Daiwa Capital Markets

U.S. Data Review

- Q1 GDP: constrained by surge in imports; private domestic demand remained solid
- Inflation: favorable in March after upward revisions to prior data; risks in coming months skewed to the upside
- Employment cost index: compensation growth remained on decelerating trend

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Q1 GDP

- The U.S. economy contracted 0.3 percent, annual rate, in Q1 -- the first negative GDP print since the first quarter of 2022 (versus the median expectation of a contraction of 0.2 percent in the Bloomberg economist survey). The soft headline results were heavily influenced by a surge in imports spurred by the Trump administration's trade policy, as firms sought to front-run tariffs set to hit in coming months with increasing force. Beyond brisk import flows and the associated inventory build by firms (which contributed to the aforementioned substantial drag from net exports and partial offset from inventory investment), domestic demand was solid – an indication that the economy remained on track in early 2025.

GDP and Related Items*

		24-Q3	24-Q4	25-Q1
1.	Gross Domestic Product	3.1	2.4	-0.3
2.	Personal Consumption Expenditures	3.7	4.0	1.8
3.	Nonresidential Fixed Investment	4.0	-3.0	9.8
3a.	Nonresidential Structures	-5.0	2.9	0.4
3b.	Nonresidential Equipment	10.8	-8.7	22.5
3c.	Intellectual Property Products	3.1	-0.5	4.1
4.	Change in Business Inventories (Contribution to GDP Growth)	-0.2	-0.8	2.3
5.	Residential Construction	-4.3	5.5	1.3
6.	Total Government Purchases	5.1	3.1	-1.4
6a.	Federal Government Purchases	8.9	4.0	-5.1
6b.	State and Local Govt. Purchases	2.9	2.5	0.8
7.	Net Exports (Contribution to GDP Growth)	-0.4	0.3	-4.8
7a.	Exports	9.6	-0.2	1.8
7b.	Imports	10.7	-1.9	41.3
	Additional Items			
8.	Final Sales	3.3	3.3	-2.5
9.	Final Sales to Domestic Purchasers	3.7	3.0	2.3
10.	Gross Domestic Income	2.1	4.5	--
11.	Average of GDP & GDI	2.6	3.5	--
12.	GDP Chained Price Index	1.9	2.3	3.7
13.	Core PCE Price Index	2.2	2.6	3.5

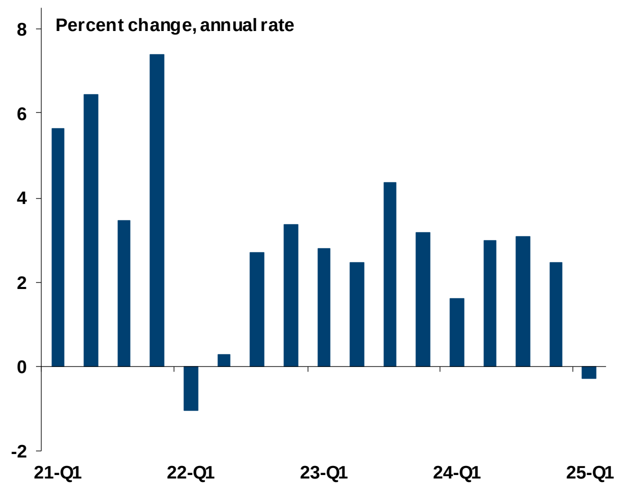
** Percent change SAAR, except as noted.*
Source: Bureau of Economic Analysis via Haver Analytics

- Leading off with trade, results for net exports offered keen insight into the disruptive effects of the administration's pursuit of more favorable trade deals through the imposition of import duties. With the brunt of the levies set to hit in the near future, imports surged 41.3 percent, annual rate. Exports also pickup up (+1.8 percent), but the overtly uneven composition of trade flows led to net exports subtracting 4.8 percentage points from GDP growth, the largest constraint on record (data back to 1947).

