Investment Clock – Economic Update

Issue #33, March 2025

Multi asset views

Royal London Asset Management manages £173.4 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 December 2024

Author:

Melanie Baker
Senior Economist

US: Activity growth looks likely to slow somewhat after a strong 2024 and given policy uncertainty. Some elements of Trump's agenda still seem likely to raise inflation and therefore may stymy Fed rate cuts this year.

China: Policy is likely to remain supportive, but China faces what may be another challenging year of external headwinds.

Euro area: I expect modestly positive GDP growth ahead. Consumers have firepower, and fiscal spending looks set to be more stimulative, but Trump's tariff agenda poses challenges.

Japan: The BoJ is likely to continue very gradually raising rates. Tariffs and potentially slower global trade growth are among the downside risks.

UK: With the global outlook uncertain and surveys sending worrying jobs signals, the growth outlook isn't upbeat. The BoE is likely to cut rates (gradually) further this year, but inflation needs to reassure.

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

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

Uncertainty Anxiety

Global growth looked to be ticking along at a modest pace at the start of 2025, but cracks are now appearing. A very uncertain US policy backdrop and related disruptions to global trade seem likely to weigh on growth in the US and beyond. Fiscal stimulus may provide something of a shield in economies like the Euro area and China. A few more rate cuts seem likely in major economies (except in Japan), albeit more gradual, careful ones, but the US inflation outlook is uncertain enough that (US) rate hikes can't be ruled out either.

Summary

Not quite more of the same for growth: In the central forecast, major economies see positive modest economic growth. Last year saw robust-to-strong US growth contrast with a much flatter picture in Europe. US growth rates look set to slow from that pace and may end up looking even less 'exceptional' if policy uncertainty remains a major feature of the Trump administration. For now, for the US economy, the more growth-negative parts of his agenda seem to be taking precedence over the more growth positive ones. Tariffs and tariff threats look set to hold back growth beyond the US.

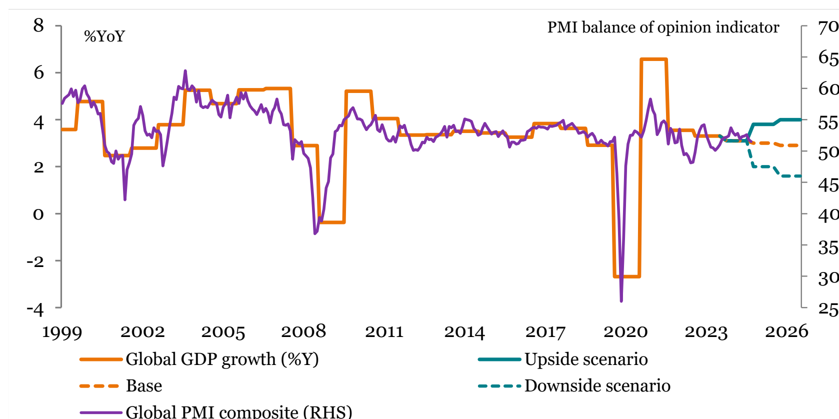
Inflation not so reassuring: Inflation trends haven't been as reassuring as I would have expected, where services inflation still looks too strong for (central bank) comfort across a number of economies, leaving inflation vulnerable to remaining above 2%. Labour markets are also a bit less loose than I anticipated at this stage. I still expect core inflation to fall (though not in the US, given tariffs), but my profiles for headline inflation do not show straight line progress and are vulnerable to tariff decisions.

Central banks likely to cut further, but risks on both sides: Most major central banks are running with interest rates above neutral, but increasingly not by much. If growth remains positive but unimpressive and if inflation reassures somewhat then central banks can continue to cut towards neutral (hike in Japan). But stickier than expected inflation, substantial policy uncertainty (Trump), and rates being closer to neutral suggests that at least some slowing of the pace makes sense beyond just the US.

The Trump factor: The Trump presidency is bringing policy discontinuity, less predictable policy, and with an apparent shift in attitude towards some global institutions and in the potential operation of US checks and balances. Sensible analysts disagree on what Trump will actually do on tariffs, immigration and fiscal policy, but the forecasts pencil in an impact on the US economy which is inflationary (assuming some degree of higher tariffs, deportations and, later, tax cuts not fully offset by spending cuts). I also assume that we see some of the 'negatives' for near-term activity growth (tight immigration, uncertainty, tariffs), before the 'positives' (tax cuts, deregulation), slowing US growth this year.

The **multi-asset team** acknowledges that the risk of tariffs and other policy changes have started to weigh on business and consumer confidence. They have taken profits on global equities and have been underweight US equities, preferring Europe where company earnings have been stronger and fiscal policy likely to support growth. For more, see the team's 'ClockWise' blog at www.rlam.co.uk.

Chart 1: Global growth central case: Modest positive growth, downside skew



Source: IMF, S&P Global (past data); RLAM (forecasts). PMI data is to February 2025. Please note all charts are for illustrative purposes only.

Economic forecast summary

March 2025 base case

Region	2024e			2025e			2026e			2027e			2028e		
	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	1.9 *2.4*	2.7 *2.6*	4.00 *3.75*	1.3 *1.9*	2.8 *2.9*	3.50 *3.25*	2.0 *1.4*	2.3 *2.3*	3.50 *3.25*	1.7 *1.8*	2.2 *2.2*	3.25 *3.25*
China	5.1	–	–	5.0 *4.8*	– *–*	– *–*	4.8 *4.6*	– *–*	– *–*	4.6 *4.4*	– *–*	– *–*	4.3 *4.2*	– *–*	– *–*
UK	0.9	2.5	4.75	0.8 *1.6*	3.3 *2.3*	3.75 *3.75*	1.0 *1.3*	2.6 *2.3*	3.25 *3.25*	1.2 *1.3*	2.2 *2.2*	3.00 *3.00*	1.3 *1.4*	2.3 *2.1*	3.00 *3.00*
Euro area	0.8	2.2	3.00	0.9 *1.0*	2.1 *2.1*	2.00 *1.75*	1.2 *1.0*	2.0 *2.1*	2.00 *1.75*	1.4 *1.2*	2.1 *2.2*	2.00 *2.00*	1.2 *1.1*	2.2 *2.2*	2.00 *2.00*
Japan	0.1	2.9	0.25	1.5 *1.2*	2.4 *1.9*	1.00 *0.75*	0.9 *0.8*	2.3 *2.0*	1.50 *1.00*	0.8 *0.7*	2.1 *1.8*	1.50 *1.00*	0.7 *0.7*	2.2 *1.8*	1.50 *1.25*
Global	3.1	–	–	3.0 *3.3*	– *–*	– *–*	2.9 *3.1*	– *–*	– *–*	3.1 *3.0*			3.0 *3.0*		

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 November 2024 forecast update are grey and in italics. 2024 figures are a mixture of past actuals and forecasts (not all data is available yet). Note: US policy rate is the upper end of the Fed Funds target range. Euro area policy rate is the deposit rate. Please note all charts are for illustrative purposes only.

Key economic policy forecasts

- My central case forecasts still see a few more rate cuts, moving closer to neutral in the US, UK and Euro area (or hikes in the case of Japan). I am assuming that, in the absence of recessions, more central banks follow the Fed and start treading more carefully (i.e. slowly) as they approach/hit the range of plausible neutral rate estimates, and reflecting increasing economic uncertainty.
- Sharper than expected downturns and more unemployment would see deeper rate cuts than in the base case (as central banks try to get rates below neutral). Higher than expected inflation (particularly core, services inflation and, relatedly, pay growth), could mean rate cuts pause. A return to rate hikes can't be ruled out for 2025/26, including in the US under the Trump presidency, especially if he pushes through substantial tariff increases and tough immigration measures alongside supportive fiscal policy and these prove inflationary. Several other economies, including the UK, look vulnerable to an increase in inflation worries with pay growth and services inflation still running strong.
- The fiscal policy outlook is difficult to pin down, but looks set to be quite a bit more supportive than expected in the Euro area and a bit less stimulative than I had expected in the US (with the administration's early focus on cutting spending).

Global economic scenarios (Chart 1)

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

- Levels of policy uncertainty fall. 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.
- Headline inflation stays relatively close to target, as higher productivity growth contains overall labour cost growth. Higher labour market participation and surprisingly robust immigration also helps in some cases.
- 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, closer to target inflation and somewhat lower rates

- Economies continue to skirt recessions in some cases, with modest growth. US growth slows against an uncertain US policy backdrop. Consumer spending is supported by positive real pay growth and business investment gets some support from rate cuts. Worsening trade relations and US-centred policy uncertainty constrain global growth. That is offset somewhat by more stimulative fiscal policy in some economies.
- Domestically driven inflation pressures ease further, even while headline inflation rises. Interest rates are cut/raised towards neutral.

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

- Rate cuts take longer than expected to feed through to demand, and the drag from past rate hikes is worse than expected. 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, immigration 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.
- Outside the US, rate cuts are deeper than in the central case (though do not fully return to pre-pandemic levels in most developed economies).

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: A little worried

The global PMI business survey suggests that at an aggregate level, growth is slowing. The Trump administration is rapidly bringing a great deal of change in style and policy substance adding significant policy uncertainty for businesses and consumers in the US and beyond – which itself seems likely to drag on growth. With an early focus on tariffs, immigration and spending cuts, the more growth-negative parts of the Trump agenda look set to dominate in the near term, helping to lower growth prospects in the US and beyond. In Europe and China, there are some sources of resilience that *could* help them weather external threats, including more stimulative fiscal policy. My central case does not build in recessions, but does build in some unimpressive growth rates. Meanwhile, underlying inflation is likely to reassure central banks in Europe and Japan into cutting/hiking rates a bit further. Rate hikes (not central case) can't be ruled out in the US.

