(UBS)

US recession fears look overdone

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Worries over global trade tensions overshadowed reassuring signs of slowing inflation in the US.

Annual core inflation, excluding volatile food and energy prices, was 3.1%—the slowest pace since September 2021. Inflation came in below the consensus forecast on a headline and core basis, as well as an annual and monthly basis.

This proved insufficient to shift markets significantly in a positive direction, with investors remaining concerned that rising tariffs could arrest or reverse progress toward bringing inflation down. Higher US tariffs on imports of steel and aluminum went into effect on Wednesday, drawing retaliation from both Canada and the European Union.

Data this week have also underlined mounting concern that higher tariffs are taking a toll on business confidence and could push prices higher over coming months. The NFIB survey of small businesses, whose respondents were more optimistic in the wake of President Trump's election win in November, have become more cautious. The share of owners who said it was a good time to expand fell by the most since April 2020, while the share that raised prices rose the most since April 2021.

This has fed into recent fears that the US economy could be headed for recession, or stagflation—a combination of weak growth and elevated inflation. But, in our view, these worries are unlikely to be realized unless the global trade conflicts escalate more than we expect.

- **A prominent model projecting a large economic contraction in the first quarter exaggerates the threat, in our view.** The Atlanta Fed's closely watched GDPNow, which uses incoming data to track GDP growth in the current quarter, has been contributing to market pessimism. This indicator has swung from pointing to an annualized expansion of more than 2% as recently as late February to a contraction of 2.4%. However, this has been distorted by a surge in gold imports, which led to a larger trade deficit in January, exerting a strong drag on GDPNow. The Atlanta Fed has pointed out that actual GDP will not be affected by the gold imports, and GDPNow would be 2 percentage points higher if the gold effect were stripped out.

- **A resilient labor market should underpin consumer spending, despite recent signs of weakness.** February's jobs report highlighted solid payroll growth, historically low unemployment, and rising wages, all of which should help support consumer spending. Additionally, data on Tuesday showed job openings rose to 7.74 million in January, up from 7.51 million in December and slightly above consensus estimates of 7.6 million openings. While immigration policy poses a risk to future labor supply, the recent data show that there is still solid demand for workers, and steady income growth should reduce the risk of a sustained downturn in consumer spending.

- **Slowing inflation should allow the Federal Reserve to cut rates later in the year.** February's CPI report further reinforced the broader disinflationary trend as both headline and core prices increased less than expected. Notably, shelter costs, a major driver of inflation, continued to ease, rising 4.2% annually—the smallest increase in over two years. While the risk of tariffs pushing prices higher remains, the Fed will likely adjust for this impact when considering the underlying inflation trend, which, aided by slowing shelter inflation, should move closer to the Fed's 2% target.

So, while the Trump administration has indicated a willingness to accept disruptions to the economy, political pressure could intensify. Initial tolerance for economic disruptions as a "transition" period may shift, as recent tariff adjustments suggest flexibility in policy.

Against this backdrop, our base case anticipates aggressive but selective tariffs, potentially heightening volatility without derailing growth. Despite short-term volatility from US policy uncertainty, robust economic growth and AI tailwinds should support equities, with the S&P 500 expected to reach 6,600 by year-end.

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