

FOCAL POINT

US: controlled slowdown with two-sided risk from AI

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Our Focal Point series explores topical issues on macro, markets and investment

- The US economic momentum is clearly slowing, with labour market softness emerging even before tariffs fully bite. Early next year, waning trade uncertainty and tax cuts should lift investment and consumption, but growth will remain subdued. High long rates will likely offset the boon from lower Fed rates.
- We forecast GDP to rise by 1.7% this year and next—still modest, but recession risks are relatively low (30%). Tariff-induced inflation is creeping higher, but corporate strategies and recent trade deals have curbed some of the price impact. Nonetheless, service sector inflation remains stubbornly high. Core PCE inflation is unlikely to drop below 3% before mid-2026.
- Risks to growth persist on the household side if the employment slowdown accelerates. The reliance of capex expenditure on AI-related investment, which constituted the bulk of business investment in H1 2025, is a two-sided risk: further growth will lead to stronger (but job-poor) growth, but a negative reassessment of the AI potential could depress capex and demand.
- At the September meeting, the Fed indicated further rate cuts to come, as risks of an unemployment increase have risen relative to that of persistent inflation. Political pressure on the Fed will likely increase, though the voting pattern (only one dissenter) points to willingness among most FOMC members to look for joint decisions in an independent Fed. We expect the policy rate to reach the 3.25-3.5% neutral range by mid 2026. But higher term premia will prevent low policy rates from decreasing borrowing costs much.

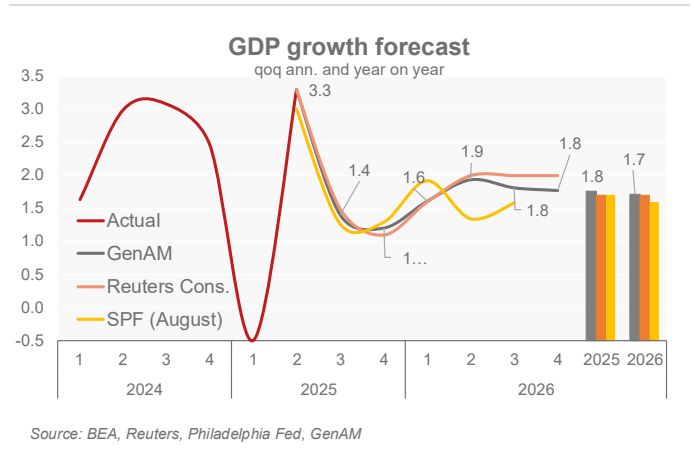
Recent summer data paints a picture of mounting weakness over and above the widely advertised worsening in employment data. Consumer spending is slowing, weighed down by tepid job and income growth. High mortgage rates and supply bottlenecks continue to stifle construction, while investment growth is limited to AI related sectors amid persistent uncertainty. Business and household confidence are low (although the former has picked up slightly), though history suggests this may understate the resilience of domestic demand. The very strong Q2 GDP showing was driven by a payback of the sharp increase in import and

stockpiling seen in Q1 whereas more stable (and informative on the longer-term outlook) components like final sales to private domestic purchasers, continued to show a loss of momentum.

We expect the slowdown to continue in H2, before growth starts to rebound on the back of lower uncertainty, marginally lower borrowing costs and the impact of the tax cuts as well as fiscal incentives legislated in the 2026 budget. Still, we expect the economy to expand by a below trend pace of 1.7% both this year and next, broadly in line with consensus. Growth will be softer, but recession risks look contained. Our

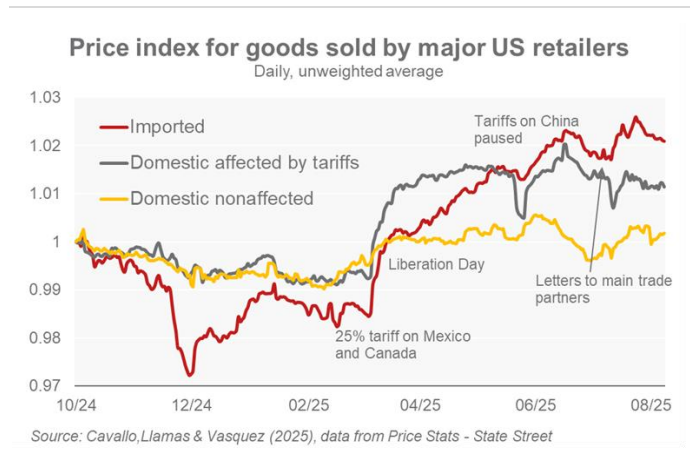
subjective estimate is around 1/3 over the next twelve months, as we argue later, the strength of the private sector balance sheet and the positive impulse from fiscal policy will provide enough cushioning.

