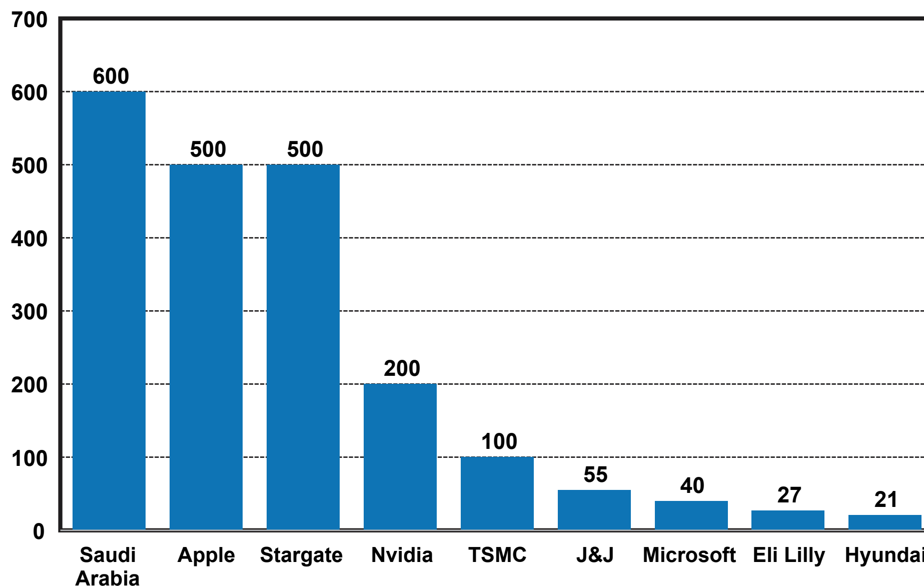
Deregulation has largely taken a backseat to the headline-grabbing drama of tariffs and DOGE, but quietly the administration is preparing for another sweeping deregulatory drive. In his first term, Mr. Trump pledged to eliminate two regulations for every new one introduced. This time around, his ambition is even grander: to slash ten regulations for each new rule enacted. The administration is also aiming to overturn some of the rules finalized in the waning months of the previous administration through the Congressional Review Act. Many of these targeted regulations pertain to loans and subsidies for renewable energy projects. The most aggressive red-tape rollback thus far has come from the Environmental Protection Agency (EPA), which in a single day unveiled 31 deregulatory actions affecting wide swathes of U.S. industry, including power plants, oil and gas firms, electric vehicles, and wastewater standards. The Treasury Department is also moving forward with initiatives to lighten the regulatory load on financial institutions. These include proposals to adjust the ratio of safe assets banks must hold relative to their exposure, and to revise capital requirements intended to safeguard against periods of economic stress.

Deregulation has largely taken a backseat to the headline-grabbing drama of tariffs and DOGE, but quietly the administration is preparing for another sweeping deregulatory drive.

Another reason for cautious optimism over the longer term is the wave of high-profile investment pledges from major corporations. A joint venture between SoftBank, OpenAI, and Oracle has committed up to $500 billion to build out U.S. technology infrastructure over the next four years. Apple has pledged an additional $500 billion investment, focused primarily on data centers (Figure 29). The semiconductor sector is also stepping up: Nvidia and TSMC have announced $500 billion and $100 billion, respectively, to expand chip production domestically. Automakers have also joined in, with Hyundai pledging $21 billion and Stellantis another $5 billion. Even countries have joined in: Saudi Arabia has pladged to invest $600 billion in the U.S. over the next four years. All told, the tally comes to around $2.2 trillion—supporting the creation of more than 500,000 jobs nationwide.

Another reason for cautious optimism over the longer term is the wave of high-profile investment pledges from major corporations.

FIGURE 29
A Bonanza of Investment Pledges
(billions of dollars)



There is, of course, a wide gulf between announced pledges and realized outcomes. Some of the figures currently being bandied about verge on the fantastical. And past efforts have often fallen far short of expectations. Consider the much-hyped Foxconn deal from 2017, which promised a $10 billion investment in Wisconsin and 13,000 jobs. In the end, the project was dramatically scaled back to $672 million and just 1,400 jobs. It's also worth noting that some of today's corporate pledges may amount to recycled announcements—investments that were likely to happen anyway.

Still, there are several reasons for cautious optimism. First, many of these new commitments—particularly in the tech sector—appear to be closer to execution than previous efforts, indicating that the likelihood of implementation is higher. Second, tech executives, with whom the administration has built stronger ties during its second term, were already preparing massive AI-related infrastructure projects. Third, higher tariffs and the possibility of new tax credits for domestic manufacturing may provide a genuine nudge for some firms to expand operations in the U.S.

A final consideration is the outlook for Europe. For a region at war, on the edge of recession, demographically challenged, productivity-constrained, economically sluggish, and energy dependent, Europe, suddenly, has a bounce in its step. Prior to the tariff tantrum, the Stoxx 600 was up 5.6%, handily outperforming the S&P 500, which had slipped 4.9%. The Euro has risen nearly 10% against the dollar so far this year.

A final consideration is the outlook for Europe. For a region at war, on the edge of recession, demographically challenged, productivity-constrained, economically sluggish, and energy dependent, Europe, suddenly, has a bounce in its step.

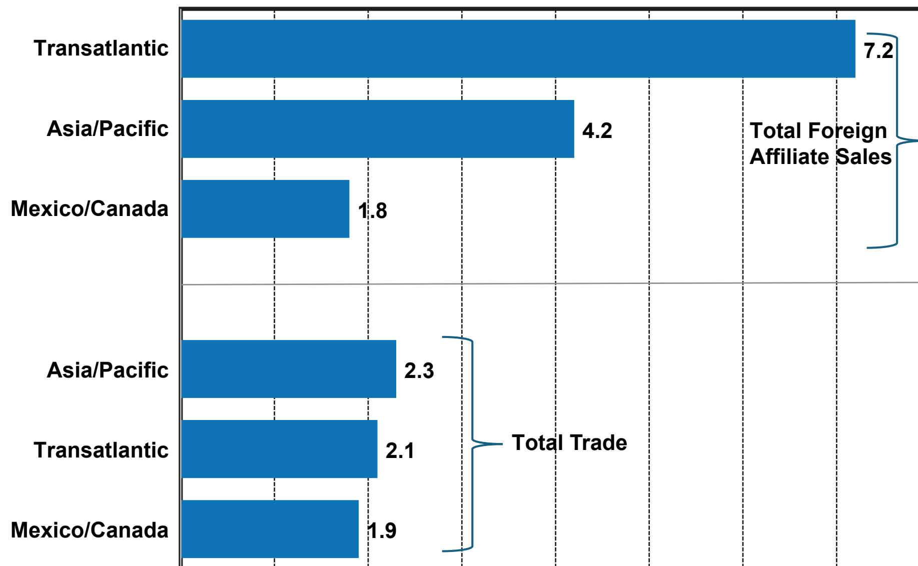
Much of this newfound momentum stems from America's strategic retreat from the continent, which has jolted the EU into a "whatever it takes" posture—echoing Draghi's era and the effort to save the single currency. At last, the continent has begun to rediscover its resolve. It has pledged to ramp up defense spending, offering $165 billion in subsidized loans to countries willing to boost military budgets, while agreeing to loosen fiscal rules to accommodate those increases. In a remarkable reversal, Germany—long known for its perennial aversion to deficits—proposed a constitutional amendment to exempt defense and infrastructure investments from its strict budgetary limits. It followed through with a sweeping legislative package—€1 trillion in total, to be spent over the next ten years—amounting to more than 2.5% of GDP per year, split evenly between defense and infrastructure.

In true European form, not all countries have shown the same level of resolve. Some are already pushing for creative reinterpretations: Spain has argued that climate change initiatives should count as defense spending, while Italy has lobbied to include measures that improve competitiveness—whatever that means. Still, assuming the tariff spat with the U.S. does not escalate—and just as importantly, that Europe's newfound resolve proves genuine—the continent's medium-term outlook is unquestionably brighter.

A full 41% of S&P 500 earnings come from abroad—much of it from Europe. U.S. companies are linked to Europe primarily through their affiliates: in 2023, U.S. affiliate sales to Europe totaled $3.8 trillion, far exceeding direct exports of goods and services, which stood at $942 billion.

This matters. A full 41% of S&P 500 earnings come from abroad—much of it from Europe. U.S. companies are linked to Europe primarily through their affiliates: in 2023, U.S. affiliate sales to Europe totaled $3.8 trillion, far exceeding direct exports of goods and services, which stood at $942 billion. Europe accounts for 46% of all U.S. affiliate sales, well above the 30% share from the Asia-Pacific region (Figure 30). It also remains the top destination for U.S. foreign direct investment (FDI), with the total stock reaching $4 trillion in 2023—nearly 60% of all U.S. FDI abroad, and close to seven times the combined total invested in Mexico and Canada. In this light, a European rebound is most welcome as it offers corporate America a much-needed external cushion as tariff shocks at home begin to weigh on domestic earnings.

FIGURE 30
Corporate Affiliate Sales Are Much Larger Than Trade Flows (trillions of dollars)



The U.S. economy has unquestionably endured a whirlwind of policy-induced shocks over the past three months. This inspired us to name our forecast “Shaken and Stirred”—a wordplay and a tribute to one of cinema’s most iconic and enduring larger-than-life figures: suave under pressure, composed in chaos, and lethal when cornered. But perhaps the more fitting description is not a 007, but an Austin Powers, with heaps of clumsiness, awkward swagger, and a (temporarily) lost mojo. And the journey is far from over! So, grab your crushed velvet suit, luxe cravat, and Cuban-heeled boots—we are headed straight into an Austin Powers-style soiree, where the colors are loud, the dance moves louder, and assassins lurk in every corner. It’s going to be a wild ride, baby—yeah!

Splendid Isolationism: The Art of the Tariff and the Radical Remaking of the Global Order

“The details of my life are pretty inconsequential…My childhood was typical. Summers in Rangoon, luge lessons. In the spring we'd make meat helmets. When I was insolent, I was placed in a burlap bag and beaten with reeds; pretty standard really”
—Dr. Evil, Austin Powers

Renaming geographical landmarks turned out to be a rather curious priority for President Trump. One of his earliest executive orders restored America’s highest peak—Mount Denali—back to Mount McKinley, a move that echoed his broader push to reassert traditional American symbols (he also rechristened the Gulf of Mexico as the Gulf of America). But this is more than just nostalgia for historical names: Much like Mr. Trump, William McKinley was a “tariff man” — a staunch advocate of protectionism. McKinley’s presidency marked a decisive shift toward mercantilism, raising tariffs from 38% to nearly 50% in the late 19th century.

President Trump’s enthusiasm for tariffs appears to rival that of his predecessor over 130 years ago. “Tariff is the most beautiful word in the dictionary,” he is fond of saying. On April 2, he unleashed a barrage of tariffs so severe that—while not quite reaching McKinley-ian heights—have pushed

the U.S. average effective tariff rate to peaks last seen in the 1930s. In a flash, the Rose Garden—typically a peaceful and bucolic setting—became the scene of a massacre, as Mr. Trump unveiled his sweeping tariff plan. A week later, some of the most punishing rates for most countries (with the exception of China) were rolled back to a universal 10% for a 90-day negotiation window. The tariff storm has unleashed a market whipsaw reminiscent of the worst moments of the financial crisis and the pandemic—much like Dr. Evil's childhood recollection of being "placed in a burlap bag and beaten with reeds."

The market is right to panic. Had "Liberation Day" tariffs remained in place for long, a U.S. recession—and likely a global depression—would have been impossible to avoid. But a downturn may not be the worst of it. Perhaps more concerning is the dawning realization that the current post-WWII global trade and financial architecture may have outlived its usefulness—and could now be headed for a radical reconfiguration. That order, which cemented America's position as the world's preeminent power, was built on a grand bargain: the U.S. would act as the consumer of last resort, absorbing global (cheap) overproduction—particularly from export-heavy economies—while the dollar functioned as the lubricant of global trade. In return, America would tolerate ever-widening current account deficits, financed by ever-larger capital inflows—flows that propped up fiscal deficits and buoyed financial markets.

Large current account and fiscal deficits have underwritten extraordinary American growth over the past five decades—especially in the years since the financial crisis. But this arrangement works smoothly only as long as the U.S. economy commands a dominant share of global GDP. That, however, is changing fast. At the end of World War II, the U.S. accounted for 60% of global output. By 1960, that figure had dropped to 40%. Today, it hovers around 24%. As emerging markets expand, America's global footprint will likely shrink further, gradually aligning with its share of the world's population. This shift creates a profound tension at the heart of the global order—and America's role within it. As the issuer of the world's reserve currency, the U.S. must supply an ever-expanding global economy with the dollar liquidity it needs to function, even as its relative weight within the global economy shrinks. Doing so requires running persistent trade and fiscal deficits—just as its capacity to sustain them is eroding. In short, what Charles de Gaulle once dubbed as the "exorbitant privilege" of dollar hegemony is beginning to look more and more like an extraordinary burden.

This may help explain, at least in part, the current administration's obsession with trade deficits, though it has yet to articulate its concerns in such explicit terms. Another reason to suspect that the administration is eying deeper structural changes lies in the swirling rumors of a potential "Mar-a-Lago Accord"—a grand bargain reminiscent of the 1985 Plaza Accord. Under such a deal, in exchange for U.S. security guarantees and continued access to American markets, partner countries would agree to weaken the dollar, lower U.S. borrowing costs, and channel more investment into U.S. manufacturing—all while preserving the dollar's primacy on the global stage. Some of this is too radical to even warrant a second thought because it would require America's foreign creditors to exchange their Treasuries for ultra-long-dated bonds—100-year maturities, perhaps—to ease the debt burden and suppress yields.

It's hard to imagine a Mar-a-Lago Accord—one that hinges on deep international cooperation—materializing amid an escalating trade war. Still, as with much of what Mr. Trump does, perhaps the idea of such a grand bargain should be taken "seriously, but not literally". At the very least, it underscores the seriousness with which the administration is pursuing a radical reordering of the global economic order.

Had "Liberation Day" tariffs remained in place for long, a U.S. recession—and likely a global depression—would have been impossible to avoid. But a downturn may not be the worst of it.

Large current account and fiscal deficits have underwritten extraordinary American growth over the past five decades—especially in the years since the financial crisis. But this arrangement works smoothly only as long as the U.S. economy commands a dominant share of global GDP.

As the issuer of the world's reserve currency, the U.S. must supply an ever-expanding global economy with the dollar liquidity it needs to function, even as its relative weight within the global economy shrinks.