Status update: Cracks appearing

Using the global composite PMI business survey as a proxy for global GDP growth (Chart 1), the indicator looks consistent with a mild pace of expansion, having slowed since late 2024. Policy uncertainty measures have ramped up and tariffs/US policy uncertainty have been mentioned as factors affecting activity and sentiment in a number of surveys. Q1 has seen US economic activity indicators look less healthy–especially survey and sentiment indicators. Weather and wildfires may have played a role earlier in the quarter. China's near-term growth picture has improved somewhat as policy support has dialled up (though there are still plenty of challenges ahead). Europe looks flatter, but with brewing shifts in fiscal policy, growth prospects have also improved. Across major economies, inflation has generally risen back above central bank targets, but real pay growth nonetheless remains positive.

Summary outlook: A few more rate cuts, middling growth, lots of uncertainty

Modest growth in the face of offsetting forces: The economic forecast summary indicates a bumpy profile for GDP growth in a number of economies. I assume that the combination of Trump's policy plans will boost US inflation and end up damaging global growth via an environment of policy uncertainty, tariff threats, actual tariff increases, some retaliation and some increase in non-tariff trade barriers. The central forecasts don't have recessions or booms pencilled into them though: 1) Real pay growth (Chart 2) and rate cuts (Chart 3) should be supportive of consumer spending, but dampened by cooling labour markets and any impact from tariffs on inflation. 2) Bank credit conditions are less tight than they were, but the past cumulative tightening will probably weigh for a while. 3) Fiscal policy looks set to be more supportive than I previously expected in the Euro area in the years ahead, but less supportive in the UK. The impact of past spending programmes under Biden may facilitate US growth but with Trump determined to put a line under those programmes, with a focus on federal job cuts and efficiency savings and with tax cuts likely to follow only with a lag, US fiscal policy looks likely to be less stimulative than I expected near-term. The balance of these factors still feels like a recipe for a bumpy central case and only modest GDP growth in major economies, with risks skewed to the downside.

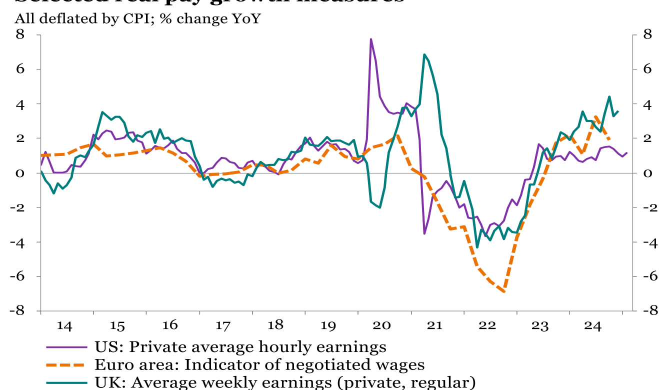
Cuts, hikes? I expect inflation to gradually reassure (through a decline in core and services inflation rather than headline) and for rates therefore to be cut further towards neutral in the US and Europe, helped by slower growth in the US. However, with central banks closer to neutral it makes sense to slow the pace in the US and Euro area. In the UK, I expect concerns about inflation persistence to keep cuts gradual while in Japan, a continuation of cautious hikes seems the most likely path as inflation there gradually reassures that it will linger around 2% rather than sink back to pre-pandemic norms. Risks for now, feel skewed towards fewer cuts/a hike this year from the Fed (on the risk that the Trump agenda proves more inflationary than expected). The election of Trump might result in a big, sustained change in US inflation (not my central case) given his proposals for tax cuts, tariffs and deporting undocumented migrants. For now, there is clearly a large amount of uncertainty around how much of his platform will end up being implemented (and when). Key considerations there include the extent to which spending cuts also materialise, to what degree tariff threats actually materialise, and how far logistical/funding constraints and worries about optics contain Trump on deportations.

The growth picture may become less divergent

Over a two-year period, my forecasts pencil in a bit of convergence in GDP growth in the US and Europe. That partly reflects an assumption that the US is currently growing a bit above trend and Europe below (so assumes some normalisation) but also builds in an assumption that some of President Trump's early policy actions drag on, rather than boost, US growth. The apparent political shift in Europe towards more defence/infrastructure spending also boosts prospects of European growth. I can also still make an upside case for Europe driven by consumer spending, where real pay growth helps confidence build and households save less–savings rates are well above pre-pandemic norms (Chart 4) and the ECB is cutting rates.

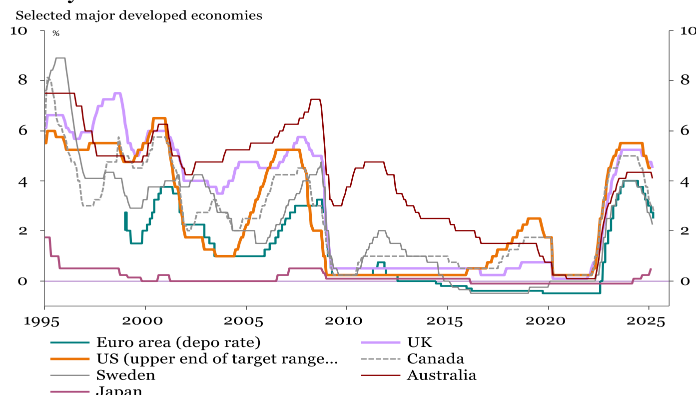
There are clearly risks that the world evolves very differently, with Trump's election revitalising hiring and investment but there are already signs in business surveys that businesses have not maintained post-election optimism (Chart 5). In Europe, the UK outlook has deteriorated since the middle of last year against the backdrop of a budget/minimum wage setting/employment reform that has substantial cost implications for businesses/employment.

Chart 2: Household real pay growth positive



Source: LSEG Datastream, BLS, ONS, ECB, Eurostat. Data is to February 2025 (US), December 2024 (UK), Q3 2024 (Euro area).

Chart 3: Rate cuts helpful for growth outlook



Source: LSEG Datastream, Data to 13th March 2025. Please note all charts are for illustrative purposes only.

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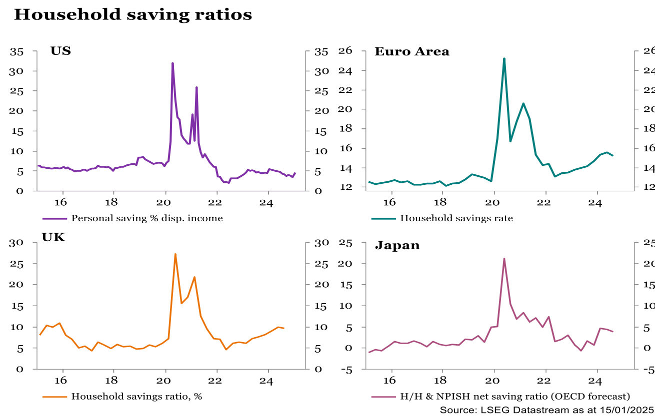
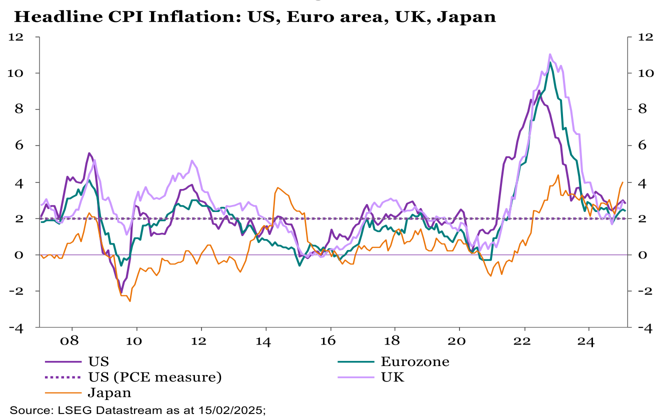
Chart 4: Households: Theoretical European consumer firepower



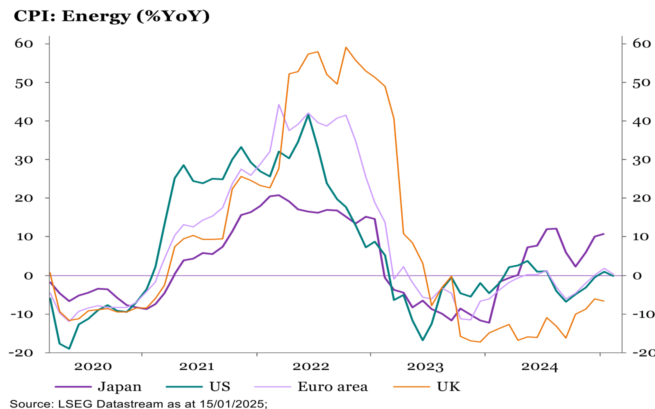
Source: LSEG Datastream, BEA, Eurostat, ONS, Cabinet Office. Data to January 2025 (US) and Q3 2024 (UK, Euro area, Japan).

