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Global Macro Research – Global Economic Outlook

Q2 2025

#Global / #Forecasts / #Scenarios

New World Order

US exceptionalism is fading as policy uncertainty mounts and the economy slows, while Europe is on the verge of a big loosening in fiscal policy. But US recession concerns are overblown, and modest tax cuts are coming. China's policy easing is gaining some traction, although it is still insufficient to offset all headwinds.

US economic activity data have cooled sharply, due to a decline in sentiment amid elevated policy uncertainty. Indeed, Q1 GDP nowcasts point to a large contraction, while recession risk probability models are also picking up.

However, sentiment surveys have been an unreliable guide to the US cycle, and technical factors appear to be overstating the extent of the underlying slowdown. The labour market is cooling but is not consistent with a downturn. So, although we expect a softer Q1, we are not forecasting a recession in our base case (see Figure 1).

Nonetheless, US tariff uncertainty is very elevated, and we expect the average tariff rate to rise from about 3% at the start of President Donald Trump's term to around 9%. This increase is larger than we previously factored in, and includes further tariff increases on China, various sector-specific tariffs, and a partial reciprocal tariff regime.

Meanwhile, federal agencies are facing significant disruptions under the reforms driven by the Department for Government Efficiency (DOGE). Federal job losses are starting to show in the employment data, with the full extent of job reductions likely to be in the range of 200-500k, and an average drag on monthly payrolls of around 10k-15k over the next year.

Progress on the "market friendly" aspects of Trump's policy mix, such as tax cuts and deregulation, has been more limited. We still expect modest fiscal stimulus, worth around 0.5% of GDP. Meanwhile, the energy and financial sectors are still likely to benefit from deregulation. However, the administration's seemingly relaxed attitude to recent equity market weakness highlights that downside growth and upside inflation risks have increased.

We've lowered our US GDP forecasts to 1.8% (-0.2 percentage points) and 1.8% (-0.4) in 2025 and 2026 respectively, while pushing up our CPI inflation forecasts to 2.9% (+0.5%) this year. This follows our previous lowering of the probability on our "Trump delivers for markets" scenario and increase to the probability on our damaging "Trump unleashed" scenario. We've also added a US recession driven by a confidence collapse to our scenarios.

All this makes for a difficult environment for the Federal Reserve (Fed), especially as there is an active debate about the relative growth versus inflation impacts of tariff increases. We think the Fed will remain focussed on the inflationary impact of higher tariffs and expect just one rate cut this year, likely in September (see Figure 2). However, risks are skewed towards more easing.

In China, financial conditions are now the most accommodative they have been since the global financial crisis, and fiscal easing worth between 1.5 and 2.0% of GDP was announced at the "two sessions". But, while policy rhetoric and action have been more positive, there was very little announced to tackle consumption weakness or the headwinds from the property sector.

We think this easing is enough to deliver growth of around 4.6%, which policymakers can plausibly claim is within the "around 5%" target rang. However, the nominal growth environment is likely to remain very weak. We have revised down our forecasts for 2025 CPI to 0.2%, and there is a risk of modest deflation especially if policymakers do not allow the renminbi to depreciate.

Risks are modestly skewed to the downside, and we continue to see the possibility of a "China balance sheet recession" scenario if policy fails to respond sufficiently to the large headwinds facing the economy. On the other hand, a more aggressive policy stance, where "China turns on the policy taps", is also possible.

The Eurozone is on the verge of a big shift in fiscal policy. The new German government looks likely to deliver constitutional reform to unlock higher defence spending and public investment.

Bond yields rose sharply on this news, but the combination of higher yields, elevated equity prices, and a stronger euro suggests the market is pricing a growth shock rather than concerns about fiscal sustainability.

We think these measures will boost GDP growth by 0.5-1.0% over the next few years. And there is a scenario where the combination of higher investment spending and structural reforms delivers an even greater boost to European growth.

A ceasefire deal over Ukraine could prompt a limited resumption of Russian gas flows, also supporting European growth. However, there may be political resistance to the wholesale resumption of gas flows.

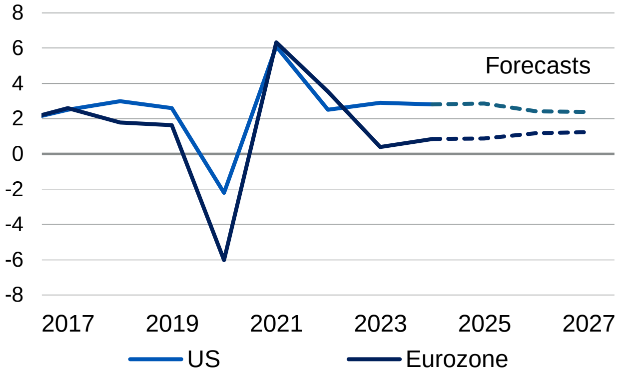
With the near-term European growth outlook very weak there is still scope for further European Central Bank (ECB) easing, and we expect rates to fall to 2% this year.

