

# Commentary

## North America Macroeconomic Update: On-and-Off Tariff Policy Weakens the Outlook

### Morningstar DBRS

June 4, 2025

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Michael Heydt  
 Senior Vice President, Sector Lead  
 Global Sovereign Ratings  
 +1 212 806 3210  
 michael.heydt@morningstar.com

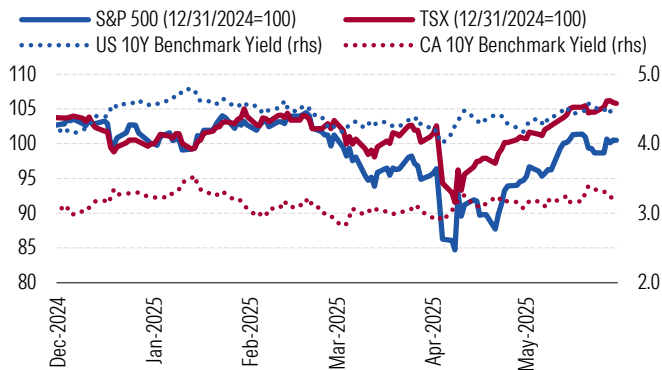
Thomas R. Torgerson  
 Managing Director  
 Co-Head of Sovereign Ratings  
 +1 212 806 3218  
 thomas.torgerson@morningstar.com

### Morningstar DBRS View and Key Trends

The U.S. and Canadian economies held up reasonably well during the first quarter amid rising trade tensions. Although headline GDP in the U.S. contracted by 0.2% annualized, final sales to private domestic purchasers, which is a better gauge of underlying domestic demand, increased by 2.5%, a slowdown from the previous quarter but still a solid pace. Meanwhile, the Canadian economy grew at an annual rate of 2.2% in the first quarter, a slight acceleration relative to the last quarter of 2024. However, trade concerns were visible in the data, with U.S. and Canadian firms both increasing inventories and business investment in an effort to front-run tariffs.

Growth concerns took a turn for the worse in early April with the announcement of Liberation Day tariffs and trade tensions intensifying between the U.S. and China. Most of the more aggressive "reciprocal" tariffs were postponed for 90 days, but tariffs between the U.S. and China rapidly escalated in April. Subsequently, the U.S. and China temporarily rolled back sky-high tariffs, and U.S.-EU trade negotiations were extended into the summer. As a result, the initial negative shocks stemming from tariffs - including higher import prices, supply chain disruptions, and adverse wealth effects - have, at least temporarily, diminished in severity. Equity and bond markets have experienced significant volatility but are more or less back to levels reached at the start of the year.

**Exhibit 1** U.S. and Canada: Equity and Bond Markets



**Exhibit 2** U.S. Travel Exports (USD billions)



Source: S&P Global; Toronto Stock Exchange; US Dept. of Treasury; Bank of Canada; Macrobond; Morningstar DBRS.

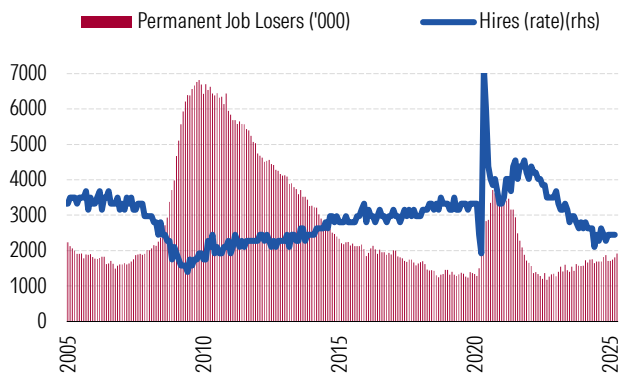
Source: U.S. Bureau of Economic Analysis; Macrobond; Morningstar DBRS.

High-frequency indicators in April and May painted a mixed picture. U.S. consumer sentiment, which dropped sharply in April, partially rebounded in May. Personal incomes expanded at a robust pace in April although consumer spending slowed, suggesting that households may be pulling back out of caution. Most credit card issuers noted that credit card spending growth in early-to-late April remained strong, as [we described](#) last month. Core capital goods orders (excluding aircrafts) - a good gauge of future business investment - declined by 6.1% annualized in the three months to April, but the pullback largely reflected a reversal of the surge in orders at the start of the year. In Canada, preliminary GDP figures showed positive monthly growth in April. Although still early days, one area of concern relates to U.S. travel-related services exports, which declined by 16.3% (non-annualized) in the three months to March.