We think there are four main key drivers of the US outlook for the next year and a half: first, obviously, the adverse impact of tariffs, secondly the cooling of the labour market, both in terms of demand and supply of workers; both will have a significant bearing on inflation. Third, the growth outlook be affected by the state of the household balance sheet and the fallout of the budget on demand. Finally, the performance of the US economy has been driven largely by AI-related investment, and it is expected to rely on it for a while, which raises the already mentioned two-sided risks.



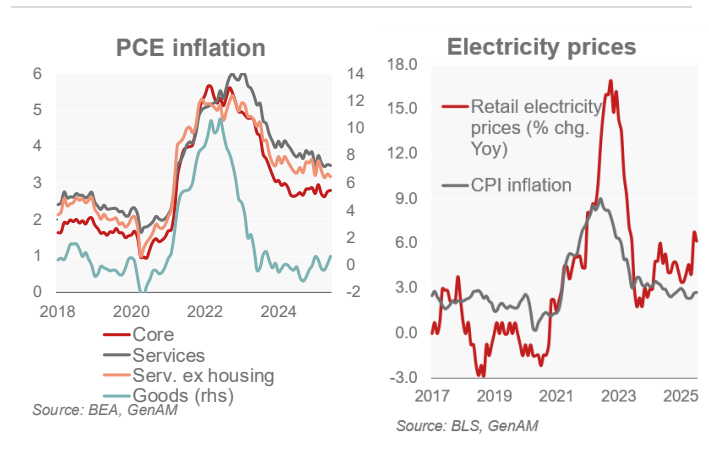
Tariffs start showing up in prices

Starting with tariffs, during the summer deals with the largest trade partners have been announced but, in many cases, (like the EU) these are not yet binding, details are still lacking, and uncertainty may linger for months, which will harm business decisions. Evidence shows that the costs are mainly on US importers rather than foreign exporters. Tariff rates currently remain lower than expected; however, their impact on prices is already apparent, both from high frequency indicators like the one [developed by the MIT and State Street](#) and in the latest CPI and PPI releases.



As of July, effective U.S. tariff rates on imports stand at 8.9%, well below the 17% [calculated by the Yale Budget Lab](#) based on past trade patterns. This gap is driven by trade diversion from China and aggressive inventory management. Fed surveys reveal that businesses are delaying price hikes, often absorbing tariff costs or passing them along through indirect means. Yet these strategies appear unsustainable; mounting cost pressure - evident in both manufacturing and services- will inevitably push more of these costs onto prices, fueling core inflation.

The uptick in goods prices from tariffs compounds slow progress in reducing services inflation. Although housing costs are moderating, non-housing services remain firm, underpinned by resilient demand and sluggish declines in



labour costs. Real-time models show core PCE inflation rising from 2.7% yoy in June to just under 3% yoy by August. As tariff effects filter through, we expect core inflation to close the year at 3.2% yoy, stay above 3% through mid-2026, and only fall to 2.3% yoy by year-end as tariff impacts roll off and softer growth curbs other cost pressures.

A key upside risk is electricity prices that are climbing by nearly 7% yoy as supply struggles to keep up, exacerbated by surging AI-driven demand and policy headwinds for renewable capacity. While electricity's share of the CPI is small—a 10% price rise lifts inflation by less than 0.2 percentage points—increasing bills hit households hard and could further erode consumer confidence.

Both labour demand and supply slow down

The August's payroll report, along with the sharp downward revisions to earlier data, revealed almost no private sector job growth—employment gains depend largely on a handful of non-cyclical sectors like health care. Tariffs are hitting manufacturing, where headcounts have slowed for the last four months. Business surveys show hiring intentions are fading. The labour market is stuck in a "no-hire/no-fire" limbo: layoffs remain at historic lows, but job seekers are finding it harder to get hired. Only 24.9% of the unemployed found work in July, compared to 29.7% at the end of 2022 and more than

27% on average before the pandemic, reflecting both lower hiring appetite and rising skill mismatches.

