

On My Mind

Markets getting wobbly?



CIO VIEWS

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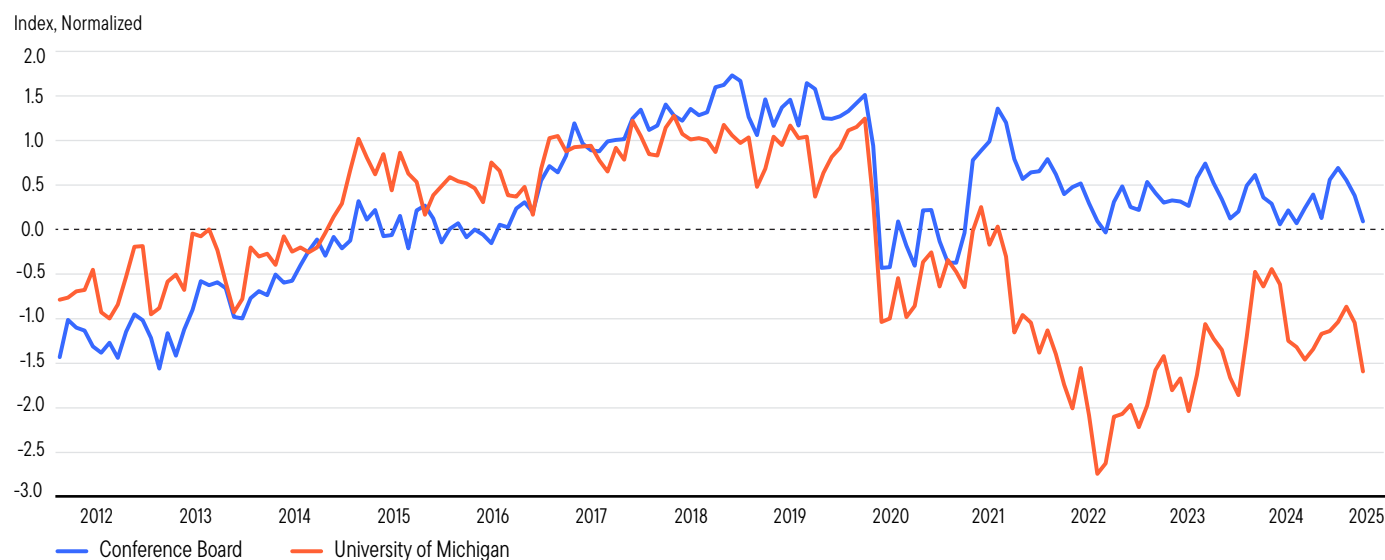
The new US administration has started off with a whirlwind of actions, plans and ideas, which in turn have generated a frenzy of reactions both at home and abroad. All this has resulted in a lot of information to process and a lot of noise to filter out. As a consequence, assessing the balance of risks to the macroeconomic environment has become especially hard. Let's try to take stock of where we stand.

Two of the administration's early lines of action have the potential to cause significant disruption, and this in turn has fueled fears of an adverse impact on economic activity. Tariff threats are the most obvious example, as they could lead companies to postpone investment while they figure out how they might need to reconfigure their supply chains or absorb higher input costs. The second is cuts in public expenditure and employment driven by the new Department of Government Efficiency (DOGE). These have raised the fear of curtailments in public services as well as a direct negative hit to overall employment.

We have seen some signs of weakness in recent data. Of particular concern is the decline in January consumer confidence recorded by both the University of Michigan and the Conference Board.

Consumer Confidence Has Dipped in the Past Two Months

2012–2025



Source: TCB, University of Michigan, Macrobond. Analysis by Franklin Templeton Fixed Income Research. As of March 3, 2025.

A deceleration in consumer spending has accompanied the drop in confidence, and it contributed to a downgrade in expected first quarter growth by the Atlanta Federal Reserve (Fed), although the main driver by far was an acceleration in imports. The disappointing February ISM manufacturing data also suggests a weaker start in the new year.

