Investment Perspectives

Not another US recession

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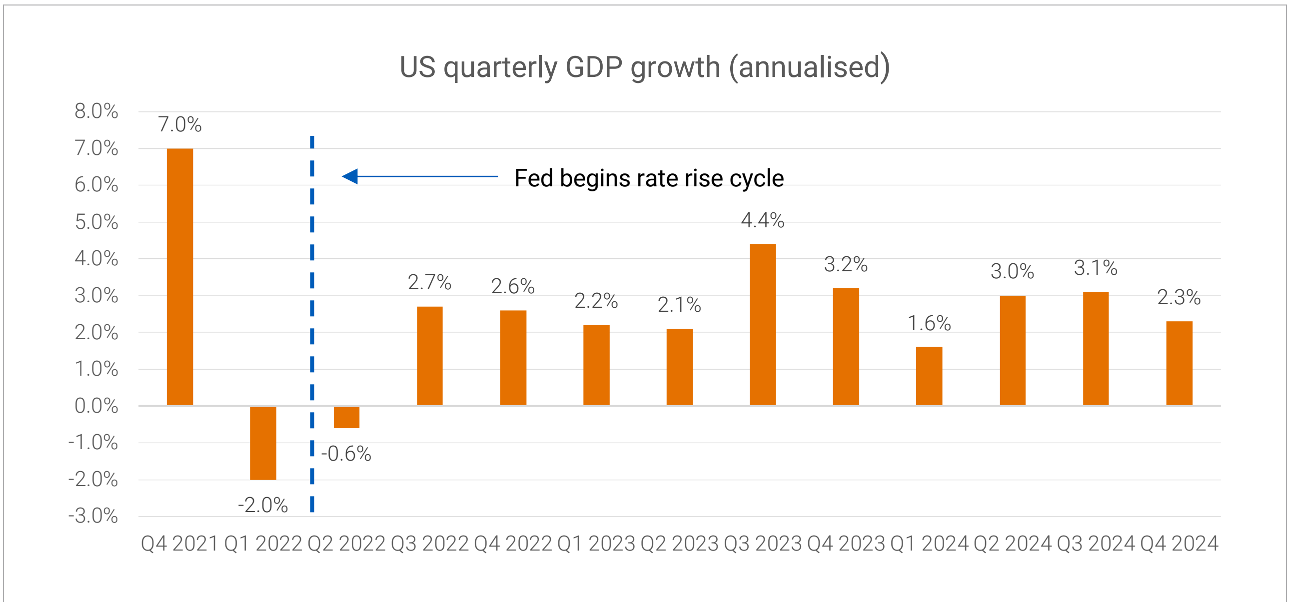
QUAYglobal INVESTORS

A Bennelong boutique

It's that time of year again. As 2025 moves into full swing, another round of (US) recession talk is escalating, creating significant market volatility.

We have heard (and dismissed) these concerns over the past few years. First, when we debunked the dreaded inverted yield curve scare in 2022. Then in 2023, we refused to buy into the so-called commercial real estate crisis. And last year we pushed back against investor panic over the so-called Sahm rule.

In fact, ever since the US Federal Reserve decided to increase interest rates in March 2022, the US economy has shown remarkable resilience. Meanwhile at Quay, we have been consistent with our 'no US recession' views.



