26 June 2025

Investment Managers

Investment Institute Macroeconomics

Monthly Op-ed

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Still Complicated

Key points

- Now that the "post-Covid" monetary policy cycle has closed, uncertainty stays the hand of central banks.
- The world economy is completely driven by supply-side shocks, which in turn shape economic policy. There is not much space for demand management.
- Higher risk premiums
- More equity volatility likely

The end of a cycle, and the beginning of an uncertain one

Christine Lagarde at her last press conference made a point about the Euro area which we think is relevant across many constituencies: the post-Covid monetary policy cycle is closing. The inflation shock triggered by the reopening has been absorbed. It is difficult at this stage to assess the contribution of the monetary policy contribution to disinflation – supply-side shocks tend to fade naturally – but central banks followed the textbook: faced with persistent, above target consumer price growth, they lifted interest rates to anchor long-term inflation expectations and probably avoided a longer and more damaging wage-loop. They did so while still avoiding a recession – in part because fiscal policy remained by and large supportive.

But shocks continue to abound, and this time they are not all symmetric. US tariffs are inflationary domestically, but on the whole, probably deflationary in the rest of the world. Again, the Federal Reserve (Fed) is following the textbook. While the policy stance is still "modestly restrictive" according to Jay Powell, the Fed is not ready to respond pre-emptively to the first – discreet – signs of cracks on the US labour market. We believe that, ultimately, when those cracks widen, the Fed will resume cutting – probably in Q4, by 50 basis points (bps) in our new baseline – but the memory of the persistence of inflation after Covid will act as a brake on the speed and magnitude of accommodation.

The European Central Bank (ECB) should be less constrained, but having hit the neutral rate, feels the need to be extra cautious. We think the ECB as well will resume cutting – after a shorter pause than in the US – and we expect the next cuts in September and December, but from now on further easing will have to be justified by the dataflow rather than being pre-emptive. The resilience of the labour market in Europe probably plays a role in the Governing Council's hesitations to cross the Rubicon and move into accommodation, but the risk is there is a severe undershooting of the inflation target – although it is already acknowledged to some extent in the ECB's latest forecasts.

Beyond the need to "see the damage" in the dataflow, the biggest issue the central banks are grappling with is uncertainty. Jay Powell was probably right when he said that "peak uncertainty" on tariffs is probably behind us, now that the US administration is clearly focused on negotiations rather than unilateral action and gave up on the most extreme custom duties. But the landing zone for those trade talks remains very wide. The ECB's latest baseline scenario assumes US tariffs on EU products at 10%: this could still prove quite optimistic. Beyond trade, while the US fiscal stance is clearly expansionary, the magnitude of the further deterioration in the deficit trajectory is still not fully quantifiable given the internal discussions in the Republican party, and overall financial conditions could still tighten more, which would weigh on the Fed's reaction function. In Europe, the ECB is counting on a fairly rapid materialisation of the massive German fiscal push on European growth, but Germany has not executed this kind of comprehensive spending plan for decades and implementation risks are significant. And of course, renewed tension in the Middle East is adding another layer of uncertainty.

What we find striking though is how the world economy is at the moment still essentially driven by supply-side shocks, which in turn dominate monetary and fiscal policy. Outside Germany, which has finally found a domestic substitute to foreign traction, demand dynamics are completely neglected. Even in the US, the fiscal push essentially prolongs the tax cuts of 2017 and will result in little additional support for demand. There is now little policy space for demand management across the world. This is a recipe for slow growth.

Markets at risk from oil price threat

Geopolitical events threaten to exacerbate the uncertainty around the global economic outlook that has already been clouded by President Donald Trump's trade policies. For markets, the key uncertainties are focused on what happens to oil prices; how central banks navigate an oil price-driven inflation bump; and whether corporate earnings might suffer from increased frictions in global energy and goods trade. Market returns have been solid in the first half of 2025, with many equity markets posting impressive double digit total returns, despite the concerns over the US's stance on trade. In contrast to European markets' strong performance, lagging US stock indices and equity markets in the greater China region suggest investors see the US-China trade issue providing the potential for the most economic damage.

