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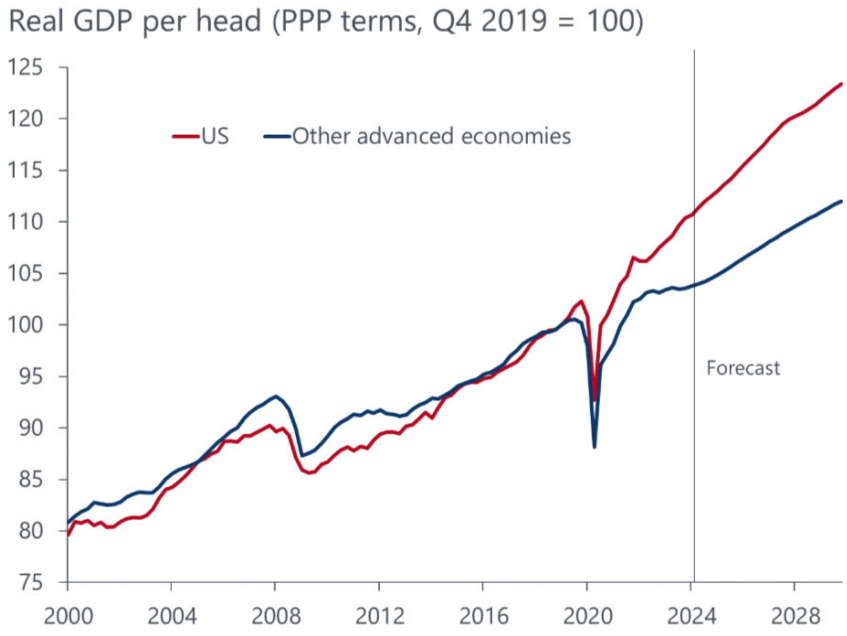
Research Briefing | US

Key Themes 2025: A twist on US exceptionalism

- **The US economy is set to outperform other advanced economies next year, according to our above-consensus view on growth. Beneath the surface, five key themes will dominate the narrative as the year unfolds.**
- ***American exceptionalism will endure*. Stronger productivity growth isn't a flash in the pan. Past immigration will continue to support labor force growth, keeping the economy's short-run potential speed limit high, regardless of the new administration's policies.**
- ***The investment boom isn't over*. Company fundamentals will underpin solid growth in real business equipment spending next year.**
- ***Fiscal dominance writ large*. Next year will be a twist on the notion of fiscal dominance as the Trump administration's fiscal and trade policies won't dominate the Federal Reserve's ability to tame inflation. Rather, it will cause the central bank to be a price taker in regard to fiscal and trade policy. The Fed will wait until fiscal policy, which will garner more attention than monetary policy, is implemented before recalibrating monetary policy theory.**
- ***Entering a new era of supply shocks*. Less immigration and higher tariffs will be a theme for 2025, but there remains some uncertainty about how far the pendulum will swing. However, the economic implications won't be felt until late in the year or 2026.**
- ***Higher rates and volatility will be the norm*. There are some early warning signs that volatility will be a theme in 2025, as the 10-year Treasury term premium has been climbing. Tariffs and expectations for expansionary fiscal policy lend upside risk to interest rates across the yield curve, but we don't believe there will be a return of the bond market vigilantes.**

Chart 1: US exceptionalism will continue



Source: Oxford Economics/Haver Analytics

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Key theme 1: American exceptionalism will endure

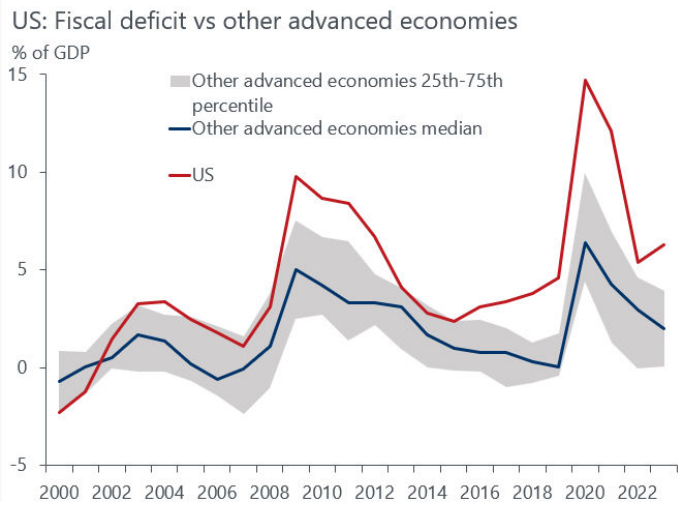
The last 15 years can be generally characterized as American exceptionalism. US per capita GDP growth was the third strongest among advanced economies in 2023 and is poised to be among the best performers this year (**Chart 1**). Even putting the prospect for expansionary fiscal policy aside, US exceptionalism will endure next year despite heighted policy uncertainty and volatility in the bond market. The key drivers for growth in the US next year are consumer spending and business investment in equipment, with strong tailwinds for both.