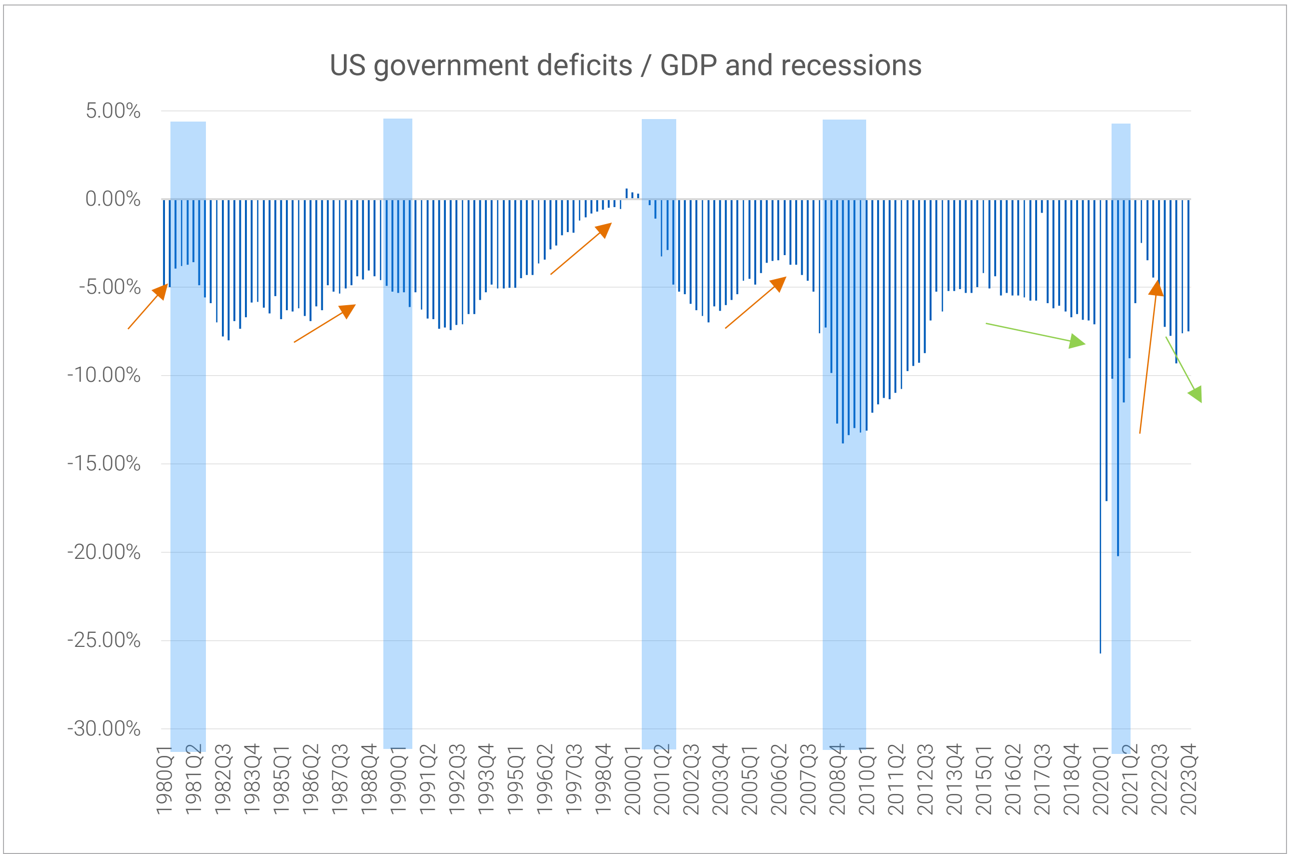
Source: BEA, US Federal Reserve, Quay Global Investors.

Are the current fears of a US recession overblown again? Let's dig in.

Focus on fiscal

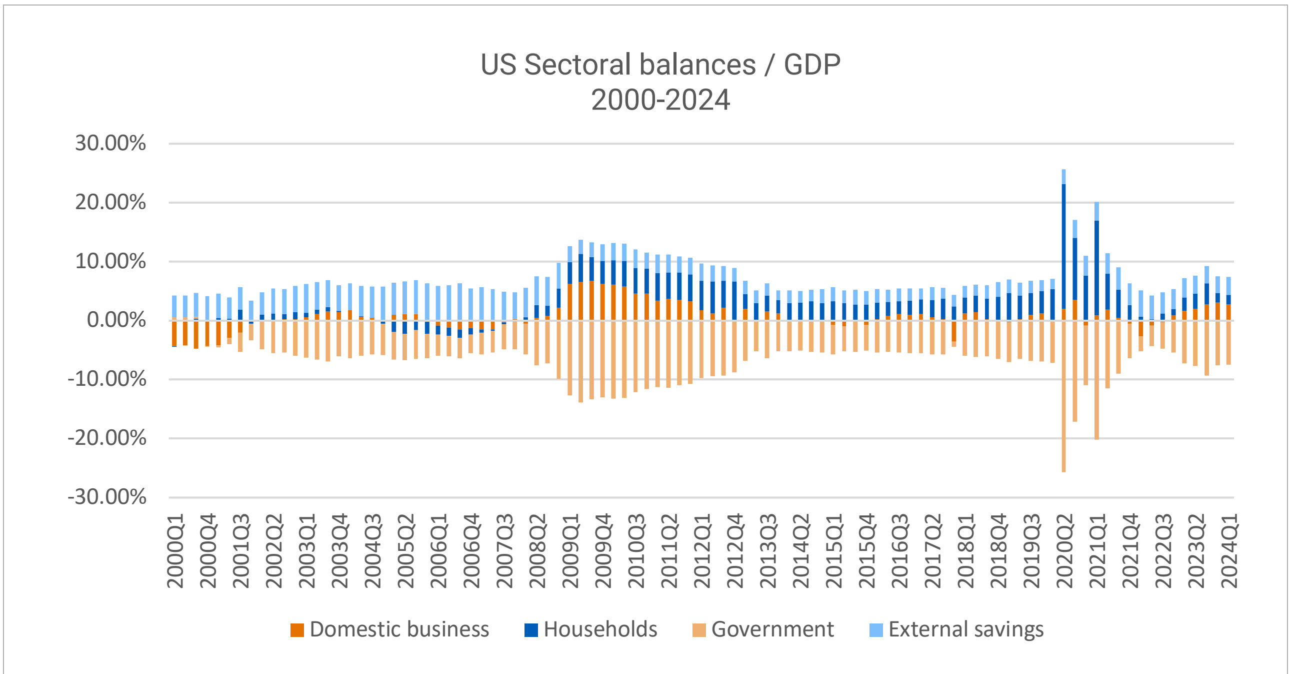
We have long argued that while macroeconomics is a hard beast to predict, investors have a better chance if focused on the fiscal pulse (ie net government spending) rather than an indirect credit pulse (monetary policy). And the data backs us up.

