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Q&A with Investment Strategy

Q1 GDP Growth Turns Negative

IS THE FIRST QUARTER NEGATIVE GDP PRINT A CAUSE FOR CONCERN?

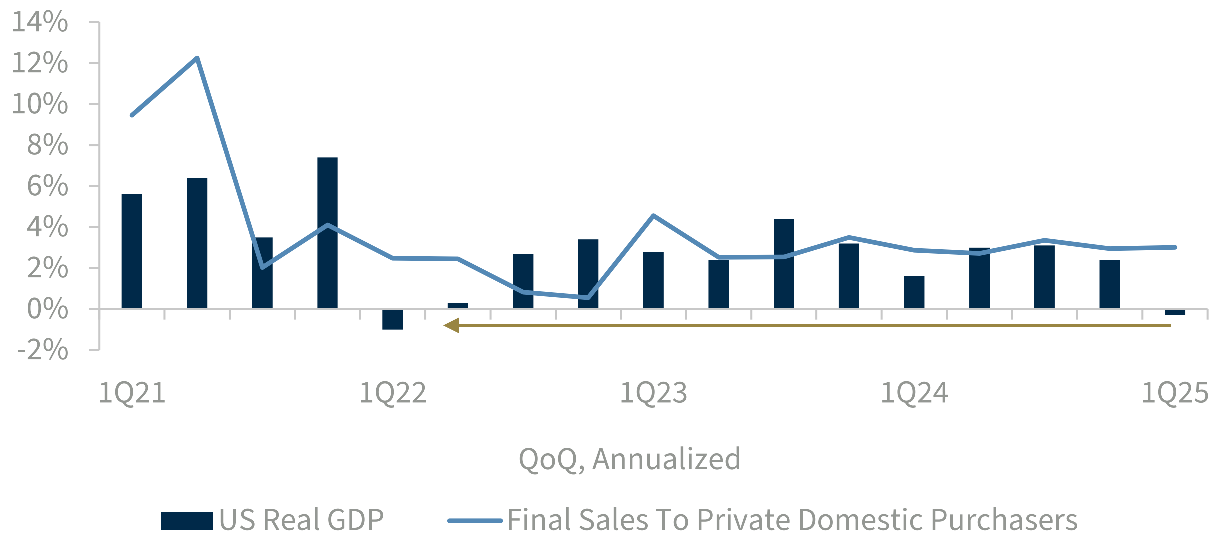
Today's US GDP data was worse than expected—in fact, growth turned negative for the first time since 2022—leading to a resurgence of market volatility. While the negative GDP datapoint can be disconcerting, this is a situation where the headlines do *not* tell the full story. Q1 GDP was unusually messy due to pre-tariff inventory building, pushing the aggregate number into the red. Our central message is that a recession is *not* a foregone conclusion, although the odds are higher than before.

WHAT HAPPENED WITH GDP IN Q1?

Heading into today's Bureau of Economic Analysis' report on Q1 gross domestic product—the broadest measure of economic activity—expectations had already been tempered by the trade war. Consensus had called for GDP to expand a mere 0.4%, compared to 2.4% in Q4 2024, but the actual print was even worse than that: –0.3%. This means the US economy shrank (very slightly), for the first time since Q1 2022.

So, why did GDP decline? The answer is: a surge in imports, the highest rate since Q3 2020. This was a direct result of the trade war initiated by the White House's tariffs (which we wrote about on April 3 and again on April 9). You may be asking: how could the trade war affect the economy before anyone knew what the tariffs would be? It was precisely that tariff uncertainty that led businesses to front-run the tariffs, in other words pre-buy as many imported products as possible from January through March. When imports rise, that results in a subtraction from reported GDP, and that is what happened in Q1. Net exports (exports minus imports) subtracted 4.8% from GDP, the most on record. If, hypothetically, imports had been at a more normalized level, GDP growth would have been in positive territory.