But even without this broader realignment, the administration's grievances with aspects of the post-war trading architecture are not without merit. Last year's U.S. trade deficit in goods reached a jaw-dropping $1.2 trillion—the largest in history (Figure 31). Over the past 25 years, the U.S. has accumulated more than $19 trillion in trade deficits, offset by equal surpluses in the capital account. This means foreign entities now own an additional $19 trillion in U.S. assets, much of which has gone toward subsidizing America's ballooning debt—now at $36 trillion (Figure 32). Future returns on those assets will flow abroad, not to U.S. households. While China specializes in manufacturing, America has become an expert at specializing in debt. To be sure, persistent trade deficits haven't prevented the U.S. from outgrowing many surplus countries. In fact, rising deficits have fueled debt-financed growth, particularly over the past 15 years—and even more so since the pandemic. The problem is that this status quo is unlikely to hold indefinitely. A fiscal reckoning—though perhaps still years away—is inevitable.

But even without this broader realignment, the administration's grievances with aspects of the post-war trading architecture are not without merit.

Foreign entities now own an additional $19 trillion in U.S. assets, much of which has gone toward subsidizing America's ballooning debt—now at $36 trillion. Future returns on those assets will flow abroad, not to U.S. households. While China specializes in manufacturing, America has become an expert at specializing in debt.

FIGURE 31
Trade Deficit in Goods Has Expanded Dramatically Over the Years (billions of dollars)

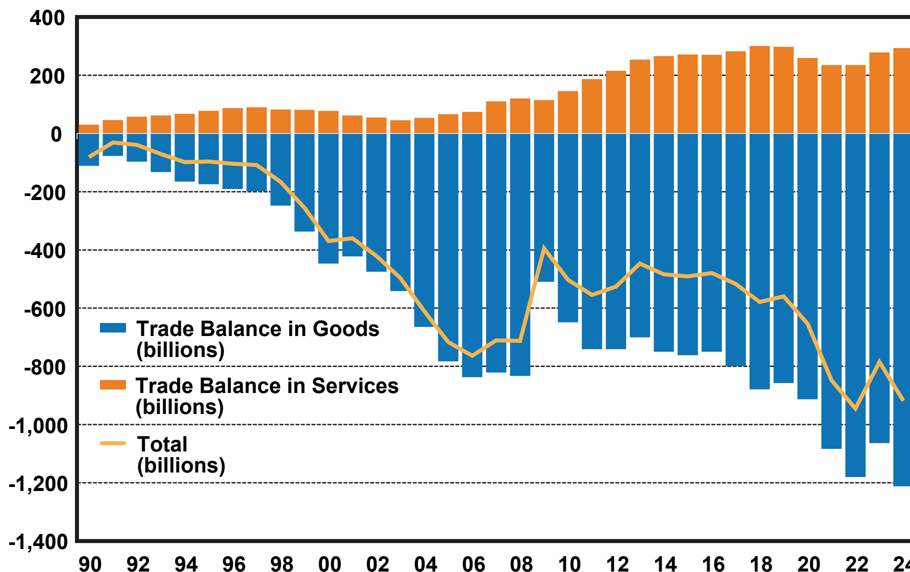
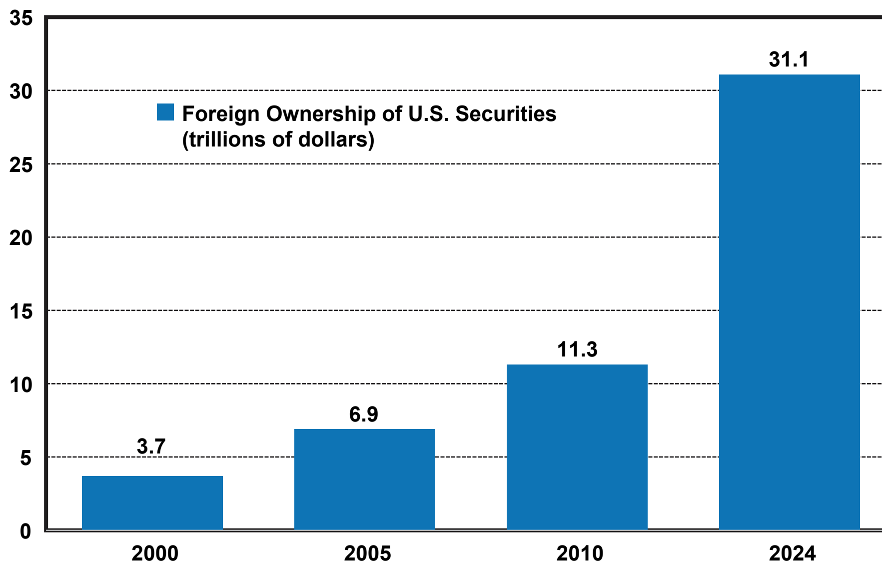


FIGURE 32
Foreign Ownership of U.S. Assets Have Increased Dramatically Over the Decades (trillions of dollars)



China is a particularly sore point—not just for the current administration, but for its predecessor as well. That's because the U.S. increasingly views China not merely as a strategic competitor, but as a mounting threat to both American manufacturing and national security. After decades of generous state subsidies and the mobilization of a vast, highly productive labor force, China now leads in a host of advanced technologies—from electric vehicles and wind turbines to batteries, robotics, drones, quantum computing, nuclear fusion, and even artificial intelligence.

The U.S. increasingly views China not merely as a strategic competitor, but as a mounting threat to both American manufacturing and national security.

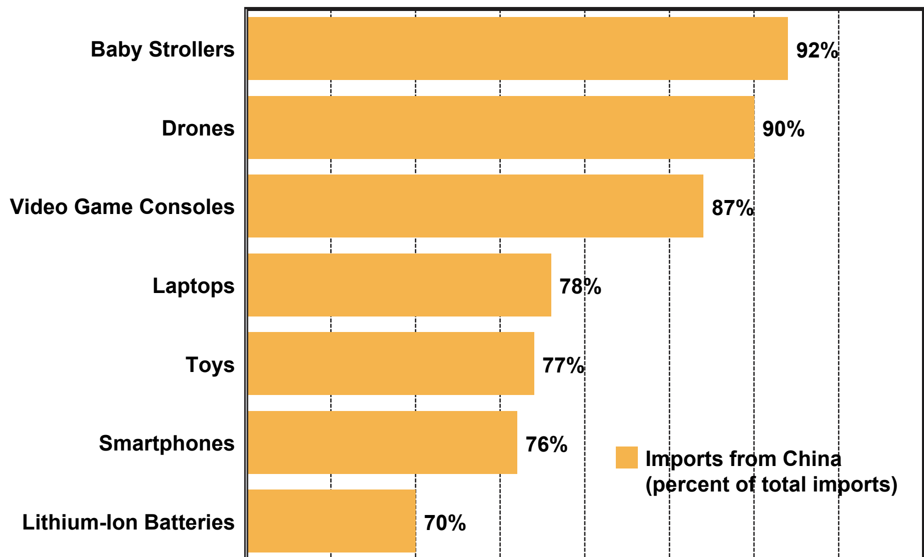
China is now the world's largest automobile producer. Its "Made in China 2025" strategy—unveiled in 2015—envisioned selling 3 million electric vehicles (EVs) globally by 2025. That goal was easily eclipsed: Last year alone, China sold over 10 million EVs, accounting for a third of global output. This rapid rise is a key reason the Biden Administration imposed a 100% tariff on Chinese EV imports. Other countries have followed suit. Canada levied a 100% EV tariff and added 25% duties on Chinese steel and aluminum. The EU has layered on additional 7.8% to 35.3% duties, atop its existing 10% car import tariff, while India imposes 70% to 100% tariffs on Chinese vehicles.

But the issue extends well beyond autos. China is now the world's largest commercial shipbuilder, responsible for half of global production, while the U.S. share has collapsed to just 0.1%—a rounding error by comparison. Its dominance stretches deep into supply chains critical to public health and national security: China supplies 30% of the active pharmaceutical ingredients (APIs) in U.S. drugs, 78% of U.S. vitamin imports, and commands 90% of the American drone market (Figure 33). In clean tech, the numbers are even more staggering. China produced 65% of the world's solar panels in 2015; today that figure is closer to 90%. Its share of global battery production has risen from 47% to nearly 70% over the past decade. In rail, it has the world's fastest high-speed rail; in space, it has landed a Rover on Mars, and in the skies, China's COMAC is directly competing with America's Boeing and Europe's Airbus.

In rail, China has the world's fastest high-speed rail; in space, it has landed a Rover on Mars, and in the skies, China's COMAC is directly competing with America's Boeing and Europe's Airbus.

These trends have created a peculiar symbiosis between the U.S. and China. The U.S. accounts for just over 30% of global consumption, while China produces nearly 30% of global goods. But the bilateral trade relationship reveals even stranger asymmetries. America's top export to China is soybeans; next come aircraft parts, followed by oil and gas. China's top exports to the U.S., by contrast, are high-end manufactured goods: smartphones, computers, and EV batteries. In essence, the U.S. is exporting raw materials, while importing complex, sophisticated, value-added products from China.

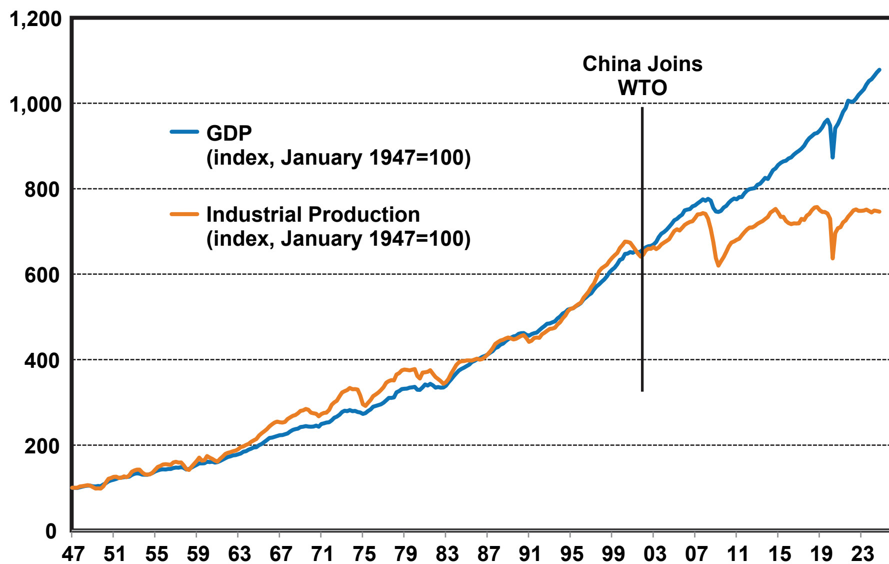
FIGURE 33
Despite Decoupling, U.S. Reliance on China is Still Large, Even for Critical Goods (percent of total imports)



The erosion of U.S. manufacturing capacity has come at a steep cost: widening income inequality. Over the past two decades, millions of well-paying manufacturing jobs have moved overseas—particularly to China—as the U.S. steadily ceded sector after sector of its industrial base (some of this is also due to automation). Since China joined the World Trade Organization (WTO) in 2001, U.S. GDP has continued to rise, but industrial production has largely flatlined (Figure 34). This divide has widened the gulf between returns to labor and returns to capital—fueling inequality. In 2023, the top 1% of households captured 20% of all income—more than double their 9% share in 1980. Today, they hold more wealth than the entire middle 60% of Americans.

The erosion of U.S. manufacturing capacity has come at a steep cost: widening income inequality.

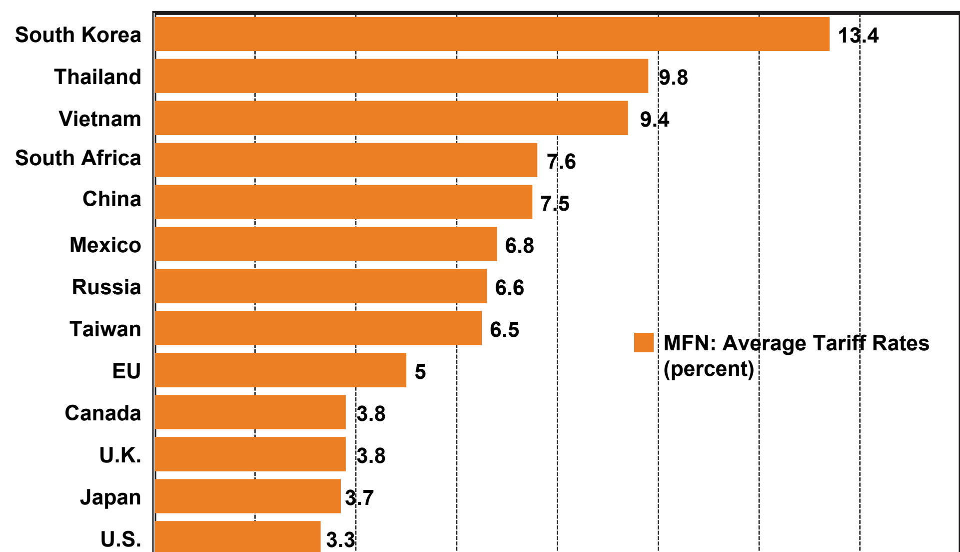
FIGURE 34
The Silence of the Plants
(index)



But what seems to provoke Mr. Trump's ire most are what he calls "unfair trade practices." At the heart of this concern is the recognition that the post-WWII trade system—though far superior to the protectionism that came before—is not truly free trade, but rather managed trade. The cornerstone of this system, the "most-favored nation" (MFN) clause, requires that WTO members apply the same tariff on a given good to all trading partners, ostensibly treating everyone equally. But in practice, MFN treatment is highly asymmetric. Countries are allowed to shield domestic industries, and less-developed nations are granted wider leeway to impose higher duties. Prior to the recent mammoth tariffs, America's average tariff rate was one of the lowest in the world, at 3.3%, far below the EU (5%), Mexico (6.5%), China (7.5%), Vietnam (11.5%), South Korea (13.5%), and India (17%) (Figure 35).

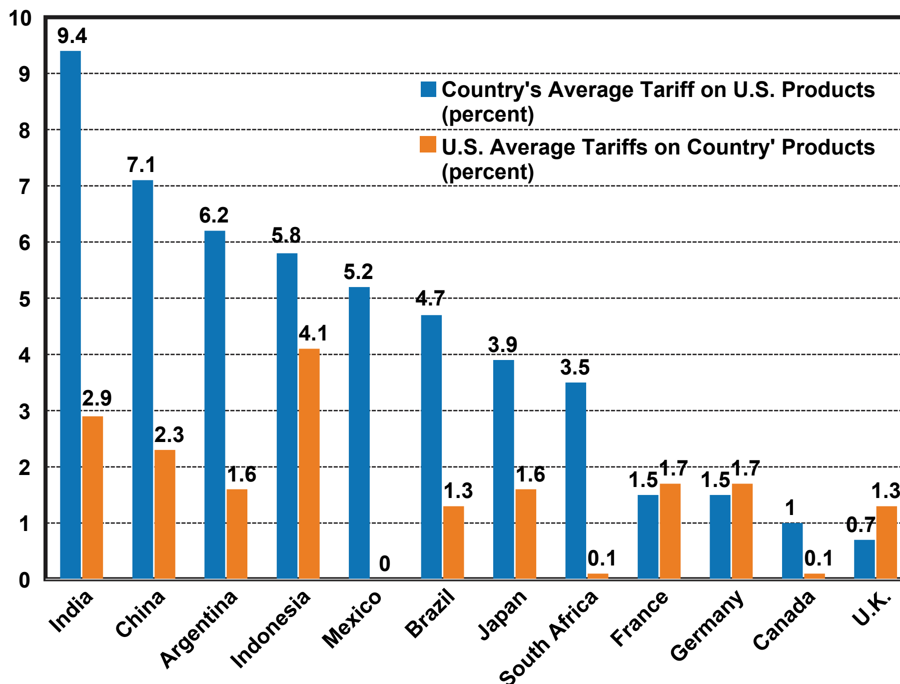
At the heart of this concern is the recognition that the post-WWII trade system—though far superior to the protectionism that came before—is not truly free trade, but rather managed trade.

