

Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

May 14, 2025

The policy shifts and flips in the first 100 days of the Trump administration have kept forecasters and financial markets on their toes. The administration has moved quickly on multiple fronts, with the unprecedented spike in U.S. tariffs having rippled within equity markets, treasury yields and the U.S. dollar, only now to move in the other direction despite ongoing risks on the tariff front. Once again, this quarter's Q&A is dominated by the potential impacts. The U.S. economic outlook darkened since "Liberation day", and the risk of a higher inflation profile creates a challenge for Fed policy. Tax cuts are next on the agenda, but their final form remains uncertain.

Questions & Answers

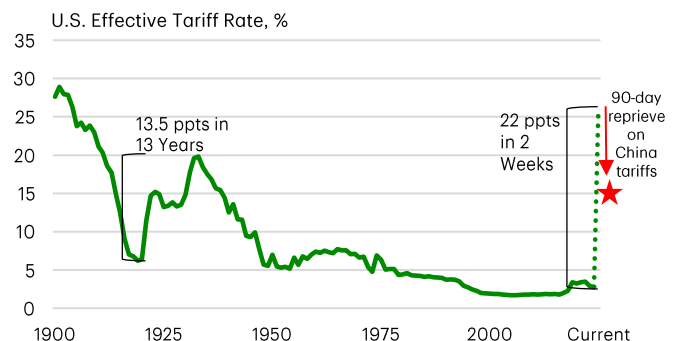
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Q1. How to judge a forecast with tariff whiplash?

The global economic outlook has weakened to 2.8 percent (vs. 3.0 percent penned in March). Although we thought conservative tariff assumptions were applied in the prior forecast round, the Trump administration pumped up the volume on breadth and depth, particularly against China. While early negotiations have already led to a temporary reprieve on the China tariffs, considerable uncertainty remains. The forecast avoids a global recession only because we deem the situation unsustainable for America to persist on a path that endures a domestic trade price shock never experienced in history (Chart 1). We expect the Trump administration will continue to negotiate with its trading partners and cut deals with countries over the next 60-90 days, helping to further reduce today's lofty tariff levels, but never return to the pre-Trump world of tariffs.

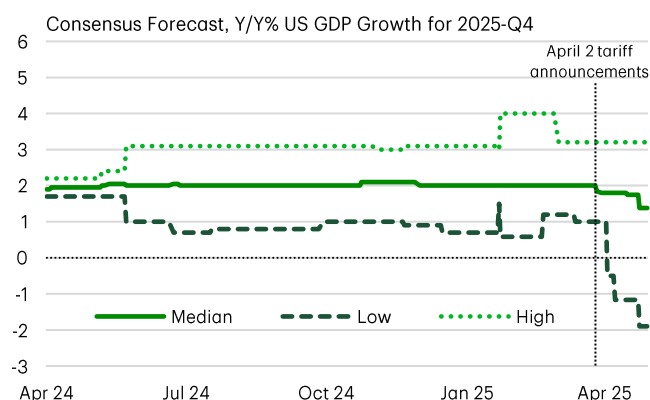
U.S. tariff policy assumptions are the biggest wildcard in our forecast and is also why disagreement among forecasters expanded following the April 2nd "Liberation Day". It sets the line between those calling for a recession versus those, like ourselves, who perceive an offramp to a negotiated path. This widening dichotomy among private sector forecasts is captured in Chart 2.

Chart 1: Tariffs at Staggering Level Relative to History



Source: Bureau of Economic Analysis, TD Economics.

Chart 2: U.S. Forecast Range Widened after April 2nd



Source: Bloomberg, TD Economics. Last data point is April 30, 2025.

Since February, we've emphasized the backdrop requires an assumption-based forecast for this very reason. Our assumptions have evolved more than a few times since then, as U.S. tariff policy has demonstrated a case of whiplash. Here's where we stand today:

- Tariffs on China, set at 145 percent in April with some exemptions, will be temporarily reduced to 30% as of May 14th (i.e., 10% reciprocal + 20% IEEPA fentanyl tariffs from February) for 90-days. We assume an agreement is eventually reached, but the end result still leaves the tariff rate on China close to today's level, which is more than double that prior to the Trump administration.
- Tariffs on Canada and Mexico, which average around 12 percent today, will fall to an effective rate of 5% by year-end, mostly through exporters making their goods compliant with USMCA.
- Tariffs on other countries will be lowered from 10% to 5%, which also remains around double the effective rates that predated Trump's current administration.

