Economic Update
Q2 2025

Tariffs, trade and tension


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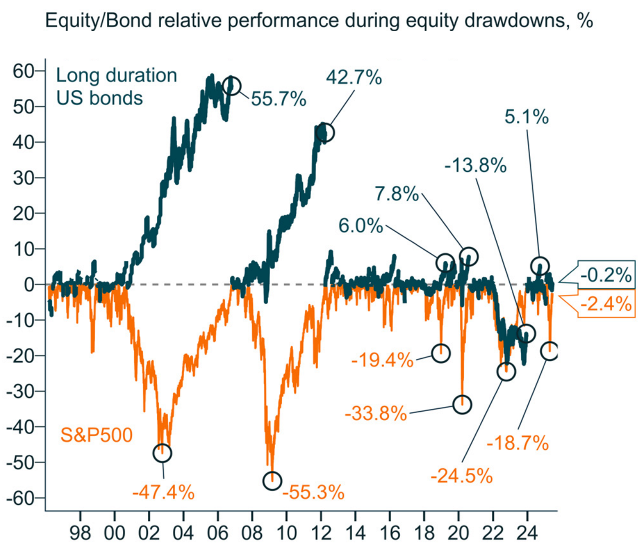
Equity markets recoiled in the aftermath of 'Liberation Day' but it was a reversal in the bond market that saw the Trump Administration reassess. Equities have rallied since then on incrementally better news flow, but uncertainty still clouds the economic outlook. Bond markets face their own challenges as yields edge higher due to stagflation and fiscal risks in the US.

GLOBAL: Tariff turmoil

It has been a quarter of market volatility and uncertainty, hitting equity and bond markets alike. The frenetic pace of announcements from the US Administration that had characterised its opening months in office culminated in what was dubbed 'Liberation Day' – the indiscriminate implementation of across-the-board tariffs on goods imports coming into the US. This initial position was both poorly thought through and likely a shock and awe gambit by the Administration to land the first blow in what it envisages to be an 'America First' trade regime. Predictably, given the negative impact on the US economy, equity markets sold off sharply in the US and globally. This was at first viewed by the Administration as the price to pay for the trade reset, but the reaction of the bond market eventually made the Administration flinch. This reversed gains in bonds, with yields briefly dipping below 4%, as markets again were forced to consider a stagflationary environment in the US. Since then, news of tariffs has become incrementally 'less bad'. Even the ratcheting up of tariffs between the US and China, that briefly saw tariff rates reach levels that would have effectively all but halted trade between the two nations, have been wound back. The news flow supported a recovery in equity markets that seems to suggest markets expect the situation to incrementally improve – despite for the most part only delays in tariffs being promised.

GRAPH 01 **US EQUITY & BOND PERFORMANCE**



Source: IFM Investors, Bloomberg, via Macrobond Note: S&P500 TR US$ index, BBG Agg US bonds 10yr+

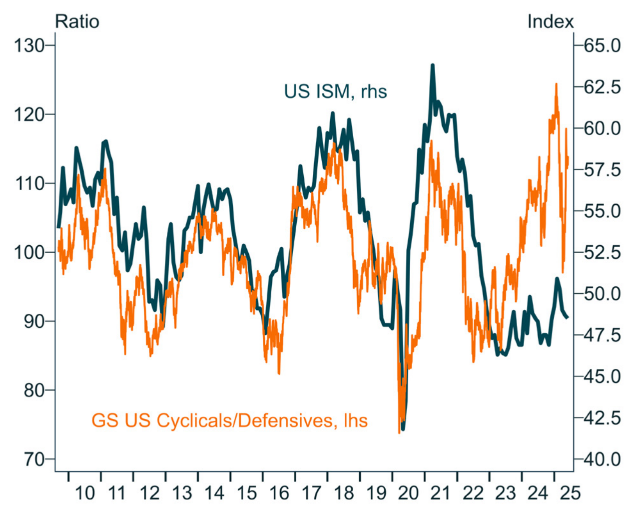
The assumption of positive news flow is being challenged as we write with the Administration threatening 50% tariffs on the European Union for not negotiating with the US in what was perceived as an appropriate manner. This is a timely reminder that uncertainty remains elevated and that at literally any moment an announcement may come that changes the environment again - for better or worse. This is a key point as uncertainty will slow or halt economic activity and investment This will have an impact on the real economy. The increase in prices that will come will erode household real incomes and subsequently spending. Yet this is not the only concern for households. As markets have reduced expectations of Fed easing due to inflation concerns; fiscal spending has become an issue (as detailed in the US section) attracting a credit downgrade from Moody's; and amidst soft demand in at least one auction of Treasuries, long end bond yields have remained elevated. This has meant 30-year fixed rate mortgages have also held at an elevated level, frustrating any recovery in dwelling starts and home sales. Further, the effective mortgage rate has crept higher and sits at 4.1% the highest level since 2013, potentially weighing on household consumption.

