

ECONOMIC NEWS – FEBRUARY 2025

A Bifurcated Economy

On the surface, the U.S. economy is strong. GDP growth is near its short-run potential, unemployment is low, consumers are spending, and manufacturing is coming back to life, spurred by AI-related spending on structures and equipment. Based on the strong performance of all key indicators in December, the economy was riding a good deal of momentum as the calendar turned to 2025. Barring an external confidence-shattering shock, such as an escalation of geopolitical conflicts, an oil crisis or a global trade war that roils international commerce, the U.S. economy should do well in 2025 and once again outperform on the global stage.



But underneath the hood we find that the aggregate data masks a bifurcated economy, a trend we expect to persist this year. High-income households have several tailwinds for spending, including positive wealth effects from past increases in equity and home prices. Because this segment of the population accounts for most consumer spending in the U.S., their contribution will be enough to keep the growth engine running on most cylinders. Conversely, low- and middle-income households don't reap the benefits from appreciating assets as much, and they will remain under financial pressure from past increases in prices for food, rent, transportation, and energy.

The perception of the economy also differs depending on employment status. The layoff rate is low, a testament to the tightness of the labor market, and nominal wage growth among job stayers is still around 4 percent a year, which is outstripping inflation. However, conditions are challenging for those who are unemployed or not in the labor force but want a job. Hiring has dropped to its lowest rate since 2010, when the economy was still reeling from the aftermath of the financial crisis.

The bifurcation of the economic landscape makes policy decisions more challenging than usual in the coming year. A pro-growth bias to policy would help close the gap between the rich and poor faster by creating more job opportunities for the lower-paid workers. But that would also heighten inflation, creating more of a burden on lower-income households down the road. The tax and spending decisions by the fiscal authorities face similar challenges, as getting our fiscal house in order has unequal consequences for the population. Simply put, the overall economy may look healthy this year, but not everyone is free of the sniffles.

Who's On First?

In the closing months of 2024, monetary policy took center stage as little was done on the fiscal front during the waning days of the Biden administration. The Fed cut rates three times, totaling a full percentage point, between September and December while congressional efforts were focused on campaigning leading up to national elections. In the early months of 2025, we should see more action on the fiscal than on the monetary side. The Fed is in a holding pattern following the last rate cut in mid-December, waiting to see how the economy holds up without another rate reduction and whether the inflation retreat, which stalled out in late 2024, resumes.

To be sure, major fiscal measures will not be implemented right away, as tax and spending proposals need to go through a grinding process in Congress. But the proposals themselves could influence behavior and, hence, the economy. That's particularly the case with President Trump's signature effort to impose wide-ranging tariffs on China and other key trading partners. It's unclear how much can be accomplished immediately without congressional approval through executive action, but the anticipation of higher tariffs is already prompting businesses to recalibrate spending plans.

Most notably, factory purchasing managers are stepping up orders for equipment and supplies, both from overseas and domestically to beat the increased price tags that would accompany higher tariffs. Many in the incoming administration believe that higher prices will be avoided because overseas producers will cut prices by as much as the tariff increase so as not to lose sales in the U.S., particularly for products that face domestic competitors. But the experience during President Trump's first term belies that notion as the tariffs imposed on steel, aluminum, washing machines, solar panels, and goods from China, affecting more than \$380 billion worth of trade,

led to steep price hikes for many of those products.

Orders Increase to Beat Tariffs



Will The Fed Respond To Tariffs?

The step up in bookings to beat price hikes may impart a short-term growth boost, which would unwind as the economy absorbs the imports and ordering settles down to pre-tariff levels. However, more serious consequences could occur if the Fed believes the growth spike is sustainable, prompting it to keep interest rates higher for longer. That prospect is even more likely if the initial strength along with the tariff pass-through to consumers also keeps inflation higher than otherwise.

Normally, the Fed does not let speculation over government policies influence its decisions. However, at the December meeting, Fed Chair Powell admitted that some officials on the rate-setting committee were factoring in the fiscal, trade, and immigration policies of the administration into their thinking. The decision to dial back its rate-cutting campaign in 2025 from what was projected at the previous meeting no doubt reflected the higher inflation risks that the Fed now associates with those policies. Bond traders seem to feel the same way, as long-term interest rates have increased significantly since the Fed started cutting rates in September, although the economy's strong performance since then likely had a bigger influence.

