ROYAL LONDON
ASSET MANAGEMENT

Investment Clock – Economic Update

Issue #34, July 2025

Multi asset views

Royal London Asset Management manages £177 billion in life insurance, pensions and third party funds*.

We have six Global Multi Asset Portfolios (GMAPs) across the risk return spectrum with a full tactical asset allocation overlay.

*As at 31 March 2025

Author:

Melanie Baker
Senior Economist

US: The US economy is likely to look a bit less exceptional this year. Assuming that the tariff impact on inflation is transitory, rate cuts still look likely late-2025, but there is significant two-way risk to the US outlook.

China: China's economy has looked relatively resilient against higher US tariff rates so far. Policy support has likely helped, alongside some trade diversion. China faces significant medium-term headwinds.

Euro area: The external outlook remains challenging and the consumer outlook more mixed. Fiscal policy should help, but more next year than in 2025.

UK: The labour market continues to look worrying and could be a catalyst for a weaker consumer. Risks are building for more tax hikes in the Autumn. Continued gradual rate cuts seem likely.

Japan: Against an uncertain external backdrop, the BoJ will need even more reassurance on inflation trends to hike further.

Please visit **investmentclock** for our blog and information about our multi asset range.

For further details, contact:
multiassetsupport@rlam.co.uk

Still Set for a Slowdown

Slowdowns look more likely than recessions this year. Trade policy pauses and reversals make that more likely. Fiscal policy looks set to be supportive in a number of places and rate cuts should help. However, it remains hard to hold a central view with confidence: US tariffs are still set to end the year much higher than they started and the policy outlook remains highly uncertain. Evidence is mixed or incomplete on the impact that changes in tariffs are having on the global economy. There are significant upside and downside risks to the base case.

Summary

Slowdowns seem likely: Higher US tariff rates and an uncertain policy backdrop seem likely to slow global growth in 2025 into 2026. Monetary and fiscal policy look set to provide some offsetting support. However, a lack of clarity on the impact of tariffs is holding back at least US rate cuts and, in a number of economies, the capacity for fiscal policy support looks limited.

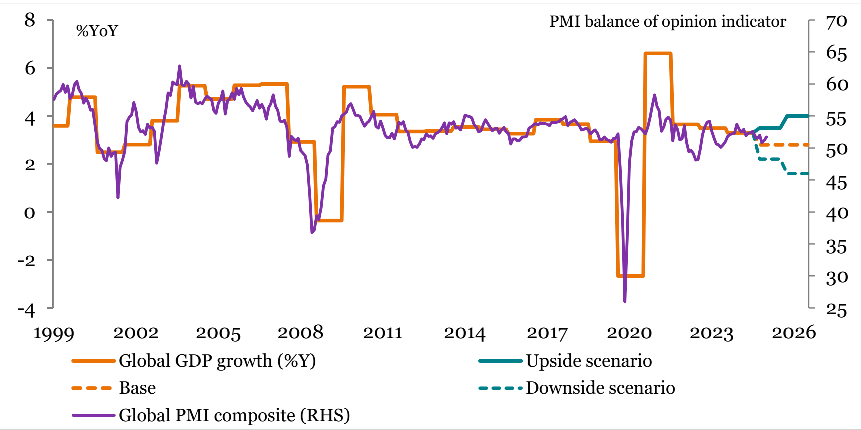
US less exceptional? The US remains a dynamic economy and US fiscal policy changes are likely to be a modest net positive for US growth over the next two years. However, policy uncertainty and higher US tariffs are likely to weigh and seem likely to leave US activity growth looking a bit less exceptional by the end of the year. The euro area is a candidate economy for seeing less *un*exceptional growth but the case isn't yet convincing.

Central banks likely to cut further: In the central case, US, Euro area and UK policy interest rates are cut further (only slightly in the case of the euro area). Given the amount of uncertainty around the US outlook, risks to that view feel especially two-sided with a very plausible scenario where the Fed keep rates on hold for a prolonged period. Euro area rates are already around the medium-term neutral, but cooling inflation dynamics justify a bit more policy accommodation. In the central case, the BoE continue with gradual rate cuts and the BoJ with (very) gradual hikes.

Inflation in the balance: Tariffs are expected to boost 2025-26 inflation in the US with risks that, in combination with the deportation agenda, inflation stays higher for longer than expected. I am still expecting domestically driven/services inflation to slow in Europe on the back of looser labour markets and/or slowing pay growth. Tariffs seem more likely to prove disinflationary than inflationary outside of the US, but with tariffs, geopolitics, climate change, AI and demographics in the mix, there is a substantial risk that inflation remains more volatile than we'd become used to pre-pandemic.

Our **Multi Asset team** are close to neutral at the broad asset class level with the impact of the trade war on the global economy still unclear. However, positioning in equities is overweight US, a region where they feel relative earnings trends justify a short-term overweight, especially versus Europe. Elsewhere the team is underweight the US dollar, which continues to be expensive on long-term measures even despite the worst start to the year since 1973. For more, see the team's 'ClockWise' blog at www.rlam.co.uk.

Chart 1: Global growth central case: Slowing a bit



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to June 2025

Economic forecast summary

July 2025 base case

Region	2024			2025e			2026e			2027e			2028e			2029e			2030e		
	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4	GDP growth	CPI end Q4	Policy Rate Q4
US	2.8	2.7	4.50	1.2	3.5	4.00	1.4	2.8	3.75	2.1	2.3	3.50	1.7	2.1	3.50	2.0	2.3	3.50	2.0	2.3	3.50
				1.4	*3.5*	*4.00*	*1.3*	*2.7*	*3.50*	*2.1*	*2.3*	*3.25*	*1.7*	*2.0*	*3.25*	*1.9*	*2.2*	*3.25*	*1.9*	*2.3*	*3.25*
China	5.0	–	–	4.7	–	–	4.7	–	–	4.6	–	–	4.3	–	–	4.0	–	–	3.9	–	–
				4.3	*–*	*–*	*4.5*	*–*	*–*	*4.6*	*–*	*–*	*4.3*	*–*	*–*	*4.0*	*–*	*–*	*3.9*	*–*	*–*
UK	1.1	2.5	4.75	1.1	3.2	3.75	0.9	2.4	3.00	1.2	2.1	3.00	1.3	2.3	3.25	1.4	2.3	3.25	1.4	2.2	3.50
				0.6	*2.8*	*3.75*	*0.9*	*2.3*	*3.00*	*1.2*	*2.0*	*3.00*	*1.3*	*2.1*	*3.25*	*1.4*	*2.1*	*3.50*	*1.4*	*2.1*	*3.50*
Euro area	0.8	2.2	3.00	1.1	1.9	1.75	1.1	1.9	1.75	1.4	1.9	2.00	1.2	2.0	2.00	1.1	2.1	2.25	1.1	2.2	2.25
				0.9	*1.9*	*1.75*	*1.1*	*2.0*	*1.75*	*1.4*	*2.1*	*2.00*	*1.2*	*2.1*	*2.00*	*1.1*	*2.1*	*2.25*	*1.1*	*2.1*	*2.25*
Japan	0.2	2.9	0.25	0.7	2.5	0.75	0.7	2.0	1.00	0.8	1.9	1.25	0.7	1.8	1.50	0.6	1.8	1.50	0.5	1.9	1.50
				0.9	*2.2*	*0.75*	*0.6*	*2.2*	*1.00*	*0.8*	*2.0*	*1.25*	*0.7*	*2.0*	*1.50*	*0.6*	*2.0*	*1.50*	*0.5*	*2.0*	*1.50*
Global	3.1	–	–	2.8	–	–	2.8	–	–	3.1			3.0			3.0			2.8		
				2.8	*–*	*–*	*2.8*	*–*	*–*	*3.1*			*3.0*			*2.9*			*2.8*		

Source: LSEG Datastream, national statistics offices, Bloomberg Finance L.P. for past actual data. All forecasts (e) are RLAM. Current data and forecasts are in black. Forecasts from the April 2025 forecast update are in grey and italics. 2024 figures are past actuals. Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the deposit rate.

Key economic policy forecasts

- My central case forecasts assume that the US renews rate cutting late this year as growth slows somewhat and the Fed grow less worried about the inflationary impact of tariffs. I have then pencilled in two more cuts over 2026/27. Given the amount of uncertainty around the US outlook, these forecasts have significant two-way risk. Euro area rates are already around my estimate of the medium-term neutral. With inflation dynamics appearing to cool, I assume one more cut to 1.75% later this year. I expect the Bank of England to continue with gradual rate cuts into next year with a terminal rate around 3% in the central case and risks skewed towards a faster pace. I am expecting very slow rate hikes to resume in Japan.
- Sharper than expected downturns and more unemployment would see deeper rate cuts than in the base case (as central banks try to rapidly get rates below neutral). Higher than expected inflation (particularly core, services inflation and, relatedly, pay growth), could mean rate cuts pause for a prolonged period. Both scenarios are plausible in the US where the trade policy outlook is especially uncertain and where its impact on the economy could surprise on the upside or downside, especially once trade policy interacts with other policy changes.
- Fiscal policy looks set to become more supportive in the euro area with more defence and infrastructure spending likely to boost growth at a euro area level (even if the spending is relatively Germany-centred). In the US, fiscal policy looks set to be growth supportive, at least for a couple of years until some of the agreed tax measures end in 2028. Fiscal policy is more likely to drag on UK growth especially assuming the Autumn Budget sees taxes rise again (as seems likely at the time of writing).

Global economic scenarios (Chart 1)

Upside scenario (20% probability): Growth picks up sharply, but without generating strong inflation

- Levels of policy uncertainty fall significantly. European consumers dissave as confidence grows in the outlook and real pay growth remains positive; Consumer spending is much stronger than expected. China's policy efforts see GDP growth stabilise rather than drifting lower over the next few years. US GDP growth surprises on the upside, helped by a resurgence in capex (supported by tax measures and deregulation).
- Headline inflation stays relatively close to target as higher productivity growth contains overall labour cost growth. Higher labour market participation and immigration also helps in some cases. In the US the impact of deportations is less than feared, while AI adaptation leads to reduced labour demand so that the labour market doesn't tighten much overall.
- Central banks prove less willing to cut rates but aren't inclined to hike rates either given contained inflation pressures. Policy rates remain closer to pre-financial crisis norms than pre-pandemic norms. Fiscal policy is more supportive than in the central case.