FIGURE 35
Glaring Differences: U.S. Tariff Rates Were Some of the Lowest in the World
(MFN, simple average tariff rates)



The disparity is even more glaring when considering bilateral trade. Thus, while U.S. tariffs on Indian exports average just 2.9%, India imposes a strikingly higher 9.4% on American goods—more than three times as high (Figure 36). The U.S. levies 0% on Mexican imports, while facing an average 5.2% tariff on its exports to Mexico. Colombia pays only 0.3% to export to the U.S., but charges 5.2% on American products. Even Japan faces a modest 1.6% U.S. tariff, while its tariffs on U.S. goods are more than double that, at 3.9%. The U.S. imposes an average tariff of 3.3% on South Korean goods, while South Korea's duties on American exports are twice as high, at 6.6%. Similarly, the EU levies a 10% tariff on U.S. cars, compared to just 2.5% imposed by the U.S. on European vehicles.

FIGURE 36
A Yawning Gap in Bilateral Tariffs between U.S. and Other Countries
(average tariffs, percent)



And that's before factoring in the many non-tariff trade barriers—export controls, subsidies, and other restrictive measures deployed by governments around the world. China has emerged as the dominant force in high-tech manufacturing through a potent mix of state subsidies, low borrowing costs, and forced technology transfers. But it isn't just China. Some 94% of European imports face some form of non-tariff barrier, compared to only 64% of U.S. imports. Government support—not textbook notions of "comparative advantage"—drove the rise of South Korea's steel industry and Taiwan's semiconductor sector. It wasn't cheap iron ore or silicon that built their industrial base in these industries—it was deliberate, strategic industrial policy.

The USMCA free trade agreement is also riddled with loopholes. To sidestep U.S. tariffs, Chinese and European firms have ramped up manufacturing operations just across the U.S. border to benefit from the agreement's favorable trade terms and lower labor costs.

The USMCA free trade agreement is also riddled with loopholes. To sidestep U.S. tariffs, Chinese and European firms have ramped up manufacturing operations just across the U.S. border to benefit from the agreement's favorable trade terms and lower labor costs. As a result, U.S. imports from Mexico have surged—rising to over half a trillion dollars, up from $343 billion in 2017, before the first Sino-American trade war. The administration's recent browbeating of Mexico and Canada likely stems from these concerns, with the U.S. ultimately expected to push for a crackdown on such trade loopholes and circumvention tactics.

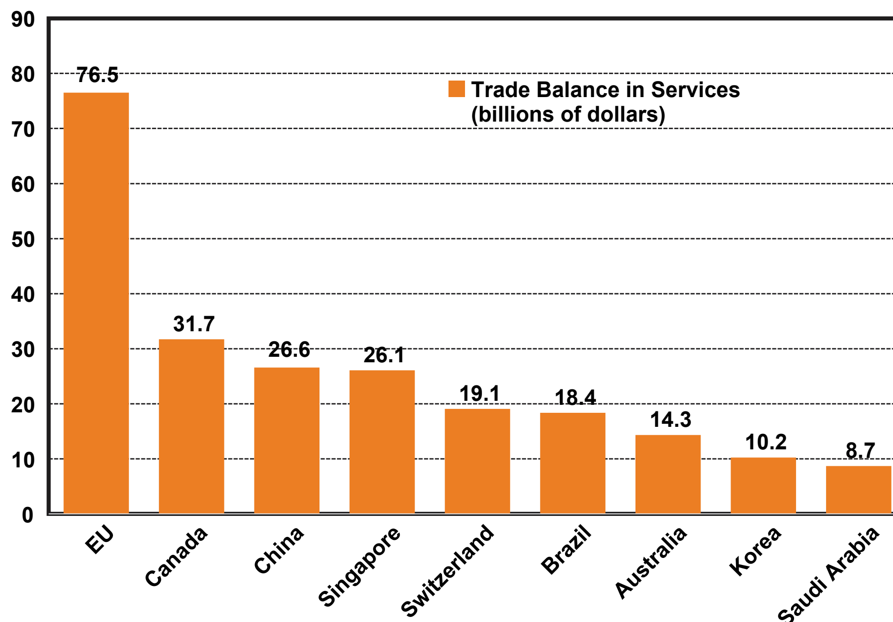
The administration is right to prioritize some of these longstanding issues. In fact, had it confined itself to a regime of purely reciprocal tariffs—charging no more and no less than what U.S. exports face abroad—it might have corralled more support within the business community. Instead, on April 2, it unleashed a barrage of levies that were so out of line with reciprocity, they verged on the incomprehensible. Not only was the formula based on crude calculations tied to bilateral trade deficits, but it also contained a glaring error. One of the key parameters—a Greek-lettered variable representing the elasticity of import prices—was set at a value roughly four times smaller than empirical estimates. Had elasticity been correctly specified, the resulting tariffs would have been four times lower, with none exceeding 14% for any country. As Warren Buffett once quipped, "Beware of geeks bearing formulas"—a clever twist on the old adage, "*Beware of Greeks bearing gifts*."

Not only was the formula based on crude calculations tied to bilateral trade deficits, but it also contained a glaring error. One of the key parameters—a Greek-lettered variable representing the elasticity of import prices—was set at a value roughly four times smaller than empirical estimates.

There were other oddities. The formula appears to have been based solely on one year of data—2024—instead of a more representative historical average. That's likely why Switzerland, which happened to export an unusually large amount of gold bullion to the U.S. last year, ended up with a steep tariff of 32%. Had a multi-year average been used to smooth out anomalies, its tariff rate would have landed closer to 19%. Botswana and Madagascar were saddled with stiff tariff rates—38% and 47%, respectively—because each exported rare, high-value products to the U.S.: diamonds from Botswana and vanilla from Madagascar. If the goal is to boost domestic production, these tariffs seem particularly misguided: We are hard-pressed to come up with viable domestic alternatives for such niche imports.

Moreover, the administration's tariff formula focused exclusively on trade in goods—ignoring services, where the U.S. consistently runs large surpluses. In 2024, the surplus in services reached nearly $300 billion, including $75 billion with the EU alone (Figure 37). In fact, factoring in services reduces the U.S. trade deficit with the 27-nation bloc from $235 billion to a more manageable $160 billion. Had this been reflected in the formula, EU's tariff rate would have been closer to 10%. Similarly, while the U.S. posted a $38 billion goods deficit with Switzerland last year, it ran a $21 billion surplus in services. Correcting the formula for services would have brought Switzerland's tariff rate down to 14%—even using 2024's lopsided figures.

FIGURE 37
The U.S. Runs a Sizable Trade Surplus in Services with Most Countries (billions of dollars)



Given their broad decoupling from reality, it is no surprise that the outsized tariffs were largely put on pause just 12 hours after taking effect. But uncertainty persists as countries haggle and negotiate for relief. Thus, to make sense of the evolving tariff landscape, it is perhaps instructive to take a longer-term view and, for simplicity, group the measures into five broad categories: (a) USMCA countries; (b) reciprocal tariff countries—typically those with which the U.S. runs large trade deficits; (c) sector-specific tariffs; (d) China; and (e) the universal 10% group. The possibility of broader trade deals varies by each category.

Take USMCA countries first. Though they escaped the brunt of the April 2 measures, the trade-weighted tariff rate on Mexico and Canada now averages around 11%—with USMCA-compliant goods entering duty-free and the rest facing rates as high as 20%. Auto imports are hit harder, facing a 25% tariff, though vehicles that meet USMCA rules are eligible for partial relief, with the tariff applying only to their non-U.S. content. In practice, this means that only 8.2% of vehicles from Mexico and 9% from Canada—those that fail to meet USMCA requirements—will be subject to the full 25% tariff. The remainder will be taxed only on their non-U.S. value-added content, which could still end up being substantial. For auto parts, non-compliance is more widespread, with 20.4% failing to meet USMCA rules. Mr. Trump has recently mused about possible temporary exemptions to his tariffs on imported vehicles and parts to give auto companies more time to set up U.S. manufacturing.

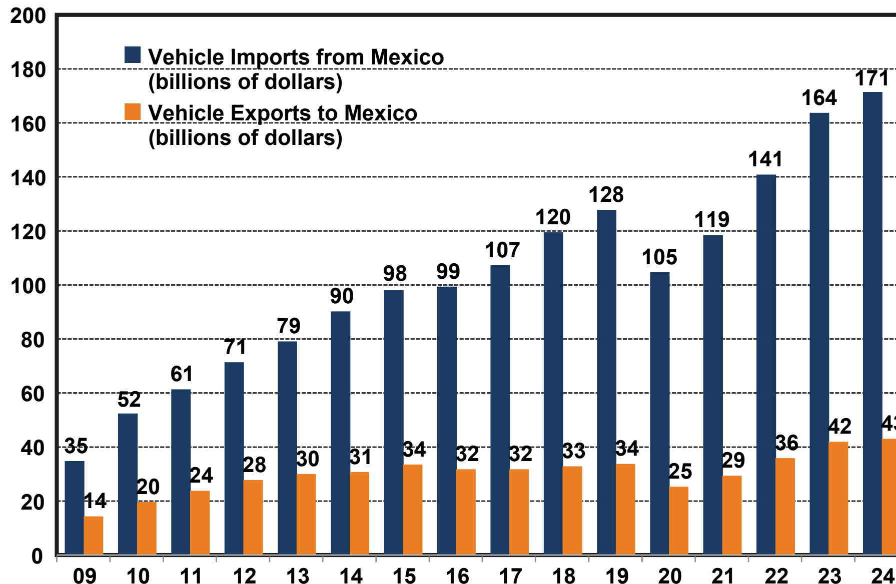
There is little doubt that, among the barrage of tariffs, those levied on Mexico and Canada are the most harmful. They threaten to unravel decades of hard-won progress—a carefully choreographed trading system that stands as one of the most successful examples of economic integration since World War II. Together, the USMCA countries form a market of 500 million people, large enough to rival the European Union. Each brings distinct strengths: Canada offers abundant natural resources, Mexico provides cost-effective labor, and the U.S. contributes a vast consumer base, cutting-edge technology, and unmatched productivity. Moreover, these countries are vital suppliers of critical goods to the United States. America imports 55% of its fresh fruit, 32% of fresh vegetables, and a staggering 94% of seafood—most of it from its two North American neighbors. An overwhelming 98% of live cattle, 97% of tomatoes and canola oil, and 93% of pickup trucks come from Canada and Mexico.

The auto industry is perhaps the clearest example of how deeply trade flows run between the three countries. Some vehicle parts cross the border up to seven times before final assembly. Roughly 50% of America's auto-part imports come from Canada and Mexico, while about 75% of U.S. auto-part exports are sent right back to them. In 2024 alone, the U.S. exported an astonishing $69 billion in transportation equipment to Canada and imported nearly as much—$67 billion. The trade flow with Mexico is even more lopsided: $174 billion in car imports compared to just $46 billion in exports (Figure 38). Disrupting this system with steep tariffs would add an estimated $2,500 to $7,000 to the cost of a new vehicle—costs that would either squeeze manufacturers' margins or be passed on to consumers, potentially cooling demand.

In practice, this means that only 8.2% of vehicles from Mexico and 9% from Canada—those that fail to meet USMCA requirements—will be subject to the full 25% tariff.

There is little doubt that, among the barrage of tariffs, those levied on Mexico and Canada are the most harmful. They threaten to unravel decades of hard-won progress—a carefully choreographed trading system that stands as one of the most successful examples of economic integration since World War II.

FIGURE 38
Vehicle Imports from Mexico Have Ballooned (billions of dollars)



Our view is that the current tariffs will be substantially reduced as part of a renegotiated USMCA, which is slated for review in 2026. Goods that meet existing USMCA rules will likely remain tariff-free, as they have been to date. However, future negotiations are expected to tighten these rules, particularly for the auto industry. Currently, the USMCA requires that passenger vehicles contain at least 75% North American content, meet a labor value content (LVC) threshold—with 40–45% of a vehicle's value produced by workers earning at least $16 per hour—and ensure that at least 70% of steel and aluminum used is sourced from within North America. These requirements are likely to be ratcheted up, in a broader push to preserve and expand manufacturing within North America, especially in the United States. Another likely area of focus will be closing loopholes that have allowed rising volumes of Chinese imports to enter the U.S. via its neighbors, particularly Mexico, or through the growing presence of Chinese firms just outside U.S. borders seeking to capitalize on USMCA's favorable trade terms.

Our view is that the current tariffs will be substantially reduced as part of a renegotiated USMCA, which is slated for review in 2026.

The second group – the reciprocal tariff countries, typically those with which the U.S. runs large trade deficits – is so broad that predicting specific outcomes remains difficult, especially with trade talks still in their infancy. Yet even here, there are glimmers of hope. Aside from China – and to a lesser extent, Canada – no country has retaliated against the "Liberation Day" tariffs. In fact, quite the opposite: most have signaled a willingness to negotiate, many even offering to come bearing gifts. Vietnam, Taiwan, and Israel have proposed eliminating tariffs on U.S. goods entirely, while the European Union has offered zero tariffs on industrial goods, including autos. Still, this may fall short of satisfying the administration, which sees tariffs as a crude benchmark—one that fails to capture the broader landscape of non-tariff barriers that continue to distort trade. Indeed, the administration's goals appear to go well beyond tariff reciprocity. Among its broader demands are increased foreign investment in the U.S., expanded purchases of U.S. energy exports, and more favorable treatment for American firms operating abroad.