Uncomfortably high term rates are another factor weighing on US economic growth. And while recession probability for the 12 months ahead is assessed at 40% the forecast for growth in the US is relatively sanguine. Consumer spending growth is expected to be soft but not negative in coming quarters, and private investment will likely turn negative in the short term given uncertainty. Imports are set to turn sharply negative in the near term which will add to growth. This outlook paints the picture of near-term economic weakness accompanied by a modest rise in the unemployment rate but fiscal and monetary tailwinds (despite the Fed's stagflation risk) supporting growth late in the year and into next. Our view is that this outlook discounts the downside risks a little too much, or at least is pricing in ongoing optimism on the direction of news flow, notably the winding back of tariffs, trade deals being done bilaterally, legal actions and further extensions of deadlines.

A modestly more cautious economic view suggests that earnings on US equities are also optimistic. It is clear equities are not pricing recession. Consensus earnings per share (EPS) is modestly lower for the first half of this year but rebounds strongly in the second half and into 2026, 12-month forward EPS growth is still around 8%. A more negative economic outlook or prolonged period of softness suggests that risks are more skewed to the downside. If this more pessimistic view proves correct market gains may be subdued (as has been the case in recent weeks with the 'good news' rip higher fading somewhat). As noted in these pages last quarter, even with the pull-back from February's peak, equity market valuations continue to appear expensive given the current economic outlook - let alone a softer one (as evidenced in GRAPH 02). Further, the equity risk premium remains negative and is almost two standard deviations below its mean since 2002 – investors are not being compensated for the risks they are taking.

Starting yields in fixed income remain attractive but are not without risk. As noted earlier the long end of the curve has steepened materially, but arguably more due to investors' concerns around fiscal discipline and stagflation than expectations monetary easing will lead to better economic outcomes. This has been underpinned by the re-emergence of the term premium. The question is whether bond yields will continue to rise, particularly if the economic outlook justifies the Fed easing rates. While the credit space offers a yield pickup, we suspect spreads in high yield (HY) also discount the risk of weaker economic outcomes. That said HY credit has belied the default cycle in recent years with spreads tightening as defaults have risen. This may lead investors to investment grade (IG) credit where there is an expectation of outperformance against treasuries whilst taking some risk off the table compared with HY. One caveat here being that larger companies in the IG space may be those, for example multinationals, most exposed to uncertainty in global trade. More defensive sectors of both equities and fixed income, such as utilities and infrastructure, seem attractive in the current environment.

GRAPH 02 **CYCLICALS/DEFENSIVES RATIO VS US ISM**



Source: IFM Investors, Goldman Sachs, Bloomberg, ISM, via Macrobond.

Key takeaways

Economic Growth
Ongoing downside risks to global growth, notably in the US. US stagflation risks, most others disinflation risks.

Geopolitics
Uncertainty remains extremely high based on announcements from US Administration.

Equity markets
Earnings still discounting economic downside

Fixed income
Starting yields attractive, HY credit also discounting economic risks

AUSTRALIA: Sticking the soft landing

The government handed down its 2025-26 Federal Budget in May that saw fiscal metrics swing back to an underlying deficit of $27.6bn in 2024-25 before widening to a deficit of $42.1bn in 2025-26. As a pre-election Budget (an election comfortably won by the incumbent), cost-of-living measures were the centrepiece. Indeed, banked windfall gains (from stronger employment growth and commodity prices) were used to support household incomes notably through a surprise tax cut for every Australian, bulk billing initiatives and an extension of energy rebates. The trend of policy initiatives being moved 'off budget' continued, the focal point here being student debt relief. There's little doubt this budget will further underpin the all too prominent impact of public demand in the Australian economy for some time to come.