Base case (60%): Modest growth and somewhat lower rates

- Worsening trade relations slow global growth. Major economies see only relatively modest growth in 2025 into 2026. US growth slows against tariffs and an uncertain US policy backdrop. Business investment gets some support from interest rate cuts. Fiscal policy supports activity in some economies.
- Domestically driven inflation pressures ease further while tariffs (temporarily) raise US inflation.
- Interest rates are cut a bit further in the US, euro area and UK, and hiked very gradually in Japan.

Downside scenario (20%): Stronger impacts from tariffs, immigration policy and uncertainty

- Political and policy uncertainty weigh heavily on global growth, alongside higher tariffs and more trade disruption than in the central case. US economic growth is hit more than in the central case by lower immigration and higher tariffs. However, deportations and tariff policy raise inflation by enough that the Fed hikes interest rates in 2025/2026. Growth is lower than in the central case.
- After a period of stronger than expected outturns, inflation falls more sharply than in the central case a couple of years out.
- This is followed by rate cuts that are delayed but deeper than in the central case.

Probabilities are subjective and indicative such that we'd broadly see a 20% chance that the economy performs in line with/better than the upside case and a 20% probability that the economy performs in line with/worse than the downside case.

Global economy: Waiting for (more) evidence

Global growth looks set for a slower year as the US administration's tariff policies and accompanying uncertainty weighs on global trade and activity. However, until the economic impact is clearer we may see some central banks continue to sit 'on the fence'. Across multiple economies, profiles for activity growth are likely to be bumpy as companies have made efforts to try and get ahead of tariffs. The US economy likely grows more slowly in 2025, but assuming that uncertainty eases and the worst of the tariff threats are not implemented, recession is avoided in my central case. In the US, euro area and China, fiscal policy should be somewhat supportive. Further rate cuts should help the UK where fiscal policy cannot, but growth prospects there remain challenged. The balance of risk looks currently skewed towards fewer rate cuts than the base case in the US, but more in the euro area and UK.

Status update: Slowed, but bumpy

Global growth looks to have slowed over 2025 so far. Using the global composite PMI business survey as a proxy for global GDP growth (Chart 2), the indicator looks consistent with a mild pace of expansion, having slowed since late 2024, skirting my 'recession warning zone' (the peach area of the chart where economist tend to start talking about recessions). Policy uncertainty measures remain elevated, likely bolstered by ongoing changes in trade policy (Chart 3). Activity data has been mixed and sometimes volatile over the last quarter or so. Efforts by companies and consumers to get ahead of tariffs have led to sequences of stronger activity data then some pullback. US GDP growth is expected to be especially bumpy as (higher) imports sharply detracted from GDP in Q1 but will likely boost Q2 figures (Chart 4). Inflation is sitting around or above target in the US, euro area, UK and Japan, but tariffs were having little visible impact on US inflation rates on data through to May 2025, even as firms signal price pressure (Chart 5).

Summary outlook: Still expecting slowing

Expecting slowing, but not recessions: The central forecasts don't have recessions pencilled into them: 1) Real pay growth (Chart 6) and rate cuts should support activity; 2) Trump has repeatedly pulled back from the worst of his threats. That may gradually reassure businesses who may also become more inured to the higher levels of policy uncertainty; 3) Fiscal policy looks set to be more supportive in the euro area than seemed likely at the turn of the year; supportive in the US and China; though less supportive in the UK.

The forecasts on page 2 assume that we see some slowing in growth though. I continue to assume that the combination of Trump's policy plans and the uncertainty accompanying them will damage global growth and boost US inflation. Still, it isn't as if, because Trump has shown some pragmatism that everything is back to normal. Tariff levels are significantly above where they were at the start of the year (Chart 7). If Trump wants to achieve two of his apparent objectives with tariffs – reshoring of manufacturing production and revenue raising – they will need to linger at significant levels.

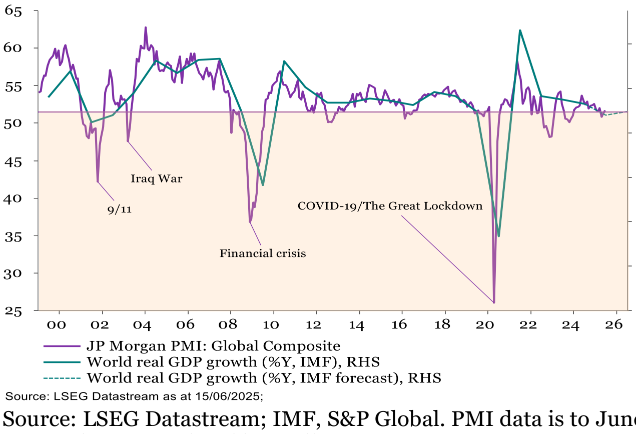
Lower inflation and a few more cuts: I expect inflation to average less in 2026 than 2025 helped by lower energy inflation, slowing wage growth (in Europe especially) and assuming that the impact of tariffs will be more disinflationary than inflationary outside the US. I am factoring in an impact around 1pp for US inflation from tariffs in 2H 2025. Against that backdrop and the assumption that tariffs prove somewhat negative for global growth, I am pencilling rate cuts from the Fed, ECB and BoE in H2 2025 though later rather than earlier in the case of the Fed and only one rate cut from the ECB. For the Fed and BoE that would still leave rates above neutral this year (with more cuts pencilled in for the BoE, especially in 2026). In Japan, a continuation of very cautious hikes seems the most likely path as inflation lingers around 2% rather than sinking to pre-pandemic norms. There is a large amount of uncertainty over the rate projections, however, especially for the US, reflecting the changing tariff backdrop. There is also uncertainty around how strongly those tariffs will feed through into inflation. Tariffs are also not the only inflationary element of the Trump administration's agenda.

US to look less exceptional

US and Euro area GDP growth rates continue to look on track for some convergence. I am not pencilling in a recession for the US, but I am assuming that trade policies and high levels of policy uncertainty drag sufficiently on US activity growth this year that, by the end of 2025, US year-on-year growth rates look a bit 'European'. Meanwhile, Euro area growth, for example, may look a bit less *un*exceptional. The political shift in Europe, especially Germany, towards more defence/infrastructure spending also boosts Euro area growth prospects, though that is more for 2026 and beyond in the forecasts.

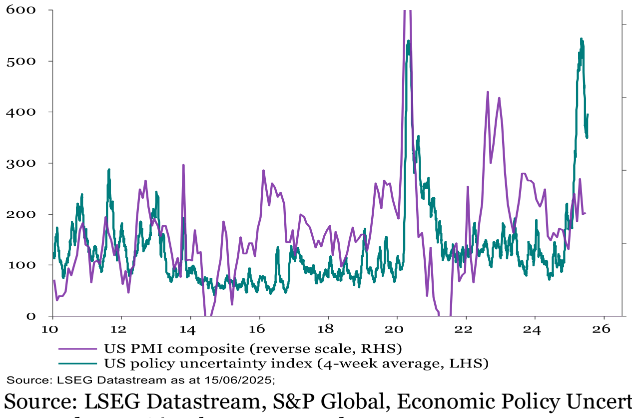
The drag on growth from policy uncertainty looks likely to play out as a drag on growth beyond just the US and especially in economies which are more trade dependent. Still, the impact seems likely to be especially noticeable in the US where uncertainty on the broader Trump policy outlook can also be thrown into the mix. In an uncertain environment, it makes sense to expect firms and households to hold back investment and large spending commitments until the risk of those actions and likely returns are better able to be judged. In a 2019 piece (summarised here) authors from the St Louis Fed concluded that large rises in policy uncertainty reduced output, but especially durables consumption, residential investment and with falls in business investment that persist for longer.

Chart 2: Surveys suggest global growth has slowed



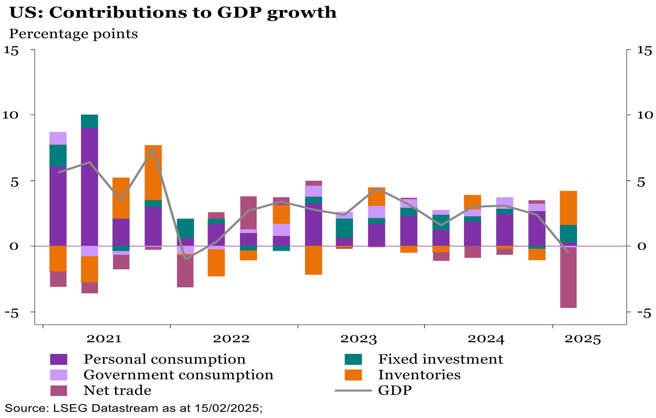
Source: LSEG Datastream; IMF, S&P Global. PMI data is to June 2025. IMF series was updated in April 2025.

Chart 3: Policy uncertainty still high (and likely to drag on activity)



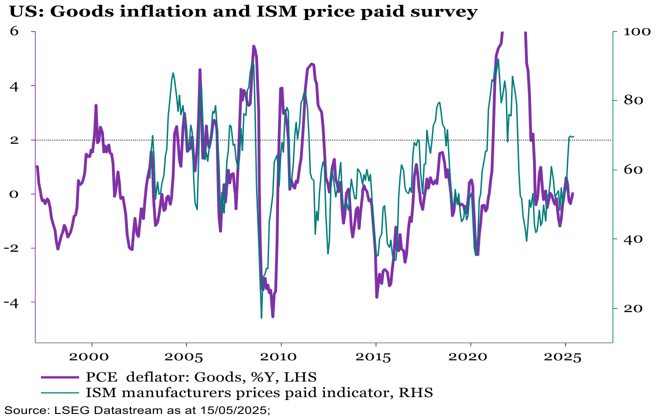
Source: LSEG Datastream, S&P Global, Economic Policy Uncertainty. Latter data to 8th July 2025, PMI data to June.