The following chart highlights whenever the US deficit begins to reduce, economic slow-down generally follows. And while the dramatic decline in net deficit spending in late 2021 did not cause a recession in early 2022 (BEA defined), it did result at the time in two quarters of negative GDP growth.



Source: US Fed Z.1 accounts, BEA, Quay Global Investors.

Why? Because as we learnt with [MMT], net government spending 'shows up' as net accumulated financial assets for the non-government sector. Higher deficits result in more money in the pocket of companies and consumers, which so far this cycle has significantly outweighed the effects of 'tighter' monetary policy.

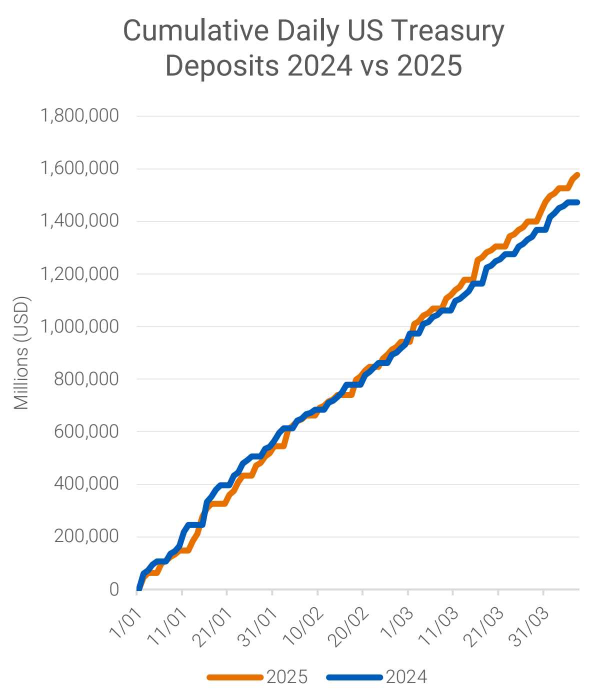


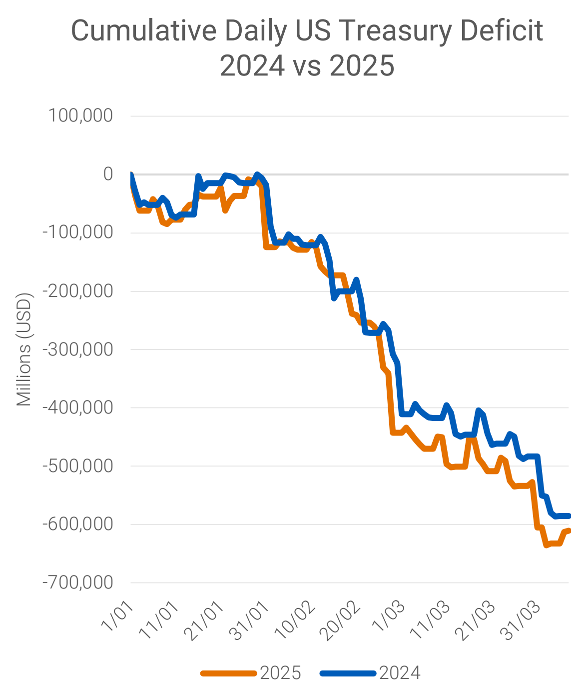
Source: US Fed Z.1 accounts, BEA, Quay Global Investors.

