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U.S. Lowers Tariffs On Chinese Imports, Recession Risk Falls; Fed Forecast To Hold Funds Target Unchanged Through Year-End

- **The U.S. reached a trade deal with China May 12, unwinding most of the tariff increases the governments imposed in April.**
- **The US tariff rate on most imports of Chinese goods was cut to 30%, and the Chinese retaliatory tariff on most U.S. exports cut to 10%.**
- **Assuming no further increase in U.S. tariffs, Comerica's May forecast will modestly lower our year-end 2025 inflation forecast from April's forecast.**
- **U.S. importers are likely to ramp up purchases near term to hedge against tariffs rising again.**
- **Real GDP could be negative again in the second quarter due to this burst of imports. Even so, recession risk looks lower than before the tariff cuts.**
- **The Fed is forecast to hold interest rates unchanged through year-end 2025 with less risk of recession and inflation set to rise.**

The U.S. and Chinese governments announced an agreement May 12 to roll back most of the tariff increases they imposed on each other in April. The tax charged to American buyers of most types of imports from China will fall to 30% of purchases from 145%. China's tax on Chinese companies' purchases of most American exports will fall to 10% from 125%. Also, China will suspend nontariff retaliation against the U.S. economy, like restrictions on their exports of rare earth metals. The governments describe the rollback as a 90-day temporary measure.

Imports are going to jump again following the rollback of tariffs. Many American businesses slowrolled import plans when the tariff on imports from China was hiked to 145%, in anticipation of a rollback. Now they will catch up on delayed purchases and build precautionary inventories in case tariffs go back up. Higher imports will show up in the second quarter's GDP report as a big headwind from the trade deficit, the same headwind that pushed first quarter real GDP into a contraction. It would be no surprise to see real GDP contract for a second consecutive quarter.

Even so, the risk of a recession over the next 12 months looks substantially lower following the tariff cuts. Economists don't define a recession as two consecutive quarterly declines in real GDP. Instead, a recession is defined by three D's: Depth, Duration, and Diffusion (widespread-ness) of declining economic activity, which affects employment, production, income, and sales. Recession risk looked uncomfortably high after April's tariff hikes. Surveys reported that businesses were starting to delay risky decisions like hiring plans and capital spending. Consumers were starting to turn more cautious toward discretionary spending on vacations and dining

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out. If too many businesses and consumers turn cautious at the same time, it could turn into a self-reinforcing downturn—a recession.

But the cut of tariffs to more manageable levels should make people feel more comfortable about the economic outlook, support discretionary spending by businesses and consumers, and likely keep the economy growing in 2025. In 2026, fiscal policy is expected to provide a further boost to growth. Congress is working on extending the 2017 tax cuts in the 2026 fiscal bill, and could follow through on some of the 2024 campaign promises for additional cuts to taxes on Social Security benefits, tips, and so forth. Those tax cuts will deliver less money to Uncle Sam's coffers and leave more in Americans' pockets, boosting domestic demand (though increasing the federal fiscal deficit).

Barring other changes to tariffs or shocks, Comerica Economics' next forecast will upgrade the outlook for job growth in 2025, lower the forecast for the unemployment rate, and lower the forecast for inflation. CPI and PCE inflation will likely run 3.0% to 3.5% in year-over-year terms in late 2025, up from around 2.5% at the start of the year but lower than in Comerica's April forecast. The unemployment rate will likely hold around 4.2% this year and next.

The Fed won't want to cut interest rates with inflation rising. Also, they won't think it necessary to cut interest rates this year with less fear of recession, and with fiscal policy expected to provide more support to growth in 2026. As such, Comerica is changing the forecast for the federal funds target to foresee no change through year-end 2025.

The 10-year Treasury yield jumped to near 4.5% and was almost the highest since February after the China trade deal's announcement, as financial markets anticipated less likelihood of the Fed cutting rates this year. The S&P 500 Index rose to the highest since early March, and the dollar appreciated against the euro to the strongest since April 10th. The Chinese yuan appreciated to the strongest against the dollar since the week after the election in November 2024. West Texas Intermediate crude oil futures rose to $62 per barrel, but are still down sharply from $79 a barrel a year ago.