Chart 4: Surge in US imports a drag on GDP in Q1



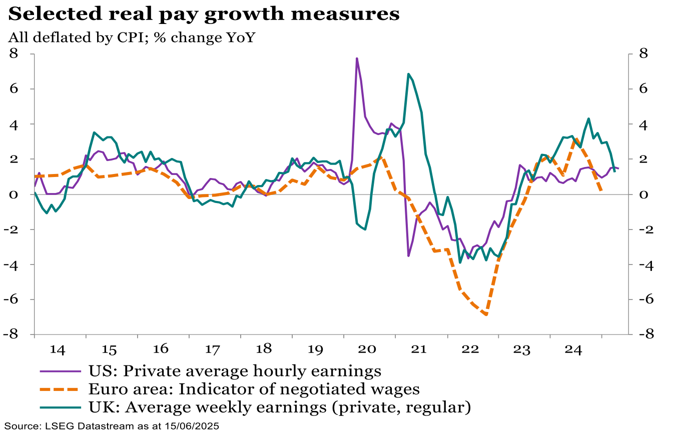
Source: LSEG Datastream, BEA. Data to Q1 2025.

Chart 5: Goods inflation – tariff effect delayed?



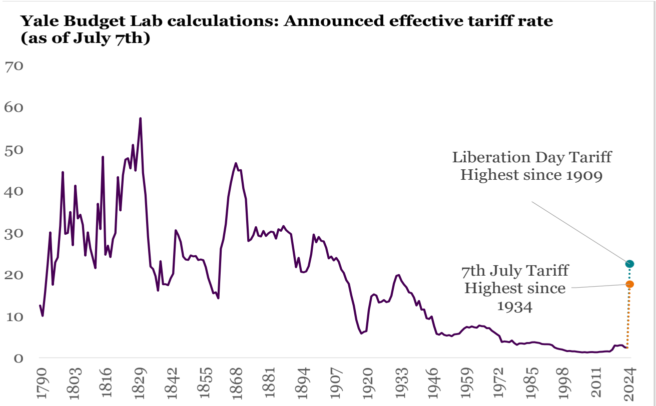
Source: LSEG Datastream; BEA, ISM. Data to May 2025.

Chart 6: Real pay growth still positive (just)



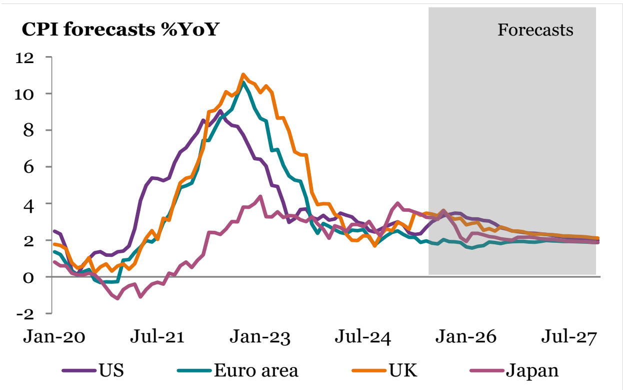
Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to May 2025 (US), April 2025 (UK), Q1 2025 (Euro area).

Chart 7: Volatile tariffs: Well above Jan-25 levels



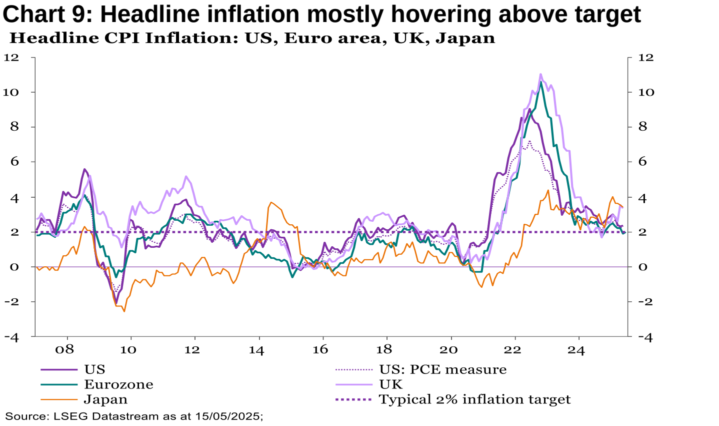
Source: The Budget Lab at Yale (https://budgetlab.yale.edu/research/state-us-tariffs-july-7-2025).

Chart 8: Central case for inflation



Source: Past data: LSEG Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with forecasts on page 2.

Chart 9: Headline inflation mostly hovering above target



Source: LSEG Datastream, BLS, Eurostat, ONS, Japan Statistics Bureau. Data as at June 2025 (Euro area), May 2025 (US, UK, Japan).

Inflation – Depends where you look: Disinflation ex-US

My central case (Chart 8) sees headline inflation slow over 2026. Headline inflation remains above 2% inflation targets in the US, UK and Japan (Chart 9). Services inflation remains elevated (Chart 10). However, with cooling pay indicators and signs of looser labour markets (Chart 11,12), services inflation looks more likely to fall in the Euro area and UK than it did. Tariffs are expected to boost inflation in the US in 2025 (into 2026), more below. However, US inflation prospects should be easier to judge once we are towards the end of summer, having allowed more time for tariff impacts to show through. In Japan, evidence continues to accumulate that inflation is at *sustainably* higher levels than pre-pandemic.

Tariffs: Inflationary or deflationary? Tariffs are likely to raise prices faced by US consumers. Beyond the US, the impact of tariffs is more likely to be disinflationary:

- **US = inflationary (at least temporarily)**: Tariffs are a tax on US importers and with the first of the Trump tariffs applied in February it is not surprising that businesses have been reporting higher cost pressures (Chart 5). At the time of writing, *announced* tariff rates again look to be in danger of moving above what many economists had analysed the impact of at the start of this year – around 10-15% on all trading partners and 60% on China (since that is roughly what Trump had been saying he would do in the build up to the election), see Chart 7. Those early estimates of the US inflation impact had been around 1pp (i.e. nowhere near a Covid level shock, but significant when you are targeting inflation of only 2%). So far, however, little impact has been visible in consumer prices. I assume that pass-through is delayed rather than not happening:

1) The May/June Fed Beige Book reported that: "Contacts that plan to pass along tariff-related costs expect to do so within three months;" 2) Firms front-loaded the tariff impact ramping up imports at the start of the year (Chart 4), helping delay pass-through; 3) Uncertainty around tariffs adds an incentive to delay pass-through (to avoid unnecessary damage to customer relationships); 4) Some hit to margins seems likely (risking job cuts down the line as firms try to cut costs).

As of the May data, although the impact of higher tariffs does look apparent for some components, it isn't clearly visible in every component that should have been impacted by tariffs and has been offset by price movements in other categories.

- **Rest of the world = disinflationary**: Assuming a lack of offsetting retaliation, the impact on inflation outside the US is likely to be disinflationary. That reflects the dampening impact on activity as exports are hit, dollar weakness (on recent evidence), potentially lower commodity prices as global demand slows and some redirection of China trade (where Chinese exporters may use discounting to try and build market share outside the US). There is already evidence of Chinese exports to other destinations picking up while dropping to the US (Chart 13).

AI brings downside inflation risk: Artificial intelligence increasingly needs to justify its high capex levels. Use cases are likely to ramp up as adoption spreads and deepens and as AI is increasingly integrated with own-company data. AI could see economies harness substantial productivity gains, though progress could also rapidly become more politically difficult as real-life jobs are increasingly affected.

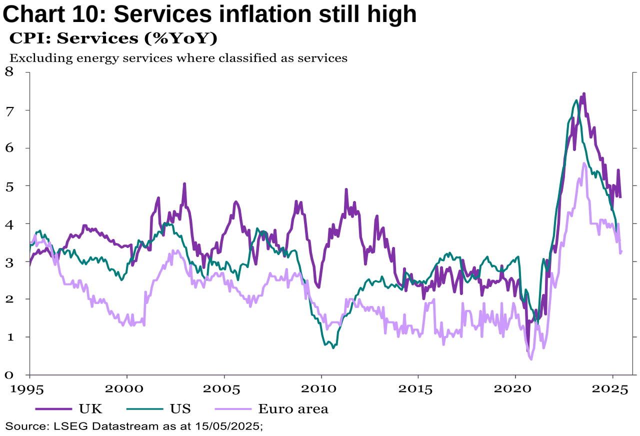
But upside risks abound in short term, especially in the US: In the US (putting tariffs to one side) the impact of deportations (see immigration section) and supportive fiscal policy (see fiscal policy section) could see US labour markets tighten quickly and therefore result in stronger pay growth.

The euro area unemployment rate remains very low (by euro area standards). A boost to demand from fiscal spending could see pay growth raise against that backdrop. In the UK, the period of high inflation in 2022-23 and jump in price levels, alongside higher labour costs in 2025 may push companies into raising prices more than expected in order to avoid a margin squeeze.

Medium-term (higher) inflation risks and 'spikeflation': Consistent with our Multi Asset team's 'spikeflation' theme (see article at www.rlam.com), a number of factors could see the global economy more prone to inflation spikes over the medium-term.

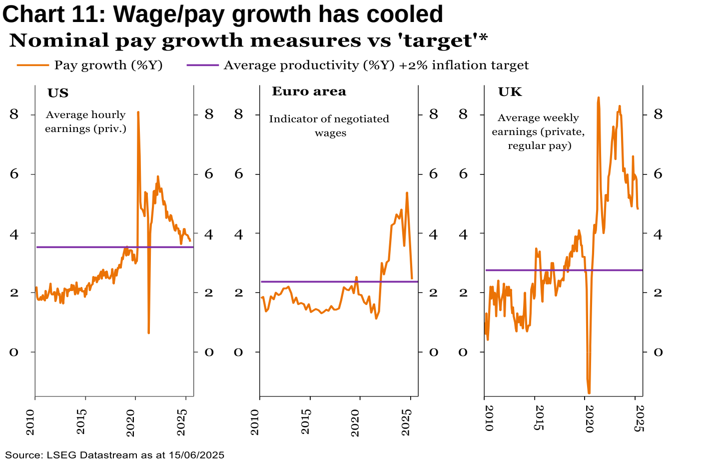
- Population ageing may boost inflation through several channels including lowering labour supply relative to overall demand; increasing the bargaining power of labour; and potentially raising fiscal deficits to fund increased age-related spending demands.
- Climate change (food price spikes and more periods of low productivity as extreme weather events become more common) and associated transition costs also seem likely to lead to recurrent upside pressures.
- Other factors that could prove more inflationary include an apparent drift in politics in many economies towards populism and deglobalisation. Post-pandemic (and government bailouts), fiscal restraint is arguably a less electable policy platform.