- Stock building by firms associated with the flood in imports cushioned, to a degree, the drag from net exports, as inventory investment contributed 2.25 percentage points to growth. Changes of the magnitude seen in Q1 are often followed by payback in subsequent quarters, but an additional stock building amid uncertainty may persist for a time before giving way to more cautious inventory management in the second half of the year as the domestic economy slows.

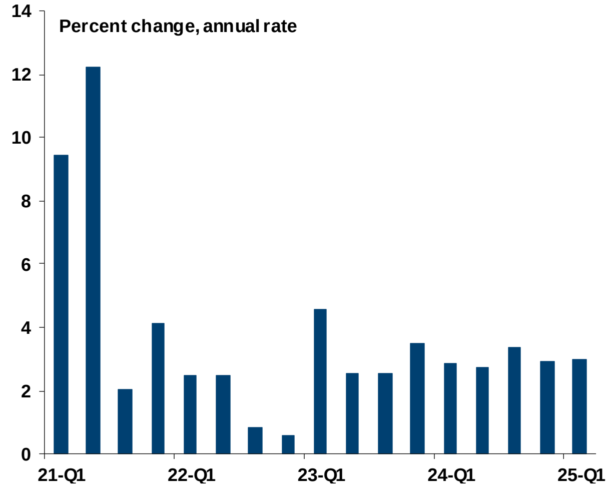
- Setting aside the large moves in net exports and inventory investment, the domestic economy remained on solid footing in Q1. Government spending fell 1.4 percent, with a contraction of 5.1 percent at the federal level only partially offset by growth of 0.8 percent at the state and local level, but other areas performed relatively well. On the point, final sales to private domestic purchasers, which excludes net exports, inventory investment, and government expenditures (thus providing a clearer view on underlying domestic demand), rose 3.0 percent in Q1 – one tick faster than growth in 2024-Q4 (chart, below right). At the core of that performance was an advance of 1.8 percent in consumer spending which outperformed market expectations preceding the release (+1.2 percent expected). Outlays in the first two months of the quarter were sluggish after brisk spending in Q4 (+4.0 percent), but the monthly Income and Consumption report for March (released following the GDP data) reported a notable rebound in the closing month of the quarter (growth of real PCE of 0.7 percent, not annualized, following a contraction of 0.4 percent in January and a pickup of 0.1 percent in February). The business sector also performed well, with growth of 9.8 percent in business fixed investment driven primarily by growth of 22.5 percent in equipment spending. Intellectual property investment also was firm (+4.1 percent), although outlays for structures were nondescript (+0.4 percent).

GDP Growth



Source: Bureau of Economic Analysis via Haver Analytics

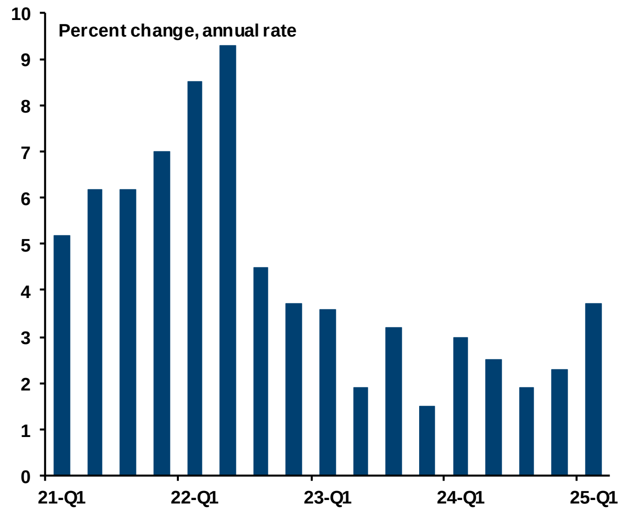
Final Sales to Private Domestic Purchasers