While the scars of tariff policy may not be evident yet, we expect policy uncertainty to remain elevated going forward and act as a drag on growth in the second half of 2025. Even in the wake of last week's ruling by the U.S. Court of International Trade that the President lacked the authority to impose tariffs under the International Emergency Economic Powers Act (IEEPA), our view stands, as the ruling is being appealed, and the Trump administration has various other options to both threaten and impose bilateral tariffs. With on-again-off-again policymaking, we anticipate that consumers will continue to spend but at a slower pace. The tariffs that are imposed will generate price increases in the coming months that will erode consumers' purchasing power. Some firms may defer investment until there is greater visibility on the economic outlook. If the U.S. administration pushes ahead with high and broad-based tariffs, the odds of recession later this year or early next year will materially increase.

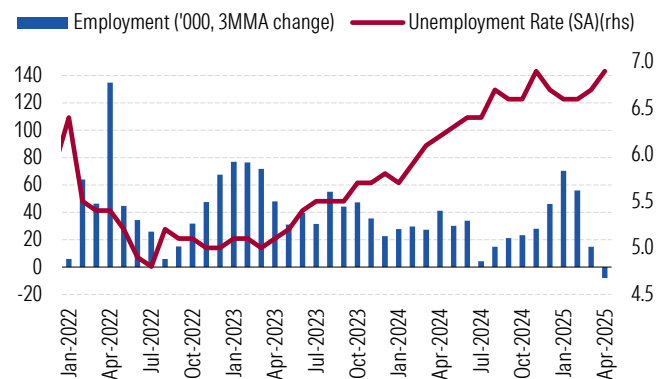
### North American Labor Markets are Cooling

**Exhibit 3** U.S. Employment Gains and Losses



Source: US Bureau of Labor Statistics; Macrobond; Morningstar DBRS.

**Exhibit 4** Canadian Employment Gains and the Unemployment Rate



Source: Statistics Canada; Macrobond; Morningstar DBRS.

The U.S. labor market has loosened since the start of the year but is still in decent shape. Average monthly nonfarm payroll growth in the three months to April was 155k, up from 113k six months ago. The prime-age employment rate is near multi-decade highs. The unemployment rate, which inched up

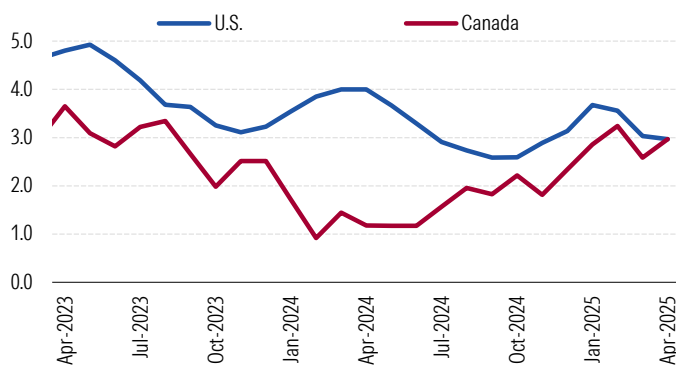
to 4.2% in April 2025, indicates that the economy is running at full employment. However, demand for labor is softening. The hiring rate has been low for the past year, and while layoffs are still modest levels, they are rising. The result is that those who have lost their job are having a more difficult time finding a new one, as reflected in the increasing duration of unemployment.

In contrast to the U.S., the Canadian jobs market has clearly weakened. Monthly employment declined on average by 8k in the three months to April. The figure would have been worse if not for a temporary gain of 37k jobs in public administration jobs in April for the federal election. These gains will likely reverse in the next month or two, thereby likely extending this period of weak employment numbers. Job losses were concentrated in goods-producing industries, potentially signaling that tariffs are already hitting the jobs market. The national unemployment rate increased to 6.9% in April, up from 6.6% in January. Increasing slack in the market is also evident in cooling wage pressures.