Chart 10: Services inflation still high



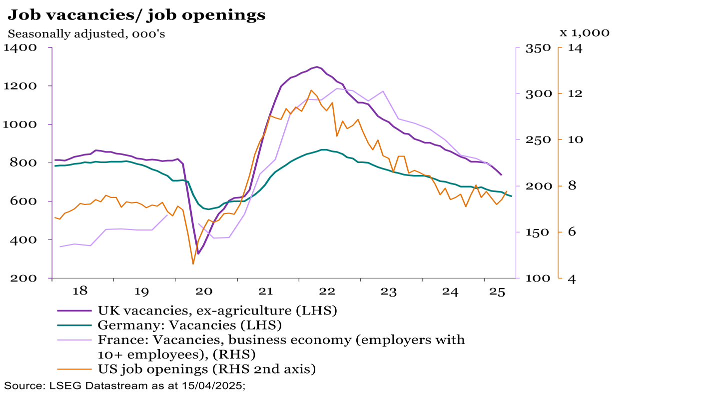
Source: LSEG Datastream, ONS, BLS, Eurostat. Data as at June 2025 (Euro area), May 2025 (US, UK).

Chart 11: Wage/pay growth has cooled



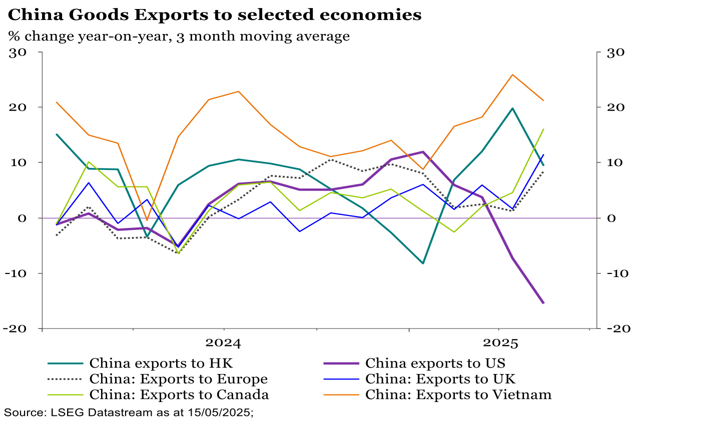
LSEG Datastream, BLS, ECB, ONS. Pay data to June 2025 (US), Q1 2025 (Euro area) and April 2025 (UK). *Productivity measures average from 2010: Output per hour (US), Total economy labour productivity (euro area), Output per worker (UK)

Chart 12: Labour market slack increasing?



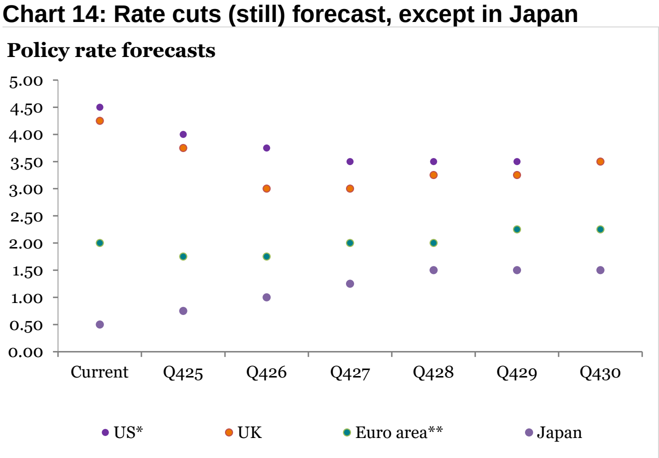
Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to April 2025, France to Q1 2025, Germany to June 2025, US to May 2025

Chart 13: Some evidence of China export redirection



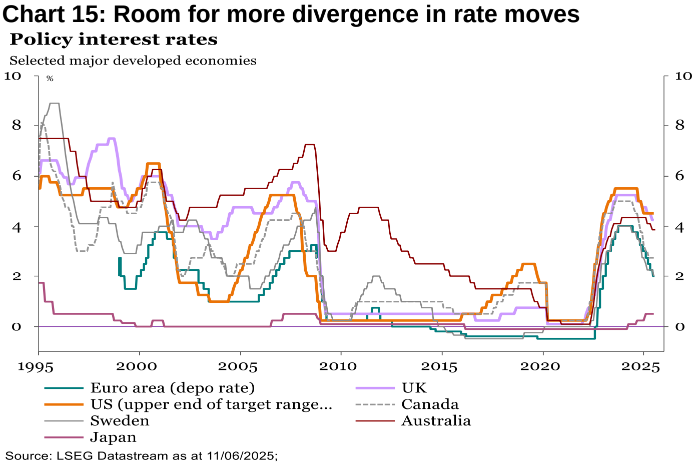
Source: LSEG Datastream, China Customs. Data to May 2025

Chart 14: Rate cuts (still) forecast, except in Japan



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q2 2025 onwards) are RLAM estimates.

Chart 15: Room for more divergence in rate moves



Source: LSEG Datastream, Data to 8th July 2025.

Central bank policy: Step-by-step and data dependent

I still expect (further) rate cuts in the US, UK and euro area in 2025/26 and hikes in Japan (Chart 14). However, with the US policy outlook so uncertain, and by extension, the outlook for growth and inflation, there are two-way risks to my central case and more uncertainty attached to the US profile:

- In my central case, the Fed cut rates twice late this year reflecting an assumption that tariffs lift US inflation 'only' around 1pp, but that the economy slows reducing the risk of that inflation proving persistent. Risks to my central case at present feel skewed towards fewer rather than more cuts than this in the short-term. In the euro area, facing benign inflation dynamics, I am pencilling a final ECB rate cut later this year to 1.75% likely taking the deposit rate a bit below neutral (2-2.25% on my tentative estimate). I have pencilled in one more rate hike this year from the BoJ. For the Bank of England, I am pencilling in two further rate cuts this year and a continuation of a gradual and careful rate cut path. I am assuming that slower underlying inflation dynamics see the Bank eventually cut a bit below neutral (3.75% medium-term) in 2026
- By the end of 2025, I still have US and UK policy rates still above my estimate of neutral. In both cases that reflects central bank inflation persistence concerns. Rates are still *below* neutral in Japan reflecting residual uncertainty on whether inflation is sustainably 2% and the threat that the external environment will drag on the economy (and prices).

If recessions did materialise then (all else being equal) I would expect central banks to rapidly cut rates below neutral. US policymakers will be especially sensitive to developments in the labour market.

How far could other major central banks diverge from the Fed? Given the differing experiences of economic growth in the post pandemic period it is perhaps surprising that the Fed, ECB and BoE have been as synchronised as they have been (Chart 15), but then each of those economies experienced a period of substantial inflation at roughly the same time. There have been periods in the recent past that have been much more divergent, namely 2015-2020, when the US went through period of rate hikes followed by cuts while the BoE and ECB kept rates much flatter. In the coming period, the combined impact of Trump's policy agenda could substantially boost US inflation while proving significantly disinflationary for Europe; there is a plausible scenario where, as a result, the US keeps rates steady or even raises them a little, while the ECB and BoE cut rates significantly further.

Fiscal policy: Shield for some; weak spot for others

Euro area fiscal policy looks set to be a partial 'shield' for the economy following reform of the German debt brake and promised additional defence spending, though this is expected to be more of a 2026 than 2025 story given lags and add a (only) few tenths to growth at a euro area level given the limited fiscal capacity of many economies beyond Germany (Chart 23).

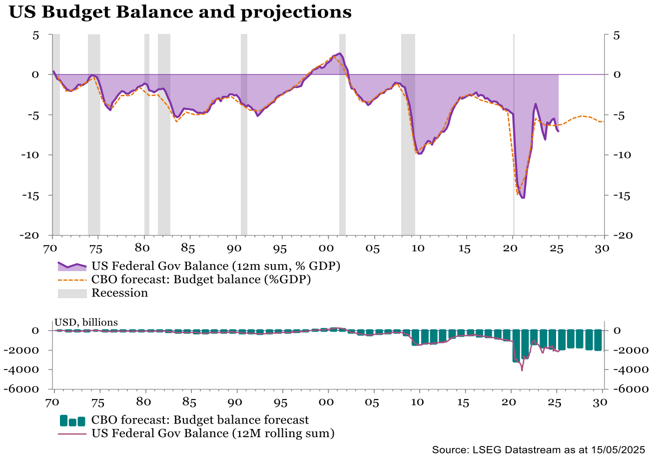
UK fiscal policy looks set to be more of a drag than a support (see UK section).

In **China**, fiscal policy is likely to be deployed further. However, with the economy looking relatively resilient recently, despite hostile US trade policy, the urgency has been reduced.

In the **US**, fiscal policy looks set to remain supportive for the economy but is not without risk. The US has been running a persistent and sizeable fiscal deficit (Chart 16). That looks set to continue following the passage of the Trump administration's 'Big Beautiful Bill' on 4th July. The bill extends tax cuts from the first administration, introduced new tax breaks including on tips, cuts social security (especially Medicaid) and raises funding for immigration enforcement. There are also business-related tax cuts, including allowing businesses to write off the cost of equipment and research. Relative to a baseline where Trump's first term cuts weren't extended, the CBO had calculated the bill would cost more than $3tln over a decade. The White House argues that tariff revenue will provide an offset (the scale of which remains a big unknown):

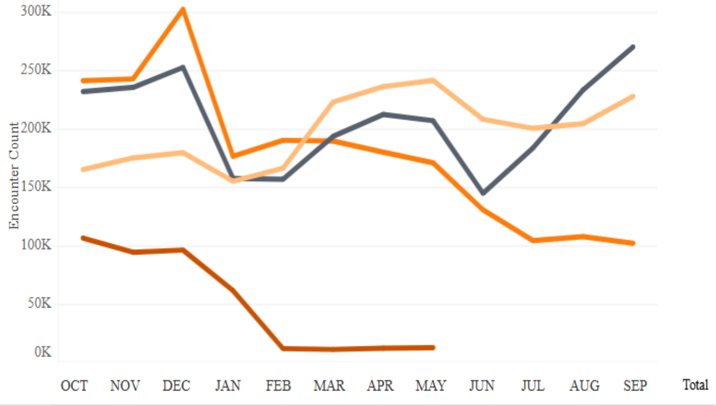
- **Reduced uncertainty**: Passage of the bill takes away one source of policy uncertainty. It also eliminates the likelihood of a debt ceiling standoff for a while by raising the debt ceiling by $5 trillion.
- **Impact on the economy**: The bill looks likely to have a modestly positive impact on US growth for the next couple of years (modest since much of the bill extends tax cuts that were about to expire rather than introducing new stimulus measures). Some of the business taxation measures may boost investment, but the bills also ends many tax incentives introduced under the Biden administration for clean energy and EVs for example. That may leave some capex effectively 'stranded' where finished and half-finished projects no longer make financial sense.
- **Impact on inflation**: The bill may be positive for inflation to the extent it boosts aggregate demand and reduces labour supply. Increasing work-requirements for social security might encourage more into work but the CBO estimates that millions will be left without health insurance. That may prolong the time others spend out of the labour force. Meanwhile, by providing more funding for deportations, the Bill may lower the size of the immigrant workforce.
- To the extent that **bond yields** are higher than they would have been under a more conservative fiscal bill, that will weigh on growth.