Under these assumptions, the weighted average effective tariff rate on U.S. imports is shown in Chart 3. The peak level occurs in the second quarter of this year, and edges down after that. It is this pattern that limits the risk of recession within our forecast framework.

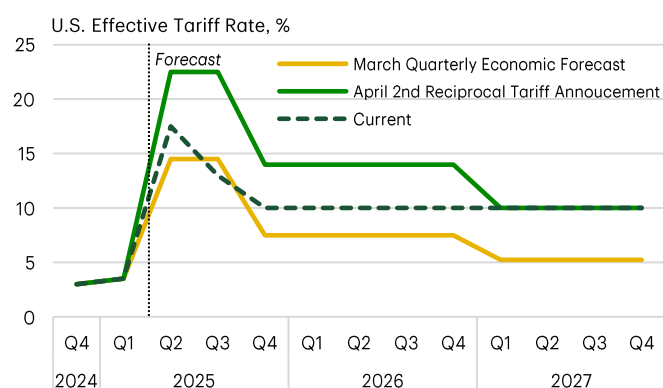
Based on the developments over the weekend between China and the U.S., events are evolving largely in line with our assumptions and perhaps are even going to be more front-loaded on the timeline.

To make sure we're on the non-recessionary path, we're keeping our eye out for a handful of markers.

1. The tariff whiplash must end. The administration must get to a "steady state", even if tariff levels remain on the high side. Businesses require a trustworthy and transparent operating environment. A necessary condition of success requires an understanding with China and the European Union, while settling the dust with the highly integrated economic markets of Canada and Mexico.
2. The clock is ticking, trade deals can't be overly complex. It took over a year and a half to negotiate the USMCA during Trump's first term, as did the U.S.-China Phase One Trade Agreement. Given broader and more crippling tariff levels, the administration will have to move faster to limit a deepening in supply chain disruptions and the passthrough to higher prices. We're looking for broad strokes on potential commitments around export controls, buy-America, tariff (or tax) reductions, prevention of Chinese trade diversion through their ports, and greater market access of US businesses.
3. Deals are not typically one-sided. We wouldn't be surprised if countries have some demands of their own, like requiring limits on the U.S. administration in applying future tariff escalation in order to maintain confidence that a deal is long lasting – once bitten, twice shy.

Are some of these pieces already coming into focus? It is encouraging that there have been not just gestures towards negotiations, but concrete indications

Chart 3: Tariffs Assumed to Come Down Over 2025



Source: TD Economics.

of what the EU and China may be willing to put on the table. For example, EU negotiators have already floated the possibility of an agreement that mirrors that with China in President Trump's first term, in which the removal of tariffs is accompanied by an agreement to increase purchases of certain U.S. products. The EU's pre-negotiation communication has floated some sticks as well as that carrot – over \$100bn in U.S. exports have been threatened with retaliation if negotiations do not result in a "mutually beneficial outcome and the removal of U.S. tariffs". Targeted exports include primarily agricultural and industrial products, suggesting those are the areas where the EU sees itself as having leverage.

The U.S.-UK deal on May 8th also provides some guidance for future deals: the UK was able to obtain lower tariffs on specific sectors in exchange for accepting quotas, but it was not able to achieve a baseline tariff below 10% on all its products. This affirms the assumption in our forecast that the U.S. is likely to maintain a higher baseline tariff rate as part of future agreements.

The next thing that would help confirm that the U.S. is on a non-recessionary path is a pivot to the pro-growth Trump agenda. Two main items define that outcome. First, the U.S. Congress securing tax cuts beyond the extensions of the TCJA, discussed in greater detail in [Question 5](#). This would support growth, even if they raise questions about fiscal sustainability. Second, the administration has telegraphed a broader agenda around deregulation of the energy, tech, and finance sectors. Attention and firm details here would help move past the risk of a tariff-triggered recession in 2025, into an economy that has a solid investment tailwind in 2026.

Q2. Where does the U.S. economy currently stand?