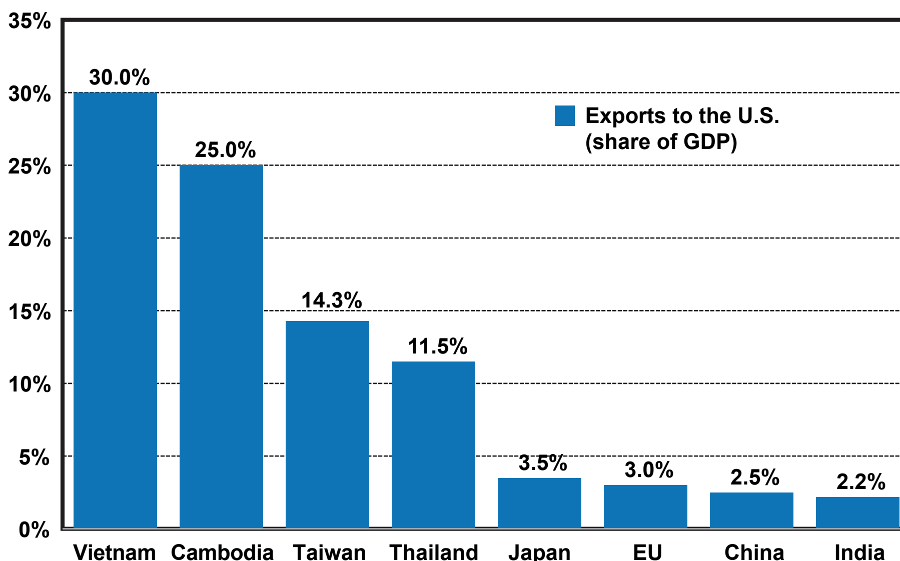
Vietnam, Taiwan, and Israel have proposed eliminating tariffs on U.S. goods entirely, while the European Union has offered zero tariffs on industrial goods, including autos.

Some countries are preparing sweeping offers to avoid steep U.S. tariffs. Japan is reportedly crafting a package that includes increased purchases of U.S. natural gas, investments in the Alaskan pipeline, additional arms imports, and looser restrictions on American agricultural and auto exports. India has offered to cut tariffs on farm goods and politically sensitive items such as bourbon and Harley-Davidson motorcycles, while also pledging to shift oil purchases from Russia to the U.S. Vietnam has already signed an agreement with Elon Musk's Starlink and committed to boosting U.S. imports in defense and security sectors, while pledging to tackle non-tariff barriers—including exchange rate policies—and to foster a more favorable investment environment for American firms.

The European Union has struck a firmer tone but has made clear it prefers negotiation over escalation. That's largely because it has both the economic heft and the strategic position to push back more effectively against U.S. pressure. U.S. exports account for only 3% of the EU's GDP, a stark contrast to the much higher exposure of others: Vietnam's exports to the U.S. make up 30% of its GDP, Cambodia's 25%, Taiwan's 14.3%, and Thailand's 11.5% (Figure 39). Still, the EU is preparing countermeasures should talks break down. These include 25% tariffs on selected U.S. goods such as motorcycles, poultry, fruit, and clothing. Plans to target bourbon and wine were scrapped after the U.S. threatened retaliatory 200% tariffs on European wine and champagne. However, the EU's most potent weapon may be the Anti-Coercion Instrument—a sweeping tool designed to deter countries from using economic leverage to influence EU policy. It allows for a broad range of retaliatory measures that go well beyond tariffs, including export controls, restrictions on intellectual property rights, investment curbs, service bans, and duties on digital platforms. Most of these would strike at the U.S. service sector, where America runs a sizable trade surplus.

U.S. exports account for only 3% of the EU's GDP, a stark contrast to the much higher exposure of others: Vietnam's exports to the U.S. make up 30% of its GDP, Cambodia's 25%, Taiwan's 14.3%, and Thailand's 11.5%

FIGURE 39
Some Asian Countries Have Large Exposure to the U.S. via Trade Links (country exports to U.S. as share of GDP)



Overall, our view is that countries in this second category will likely be able to negotiate the April 2nd tariffs down—even below the current 10% level. The likelihood is higher for East Asian and Pacific Rim nations, though we do not rule out a broader trade accord with Europe. Another reason the "reciprocal tariffs" announced on April 2 are unlikely to be fully implemented is their shaky legal foundation. Unlike Section 232 tariffs, justified on national security grounds for steel and aluminum, or Section 301 tariffs, used against China for discriminatory trade practices, the April 2 tariffs rely on the International Emergency Economic Powers Act (IEEPA). This statute grants

Our view is that countries in this second category will likely be able to negotiate the April 2nd tariffs down—even below the current 10% level. The likelihood is higher for East Asian and Pacific Rim nations, though we do not rule out a broader trade accord with Europe.

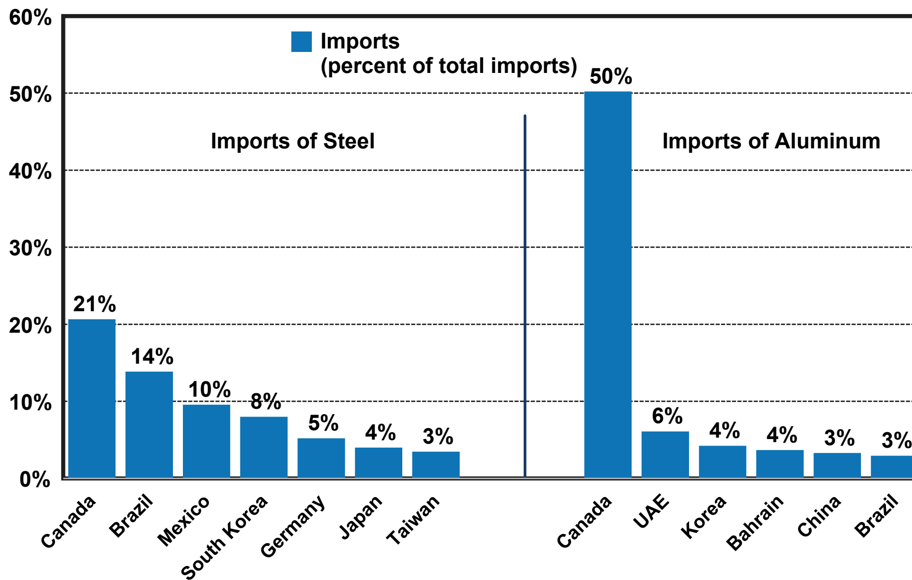
the president authority to respond to an "unusual and extraordinary threat" to national security—but only if a national emergency is declared. President Trump has invoked IEEPA by designating large trade deficits as a national emergency and citing the fentanyl and immigration crises to justify tariffs on Mexico and Canada. But these justifications are tenuous. The U.S. has run trade deficits for over five decades—hardly an "extraordinary" threat. And citing the fentanyl crisis to justify tariffs on Canada is a stretch: virtually no fentanyl is trafficked into the U.S. through its northern border.

The third category—sector-specific tariffs—will likely be implemented first, then negotiated away through country-specific trade deals.

The third category—sector-specific tariffs—will likely be implemented first, then negotiated away through country-specific trade deals. The U.S. has already imposed 25% tariffs on steel and aluminum imports under Section 232, citing national security concerns. Coddling these industries has long been a priority for presidents on both sides of the isle, and Mr. Trump is no different. During his first term, he invoked national security concerns to justify tariffs under Section 232, aiming to protect domestic producers from an influx of cheap foreign supply. Canada, as the largest exporter of both steel and aluminum to the U.S., would again be most affected (Figure 40). The administration is also reviewing additional sectors, including copper, lumber, pharmaceuticals, and semiconductors. We expect these industries to be next in line for 25% tariffs, though we also anticipate some country- and product-specific exemptions to follow. During the 2018–2019 trade war, the administration granted more than 100,000 exemptions for steel and 20,000 for aluminum. Though the carveouts are likely to be far less generous this time around, we expect some of the sector-specific tariffs to be used in negotiations for broader trade deals.

The administration is also reviewing additional sectors, including copper, lumber, pharmaceuticals, and semiconductors. We expect these industries to be next in line for 25% tariffs, though we also anticipate some country- and product-specific exemptions to follow.

FIGURE 40
U.S. Relies Heavily on Canada for Imports of Steel and Aluminum (percent of total imports)



China occupies a category of its own, not least because it is the only country with which the trade war has fully escalated. In response to the U.S.'s "reciprocal tariffs," Beijing imposed a 34% levy on U.S. imports, prompting Washington to retaliate with an additional 50% tariff. Though the tit-for-tat escalation is dizzying, retaliatory tariffs on Chinese goods have climbed to 125%—or 145% with the previous baseline included. Chinese tariffs on U.S. goods are also now at 125%, mirroring Washington's escalation. However, Beijing has signaled it will not impose further levies, even if the U.S. does—because at these levels, bilateral trade is, for all practical purposes, effectively shut down.

Given how vertiginous these bilateral tariffs have become, it's hard to imagine they remain at current levels for long. The U.S. has already rolled back "reciprocal tariffs" on a wide range of consumer electronics, including smartphones and computers—amounting to nearly $390 billion in U.S. imports, with more than $101 billion coming from China. While Chinese imports of these goods are still subject to the earlier 20% tariff, imports from other countries now face no tariffs at all.

The possibility of a U.S.–China deal is probably higher than what originally meets the eye. While the U.S. economy is slowing, China faces its own set of vulnerabilities—many of them mirror images of America's. Instead of inflation, China is battling deflationary pressures; domestic consumption remains weak despite stimulus efforts; the property crisis continues to simmer, and youth unemployment remains persistently high. Now, it's facing a trade war that threatens up to $438 billion of its exports. If tariffs remain at current levels, the estimated hit to Chinese GDP could reach 2.4% in 2025—making it nearly impossible for Beijing to meet its 5% growth target. Our view is that when all is said and done, the tariff rate between the U.S. and China will likely settle between 25% and 35%—still steep by historical standards, but a marked improvement over current levels. The only concern is that any potential deal between the two countries is likely to take time to materialize, given the deeply thorny issues that will need to be hammered out.

The possibility of a U.S.–China deal is probably higher than what originally meets the eye. While the U.S. economy is slowing, China faces its own set of vulnerabilities—many of them mirror images of America's.

The final group—the universal 10% tariff—is likely to see the least direct negotiation, though some countries, particularly in Latin America, may still attempt to engage in bilateral talks to reduce it further. We anticipate varying degrees of success, with countries like Argentina, and possibly Brazil—which is especially concerned about steep tariffs on steel and aluminum—having a reasonable chance of securing reduced rates through targeted negotiations.

The final group—the universal 10% tariff—is likely to see the least direct negotiation, though some countries, particularly in Latin America, may still attempt to engage in bilateral talks to reduce it further.

Thus, our view is that by the end of 2026, the effective tariff rate will be lower than the current 16.3%, and significantly below the 25.5% proposed on April 2nd. Tariffs could generate approximately $280 billion in annual revenue, but not without cost: we estimate a near-term reduction in GDP growth of about 1.2 percentage point, and a rise in inflation of roughly 1.3 percentage points.

In his quest to conquer the world, Dr. Evil's plans include overly elaborate schemes that defy logic, budget, and basic practicality. As he once proclaimed, "Preparations A through G were a complete failure. But now, ladies and gentlemen, we finally have a working tractor beam, which we shall call—Preparation H." Much like Dr. Evil's theatrics, the complicated trade talks with multiple partners will be anything but straightforward—marked by complicated negotiations, potential setbacks, and the inevitable back-and-forth before any real progress is made. Here's to hoping they find smooth sailing—and a potent Preparation H.

TABLE 2
U.S. Forecasts

	REAL GDP GROWTH	EMPLOYMENT GROWTH	UNEMPLOYMENT RATE	CPI INFLATION
2022	2.5	4.3	3.6	8.0
2023	2.9	2.2	3.6	4.1
2024	2.8	1.3	4.0	3.0
2025	1.4	1.0	4.4	3.2
2026	1.7	0.6	4.6	2.9

ORANGE COUNTY, SOUTHERN CALIFORNIA AND CALIFORNIA

How Will California be Affected by Trumponomics?

California will be affected by many of the economic and structural shocks currently buffeting the national landscape, as outlined in our macroeconomic forecast. The state is likely to face amplified disruptions, owing to the disproportionate impact of federal policies advanced under the Trump Administration. While the full contours of President Trump's agenda have yet to fully take shape, and a cohesive policy vision remains elusive three months into his term, four distinct policy strands have emerged: tariffs, public sector belt-tightening, deregulation, and immigration. California finds itself squarely in the crosshairs of each. The state has significant exposure to global trade, particularly with Mexico, China, and Southeast Asia. As the most populous state, it receives a large share of federal funding; it operates under one of the most complex regulatory environments in the nation; and it is deeply reliant on immigrant labor across key industries.

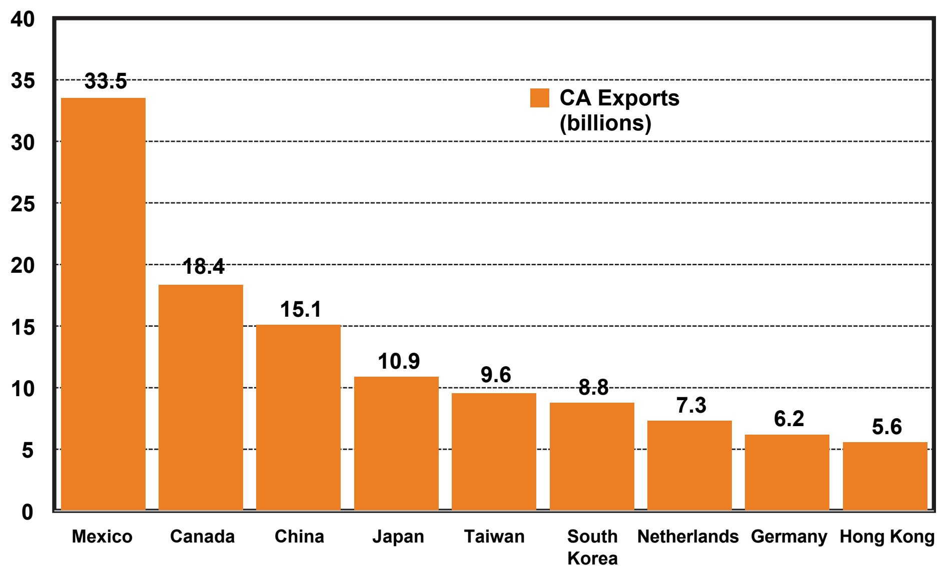
The state is likely to face amplified disruptions, owing to the disproportionate impact of federal policies advanced under the Trump Administration.

Trade is at the forefront of these concerns, as a rise in protectionism is likely to trigger a sharp contraction in international trade volumes. This is particularly significant for California, whose ports handle roughly 40% of the nation's containerized imports and 30% of its exports. In 2024, the state exported $184 billion in merchandise goods, while importing a staggering $500 billion—including $121 billion from China alone. The ports of Los Angeles and Long Beach serve as critical gateways for trade with China and Southeast Asia, leaving Southern California especially vulnerable to global trade disruptions. The region's logistics sector, closely intertwined with international shipping and distribution, would bear the brunt of any slowdown.