Chart 16: US deficits – already at high levels



Source: LSEG Datastream, Bureau of the Fiscal Service, BEA, CBO. Data to Q1 2025/May 2025. CBO forecasts from June 2025.

Chart 17: US Southwest land border encounters suggest a sharply changing (illegal) immigration picture



Source: https://www.cbp.gov/newsroom/stats/southwest-land-border-encounters

Fiscal sustainability concerns: I still worry that fiscal sustainability may become a bigger market concern over the next few years, let alone over the longer term as the pressure from ageing populations increasingly strains public finances. Globally, debt to GDP ratios of major economies are already elevated and governments are already collectively asking markets to swallow large amounts of debt issuance (not least given to cover interest costs).

European economies (including the UK) are likely to be subject to relatively tight market discipline against that backdrop. That will probably mean limited scope outside of a crisis to borrow a lot more, with governments reluctant to risk significant further increases in the cost of borrowing. Most major economies do not look like Germany, where fiscal fundamentals are currently strong and where planned extra spending credibly promises to boost growth – and therefore tax revenue - prospects. The US is able to 'get away with more' with the US dollar the world's largest reserve currency (helping to see more underlying demand for US Treasury assets). However, actions that were seen as eroding Federal Reserve monetary policy independence would be particularly risky against the high debt and high borrowing backdrop.

Are markets thinking enough about immigration?

While most of the attention on Trump's economic policies seems to have fallen on tariffs, arguably not enough focus has fallen on migration. Immigration has played a key role in driving growth in US working age population (Chart 19). Immigration (legal and illegal) can respond and prevent inflationary tightness in the labour market when demand rises. Immigration is also a source of demand as immigrants spend in the US economy.

Looking at the period since 2008, the growth in US population aged 16-64 has slowed but been compensated for by increases in the non-native-born working age population.

Working age population growth is a key driver of overall potential growth in any economy, so prospects of a sharp change in migration dynamics is important to any assessment of US medium-term prospects. Trump came into office with promises around driving out illegal migrants and has proceeded to tighten up enforcement action. Illegal migration forms such a large part of the US workforce, however, that work from the Peterson Institute in the build up to the election suggested that if Trump was successful in deporting all unauthorised workers, the hit to GDP could be 7.5 percentage points! One of the most startling pieces of data here comes from US Customs and Border Protection which shows a very sharp drop-off in Southwest land border encounters (immigrants experiencing apprehension, those determined inadmissible and those expelled), Chart 17.

The fear of deportation may prove as successful as actual deportations and tighter border control at changing workforce dynamics. If people are too afraid to turn up to places of work (and education) for fear of being rounded up, then these workers are no longer an effective part of the workforce and the labour market should duly tighten. Agriculture (and by extension) food prices are, one of the most vulnerable areas here, although enforcement actions by immigration officials have reportedly been steered to focus more on cities of late (see for e.g. WSJ: Trump's Good Deportation Exceptions, 15th June 2025). That may partly reflect some pragmatism on the part of the Trump administration when it comes to limiting the potential inflationary impact of his immigration agenda.

As well as constraining potential growth, it is also worth thinking through what a lack of migrant labour might mean for the unemployment rate and monetary policy. By both tightening labour markets and raising prices, even if it means an overall slowing of demand growth in the US, the deportation agenda might end up lending itself more to rate hikes more than rate cuts.

Potential growth and silver linings

It is probably too early to think about potential silver linings from the recent period but there could be a number of them. Outside of the US those include variations on 'getting the house in order'. Trump's attitude towards America's allies has already helped result in momentum for higher fiscal spending in **Germany** (long overdue) and less reliance on the US for defence (potentially bolstering domestic defence industries which *could* be catalysts for innovation elsewhere). More speculatively, events could be a spur towards bolstering **European Union** integration, resilience and competitiveness including through takings steps to complete Capital Markets Union. **In the UK**, the global backdrop helps explain some of the progress the EU and UK appear to have made towards a closer relationship and fewer trade barriers. **In China**, the global backdrop helps keeps the pressure on for more fiscal support against a backdrop of weak domestic demand. **Within the US**, it is important to recognise that not all Trump's policy agenda is negative for US growth. If the market punishes Trump for higher tariffs again and that ultimately encourages Trump to soften the worst of the measures and to move on from focusing on trade policy, we could move into a more GDP growth positive phase of the Trump administration.

United States: Substantial uncertainty

Evidence is still mixed or inconclusive on the impact of tariffs on the economy with economists generally expecting tariffs to more visibly impact inflation over the summer. In my central case, the US economy looks a bit less exceptional by the end of the year. I am expecting policy uncertainty, tariffs and deportations to weigh on US growth. Fiscal policy, while supportive, doesn't look set to result in a big boost to growth. Assuming that the tariff impact is transitory on inflation, rate cuts still look likely late this year.

Status update: Bumpy – waiting for more evidence

Real GDP growth fell -0.5% quarter-on-quarter annualised in Q1 2025, much of which reflected strong imports (likely an attempt to get ahead of tariffs). GDP is likely to bounce as imports fall in Q2. None of this says much about the underlying strength of the economy. At the end of the Q2, neither ISM not PMI business surveys were pointing at strong growth. Private sector employment trends look a bit weaker than they did at the start of the year, though not especially weak by US standards. Housing-related data looks soft. Business (including small business) and consumer sentiment by the middle of 2025 was still weaker than it was in the wake of Trump's election.

Still expecting cuts

Federal Reserve Chair Powell has been signalling that the economy is in a relatively good place which means they can afford to wait for more evidence on how tariffs are feeding through to prices and activity. My central case is still that they cut rates by 25bps twice late this year, with September as the earliest date for a cut. I am expecting the impact of tariffs to prove temporary on inflation and not push inflation above 4% year-on-year, but am expecting tariffs and accompanying uncertainty to slow economic activity. However, there is still a significant probability of the Fed remaining on hold this year if tariffs start to feed through with more strength into prices; if tariff rates more closely resemble 'Liberation Day' than how they looked after all the 90-day pauses (and the Fed believes that inflation effects are delayed rather than mitigated); and particularly if there are signs of price rises in items with little direct exposure to tariffs and/or signs of rising inflation expectations. Beyond 2025, my central case has two rate cuts over 2026/27. There are two-way risks to this profile, with an additional uncertainty from the replacement of Fed Chair Powell in 2026 and what that might mean for the conduct of policy where President Trump has strongly expressed anti-Powell views and a desire to cut interest rates substantially.

Could policy tip the US into recession?

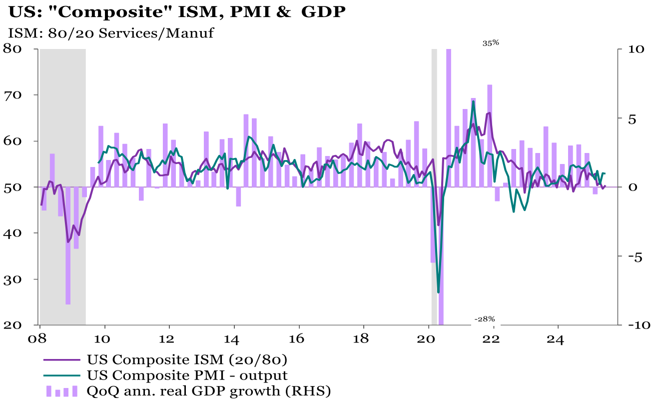
A case for a bigger downturn: The US remains a dynamic economy. However, that does not mean that the economy cannot experience short-term highs and lows. In an environment of substantial policy change, a combination of some of those policies, plus high levels of policy uncertainty, could prompt a more serious downturn than in my base case. At the time of writing (frequent tariff announcements), tariffs look at risk of rising substantially in August. Combined with an intensifying deportation agenda, that may subtract more from output than expected. Fiscal policy already doesn't look set to provide a big additional fiscal boost (even while the deficit looks set to stay large) and deregulation may add to policy uncertainty rather than spur growth depending how it proceeds. It is also not a given that Trump backs down from tariff hikes if they start showing signs of being deleterious.

Deportation complications: Deportations (and fear of deportations) seem likely to affect both supply and demand in the economy. It could result in tighter labour markets – in a *lower* unemployment rate. That would also be an important metric for the Fed in judging whether rate cuts are appropriate and could limit the appetite of the central bank to support the economy even while it slowed.

Medium-term growth damage regardless? Even without a recession and even retaining characteristics of a dynamic economy, it is plausible that US medium-term potential growth sees some damage over the next 12 months. High levels of uncertainty disincentivise investment and a slower build of capital in the economy can damage potential growth. Trump's immigration agenda already looks set to damage the likely path of working age population growth (again, hindering the growth rates the US is likely to be capable of sustaining without inflation ramping up). Attacks on universities and foreign students might also make some of the technological and scientific breakthroughs that help power US economic dynamism less likely. You could also argue that, although the US dollar's reserve status and US treasuries safe haven status mean that the US can sustain more fiscal indiscipline than elsewhere, appetite for US debt may erode somewhat if investors start to feel uncomfortable with what the apparent increase in executive power means longer-term for checks and balances in the US system. Sustained criticism of the Fed can also weigh. A higher US risk premium, raising financing costs for businesses on a more sustained basis, could again lead to less capex than would have been the case.