The outlook for the second half of 2025 depends on numerous political developments. In the near-term these include any re-escalation following the cease-fire between Iran and Israel after the US intervention. Early July should also see Trump clarify the global tariff stance, while the finalisation of the US budget process will put more focus on the (worrying) fiscal outlook. These political events could trigger financial market volatility via their impact on inflation, growth and corporate earnings over the remainder of 2025. Chances of risk premiums increasing in interest rate, credit and equity markets are rising. There has already been a broad-based increase in long-term government bond yields in 2025 with inflation and fiscal risks driving the steepening of yield curves at longer maturities. Increased geopolitical uncertainty and higher oil prices could extend these moves.

Inflation risks

Investors will be focused on oil and on the upcoming US inflation data. Just before the US strikes on Iran, crude oil prices had risen 25% in the month of June, pushing up US wholesale gasoline prices. This inflationary shock has for now been stopped in its tracks by the cease-fire, but the situation in the Middle East remains very fluid. Furthermore, it is thought the impact of the tariffs already put in place will start to show up in the hard data in the next few months. As such there is a risk that US headline inflation rises above 3.0% again this summer. The US Fed will find it even more difficult to cut interest rates as a result. Indeed, the risk to the US bond market is that expectations of any rate cuts in 2025 (currently almost two cuts are priced in) will be removed, pushing yields higher across the curve. Unless the hard economic data points to a sharp deceleration of economic activity and there is evident weakness in the jobs market, long-duration fixed income assets are likely to continue to underperform.

Buy the dip in credit

Credit markets have been remarkably resilient in recent years, reflecting improved corporate balance sheets. Indeed, a common discussion with investors is whether the relative improvement in private sector fundamentals compared to the deterioration in public sector balance sheets should mean credit spreads can move and stay even narrower than their current levels. However, as witnessed in April, spreads' reaction to a macro shock is to widen quickly. A re-escalation of the Middle East situation, with concerns about the growth and inflation outlook, would likely lead to a similar reaction. The demand for credit, however, remains very strong given current yield levels. This inclines us to believe that credit markets would very much benefit from a *buy the dip* response to any rapid widening of spreads. It would also give investors the opportunity to lock in higher yields and, at the same time, improve the credit quality of their exposure.

It is difficult to make relative regional or country calls in this environment as sharp market risk-off moves tend to be highly correlated. It is also difficult to reconcile deteriorating fundamentals with sentiment-driven flows. The US dollar outlook is a case in point. The greenback has weakened in 2025 and there are multiple reasons why further dollar weakening would happen over the course of the year. However, traditionally the dollar has been a 'safe haven' asset class in times of geopolitical uncertainty. Other currencies that should benefit from more defensive investor allocations are the Swiss franc (already very strong) and the Japanese yen. Gold is also likely to remain on its upward trend.

More equity volatility coming?

European equity markets have significantly outperformed their US counterparts so far this year. Relative valuations, US policy uncertainty and the prospect of fiscal stimulus in Europe have all contributed. However, Europe's economies are vulnerable to an energy shock whereas the US is a net energy exporter these days. Any prolonged period of high oil prices could undermine the outlook for earnings in Europe and other markets. As an aside, however, high oil prices should provide additional impetus to investment in renewable energy sources, benefitting companies that provide the equipment for solar and wind farms, and associated electricity distribution grids.

It would be surprising if the combination of trade tariffs, high budget deficits and escalated military conflict in the Middle East did not threaten financial markets. Equities and credit markets are most at risk from a revised outlook for growth and what that implies for corporate cash-flow, with the US equity market having the most to lose from a valuation standpoint. Even if there is no escalation and Iran and the US can somehow find a diplomatic solution to the standoff over suspected uranium enrichment, the upside for risk assets would appear to be limited by valuations and other potential negative policy events. Greater geographical balance to equity portfolios, and therefore reducing the absolute exposure to the US, seems to be a common theme with investors. On the fixed income side, with the Fed remaining on hold and the European Central Bank suggesting it has "done" cutting interest rates (at least for a while) prevailing yield levels in bond markets will continue to generate a modest level of income return to investors.

The second half of 2025 is likely to be challenging for markets. For many asset classes, returns in the first six months have been stronger than what most analysts would have expected for the whole year. For fixed income, global diversified strategies should continue to deliver decent returns while short-duration and inflation protection strategies also seem appropriate in this environment. On the equity side, the very strong performance of European stocks has reflected expectations of future fiscal stimulus coming from Germany and the related impressive gains in defence and related stock prices. It is not clear that, if we do face another geopolitically driven macro shock, such returns can be sustained.