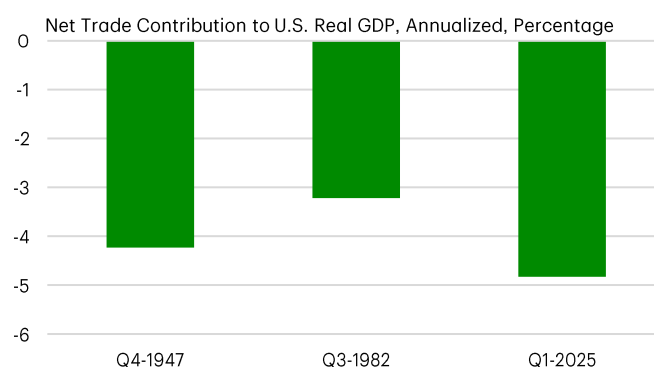
The outlook for the U.S. economy has darkened since Liberation Day, reinforced by a collapse in sentiment indicators and broad tightening in financial conditions. Our forecast for 2025 stands at 1.5% compared to 1.9% in March. That magnitude of markdown is representative of revisions occurring on the "street".

However, this top-line figure does a disservice to the complexity of the day. It's still early days under the new administration, and data show both sturdiness and fragility. For instance, where it matters most in the

hard data, jobs and prices, the story remains largely positive. While inflationary pressures had shown signs of heating up at the beginning of the year, the March reading came in on softer side. Meanwhile, the labor market has not shown signs of buckling. Job growth remained strong through April, adding 177k jobs last month, or roughly 20k more than the three-and-twelve month averages. At its current pace, payrolls are still running slightly above what's required to hold the unemployment rate steady. It's hard to say whether this trend will continue, but our gut feel is that things are likely to slow over the coming months. But even if job growth were to turn lower, layoffs are likely to remain small compared to prior downturns. Constraints in labor supply will likely limit any knee-jerk reductions in the workforce. This should keep any downturn shallow in nature, perhaps acting as a catalyst for the administration to move faster on implementing its tax cut and deregulation agenda.

In other corners of the economy, trade tensions are already leaving a mark. Real GDP recorded a small contraction in the first quarter, snapping three-years of steady expansion. Much of the drag came from a surge in goods imports, as businesses rushed to stockpile ahead of tariffs. A 41% surge in imports resulted in net trade shaving nearly five percentage points from GDP growth. Since the post-war era, there were only two other times when net trade shaved more than three percentage points in a single quarter (Chart 4). But it wasn't only suppliers front-running tariffs, as companies also ramped up purchases of equipment, including computers, communication, and medical equipment. It was a similar story for households, where there was surge in new vehicle sales. This rush

Chart 4: Q1 Drag From Net Exports in the U.S. Was Largest on Record



Source: Bureau of Economic Analysis, TD Economics.

to spend created an illusion of a still-resilient domestic economy. Private sales to domestic purchasers – the best gauge of underlying economic activity – rose by a healthy 3%, matching Q4's gain. But this influence will be temporary, evidenced by a collapse in shipping containers that would have been caught in the tariff-trap by the time they docked in port.

Economic forecasting is a humbling exercise at the best of times, and today's heightened uncertainty adds a whole new layer of complexities. But it's usually safe to assume that there will be some economic costs to bear from the sharp erosion in consumer and business sentiment. The clock is ticking for the administration to secure influential trade deals and some good news for Americans in budget negotiations to turn the dial firmly in the other direction. We think they'll succeed on this front.

Q3. Are we at the dawn of a weaker-U.S. Dollar era?

The recent pace of the dollar's decline has been striking. In just four months, the trade-weighted dollar has reversed over a quarter of the 16% gain accumulated from 2021 through 2024. The reason – a spike in economic policy uncertainty driven by the Trump administration's erratic tariff announcements. Investor confidence in the U.S. growth outlook has taken a hit as recession fear rise.