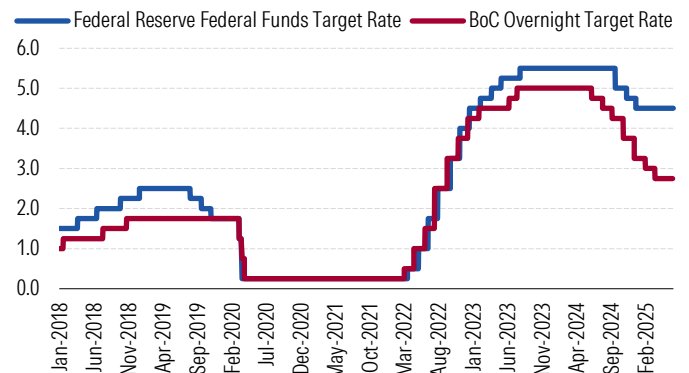
**Initial Effect of Tariff Shock is Disinflationary but Price Increases are Coming**

U.S. inflation continues to run a bit above target. Core CPI has been fluctuating around 3.0% since last summer. Housing-related inflation is gradually moderating, and the labor market is no longer a source of price pressures. However, core goods inflation has picked up in recent months and non-housing services inflation remains somewhat elevated. The initial effect of the tariff shock has been disinflationary as diminished growth expectations quickly led to lower energy prices. However, we expect firms will pass some portion of the increased import duties on to consumers in the coming months. With the economy operating at full capacity and a weaker U.S. dollar, core inflation looks set to remain above target through the end of the year.

**Exhibit 5** U.S. and Canada: Core Inflation (SA, 6M annualized)



**Exhibit 6** Policy Rates



Source: U.S. Bureau of Labor Statistics; Statistics Canada; Macrobond; Morningstar DBRS.

Source: U.S. Federal Reserve; Bank of Canada; Macrobond; Morningstar DBRS.

While headline inflation is below the 2% target in Canada, core inflation - like the U.S. - is running close to 3.0% (six-month annualized). Services, including rent, are the primary drivers of inflation. Potential retaliatory tariffs could add to inflation pressures if trade tensions escalate. However, the Canadian

economy is operating with a negative output gap, the labor market is weakening, and housing prices are now declining. Looking ahead, the emerging slack should gradually moderate price pressures.

### **The Federal Reserve and Bank of Canada Take a Wait-and-See Approach**

With inflation above target and unemployment low, the Fed has been in a holding pattern since December 2024. The policy rate was left unchanged during the first three meetings this year. Tariffs raise the risk of some goods price increases and higher unemployment going forward, but there is little evidence of deterioration on either side of the Fed's dual mandate so far. Medium-term inflation expectations have not changed: the 5-year, 5-year forward rate is 2.3%, the same level where it was at the start of the year. Against this backdrop, the Fed will likely remain non-committal regarding future monetary policy until there is greater visibility about the outlook for prices, activity, and expectations. According to Fed Funds futures, the market expects 2 rate cuts by December 2025. This suggests that monetary policy settings will remain restrictive through the end of the year.

The Bank of Canada will also take a cautious view to adjusting monetary policy in the second half of 2025. However, the BoC's approach largely reflects its starting position. While the Fed lowered rates by 100 basis points (bps) over the last year, the BoC has lowered rates by 225bps. This means that the overnight target rate - at 2.75% - is already in neutral territory. With core inflation still running above target and federal fiscal stimulus going into effect in July, BoC policymakers will likely deliver any further easing only gradually. The market is pricing in 1-2 cuts in the second half of the year as economic and labor market concerns intensify and inflation pressures moderate.

## Major Macro Headlines

### United States

**Inflation & Wage Growth:** CPI for urban consumers declined slightly to 2.3% y/y in April from 2.4% in March. Core CPI, which excludes food and energy prices, rose 2.8% y/y. The decline in energy prices, down 3.7% over the last 12 months, offset rising food and non-energy items. Personal consumption expenditures prices index (PCE) rose 2.1% y/y, while core PCE inflation rose 2.5% y/y in April. Real average hourly earnings remain unchanged from March to April and rose 1.4% y/y.

**Employment:** Payroll employment grew by 177k in April, broadly in line with expectations. Employment increased in the healthcare, transportation and warehousing, and financial sectors, while federal government employment declined. Other labor market indicators also held steady over the last year. The unemployment rate was 4.2% in April, staying between the 4.0-4.2% range of the last year, while the participation rate remained at 62.6%. Average hourly earnings for all employees increased by 3.8% over the last 12 months.

**Retail Sales:** Advanced estimates of retail and food services sales increased by 0.1% (SA) between March and April and were up 5.2% (SA) relative to one year ago. Most sectors saw an increase in nominal sales over the last 4 months, versus the same period in 2024, except for electronics and appliance stores, gasoline stations, and hobby goods stores.