Chart 6: Inflation above target (still)



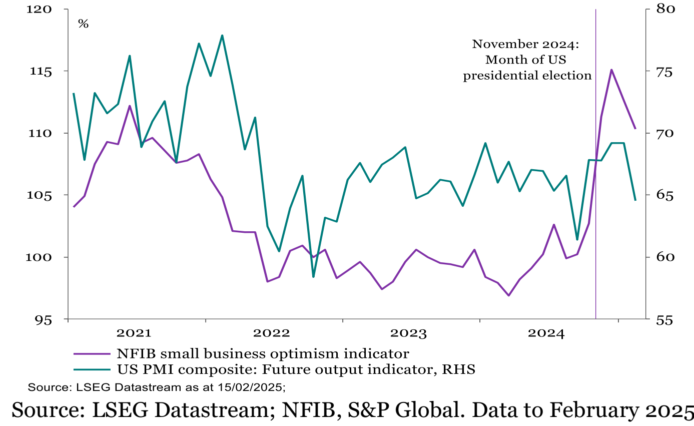
Source: LSEG Datastream, BLS, Eurostat, ONS, Japan Statistics Bureau. Data as at February 2025 (US, Euro area), January 2025 (UK, Japan).

Chart 8: Energy inflation rising again



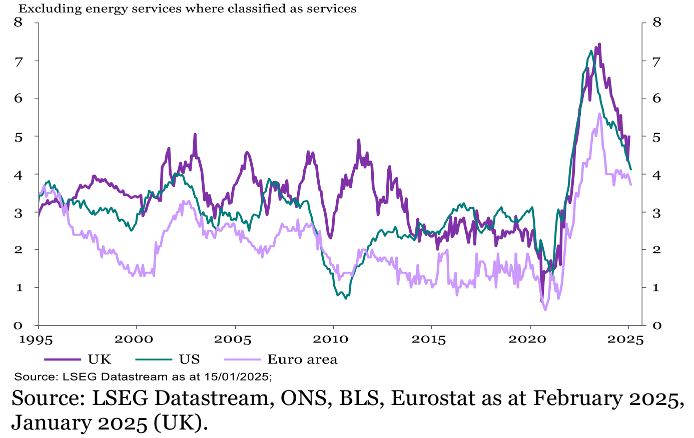
Source: LSEG Datastream, BLS, Eurostat, ONS, Japan Statistics Bureau. Data as of February 2025 (US, Euro area), January 2025 (Japan, UK).

Chart 5: Faded US post-election optimism



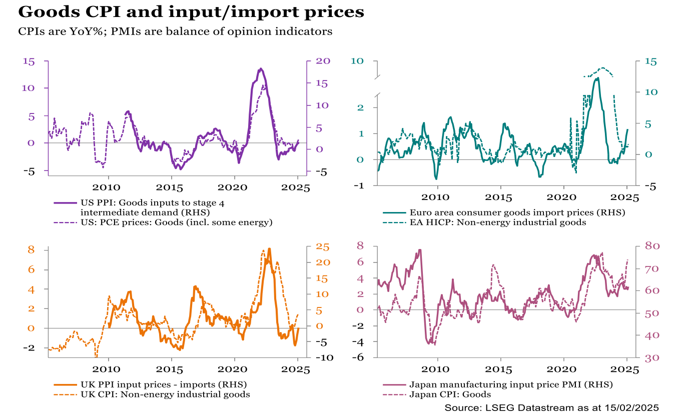
Source: LSEG Datastream; NFIB, S&P Global. Data to February 2025.

Chart 7: Services CPI still high



Source: LSEG Datastream, ONS, BLS, Eurostat as at February 2025, January 2025 (UK).

Chart 9: Import and input price indicators support rising goods price inflation – more to come on tariffs



Source: LSEG Datastream, BLS, BEA, Eurostat, ONS, Japan Statistics Bureau, S&P Global. Data as at January 2025 except US PPI (February 2025). Please note all charts are for illustrative purposes only.

Inflation – likely to reassure in a bumpy way, but not everywhere all the time

The inflation picture is not as reassuring as I had expected. Headline inflation remains stubbornly above typical 2% inflation targets (Chart 6). Services inflation remains elevated (Chart 7). Meanwhile energy price inflation has crept up (Chart 8) and some upward momentum has re-emerged for core goods inflation (Chart 9). Pay growth remains elevated (Chart 10).

Next 12 months: Central case (Chart 11) sees headline inflationary bounce around including periods of higher inflation, partly reflecting changing base effects and the impact of past increases in oil prices and currencies. Tariffs are expected to boost 2025-26 inflation in the US. I am still expecting domestically-driven/services inflation to slow, especially in Europe–labour markets have loosened *somewhat* (Chart 12) and lower headline inflation itself (compared to the last couple of years) should also lower pressure on pay settlements, in turn helping services inflation in particular to slow.

Some downside risks: There are a number of additional factors that could *weigh* on inflation. 2025 is set to see a lot of supply come online for oil, while Trump is pursuing supportive policies for oil and gas production. With the US imposing substantial tariffs, that could prove deflationary outside the US if 1) it results in a significant economic hit and 2) affected economies try to ramp up market share elsewhere. Artificial intelligence could see economies harness substantial productivity gains, though progress could also rapidly become more politically difficult as real-life jobs are increasingly affected (see,

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for example, Trump's backing of dockworkers in a dispute over automation in December).

But upside risks abound, especially in the US: Geopolitical risks to prices are probably two-sided depending how things continue to evolve in the Ukraine and Middle East. A bounce in US demand/deportations/tax cuts could see US labour markets tighten quickly and therefore result in stronger pay growth. President Trump's election could prove an inflationary sea-change domestically. He wants to cut taxes, regulation, deport illegal migrants and threatens substantial tariffs on trade partners.

- **Tariffs** would likely raise prices faced by US consumers, with scale depending on currency moves and how much of the impact is absorbed by importer or exporter margins–likely itself to vary depending on whether domestically produced substitutes for goods are available and how large and permanent the tariff hikes are.
- **Deportations** (and fear of deportations) could reduce the supply of labour (the estimated size of the unauthorized immigrant US population in 2022 was 11 million) with the same end effect on prices.
- **Deregulation and any fiscal expansion** could boost demand and demand for labour, again raising price pressures, especially if labour supply has been reduced.

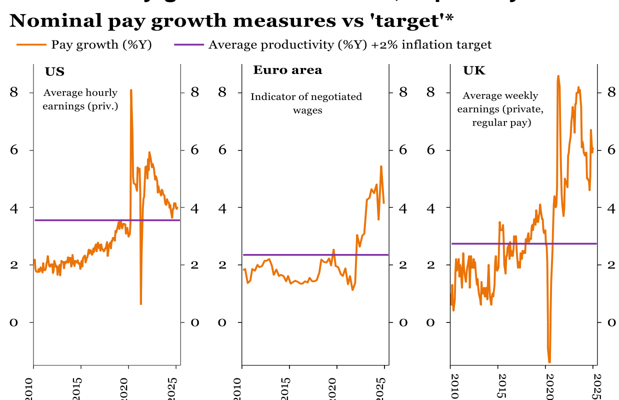
A succession of sizeable minimum wage increases in the UK may have played some role in supporting persistently strong UK pay growth (Chart 10) and the combination of that, recent tax changes, a period of above target inflation more broadly (including higher energy prices) and prospects of more employee-friendly labour market regulation has raised costs for firms. 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.

Medium-term (higher) inflation risk and 'spike-flation': A number of factors could see the global economy more prone to inflation spikes and higher-than-target average inflation over the medium-term.

- Population ageing (Chart 13) 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, lower productivity) and associated transition costs also seem likely to lead to recurrent upside pressures.
- Other factors that could prove more inflationary on average 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.

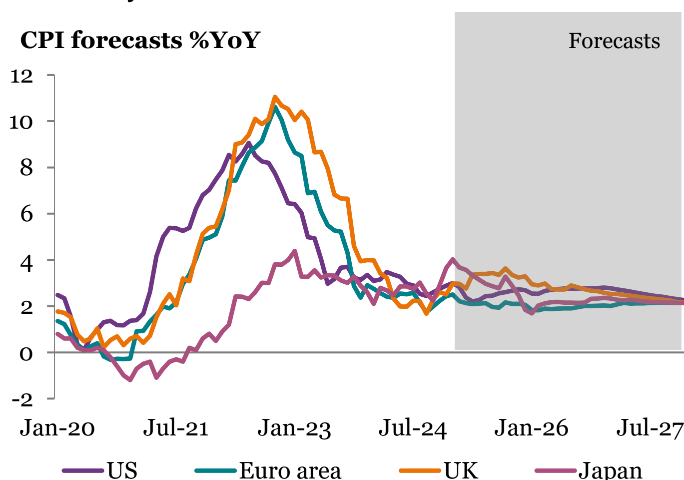
On the downside, AI *could* be transformative for productivity and prove deflationary while also having more disruptive potential. However, AI seems unlikely to result in overwhelming productivity gains over the next couple of years. Upside inflation risks look more likely to dominate.

Chart 10: Pay growth still elevated, especially in the UK



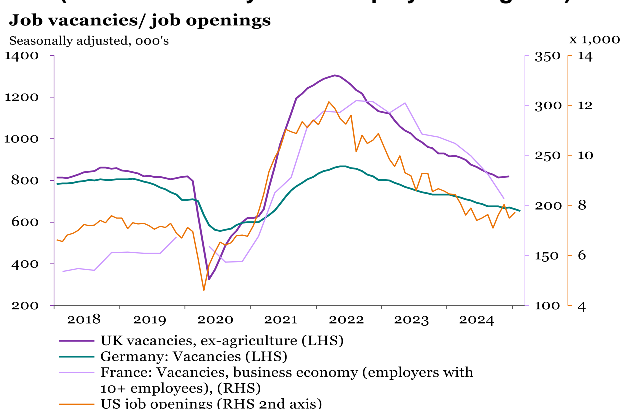
Source: LSEG Datastream, RLAM, BLS, ECB, ONS. Pay data to February 2025 (US), Q4 2024 (Euro area) and December 2024 (UK). *Productivity measures average from 2010: Output per hour (US), Total economy labour productivity (euro area), Output per worker (UK).

