TD Economics

Questions? We've Got Answers

Addressing Issues Impacting the Economic and Financial Outlook

August 20, 2025

The global economy continues to slow in 2025, catalyzed by thickening trade barriers. This quarter's Q&A discusses the impacts of the evolving U.S. tariff regime along with several other policy shifts.

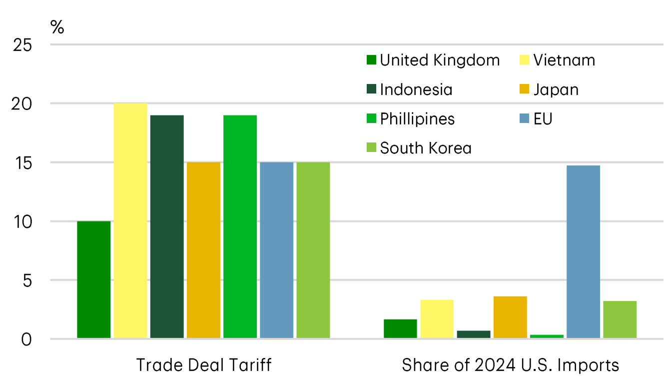
Questions & Answers

Q1. You get a deal, and You get a deal! Where do U.S. trade deals stand?

It has been six months since the first announced tariffs went into effect, which is now considered the good ‘ol days. Since then, a multitude of country and sector specific tariffs have raised the effective U.S. tariff rate from roughly 2.5% to nearly 20%. Although we expect the effective tariff rate to decline modestly as additional trade deals are reached, elevated U.S. tariff rates will remain a fixture of the economy. So far, seven nations have negotiated trading arrangements: U.K., Vietnam, Indonesia, Japan, Philippines, E.U., and South Korea. Collectively, these nations account for a little over a quarter of U.S. imports, with tariff rates ranging from 15-20%. The U.K. marks the exception at 10% (Chart 1).

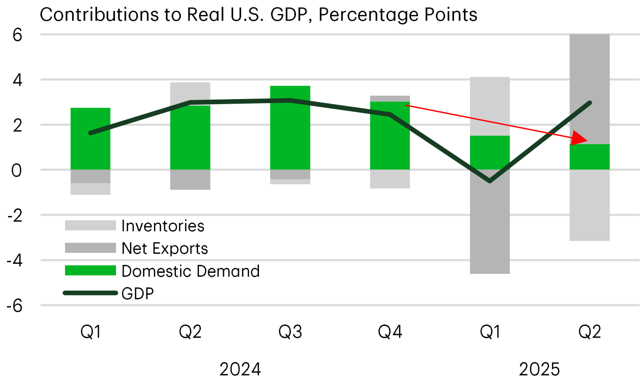
In addition, the U.S. agreed to varied reductions in sectoral tariffs captured under section 232 reviews. For steel/aluminum, only the U.K. received a modification that maintained the original 25% tariff, as opposed to the 50% faced by all other nations. It’s still possible regions, like the E.U., will negotiate carve outs or quota limits with discussions remaining ongoing. With regards to automobiles, the U.K. again secured the better deal with a quota for 10% tariffs on automobiles, while Japan, South Korea, and the E.U. all received a 15% tariff. Collectively these nations account for nearly all the U.S. automobile & parts imports from outside North America.

Chart 1: Announced U.S. Trade Deals Cover 28% of U.S. Imports



Source: White House, U.S. Census Bureau, TD Economics.

Chart 2: U.S. Domestic Demand Has Cooled in 2025



Source: Bureau of Economic Analysis, TD Economics.

To get ahead of the next shoe to drop, the E.U. stated it agreed to 15% tariffs on pharmaceutical and semiconductor products. This is expected to be lower than the eventual sectoral tariff applied to those products. For pharmaceuticals, the E.U. accounted for 62% of U.S. imports in 2024, indicating this adjustment was material. Furthermore, the E.U. stated it had agreed to zero-for-zero tariffs on aircraft & parts, semiconductor equipment, natural resources & critical raw materials, in addition to certain chemicals, generics, and agricultural products. Once these become formalized by the U.S. rather than merely statements by the E.U., the effective tariff rate will be nudged down.

A trade deal with the U.S. is about more than just tariffs. Frameworks have also included over a trillion dollars in cumulative investment intentions in U.S. energy, agricultural, aerospace, and shipbuilding projects. Most of this will come from the E.U., Japan, and South Korea, however it is important to note that the details of these investments are murky. There are conflicting accounts of the arrangements arising between trading partners. Given this is the largest shift in trade policy in generations, the many nuances will need more time to be hashed out. This means that uncertainty over the business environment can prevail for countries long after reaching trade deals in principle.