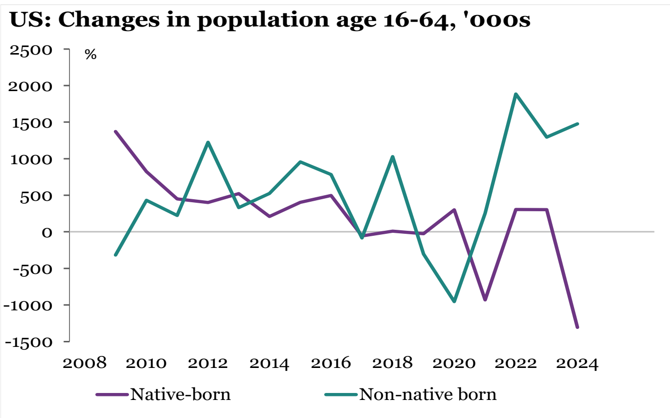
It is worth considering upside cases, however. Tariff increases may effectively be recycled into the US economy in the form of tax cuts, helping to neutralise the impact on the US economy. Meanwhile, as we become inured to the amount of policy change taking place, it is *possible* that markets and businesses become less impacted by it. The election of President Trump boosted business and consumer sentiment in its immediate aftermath for a reason. Should the focus of the administration move on from tariffs and deportations to implementing those tax cuts and deregulation, then talk of US recession and slowdown could quickly be superseded by discussion of more positive scenarios.

Chart 18: Surveys signal sluggish growth



Source: LSEG Datastream, BEA, S&P Global, ISM. Data to Q1 2025 (GDP), June 2025 (PMIs, ISMs).

Chart 19: Population growth: Big US role for immigration 2022-2024



Source: LSEG Datastream, BLS. Data to 2024

China: Facing external and domestic challenges

Despite the rise in US import tariffs on China, the Chinese economy has looked relatively resilient. China's economy had already shown signs of stabilisation and improvement following increased policy support last year. However, China has not resolved some of its fundamental challenges (including a shrinking working age population and very high household savings rate). Meanwhile, China likely faces a multi-year period of external headwinds. Although more policy stimulus would be welcome, especially if it directly boosted domestic demand, recent data resilience may mean that policymakers do not regard that as a priority.

Status update: Not looking strong

China's activity indicators have held up well against a backdrop of higher US tariff rates. Q1 GDP growth was close to expectations at 1.2%Q and consensus expectations are for 0.8%Q in Q2, that is healthier than it could have been in the wake on higher tariff rates applied by the US from February. The more supportive policy backdrop since last year has probably helped, while data also suggests that China has ramped up exports to other destinations in lieu of the US. Still, business surveys (NBS and Caixin PMIs) were at subdued levels through Q2 (Chart 20) and consumer confidence remains weak.

Policy support still important but still falling short

Policy support has likely been important in the stabilisation and improvement seen in some of the China data at the end of last year/this year, including the consumer trade-in scheme and lower interest rates (Chart 21). Much of the support from Chinese policymakers, however, has continued to focus on the supply rather than demand side of the economy. Recent efforts to help alleviate financial problems in local governments (local government debt swap) and interventions in the property sector more broadly should be helpful in stabilising prospects, but fundamental problems around the challenge of an ageing population, high consumer savings rates (reduced consumer demand) against a production oriented industrial policy (plenty of supply) and youth unemployment have yet to be resolved. These are not quick and easy problems. But while there does seem to have been some increase in focus on supporting domestic demand, that still feels secondary to industrial policy.

The start of the year saw a flurry of new policy announcements and we may get another round at the July Politburo meeting. But the apparent stabilisation in the economic data and relative resilience so far in the wake of tariff changes has arguably removed the urgency for further policy action.

Industrial policy is likely to remain a key focus for policymakers with the approaching end of China's 'Made in China 2025' five-year plan this year. Given the apparent success of that programme (see China's market share high in a number of key industries – including electric cars and solar panels, for example), the next five-year plan may effectively double down on industrial policy and championing of industries rather than pivoting to focus more on domestic demand and social safety net reform.

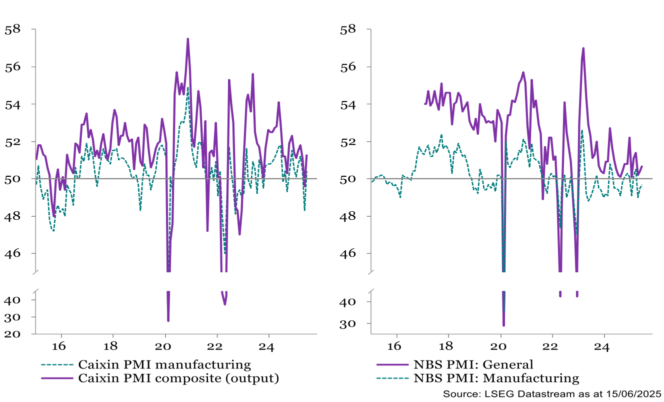
Long-term challenges remain substantial: Medium-to long-term challenges facing China still include an overhang of private sector debt and population ageing. China's falling working age population is a key reason to expect overall GDP to steadily trend lower in coming years. China's stance toward Taiwan continues to present a risk to China's (and the global) economic outlook should any action against Taiwan prompt a deterioration in economic relations between China and other major economies. There are still risks of capital misallocation where China's industrial policy may or may not support the 'right' industries that will support sustainable growth.

Trade vulnerability

China's economic model still seems to rely relatively too much on external demand. Domestic demand continues to look insufficient to mop up industrial supply, with symptoms including low inflation, youth unemployment problems and a high household savings rate (and with an insufficient social security safety net likely still a key reason for the latter). The external environment, meanwhile, has become more hostile this year. Although President Trump has stepped back from the very high April tariff rates (that effectively meant a trade embargo), US tariff rates on Chinese imports remain higher than the start of the year and have been extremely volatile. The end of the tariff exemption for small packages is also notable (which had previously led to growth of a significant US client base for the likes of Shein and Temu). Other US trade deals have included measures that might impact China indirectly, including a higher tariff rate for Vietnamese exports that are deemed 'transshipments' and the provision in the UK deal requiring the UK to "promptly meet" US demand on "security of supply chains" for aluminium and steel exports (see BBC).

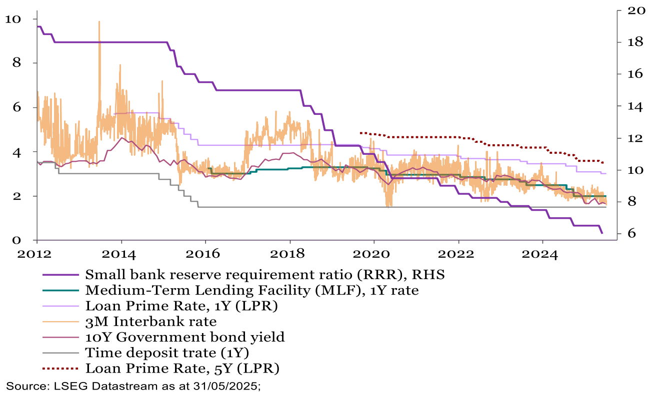
There has been some expectation that we could see China engage in substantial trade re-direction, pushing to increase non-US market share and with some attempts to redirect trade through other more lightly tariffed countries. Evidence in China's trade data suggests an increase in export growth to the likes of the EU, UK and Canada but a sharp decrease in export to the US since March 2025 and with growth in exports to Vietnam for example (a key alternative global manufacturing destination) remaining at strong levels (Chart 13).

Chart 20: Surveys still subdued



Source: LSEG Datastream, S&P Global, NBS. Data is to June 2025.

Chart 21: More (and more) policy support



Source: LSEG Datastream, PBoC. Data updated 8th July 2025.

Euro area: Holding back the optimism

Euro area growth picked up at the start of this year but looks set to grow more slowly over the rest. I am watching three drivers in particular: 1) The consumer, where rate cuts and a high savings rate suggest some upside risks for consumer spending, tempered now by lower real pay growth; 2) Fiscal policy, which looks set to be more growth supportive but is likely more of a 2026 and onwards story; 3) Trump and the external environment – where the combination of higher tariffs, slower global trade, greater trade policy uncertainty and geopolitics look likely to weigh on activity. A sharper deterioration in US trade relations might have some positive outcomes over the longer-run though, if that were to drive further integration and policy reform in the EU.

Status update: Better than surveyed?

GDP grew 0.6%Q in Q1, stronger than looked consistent with the business surveys, with a large contribution from gross fixed investment and net trade. Consensus expectations are for a much slower Q2 with the composite PMI business survey indicator, at 50.6 in June, not signalling much growth in the private sector. Still, that was the case with Q1 survey data too. The unemployment rate remains at around record lows, however, and credit demand has improved too from levels at the start of last year (albeit falling a bit for businesses on the Q2 ECB survey). Although the savings rate shows some signs of falling (supporting consumer spending), real pay growth has slowed significantly. Consensus expectations are for (only) around 0.0%Q GDP growth in Q2.

Still reluctant to turn optimistic

My central case remains modest positive GDP growth but with the balance of risk to growth tilted to the downside in light of global developments and slippage in real pay growth. There are a number of supportive factors for the euro area growth outlook, but enough challenges to stop me being optimistic:

Euro area fiscal policy should move from a drag to a support for growth (Chart 23). German fiscal policy following debt brake reform looks set to benefit euro area growth. Combined with expectations of somewhat higher defence spending in Europe more broadly, fiscal policy change is expected to add a few tenths to GDP growth. However, given the lags involved with infrastructure and defence spending – this is expected to be more of a 2026 and onwards story, than a 2025 one. A fiscal impulse of perhaps 0.3% GDP is significant in the context of an economy with a potential growth rate not much above 1%.

The biggest *upside risk* to euro area growth is arguably still the consumer. The savings rate remains well above pre-pandemic norms (Chart 22). Interest rate cuts should disincentivise saving and encourage spending. The savings rate already appears to have fallen a bit from the highs. However, with the global backdrop so uncertain there is no guarantee that consumers won't want to keep savings rates elevated regardless; fears of unemployment – while not at very high levels (and despite official data showing a low unemployment rate by euro area standards) are also significantly above levels seen just before the pandemic. Real pay growth has also slowed significantly from its recent highs as nominal wage growth measures have cooled (Chart 6).

US tariffs on EU goods, depending on scale and duration, could be a significant drag on growth. Work by the ECB estimated that tariffs of 25% could subtract 0.3pp from growth. That would be significant in the context of the euro area's low potential growth rate. Trump has threatened the EU with tariffs twice this level. At time of writing Trump has announced a 30% tariff. Other reports have suggested that they may be able to agree a deal at closer to 10%.

