The Recession of 2025: Myth or Reality in the Age of Uncertainty

by

Manfred Keil and Mark Schniepp[1]

May 8, 2025 - A host of important economic statistics became available last week to give us insights into the current state of the U.S. economy. There was negative (annualized) quarterly growth of real GDP, with output shrinking by 0.3 percent. The unemployment rate remained unchanged at 4.2 percent but job numbers showing a better than expected increase of 177,000. Finally the yearly inflation rate fell slightly towards the Fed's target judging by both the Federal Reserve's preferred measure and the headline making consumer price index (2.3 percent and 2.4 percent respectively).

This gives us a mixed picture and does not yield a clear answer of where we are heading. Certainly these statistics alone do not justify forecasts of a downturn later in the year. It is the uncertainty that has raised the prospect of recession in 2025. The so-called *soft-landing* (reduction in inflation without causing a recession) is still a possibility, and the dreaded stagflation scenario (stagnating output coinciding with inflation) has not materialized, yet.

Some have pointed to the fact that the negative growth in GDP was related to households and firms hoarding imported goods to beat tariff related future price increases. After all, imports rose by over 41 percent (annualized) from the last quarter, which is of an order of magnitude only seen twice over the half century. Unfortunately, this is wrong, since GDP only measures domestic production or aggregate demand for domestic goods (the imported consumption and investment goods are subtracted out by national income accountants resulting in a net effect of zero). To emphasize, GDP is neutral to imports, unless there are measurement errors.

Two quarters of negative GDP growth are commonly perceived as the start of a recession. This suggests that if we observe negative real GDP growth in 2025 Q2, then the recession started in the current quarter. Unfortunately this definition of a recession is false. Instead, it is the dating committee of the National Bureau of Economic Research (NBER) that determines the start and end of recessions, and it does so by month. The Great Recession of December 2007 to July 2009 would not have been labeled such if you went by the "two quarter" definition: there was positive economic growth during the second quarter of 2008. Unfortunately, the NBER typically publishes the start of a recession with a considerable delay: it took the committee 12 months (December

[1] Keil: Chief Economist, Inland Empire Economic Partnership, Associate Director, Lowe Institute of Political Economy, Robert Day School of Economics and Finance, Claremont McKenna College. Schniepp: Director, California Economic Forecast

2008), to date the peak of the previous economic expansion. This does not make it useful to pursue alternative policies or to prepare for a downturn.

One of the earliest signs that we are in a recession will come from the so-called Sahm measure. The statistic, named after a former Federal Reserve Principle Economist Claudia Sahm, compares the most recent three-month average unemployment rate with the minimum three-month average over the previous year. If the difference is greater than 0.5, then a recession has started. There are almost no false positives using the Sahm measure for the post World War II period. The statistic currently sits at close to 0.3 and would require monthly unemployment rate increases of 0.1 percentage points until September 2025 to reach the threshold. Relatively large monthly increases of 0.2 percentage points would be needed to move the starting point of a recession to July 2025. The bottom line: we are currently not in a recession and even another quarter of negative growth is unlikely to generate one.

There are other "sensors" that, similar to a volcano outbreak, predict disaster. The Conference Board summarizes these in a so-called Index of Leading Economic Indicators. The series is a weighted average of such variables as the stock market, housing starts, consumer sentiment index, new orders, etc., and, as a rule of thumb, rings alarm bells of a subsequent recession if it turns south three months in a row. This statistic has remained above the "recession threshold." Finally, 45 percent of economists polled by the Wall Street Journal have forecasted a recession within a year. However, this same bunch felt that a downturn was imminent (63 percent at the time). This became known as the "Godot Recession:" in Samuel Becket's play 'Waiting for Godot,' the messenger repeatedly arrives to announce that Mr. Godot could not make it today but surely would come tomorrow.

Consumers are clearly on edge as the consumer confidence and sentiment indices have fallen to recession territory levels. Given current fundamentals, it is difficult to forecast a reversal in confidence. However, movements in consumer sentiment, even large ones like those seen recently, do not necessarily generate similar moves in real consumer spending. If there were such a correlation, we would undoubtedly be in a recession by now.

The case for a recession in 2025 stems from ongoing uncertainty which is delaying domestic investment decisions (and therefore domestic business spending), and less government spending by the administration to directly address corruption, fraud, and waste. However, domestic consumption - the largest component of GDP and the main driver of growth - is less likely to weaken. This is because consumer spending remained resilient in the first quarter and a near fully employed labor market continues to support household incomes, enabling continued consumer spending throughout the year.

The resilience of consumer spending, amid contractions in domestic investment due to prolonged uncertainty and government spending from overdue government downsizing, could result in more quarters of negative GDP growth this year, potentially prompting the NBER to declare a recession. However, given that consumer spending remains stable, the most likely scenario based on the current evidence is a recession that would be shallow and brief, with its duration limited by the eventual resolution of uncertainty. More likely, the Trump administration's economic policies will diminish the U.S. economy, but not derail it. We also feel that the president will pivot on his policies when it becomes clear that without a course correction, stock prices will decline further, consumers would become so fearful they stop spending, and the economy would suffer a bona fide downturn.