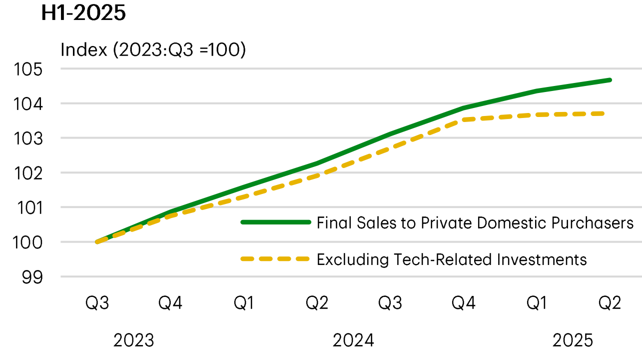
Q2. How has the U.S. economic outlook changed?

Earlier this summer, we were surprised by the U.S. economy's unwavering resilience amid heightened policy uncertainty, the haphazard rollout of tariffs and elevated interest rates. But that narrative has quickly shifted over the last six weeks. Softening economic data and revisions to prior months have revealed a weaker underbelly in consumer spending and job creation. This has been masked by significant volatility within the aggregate GDP measure – which contracted in Q1 before rebounding by 3% in Q2 – due to massive swings in the trade data. Looking under the hood reveals clear signs that the economy is losing steam (Chart 2).

Chief among these is sputtering consumer spending momentum through the first half of the year, which has averaged just 1% (see further detail in question 3). Fortunately, some offset has come from stronger business investment, particularly within a 10% jump in equipment spending through H1-2025. At first glance, it would be plausible to assume that most of this strength could be chalked up to tariff frontrunning. But the bulk of the gains came from a surge in computer equipment and software, some of which is likely related to AI investments.

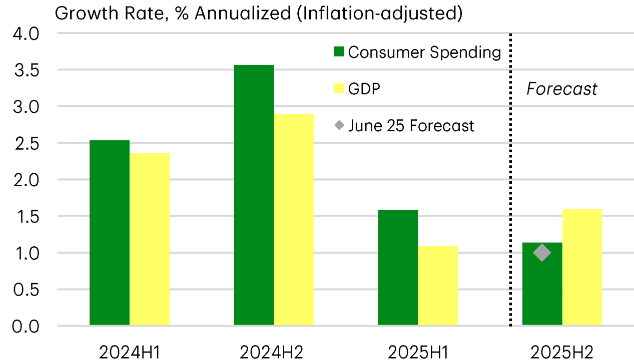
We have long argued that the surge in data centers and semiconductor facilities that started to break ground in 2022 would eventually lead to a big push on equipment spending as those projects neared completion. And that is now playing out. By our estimates, spending on tech-related projects added 0.7 percentage points to GDP through H1-2025 and will likely remain a persistent tailwind over the coming years. Absent its contribution, final sales to private domestic purchasers – the best gauge of underlying economic activity – would have flatlined in the first half of this year, reinforcing that there wasn't a growth-catalyst elsewhere in the economy (Chart 3). We see growth averaging around 1% through H2-2025, bringing the annual aver-

Chart 3: Tech-Related Investments Supporting Growth in H1-2025



Source: Bureau of Economic Analysis, TD Economics. *Tech-related investments include all spending on computers and other peripheral equipment, software, and manufacturing structures (including data centers and semiconductor facilities).

Chart 4: U.S. Consumers Tap the Breaks



Source: Bureau of Economic Analysis, TD Economics.

age to 1.7% – slightly below trend and a notable downshift from 2024's 2.8%).

In 2026, the economy should edge up to 1.8%, which is not particularly remarkable and reflects a markdown in our forecast (previously 2.1%). This is because the U.S. effective tariff rate appears to be settling higher than we previously assumed, even as AI and fiscal tailwinds continue to offer a cushion and potential upside risk for 2026. Under the One Big Beautiful Bill Act (OBBBA), the combination of new household tax breaks, the 100% bonus depreciation on equipment and increased federal spending on defense and border security could amount to a fiscal bump of 0.3-0.5 percentage points in each of the next few years. But the fiscal dividend will not persist, as the new household tax breaks expire after 2028, just as the deep spending cuts to Medicaid, supplemental nutrition programs and clean energy subsidies ramp-up.

Q3. The U.S. consumer is contending with several forces, what is the outlook?

