GLOBAL RESEARCH

The Carlyle Compass

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*Welcome back to **The Carlyle Compass**, your weekly newsletter that brings together the latest research and market insights from our global team.*

Ready the Clown Suit

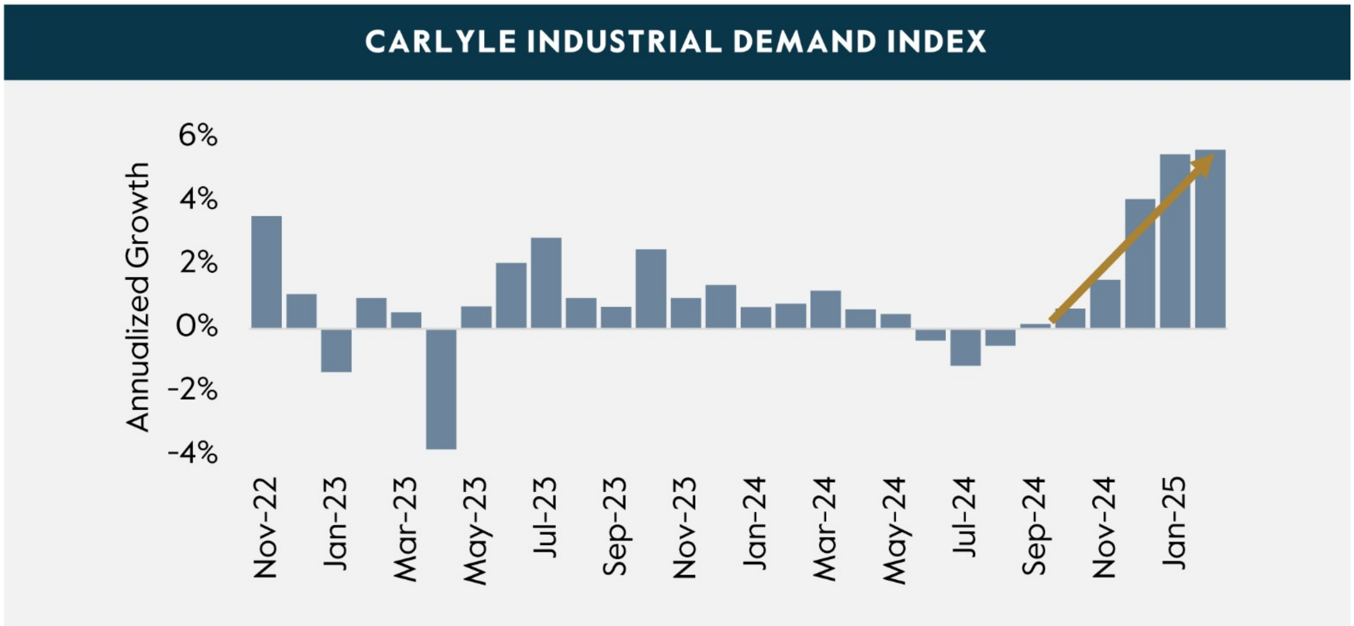
No one likes to furnish economic forecasts when things are this uncertain. Why risk turning today into the yesterday that you're embarrassed about tomorrow? It's safer to throw up one's hands and wait and see. But the greater the potential for embarrassment, the greater the scope for learning. Forecast errors embed valuable information that cannot be obtained without an underlying forecast.

Expect Volatile Official Statistics

The U.S. economy has not buckled under the weight of tariff uncertainty, but the time and attention management teams have devoted to contingency planning has resulted in significant deadweight loss. Last year, the U.S. imported $3.3 trillion of goods (11.3% of GDP) across thousands of different product categories from more than 200 trading partners. A business evaluating its financial exposure to an entirely new tariff regime must consider each product it imports, its country of origin, the range of new tariff rates that could be applied to each country-product pair, the length of time those new tariffs remain in place, and then contemplate remediation steps it could take in each scenario. The 30% (or more) of the day devoted to tariff planning is time not spent thinking about ways to grow the business or enhance operational efficiency.

What sort of drag have these "compliance costs" imposed on productivity and output? The Q1-2025 GDP report due out next month may provide some clues, but don't pay much attention to its headline number. In anticipation of tariffs, management teams frontloaded deliveries of components, parts, equipment, and raw materials (Figure 1). Since imports subtract from GDP, but inventories of intermediate goods do not contribute to it, the result could be an ugly figure that reflects timing shifts rather than underlying fundamentals. Volatility in official statistics will translate to greater volatility in financial markets as some analysts cite the report as confirmation that the U.S. has entered recession.