Looking at the other line items that collectively make up GDP, consumer spending, which is more than two-thirds of the economy, was up 1.8%, slower growth than in Q4, but still healthy: in other words, *not* signaling a recession. Investment was also a bright spot, even though government spending was down (initial impact from DOGE's cuts). Taking this into account, when some of the 'noisy' tariff-related impacts are stripped out, domestic demand in the US remained solid. A metric of this—real sales to private domestic producers—grew 3%, suggesting that the economy remains healthy despite the headline GDP drop.



Source: Bureau of Economic Analysis, FactSet. As of 4/30/2025.

GIVEN THE Q1 GDP DECLINE, IS THE US ECONOMY ON THE PRECIPICE OF A RECESSION?

The answer is: we do *not* think so. Despite the Q1 print, it remains our base case that the US economy will be able to avoid a recession in 2025. As we mentioned above, much of the Q1 weakness was attributable to GDP accounting as tariff-related front running weighed on net exports. There were also some transitory factors: a colder winter along the East Coast, a relatively severe flu season, and the California wildfires.

Tariff-related impacts—pulled-forward spending and reduced investment due to policy uncertainty—will be headwinds to growth over the coming months, but this has already been reflected in our reduced full-year 2025 forecast for GDP growth: ~ +1.0% vs. +2.4% at the start of the year. When we look at real-time indicators, they continue to suggest that the economy is on solid footing. From a labor market perspective, withholding taxes growing 5-6% YoY and historically low jobless claims are in good shape. For the consumer, banks and credit card companies (e.g., Visa, Capital One) throughout the Q1 earnings season have highlighted that consumer fundamentals have remained resilient, and spending has actually picked up in recent weeks despite tariff-related concerns. This is consistent with activity metrics, as TSA screenings (air traffic) have accelerated in recent weeks and are now growing 4% YoY; restaurant bookings remain up 4% YoY; and hotel occupancy is in line vs. one year ago. Unless and until we see a significant downturn in the labor market—which is *not* our base case at this point—we believe that consumer spending will remain positive, albeit slower than last year.

If, however, a recession were to take place, it would likely occur quickly. On average, the final quarter of growth before the recession begins has seen +2.6% growth; by contrast, the first quarter of recession has averaged –3.5%. In other words, the economy can turn on the proverbial dime. This is why following real-time indicators is so critical for determining the short-term trajectory of the economy and any noticeable change in activity. If a recession were to occur, we would expect it to be mild and short-lived by historical standards as there are few excesses in the economy (e.g., inventories/valuations); consumers and businesses remain on solid footing; and we expect factors such as midterm elections and the World Cup should help boost spending into 2026.

DOES THE GDP FIGURE IMPACT YOUR EQUITY VIEW?

It was not surprising to see increased volatility to start the morning on the back of the GDP print. After rallying ~12% from the lows set on April 8, the S&P 500 had moved to the upper end of our expected near-term trading range of 5,100-5,600. While full-year 2025 earnings estimates have been revised 3% lower since the start of the year, we expect further downside to estimates toward ~$250-$255 as the impacts from tariffs (on margins and sales) gradually materialize. As earnings come in, and it takes time for trade deals to be negotiated, we expect volatility to remain elevated. However, as mentioned earlier, our base case remains that the US economy will be able to skirt a recession, and earnings growth will remain positive: $250-$255 in EPS equates to 3-5% EPS growth from 2024. With that in mind, we expect the market to trend higher toward our year-end target of 5,800. However, if a recession were to materialize, the market would likely re-test the April lows as the S&P 500 typically declines ~24% on average during a mild recession.

THE BOTTOM LINE

The fact that Q1 GDP unexpectedly turned negative has reignited market volatility, but we need to look past the headlines. The US economy retains many fundamental positives, despite the trade war's impact, with consumers in particular showing resilience. If, as we believe, a recession can be avoided in 2025, that should support further recovery in the equity market as the year progresses.

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Source: FactSet

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