Moody's Analytics

COMMENTARY
18 February, 2025

Author
Mark Zandi

Contact Us

Americas
+1.212.553.1658
clientservices@moodys.com

Europe
+44.20.7772.5454
clientservices.emea@moodys.com

Asia (Excluding Japan)
+85 2 2916 1121
clientservices.asia@moodys.com

Japan
+81 3 5408 4100
clientservices.japan@moodys.com

U.S. Outlook: Wealth Effect

Asset markets and the economy feel increasingly fragile.

- Americans' rising wealth has been powering consumer spending and the U.S. economy.
- But the forces driving the growth of that wealth are under considerable risk of slowing or reversing.
- Of the possible catalysts for such a reversal, the most likely and immediate are U.S. tariffs and a resulting global trade war.

U.S. asset prices are at best richly valued, even overvalued, bordering on frothy. Stock prices and housing values have never been higher, corporate credit spreads never thinner, and gold and crypto prices are soaring. This has made enough Americans wealthy to power consumer spending and the economy. But given the stretched valuations and the heightened economic policy uncertainty, the risk of a significant correction in asset markets is uncomfortably high and rising, with clear implications for the economy.

Losing its luster

The economy appears to be losing some of its luster. The January economic data indicate that growth is throttling back. Retail sales and manufacturing production fell, and job growth was uninspiring. It is still early, but real GDP growth in the first quarter is tracking closer to 2% than the near 3% growth enjoyed last year. Moreover, the disinflation from the pandemic and Russian-war-induced surge in prices also appears to be over, at least for a while. Consumer price inflation jumped in January with surprisingly big price increases across many goods and services.

Measurement problems may be a factor in the disappointing data. The burst in CPI inflation could be overstated as many businesses raise prices at the start of the year. The Bureau of Labor Statistics seasonally adjusts the data to account for this, but it is tough to get it right, particularly in the topsy-turvy wake of the pandemic. There are also some idiosyncratic factors such as the Avian-flu impact on egg prices and the jump in motor vehicle insurance rates. The Los Angeles wildfires and other weather events also may be playing a role. Regardless, prices were up strongly too broadly to result only from measurement issues and natural disasters.

It also would not be surprising if the economy takes a step back from its strong performance of the past couple of years. The economy benefited from a pickup in productivity growth that is proving to be at least in part temporary. Workers who quit their jobs during the Great Resignation landed better jobs more suited to their skills and interests, lifting their productivity. This likely provided a one-time productivity boost.

Labor force growth is also moderating. The immigration surge put enormous strains on many communities across the country, but one economic benefit is that many of those immigrants quickly applied for and went to work. But with President Biden's crackdown on asylum seekers last summer and President Trump's aggressively anti-immigrant policies quickly going into effect immigration is way off and so too is labor force growth.

Productivity and labor force growth determine the economy's potential growth and, with the economy at full employment, its effective speed limit. Growth must moderate more or less consistently with the slowing in the economy's potential, or inflation and interest rates will increase.

Policy uncertainty

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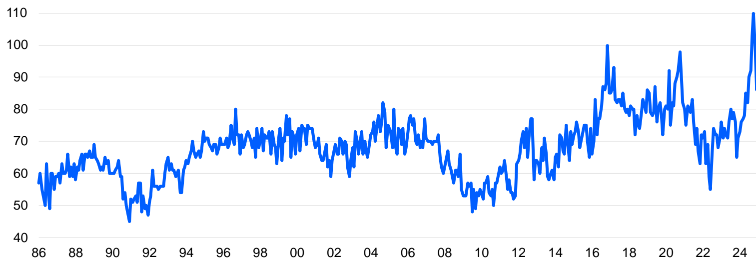
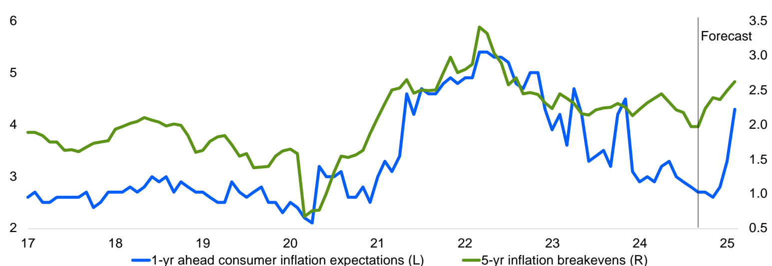
The turn in the economy's performance may also be due in part to the hard shift in economic policy under Trump. The president is moving quickly on policy fronts from tariffs and immigration to fiscal policy and government layoffs and funding cuts. The resulting drama, and in some instances chaos, is creating substantial uncertainty.

This is evident in the small business sentiment survey conducted each month by the National Federation of Independent Business. There is a clear political bias in the survey results—it skews Republican—so it is not surprising that sentiment has decidedly improved since the election. What is surprising is the jump in the survey's uncertainty index, which measures the number of "don't know" and "uncertain" responses. In the most recent survey, this index was its highest in history, save for a couple of months leading up to the election.