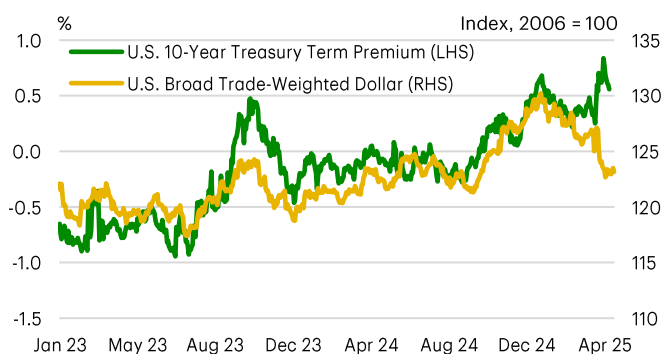
That puts the Federal Reserve in a difficult position. With the policy rate at 4.5%, there's room for a few precautionary cuts (see [Question 4](#)). Futures markets are already pricing in three quarter-point cuts this year, which is in line with our base case. If that pricing holds, we estimate the trade-weighted U.S. dollar could fall another 3% from where it sat at the end of April by year-end.

This is where fundamentals butt heads with other risks. Beyond interest rates, fiscal developments could add a new source of pressure. The proposed budget framework agreed by House and Senate Republicans is estimated to expand the deficit between \$2.8 and \$5.8 trillion. The upper end of that range exceeds the pandemic-era stimulus and would be largely unfunded absent cuts to big-spend areas like social security, Medicaid and Medicare – deemed untouchables. The financing gap could limit investor appetite for Treasuries, further exacerbating bond market volatility.

The current fiscal stance has revived comparisons to the U.K.'s 2022 mini-budget crisis, which triggered a spike in Gilt yields and forced a Bank of England intervention. Some of this risk-premium is already embedded in the greenback and bond yields. The term premium on 10-year Treasuries peaked near 84 basis points in late April, resembling the move in the Gilt crisis, before narrowing to 56 basis points (Chart 5). That moderation signaled some market reassurance. And the U.S. is not the U.K. – a sovereign-debt-crisis-style disruption is not a baseline for the world's core bond market unless political risks become significantly more amplified.

Market nerves were briefly tested when the Fed's independence was questioned by offhanded remarks made within the administration – 10-year yields rose nearly 10 basis points, while the U.S. dollar fell by over half a percent in a single trading day. Although markets were quickly reassured when Trump explicitly noted he wouldn't fire Chair Powell, the over arching theme remains: markets can no longer take Fed independence for granted, particularly given the appointment of a new Chair in 2026. That tension is reinforced by the whispers still circulating on the so-called Mar-a-Lago accord – despite not being endorsed formally or publicly by the Trump administration. Yet, many analysts still felt compelled to review the report that laid the groundwork for a weak dollar. It relies on a cooperative Fed willing to backstop liquidity as markets digest unconventional measures (see [report](#)). At the core of this policy is a flawed theory that U.S. trade deficits are primarily driven by foreign demand for dollar reserves, a view that isn't supported by actual capital flow dynamics. The proposed measures range from pressuring allies to hold century bonds to imposing a “user fee” on

Chart 5: U.S. Term Premium Rises Sharply As Dollar Weakens



Source: Federal Reserve Board, Federal Reserve Bank of New York, TD Economics.
Last data point is April 29, 2025.

foreign official holders of US Treasuries. Naturally, any resurrection of this theory would inject explicit credit risk into what is supposed to be a “risk-free” asset.

The dollar’s role as the world’s reserve currency rests on deep, liquid markets and credible institutions, both of which are increasingly being tested. The dollar’s depreciation is helping to return the value closer to fair value, but holding there hinges less on traditional rate differentials and more on whether investors continue to trust the institutional and policy frameworks that underpin U.S. financial markets.

Q4. How do we think the Federal Reserve will navigate inflation vs. growth?

The Federal Reserve could soon find itself stuck between a rock and a hard place. Inflationary pressures have been sticky even before the administration started implementing its tariff agenda. The Fed’s preferred core PCE Inflation metric has been holding within a range of 2.6 to 3.0 percent for 14 months. And Respondents to the Fed’s Beige Book have noted that price pressures are building across supply chains, with costs likely to be passed to the consumer over the coming months – albeit the magnitude and timing remains uncertain.

Provided inflation expectations remain well anchored, protocol would be for the Fed to look through the inflation shock as a one-time increase in the price level. But they’ve been burned before on that thinking in the years following the pandemic. And there’s another wrinkle to consider – the labor market. So far, the jobs market has remained incredibly resilient. However, the latest employment survey was conducted just days after the April 2nd reciprocal tariff announcement, which was too soon to show whether corporations were getting nervous on hiring intentions. Since that survey was conducted, ISM surveys have shown hiring intentions remain weak, while Indeed job postings have drifted lower– suggesting some softening in the labor market is likely to materialize in the coming months.