Figure 1: Management Teams Frontload Deliveries in Advance of Tariffs

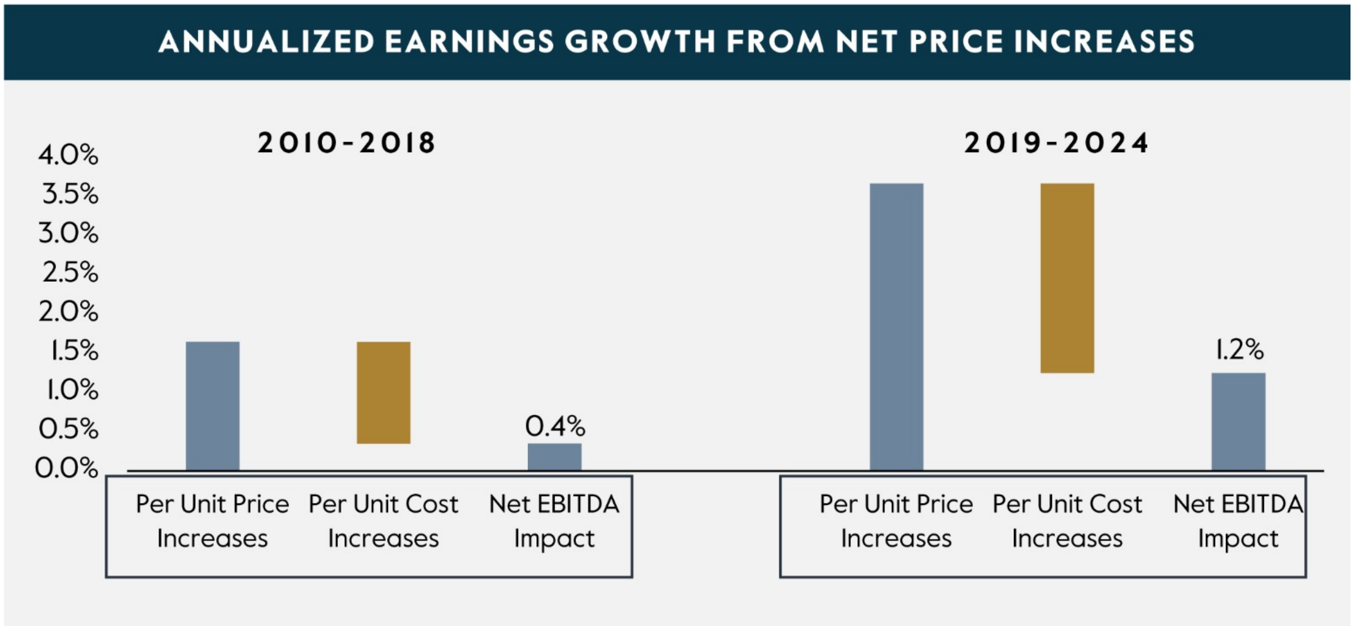


Source: Carlyle Analysis of Portfolio Company Data; February 2025. There is no guarantee any trends will continue.

Tariffs Impose Their Toll

Eventually, the new tariff regime will be unveiled (hopefully the first week of April) and this drag should subside. But the economy will then confront the price shock associated with tariffs, potential retaliation from trading partners, and any adjustment in foreign exchange rates. If we assume the average effective tariff rate rises from about 2.5% to 10%, the shock (measured in terms of the increase in implied tax liabilities) will amount to nearly 1% of GDP. The pandemic and “supply chain crisis” taught management teams how to “push on price” (Figure 2). And AI and pricing algorithms have made them more adept at discriminating across customers based on demand elasticities and switching costs. Headline CPI could rise by as much as 2% in Q2-2025 (8% annualized(!)).

Figure 2: Pandemic Taught Management Teams How to Push on Price



Source: Carlyle Analysis; BEA, March 2025. There is no guarantee any trends will continue.

If this negative real income shock materializes, a "fake" contraction in Q1-2025 may be followed by the real McCoy. But that's when the Fed steps in. A one-time jump in the price level due to tariffs should not deter the Fed from cutting rates, and the magnitude of those rate cuts should be proportionate to the observed deterioration in real activity. As Fed Chair Powell and FOMC Vice Chair Williams have made clear, the Fed most closely tracks "super core" inflation (core services excluding housing), which they believe to provide the clearest measure of the underlying price pressures relevant to monetary policy. Core services inflation will not be directly impacted by tariffs and should fall as consumption and the labor market weaken.