This is largely due to the slowdown in labour supply, especially among immigrants whose contribution—key in the post-Covid recovery—is dropping quickly following tougher US immigration policy. While native participation has picked up somewhat, an ageing population will cap this. As labour demand weakens, the unemployment rate is likely to peak at 4.5% by mid-2026 rather than trending higher, masking real labour market softening. Tighter labour supply may limit wage deceleration, keeping inflation in labour-intensive services uncomfortably high even as overall growth remains subdued. The output gap will stay tight due to the demographically induced slump in trend growth.

The softening labour market is now curbing real income growth, a trend increasingly evident in the data: by July, real consumption was up just 0.8% from Q4 2024—one of the weakest increases since 2000 outside recession years. While stress is set to persist, we see little risk of a collapse in consumer spending, keeping recession odds relatively low at around 30% for the next six months. Tariff impacts should not trigger a major labour shock; fiscal policy will offer support, and household balance sheets remain solid despite rising delinquencies.

Nonetheless, consumption growth will slow noticeably: from 2.8% yoy in 2024 to 1.9% yoy this year, and to a muted 1.7% yoy in 2026. Downside risks loom, as deeper job losses and further price hikes could erode confidence. Survey pessimism has yet to dent spending, but an extended decline—especially if household wealth drops and uncertainty persists—could prompt a return to pre-Covid saving habits, weighing heavily on demand.

The AI boom keeps capex growing...

Investment played a crucial part in H1 growth, but it is a two-speed process. High borrowing costs and material prices are holding up residential investment, while the strong performance of the non-residential component is driven to a very large extent by AI-related expenditure. Indeed, business equipment spending outside information processing equipment, has been nearly flat over the past couple of quarters.

Data on orders show that Q3 investment will remain bifurcated. While business spending on equipment and intellectual property remains firm — driven by high-tech demand and a surge in nondefense aircraft orders — private construction is faltering. July saw construction spending dip 0.1% mom, with private non-residential outlays falling 0.5% mom. Manufacturing-related building, previously lifted by the CHIPS Act and Inflation Reduction Act, posted its worst

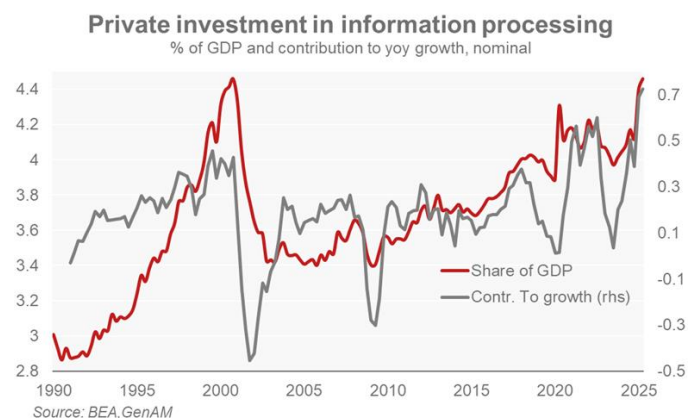
monthly loss this year. Only data-centre construction managed a slight gain.

A turnaround in private residential or business structures is unlikely for the remainder of 2025. Elevated mortgage rates, poor affordability, and softening house prices will keep housing subdued, while non-residential construction suffers from ongoing policy uncertainty. Major manufacturing projects are wrapping up, and the semiconductor boom sparked by the CHIPS Act is fading. Data-centre activity, though positive, won't make up for declining factory construction.

For 2026, new tax incentives may rekindle factory builds and support broader capital spending. As policy clarity improves, firms will likely raise investment to adapt to higher tariffs. Fed rate cuts may help borrowing costs, but a steeper yield curve will likely blunt any gains, especially for mortgages. Overall, capex growth is forecast to slow from 4.3% yoy last year to 2.2% yoy in 2025, with next year averaging 1.6% yoy after a pickup in H2.