The key underlying issue, in my view, is the sequencing of policy measures. Most of the action so far has been focused on tariffs and on DOGE. We have seen less concrete progress on deregulation and tax cuts, the two areas that hold the key to boosting economic growth while containing inflation.

As a consequence, for the moment, households and businesses are feeling heightened uncertainty (predictably played up by the media), little relief on price pressures, since inflation remains elevated, and no definite good news on taxes.

But we must remember that it's early days; this administration has been in office for barely over a month. The immediate focus on cost cuts and personnel changes throughout government agencies in itself makes it hard to simultaneously move forward with deregulation. It is disrupting the very same agencies responsible for reforming the regulatory frameworks in their respective areas. This delay in deregulation efforts is disappointing, but we do not yet have reason to doubt the administration's commitment in this regard. President Trump has often emphasized that lightening the regulatory burden is a priority, and the track record of his first term confirms it. Also, the decisive approach of DOGE to making the bureaucracy leaner and more efficient seems to portend a similar attitude toward regulation.

Meanwhile, the House and Senate have recently passed two different budget bills that include substantial tax cuts as well as planned spending reductions. Progress on this front will be harder and will need more time. Congress and the administration need to reconcile ambitious tax-cut goals with the need to reduce the budget deficit to more manageable proportions than the 6%–7% of gross domestic product average of the last several years. Since cuts to Social Security and Medicare seem to be off the table, achieving appropriate spending cuts will be hard, so that agreement on a new fiscal framework will require a lot more work.

Some help will come from DOGE, which appears to be making steady progress in identifying government expenditures of questionable value. This is hardly surprising. Last year, the Government Accountability Office estimated about US \$240 billion in improper payments in fiscal year 2023, and a cumulative US \$2.7 trillion over the past ten years. (Improper payments are defined as overpayments, payments made to ineligible people or entities, and, in some cases, fraud.) There is definitely room for savings. However, what we've seen so far does not change my view that it's going to be hard to put US fiscal policy on a sounder long-term trajectory without addressing entitlements.

DOGE can help the budget and support stronger growth through a more efficient public sector, but it won't solve the long-term fiscal challenge, which remains a crucial policy issue for both the president and Congress to tackle.

On balance, the new US administration is still moving in the direction of growth-enhancing policy changes. The accompanying uncertainty poses some risks, and we need to keep a close eye on both confidence measures and activity indicators. I mentioned above the recent drop in consumer confidence, which causes some concern. On the other hand, the Conference Board also recorded a sharp increase in CEO confidence, which remains a strong show of optimism in the economic outlook. And while personal consumption decelerated in January, we saw a similar deceleration in January last year, and it was followed by a healthy rise through 2024. Overall, economic activity remains resilient, and the labor market is still in very good shape. Concerns about the potential negative impact of tariffs on growth are reasonable but should not be exaggerated: As I wrote in a previous article, the United States is a large and mostly closed economy, and trade has a limited effect on growth. We need to be watchful, but pessimism would be very premature, in my view. I still expect that the US economy will grow above its potential this year.

I also still expect inflation pressures to remain resilient, with headline inflation to end the year around current levels. And as the Fed has already signaled caution and identified tariffs as a potential inflation risk, I still believe the current easing cycle might be over or nearly over, even if markets have recently moved to price two additional rate cuts instead of just one.

A slowdown in economic activity might mitigate at the margin the upward pressures on bond yields, but not by much, especially if fiscal policy remains as loose as it currently is. I still expect the 10-year US Treasury yield to be in the 4.75%–5% range by year-end, but lack of progress on deregulation could keep us closer to the lower end of my narrow range. Conversely, a significant further expansion in the budget deficit could push yields above the 5% threshold.

We can expect noise and volatility to remain elevated. But the one thing we should be watching closely in the coming weeks is progress on tax reform and on deregulation, with its attendant positive jolt to confidence, because these are the keys to a sustainably strong growth outlook.



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