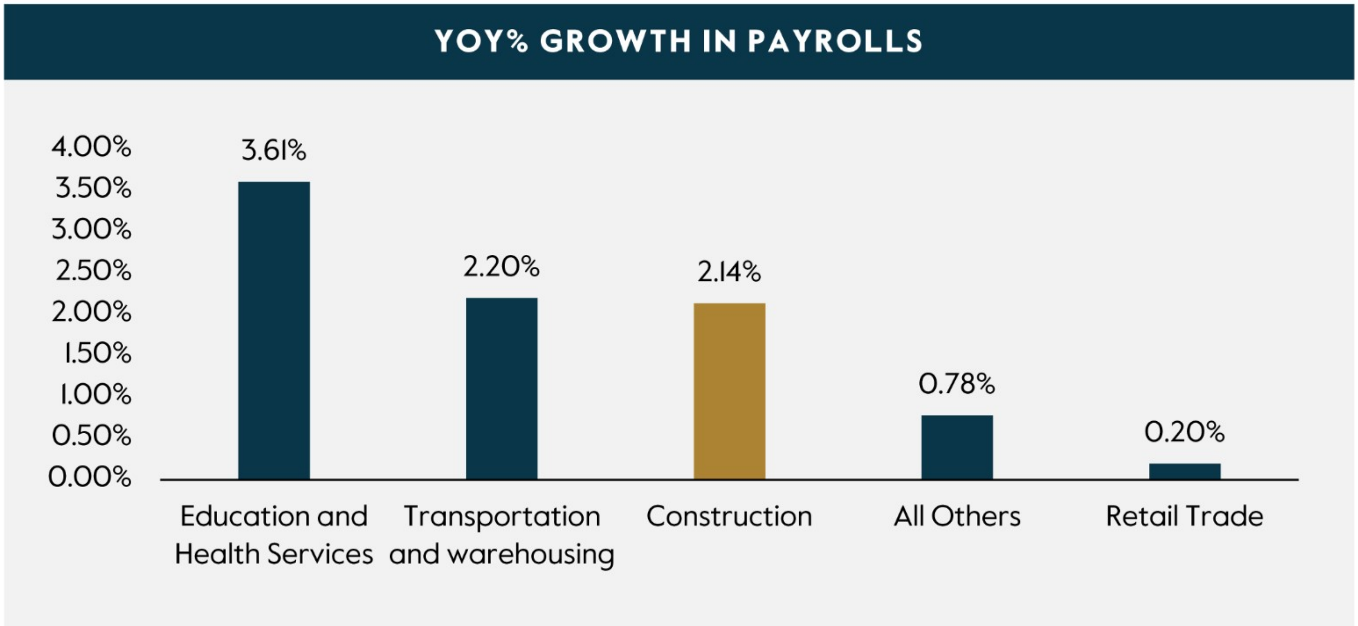
Commentators will be tempted to ascribe these rate cuts to untoward White House influence, but there's nothing unorthodox about "looking through" tariffs as though they're akin to an oil price shock. Don't expect cuts at the May or June FOMC meetings, but a cut in July is possible and one in September looks probable in this scenario. These rate cuts should arrive just as the more stimulative aspects of the Administration's policies come into view. The Administration will have secured working majorities in key regulatory agencies eager to reduce barriers to acquisitions, public listings, and permits. And the parameters of the reconciliation package will be better understood, with net tax cuts an easier sell in a weaker economy.

Through these policy-induced ups and downs, the economy will retain an important secular force at its back: AI and the seemingly insatiable demand for data center, computational, and energy capacity. Nvidia's top *five* customers intend to spend over $400 billion this year alone, up 2.3x from their capital budgets two years ago. And to this one must add the hundreds of billions of dollars of capex announced by Apple, Oracle, and myriad other competitors. As observed in 1998, rate cuts arriving during a concentrated capex boom can prove far more stimulative than rate cuts in other circumstances.

Conclusion

We expect a very bumpy ride to a place that, by year end, looks and feels pretty good. To say there are risks to this forecast would be a colossal understatement; strong convictions in this environment are a clear sign of overconfidence bias. But we continue to believe that the biggest risk is not tariffs or other policy developments but a sudden pullback in AI-related spending, the positive spillovers of which are evident in construction employment (Figure 3), energy development, household income, and many other seemingly unrelated categories. We see no signs of that yet; AI-exposed order books continue to grow at 30% to 70% annualized rates as the road to the future envisioned by technologists remains paved by ever larger and more energy-consumptive GPU clusters.

Figure 3: Data Centers Cause Construction Employment to Grow 2x Overall Payrolls Despite Depressed Real Estate Development



Source: Carlyle Analysis; Bureau of Labor Statistics, March 2024. There is no guarantee any trends will continue.

When you're feeling shy about making pronouncements about the future, just remember: probability doesn't exist. That's not my assertion; that was the view of the two greatest probability theorists of the 20th century. We can neither imagine all of the possible events that could affect the economy over the course of the next year, nor transform them mathematically into objective probabilities. The best we can do is stipulate *conditional* likelihoods, based on our own subjective impressions, and then humbly update them as new information arrives.

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