Economic view

July 25, 2025

From the desk of Chief Economist Beth Ann Bovino

Animal spirits in hibernation

Should it be anyone's surprise that Keynesian "animal spirits" are in hibernation as the tariff war weighs on private sector moods. Already high, inflation fears will likely exacerbate after the White House announcements last week on the escalation of the tariff war, but also the One Big Beautiful Bill (OBBB), which adds additional inflationary pressure for the Federal Reserve to fight. Higher prices challenge household and business spending plans, with tentative signs already appearing in the data.

The escalation of the new tariffs announced last week by President Trump, if implemented, would push the effective tariff rate (ETR) over 21%, according to the Yale Budget Lab. We expect some of these tariffs to be reduced, but only to 16%, and over six times its 2024 average. That tax must be paid. Most American businesses currently seem to be absorbing the costs, to hold onto customers. But, according to the Beige Book, some are passing it on. We estimate that the average household would lose $2,100 from a 16% tariff tax.

President Trump's OBBB was also passed by Congress last week – the same week the Treasury Budget saw its first monthly surprise in eight years (June 2017). OBBB is predicted to add nearly $3 trillion to the U.S. federal debt over a decade, according to the Congressional Budget Office's (CBO) updated cost estimate, largely by cutting tax revenue, with nearly three-fourths of the impact in the first four-and-a-quarter years, as it reportedly "front-loads tax cuts and spending increases while delaying savings." They found that debt would rise to 124% of GDP in 2024 under the bill as written, with little change when accounting for economic effects. While not yet seen, higher debt levels could eventually undermine confidence in U.S. government debt and diminish the dollar's status in global markets, resulting in reduced investment and higher costs for financing.

We expect OBBB to provide a modest boost to economic output in 2026 but also add to inflation pressures and keep interest rates higher to weaken growth. A government deficit often leads to a private sector surplus, with more money in the hands of consumers. If inflation is moderate and interest rates are low, the cost of servicing the government debt would be manageable. But today, dollar for dollar, the cost of servicing debt has grown significantly over time and is now larger than the cost of funding defense. As interest payments grow, less money is available for other government services, like education and infrastructure, negatively impacting long-term economic growth. It can also crowd out private investment as the government competes for available credit.

With interest rates staying higher for longer, as we expect, the cost of servicing debt will only grow. By stimulating consumer demand when wages are one-and-a-half times its historic average and the unemployment rate is near its historic low, the bill is likely to spark more inflation in the coming years, forcing the Fed to keep rates even higher to stabilize prices, weakening growth. If the government needs to print more money to manage its debt, inflation will climb higher, squeezing purchasing power even more.

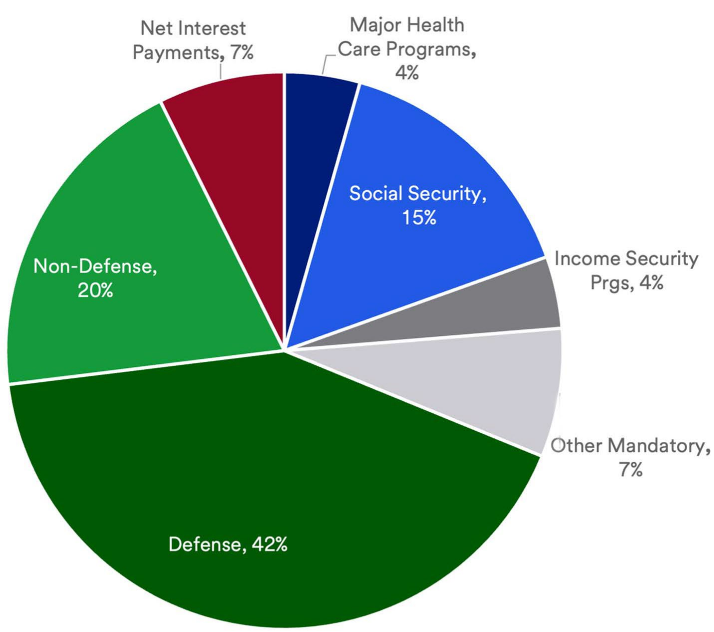
Households have shown signs of trade-war fatigue. After reaching its second lowest reading since 1952 on tariff-related inflation fears, the University of Michigan consumer sentiment index improved recently on announcements of trade agreements, particularly with China, though it remains in recession territory. Consumer spending slowed to a 1.6% pace, in 1H 2025, nearly half the 3.0% pace seen last year. And home buying remains lackluster, as poor affordability remains challenging given record prices and still-elevated rates. This is before the full force of the tariff war is absorbed in people's budgets.