Above-trend growth in productivity isn't a flash in the pan, as past investment in research and development and a tight labor market will continue to support it. US productivity growth next year will outpace the euro zone, the UK, and Canada. Along with gains in the labor force, strong trend productivity growth will keep the US economy's short-run potential GDP growth elevated next year.

The Trump administration's stance on immigration and trade will be a drag on potential GDP growth down the road, but it won't be a major factor in 2025, helping ensure American exceptionalism endures for another year.

The US economy has also outperformed other advanced economies because of the aggressive expansion in its fiscal policy during the pandemic (**Chart 2**). The deficit-financed spending helped the economy outperform others, but not all of the deficit spending went toward transfer payments; the bipartisan infrastructure bill, Inflation Reduction Act, and CHIPs acts will continue to support business investment in structures, equipment, and support productivity growth.

Chart 2: Deficit-financed spending helped the US outperform



Source: Oxford Economics/Haver Analytics/IMF

As the dominant player in global financial markets, the US has been able to run high and rising debt-to-GDP ratios. Although there will be concerns about fiscal sustainability, it won't be a key theme next year, but another type of fiscal dominance will.

Key theme 2: Passing the baton to equipment investment

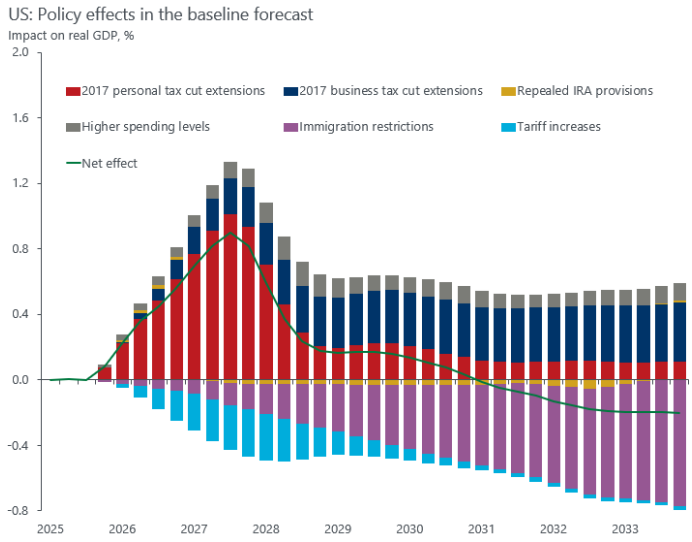
The strong growth in nonresidential structures investment, particularly in manufacturing, will be a tailwind for equipment spending next year. There is a roughly two-year lag between an increase in factory construction and the associated boost to equipment investment, though it can vary. The equipment cycle will remain strong in 2025 and into 2026 as real investment in manufacturing structures this year is on track to be the largest in the post-war era.

However, the narrow concentration of the manufacturing construction boom means the benefits to equipment providers will not be widely shared. Nevertheless, there are plenty of tailwinds for growth in real business investment in equipment, which is expected to be a key support to GDP growth next year along with the consumer, who shows no sign of tightening their purse strings.

Key theme 3: Fiscal dominance writ large

Fiscal dominance occurs when enough government debt and deficits increase inflation to the point that it overwhelms the central bank's capacity to keep inflation low. Next year is a twist on this notion of fiscal dominance as the Trump administration's fiscal and trade policies won't dominate the Fed's ability to tame inflation, rather it will cause the path of monetary policy to be less significant for the near term (**Chart 3**). Debt and deficits will garner more attention, but the macroeconomic implications are not significant for next year, let alone Trump's second term as president.