**Housing Market:** New residential construction looks weaker across all three stages of development. Building permits and housing starts are down 3.2% and 1.7% below the April 2024 rate. New housing completions have been gradually falling over the last year, declining 14.3% over the period. New homes sales rose by 3.3% y/y. The monthly supply of new homes in the U.S. has been gradually growing, standing at 8.1 months in April, from a trough of 3.1 months in October 2020. At the same time, home prices according to the FHFA continue to appreciate, rising 4.0% in the 4 quarters ending Q1-2025.

## ■ ■ Canada

**GDP:** Real GDP increased by 2.2% at an annualized rate in the first quarter of 2025. However, domestic demand stalled as gains in private consumption and machinery and equipment investment were offset by declines in non-residential structures, residential investment, and government investment. The preliminary monthly GDP growth estimate for April was 0.1% m/m. Real GDP per capita increased by 0.4% in the first quarter, up from 0.1% q/q in the prior quarter.

**Inflation:** Annual headline CPI inflation came in at 1.7% in April, down from 2.3% in March. The decline was driven by the removal of the carbon tax from energy products. However, core inflation dynamics accelerated. The Bank of Canada's preferred inflation metrics - CPI-median and CPI-trim - increased to 3.2% (y/y) and 3.1% (y/y), respectively, their highest levels in over a year.

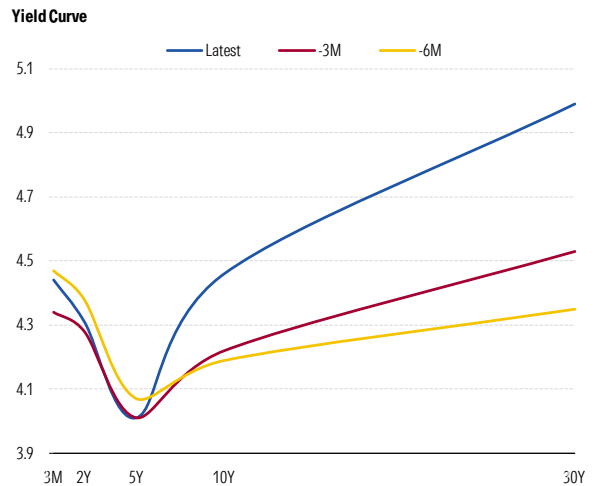
**Retail Sales:** Nominal retail sales rose 0.8% m/m in March, with increases in 6 of 9 subsectors. The largest increases were recorded by motor vehicle and parts dealers (+4.8%), followed by building material and garden equipment and supplies dealers (+2.6%), and clothing and clothing accessories retailers (+2.6%). The gains were offset by a decline in gasoline stations and fuel vendor sales (-6.5%) and general merchandise retailer sales (-2.7%). In real terms, retail trade increased 0.9% m/m in March. Retail sales rose in 8 provinces, with Quebec (+1.6%) experiencing the largest increase. Preliminary estimates by Statistics Canada indicate that sales nationwide increased 0.5% in April.

**Employment:** Employment levels remained steady in April (7k increase), following a decline of 33k in March. However, April data was flattered by a 37k increase in temporary public administration jobs related to the federal election. Monthly job losses in manufacturing (-31k) and wholesale and retail trade (-27k) were partially offset by job gains in finance, insurance, real estate, rental, and leasing (+24k). The unemployment rate increased to 6.9% in April, up from 6.2% one year prior. The employment rate, which has gradually trended down since January 2023, declined slightly to 60.8% in April, as compared to March.