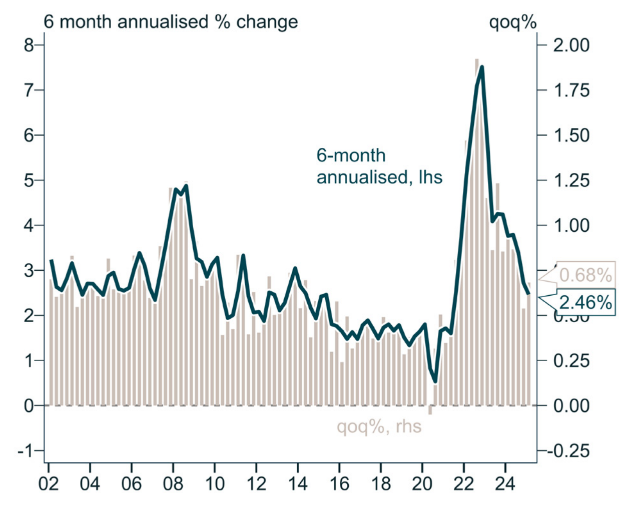
This is also felt in the labour market that continues to add jobs, most notably in government-aligned sectors. April saw an 89,000 person increase in employment which was after a contraction of 56,000 in February due to some demographic volatility. Further, the election may have had some impact with the Australian Electoral Commission thought to have hired around 100,000 temporary workers in the lead up to the May 3rd ballot which may see some downside to the June print. Nonetheless the jobless rate tracked sideways at 4.1% as the participation rate rose materially to 67.1%. While the labour market remains solid, simultaneous progress on disinflation continued to be encouraging for the Reserve Bank of Australia (RBA). In Q1, the policy-relevant trimmed mean measure was 0.7%qoq, a tenth above consensus but in line with the RBA outlook with ongoing disinflation over a range of market services and continued cooling across housing categories. The annual gauge has dipped into the RBA's target band at 2.9%yoy and promisingly is running at the midpoint of 2.5%yoy on a 6-month annualised basis. What's more, while wages firmed in Q1 (0.9%qoq, 3.4%yoy) the outcome was in line with the Bank's outlook and an ongoing, albeit gradual, moderation in vacancies-to-unemployed persons is suggestive of further wage disinflation.

Against this domestic backdrop, the RBA lowered the cash rate by 25bps to 3.85% in May in line with market expectations. The statement has evolved in an incremental manner to become more confident that the key measures of inflation will sustainably be at or around the mid-point of the Bank's target range. The Bank sees the risks around inflation becoming more balanced with solid economic performance and a strong labour market being balanced by disinflation impacts from China and concern about uncertainty in the global economy due to trade tensions. On the balance of risks the Bank can ease policy at a measured pace. There's no emergency it needs to address and we think it will proceed on that basis with cuts in August and November – and little need to move policy settings beyond what might be considered a neutral rate.

The Australian economy expanded by just 0.2%qoq and 1.3%yoy in the March quarter - slipping back into negative territory on a per capita basis, (now recording a negative per capita outcome in 9 of the last 11 quarters, with per capita GDP declining a total of 1.7% over that period). The Statistician attributes at least some of the weakness in overall growth to extreme weather events, but the underlying pulse of growth more broadly is clearly still weak.

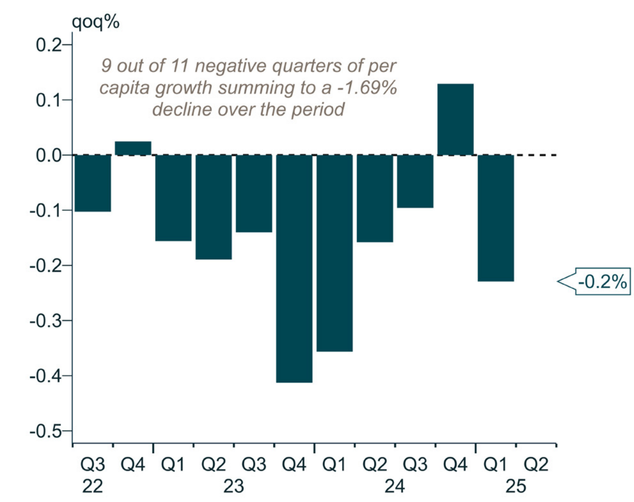
What's clear is that modest acceleration in the year-ended growth rate from the nadir reached in Q3 2024 has stalled. The result underwhelmed the RBA's relatively modest quarterly expectation of 0.45%qoq growth and 1.8%yoy. The Bank now needs 0.7%qoq in Q2—a rate not seen since Q2 2022. This outcome adds to the case that it is appropriate for the RBA to ease policy settings further. However, for now, taken together with a tight labour market, it supports the Bank's assertion that there is currently no need to move to an "expansionary stance." Our slide deck detailing the national accounts result can be found here.