Chart 11: My central inflation forecasts



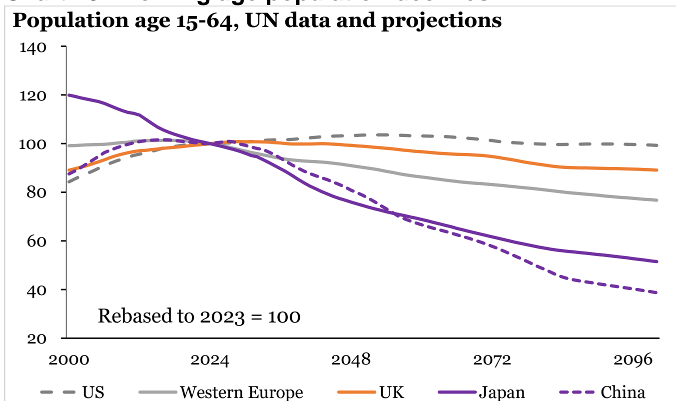
Source: Past data: LSEG Datastream, BLS, Eurostat, ONS, Japan Ministry of Internal Affairs and Communications. Forecasts are RLAM, consistent with the economic forecast summary.

Chart 12: Some labour market loosening visible in vacancies data (even if not always in unemployment figures)



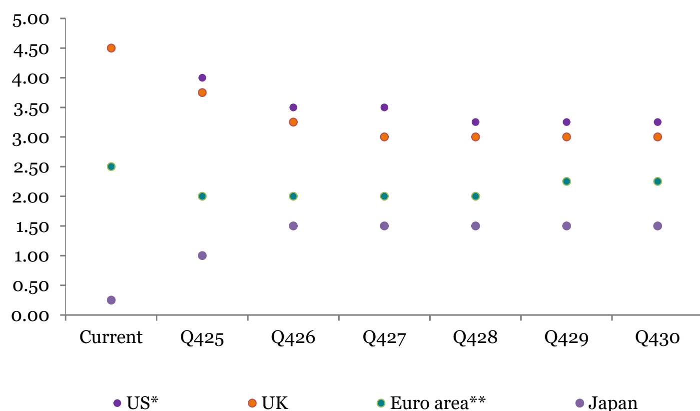
Source: LSEG Datastream, ONS, Deutsche Bundesbank, Eurostat, BLS. UK data to December 2024, France to Q4 2024, Germany to February 2025, US to January 2025.

Chart 13: Working age population declines



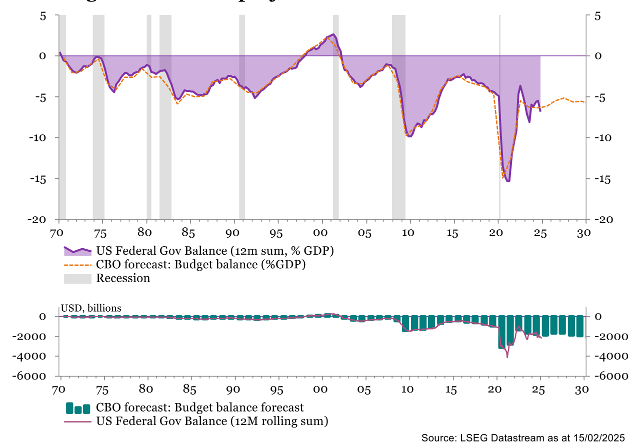
Source: LSEG Datastream, UN; UN 2024 population projections. Please note all charts are for illustrative purposes only.

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



Source: National central banks/LSEG Datastream (past actuals). All forecasts (from Q4 2025 onwards) are RLAM estimates.

Chart 15: Sizeable US fiscal deficit – likely to stay sizeable



Source: LSEG Datastream, Bureau of the Fiscal Service, BEA, CBO. Data to Q4 2025/January 2025. CBO forecasts from January 2025. Please note all charts are for illustrative purposes only.

Central bank policy: Getting to neutral eventually (probably)

I still expect rate cuts in the US, UK and Euro area in 2025 and hikes in Japan (Chart 14). In all cases, my forecasts have rates moving close to a likely neutral rate:

- On my estimate, the Fed, ECB and BoE can cut a bit more and still run restrictive policy. Policymaker comments suggest that their range of estimates of neutral are in a similar vicinity as mine (my central case medium-term nominal neutral rate is 3.25% in the US, 2.00% in the Euro area, 3.25% in the UK and 1.50% in Japan). However, with neutral rates unobservable, and different methodologies producing different numbers, it makes sense for central banks to tread more cautiously as they get closer to a plausible range for neutral.
- By the end of 2025, I still have US and UK policy rates still above my estimate of neutral. In the US that reflects a bump in inflation pencilled in from the impact of Trump policies. In the UK that reflects inflation persistence concerns.
- I am not assuming recessions in my central case. If they materialise then (all else equal) I would expect central banks to rapidly cut rates below neutral. US policymakers are likely to be especially sensitive to developments in the labour market.

Don't rule out rate hikes (2025/26): Rate hikes are part of my Japan central case. Elsewhere, rate hikes remain far from my central case. However, given some of the upside inflation risks outlined earlier, I wouldn't rule them out either. The bar to hikes is not as high as it was, given how far central banks have already cut rates. Inflation may also rise without stronger than expected demand (e.g. after an oil price bounce or in response to tariff hikes), with central bank responses to that likely to depend on how concerned they are that this could add persistent inflation pressure. Worries around inflation persistence seem elevated at the BoE. Upside inflation risks could see the Fed hike rather than cut by year end.

Watch the politics: Trump has been vocal on monetary policy, saying in late January that "I'll demand that interest rates drop immediately" and "I think I know interest rates much better than they do, and I think I know it certainly much better than the one who's primarily in charge of making that decision". Investors I think will be expecting President Trump to be vocal on interest rates but stopping short of interference. Sustained pressure and disrespect for Fed independence could nevertheless impact the USD and inflation expectations, raising inflation pressures.

Fiscal policy–still a source of two-sided risk

The US has been running a sizeable fiscal deficit (Chart 15). There are competing pressures on that profile going forward. Although Republicans won a clean sweep in the 2024 election, that does not mean that Trump will get all his tax and spend priorities met; different wings of the Republican party have different views on fiscal policy and the Republican majority in the House is very slim; when Trump demanded that Congress raise the debt ceiling late last year, a sizeable number of Republicans voted against. An expansionary fiscal policy with a focus on tax cuts and insufficient focus on spending cuts may not be palatable to 'deficit hawks'. However, a fiscal agenda that cuts entitlements substantially could face pushback from other parts of the party. Department of Government Efficiency (DOGE) and Musk's aims to slash government spending have already met with at least some pushback. More spending, too, will be needed if Trump is serious about his territorial objectives and mass deportations. I assume US fiscal policy will remain expansionary on balance.

In China, policy signals remain supportive and 2024 saw a change in intent and focus from Chinese authorities on fiscal policy (though with some concerns to that there was insufficient focus on bolstering domestic demand).

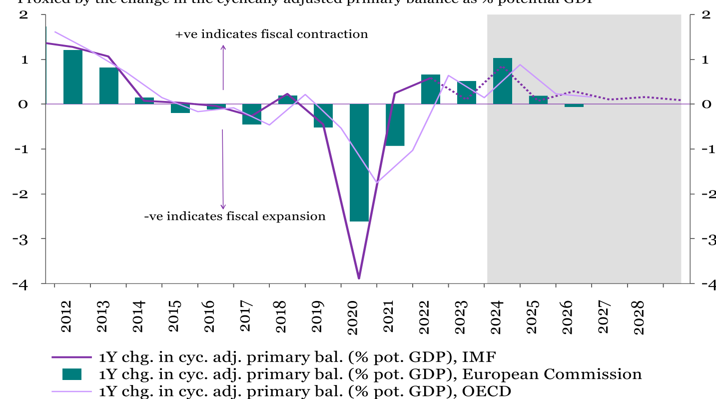
Euro area economies *looked* set to run less supportive fiscal policies in coming years (Chart 16). However, Germany's debt brake looks set to be reformed and will allow substantially more room for defence and infrastructure spending in a potential sea-change for German fiscal policy. Discussions are ongoing at EU level around how to support/allow room in the fiscal rules for more defence spending–with loans and more fiscal rule flexibility to at least *allow* for more spending (even if not all economies take this up). Disbursements are also still ongoing from the EU's NextGenerationEU programme. Although several economies are under pressure to rein things in domestically having hit Excessive Deficit Procedure triggers by running too big deficits, the substantial shift within Europe towards boosting defence spending works against that. France loosened its original proposals following PM Barnier's resignation in December 2024.

In the UK, the government's plans still build in fiscal tightening, despite having increased planned spending in October. The potential boost to growth from public spending in 2025 faces offsets from the 'indigestion' relating the large tax rises in the October budget; private sector business sentiment has deteriorated since the budget, as has the employment picture looking at business survey data. Movements in the outlook for demand and movements in bond yields look set to reduce the likelihood of the government meeting its fiscal rules, suggesting spending cuts/tax rises are likely. High debt levels, with associated significant debt service costs, constrain the UK government's room to boost growth.