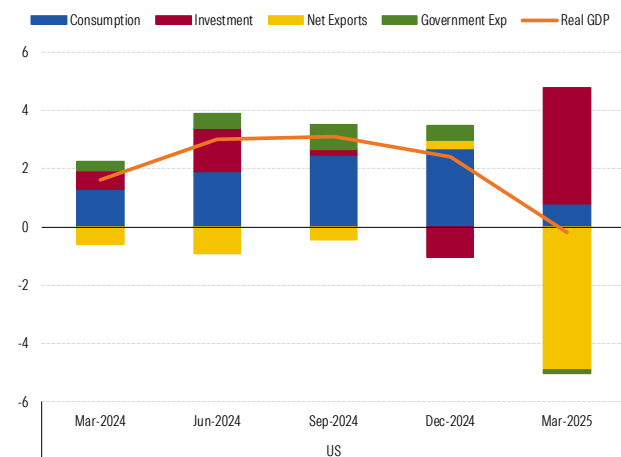
### U.S. Economic Dashboard

Economic Indicators	1-YR Trend	Latest	As of	T-1	T-3 MA	1-YR MA	Latest vs. 1-YR MA
Retail Sales, MoM (%)		0.1	4/30/2025	1.7	0.6	0.4	Deteriorated
Consumer Sentiment		52.2	5/31/2025	52.2	53.8	65.6	Deteriorated
Average Hourly Earnings, YoY (%)		3.8	4/30/2025	3.8	3.8	3.9	Deteriorated
Unemployment Rate (%)		4.2	4/30/2025	4.2	4.2	4.1	Deteriorated
Non-farm Payrolls Change, MoM (000s)		177.0	4/30/2025	185.0	154.7	156.8	Improved
Auto Sales (M)		17.2	4/30/2025	17.8	17.0	16.2	Improved
Durable Goods Orders, MoM (%)		-6.3	4/30/2025	7.6	0.7	0.3	Deteriorated
New Home Sales (000s)		743.0	4/30/2025	670.0	688.7	683.2	Improved
Building Permits (000s)		1,422	4/30/2025	1,481	1,452	1,454	Deteriorated
New Housing Starts (000s)		1361.0	4/30/2025	1339.0	1396.7	1363.8	Deteriorated
Industrial Production, MoM (%)		0.0	4/30/2025	-0.3	0.2	0.1	Deteriorated

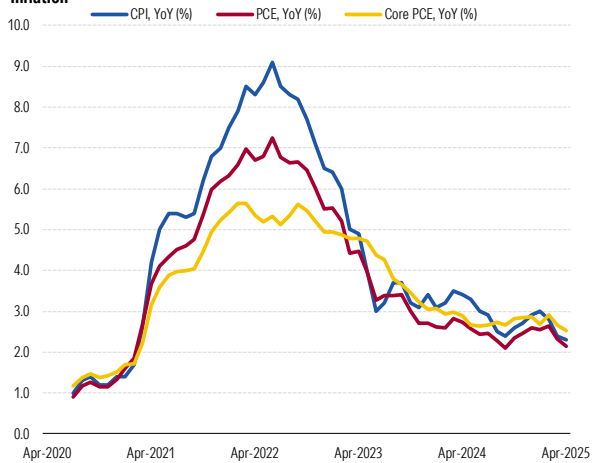
Market	1-YR Trend	Latest	3-MO Ago	1-YR Ago
Dow Jones Industrial Average		42,270	43,191	38,686
Nasdaq Composite		19,114	18,350	16,735
S&P 500 Index		5,912	5,850	5,278
S&P 500 Financials		846	859	691
USD/CAD		0.727	0.693	0.733
USD/GBP		0.742	0.788	0.786
USD/EUR		0.876	0.947	0.922
USD/JPY		142.74	148.34	156.16
USD/CNY		7.185	7.175	7.109
Federal Funds Rate (%)		4.50	4.50	5.50
3-Month Treasury Bill (%)		4.360	4.350	5.460
2-YR Government Yield (%)		3.890	3.960	4.890
10-YR Government Yield (%)		4.410	4.160	4.510
30-YR Government Yield (%)		4.920	4.450	4.650
NYMEX WTI Crude Oil (\$/barrel)		61.46	68.63	77.97
NYMEX Brent Crude Oil (\$/barrel)		62.61	71.39	81.28
Gold (\$/oz)		3,370	2,908	2,332
Silver (\$/oz)		34.30	31.70	30.50



#### Quarterly Growth, SAAR QOQ



#### Inflation



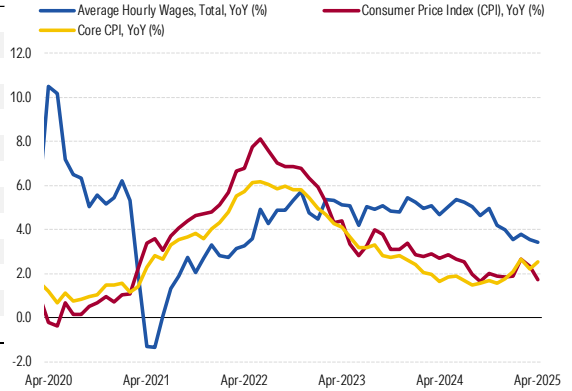
Sources: Nasdaq; S&P Global; Bank of Canada; Bank of England; European Central Bank; Bank of Japan; State Administration of Foreign Exchange; U.S. Federal Reserve; U.S. Department of the Treasury; Energy Information Administration; Intercontinental Exchange; BASF; Census Bureau; University of Michigan; Bureau of Labor Statistics; Bureau of Economic Analysis; Macrobond; Morningstar DBRS.