Download the full slide deck of our June Investment Strategy

Investment Managers

26 June 2025

Macro forecast summary

Real GDP growth (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.3	2.6		2.4	
Advanced economies	1.7	1.1		0.7	
US	2.8	1.2	1.4	0.5	1.7
Euro area	0.9	0.9	0.9	0.6	1.2
Germany	-0.2	0.0	0.1	0.3	1.3
France	1.1	0.3	0.6	0.6	1.0
Italy	0.5	0.6	0.5	0.7	0.8
Spain	3.2	2.3	2.5	1.9	1.9
Japan	0.1	0.8	1.0	0.9	0.7
UK	1.1	0.9	0.7	1.1	1.1
Switzerland	1.3	1.1	1.1	1.2	1.5
Canada	1.5	1.4	1.0	0.5	0.8
Emerging economies	4.2	3.5		3.4	
China	5.0	4.3	4.5	4.0	4.2
Asia (excluding China)	5.4	4.5		4.6	
India	6.9	6.5	6.3	6.1	6.5
South Korea	2.0	0.5	1.3	1.7	1.9
Indonesia	5.0	4.5	4.9	4.9	5.0
LatAm	2.4	1.8		2.0	
Brazil	3.4	1.9	1.9	1.8	1.7
Mexico	1.5	0.0	0.2	0.8	1.4
EM Europe	3.3	2.1		2.0	
Russia	4.1	1.5	1.7	0.9	1.2
Poland	2.9	2.8	3.3	2.9	3.2
Turkey	3.2	3.0	2.9	3.4	3.4
Other EMs	2.8	3.2		3.7	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 June 2025
**Forecast*

CPI Inflation (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	2.7	2.7		2.4	
US	3.0	3.2	3.2	3.2	2.3
Euro area	2.4	2.0	2.0	1.6	2.0
China	0.2	0.1	1.3	0.4	1.6
Japan	2.7	2.9	2.0	1.5	1.7
UK	2.5	3.3	2.3	2.0	2.0
Switzerland	1.1	0.2	1.0	0.5	1.0
Canada	2.4	2.4	2.1	2.5	2.1

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 25 June 2025
**Forecast*

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q3-25	Q4-25	Q1-26	Q2-26	Q3-26	Q4-26
United States - Fed	Dates	4.50	29-30 Jul 16-17 Sep	28-29 Oct 9-10 Dec	27-28 Jan 17-18 Mar	28-29 Apr 16-17 Jun	28-29 Jul 15-16 Sep	27-28 Oct 8-9 Dec
	Rates		unch (4.50)	-0.50 (4.00)	-0.50 (3.50)	-0.25 (3.25)	unch (3.25)	unch (3.25)
Euro area - ECB	Dates	2.00	24 Jul 11 Sep	30 Oct 18 Dec	5 Feb 19 Mar	30 Apr 11 Jun	23 Jul 10 Sep	29 Oct 17 Dec
	Rates		-0.25 (1.75)	-0.25 (1.50)	unch (1.50)	unch (1.50)	unch (1.50)	unch (1.50)
Japan - BoJ	Dates	0.50	30-31 Jul 18-19 Sep	29-30 Oct 18-19 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		+0.25 (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)
UK - BoE	Dates	4.25	7 Aug 18 Sep	6 Nov 18 Dec	5 Feb 19 Mar	30 Apr 18 Jun	30 Jul 17 Sep	5 Nov 17 Dec
	Rates		-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)	unch (3.50)	unch (3.50)	unch (3.50)
Canada - BoC	Dates	2.75	30 Jul 17 Sep	29 Oct 10 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		-0.25 (2.50)	unch (2.50)	-0.25 (2.25)	unch (2.25)	unch (2.25)	unch (2.25)

Source: AXA IM Macro Research - As of 25 June 2025

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Our Research is available on line: www.axa-im.com/investment-institute

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AXA IM manages approximately €879 billion in assets*, of which €493 billion are categorised ESG-integrated, sustainable or impact. As an established player in responsible investing, we adopt a pragmatic approach with a view to provide long-term value to our clients, our employees and the broader economy.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employs over 3,000 employees and operates from 24 offices in 19 countries globally.

**All figures, as at end of December 2024*

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