GRAPH 03 **TRIMMED MEAN INFLATION**



Source: IFM Investors, Australian Bureau of Statistics, via Macrobond

GRAPH 04 **PER CAPITA REAL GDP GROWTH**



Source: IFM Investors, Australian Bureau of Statistics, via Macrobond.

US: Await the hard data

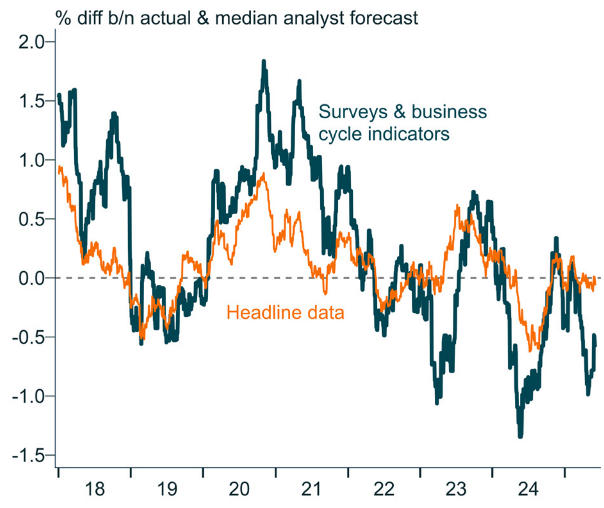
While leading indicators are suggestive of an imminent slowdown, the negative print on Q1 real GDP (-0.2%qoq saar) was unduly impact by the anticipation of tariff announcements rather than the announcements themselves. It was imports surged in the quarter prompting the largest net export drag observed in the modern series. What's more, an uptick in imports is usually offset by stronger consumption and inventories which was not seen in Q1. Difficulty in measuring inventories (which are not taxed) relative to imports could lead to upward revisions. That said, personal consumption decelerated from 4.0%qoq saar to 1.2%, partially explained in part by extreme weather impacts. Private investment was a bright spot up sharply (24.4% qoq saar) by equipment investment (imports likely to beat tariffs) amid data centre buildouts and a resumption of activity at Boeing after strikes.

Going forward we expect some deterioration in the hard data but suggest the market economist 40% probability of recession is a touch high. Policy uncertainty and expectations of price increases have worked to undermine consumer confidence posing a downside risk to household spending. Meanwhile, corporate earnings expectations have deteriorated, as firms brace for margin compression as input costs rise and firms pass up growth opportunities. The latter is set to reverse recent momentum in investment with a significant downturn across regional Fed capex surveys suggesting firms are 'sitting on their hands' rather than deploying capital.

That said, the Fed has been resolute in its determination to focus on 'hard data' rather than sentiment (which have diverged recently see GRAPH 05). Indeed, the funds rate was left unchanged at 4.5% in May with Chair Powell pushing back against the notion of pre-emptive cuts. The statement did however acknowledge that "risks of higher unemployment and inflation had risen". Our read is that the Fed will be late to cut this cycle as it looks to await clarity in the activity data and labour market. At a glance, underlying growth has held up to date, disinflation progress continues with a headline PCE outturn of 2.3%yoy in March (prior: 2.7%yoy) and the labour market is yet to deteriorate. Indeed, payrolls accelerated from a monthly average of 133k in Q1 to 177k in April with the jobless rate steady at 4.2% offset by a higher participation rate. Although context matters, a (hard) data-dependent Fed will remain watchful.