Businesses have good reason to be highly uncertain given the Trump administration's messy tariff policy and the prospects for a global trade war. Then there are the haphazard Department of Government Efficiency cuts to government jobs and spending. These moves are on-again, off-again given the inevitable court challenges. And all this is before the immigration restrictions are fully implemented and what is sure to be high legislative drama over tax and spending policy and how to handle the Treasury debt limit. Policy uncertainty, at best, casts a pall over business investment and hiring decisions, and if it lasts for long, it becomes a corrosive on the economy's performance.

Another economic side effect of Trump's tariff and other policies is higher inflation expectations. Both global investors and American consumers are discounting higher inflation dead ahead.



Five-year inflation breakevens have been rising since September, when Trump's lead in the election polls and betting markets gained momentum. Consumer expectations of inflation in the coming year have increased even more sharply recently, according to the University of Michigan's survey. This is especially telling as oil and gasoline prices—often a key consideration in setting inflation expectations—have remained low.

The higher inflation expectation may already be affecting actual inflation. Vehicle dealers reported a spurt in sales as worried buyers look to get ahead of any tariff increases. President Trump has consistently called out vehicle imports as a target for higher tariffs. Not surprisingly, the dealers have used the opportunity to pare back price incentives, effectively raising prices.

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Wealth effect

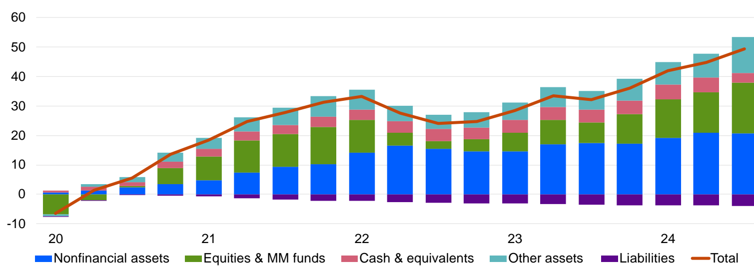
Despite the Sturm und Drang over policy and the developing economic fallout, investors are still nonplussed. Stock prices are flirting with record highs on an almost daily basis, and the Standard & Poor's 500 stock index has doubled in the five years since just before the pandemic hit. That's a stunning well over 13% annualized gain. There are only a half dozen other times in the index's history from the late 1800s that the market has posted such a consistently strong performance.

House values have also taken off. The Moody's Analytics repeat-sales national house price index is up more than 50% since just before the pandemic, an annualized gain of close to 9%. House price gains have cooled with the recent runup in mortgage rates and the resulting hit to affordability and demand, particularly in the South and West where prices had previously runup the most and homebuilding has been stronger. Even so, national house prices continue their march to record highs.

Surging stock prices and house values have fueled a remarkable increase in household wealth. Household net worth—the difference between the value of what households own and what they owe—has increased by an estimated $56 trillion since just prior to the pandemic. This, in turn, has unleashed a powerful wealth effect.

Increasing Household Wealth Supercharges Spending

Household net worth, change from 2019Q4, $ tril

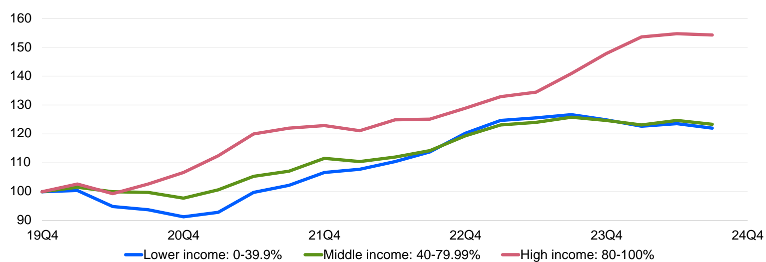


Sources: Federal Reserve, Moody's Analytics

The wealth effect is the change in consumer spending that is driven by a change in household wealth. The reasoning is straightforward. Wealthier households are financially more secure and thus more able and willing to spend from their income. That is, they save less than they would otherwise. This is consistent with our estimates of consumer spending by income group, which shows the well-to-do in the top quintile of the income distribution powering the recent growth in spending.

The Well-To-Do Power Consumer Spending

Personal outlays by income group, 1999Q4=100



Sources: BLS, Moody's Analytics

The wealth effect can vary considerably, depending on whether asset prices are rising or falling, which assets are appreciating or depreciating in value, and the volatility in price changes. A good econometrically based rule of thumb is that a sustained and broad-based appreciation in asset prices like we have been enjoying is consistent with a wealth effect of two cents. That is, for every $1 increase in net worth, consumer spending ultimately increases by two cents.