Chart 15: Euro area: Fiscal drag? On track to look significantly more supportive than these projections

Euro Area: Fiscal expansion and contraction

Proxied by the change in the cyclically adjusted primary balance as % potential GDP

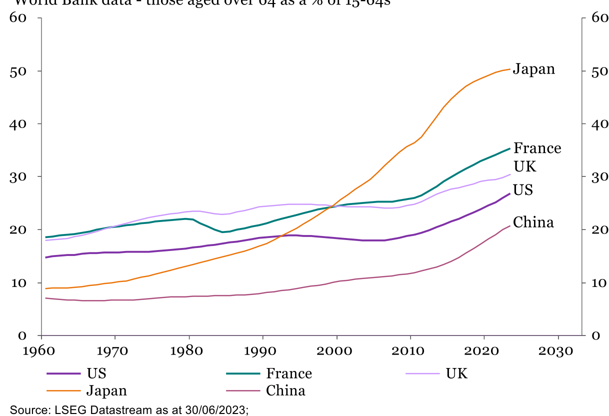


Source: LSEG Datastream as at 30/06/2025;

Source: LSEG Datastream, IMF (November 2024); EU Commission (as of November 2024) and OECD (December 2024).

Chart 17: Dependency ratios problematic for fiscal policy

Old age dependency ratio



Source: LSEG Datastream as at 30/06/2023;

Source: LSEG Datastream, World Bank data and forecasts as of December 2024. Please note all charts are for illustrative purposes only.

Fiscal sustainability may become a bigger market theme: France and UK fiscal sustainability saw some focus in recent months. In the US, it has been easy to brush away concerns around fiscal sustainability on the grounds that the USD is the world's reserve currency, the demographic trends look healthier than in Europe and underlying demand for Treasuries is strong. However, the deficit is large and projected to remain large, while debt looks on an unsustainable trajectory. Ageing populations are set to add to pressure on public services and create challenges for tax revenue. Problems look more acute in Europe, Japan and China than they do in the US, but the US is nonetheless seeing an ongoing and significant rise in the old-age dependency ratio (those age above 64 as a proportion of those age 15-64) (Chart 17). The CBO currently predicts that Social Security's Old-Age and Survivors Insurance Trust will be exhausted in 2033 (the fund is used to pay monthly benefits to retirees). Underlying demand for Treasuries may weaken as overseas relations sour.

Politics: It's not quite 2024, but politics still set to play a big role in 2025 in the US, Europe and beyond

Elections in Germany have already helped see debt brake reform progress, even if there are still uncertainties ahead as the anti-reform AfD takes its additional seats shortly and with coalition negotiations ongoing at the time of writing. Depending how well the government functions in coming months, another legislative election could also take place in France. Other elections are expected in Japan (upper house) and Canada (the next federal election must be held by October).

Even without an election, politics looks set to be a focus in the US. Trump's early actions appear to be fuelled by both economic and political considerations. The operation of 'checks and balances' in the US could yet blunt some of Trump's plans, but it is unclear at this point how effective any Democrat opposition will prove. The Republican majority in the House is very slim, so there is theoretical scope for Congress to prove a moderating influence even if evidence of it doing so is limited so far. Evidence from the first few weeks of the Trump administration suggests extensive reliance on executive orders rather than legislation. Still, tax cuts will need Congressional approval and the Courts may yet push Trump down legislative routes if executive orders are judged to have overstepped.

Climate and AI: Staying on the watchlist

I continue to expect climate change to cause more volatility in inflation and to leave it higher on average. There are a number of channels through which climate can affect prices. One of the most obvious, and likely to recur over coming years, is the impact of extreme weather events on agricultural and other prices. Extreme heat can have a notable impact on productivity for example, while transition costs can also impact prices–both the cost of companies adapting to changing weather patterns and any near-term costs associated with attempts to lower carbon emissions. Dry conditions, for example, can also lower the supply of hydroelectric power and disrupt waterways, e.g. the Panama Canal. With climate change politicized there is also perhaps a higher chance that climate-related policies become a source of wider trade tensions, e.g. as the EU's carbon border adjustment mechanism is implemented.

A higher frequency of extreme weather events–as we appear to be seeing–is likely to mean more volatile data in general, increasing the chance that sometimes data will send misleading signals around trends in activity.

Climate change is still a key reason why I have pencilled in medium-term central inflation forecasts that tend to hover a little above target in major economies.

Notably, AI could help raise productivity and lower overall inflationary pressures. However, it is important that technology is used effectively and widely adopted. Having a few companies at the technological frontier is all very well but, to transform productivity trends, ideally the most productive practices would permeate well beyond that. It isn't clear either quite how fast the technology will develop but also how fast and how deep usage will spread in the next few years. With DeepSeek, the chances of the technology spreading have increased though, and cost is looking set to be less of a barrier for the development of platforms and applications with real productivity enhancing benefits. Under President Trump, regulation (including safety concerns) seems less likely to slow things down (wisely or otherwise) given his deregulation agenda. Politics may eventually get in the way though. Disruptive technology that upends working patterns and makes jobs in many areas uneconomical (even if/while it creates others) may not prove popular. The technology may end up being stymied by politicians keen to be re-elected.

United States: Trump risks continued

US activity growth indicators have been mixed of late and there are risks on all sides with President Trump bringing policy upheaval on multiple dimensions. To the extent that the surprisingly robust growth picture of the last couple of years was fiscal spending and immigration assisted, there are additional reasons to worry with the early targets for Trump's team including cutting Federal spending and immigration, alongside raising/threatening tariffs. Current substantial policy uncertainty is itself a negative for growth. Some elements of Trump's agenda still seem likely to raise inflation and therefore may stymy further Fed rate cuts.

Status update: Fine for now, with quite a few things to keep an eye on

Real GDP growth slowed in Q4 2024, but that belied particularly strong consumer spending and, at 2.3%, quarter-on-quarter annualised GDP growth remained solid. Employment trends looked stronger into the turn of the year and the unemployment rate fell to 4% with the Federal Reserve at least regarding the labour market as broadly in balance. Recent data has been mixed, but with more signs of softening activity trends. ISM and PMI business surveys look consistent with a slower pace of activity growth in Q1 (Chart 18). There are some signs of consumer finances looking stretched too: not only are savings rates below pre-pandemic norms (Chart 4, suggesting limited scope to boost spending further), but consumer credit indicators have been strong (Chart 19) and delinquencies have risen. While small business optimism soared in the wake of Trump's victory, recent indicators look shakier, and consumer confidence has weakened. Elevated policy uncertainty is likely to drag on activity (Chart 20). With Trump pushing ahead with tariffs too, my GDP growth forecasts have been revised down.

"In no hurry" to cut rates, but doesn't mean they won't

The Fed has been clearly signalling an "in no hurry" to cut message. My central case is still that they cut rates this year (albeit less than previously forecast). However, there is a significant probability of them remaining on hold this year into next and over the same timeframe I wouldn't want to rule out a rate hike either given inflation risks (see below). At 4.25%-4.50%, the Federal Funds rate is probably still above neutral, giving them room to cut once they increase their confidence that inflation is back on the right track or if labour market figures take a clear turn for the worse. The March FOMC participant projections has a range for the long-run Fed Funds rate–a proxy for a medium-term neutral rate–at 2.6-3.6% (excludes the three lowest and highest forecasts). However, the upper end of that range doesn't leave much headroom against current rates. If inflation (ex-tariff impacts) continues to hover above 2%-consistent levels, more US policymakers may start to wonder if neutral is even higher than they thought. A bigger than expected slowing in the economy (which can't be ruled out in the current environment), could, however, see the Fed cut more decisively than my central case.

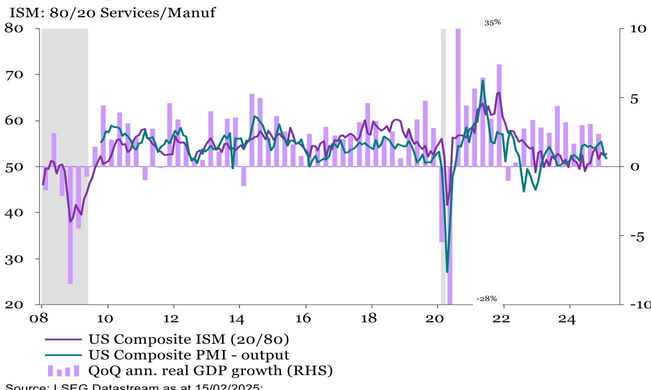
Immigration vs tariffs vs fiscal agenda

President Trump continues to engage in policy change on multiple fronts. Things remain uncertain at this stage. Trump has not moved forward with his universal tariff proposals but is instead proceeding with reciprocal tariffs; tariff threats directed at individual economies have been paused/reversed in some cases. I continue to assume, however, that tariffs will raise inflation noticeably in 2025 and into 2026. For inflation and the Fed, the question is whether this can be treated as more of a one-off price shock, or if tariffs have a lasting positive impact on inflation. For now, I lean more to the former.

Focusing on immigration, this is an inflationary agenda especially against a backdrop where there does not seem much slack in the labour market to start with. Less immigration and more deportations could see the labour market tighten assuming demand holds up reasonably well. The non-native born population has been the main reason the working age population is rising at all in the US. It is conceivable that the immigration part of the Trump agenda has a more long-lasting upward impact on inflation and downward impact on growth than tariffs.