### Canada Economic Dashboard

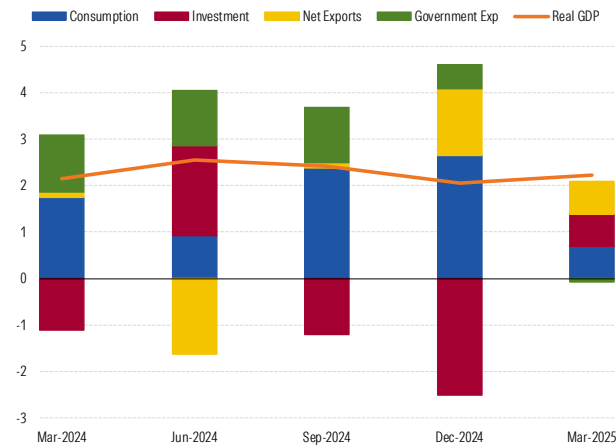
Economic Indicators	1-YR Trend	Latest	As of	T-1	T-3 MA	1-YR MA	Latest vs. 1-YR MA
Retail Sales, MoM (%)		0.8	3/31/2025	-0.5	-0.1	0.5	Improved
Average Hourly Wages, Total, YoY (%)		3.4	4/30/2025	3.6	3.6	4.4	Deteriorated
Unemployment Rate, Total (%)		6.9	4/30/2025	6.7	6.7	6.6	Deteriorated
Consumer Credit, Total (\$M)		784,549	3/31/2025	781,471	782,168	771,624	Deteriorated
Building Permits, MoM (%)		-4.1	3/31/2025	4.9	-1.0	1.7	Deteriorated
Residential Mortgage, Total (\$M)		2,269,588	3/31/2025	2,262,470	2,261,917	2,222,165	Deteriorated
Producer Price Index, YoY (%)		2.0	4/30/2025	4.5	3.8	2.6	Deteriorated
Government Debt to GDP (%)		91.6	12/31/2024	91.6	91.5	91.4	Deteriorated
Household Debt to GDP (%)		97.9	12/31/2024	98.2	98.1	98.1	Improved
Household Debt to Disposable Income (%)		175.4	12/31/2024	176.6	176.5	177.1	Improved
Household Savings Rate (%)		5.7	3/31/2025	6.0	6.3	6.3	Deteriorated

Market	1-YR Trend	Latest	3-MO Ago	1-YR Ago
S&P/TSX Composite		26,175	25,002	22,269
S&P/TSX Financials		4,626	4,441	3,669
CAD/USD		0.727	0.693	0.733
CAD/GBP		0.540	0.546	0.576
CAD/EUR		0.640	0.661	0.676
CAD/JPY		104.60	104.17	115.21
CAD/CNY		5.233	5.051	5.311
BoC Overnight Rate (%)		2.75	3.00	5.00
Prime Rate (%)		4.95	5.20	7.20
BoC 5-YR Fixed Mortgage Rate (%)		6.09	6.49	6.84
Canada 2 YR Gov't Yield (%)		2.6	2.57	4.26
Canada 5 YR Gov't Yield (%)		2.82	2.60	3.76
Canada 10 YR Gov't Yield (%)		3.21	2.90	3.70

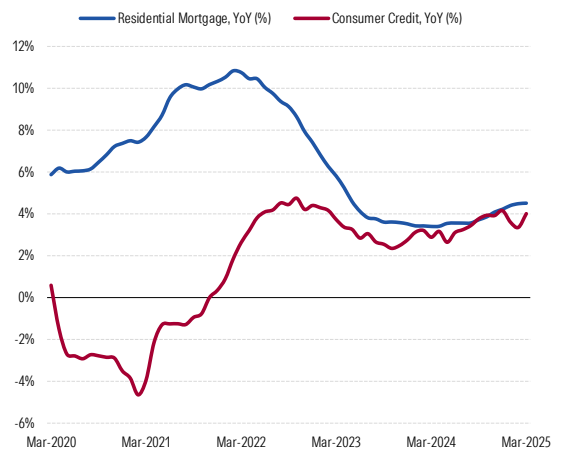
#### Wage Growth and Inflation (%YOY)



#### Quarterly Growth, SAAR QOQ



#### Consumer Credit and Mortgages



Source: Toronto Stock Exchange; Bank of Canada; Statistics Canada; Macrobond; Morningstar DBRS.

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