While tariffs are the most discussed influence behind inflation concerns, it would be a mistake to overlook the impact that mass deportations would also have. According to the PEW Research Center, undocumented immigrants account for more than 10 percent of construction and agricultural jobs, and almost as big a share of home health aides. Housing, food, and health care have contributed mightily to the inflation surge in recent years, and removing a big chunk of labor in those sectors would intensify the pressure on prices, a burden that would fall more heavily on low- and middle-income families than wealthier households.

Some Are Falling Behind

The good news for lower income workers is that their wages increased faster than better-paid workers during the white-hot job market over most of the post-pandemic recovery. Recall that in 2022 and 2023, the unemployment rate fell to a 50-year low of 3.5 percent and there were 2 job openings for every unemployed worker when the job market was at its tightest. But that has changed. Hiring slowed in 2024 and the labor supply expanded – due in good part to immigration – a combination that loosened labor conditions considerably. At the end of 2024, the ratio of job openings to unemployed workers had fallen to 1.1 – essentially a balanced labor market.

But even as they enjoyed faster pay increases than others, lower-income workers faced even steeper price increases, particularly for necessities like housing and groceries, and were forced to go deeper into debt to sustain living standards. Now they are being hit with a double whammy. Wages are slowing overall, thanks to the Fed's rate-hiking campaign in 2022 and 2023 that weakened the job market, but wage increases for lower paid workers are slowing even more. For the first time in a decade, workers on the bottom rung of the wage scale had smaller raises than the highest paid workers.

Wage Growth Slows More for the Little Guy



Fortunately, most workers still have a job and are getting paychecks, as the unemployment rate is still near historical lows at around 4 percent. But the slimmer wage gain for lower-paid workers not only strains their budgets more than higher earners, it has significant consequences for the broader economy. Keep in mind that poorer people tend to spend almost every penny of a wage increase, so the smaller raises have an amplified impact on consumer spending.

Small Firms Are Also Hurting

Like wealthy households, medium and large businesses are doing well and are better positioned to weather high interest rates. They have been ringing up healthy profits, have more pricing power and have access to the capital markets as well

as banks to raise funds. But small firms are the backbone of the economy and, according to the ADP National Employment Report, employment in this sector has been little changed over the past couple of years. Small businesses are under pressure from high interest rates, elevated costs, a difficult lending backdrop, and softening sales. What's more, small businesses have less access to capital markets than larger ones and are more reliant on banks for funds.



As a result, they are more vulnerable to tightening lending standards of banks as well as high borrowing costs, which more closely track Fed rate increases than the capital markets.

This becomes particularly important when small firms run into trouble and cannot raise funds to ward off bankruptcy. Not surprisingly, small business bankruptcy filings, proxied by Chapter 11 Subchapter V, are surging. Subchapter V filings in 2024 were 9.8 percent more than in 2023 and 44.2 percent higher than in 2022. Keep in mind that there was a surge in business formations after the pandemic; with more births come more deaths as the survival rate across industries declines over time.

This is where the Fed could find itself in a bind. The three rate cuts last year provided some relief for small firms, and hopes were high that they would be followed by several more cuts this year, beginning as soon as January. But following stickier inflation late last year and the economy's sustained strength, follow-up rate cuts have been pushed back and the number of planned cuts reduced. No doubt, sticky inflation could justify a long pause; but that could risk imposing an additional burden on small businesses and, by extension, the labor market. Simply put, monetary policy is a blunt instrument and the prospect of rates staying higher for longer may well be necessary to keep inflation in check. Hopefully, the Fed will weigh the balance of risks appropriately and guide the economy into a slower, but still sustainable growth path in 2025. But the presence of a bifurcated economy will continue to be with us for a while longer.