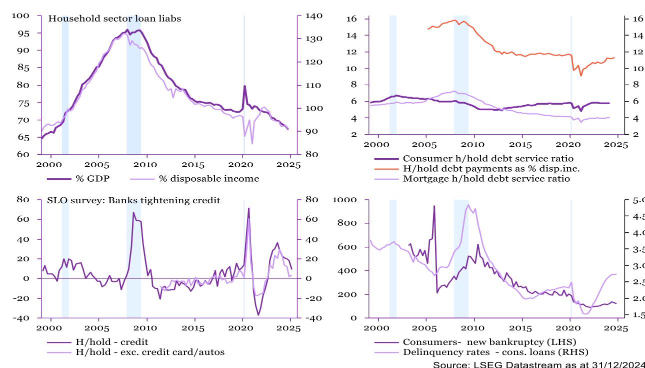
The fiscal part of Trump's agenda remains uncertain. While parts of his administration talk about slashing Federal spending, Trump campaigned on a range of tax cut promises. I assume that fiscal policy will remain (net) supportive for now and thus somewhat add to inflationary pressure.

Chart 18: Surveys signal growth is slowing a bit



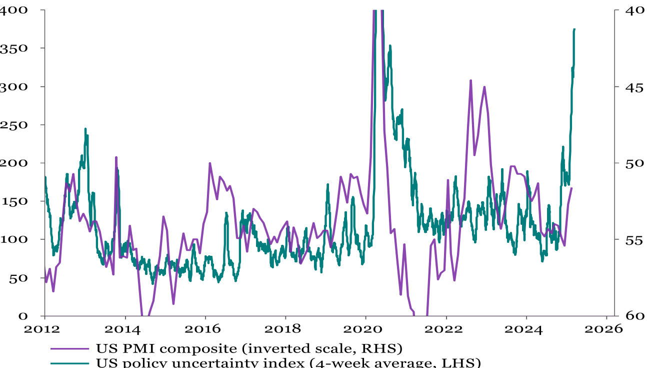
Source: LSEG Datastream, BEA, S&P Global, ISM. Data to Q4 2024 (GDP), February 2025 (PMIs, ISMs).

Chart 19: Rising delinquency rates (lower RHS) stand out amid so far good household finance metrics



Source: LSEG Datastream, BEA, Federal Reserve, Federal Reserve Bank of New York. Data to Q1 2024 (household debt service ratios), Q3 2024 (household debt payments), Q4 2024 (Household loan liabilities, delinquency rates, bankruptcies), Q1 2025 (SLO survey).

Chart 20: High levels of policy uncertainty likely to drag on growth



Source: LSEG Datastream, S&P Global, Economic Policy Uncertainty. Latter data to 12th March 2025, former data to February. Please note all charts are for illustrative purposes only.

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China: New year, new challenges

Following last year's step up in policy support, China's economy has shown signs of stabilisation and improvement. Policy is expected to remain supportive, including further monetary policy easing. China now faces what may be another challenging year of external headwinds, however, with US President Trump already having imposed higher tariffs on Chinese goods and likely more tariffs to come. Demographic challenges are still expected to dominate the trajectory of China's growth rate in the medium and longer term, leading to a slowing economy.

Status update: Perking up?

Q4 GDP growth was close to expectations at 1.6%Q, picking up from Q3 which itself was stronger than Q2. China managed to achieve 5.0% annual growth in 2024 which looked set to be a challenge at the start of the year. Survey-based measures however, look less perky with consumer confidence still looking weak and business surveys (NBS and Caixin PMIs) looking consistent with relatively subdued GDP growth at the start of the year (Chart 21). With that backdrop and still very low inflation, and those external challenges, further stimulus measures seem likely to be announced.

Policy support still important and still coming

Policy support has likely been important to the improvement in some of the China data at the end of last year/early this year, including the consumer trade-in scheme. 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 improving medium-term prospects too. Other factors may have made a difference (or be about to) as well. The DeepSeek announcement on AI advances may act as a broader boost to confidence beyond the sector. The recent meeting between President Xi and business leaders (including DeepSeek's Wenfeng Liang) *might* signal a period of more supportive government policy towards private business which would be an additional positive for China's growth prospects. However, as the impact of some of the earlier stimulus fades and assuming that some trade activity was bought forward to get ahead of US import tariffs, there are risks that activity growth tails off a bit.

More/continued policy action expected: The start of the year saw a flurry of new announcements, including an extension and expansion of the consumer goods trade-in programme (a key, more domestic demand-oriented, element of recent policy announcements). The target official deficit has been raised and the growth target set at 5%. The timing of additional policy support could depend on future tariffs if Chinese authorities respond with more support for the domestic economy (as well as further retaliation). The PBoC reiterated their "moderately loose" policy stance in their Q4 monetary policy report. They also pledged to "strengthen counter-cyclical adjustments".

Stabilising and improving the situation in China's property market remains crucial for short- to medium-term growth prospects. Property market problems, including large stocks of unsold homes, likely help explain continued subdued consumer confidence, soft domestic demand and still raise questions around the future funding of local government tax revenue (having been such an important source).

Long-term challenges remain substantial: Long-term challenges facing China still include an overhang of private sector debt and population ageing. China's stance toward Taiwan continues to present a risk to China's economic outlook should any action against Taiwan prompt a deterioration in economic relations elsewhere. 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.

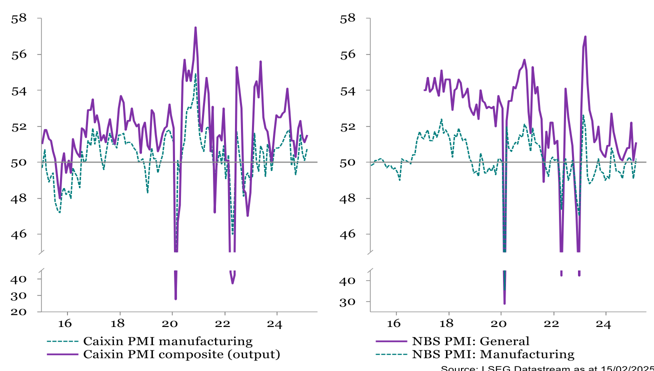
Tariffs and trade barriers

China's economic model still looks like it relies relatively too much on external demand and not enough on domestic demand in an environment that is less welcoming to Chinese products than in the past. So far, President Trump has not followed through with the worst of his China-focused tariff threats with (only) a 20% tariff increase having threatened 60% in the build up to the election, but that doesn't mean tariffs won't rise further. Trump has promised more tariffs on specific products and materials and is also looking at reciprocal tariffs where US action would depend on the degree of trade friction it faces in exporting (including tariff, non-tariff barriers and including VAT). In China's case, average tariffs on the US are lower at present than Chinese tariffs on US imports. However, given the broad scale of this aspect of Trumps investigations it isn't clear how 'safe' any trade partner will be. If Trump can proceed with sizeable tariffs against one of the US' closest allies (Canada), things could get much worse from here for China.

The end of the exemption from tariffs for small packages (currently on hold) may quickly lead to at least trade diversion, if not somewhat lower exports altogether. Bloomberg reported that Shein was asking some of its suppliers to relocate in Vietnam with incentives including higher procurement prices. Bloomberg also reported that ahead of the US policy change being implemented, Shein and Temu merchants were being asked by logistics agents to prepay an extra 30% of the retail value of goods sold to factor in tariffs. All of which is a possible early sign of how 'trade wars' may partly be offset by substantial rerouting but also result in higher prices for consumers globally.

Chart 21: Surveys subdued

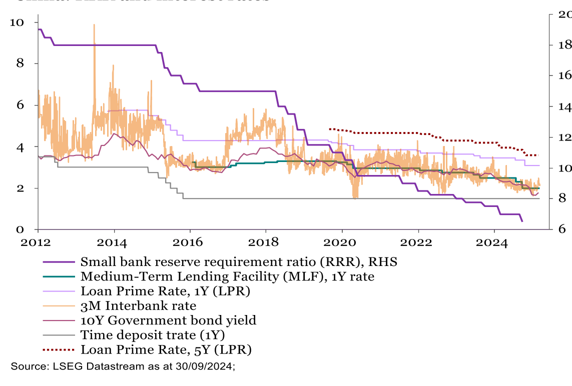
China business surveys: Caixin PMI, NBS PMI



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

Chart 22: More (and more) policy support

China: RRR and interest rates



Source: LSEG Datastream, PBoC. Data updated 13th March 2025. Please note all charts are for illustrative purposes only.

Euro area: A bit more upbeat (but watch tariffs)

Euro area growth petered out at the end of last year. I am expecting modestly positive GDP growth ahead, but I am watching three drivers of European growth–similar to those I was watching at the end of last year: 1) The consumer–where (ongoing) rate cuts and positive real income growth are supportive and where I see upside risk; 2) Fiscal policy, where again things are looking positive; 3) Trump and the external environment–where slower global trade, higher tariffs and greater trade policy uncertainty all have the potential to weigh on activity. The Euro area has a history of making strides in a crisis and a sharp deterioration in US trade relations might drive more policy change (beyond spending more on defence).

Status update: Almost flat

After GDP grew 0.2%Q in Q4, the composite PMI business survey indicator at 50.2 in January/February isn't signalling much growth in the private sector. Neither is the European Commission's economic sentiment measure (Chart 23). The unemployment rate remains at around record lows though (even if survey-based measures that tend to track the unemployment rate look more downbeat). Credit demand has improved too from levels at the start of last year; business loan growth looks healthier (Chart 24). Consumer confidence is still well above its cost-of-living crisis lows, but has slipped a bit in recent months. Consensus expectations are for (only) around 0.2%Q GDP growth in Q1 which, considering all that data, looks a reasonable estimate.