Against this backdrop, Republicans managed to pass a permanent extension of first-term tax cuts in the House. The initiative, dubbed 'big and beautiful' by the Administration is expected to add $3.3 trillion to national debt over the next decade, reaching a post war high relative to GDP according to the Congressional Budget Office. Despite the likely pushback from 'fiscal hawks' among Republican Senators, initial progress in the House sparked a sell-off in the bond market with yields soaring at the long end of the curve. This came after Moody's stripped the US of its top tier credit rating, highlighting increases in government debt levels were 'significantly higher than similar rated sovereigns'. The selloff spilled into other markets, coinciding with a 'buyers strike' in Japan where life insurers failed to absorb

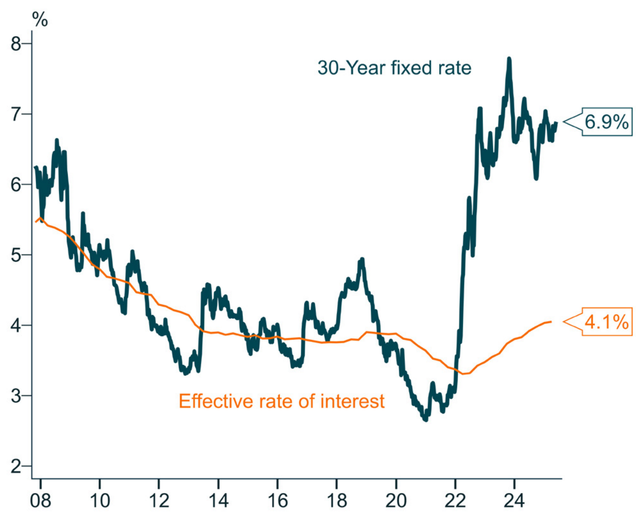
GRAPH 05 | **US ECONOMIC SURPRISE INDEXES**



Source: IFM Investors, Bloomberg, via Macrobond.

residual demand as the BoJ began tapering bond purchases. In the US, the shorter end of the curve fared relatively well, signalling investors are more concerned about an economic slowdown in the short term while concerns around fiscal largesse and inflation have supported a rise in term premia at the long end. Concerningly, the latter tightens financial conditions for businesses and for households supports higher mortgage rates. Indeed the effective interest rate has already climbed to its highest level in over a decade, another headwind for the consumer. Our view is that there's risks to US growth throughout 2025 before the prospect for improvement into next year.

GRAPH 06 | **NEW AND EFFECTIVE RATE ON US MORTGAGES**



Source: IFM Investors, Bureau of Economic Analysis, Freddie Mac, via Macrobond.

UK & EUROPE: Deals & diplomacy

In the UK real GDP growth came in a touch above expectations for Q1, expanding 0.7%qoq. This was on positive net trade, gross capital formation and household consumption, while public consumption subtracted from growth materially. Leading indicators point to a trade tension induced slowdown in Q2, with declines in services and manufacturing PMI subcomponents pulling the headline measure to its lowest level in 50 months. Further, the new export orders measure contracted deeply to a level not seen since the GFC. However, the outlook may prove to be less pessimistic after the Trump Administration struck a preliminary trade deal with the UK (the first of its kind) in May which sees a baseline 10% tariff remain in place but scaled back sectoral tariffs on autos, steel and aluminium.

The Bank of England (BoE) lowered the policy rate 25bps in May in what was a relatively 'hawkish' cut. The decision was described as 'finely balanced' in the minutes with votes going 5-4 in favour (2 for a hold and 2 for 50bp cut), but the range of opinions was clearly quite broad. Nonetheless, the minutes reiterated that a 'gradual and careful approach' to removing monetary tightness was appropriate. What followed was a significant upside surprise in the April inflation print with the headline measure expanding 3.5%yoy (consensus: 3.3%) and the services gauge increasing 5.4%yoy, materially higher than the BoE's 5% forecast. A key question for the BoE is whether it views the reacceleration in inflation as transitory or a signal that underlying inflation is uncomfortably high. What is concerning for the Bank is that despite weakness in PMI data, retail sales have been robust, expanding 1.1% in April. It may be that this strength reflects a coming turnaround in consumer confidence following a string of positive developments including rate cuts and progress on US-UK trade negotiations – difficult to reconcile with the argument that inflation is transitory. Further, the risk is that Q2 GDP growth in the UK outperforms what the PMIs imply, only adding to this narrative.