Source: Bureau of Economic Analysis via Haver Analytics

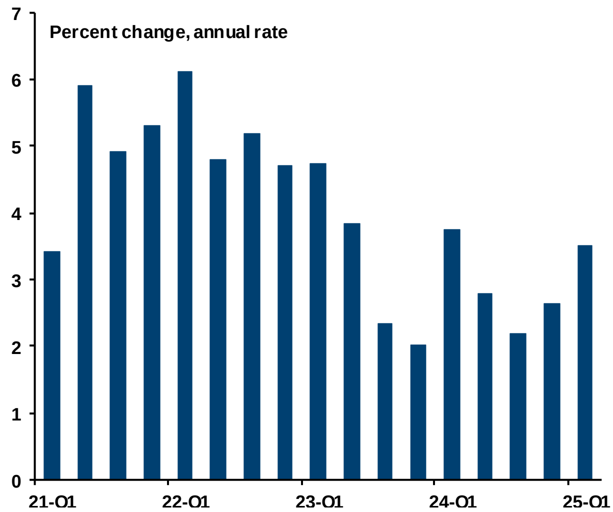
- Inflation data surprised to the upside, with the GDP price index advancing 3.7 percent (versus +3.1 percent expected) and the core price index for personal consumption expenditures increasing 3.5 percent (versus +3.1 percent anticipated; charts, below). The monthly breakdown on PCE published in the March Income and Consumption report revealed upward revisions to inflation data for the opening two months of the year but soft readings in the latest month, thus explaining the unexpected jump (see below).

GDP Chained Price Index



Source: Bureau of Economic Analysis via Haver Analytics

Core PCE Price Index



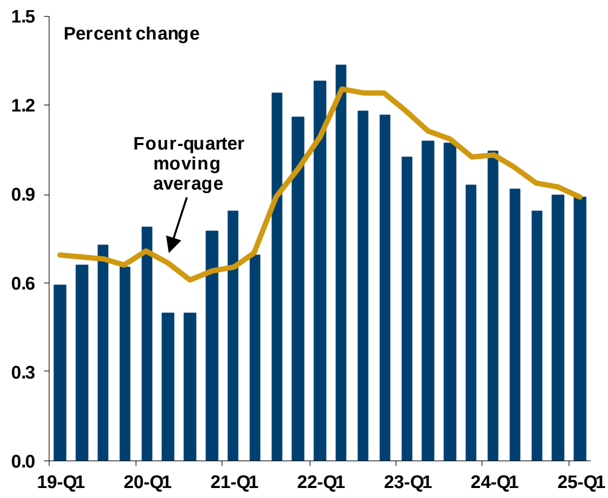
Source: Bureau of Economic Analysis via Haver Analytics

- All told, the Q1 GDP report showed an economy that remained on a growth trajectory in the face of headwinds generated by the policy objectives of the Trump administration. Although we are clinging to hope that the chilling effects on household and business sentiment generated by the administration's actions will not result in recession over the next 12 months, we anticipate domestic demand slowing further in the next few quarters absent a pivot away from further escalating trade tensions. Even if the U.S. does avoid recession, the outlook is materially different than it was a few short months ago when tailwinds from renewal of tax cuts and pursuit of regulatory reform were focused on as catalysts for ongoing economic growth.

Employment Cost Index

- Total compensation costs increased 0.9 percent (not annualized) in 2025-Q1, a reading in line with the Bloomberg survey median expectation. While the latest observation was essentially unchanged from that in the prior quarter (0.891 percent versus 0.899 percent in 2025-Q1 and 2024-Q4, respectively, with less rounding), it is still one of the lowest seen in recent quarters and notably off the expansion peak of 1.3 percent in 2022-Q2 (chart). In other words, the underlying decelerating trend is suggestive of easing in compensation growth on account of a rebalancing in previously tight labor market conditions. On a year-over-year basis, compensation costs rose 3.6 percent, down from 3.8 percent in the prior quarter and the recent high of 5.1 percent.