Risks on both sides – but a bit more upbeat

There are certainly still plenty of things to worry about. Although Q1's ECB survey figures suggested that credit demand is expanding, they also suggested that credit standards tightened. In an economy where bank lending is a dominant source of debt financing for firms–especially smaller ones, that is less encouraging. President Trump continues to berate the EU, and tariffs seem likely to be announced soon. In late January he outlined some of his grievances: "…the EU treats us very, very unfairly, very badly. They have a large tax…a VAT tax…They…don't take our farm products and they don't take our cars". More recently he said April 2nd would be a very big day and he called the EU "one of the most hostile and abusive taxing and tariffing authorities in the world, which was formed for the sole purpose of taking advantage of the United States". This does not mean there *won't* be a US-EU deal in the future, but for now the EU looks likely to face tariffs. There is a good chance these are large enough to offset the impact from any additional fiscal spending in 2025/2026.

Euro area growth will benefit from looser German fiscal policy. Reform of the debt brake at the time of writing looked on track to progress and to result in substantially more support for German infrastructure and defence spending. One of the notable things about 2024 was the divergence between the fortunes of France and Germany on one hand, and some of the economies most closely linked with the Euro area debt crisis on the other. 2024 saw Germany's economy contract 0.2%, but Spain's expand 3.2%. Significant fiscal stimulus should help Germany make up ground. With Europe more broadly expected to increase defence spending, fiscal policy looks set to be more supportive than expected for Euro area growth (even with likely lowish multipliers on defence). However, so far, analyst estimates of the impact of the upcoming fiscal boost seem to be typically only around a few tenths for Euro area GDP growth by 2026. The impact in 2025 into 2026 could be more than fully offset by US tariffs on EU goods, depending on scale and duration.

Having built more fiscal support into the central case for the Euro area, the biggest *upside risk* to Euro area growth is arguably still the consumer. Real pay growth is positive and the savings rate remains well above pre-pandemic norms. With the ECB cutting rates, savings rates could drop further and boost consumer spending. There were tentative signs last year that some of this is starting to play out, with a bit of a pick-up in consumer spending in H2 2024.

Were we to see an end to the Ukraine-Russia conflict, that could bring both upside and downside risks to the rest of Europe depending on: 1) whether businesses/populations in the EU–and especially its Eastern borders–feel more or less secure; 2) what happens to commodity prices (especially oil and natural gas prices).

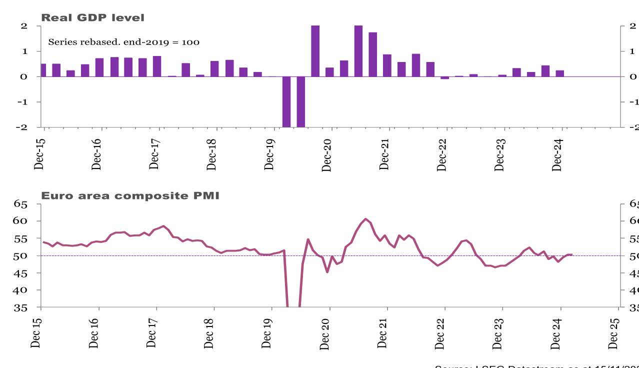
Longer-term challenges include adverse demographic trends. Growth is hampered somewhat by incomplete capital markets union and a lack of harmonised regulation in some areas across the region. Implementing the recommendations of the Draghi Report could go a distance towards raising European competitiveness. If global events create a crisis atmosphere, this might avoid being kicked down the road.

Inflation: Room for but more rate cutting

Modest growth and a somewhat more reassuring inflation picture, leave the ECB expected to cut rates a bit further this year. The ECB continue to see disinflation as on track. There are signs in pay data of slowing wage growth; that should help to services inflation fall further. Fiscal stimulus works against the need for cuts, but financing conditions have already tightened–with European government bond yields significantly higher on German debt brake proposals. The deposit rate is nearing the top end of estimates of neutral though, which may see the ECB start to slow the pace; at their March meeting, the policy statement was explicit that "Monetary policy is becoming meaningfully less restrictive". Uncertainty was also used to justify an ongoing data dependent, meeting-by-meeting approach. Upside risks for inflation include unemployment lows: an ageing population, potentially less immigration as populism advances plus a boost from fiscal policy may leave European economies vulnerable to a rekindling of wage growth.

Chart 23: Subdued growth; subdued surveys

Euro area GDP and PMI business survey

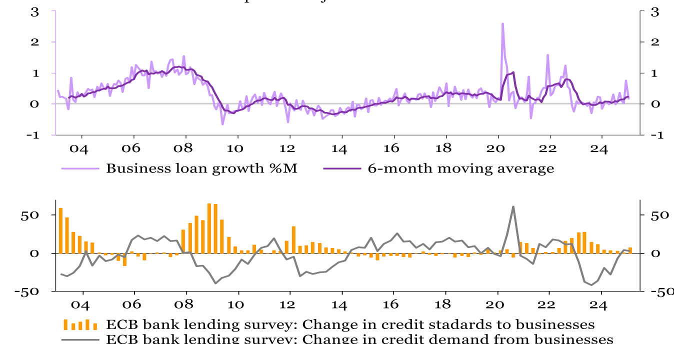


Source: LSEG Datastream, Eurostat, S&P Global. Data to Q4 2025 (GDP) and February 2025 (PMI).

Chart 24: Business loan growth picking up

Euro area: Business loan growth & credit standards

MFI loans to non-financial corporates adj. for sales & securitisations



Source: LSEG Datastream, Eurostat, ECB. Data to January 2025 (loans), Q1 2025 (bank lending survey). Charts for illustrative purposes only.

United Kingdom: Back to Flat

The UK economy is looking flattish–at least in terms of overall activity, and the growth outlook isn't promising. October saw the government add near-term fiscal stimulus and the Bank of England is cutting rates. However, the global outlook is uncertain and domestic surveys are sending worrying signals about the jobs market following the tax hike announcements in October. Inflation and pay growth data have reassured enough that the Bank of England has been gradually cutting rates and I expect that to continue in 2025 (albeit with risks on both sides). Positive real pay growth justifies stronger consumer spending and there is room for households to save less, but if the employment picture really does deteriorate dramatically then the outlook will worsen again.

Status update: Still a bit worrying

After a decent first half of the year, UK GDP growth slowed to almost nothing in the second half of 2024. Q4 GDP rose only 0.1%Q although the December monthly figures suggested a bit of a bit of a pick-up in pace. Most of the growth in Q4 was from government spending. Business surveys indicate that private sector activity growth is flattish in Q1. The October Budget has been cited by businesses in surveys in recent months as a factor holding back hiring (Chart 26), as well as hitting business confidence, with geopolitical uncertainty also playing a role. Although headline inflation has picked up, the 'domestic' underlying inflation picture isn't getting any worse at least, but strong services and wage inflation (Chart 25) constrains how far and fast the Bank of England is likely to ease policy.

Modest growth support

I continue to expect only modest growth in the UK economy this year. I don't have a recession as a central case, but with growth so close to flat and recessionary labour market signals in some of the surveys, a recession is not a small probability either. Despite falling in Q4, there are still good reasons for consumer spending to grow in 2025, supporting overall GDP growth alongside government spending. Real pay growth remains positive, reflecting above-inflation pay growth, and there is room for households to save less (the savings rate is still sitting above pre-pandemic levels, see Chart 4). Consumer confidence remains well off its lows, even if it isn't exactly strong. Interest rate cuts, gradual as they are, should also be growth supportive.

Labour market could knock things off course

Higher prices, slower pay growth and slower hiring will likely all be part of the response of businesses to the upcoming National Insurance tax hike and other increases in labour costs. Whether this moves from non-replacement of workers to layoffs will be important for the consumer outlook. The balance of price and employment impacts will be important for the Bank of England outlook. This tax hike is occurring against the backdrop of another significant increase in the minimum wage and reforms to the labour market that increase worker protections, making it a bigger/riskier/more expensive decision to hire in the first place. The minimum wage now aims to stay at two-thirds median pay. Logically then, a very large proportion of employees will now be paid, or be paid close to, the minimum wage. According to the Low Pay Commission, the share of jobs paid within £1 of the minimum wage rate returned to pre-pandemic levels of 18-19% in 2024. At some point, this might itself damage productivity and contribute to labour shortages in some areas even while the overall labour market deteriorates. For example, there is some evidence of reluctance of people to take on responsibility (and 'tougher' jobs where the premium over the minimum wage has shrunk, e.g. long distance lorry driving, see FT) where the extra premium is now so small. Firms, at least in the near term, may also end up reducing investment (potentially constraining future growth) in order to meet increased labour costs.