GRAPH 07 **UK RETAIL SALES AND CONSUMER CONFIDENCE**

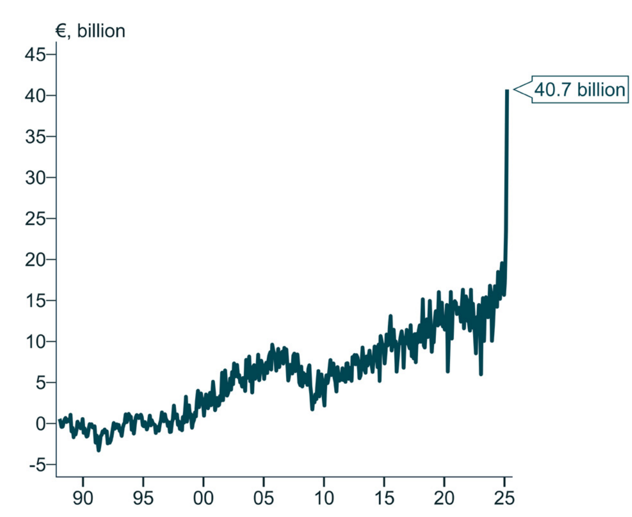
Source: IFM Investors, ONS, GfK UK, via Macrobond

On the continent, the European Central Bank (ECB) cut the policy rate by 25bps to 2.25% in April, citing a deterioration in the growth outlook on rising trade tensions. Indeed, President Lagarde acknowledged that the impact on the inflation outlook is more ambiguous as an appreciation in the Euro, lower commodity prices and trade rerouting may pose downside risks to prices. From here the ECB has room to manoeuvre as disinflation remains on track, driven by a recent moderation in services sectors. That said, a later than usual Easter had services inflation bouncing to 4%yoy, resulting in an April HICP outturn that had the headline measure stable at 2.2% (consensus: 2.1%) and the core gauge at 2.8% (consensus: 2.4%). Despite the temporary pick up, the focal point for the ECB is growth.

Euro Area Q1 GDP was firm expanding 0.4%qoq – stronger than market expectations with the pull forward of exports to beat US tariffs a material driver (GRAPH 08). The print is softer than the beat implies with Ireland picking up 3.2%qoq on export strength and contributing an outsized 12ppt. Across the majors, an increase in household consumption and capital formation supported growth in Germany (0.2%qoq); flat domestic demand and modest public consumption saw soft growth in France (0.1%qoq); domestic demand offset a slowdown in net exports in Italy (0.3%qoq); and household consumption, public consumption and investment saw Spain continue to outperform (0.6%qoq).

Growth is likely to slow going forward as trade uncertainty will weigh on external demand and investment. Indeed, in late May, the Trump administration announced a 50% tariff on imported goods before announcing a month long pause. This uncertainty has seen a deterioration in new export orders as evinced by April's PMI release, suggestive of tough times ahead for the bloc which depends heavily on external demand. In order to appease the Administration the EU may need to offer up renewed commitments to bolster defence spending or an increase in US energy imports to reduce its trade surplus. Domestically, fiscal measures will likely come to support growth for those countries with the capacity to do so.

GRAPH 08 **EURO AREA MONTHLY TRADE BALANCE WITH US**



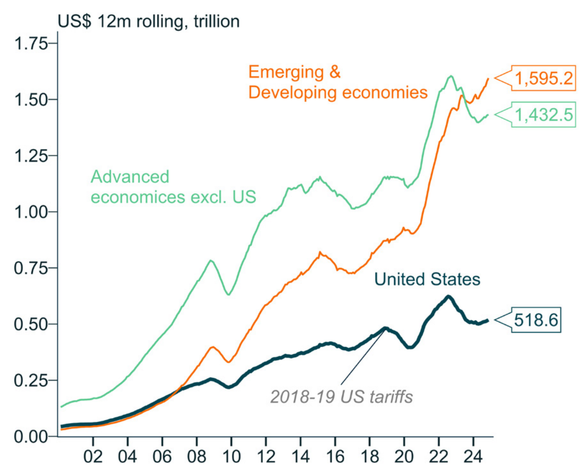
Source: IFM Investors, Eurostat, via Macrobond.

NORTH ASIA: Tariff turbulence

In the aftermath of 'Liberation Day', China and the US engaged in a series of tit-for-tat tariffs with imports from each country becoming subject to a 134% and 125% levy respectively. Yet following a selloff in the US bond market, deterioration in consumer sentiment or by design, tensions dissipated somewhat as the US announced carveouts for tech products, before officials agreed on a 90-day pause in these extreme measures. In the interim, Chinese imports will be subject to the 10% baseline and a 20% 'fentanyl tariff', this de-escalation reflecting a shared view that conditions were unsustainable. The truce is positive for China's short-term recovery with the longer-term outlook dependent on the durability of the truce and whether policymakers are successful shoring up domestic growth. It is notable that China's diversification of its export base away from the US accelerated materially after the pandemic and will continue (GRAPH 10) leaving it less vulnerable than it was in the first round of US tariffs in 2018-19.