Consumer spending crawled at a 1.6% annualized pace in the first half of the year compared to the 3.6% pace through H2-2024. This occurred even as households accelerated big-ticket purchases ahead of expected tariff increases. Much of the loss in momentum was due to a pullback in discretionary spending – a cautionary sign – as many forces conspire against households, including the softening job market, heightened economic uncertainty, and tighter immigration (Chart 4).

Significant downward revisions to payroll figures went a long way to help economists understand why consumer spending had become out-of-step with broader fundamentals. Revisions revealed that job growth stalled in May and June followed by only a modest rebound in July. Hiring averaged only 35k over the past three months. That's about one-third the running speed of America.

Inflationary pressures are also returning as a headwind for consumers. As higher tariffs take effect and inventories are depleted, firms are beginning to pass rising costs on to consumers. Goods prices, which had been declining, are once again trending higher. In response, households have begun cutting back on categories with the steepest price increases, such as furniture and recreational goods. Assuming half the tariff costs are passed onto the consumer, we estimate that it would raise the average household's cost of living by around $1,900 per year – equivalent to a tax hike of 1% of GDP.

Beyond tariffs and labor market concerns, spending patterns also reflect weak population growth, elevated mortgage rates, and the resumption of student loan payments. Some of these influences will linger, such as those with student loans facing higher monthly payments due to student debt reforms introduced in the OBBBA.

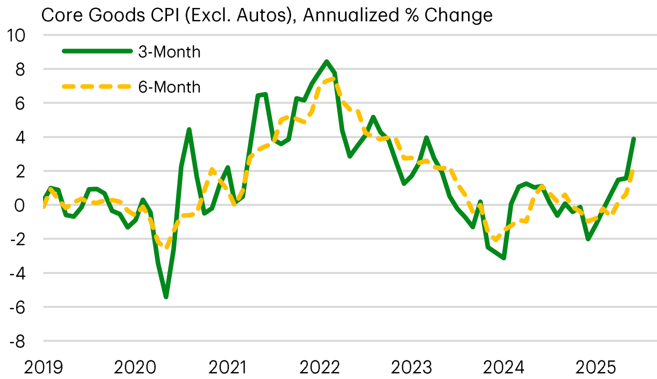
Offsets will come from the OBBBA on new measures—such as eliminating taxes on tips and overtime, making auto loan interest deductible, and providing a $6,000 deduction for seniors. However, these changes will only partially offset the impact of higher consumer prices as tariffs snake through the business cost structures with time.

Looking ahead, we expect consumer spending growth to pick up from about 1% this year to 1.7% (Q4/Q4) in 2026. However, this is still considered to be a modest pace.

Q4. Is inflation capturing tariff impacts?

The short answer is yes. Goods prices in the U.S. are showing early signs of tariff passthrough. As of July, price growth on core goods was up 1.2% year/year, compared to 2024 where prices fell by about 1%. Admittedly, this a relatively small uptick, particularly when benchmarked against the burst of inflation that

Chart 5: U.S. Goods Prices Are Heating Up



Source: Bureau of Labor Statistics, TD Economics.

occurred post-pandemic, when goods prices hit a peak of 12.5% year/year. Inventory stockpiling ahead of the tariff announcements have been a factor limiting tariff exposure and thus the extent of price passthrough.

But the trend is not our friend when it comes to core goods price metrics. A single category is masking a resurgence in broader pressures. New and used vehicle prices have fallen by 1% since the auto tariffs were first announced in March, owing to increased inventories alongside a pullback in demand. Outside of this, all other goods prices (as measured by CPI inflation) are up nearly 4% annualized over the last three-months (Chart 5). These pressures risk heating up further in the coming months given that inbound products will be hit by the August 7th reset on tariff rates. It may not be immediately obvious because there's a grace period for goods in transit until early October. This timing will collide with an anticipated rise in vehicle prices, once dealerships start to roll out 2026 models.

Until recently, cooling services inflation had provided an offset to rising goods prices earlier in the summer. But that ended in July, as price pressures on non-housing services turned meaningfully higher. It's too early to know if this trend will persist, but even under the 'best case scenario' where services resume cooling on trend, core measures of inflation are likely to hang around today's 3% for another year.

Q5. What's the impact on Fed policy and bond yields?