Chart 3: Fiscal policy passed in 2025 will boost economy in 2026

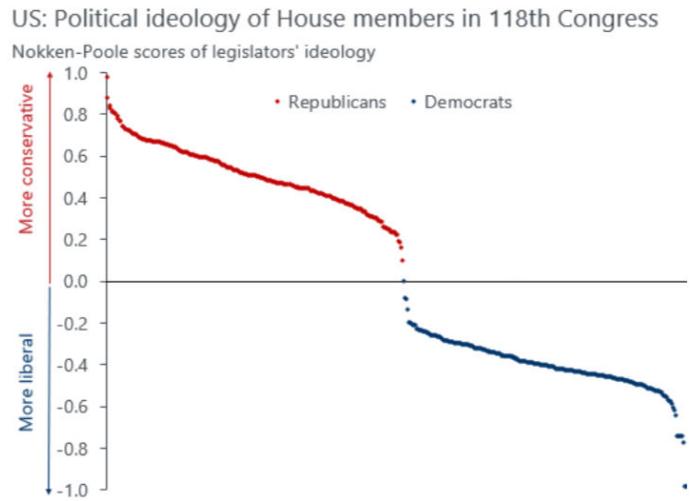


Source: Oxford Economics

The forecast assumes Trump's fiscal agenda is expansionary, but the implications for growth next year are minimal because of the lag between when fiscal policy is signed into legislation and when it impacts the economy.

Expectations are that expansionary fiscal policy is in the works, and it is, but it is unlikely to have a meaningful impact on growth next year. It will require a lot of political capital and the annual appropriations process will remain a bipartisan exercise. Without a filibuster-proof majority in the Senate, Republicans would still need Democratic support to pass an annual budget. Therefore, there will be twists and turns in fiscal policy next year, fanning volatility in financial markets as Republicans' grip on Congress isn't as overwhelming as some make it out to be (**Chart 4**).

Chart 4: Republicans have a light grip



Source: Oxford Economics/Lewis, Poole, Rosenthal, Boche, Rudkin & Sonnet (2024)

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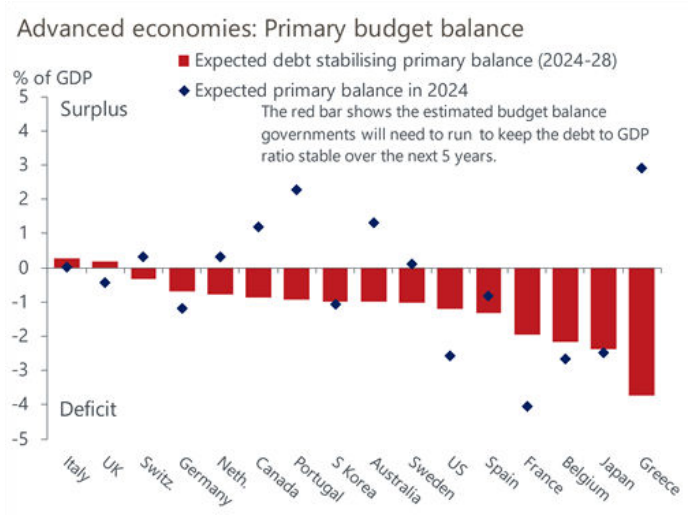
The last time Republicans controlled government, they pushed for higher funding for national defense, while Democrats called for more spending on domestic nondefense programs. The result was the Bipartisan Budget Act of 2018, which significantly raised spending levels for defense and nondefense.

The baseline assumes a similar grand bargain between the two parties, albeit to a lesser extent than 2018. Odds are that political conflict and uncertainty will remain a common theme throughout the year, putting the fiscal agenda on a roller coaster. How smoothly the legislative process will be depends on whether Republicans are able to pass a reconciliation package early in the year, the first of two possible packages. The House Republican majority is so narrow that two reconciliation packages aren't in our baseline.

The federal budget is already on an unsustainable trajectory, but federal fiscal conditions will worsen relative to our prior baseline assumption of the political status quo, with the federal debt-to-GDP ratio a decade from now more than 5ppts higher than we previously forecast. Risks to our forecast for debt and deficits are to the upside, as we may be too conservative in our assumptions around tax cuts and spending.

Even if the aggressive expansionary fiscal policy is accompanied by larger cuts in government spending, including government agencies, the focal point of discussions would be debt and deficits. A key source of revenue raisers will not come via Congress. Instead, Trump expects it to come via revenues generated through tariffs. This will fan discussion and debate of when the traditional definition of fiscal dominance rears its head, if at all in the US.

Chart 5: US not joining the fiscal consolidation party soon



Source: Oxford Economics/Haver Analytics

It won't be next year, but at some point, the government debt-to-GDP ratio will rise enough that the real demand for government debt will reach a limit. Any issues of nominal debt beyond that would be pushed back on by the bond market. The US won't flirt with this threshold in 2025, but that won't prevent it from being a hot topic, particularly as other advanced economies took steps to improve their fiscal situation, but the US hasn't (**Chart 5**). Something to consider is that every percentage point increase in the US debt-to-GDP ratio increases the 10-year Treasury yield by 2.5bps.