It is too early to observe this turmoil in the activity data. March real GDP came in two tenths above consensus expanding 5.4%yoy, distorted by higher external demand on tariff front-running. Meanwhile, retail sales were strong (4.3%yoy) bolstered by consumer trade-in schemes. Investment (4.2%yoy) was buoyed by infrastructure which more than offset another decline in residential activity. However, April's PMI suggests the economy took an immediate and heavy hit from the trade war with manufacturing and export orders down firmly. Nonetheless policymakers have projected confidence with a re-commitment to the 2025 growth target of around 5% supported by monetary and fiscal measures. On the former, the PBoC announced a comprehensive set of measures including a 50bps reduction in the reserve requirement ratio for banks, a 10bp cut in the policy rate and an extension of relending quotas to support the real economy.

GRAPH 09 **CHINESE GOODS EXPORTS**

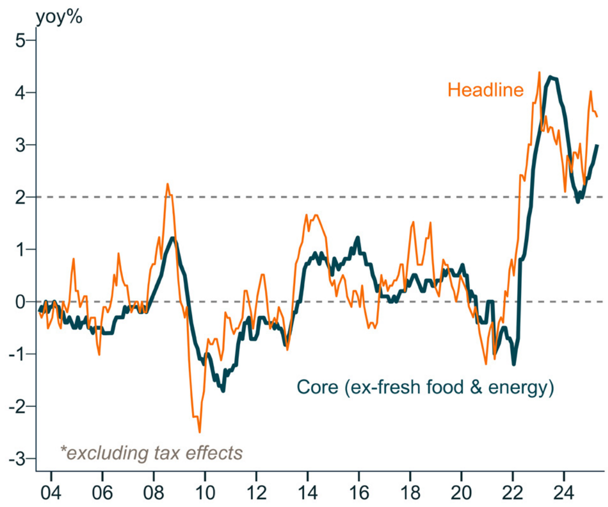


Source: IFM Investors, IMF DoTS, via Macrobond

In Japan, preliminary GDP estimates saw real growth come in at -0.7%saar, worse than expected, with net exports driving the contraction (-3.3ppts) due to a sharp rebound in imports. That said, part of the weakness also stems from an ongoing deceleration in private consumption as consumers grow increasingly cautious amid cost-of-living pressures. Prices continue to climb (due to supply-side factors), particularly surging rice prices, and the national core CPI (excl. fresh food and energy) reaccelerated hitting 3.0%yoy in April. Moreover, the GDP deflator rose 3.3%yoy from 2.9% the prior quarter while the consumption deflator rose 2.7%yoy from 2.0%, suggesting price increases are becoming broad-based.

The BoJ was on hold in May, with the statement focussing on tariff risks to Japan's trade sector. Yet there remains pressure on the BoJ to raise rates as the 'virtuous wage-price-cycle' has become less virtuous. This comes as inflation has persisted well above the two percent target, compounding pressures from import and food price rises. The BoJ also has issues in financial markets, as it considers tapering bond purchases longer dated government bond yields have soared, in line with US yields and as institutional investors shunned debt auctions. Higher yields at the long end of the curve may crimp private borrowing and also put further pressure on fiscal metrics due to extreme levels of public debt.

GRAPH 10 **JAPAN INFLATION***



Source: IFM Investors, SBJ, via Macrobond

Across the strait, the Bank of Korea (BoK) delivered a 25bp cut to the policy rate in May. With inflation near target, the move aims to buffer Korea's export driven economy from tariff headwinds and revive domestic activity after months of political turmoil eroded sentiment and growth. The Bank has become significantly bearish on the outlook, slashing growth expectations for the year to 0.8% (prior: 1.5%). Indeed, the Q1 growth outturn was poor coming in at -0.7%saar driven by a broad-based contraction in demand components and investment as well as a sharp fall in exports. The outlook has become somewhat less pessimistic as 25% 'Liberation Day' tariffs were paused with exemptions granted for certain tech products. Moreover, it is likely that a trade deal with the US is reached as Korea boasts several bargaining chips including a near zero effective tariff rate on American imports, an ability to increase defence cost sharing in the region and optionality in scaling up US LNG imports.

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