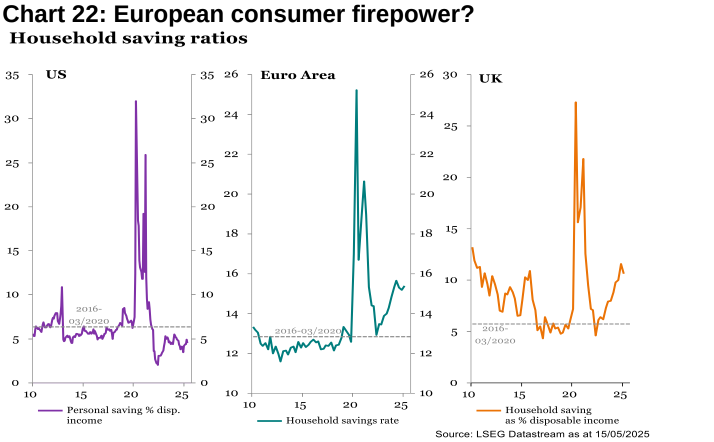
Energy prices are a further unknown. The euro area is a sizeable importer of oil and natural gas and the Spain/Portugal blackouts earlier this year were arguably a reminder that the transition to (cheap) renewables is not yet an easy alternative. With geopolitical tensions high but changeable, there is significant potential for energy prices to at least lead to short-term volatility in inflation with two-way risks for activity depending on developments.

Longer-term challenges still include adverse demographic trends, incomplete capital markets union and a lack of harmonised regulation in some areas across the region. If trade (and broader) relations with the Trump administration sharply deteriorate (as seems at least plausible – if not in the next three months, then at some point in the next three years), that *could* spark progress for reforms and integration, but evidence so far is limited.

ECB: Nearly done

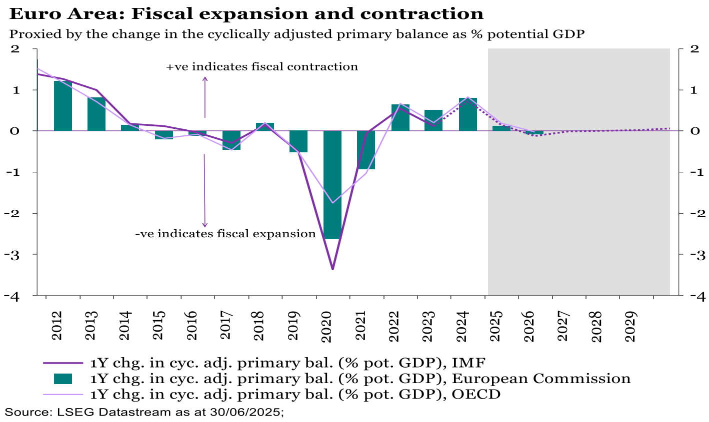
Modest growth and a somewhat more reassuring inflation picture, set alongside significant global risk leave me expecting the ECB to cut rates once more to 1.75%, below my central estimate of a medium-term neutral rate. The ECB view measures of underlying inflation as indicating that inflation will settle around the 2% inflation target. Pay data continue to signal slowing wage growth with the ECB's own wage tracker indicating significantly slower pay growth and a number of other pay indicators have been pointing to the same thing. That should help services inflation to fall further but, alongside a likely disinflationary impulse from tariffs (see global section), raises the risk that inflation *undershoots* the target. Redirection of Chinese exports from the US seems a particular risk here. Both that, and a hit to US demand on higher tariffs, risk weighing significantly on euro area manufacturers. With fiscal stimulus unlikely to be much of a supportive force before 2026 and, even then, a limited support), the risks feel skewed for now towards more rather than less rate cuts than my central forecast. Upside risks for inflation still include what looks like a tight labour market (based on official unemployment figures) such that an upside shock to demand might quickly rekindle wage growth.

Chart 22: European consumer firepower?



Source: LSEG Datastream, BEA, Eurostat, ONS. Data to May 2025 (US) and Q1 2025 (Euro area, UK).

Chart 23: Euro area: Fiscal drag to fiscal support



Source: LSEG Datastream, IMF (April 2025); EU Commission (as of May 2025) and OECD (June 2025)

United Kingdom: Still a source of concern

The UK economy grew strongly in Q1, but looks set to slow significantly in Q2 and with prospects not especially promising for the rest of the year either. Survey-based signals for the economy in Q2 have been mixed, but the labour market continues to look worrying and could be a catalyst for downside in consumer demand. The UK has also experienced another rise in inflation (much of which thanks to energy prices) which ought to prove temporary but helps keep the Bank of England on track for only gradual rate cuts for now. Meanwhile, risks are building for another substantial tax hike announcement in 2025's Autumn Budget.

Status update: Still worried by labour market trends

UK GDP growth was a stronger than expected 0.7%Q, a very good pace of growth by UK standards. The PMI business surveys signal modest positive growth in Q2, though survey signals are mixed overall, while monthly GDP figures also look consistent so far with something flatter than in Q1 (Chart 24). The October Budget's employment tax hikes were implemented in April and labour market figures still look weak.

Challenging environment

I continue to forecast unimpressive growth rather than a recession in the UK, but I worry about the economy's vulnerability to shocks and would *not* put a low probability on recession at some point over 2025-26. The outlook for consumer spending has deteriorated somewhat in light of a continued cooling in the labour market combined with signs that wage growth will slow further and after bill increases this year already. Household savings rates have come down a little, but remain high (by UK standards) consistent perhaps with underlying worries about future cost of living shocks (measured consumer confidence itself is still well off its lows). Royal London data continues to suggest a substantial amount of vulnerability among consumers with one in 5 adults saying they have less than £100 in cash savings. After the US-UK trade 'deal', domestic sources of downside risk look relatively more concerning than international ones although the external environment clearly remains challenging.

Labour market remains worrying

Since the announcement of April's National Insurance tax hike the previous October, alongside labour market reforms and another significant rise in the minimum wage, business surveys have signalled weaker employment trends (Chart 25). The June composite PMI employment indicator was below 50 (signalling falling employment) for the 9th month with respondents citing excess capacity and squeezed margins for hiring freezes and redundancies. Real pay growth is already slowing (Chart 6) and in the absence of a big fall in household savings rates, a worsening labour market backdrop could slow consumer spending growth.

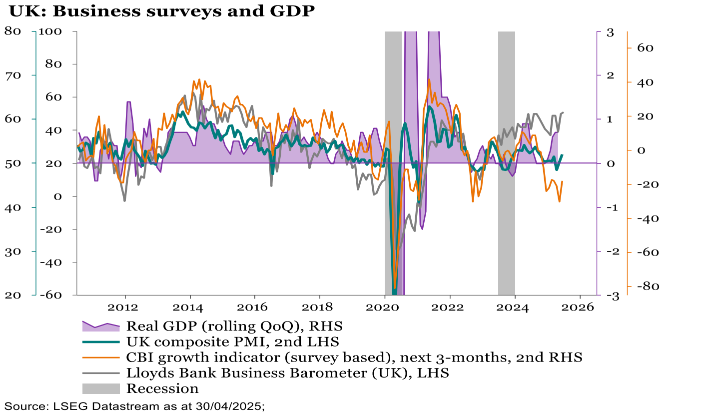
How much of a concern for the outlook is the UK fiscal situation?

The UK still faces significant long-term fiscal challenges related to an ageing population. Higher UK government bond yields and a relatively weak potential growth rate (reflecting the UK's long-run productivity problems and now an ageing population too) mean that we could again (and again) see economic forecast revisions from the OBR eliminate the Government's headroom against their fiscal rules. Tax increases seem likely at the Autumn Budget. In turn, that fiscal tightening could further weigh on the growth outlook. The UK government is already borrowing heavily in financial markets, against which backdrop there may likely be limited patience for stretching the fiscal rules or a further deterioration in the growth outlook. The government have made much out of a push to increase public investment, ease planning regulations and ease some of the funding pressures for key areas of day-to-day spending. To a reasonable degree these are welcome moves, but they seem unlikely to show results fast enough in terms of improvements in economic growth for markets to give the Chancellor much room for manoeuvre.

Inflation and the BoE: Needing reassurance

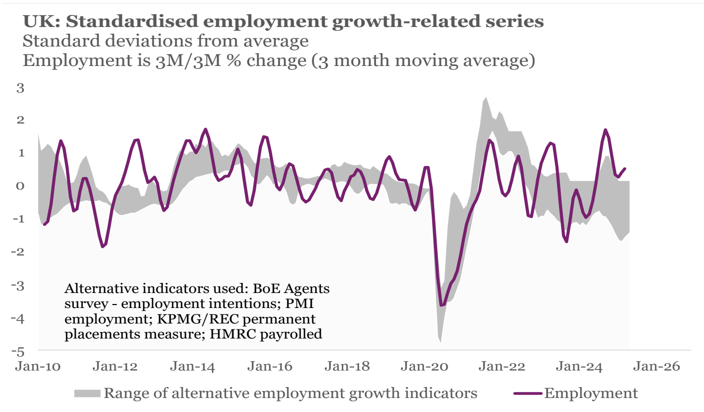
Various members of the MPC continue to sound worried about inflation persistence and the risks that price shocks can flow through to broader pricing, inflation expectations and pay in a way they didn't pre-pandemic. The recent mention in the MPC minutes of monitoring food prices was perhaps notable in that regard too. Pay growth does seem to have cooled a bit through this period though, and businesses continue to signal slower pay growth in 2026 than 2025 (looking at 12 month ahead pay expectations in the Bank of England's DMP business survey). That should help contain services inflation. Alongside which, the impact of tariffs looks likely to be disinflationary for the UK. That reflects an expectation of a negative impact on activity as exports and global trade are hit and Chinese producers may discount to expand their non-US market share. There is some evidence already that, in the wake of tariffs earlier this year, imports to the UK from China have risen significantly (Chart 13). I expect the Bank of England will feel reassured enough to continue cutting rates gradually and that, especially given the labour market backdrop, that the risks to that 'careful, gradual' rate profile are for now skewed more towards them stepping up the pace of cuts than slowing it down.

Chart 24: Mixed survey messages



Source: LSEG Datastream; ONS, S&P Global, CBI, Lloyds Group. GDP data to April 2025; Survey data to June 2025.