And while managers continue to keep running their businesses with little change to day-to-day operations, the appetite for expanding seems subdued. Business investment in equipment surged by almost 24% in the first quarter as businesses front-loaded orders to avoid tariffs. Core Capital Goods orders, excluding defense and aircraft – a leading indicator for equipment spending – are down 2.1% so far in the second quarter, and well below the 9.2% tariff war-related surge in the first quarter.

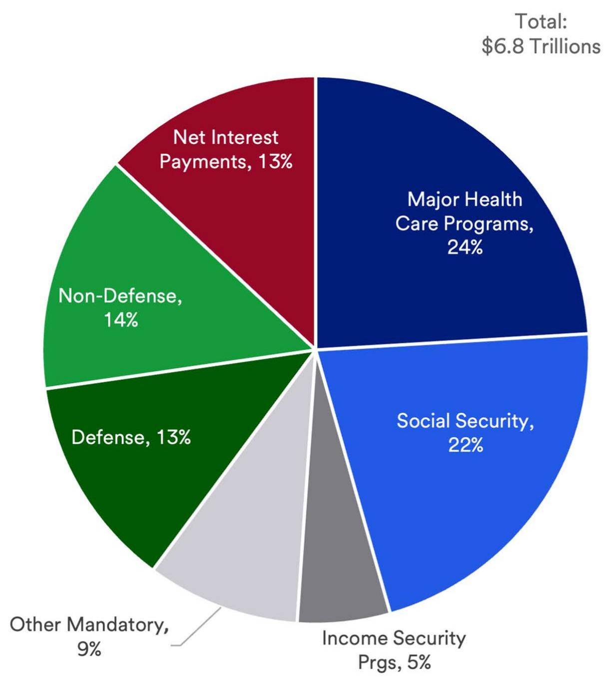
We are still betting on a moderate rise in consumer prices through the fourth quarter with the Fed likely to be able to cut rates starting in September. But this ultimately depends on how far governments will take the trade war this year. And a new challenge will begin as the Fed manages the impact of the new bill on the economy.

The OBBB may give the U.S. private sector a "sugar lift" next year, but at what cost? The U.S. government debt, as a percent of GDP, now dwarfs its previous record of 106%, reached during World War II. With implications for the economy, interest rates, inflation and long-term economic stability and prosperity.

U.S. Federal spending - Fiscal year 1970
In billions of dollars



U.S. Federal spending - Fiscal year 2024
In billions of dollars



Disclosures

The views expressed in this commentary represent the opinion of the author and do not necessarily reflect the official policy or position of U.S. Bank. The views are intended for informational use only and are not exhaustive or conclusive. The views are subject to change at any time based on economic or other conditions and are current as of the date indicated on the materials. It is not intended to be a forecast of future events or guarantee of future results. It is not intended to provide specific advice. It is issued without regard to any particular objective or the financial situation of any particular individual. It is not to be construed as an offering of securities or recommendation to invest. It is not for use as a primary basis of investment decisions. It is not to be construed to meet the needs of any particular investor. It is not a representation or solicitation or offer for the purchase or sale of any particular product or service. Investors should consult with their investment professional for advice concerning their particular situation. The factual information provided has been obtained from sources believed to be reliable, but is not guaranteed as to accuracy or completeness. U.S. Bank is not affiliated or associated with any organizations mentioned. U.S. Bank and its representatives do not provide tax or legal advice. Each individual's tax and financial situation is unique. You should consult your tax and/or legal advisor for advice and information concerning your particular situation.