...but raises risks of a boom boost cycle

The heavy focus on AI-related capex is a two-sided risk. After the hardware innovation, helped by IRA, companies are now engaged in investment in AI infrastructure and early adoption. Indeed, business investments in digital technologies, which include software, computers, peripheral equipment, and data centres, are as large a share of GDP as in the dot-com bubble, while the contribution to growth is at an historical high.

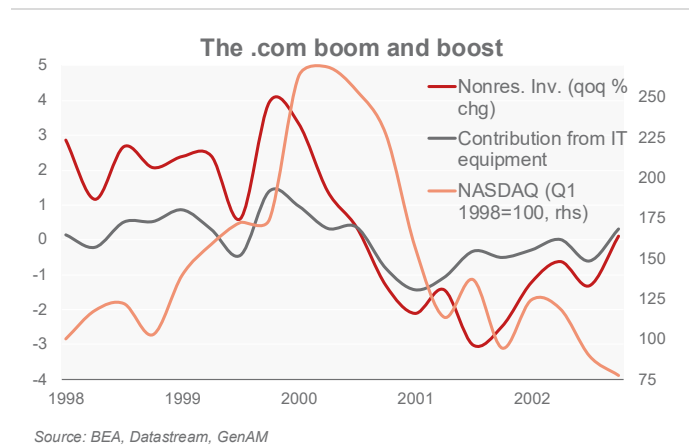


AI adoption rates are increasing but have plenty of room to rise, particularly outside of tech and financial services, which will underpin demand for equipment and software. Analysts' calls show that large tech companies have also increased their capital expenditure plans for next year. An even quicker adoption and higher investment are an upside risk to the capex forecast. Yet, given the very nature of the technology, this extra growth would be poor in terms of job creation and then would fail to offset the weak employment dynamics elsewhere in the economy.

Risks are related to how successful the two final phases of the process are: development of AI-powered software, and widespread productivity gains driven by AI. Business investment hinges on bold expectations for AI-driven productivity, exemplified by the stellar high valuation of tech stocks. Lessons from the PC revolution suggest the benefits may take longer and be less uniform across sectors, risking disappointment and volatile valuations. In August, an [MIT study](#) showing 95% of firms had yet to benefit from AI triggered a brief tech stock correction. While an AI bubble burst is a tail risk for now, the dot-com bust of the late 1990s is a sobering reminder: speculative investment cycles can quickly swing from boom to bust, with sharp consequences for growth.

Concerns about a rapid loss of the Fed's independence eased somewhat after a judge allowed Governor Cook to join the September meeting. This suggests that allegations against her seem unfounded. The decision to cut rates by 25 bps was made with only one dissenting vote — the newly appointed governor Miran who wanted a more decisive cut of 50 bps. So far, the two governors appointed by the previous Trump administration (Waller, Bowman) have rejected calls for aggressive rate cuts and have aligned with the board's traditional, evidence-based approach.

Looking ahead, we expect an additional 75 bps in rate cuts by spring 2026. This would bring the policy rate into the neutral range of 3.25% to 3.5%. However, we believe the benefits of lower short-term rates on economic activity will be less pronounced than usual. Higher risk premia are preventing expected policy rate reductions from resulting in significantly lower borrowing costs. Moreover, the main factors slowing GDP and employment growth are related to supply issues, which lower interest rates alone cannot effectively address.



New tax cuts and incentives will boost activity in early 2025, partly offsetting tariff pressures. Income tax cuts, retroactive to January 1, mean households will see refunds by Q1, giving consumption a short-term lift that could delay core inflation's drop below 3% yoy. Corporate provisions — full expensing of certain investments, R&D write-offs, relaxed net interest limitations, and immediate deduction for manufacturing structures — should further spur spending. We factor in a modest 0.2 percentage point growth bump from these measures, though in a more optimistic scenario, the boost could approach 0.4 percentage points, pushing next year's annual growth close to 2%.

Labour woes tilt the Fed more dovish

At its September meeting, the Fed acknowledged that risks have shifted towards a weaker labour market, lowering the policy rate by 25-and signalling cuts by another 50 bps by year-end. These measures are designed to provide insurance against a potential rise in layoffs. This is particularly important because the labour market currently faces a hiring rate of 3.3%, below the 3.8% mean of the two years before COVID. Unemployed individuals are also finding it increasingly difficult to secure work. The Fed's median dots show further 25 bps cuts for 2026 and 2027.



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