First Trust
Monday Morning OUTLOOK

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No Recession Yet, But Risks Remain

Noise about tariffs, business uncertainty, a constitutional fight, and a drop in stock prices had already created fear of a recession. When real GDP declined in the first quarter of 2025, some started to question if a recession is already here. Let's take a deep breath and consider the facts.

Yes, real GDP dipped at a -0.3% annual rate in Q1, the first decline for any quarter since 2022. But the main reason was that trade with other countries accounted for the largest drag on the economy for any quarter since at least 1947, as both consumers and companies loaded up on goods from abroad before higher tariffs kicked in. Since GDP is designed to measure domestic production, imports are subtracted even though Americans buy them because they were produced abroad. We aren't saying GDP is a flawed statistic, we are saying it needs to be viewed correctly.

Real (inflation-adjusted) consumer spending increased at a moderate 1.8% annual rate in the first quarter and real business investment in equipment spiked up at a 22.5% annual rate, neither of which looks recessionary. We like to track "core" GDP, which is consumer spending, business fixed investment, and home building, but excludes the most volatile categories like government purchases, inventories, and international trade. Core GDP grew at a 3.0% annual rate in Q1, exactly matching the growth rate of the past year.

So, GDP was not the signal that the headline number suggested. In fact, when it was released, initially stocks went down only to recover as calmer heads prevailed. Nonfarm payrolls rose 177,000 last month and are up 144,000 per month so far this year. And the mix of jobs is much more positive. In 2023-24, 73% of the increase in payrolls were government, education, health care, and social services jobs. These jobs are largely driven by government spending policies, especially deficit spending. In the past three months, that share has dropped to slightly less than half. In other words, less of the recent job growth is due to government spending expansion.

Another signal that the US wasn't in recession in the first quarter was that industrial production was up at a 5.4% annual rate while manufacturing rose at a 5.1% annual rate.

Instead, the slippage in real GDP reminds us of the decline in early 2022, when many analysts and investors (as well as conservative political commentators) were quick to declare a recession even though the decline in GDP, like in Q1 this year, was driven by one-off factors like inventories and trade, while the job market and industrial production kept growing.

Nonetheless, while we don't think the data show a recession yet, the odds of a recession starting in the next year or so are still higher than normal. We estimate in the range of 40 – 50%. Why is the recession risk higher than normal? For one thing, we have yet to fully feel the effects of the tightening of monetary policy in 2022-23 – with both a drop in the M2 measure of the money supply as well as higher short-term interest rates.

At the same time, federal budget hawks have taken over. In both 2023 and 2024, we saw the most reckless spending of our lifetimes, with the budget deficit running in the range of 6.0 - 6.5% of GDP even as the unemployment rate hovered near 4.0%. To put this in perspective, the highest deficit under President Regan was 5.9% of GDP when the unemployment rate was 10.0%. The reckless deficit expansion of the past two years likely masked or hid some of the pain we were eventually going to feel from the tightening of monetary policy.

But now fiscal policy is going in reverse, with the potential to unmask or reveal that pain. Tariffs are going up, meaning higher receipts, while the part of the federal budget that presidents have the most power to control – non-defense discretionary spending – is being curtailed, including at USAID, the Department of Education, and elsewhere. This past week the Trump Administration made a budget authority request for non-defense discretionary programs in FY 2026 for $679 billion, which is 32% below the $997 billion the Congressional Budget Office had assumed as recently as January.

This represents a major shift in the spending habits of the federal government and will, if enacted, lead to more resources staying in the private sector. But, in the very short run, it might also bring some transitory economic pain to those who rely on that spending for their livelihood. The impact is not immediate.

In the meantime, uncertainty about tariffs might also contribute to a slowdown. Already, imports are slowing after their surge, and companies are hesitant to re-shore economic activity because the timing and duration of tariffs is unknown.

The bottom line is that it's unlikely a recession has started yet, but investors should remain alert.

Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
5-5 / 9:00 am	ISM Non Mfg Index – Apr	50.2	**50.2**	51.6	50.8
5-6 / 7:30 am	Int'l Trade Balance – Mar	-$136.8 Bil	**-$136.7 Bil**		-$122.7 Bil
5-7 / 2:00 pm	Consumer Credit – Mar	$9.5 Bil	**$4.5 Bil**		-$0.8 Bil
5-8 / 7:30 am	Initial Claims – May 3	230K	**233K**		241K
7:30 am	Q1 Non-Farm Productivity	-0.7%	**-0.8%**		+1.5%
7:30 am	Q1 Unit Labor Costs	+5.2%	**+6.2%**		+2.2%

Consensus forecasts come from Bloomberg. This report was prepared by First Trust Advisors L. P., and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Opinions and forward looking statements expressed are subject to change without notice. This information does not constitute a solicitation or an offer to buy or sell any security.