Employment Cost Index: Total Compensation



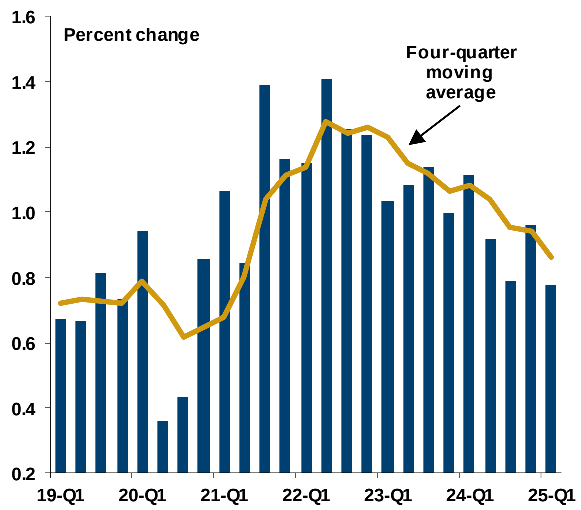
Source: Bureau of Labor Statistics via Haver Analytics

- The wages and salaries component rose 0.8 percent in the latest quarter, slower than the 1.0 percent advance in 2024-Q4 and a cycle peak of 1.4 percent in 2022-Q2 (chart, below left). Year-over-year wage growth eased to 3.5 percent from 3.8 percent in the previous quarter and the recent high of 5.3 percent in 2022-Q2.

- After increasing by 0.9 percent per quarter on average in 2024, benefit costs surprised to the upside in Q1, advancing 1.2 percent. That said, despite the jump, the latest read is still off from the recent peak of 1.5 percent in 2022-Q1 and the underlying trend still suggests moderation (chart, below right).

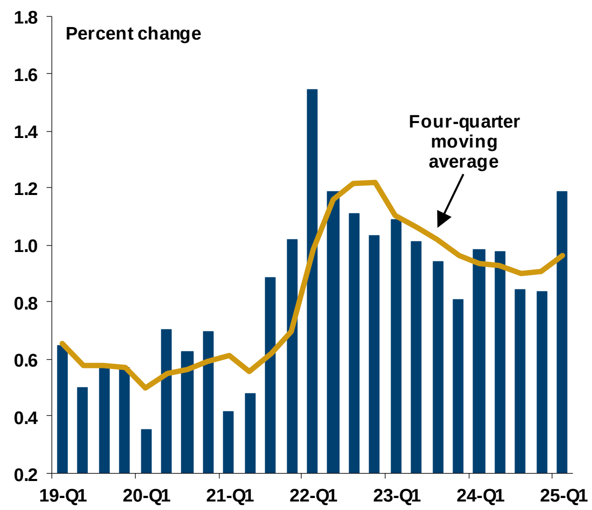
- On balance, the ECI report, which is usually viewed by Fed officials as the most reliable series on compensation trends on account of it being a fixed-weight measure (versus average hourly earnings, which is influenced by compositional shifts in hiring), supports the notion that labor costs have cooled in response to the recent recalibration in underlying labor market conditions. In other words, wage growth is no longer meaningfully inconsistent with the FOMC's inflation mandate.