In 2024, the state exported $184 billion in merchandise goods, while importing a staggering $500 billion—including $121 billion from China alone. The ports of Los Angeles and Long Beach serve as critical gateways for trade with China and Southeast Asia, leaving Southern California especially vulnerable to global trade disruptions.

Mexico and Canada—two of California's primary trading partners—now face renewed headwinds under the current trade regime. While USMCA-compliant goods remain tariff-exempt, nearly half of imports from Mexico and 62% from Canada are currently non-USMCA compliant, making them subject to a 25% tariff. However, these figures may overstate the true level of non-compliance. In many cases, firms have simply not completed the necessary paperwork to certify compliance—suggesting that actual non-compliance may prove significantly lower once firms are prodded to act. Still, under current conditions, the effective tariff rate stands at 9% for Mexico and 12% for Canada, impacting roughly $80 billion in imports to California (Figure 41). On the export side, as much as $52 billion in goods could be affected should these trading partners retaliate (as Canada already has) or enter an economic downturn (which is very likely), thereby reducing demand for California-made products.

FIGURE 41
CA Exports May Be in Jeopardy Due to Trade Disruptions (billions of dollars)



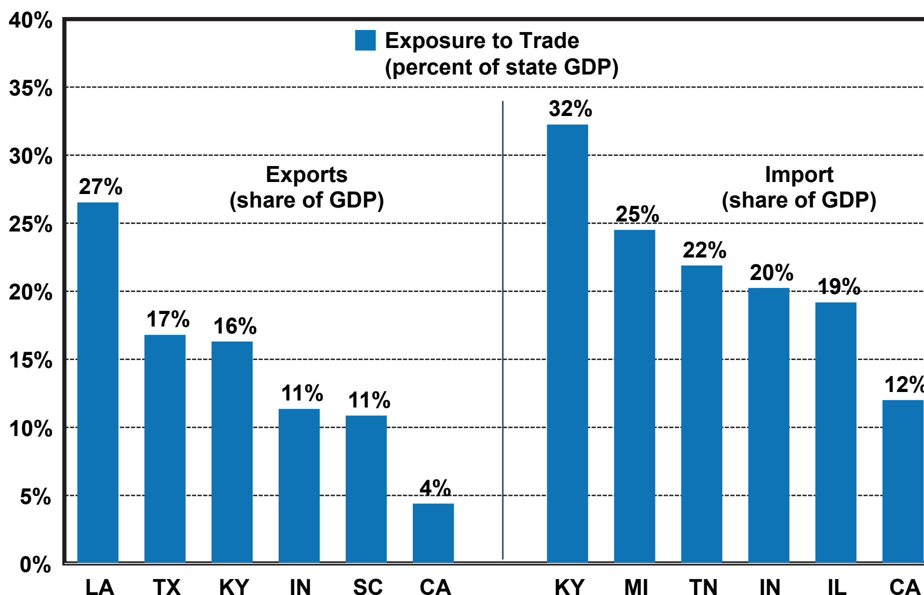
Certain sectors are particularly vulnerable to the fallout from trade wars. In 2024, California exported $37 billion in high-tech goods, including computers, semiconductors, and medical devices—making it one of the most exposed segments of the state's economy. Agriculture ranks a close second. The state exported $14.9 billion in agricultural products, with almonds and citrus alone accounting for $11.4 billion, much of it produced in Central and Southern California, where farms are likely to bear the brunt of trade-related disruptions. Adding to the strain, China's ban on most Hollywood film imports has compounded challenges for California's entertainment industry, which is still recovering from recent labor disputes and production delays.

That said, California's diverse economy offers a measure of insulation—a blessing in disguise. Exports account for just 4.4% of the state's GDP, well below the national average of 7%, and significantly lower than states like Louisiana (26.5%), Texas (16.8%), and Kentucky (16.3%). While California's economy—particularly its logistics sector—is more exposed to imports, with imports comprising 12% of state GDP (roughly in line with the national average), this exposure is still lower than in several other states. For comparison, Kentucky's import exposure is 32.3%, Michigan's 24.5%, and Tennessee's 21.9% (Figure 42).

China's ban on most Hollywood film imports has compounded challenges for California's entertainment industry, which is still recovering from recent labor disputes and production delays.

California's diverse economy offers a measure of insulation—a blessing in disguise. Exports account for just 4.4% of the state's GDP, well below the national average of 7%, and significantly lower than states like Louisiana (26.5%), Texas (16.8%), and Kentucky (16.3%).

FIGURE 42
Mercifully, CA is Less Exposed to Trade Than Other States (exports and imports, percent of GDP)



Beyond trade, federal policies on immigration, fiscal austerity, and deregulation pose additional risks to California's economy. The state's $60 billion agriculture sector—the largest in the nation, producing over one-third of U.S. vegetables and nearly three-quarters of its fruits and nuts—is critically dependent on immigrant labor. Other major sectors share this vulnerability. Construction, which employs 900,000 workers (about 5% of statewide employment), relies on immigrants for 25% of its workforce. The Leisure and Hospitality sector, with 2 million jobs (roughly 11% of state employment), is similarly exposed, with 23% of its labor force made up of immigrants. The administration's tightening of immigration policy and stepped-up deportation efforts threatens all three sectors.

California faces significant challenges due to proposed federal budget cuts to Medicaid (Medi-Cal in California), which will disproportionately impact the state, as it has expanded coverage beyond federally funded levels. While actual data is hard to come by, it appears that the state spent $4.6 billion on Medicaid for undocumented residents. The percentage of the population in California covered by Medicaid, at 27%, ranks among the highest in the nation, placing fourth behind New Mexico (34%), Louisiana (32%), and New York (28%). In contrast, states like Texas and Florida have much lower coverage—16% and 18%, respectively. Additionally, environmental deregulation at the federal level threatens to erode California's longstanding efforts in emissions reduction. Federal skepticism toward the state's initiatives in wildfire management, water policy, and the high-speed rail project further complicates California's policy landscape. As these federal policies continue to evolve, California can expect to face mounting headwinds on multiple fronts.

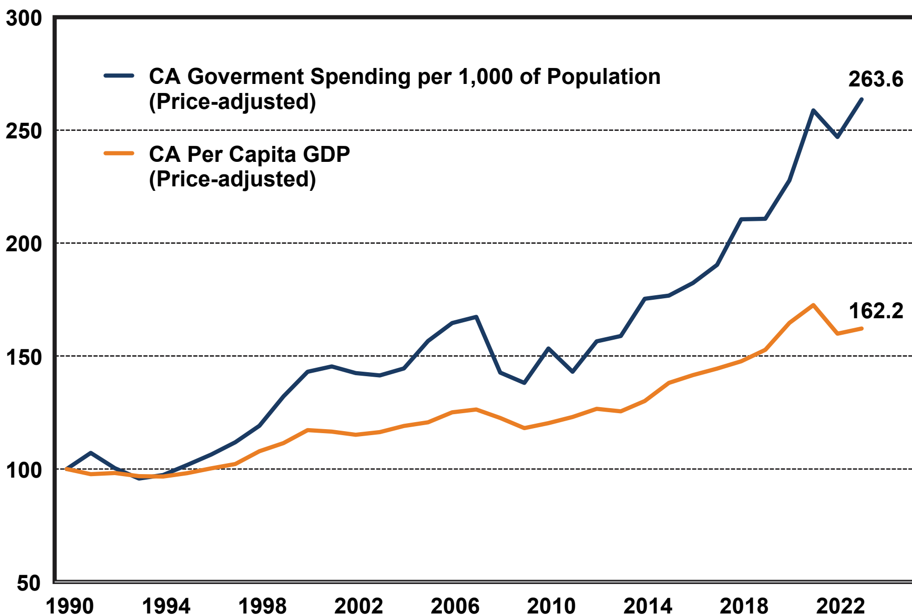
The percentage of the population in California covered by Medicaid, at 27%, ranks among the highest in the nation, placing fourth behind New Mexico (34%), Louisiana (32%), and New York (28%).

Assessing Fiscal Discipline: Does California Need a Department of Government Efficiency (DOGE)?

Not all of California's challenges stem from national politics. In recent years, the state's budgets have reflected a pattern of steady and expansive growth in government spending. Over the past 35 years, real GDP per capita has increased by 162%, while inflation-adjusted per capita expenditures—including both general and special funds—have surged by 263% (Figure 43). At the same time, California's revenue base remains highly volatile, driven by its heavy dependence on top income earners and capital gains. These revenue streams are inherently cyclical, rising sharply during economic expansions but falling just as quickly in downturns—and are especially sensitive to fluctuations in financial markets.

Over the past 35 years, real GDP per capita has increased by 162%, while inflation-adjusted per capita expenditures—including both general and special funds—have surged by 263%

FIGURE 43
CA Government Spending Has Surpassed Growth By a Wide Margin (index, 1990=100



More recently, California's policymakers have increasingly relied on a recurring mechanism to address budget shortfalls without resorting to significant spending cuts or new revenue measures: projecting efficiency savings within state agencies and programs. These assumed savings are typically attributed to projected cost reductions through operational improvements, often without empirical validation. In effect, they serve as a tool to reconcile budget deficits on paper, rather than through concrete structural adjustments.

More recently, California's policymakers have increasingly relied on a recurring mechanism to address budget shortfalls without resorting to significant spending cuts or new revenue measures: projecting efficiency savings within state agencies and programs.

The 2024–2025 budget exemplifies this approach. Initially enacted at $297.9 billion, including $211.5 billion in general fund expenditures, the budget was built on expectations of projected General Fund revenues of $207.2 billion—necessitating a deficit-financing strategy. To close the gap, Governor Gavin Newsom and state legislators employed a series of fiscal maneuvers, including $2.9 billion in assumed efficiency gains across state agencies and universities, to balance the accounts.

However, when the governor unveiled the 2025–2026 budget proposal, it became clear that the efficiency savings assumed in the prior year had largely failed to materialize. While state universities met their relatively modest $200 million target, other agencies achieved only $800 million in savings—less than one-third of the projected $2.7 billion. At the same time, general fund expenditures for 2024–2025 ballooned to an estimated $232 billion, exceeding the enacted budget by $21 billion. Although revenue projections were also revised upward to $217 billion, the underlying budget deficit widened to $15 billion.

Another tactic employed by the administration has been to shift a portion of general fund expenditures to the recently passed Proposition 4 bond funding. While the measure was intended to support priorities such as safe drinking water, wildfire prevention, and climate resilience, reallocating budgeted expenditures to bond proceeds allows the governor to present a smaller budget deficit. However, this maneuver also means the state will ultimately spend less toward fulfilling the core objectives of Proposition 4—potentially undermining progress on these critical issues.

California continues to grapple with a persistent structural deficit—a recurrent disequilibrium between revenue and legislatively mandated expenditures. This imbalance was made worse in 2022 when a temporary revenue surge led to a projected $97.5 billion surplus, prompting a significant expansion in state outlays. However, as revenues normalized, expenditure commitments remained elevated, thus leading to a multi-year fiscal gap.

California continues to grapple with a persistent structural deficit—a recurrent disequilibrium between revenue and legislatively mandated expenditures.

Exogenous shocks—such as the recent wildfires in Los Angeles—have further strained the state's fiscal outlook. California has already allocated $2.5 billion in emergency appropriations to cover fire-related costs, a burden that will widen the deficit in the absence of federal assistance. While Governor Newsom may pursue federal relief, such one-time measures do little to address the state's deeper, structural budgetary misalignment.

Exogenous shocks—such as the recent wildfires in Los Angeles—have further strained the state's fiscal outlook. California has already allocated $2.5 billion in emergency appropriations to cover fire-related costs, a burden that will widen the deficit in the absence of federal assistance.

Despite sluggish revenue growth, the administration has selectively expanded discretionary spending—most notably through increased subsidies for the Southern California film and video industry, as well as various social programs. These policy choices raise important questions about how the state prioritizes its fiscal resources, particularly in a period of mounting budget pressures.

The state's continued reliance on accounting maneuvers, speculative efficiency gains, and one-off fiscal interventions is unlikely to yield a sustainable budgetary framework. Without meaningful structural reforms—whether through expenditure rationalization or revenue adjustments—California's fiscal challenges will persist. Perhaps California does indeed need a Department of Government Efficiency, albeit a prudent and rigorously analytical one.

Population and Immigration Dynamics

California's population grew by 49,000—or 0.12%—in the year ending July 1, 2024, reaching 39.2 million, according to recent data from the California Department of Finance. After three consecutive years of declines during the pandemic, this modest increase marks the state's return to population growth. Several factors contributed to the turnaround. Legal immigration rebounded, with a net gain of 134,400 people in 2023–2024, up from 115,900 in 2022–2023, reaching the highest level since 2018. At the same time, domestic out-migration slowed, and in-migration picked up, reducing net domestic losses to below 200,000 in 2023–2024, compared to nearly 250,000 the year before. Net domestic migration has now returned to levels similar to those before 2018, dropping to about one-sixth of the 2021 peak. Natural increase—the difference between births and deaths—added 111,500 people in 2023–24, up from 107,400 in 2022–2023, as the number of deaths continued to decline from their pandemic highs and moved closer to long-term trends.

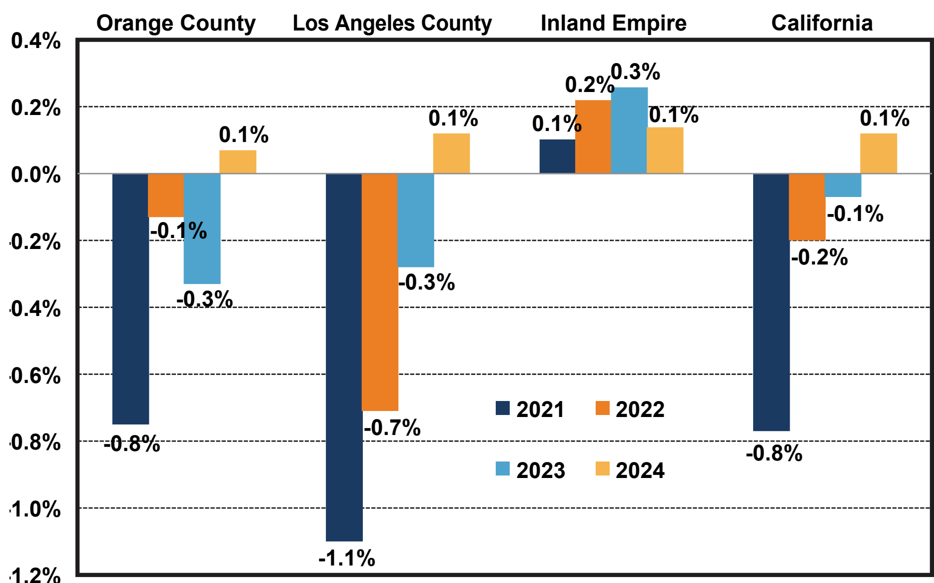
California's population grew by 49,000—or 0.12%—in the year ending July 1, 2024, reaching 39.2 million, according to recent data from the California Department of Finance.