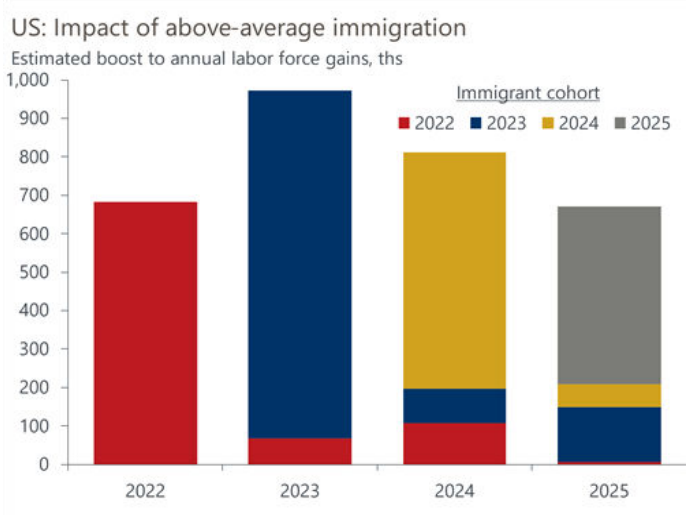
Key theme 4: Entering a new era of supply shocks

While less immigration and higher tariffs will be a theme for 2025, there remains some uncertainty about how far the pendulum will swing. However, the economic implications won't be felt until late in 2025 or early 2026. The baseline forecast assumes that net immigration will fall from an annual pace of 1.1mn to 800,000, with reductions to inflows of foreign-born individuals occurring as soon as mid-2025.

There will be talk of mass deportations, but we're sceptical that the kind of deportations proposed on the campaign could occur, given the enormous legal and logistical obstacles they would face, in addition to the cost. The concerns that stricter immigration will have an immediate and substantial impact on the labor supply are, in our view, overdone.

New immigrants become progressively more attached to the labor market over time (**Chart 6**). Therefore, immigrant cohorts from the past two years will continue to contribute to labor force gains next year. The 2025 cumulative increase in the labor force is expected to be shrink by 139,000 because of the outcome of the election. This is noticeable, but is only 12,000 per month.

Chart 6: Past immigration will continue to lift the labor force



Source: Oxford Economics/Haver Analytics

Trade policy will also determine how far the protectionism pendulum swings next year. Tariffs will cause more diversification in global trade, but the notion that they will significantly reduce, let alone eliminate, the US trade deficit are misguided. The US consumes significantly more than it produces domestically; therefore, tariffs will alter the sources of imports rather than significantly reduce them. In fact, expansionary fiscal policy will cause the US trade deficit to be wider than it otherwise would've been.

Protectionism is a two-way street and retaliation from trading partners would eventually hurt the US. The US exports 11% of all the goods and services it produces, roughly where it was during Trump's first term and noticeably higher than when the economy was more manufacturing dependent, including in the 1960s and 1970s. Currently, 10% of the US national income comes via exports, which would be a risk depending on how global protectionism plays out.

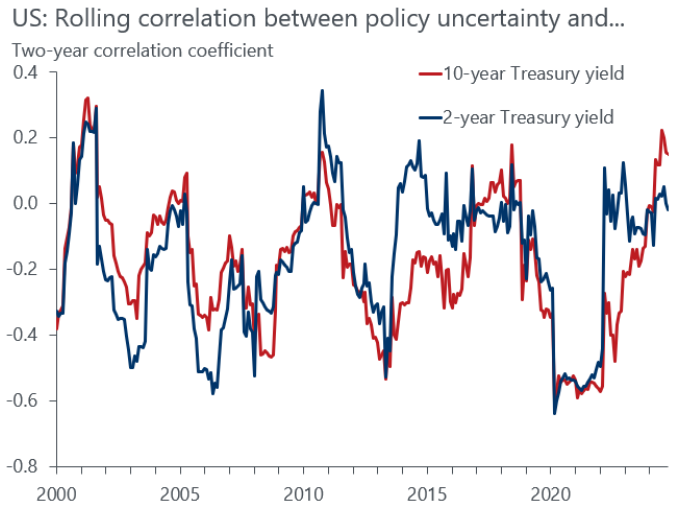
US protectionist trade policies could cause disruptions in supply chains and spill over into foreign policy, with both feeding back into the economy. Trump's approach to the Middle East and China-Taiwan could have negative implications for the US economy via global oil prices and broader financial market conditions that are not assumed in the baseline.