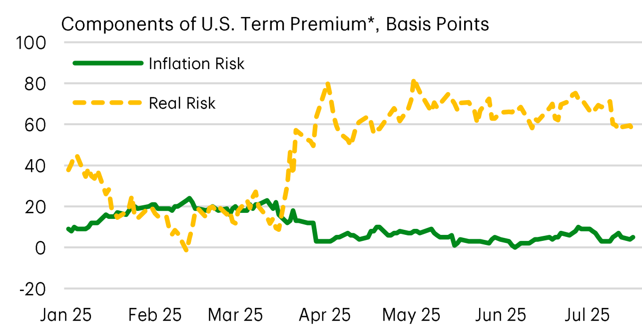
Despite inflation still tracking hotter than Fed decision makers might prefer, a softer economic backdrop gives the Fed reasonable grounds to resume cutting interest rates. We expect three quarter-point cuts to the federal funds rate at each of the next three meetings, to an upper target range of 3.75% by year-end. And there's further room to run in order to return to a neutral rate of 3.25% by mid-2026.

That said, a 125-basis-point reduction in short rates may not be felt equally across the curve. The U.S. 10-2-year spread has risen by less than 20 basis points since January, a smaller rise compared to the 40 and 30 basis point steepening seen in Germany and Canada. This suggests that the lift to the U.S. term premium has been relatively small.

Yet, the risk remains. Our analysis shows that the bulk of the increase in the U.S. term premium thus far captures uncertainty around growth, fiscal sustainability, and geopolitical volatility, as well as evolving supply-demand dynamics for long-term bonds (Chart 6). In contrast, America's large and growing fiscal deficit does not yet appear to be substantially lifting the term premium, which can come back into focus at any time. Several factors may explain this, including markets' expectations of relatively stronger U.S. growth and the U.S. Treasury market's status as a safe haven. Both suppress the term premium relative to other sovereigns.

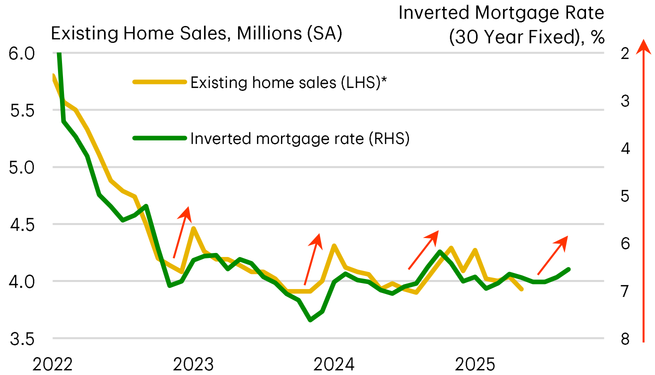
In addition, the U.S. term premium has been kept in check by the Treasury's issuance strategy. This includes tilting issuance toward the front end of the curve, holding the pool of longer-dated securities steady, and expanding its buyback program to retire older, less liquid long bonds. The net effect is a shrinking pool of long-dated bonds, which helps cap those

Chart 6: Real Risk Is Driving the Recent Increase in Term Premium



* Inflation and Real Risk Premia (IRP and RRP) estimated via the ACM model. IRP is inferred from break-evens, RRP captures residual risk unrelated to inflation.
Source: Federal Reserve Board, Federal Reserve Bank of New York, TD Economics.

Chart 7: Latest Drop in Rates to Help Encourage More Homebuying



Source: TD Economics. *Lagged by 2 months.

yields. However, the risk of another upward leg in the risk premium cannot be dismissed as yet. Inflation risks haven't disappeared, and the trade war may continue to run interference on the Fed's desire to lower rates. For now, our current base-case forecast sees the U.S. 2-year at 3.25% and the 10-year yield at 4.0% by Q2 2026, steepening the 10-2-year yield spread from today's 50 basis points to roughly 75 basis points.

Q6. How does this add up for U.S. housing markets?

Elevated longer-term interest rates have continued to take a toll on housing activity through the first half of 2025. Home sales levels remain near the lows of the Global Financial Crisis, arguing that this segment of the economy has behaved "recession like". However, that's only one side of the equation. Tight inventory levels have stymied home price relief for would-be buyers. This is slowing starting to change, with modest gains in inventory creating dynamics for home price growth to ease below 2% y/y for the first time since 2012 (as per the CoreLogic measure). However, experiences vary throughout the country, with the recent softness concentrated in the South and West Census regions, with many of those metros recording price declines. Meanwhile, prices in the Midwest and Northeast are holding up better. A similar divide can be seen along the East Coast, with the slowdown in home price growth generally more pronounced in the southern half of the region where seven of nine states have falling prices. A tighter inventory backdrop has favored sturdier price growth in the Northeast, where only two states have recorded price declines recently.

With affordability stretched tight, every little bit of downdraft in mortgage rates should help spur more sales activity, where there are high correlations (Chart 7). Because we anticipate the central bank will offer some rate-relief in the coming months, the market should begin to firm up, albeit this is really a "next year" story.

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