For the last two decades, California has experienced negative net domestic migration, in which the number of people moving out of the state in a year is higher than the number moving in. Since 2016, net domestic outmigration has been higher than the net international migration, leaving natural increase as the only source of population growth. But the natural increase is constrained by declining fertility rates and increased deaths from an aging population. Net international migration to California reached 134,400 people in the year ending July 2024, a significant positive for overall population growth. However, negative domestic net migration still outweighed these gains, resulting in a net migration loss of over 62,600 residents. It is expected that California will experience slow but positive growth for the near future as net domestic migration continues to recede to the lower rates of the 2010s.

A similar dynamic is unfolding across Southern California, where all counties returned to net positive population growth in 2023–2024 after three consecutive years of decline—with the exception of the Inland Empire, which continued to grow throughout this period.

A similar dynamic is unfolding across Southern California, where all counties returned to net positive population growth in 2023–2024 after three consecutive years of decline—with the exception of the Inland Empire, which continued to grow throughout this period (Figure 44). In each case, international migration has been the primary driver of growth, more than offsetting continued net domestic out-migration. As with the state overall, Southern California's population growth could remain on a positive trajectory, but longer-term sustainability will depend on addressing persistent structural factors - including high housing costs, burdensome regulations, and chronic congestion. Unless these structural challenges are mitigated, domestic outflows may continue to weigh on the region's demographic outlook.

FIGURE 44
At Last, a Few Positive Trends on Demographic Changes (population, y-o-y percent change)

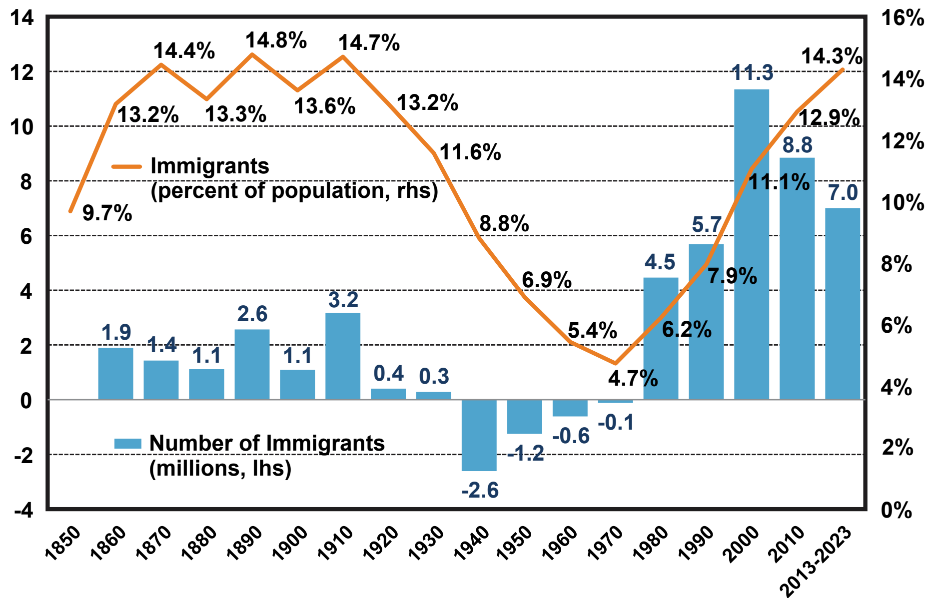


Under the current environment—marked by the Trump administration's efforts to reduce immigration and intensify deportations— the issue of immigration has become increasingly critical for the economy and warrants closer scrutiny. The term "immigrant" (or "foreign born") refers to individuals residing in the United States who were not

U.S. citizens at birth. This includes naturalized citizens, lawful permanent residents, certain legal nonimmigrants (such as those on student or work visas), individuals admitted under refugee or asylee status, and undocumented residents.

Historically, the share of immigrants in the U.S. population remained relatively steady at around 14.5% from 1860 to 1920. That share declined significantly during the mid-20th century, reaching a low of 4.7% in the 1950s, when large-scale deportation of immigrant workers occurred. Since then, however, immigration has steadily increased, and from 2013 to 2023, immigrants made up 14.7% of the U.S. population—a rate that mirrors the levels observed in the late 19th and early 20th centuries (Figure 45). Of course, in absolute terms, the immigrant population is far larger today as the nation's total population has also grown. Moreover, a substantial increase likely occurred in 2024, although official data are not yet available.

FIGURE 45
Share of Immigrant Population is as High Now as in the Late 1800s/Early 1900s (level and percent of population)



California has long held the distinction of having the largest immigrant population in the country—both in absolute numbers and as a share of its residents. The same holds true for the number of unauthorized immigrants. But while the state's immigrant share has risen modestly—from 21.7% in 1990 to 27.3% in 2023—the national average has nearly doubled, from 7.9% to 14.3% over the same period (Table 3). That suggests immigration has surged more dramatically in other parts of the country than in California.

While the state's immigrant share has risen modestly—from 21.7% in 1990 to 27.3% in 2023—the national average has nearly doubled, from 7.9% to 14.3% over the same period. That suggests immigration has surged more dramatically in other parts of the country than in California.

TABLE 3
CA Has a Far Greater Share of Immigrant Population than the Nation (total population and immigrant share)

		U.S.	CA
1990	Total	248.7	29.8
	Immigrant	19.8	6.5
	Share	7.9%	21.7%
2000	Total	281.4	33.9
	Immigrant	31.1	8.9
	Share	11.1%	26.2%
2010	Total	309.3	37.3
	Immigrant	40.0	10.2
	Share	12.9%	27.2%
2019	Total	328.2	39.5
	Immigrant	44.9	10.6
	Share	13.7%	26.7%
2023	Total	334.9	39
	Immigrant	47.8	10.6
	Share	14.3%	27.3%

Estimates of unauthorized immigration are inherently imprecise. The latest figures from the Center for Migration Studies place the total number of unauthorized immigrants in the U.S. at 11.7 million as of July 2023. That estimate closely aligns with earlier projections from the Migration Policy Institute, which are based on 2015–2019 data. Across most of Southern California, the state, and the nation, unauthorized immigrants account for roughly one in four of all immigrants. That share is slightly lower in Orange County and somewhat higher in Los Angeles (Table 4).

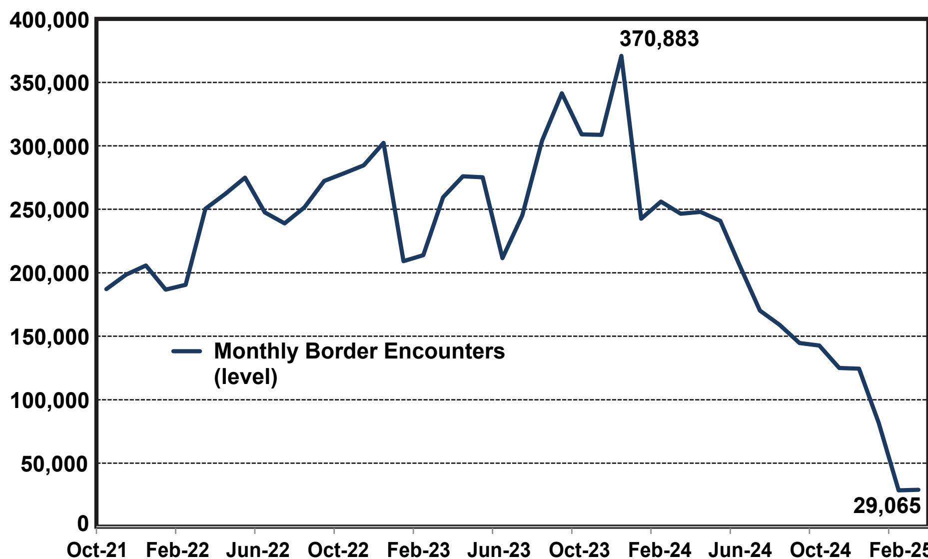
TABLE 4
Unauthorized (Illegal) Immigrants
(total and percent)

	Number of Unauthorized Immigrants	Total Immigrants	Illegal Immigrants as Percent of Total Immigrants
Los Angeles County	951,000	3,285,200	28.90%
Orange County	236,000	1,108,400	21.30%
Riverside County	132,000	529,800	24.90%
San Bernardino County	127,000	468,200	27.10%
California	2,739,000	10,640,000	25.70%
United States	11,047,000	46,109,000	24.00%

While the broader debate over the value of immigration—particularly unauthorized immigration—remains contentious and beyond the scope of this report, there is little doubt that immigration has a significant impact on the U.S. economy and society. Recent administrative efforts to stabilize border crossings, increase deportations, and reduce legal immigration, though still in their early stages, are likely to carry both short- and long-term consequences. Crossings at the borders have dropped dramatically (Figure 46). The full extent of the administration's immigration policies is unlikely to become clear until later this year. California's economy, which relies heavily on immigrant labor from Mexico and other Latin American countries—particularly in agriculture, construction, and the leisure and hospitality sectors—could face labor shortages in these and other low-skilled industries.

California's economy, which relies heavily on immigrant labor from Mexico and other Latin American countries—particularly in agriculture, construction, and the leisure and hospitality sectors—could face labor shortages in these and other low-skilled industries.

FIGURE 46
Border Crossings Have Collapsed
(encounters at the border, level)



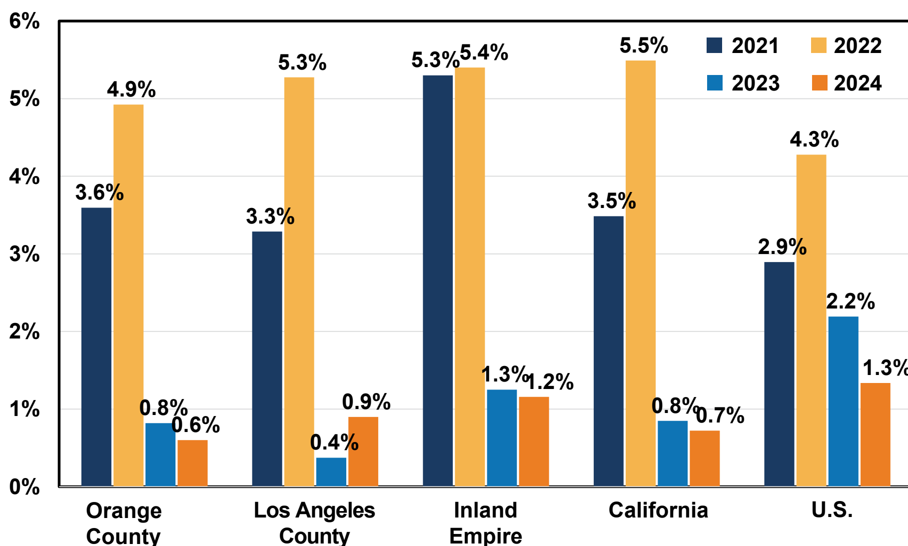
Are Southern California and Orange County Economies Already in Slowdown?

As outlined in our national report, the U.S. economy has begun to slow—due in part to the natural phase of the business cycle, and in part to the Trump administration's policies on tariffs, government restructuring, and immigration. These headwinds are likely to usher in a period of heightened volatility marked by stagflationary dynamics—where recession risks remain elevated by the second half of 2025 and into 2026.

Regional economies are already limping. Job growth in Southern California and across the state has lagged the national pace over the past two years. The rapid rebound in 2021–2022 following the pandemic's sharp downturn was expected. But the concern now is that the recent slowdown in job creation is aligning with broader national economic weakness. California's payroll employment grew by 2.5% in 2021 and 5.5% in 2022 but slowed sharply to 0.8% in 2023 and 0.7% in 2024. Orange County followed a similar path, with growth of 3.6% and 4.9% in 2021 and 2022, dropping to just 0.8% in 2023 and 0.6% in 2024 (Figure 47). Los Angeles County also saw a sharp moderation, from 3.3% and 5.3% to 0.4% and 0.9% over the same period. The Inland Empire fared slightly better, posting gains of 1.3% in 2023 and 1.2% in 2024. Still, in all of these regions, payroll job growth remained well below the national rates of 2.2% in 2023 and 1.3% in 2024.

Regional economies are already limping. Job growth in Southern California and across the state has lagged the national pace over the past two years.

FIGURE 47
Regional Labor Markets Have Slowed Down Dramatically
(y-o-y percent change)

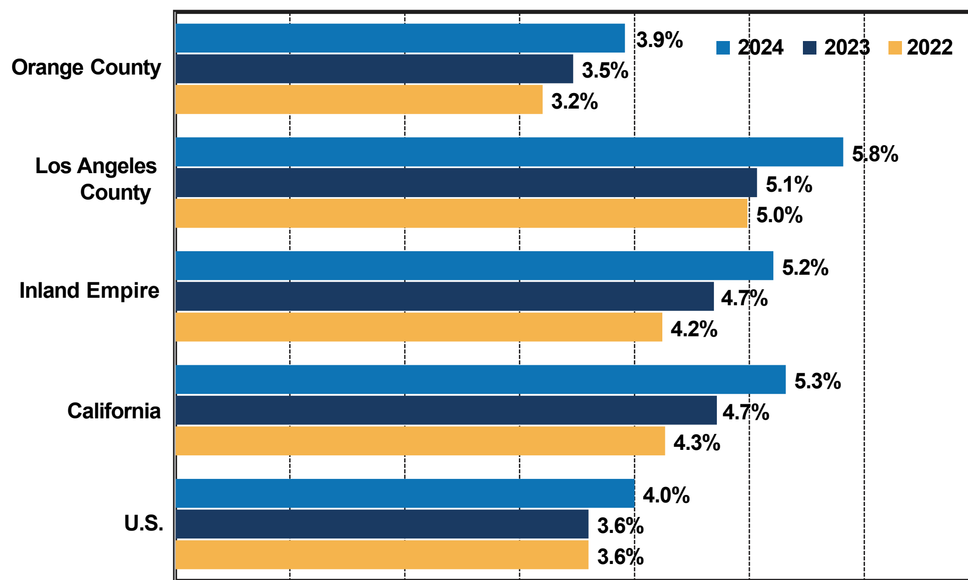


Not only has job growth been anemic, but it has also been worryingly lopsided, concentrated in just a few sectors. Over the past two years, the largest gains have come from Private Education and Health Services, Government, and Leisure and Hospitality. Meanwhile, one of the state's largest sectors—Professional and Business Services—has underperformed. This pattern is consistent at both the state level and across Southern California's counties: Orange, Los Angeles, Riverside, San Bernardino, and Ventura. Notably, two of the main drivers of job growth—Health Services and Government—are heavily dependent on public funding and subsidies. Meanwhile, growth in the Leisure and Hospitality sector slowed in 2024. Taken together, the limited and narrowly focused nature of private-sector job creation raises concerns, especially given the broader economic headwinds expected in the macro economy.