Chart 25: Jobs data still a bit worrying



Source: LSEG Datastream, BoE, S&P Global, S&P Global, KPMG/REC, ONS/HMRC. Survey data (grey area) to May 2025. Official employment series to March 2025.

For professional clients only, not suitable for retail clients.

Japan: Very gradual

Despite so much global uncertainty, the Bank of Japan is likely to continue (very) gradually raising rates this year. However, inflation dynamics need to convince BoJ policymakers that the 2% inflation target is going to be hit sustainably. Wage and inflation dynamics so far look reasonably convincing, but policymakers will likely want more evidence that global events aren't knocking this off course. US tariffs and potentially slower global trade growth remain among the key downside external risks to the outlook.

Status update: More convinced on inflation; unconvinced on growth

Measures of inflation remain elevated in Japan by historical standards (Chart 26). We have not seen the same kind of retreat in inflation measures in Japan post-2022 as we have elsewhere. Inflation outcomes continue to look well above their pre-pandemic norms. As of May, headline CPI and both main 'core' measures of inflation remained above 3%. Neither services inflation nor pay growth have slipped back to the anaemic levels seen before the pandemic. The provisional results of the Spring wage rounds have been stronger than the wage growth achieved in 2024. The share of items in the CPI basket rising over those falling has also remained close to the levels reached in 2023. Supporting all that, the labour market still looks relatively tight.

The picture from activity data has been mixed. Q4 GDP was stronger than expected, followed by limited payback in Q1 2025 (Chart 27) with the economy contracting very slightly. Indicators from business surveys so far look consistent with flat to modestly positive growth in Q2 2025 and some of the April 'hard' data looks consistent with that too. The Japanese economy continues to look far from strong though and with a low potential growth rate, never feels too far from recording negative growth quarters.

2025: Not all of the uncertainty is external

Partly reflecting a strong end to 2024, annual GDP growth in 2025 still looks likely to come in significantly higher than in 2024. Japan's growth trends, however, remain far from strong and the consumer has failed to show as much life as I'd expected and real pay growth trends look more negative than flat at the moment. Consumer confidence has fallen from levels seen at the start of the year. High rice prices will be a strain on some household's finances and confidence. Nominal pay growth continues to run well above pre-pandemic levels though (Chart 28) and the labour market continues to look relatively tight with the unemployment rate still (only) around the 2.5% mark. That tight labour market should support incentives for capital expenditure too, supporting production even while demographic pressures likely lead to further shrinkage in the working age population.

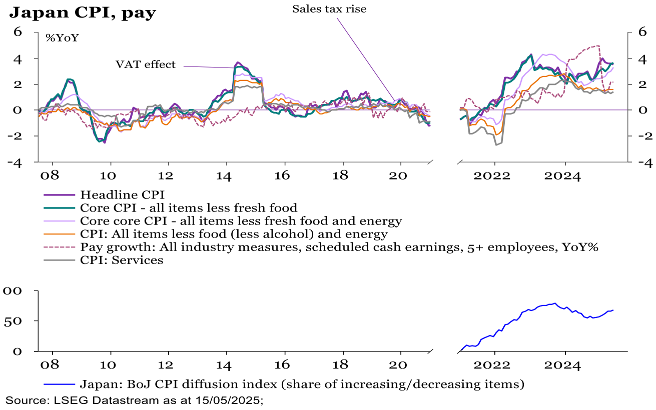
There are some significant sources of uncertainty. Domestically those include the Upper House election scheduled for July 20. A loss by the ruling coalition would add to fiscal uncertainty where opposition parties are demanding a consumption tax cut. Externally, there is a big question around the impact of US trade policies. The final tariff level Japan will face is still subject to a large level of uncertainty. Trump has previously referred to Japan as a currency manipulator and the early April level of reciprocal tariffs announced by the US had Japan facing a 24% tariff rate, with an early July letter signalling a 25% rate from August 1. However, that does not preclude a trade deal being done at a better tariff rate. From a BoJ perspective there are concerns that the global trade environment will weigh on activity and prices.

(Very) gradual rate rises

Further rate increases look likely over the next year or so from the Bank of Japan (BoJ). However, against an uncertain backdrop and despite few signs of Japan's inflation-related data returning to subdued pre-pandemic norms, these rate rises are likely to be very gradual and very careful. That makes sense against a risky global backdrop and where it is still not taken for granted that Japan has sustainably left behind its low inflation past.

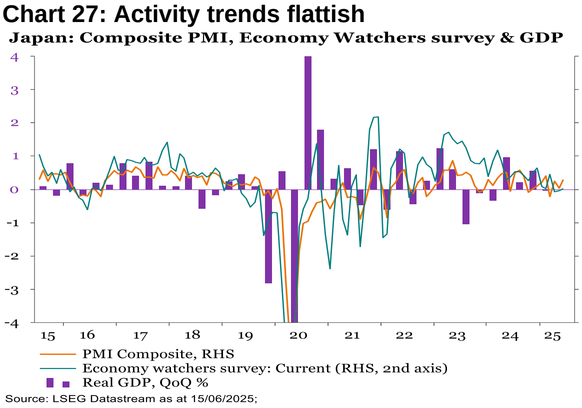
Policy settings remain accommodative with the policy rate, at 0.50%, still at very low levels after three hikes and with the BoJ on hold since January. Consensus is for only one further rate rise this year (in Q4) then one further rate rise in 2026. The neutral rate is likely relatively low (on a 5-10 year ahead basis, my central estimate is around 1.75%, while BoJ staff have put neutral as between 1% and 2.5%). Those estimates of neutral suggest that policymakers should raise rates further as their confidence grows that the 2% inflation target will be hit on a sustainable basis.

Chart 26: Still strong inflation (by Japan's standards)



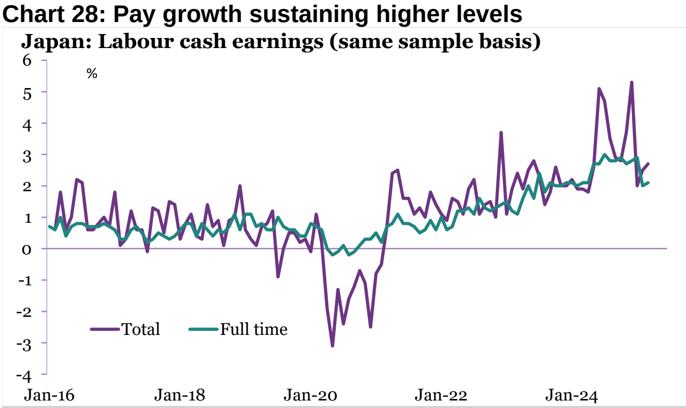
Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of May 2025.

Chart 27: Activity trends flattish



Source: LSEG Datastream, S&P Global, Cabinet Office. Data to June 2025 (PMI and Economy Watchers); Q1 2025 (GDP).

Chart 28: Pay growth sustaining higher levels



Source: LSEG Datastream, Ministry of Health, Labour and Welfare to May 2025.

For Professional Clients only, not suitable for Retail Clients. The views expressed are the author's own and does not constitute investment advice. The views expressed are based on available information at the time of publication and are subject to change without notice. Unless otherwise noted, the information in this document has been derived from sources believed to be accurate as of end of June 2025. Information derived from sources other than Royal London Asset Management is believed to be reliable; however, we do not independently verify or guarantee its accuracy or validity.

Derivative Risk: Derivatives are highly sensitive to changes in the value of the underlying asset which can increase both Fund losses and gains. The impact to the Fund can be greater where they are used in an extensive or complex manner, where the Fund could lose significantly more than the amount invested in derivatives.

Credit Risk: Should the issuer of a fixed income security become unable to make income or capital payments, or their rating is downgraded, the value of that investment will fall. Fixed income securities that have a lower credit rating can pay a higher level of income and have an increased risk of default.

EPM Techniques: The Fund may engage in EPM techniques including holdings of derivative instruments. Whilst intended to reduce risk, the use of these instruments may expose the Fund to increased price volatility.

Exchange Rate Risk: Changes in currency exchange rates may affect the value of your investment.

Interest Rate Risk: Fixed interest securities are particularly affected by trends in interest rates and inflation. If interest rates go up, the value of capital may fall, and vice versa. Inflation will also decrease the real value of capital.

Liquidity Risk: In difficult market conditions the value of certain fund investments may be difficult to value and harder to sell, or sell at a fair price, resulting in unpredictable falls in the value of your holding.

Emerging Markets Risk: Investing in Emerging Markets may provide the potential for greater rewards but carries greater risk due to the possibility of high volatility, low liquidity, currency fluctuations, the adverse effect of social, political and economic instability, weak supervisory structures and accounting standards.

Counterparty Risk: The insolvency of any institutions providing services such as safekeeping of assets or acting as counterparty to derivatives or other instruments, may expose the Fund to financial loss.

Fund investing in Funds Risk: The Fund is valued using the latest available price for each underlying investment, however it may not fully reflect changing stock market conditions and the Fund may apply a 'fair value price' to all or part of its portfolio to mitigate this risk. In extreme liquidity conditions, redemptions in the underlying investments, and/or the Fund itself, may be deferred or suspended.

Liquidity and Dealing Risk: The Fund invests indirectly in assets that may at times be difficult to value, harder to sell, or sell at a fair price. This means that there may be occasions when you experience a delay in being able to deal in the Fund, or receive less than may otherwise be expected when selling your investment.

Investment risk: The value of investments and any income from them may go down as well as up and is not guaranteed. Investors may not get back the amount invested.

The RL Multi Asset Funds are sub-funds of Royal London Multi-Asset Funds ICVC, an open-ended investment company with variable capital with segregated liability between sub-funds, incorporated in England and Wales under registered number IC001058. The Company is a non-UCITS retail scheme. The Authorised Corporate Director (ACD) is Royal London Unit Trust Managers Limited, authorised and regulated by the Financial Conduct Authority, with firm reference number 144037. For more information on the fund or the risks of investing, please refer to the Prospectus or Non-UCITS retail scheme Key Investor Information Document (NURS KII Document), available via the relevant Fund Information page on www.rlam.com

Issued in July 2025 by Royal London Asset Management Limited, 80 Fenchurch Street, London EC3M 4BY. Authorised and regulated by the Financial Conduct Authority, firm reference number 141665. A subsidiary of The Royal London Mutual Insurance Society Limited. Our ref: PDF RLAM PD 0279.