American exceptionalism maybe. But budget deficits help.

Forget the Fed, focus on the Daily Treasury Statement

While the vast majority of market commentators and participants slavishly obsess over US Federal Reserve monetary policy and commentary, given the power of the fiscal pulse we find it more instructive to focus on net spending. And despite the concerns of government cuts and drive for government efficiency via 'DOGE', the Daily Treasury Statement shows there has been no deceleration of government spending or net deficit (so far) this year (data up until April 6). In fact, relative to the same time in 2024, gross and net spending have increased.





Source: US Daily Treasury Statement, Quay Global Investors.

Further, despite calls for increased government efficiency (via DOGE) and elimination of government waste, the recently passed stopgap funding bill (known as a Continuing Resolution) extended most current funding for the next six months, as well as increased spending on defence and border security.[1]

But, the tariffs

The real spanner in the works this time will be the impact of tariffs. On April 2, the second Trump administration has called for universal base line 10% tariffs on all exports to the United States. Some sectors and countries have come in for some harsher, so called 'reciprocal' rates (46% for Vietnam, 20% for Europe, 24% for Japan etc) in an attempt to deal with US trade deficits.

Markets reacted negatively to the news with key global equity indices falling c20%.

Approximately one week later, the Administration announced the 'reciprocal' tariffs were delayed for 90 days on almost all countries except China (125%). The new 10% base global tariff (at the time of writing) is still in place, as too are the steel and aluminium rates announced pre April 2. Whether these new tariffs remain in place remain to be seen.

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[1] Source: Bloomberg

We argued that while tariffs may increase the price level, it does not follow that they are inflationary. Indeed over time, viewed (correctly) as a tax, the tariffs may well be deflationary by slowing the economy.

We believe it's not relevant whether the increase cost of tariffs is absorbed by US companies or passed on to consumers. From a sectoral balances perspective, the increased federal tax take will reduce the deficit, and thus reduce the flow of net financial assets to the non-government sector. This will almost certainly impact company and consumer spending.

Uncertainty is a bigger threat

The announcement and subsequent partial withdrawal of the tariffs highlights the current Administration's fluid, even whimsical approach to policy, with what seems to be a changing stance on almost a weekly basis. While markets celebrated the pause in reciprocal tariffs, history shows that too may change. It is this policy uncertainty, in our view, which represents a bigger threat to the health of the US economy.

Last month we attended a global real estate conference. Among the themes that emerged were not so much the prospect of less regulation spurring growth, but moreso the lack of consistent policy around trade may result in delayed investment decisions. If companies do choose to delay investment decisions (real investment, leases etc), this in itself can become a drag on the economy and at a macro level a significant drag on company profits (as we detailed in our Kalecki-Levy profits equation paper).

Concluding thoughts

We note some real time US GDP measures (such as the Atlanta Fed GDPNow) are pointing to a Q1 contraction. However much of this has been driven by accelerating imports (a detraction in GDP) attempting to front run tariffs. This front running may reverse in Q2 (adding to GDP growth).

Fears on an imminent US economic downturn seem somewhat premature. The Daily Treasury Statement data along with recently passed budget resolutions indicate net fiscal spending will remain consistent or even higher than last year. All other things being equal, this will support growth, jobs and profits.

However, tariffs ensure not all things are equal. In the absence of any other fiscal adjustment, tariffs will act as a fiscal drag, slowing the economy and reducing profits and/or consumer spending. In what is perceived to be an over-heated economy, that may not be a bad thing and may provide scope for the Fed to continue to lower interest rates[2] (and quite positive for real estate).

The bigger risk is policy uncertainty – which could delay private investment, compounding the impacts of higher taxes (tariffs) resulting in a more meaningful slowdown. At this point however, we feel that outcome is too early to call, but something to monitor.

[2] The March Fed 'dot plot' continues to expect another 50bpts reduction in the cash rate this year.

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