Over the past two years, the largest gains have come from Private Education and Health Services, Government, and Leisure and Hospitality. Meanwhile, one of the state's largest sectors—Professional and Business Services—has underperformed.

In line with the softening payroll picture, unemployment rates reported in the household employment surveys have edged up across the state and Southern California over the past two years (Figure 48). In Orange County, the jobless rate rose from 3.2% in 2022 to 3.5% in 2023 and 3.9% in 2024. Los Angeles County saw an increase from 5.0% to 5.1% and then 5.8%, while the Inland Empire moved from 4.2% to 4.7% and 5.2% over the same period. While these shifts generally mirror national patterns, a key difference lies in the stagnation of labor force growth—particularly in Los Angeles and Orange Counties, where the number of people in the labor force remains below pre-pandemic levels. By contrast, the Inland Empire has bucked the trend, with labor force participation now exceeding 2019 levels. The pandemic-induced wave of retirements and workforce exits appears to have left a more persistent mark on coastal counties.

FIGURE 48
Unemployment Rates Have Edged Up in the Region (percent)



On top of the broader economic slowdown, Los Angeles County was hit in January 2025 by the most devastating wildfires in its history—the Palisades and Eaton Fires—which together scorched over 55,000 acres, destroyed 16,251 structures, and claimed at least 30 lives. When all is said and done, this will likely go down as one of the costliest natural disasters on record—second perhaps only to Hurricane Katrina—not because of its size, but because of the extraordinarily high real estate values in Los Angeles County.

When all is said and done, this will likely go down as one of the costliest natural disasters on record—second perhaps only to Hurricane Katrina—not because of its size, but because of the extraordinarily high real estate values in Los Angeles County.

In response, all levels of government mobilized aid and resources. President Biden approved a major disaster declaration for Los Angeles County in early January, while Governor Gavin Newsom declared a state of emergency and signed a $2.5 billion state relief package. To accelerate rebuilding, the Governor temporarily suspended certain permitting and environmental review requirements, including select provisions of the California Environmental Quality Act (CEQA), for homes and businesses destroyed by the fires. Local governments also stepped in, offering targeted support such as deadline extensions for business tax filings and waivers of the city's 2025 business taxes for affected firms.

Early estimates of economic losses range from $53 billion in property damage (L.A. Economic Development Corporation), to $131 billion (UCLA), which includes up to $45 billion in insured losses. The higher estimate accounts for direct property damage as well as infrastructure losses—such as roads, power lines, and public utilities. Insurance limitations, including underinsurance and insurer withdrawals from the market, are expected to have uneven impacts on the affected homeowners.

Early estimates of economic losses range from $53 billion in property damage (L.A. Economic Development Corporation), to $131 billion (UCLA), which includes up to $45 billion in insured losses.

Historically, property values in wildfire-prone areas tend to dip temporarily before gradually recovering. But this time, the landscape is more precarious. Soaring insurance premiums and an already tight housing supply are further eroding affordability. In the wake of the fires, rental prices in Los Angeles surged, compounding the city's long-running housing crisis. Meanwhile, in the San Bernardino Mountains, the dynamic is shifting in the opposite direction. Rock-bottom land prices—driven by fire-related fears and mounting insurance costs—are pushing out longtime residents. In their place, new arrivals from the lowlands, priced out of urban housing markets, are moving uphill, transforming these mountain communities.

California's home insurance market has become increasingly unstable, with many insurers pulling out of high-risk regions. In response, the state introduced a new Sustainable Insurance Strategy, allowing insurers to use probabilistic models and incorporate reinsurance costs into premium pricing. While these changes aim to stabilize the market, they are also expected to drive up insurance costs for homeowners. Meanwhile, the state's FAIR Plan—the last-resort fire insurance program—is under mounting financial pressure and may require higher assessments from all policyholders to stay afloat.

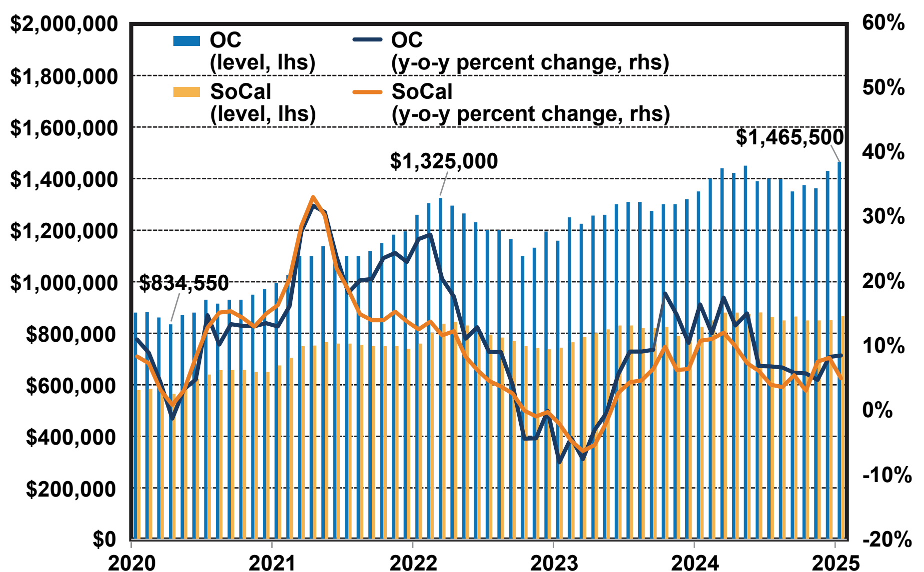
The state's FAIR Plan—the last-resort fire insurance program—is under mounting financial pressure and may require higher assessments from all policyholders to stay afloat.

The wildfires also released large volumes of air pollutants, contributing serious long-term health risks and imposing additional economic costs. These health impacts translate into higher public health costs over time. Municipal budgets are under strain from rising expenditures on firefighting, rebuilding, and public assistance. While reconstruction efforts may provide a short-term boost to sales tax revenue, property tax collections are likely to decline due to disaster-related relief measures. Meanwhile, cleanup costs continue to mount. These events highlight the urgent need for sustained investments in wildfire mitigation, resilient infrastructure, and comprehensive insurance reform to address the mounting risks associated with climate change.

Housing Market Trends

Housing markets in Southern California continue to reflect similar persistent trends over the last five years: tight inventory, below-average new construction, and limited turnover. These supply constraints have driven housing prices higher—though often in erratic bursts. In Orange County, the median price of a single-family home surged from $861,000 in April 2020 to $1,325,000 by April 2022—a 54% jump—before falling 17% to $1,100,000 by November 2022 (Figure 49). Prices then rebounded, climbing 32% over the next 17 months to reach $1,450,000 by June 2024. As of February 2025, the median price stands at $1,465,500, but not without a downswing of over $150,000 in the intervening eight months.

FIGURE 49
Home Prices Have Continued to Rise (level and percent change)

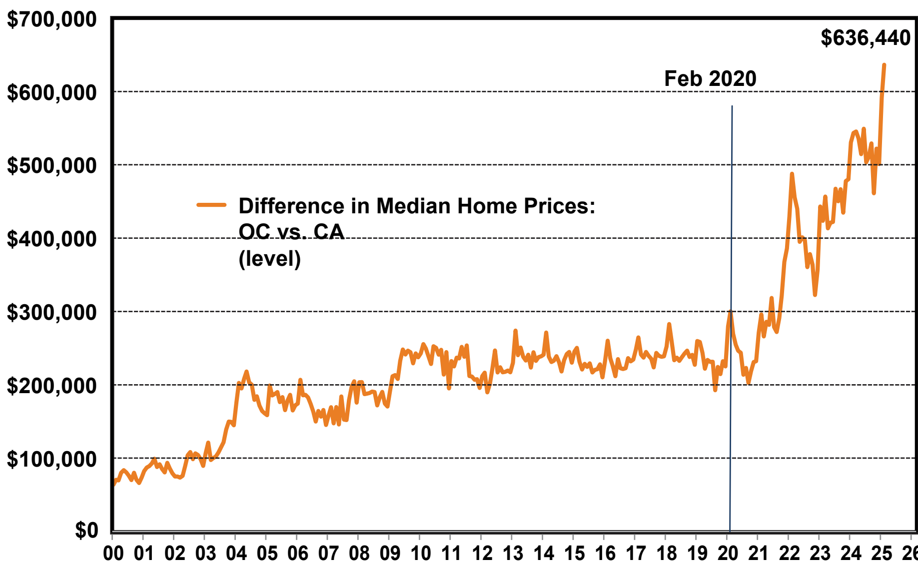


Housing remains expensive, but timing clearly matters. For those who bought at the right moment, returns have been exceptional. Over the past five years—spanning the pandemic and the surge in tech stocks during the "Magnificent 7" rally—the median price of a single-family home in Orange County has climbed nearly 70%, matching the gains in the S&P 500 index.

Orange County home prices have consistently outpaced the statewide median, with the gap widening notably over time. In February 2020, just before the pandemic, the median home in Orange County was priced $300,000—or 34.1%—above the California median (Figure 50). By February 2025, that difference had more than doubled, reaching $636,000—a 43.4% premium over the state average.

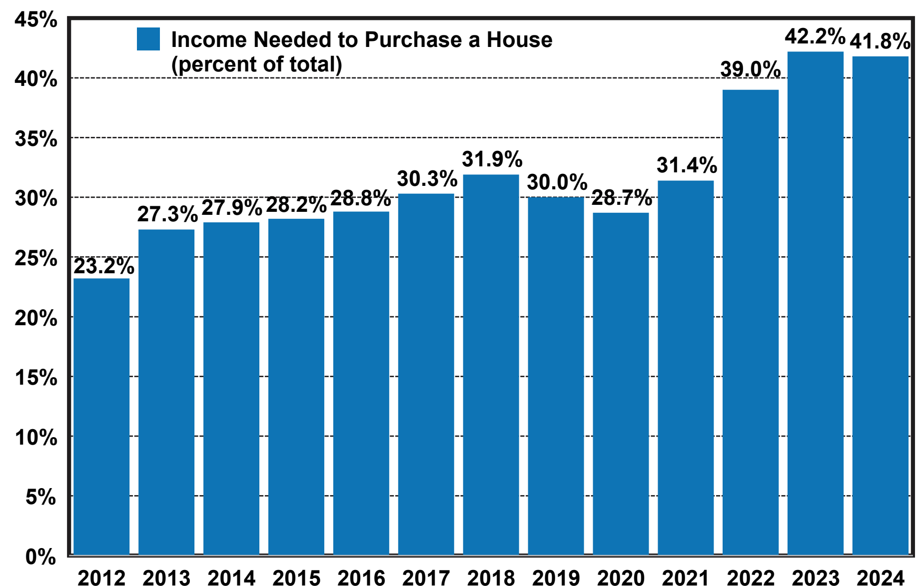
In February 2020, just before the pandemic, the median home in Orange County was priced $300,000—or 34.1%—above the California median. By February 2025, that difference had more than doubled, reaching $636,000—a 43.4% premium over the state average.

FIGURE 50
Difference in Home Prices Between OC and CA Has Skyrocketed (median single family home price, difference, level)



Housing affordability remains a major barrier to homeownership, despite a modest drop in mortgage rates over the past 15 months. The 30-year fixed mortgage rate, for instance, fell from 7.8% in October 2023 to 6.1% by September 2024. This easing brought some relief. The share of household income needed to purchase a median-priced home—based on national income levels, a 15% down payment, and including principal, interest, taxes, and insurance—declined slightly from 42.2% in 2023 to 41.8% in 2024 (Figure 51). However, that share remains nearly double what it was in the early 2010s, underscoring the ongoing affordability crisis. In addition, the 30-year fixed mortgage rate edged back up earlier this year and currently stands at 6.7% as of this writing (early April 2025).

FIGURE 51
Purchasing a Home is Gobbling Up an Increasing Share of Income (percent of total income)



The affordability issue is particularly acute for the Southern California region. With both home prices and borrowing costs remaining elevated, qualifying for a home purchase in Southern California now requires significantly higher income levels and monthly payments (see table below). In Orange County, for example, purchasing a median-priced home at the end of 2024 required an annual income exceeding $230,000 and a monthly mortgage payment of $7,690. Compounding the affordability challenge, property insurance rates—already high—are expected to climb sharply following the devastating Los Angeles wildfires earlier this year.

As noted earlier, pent-up demand is only part of the explanation for Southern California's elevated home prices. The other, arguably more critical factor, is the region's chronically tight housing supply, which is more constrained than the national average. A key contributor to this limited inventory is the growing tendency of homeowners to stay put. Nationally, the average home tenure is now 11.8 years, down slightly from its pandemic-era peak but nearly double the average from the early 2000s. Much of this trend is driven by the "rate lock-in" effect: millions of homeowners refinanced at historically low mortgage rates during the pandemic and are now reluctant to trade them for today's much higher rates.

This trend is even more pronounced in California, where a combination of pandemic-era ultra-low mortgage rates and Proposition 13—which caps property tax increases—gives homeowners strong incentives to stay put. In the Los Angeles metro area, the typical homeowner remains in their home for an astounding 19.4 years—the longest tenure of any major U.S. metro and the highest on record for the region. California is also home to three of the five metro areas with the sharpest increase in homeowner tenure over the past decade. Following Providence, RI, the biggest jumps were seen in Los Angeles, San Jose, New Orleans, and San Francisco.

In the Los Angeles metro area, the typical homeowner remains in their home for an astounding 19.4 years—the longest tenure of any major U.S. metro and the highest on record for the region.

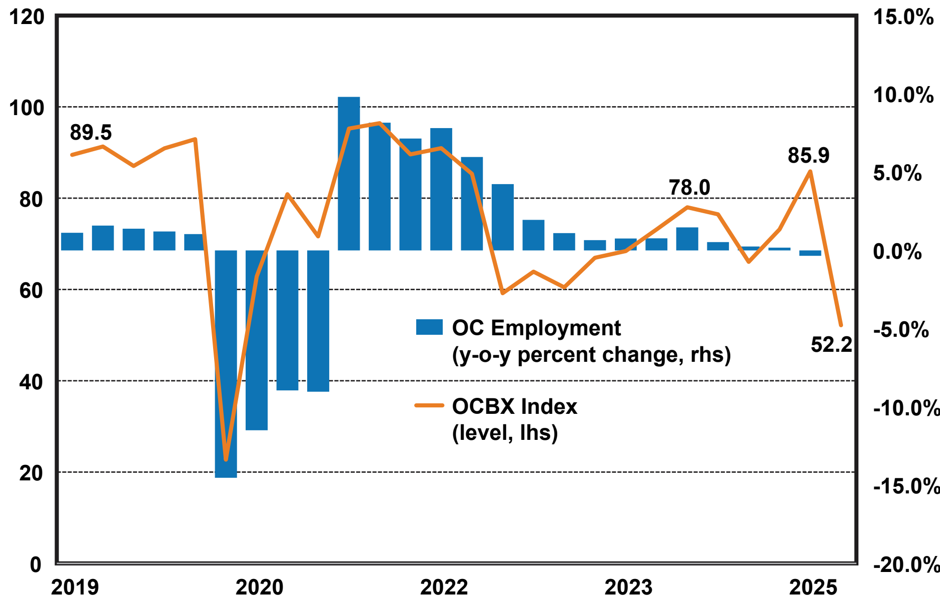
In the near term, little is likely to shift meaningfully in the housing market. Mortgage rates, which are closely tied to long-term Treasury yields, remain highly volatile amid ongoing macroeconomic uncertainty. As discussed earlier, weakening economic conditions—combined with uncertainty around the path of interest rates, inflation, and future growth—will continue to weigh on housing demand and affordability. Given these headwinds, we expect housing prices to remain largely flat over our forecast horizon, which extends through the next 18 months.