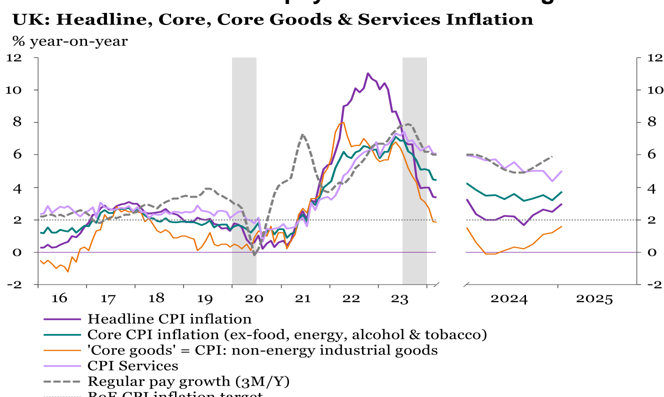
Fiscal constraint

The UK still faces significant long-term fiscal challenges related to an ageing population. Nearer term, higher bond yields and a weaker OBR growth outlook may have eliminated the Government's headroom against their fiscal rules so that more fiscal tightening will need to be announced at the March and/or October fiscal events. PM Starmer recently announced a rise in defence spending. Outside of a crisis, the UK government has little room to add fiscal support for the economy. Fortunately, the UK does not (yet) seem to be a focus for President Trump's tariffs, but that may not last.

Inflation and the BoE: Needing reassurance

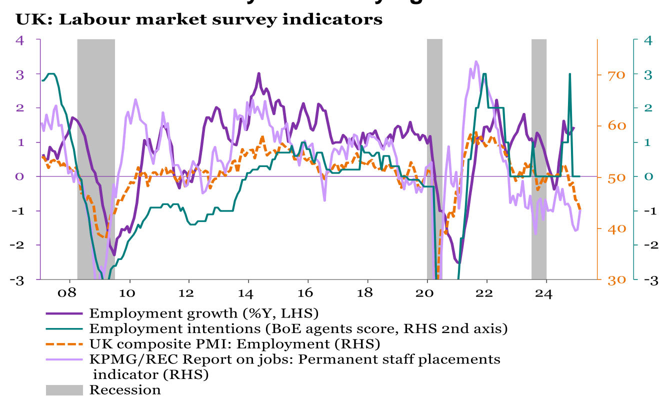
CPI inflation is above its recent lows and is set to rise further in coming months. Much reflects higher energy prices, but services inflation remains relatively strong still, supported by strong pay growth (Chart 25). There are still good reasons though to expect core/services/underlying inflation to fall further. With headline inflation well below the peaks and with corporate pay expectations indicators pointing to lower pay settlements, pay growth should slow later this year. A likely further cooling in the labour market should also help. If the labour market survey indicators (Chart 26) are representative of future hiring trends, then Bank of England confidence should also build, given that more of the slow UK growth story is demand rather than supply related. This would increase the central bank's confidence in downward inflation trends and likely see some speeding up in the pace of rate cuts (where, unlike the ECB for example, UK policy rates are still quite a way above the likely upper end of the range for neutral). For now, I continue to expect once a quarter rate cuts in 2025.

Chart 25: Services and pay inflation still strong



Source: LSEG Datastream; ONS, as at January 2025, except pay growth which is to December 2025. Charts for illustrative purposes only.

Chart 26: Jobs survey data worrying



Source: LSEG Datastream; ONS, BoE, S&P Global. ONS data to December 2024, KPMG/REC figures, BoE and PMI are to February 2025.

Japan: On a hiking path

The Bank of Japan has raised rates and is likely to continue gradually raising rates this year into next if wages in particular continue to send reassuring messages on inflation dynamics. Inflation remains high by Japan standards. Confidence is growing that Japan's inflation trends/expectations have shifted sufficiently upwards in a lasting way. Shifts in corporate practice and the BoJ's very cautious approach to rate hikes make that more likely. Higher US tariffs and potentially slower global trade growth remain among the key downside risks to the outlook, alongside some uncertainty about the sensitivity of the economy to rate rises.

Status update: Bumpy progress to a new normal

Measures of inflation remain elevated in Japan–by Japan standards (Chart 27). Inflation outcomes continue to look much more consistent with achieving a 2% inflation target than they did pre-pandemic. That's true whether you look at headline, core or diffusion indices for inflation, but especially if you look at pay growth (Chart 28) and recent pay settlements figures–these continue to show no sign of return to old wage-setting norms. Supporting that, the labour market still looks relatively tight. The picture from activity data has been mixed, but Q4 GDP was stronger than expected (Chart 29), completing a run of three consecutive quarters of positive GDP growth. Indicators from business surveys so far look consistent with positive growth in Q1 2025.

2025: Promising, so long as Japan stays on the right side of Trump

Partly reflecting a strong end to 2024, annual GDP growth in 2025 looks likely to come in higher than in 2024. Japan's growth trends remain far from strong, but there is a good case for expecting more supportive trends in consumer spending: pay growth continues to run well above pre-pandemic levels rather than showing signs of reverting and real pay growth looks more flat than negative now; the labour market continues to look relatively tight. That tight labour market should support incentives to invest in capex too, supporting production even while demographic pressures likely lead to further shrinkage in the working age population. Tourism trends have been strengthening too.

However, there are some significant sources of uncertainty. Domestically those include some uncertainty about how the economy will respond to rising interest rates as they continue to move off such a long period of ultra-low settings. Externally, there is a big question around the tariff environment Japan will face, especially around autos tariffs and reciprocal tariffs (with Trump also taking into consideration non-tariff barriers and taxation). Trump has already referred to Japan as a currency manipulator.

Further rate increases look likely over the next year or so from the Bank of Japan (BoJ). However, most analysts expect the BoJ to (continue to) raise rates only gradually/cautiously. On fiscal policy, the LDP's loss of majority continues to add uncertainty to the fiscal spending outlook ahead of the upper house election this year.

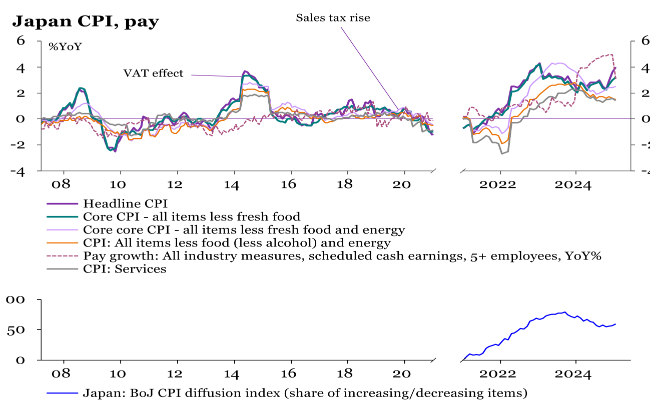
Gradually higher rates

Policy settings remain accommodative with the policy rate, at 0.50%, still at very low levels after three hikes. While initial hikes were arguably more symbolic than economically meaningful, markets have moved to price more hikes in by the end of the year than was the case in late-2024. Although the neutral rate is likely relatively low in Japan (on a 5-10 year ahead basis, my estimate, for example, is around 1.5%, while BoJ staff have put neutral as between 1% and 2.5%), those estimates of neutral would still suggest that policymakers should raise rates further as their confidence grows than the 2% inflation target will be hit on a sustainable basis.

Longer-term change

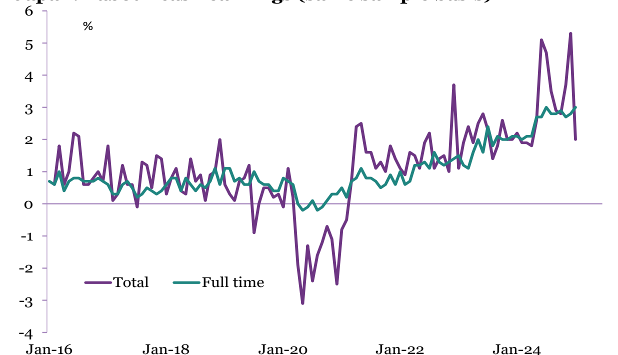
Wage settlement data looks likely to reassure the BoJ in terms of staying on a rate hiking path. Spring wage rounds were always going to be important to building confidence that Japan may have permanently moved on from its low inflation past. Indications from the Trades Union grouping Rengo suggest even higher pay demands and pay settlements this year than last year. Although some of the ongoing wage increases could be seen as lagged adjustments to compensate workers for a higher price level, changes under the surface have made sustained wage growth more likely including moving away from seniority-based pay, and guidelines to help SMEs pass on increased labour costs in prices. Inflation expectations measures have also become more aligned with the inflation target.

Chart 27: Still strong inflation (by Japan's standards)



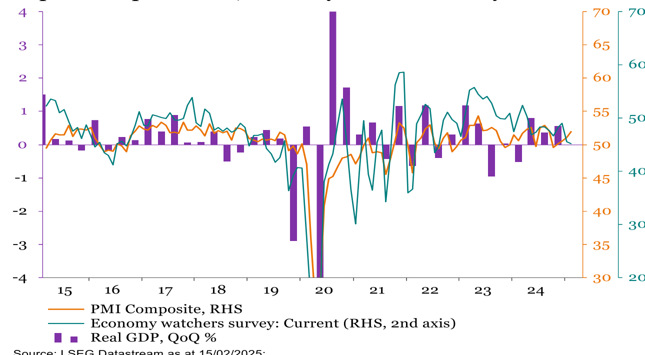
Source: LSEG Datastream, Ministry of Internal Affairs & Communication, Ministry of Health, Labour and Welfare, Bank of Japan as of January 2025.

Chart 28: Pay growth stronger



Source: LSEG Datastream, Ministry of Health, Labour and Welfare to January 2025. Please note charts are for illustrative purposes only.

Chart 29: Activity trends flat to positive



Source: LSEG Datastream, S&P Global, Cabinet Office. Data to February 2025(PMI and Economy Watchers); Q4 2024 (GDP)

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