Employment Cost Index: Wages



Source: Bureau of Labor Statistics via Haver Analytics

Employment Cost Index: Benefits



Source: Bureau of Labor Statistics via Haver Analytics

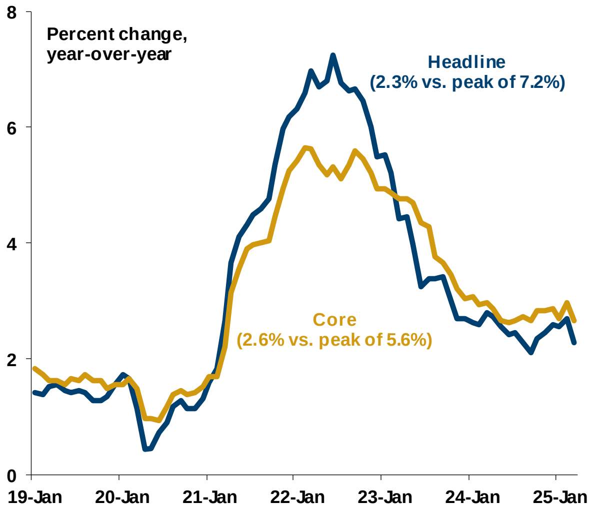
March PCE Inflation

- The monthly breakdown of consumer inflation data for Q1 (released with the Personal Income and Consumption report) revealed upward revisions to prior data that gave way to favorable results for March. In the latest month, the headline PCE price index rounded up to no change (-0.045 percent with more precision) and the core index rounded down to the same result (+0.028 percent versus the market expectation of +0.1 percent). The monthly shifts equated to year-over-year advances of 2.3 percent and 2.6 percent, respectively, down from 2.7 percent and 3.0 percent in the prior month (chart, below left).

- The favorable change in the core PCE price index followed an upward revision to prior data (+0.50 percent in February versus +0.37 percent first reported), although much of the upward revision to prior data was tied to portfolio management fees. Broad subcomponents, for the most part, remained on recent trends. Core goods prices declined 0.3 percent after back-to-back advances of 0.4 percent, with the year-over-year advance slowing to 0.1 percent from 0.4 percent in the prior month. Ongoing disinflation in this area may be unlikely, but the ongoing subdued trend is close to that which prevailed prior to the onset of the pandemic. Core service inflation rose 0.1 percent, consistent with a year-over-year advance of 3.5 percent (a reading within the recent range). Perhaps most notable was the pickup in core services inflation excluding housing, which rounded down to no change (+3.3 percent year-over-year, down from +3.6 percent in February; chart, below right). With supply and demand in the labor market in balance, and wage growth moderating as a result, limited pass-through to the costs of services may help offset potential pressure resulting from tariffs.

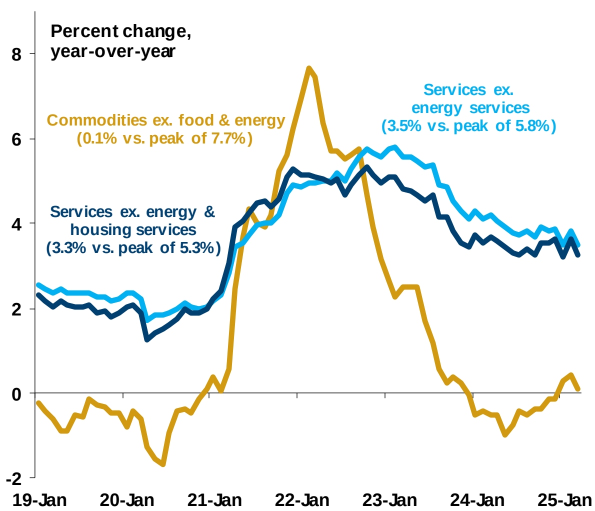
- In a vacuum the March inflation data would be welcomed by Fed officials, as they offer evidence that inflation is (was) moving gradually back toward the 2.0 percent inflation target. With that said, trade policy again generates significant uncertainty in this area. Anecdotal evidence suggests that some firms are already raising prices in response to announced levies, with others likely to follow suit if they are indeed fully implemented by July. At this time, we suspect that at least some stirring in price pressure is assured, although the outcomes of ongoing negotiations with major trading partners will determine if it is a one-time shift (of yet indeterminant magnitude) or an inflationary episode that becomes more persistent. In any case, we look for the unknowns surrounding trade policy and inflation effects to prompt the FOMC to proceed cautiously. The Committee is unlikely to move in May, and we believe odds favor continued caution in June. Absent a dovish shift by policymakers, we could foresee the Committee remaining on hold until the fall.

PCE Inflation



Source: Bureau of Economic Analysis via Haver Analytics

Decomposition of Core PCE Inflation



Source: Bureau of Economic Analysis via Haver Analytics