Orange County Business Sentiment

For over two decades, the Woods Center has conducted quarterly surveys of Orange County business leaders to gauge their views on the economy and their own firms. From these responses, we construct the Orange County Business Expectations Index (OCBX), which ranges from 0 to 100. A reading above 50 signals continued economic expansion. The most recent survey, conducted in the third week of March for the second quarter of 2025, revealed a sharp drop in sentiment. The OCBX index plunged from 85.9 to 52.2, marking the steepest quarterly decline since the Great Financial Crisis of 2008–09 (Figure 52). Business leaders not only anticipate a slowing economy, but they also express deep concerns over policy uncertainty coming out of Washington. Below, we take a closer look at the individual survey questions to gain further insight into the drivers behind this sharp deterioration in sentiment.

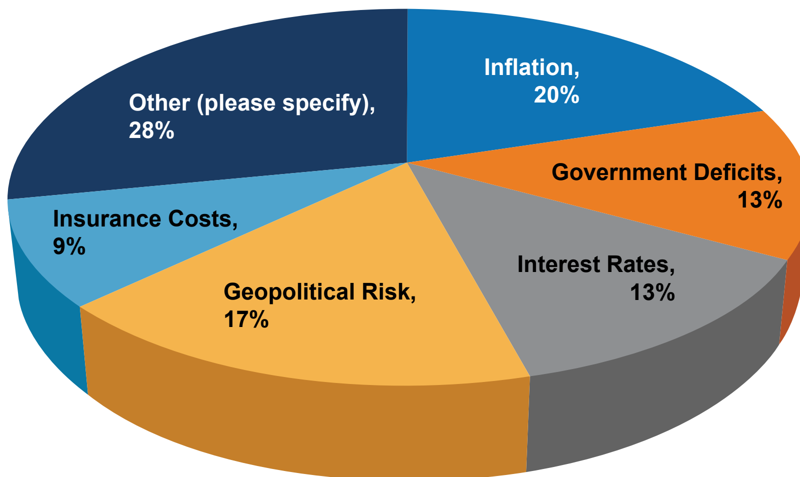
The OCBX index plunged from 85.9 to 52.2, marking the steepest quarterly decline since the Great Financial Crisis of 2008–09.

FIGURE 52
OC Business Sentiment Has Collapsed
(OCBX and payroll employment, level and percent change)



When asked about their top concern, business leaders were sharply divided, pointing to inflation, interest rates, government spending, geopolitical risks, and rising insurance costs. But inflation has once again taken the lead, with 20% of respondents citing it as their primary concern (Figure 53). This marks a shift from last quarter, when interest rates and government spending topped the list. We also asked respondents to forecast inflation for December 2025, given the current February rate of 2.8%. Nearly half (48%) expect inflation to remain above 2.7%, while fewer than 10% believe it will fall to the Fed's 2% target. This marks a significant shift in sentiment from the previous quarter, when only 23% expected inflation to exceed 2.7%.

FIGURE 53
Most Important Concerns: Inflation and Geopolitical Risks
(OCBX percent of respondents)



Geopolitical risks ranked as the second most pressing concern, cited by 17% of respondents—unsurprising given the ongoing conflicts in the Middle East and Ukraine. But topping the list was a broader set of anxieties voiced by many business leaders, including tariffs, anti-Semitism, financial instability, and leadership volatility. Some highlighted that "tariffs are causing companies to hold back on investments for growth," while others pointed to "the fast pace of government firings causing individuals to hold back on purchases, leading to a slowdown in the economy." Others emphasized the uncertainty, instability, and lack of clarity coming from the federal government, summing it up simply as "D.C. chaos." Taken together, the responses reveal a deep sense of unease among the business community about the broader policy and economic environment.

As discussed in our macro section, Federal Reserve's interest rate policy plays a pivotal role in shaping the trajectory of the economy and financial markets. We asked business leaders what they expect for the federal funds rate, currently at 4.5%, over the remainder of the year. Responses were evenly split: One-third anticipate the rate will remain unchanged, while another 35% expect a single 25-basis-point cut, bringing the rate down to between 4% and 4.25%. About 26% foresee two cuts, lowering the rate to between 3.75% and 4%. Only 2% expect three cuts, pushing the rate into the 3.5% to 3.75% range. Meanwhile, 4% of respondents believe the rate could rise above its current level.

The Trump Administration is poised to reshape the U.S. economy in several key ways, including through tariffs, spending cuts, promised tax reductions, and deregulation. To gauge business sentiment, we asked executives a series of questions about how they expect these policies to impact the economy over the next two years.

When asked about the impact of tariffs on inflation, responses were mixed. A plurality—nearly 40%—expect tariffs to raise inflation but believe the effect will be temporary. Another third (33%) anticipate a more persistent impact, though they see it as relatively modest. In total, nearly three-quarters of respondents expect the inflationary effects of tariffs to be either small or transitory. Only one-quarter believe tariffs will lead to a significant and lasting increase in inflation.

Views on the impact of tariffs on economic growth were similarly divided. About 35% of respondents believe tariffs will temporarily dampen growth, while 30% expect a small but more lasting negative effect on the economy. Another 20% foresee a significant and sustained drag on growth. The relatively muted assessment of tariffs' impact on both inflation and growth may reflect the timing of the survey, which was conducted before the announcement of the April 2 "Liberation Day" tariffs—an event that triggered far broader and more aggressive reciprocal measures than many had anticipated.

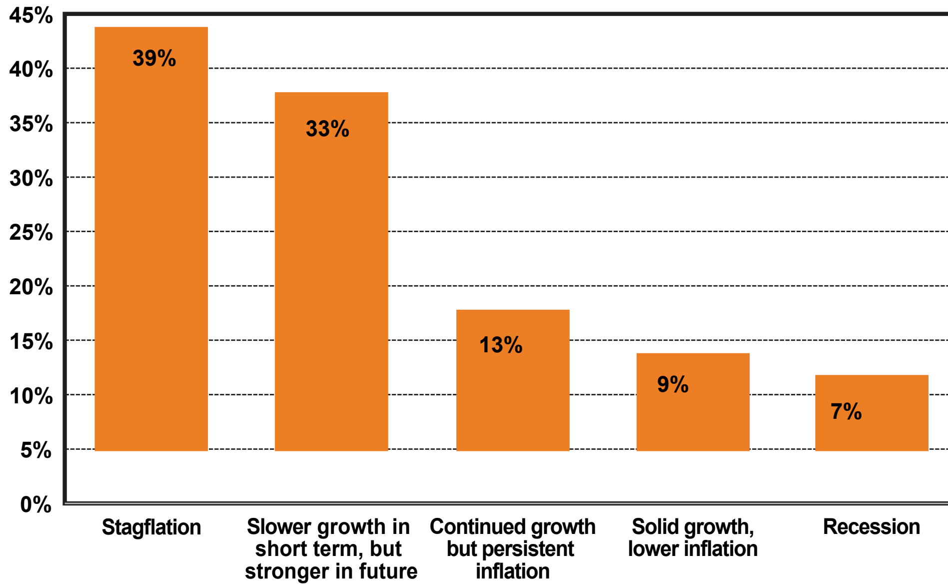
When asked about the likely impact of proposed Trump policies on the economy, responses revealed a wide range of views (Figure 54). The largest share (39%) expects the policies to result in stagflation, characterized by higher inflation and slower growth. Another third (33%) anticipate slower growth in the short term but stronger performance over the longer run. Meanwhile, 13% foresee continued growth accompanied by higher inflation, and 9% expect solid growth with lower inflation. A smaller share (7%) believes the policies could tip the economy into a recession.

One-third anticipate the rate will remain unchanged, while another 35% expect a single 25-basis-point cut, bringing the rate down to between 4% and 4.25%. About 26% foresee two cuts, lowering the rate to between 3.75% and 4%.

Nearly three-quarters of respondents expect the inflationary effects of tariffs to be either small or transitory. Only one-quarter believe tariffs will lead to a significant and lasting increase in inflation.

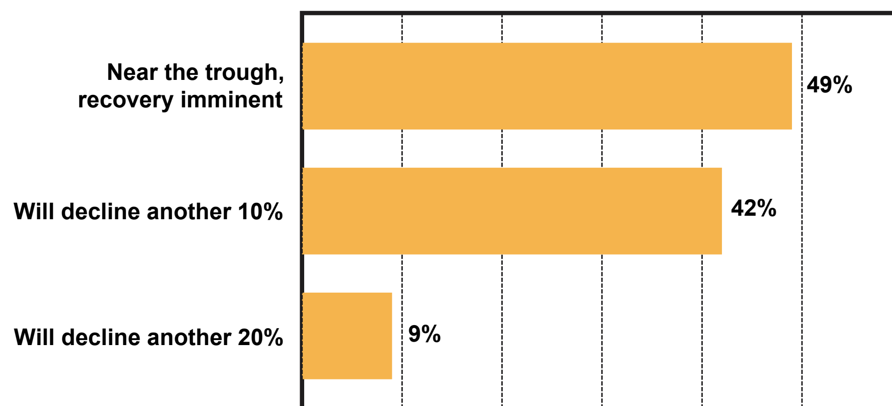
The largest share (39%) expects the policies to result in stagflation, characterized by higher inflation and slower growth. Another third (33%) anticipate slower growth in the short term but stronger performance over the longer run. Meanwhile, 13% foresee continued growth accompanied by higher inflation, and 9% expect solid growth with lower inflation. A smaller share (7%) believes the policies could tip the economy into a recession.

FIGURE 54
Likely Effect of President Trump's Policies on the Economy
(OCBX, percent of respondents)



Finally, we asked respondents about their expectations for the stock market, given its significant influence on the broader economy. The market had recently dipped into correction territory, marked by a 10% decline. As is often the case, views on the market's direction remain closely divided. Nearly half (49%) of business leaders believe the market has already bottomed out and expect an improvement in the near term (Figure 55). On the other hand, 42% anticipate an additional 10% decline, while 9% foresee an even steeper drop.

FIGURE 55
The Verdict on the Stock Market is Evenly Split
(OCBX, percent of respondents)



Employment Forecasts

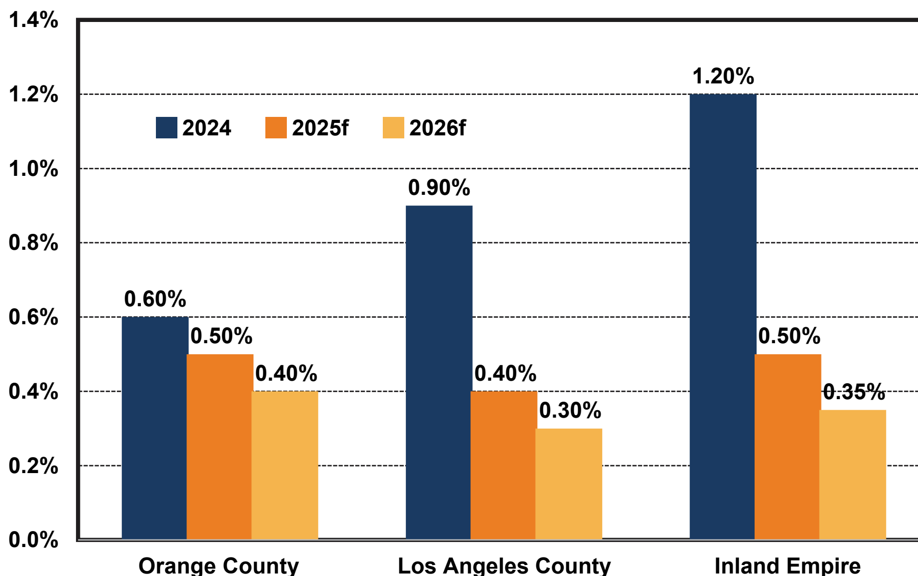
The California and Southern California economies are facing a growing set of headwinds. As noted above, the state's economic performance has been on a downtrend for the past two years, consistently lagging the national average in job creation. Only three sectors—Private Education and Health Services, Government, and Leisure and Hospitality—have added jobs. Of these, the first two are heavily reliant on public funding, which is increasingly under strain. Meanwhile, key industries such as Business and Professional Services and Construction—both major contributors to the state's economy—have been underperforming. Southern California counties are mirroring these statewide trends.

Looking ahead, tariff-induced trade shocks are expected to dampen activity at the ports of Los Angeles and Long Beach, with ripple effects across logistics and transportation industries throughout the region, particularly in Los Angeles and the Inland Empire. Additionally, anticipated reductions in immigrant labor will hit labor-intensive sectors such as agriculture and construction especially hard.

Tariff-induced trade shocks are expected to dampen activity at the ports of Los Angeles and Long Beach, with ripple effects across logistics and transportation industries throughout the region, particularly in Los Angeles and the Inland Empire.

The City of Los Angeles is grappling with the aftermath of the recent wildfires, a slowdown in its film and entertainment sector, and a sizable budget deficit. While Orange County's economy is more diversified than others in the region, it is not immune to the broader slowdown. We expect the national economy to weaken noticeably in the second half of 2025 and into 2026, with Southern California counties following a similar trajectory. Orange County's payroll employment is projected to grow by just 0.5% in 2025 and 0.4% in 2026 (Figure 56). Its average unemployment rate is expected to rise to 4.7% in both years, with monthly rates likely exceeding 5.3% by late 2025 and early 2026. Los Angeles County is forecast to see even slower payroll growth—0.4% in 2025 and 0.3% in 2026—with unemployment rates climbing to 6.5% and 6.7%, respectively, and monthly peaks surpassing 7%. Job growth in the Inland Empire is also expected to decelerate, falling to 0.5% in 2025 and 0.35% in 2026. Unemployment in the region is projected to reach 6.3% and 6.6%, respectively, with monthly highs topping 7%.

FIGURE 56
A Tougher Outlook for Regional Labor Markets Ahead
(payroll growth, y-o-y percent change)



WOODS CENTER FOR ECONOMIC ANALYSIS AND FORECASTING

California State University, Fullerton
College of Business and Economics
800 N. State College Blvd.
Fullerton, CA 92831

business.fullerton.edu/woodscenter

CSUF | COLLEGE OF Business and Economics