But there are reasons for optimism. Protectionism rhetoric and policy announcements could start to plant more seeds for multilateralism. Trump has touted tariffs as a negotiating tactic to form or redo trade agreements, which could move other US trading partners toward multilateralism, particularly concerning China. Multilateral measures against unfair Chinese competition are more efficient and more difficult for China to retaliate against. Discussions around trade deals could also intensify next year, including a UK-US free-trade agreement. Although the US-Mexico-Canada Agreement (USMCA) is up for review in July 2026 – when any of the three countries can opt not to renew the trade accord – talks could begin in 2025. These few tests could show whether the Trump administration has any willingness to move toward multilateralism.

Key theme 5: Higher volatility will be the norm

Volatility in the bond market will remain elevated because of the uncertainty in fiscal, trade, and monetary policy (**Chart 7**). There are already some early warning signs that volatility will be a theme in 2025. The 10-year Treasury term premium, which compensates investors for bearing the risk of future interest rate fluctuations, has been climbing.

Chart 7: Bond market likes clarity



Source: Oxford Economics/Haver Analytics

Fluctuations in the term premium can cause financial market conditions to either tighten or loosen for any given stance of monetary policy. This can add to volatility in the economy as financial market conditions, over time, can be a support or a weight on the economy, and a focal point for next year will be the term premium as that could be the primary driver of fluctuations in the 10-year Treasury yield.

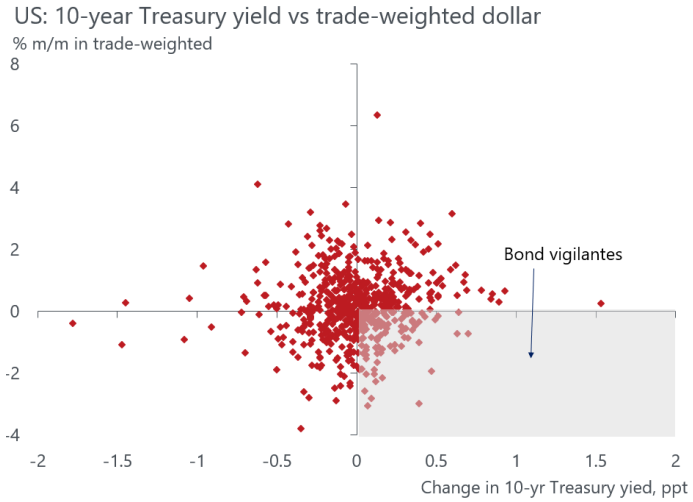
This yield can be decomposed into three components: long-run inflation expectations, expected path of the real fed funds rate, and the term premium. Long-term inflation expectations are and should remain anchored. If market-based measures of inflation expectations move noticeably next year, it will likely be attributed to changes in global oil prices. There is a strong correlation and causal relationship between market-based long-term inflation expectations and global oil prices, putting geopolitical tensions and, to a lesser extent, the Trump administration's efforts to increase domestic oil production in the spotlight.

Increases in the term premium would raise the 10-year Treasury yield, slowing the economy. This would require less restrictive monetary policy to achieve the central bank's dual mandate, adding uncertainty to the path of real short-term interest rates and volatility to interest rates.

To gauge the implications of the higher rise in long-term rates, we ran a few scenarios though the Oxford Economics Global Economic Model. We assumed a permanent increase in the 10-year Treasury yield of 25bps, 50bps, and 75bps relative to the baseline. The drag on the economy isn't enormous but lends some downside risk to the forecast, particularly as there will be a wave of refinancings next year, including for commercial real estate. Residential investment is vulnerable to volatility in interest rates and risks to the forecast for housing starts are weighted to the downside, while mortgage spreads will likely determine the fate of home sales next year.

Although the Trump administration will aggressively pursue expansionary fiscal policy and tariffs. This could fan concerns of a return of the bond vigilantes, or when investors sell Treasuries because fiscal policies are viewed as inflationary or fiscally irresponsible, which pushes long-term interest rates higher. Periods when bond vigilantes flourished occur when long-term rates are rising and the US dollar is depreciating, but the currency is unlikely to decline next year (**Chart 8**).

Chart 8: Vigilantes are being kept at bay



Source: Oxford Economics/Haver Analytics

Risks to our forecast for the US trade-weighted dollar are skewed to the upside. Interest rate differentials will remain in favor of the US relative to other advance economies. Tariffs will likely put some upward pressure on the dollar as other countries attempt to offset the impact of a US-imposed tariff through depreciating their currency.

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