BankRI Executive Management

William C. Tsonos
President & CEO
Will.Tsonos@bankri.com

Steven M. Parente
Executive Vice President, Director of Retail Banking
Steven.Parente@bankri.com

KEY FINANCIAL AND ECONOMIC INDICATORS

FINANCIAL INDICATORS

	December	November	October	September	August	July	June	12-Month Range
	High	Low						
Prime Rate	7.65	7.81	8.00	8.30	8.50	8.50	8.50	8.50 - 7.65
3-Month Treasury Bill Rate	4.27	4.42	4.51	4.72	5.20	5.20	5.24	5.25 - 4.27
5-Year Treasury Note Rate	4.25	4.23	3.91	3.50	4.16	4.16	4.32	4.56 - 3.50
10-Year Treasury Note Rate	4.39	4.36	4.10	3.72	4.25	4.25	4.31	4.54 - 3.72
30-Year Treasury Bond Rate	4.58	4.54	4.38	4.04	4.46	4.46	4.44	4.66 - 4.04
Tax-Exempt Bond Yield	4.04	4.14	3.96	3.83	3.87	3.94	3.94	4.14 - 3.36
Corporate Bond Yield (AAA)	5.20	5.14	4.95	4.68	5.12	5.12	5.13	5.28 - 4.68
Conventional 30-Year Mortgage Rate	6.72	6.81	6.43	6.18	6.85	6.85	6.92	7.06 - 6.18
Dow Jones Industrial average	43656	43717	42494	41491	40086	40086	38904	43717 - 37764
S&P 500 Index	6011	5930	5792	5621	5538	5538	5415	6011 - 4804
Dividend Yield (S&P)	1.24	1.23	1.28	1.31	1.31	1.31	1.33	1.47 - 1.23
P/E Ratio (S&P)	26.5	27.0	26.0	26.3	25.7	25.8	25.6	27.0 - 23.4
Dollar Exchange Rate (vs. Major Currencies)	127.8	126.5	123.8	122.1	123.7	123.7	124.0	127.8 - 120.6

* Monthly Averages

ECONOMIC INDICATORS

	December	November	October	September	August	July	June	12-Month Range
	High	Low						
Housing Starts (Thousands of Units)	1499	1294	1344	1355	1379	1262	1329	1568 - 1262
New Home Sales (Thousands of Units)	664	627	736	691	707	672	736	736 - 627
New Home Prices (Thousands of Dollars)	403	426	418	406	429	414	436	436 - 403
Retail Sales (% Change Year Ago)	3.9	4.1	3.0	2.0	2.0	2.9	2.0	4.10 - 0.2
Industrial Production (% Change Year Ago)	0.5	-0.6	-0.5	-0.7	-0.1	-0.5	0.9	0.9 - -1.2
Operating Rate (% of Capacity)	77.6	77.0	77.0	77.4	77.9	77.6	78.2	78.2 - 77.0
Inventory Sales Ratio (Months)		1.37	1.37	1.38	1.38	1.37	1.38	1.38 - 1.37
Real Gross Domestic Product (Annual % Change)				3.1			3.0	3.2 - 1.6
Unemployment Rate (Percent)	4.1	4.2	4.1	4.1	4.2	4.3	4.1	4.3 - 3.7
Payroll Employment (Change in Thousands)	256	212	43	255	78	144	118	310 - 43
Hourly Earnings (% Change Year Ago)	3.9	4.0	4.0	3.9	3.9	3.6	3.8	4.3 - 3.6
Personal Income (% Change Year Ago)	5.3	5.5	5.1	5.2	5.4	5.4	5.4	6.0 - 5.1
Savings Rate (Percent of Disposable Income)	4.4	4.5	4.1	4.4	4.4	4.4	4.8	5.5 - 4.1
Consumer Credit (Change in Blns. of Dollars)		-7.5	17.3	3.0	4.3	23.7	2.3	23.7 - -7.5
Consumer Prices (% Change Year Ago)	2.9	2.7	2.6	2.4	2.5	2.9	3.0	3.5 - 2.4
CPI Less Food & Energy (% Change Year Ago)	3.2	3.3	3.3	3.3	3.2	3.2	3.3	3.9 - 3.2
Wholesale Prices (% Change Year Ago)	3.3	3.0	2.7	2.1	2.1	2.4	3.0	3.3 - 1.0