Déjà vu! A higher unemployment rate and rising inflationary pressures would be the worst combination for the Fed. In that scenario, policymakers would assess how far each of its mandates are from their long-run goals and adjust policy accordingly. The prospect of the Fed being caught in this difficult situation has pressured long-dated treasuries, pushing term premia to match

some of the highest readings recorded in recent years. But we’re not there yet. We anticipate the labor market will start to deteriorate through the summer, allowing policymakers to deliver a few insurance rate cuts to support the economy. However, the Fed will be hard pressed to entertain anything beyond that if inflationary pressures are inching higher. The economy needs to weaken more than expected to win over that case.

Q5. Where do things stand on U.S. tax cuts and budget developments?

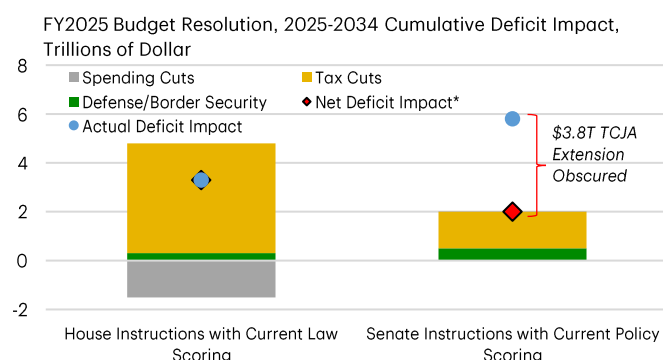
The administration has maintained that its upcoming tax bill will provide a more-than-sufficient boost to economic growth to offset the near-term downside risks of trade policies. However, at this time, we only have a broad outline of what the Republican tax bill will look like as Congress goes through the somewhat arduous process of passing a reconciliation bill. Using the reconciliation process bypasses the filibuster rule in the Senate, meaning it can be passed with a simple majority, but it needs to meet certain requirements like not increasing the fiscal deficit beyond the ten-year budget horizon.

This can become a sticking point when trying to pass a multi-trillion tax cut package that requires equally large spending cuts. There are several tax cut proposals under consideration by Congressional Republicans, including a full extension of the 2017 Tax Cuts & Jobs Act (TCJA) and eliminating taxes on social security, overtime pay, and tips. These have been core considerations, but additional measures include reviving the deductibility of auto loan interest and enhancing capital cost deductions. In total these provisions could cost \$4-5 trillion over the next ten years – creating a tall order for spending cut offsets.

So how can Republicans pay for this? The simple answer is that they can’t, not fully anyways. To get around this, Senate Republicans have outlined a plan to use an unconventional method to calculate the net deficit impact of the reconciliation bill, referred to as the ‘current policy’ scoring method. Using this method, the bill would assume that existing policy continues in perpetuity. In the context of the current bill, this would mean allowing the 2017 TCJA to be extended without affecting the assessment of the reconciliation bill’s net deficit.

This would wipe roughly \$4 trillion off the scoresheet, bringing the tax cuts roughly in line with the proposed \$1.5 trillion in spending cuts outlined by House Republi-

Chart 6: U.S. Budget Scoring Method Could Distort Appearance of Deficit Impact



The House and the Senate still need to agree on the final details of the tax cuts. Congressional Republicans initially intended to pass the bill by Memorial Day, but that now appears too ambitious with the deadline shifted to July 4th. Given the inherent complexities involved in this process, a more realistic timeline would be mid-to-late summer for the final passage. Barring that, the expiration of most of the provisions of the TCJA at the end of the calendar year creates a natural stopping point to ensure the bill is passed, as failing to do so would result in an average tax liability increase of \$1,900 per household according to the Brookings Institution.

cans in their budget resolution (Chart 6). At this time, it's unclear whether this would be permissible under Senate rules, but if so, it would go a long way in narrowing the gap between the cost of the tax cuts and spendings cuts proposed to pay for them in the budget resolution. However, this creative accounting trick would not change the actual impact on the deficit, nor the associated increase in debt issuance. It's uncertain how bond markets would react or whether the term premium would rise to account for a further deterioration in the nation's fiscal position.

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