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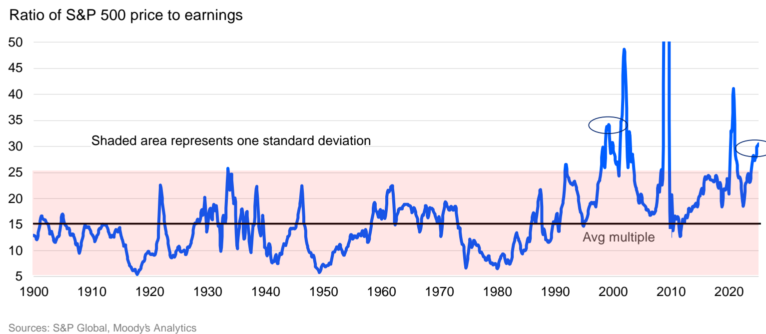
This seems insignificant at first blush, but do the arithmetic. Last year, the wealth effect added a full percentage point to consumer spending growth and over 0.7% to GDP growth. An outsize approximately one-fourth of the growth in GDP last year was due to greater household wealth.

Stretched valuations

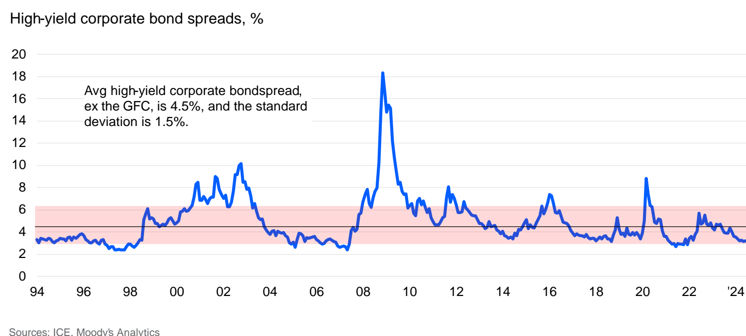
Thus, if asset prices continue at the very least to hold their own, the wealth effect will fade, and consumer spending and overall growth will moderate. This is the Moody's Analytics baseline or most likely outlook. However, given stretched asset price valuations, the threats to this sanguine outlook are consequential.

Take valuations in the stock market. The price-earnings multiple on the S&P 500 based on trailing earnings is well over 30 times. This is almost double the average multiple over history, and aside from the financial crisis and pandemic shutdowns, when corporate earnings cratered, the market's PE was only higher once before, during the dot-com bubble.



Times are different, as the handful of technology companies powering the current stock market run are minting profits and riding a rare technological wave. Nonetheless, the rest of the stock market is also richly (over) valued.

Stretched valuations are also clear in the corporate bond and structured finance markets. Spreads—the difference between the yield on these fixed-income investments and Treasury yields—are about as thin as they have ever been. These spreads are the compensation investors demand for the credit and liquidity risks they are taking compared with Treasuries. Consider, for example, that the spread on high-yield (or below investment grade) corporate bonds is about half its historical average. It was narrower briefly once before—just prior to the Global Financial Crisis.



There are compelling reasons why asset price valuations should be high. After all, businesses are making lots of money and outside of private equity deals have done a good job managing their leverage. Many also did an admirable job locking in the very low interest rates that prevailed at the height of the pandemic and are thus more insulated from the adverse financial impact of the now higher rates.

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However, it is reasonable to worry that investors are becoming overly cavalier in their assessment of the risks. Consider the recent hysteria over Trump's newly minted meme coin. This is a cryptocurrency unveiled by the president on social media soon after his inauguration. Its price at once rocketed to more than $70 a coin, and while it has been swinging wildly since, it is currently trading at close to $17. Despite the slide in price, the total market capitalization of the coin is still an eye-popping $3.4 billion. This is unadulterated speculation—like Dutch tulip bulbs or Beanie Babies on steroids. It is tough to see other asset markets completely inoculating themselves from this greater-fool mania.

Catalyst for a correction

While asset markets are stretched and vulnerable to a significant correction, a correction needs a catalyst. Asset prices supported by momentum investors do not cave under their own weight. They need a push, although the more stretched the valuations the softer the push needed. A bum earnings report from one of the high-flying tech companies might be sufficient or a geopolitical misstep.

However, most likely, most immediately are U.S. tariffs and a resulting global trade war. Trump's recent endorsement of reciprocal tariffs stands out. The U.S. will broadly impose higher tariffs based on its determination of the value of the tariffs and other non-tariff trade subsidies and restrictions imposed by other countries. It looks increasingly as though Trump is looking to tariffs as an ongoing source of revenues. If so, other countries are more likely to retaliate with their own tariffs and trade restrictions. Publicly traded U.S. companies recently reporting their fourth-quarter earnings are taking note and planning for a trade war. Those companies with exposure to a trade war have no plans to increase their capital spending, while those that do not are planning mid-single-digit increases.

Investors continue to hold to the belief that Trump will not follow through on broad-based tariffs, or that if he does, he will quickly pull back on them if the stock market and economy begin to stumble. That was his modus operandi in his first-term trade war. But a hall of mirrors syndrome may be taking hold, where the president is looking to the stock market to decide how far he can take the trade war, while stock investors are holding on, thinking the president will relent in time to save them from losses. This is a fragile dynamic. And fragile is increasingly a good way to describe how asset markets and the economy feel.

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