In the UK, fiscal policy is set to tighten further, with the chancellor likely to announce spending cuts at the end of March. The Bank of England (BoE) is likely to continue with its quarterly rate-cutting profile. Policymakers will wait to see how the economy responds to the large cost shock this spring before considering speeding up the pace of easing.

The Bank of Japan (BoJ) is likely to tighten policy further, as wage pressures mount and interest rates are returned to a more neutral stance. We are expecting one further hike this year in October, but earlier tightening is possible.

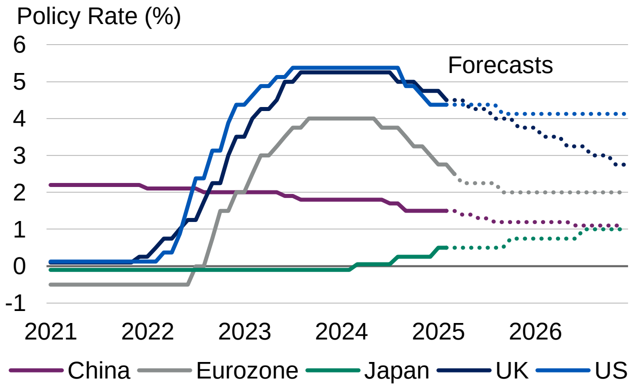
Across emerging markets, the rate-cutting cycle will continue cautiously. Mexico, India, and many South-East Asian economies could be relative beneficiaries from redirected global trade flows, if US tariff increases primarily focus on China. However, if much broader US tariff raises stick, then many of the same economies would face considerable headwinds.

Figure 1: We expect US growth exceptionalism to moderate



Source: Aberdeen, Haver, March 2025

Figure 2: Monetary divergence to continue as tariff policy keeps US easing limited



Source: Aberdeen, Haver, March 2025

Figure 3: Global economic forecasts

	GDP (%)				CPI (%)				Policy Rate (%, year end)			
	2024	2025	2026	2027	2024	2025	2026	2027	2024	2025	2026	2027
US	2.8	1.8	1.8	2.1	2.9	2.9	2.6	2.4	4.375	4.125	4.125	3.875
UK	0.9	0.8	1.2	1.5	2.5	3.3	2.5	2.1	4.75	3.75	2.75	2.50
Japan	0.1	1.2	0.9	1.0	2.5	2.6	1.6	1.5	0.25	0.75	1.00	1.25
Eurozone	0.8	1.0	1.2	1.2	2.4	2.1	1.8	1.8	3.00	2.00	2.00	2.00
Brazil	2.9	1.5	1.7	2.2	4.4	5.2	4.4	3.8	12.25	15.00	12.00	10.00
India	6.6	6.2	6.0	6.0	4.9	3.9	5.1	4.8	6.50	5.75	5.50	5.50
China	5.0	4.6	4.2	4.1	0.2	0.2	1.2	1.4	1.50	1.20	1.10	1.10
Global	**3.2**	**3.0**	**3.1**	**3.2**	**5.9**	**4.3**	**3.7**	**3.5**				

Source: Aberdeen, March 2025.

Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.

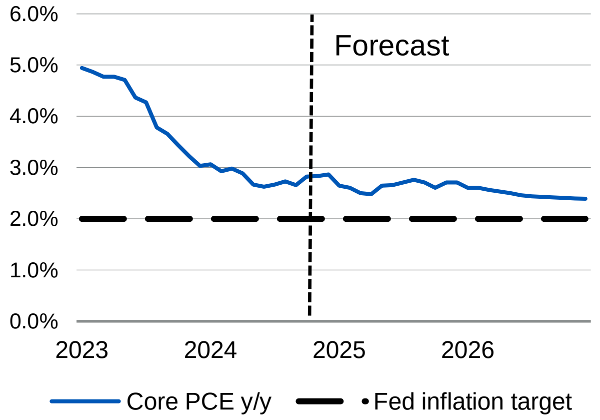
US

Activity: The US economy looks to be losing momentum. Activity data have been weak in early 2025 and business and consumer sentiment have deteriorated sharply in the face of tariff threats. Uncertainty over trade policy and disruptions from higher tariffs now look set to provide a deeper drag on consumption and investment this year. This is likely to lead to slower, as opposed to stalling, growth, with strong household and corporate balance sheets to provide some ballast against policy disruptions. However, the risk of a downturn has increased, especially should tariff rates rise even more than we expect.

Inflation: US inflation is set to remain higher for longer in the face of protectionist trade policy (see Figure 4). Indeed, we now expect larger and broader increases in tariffs to drive consumer prices higher this year, absent any large offsetting currency moves or significant corporate margin compression. As such, the slowdown in core PCE inflation will stall over 2025, leaving the year-over-year rate running uncomfortably hot between 2.5-3%. Risks are tilted towards even higher inflation should tariffs rise more than we expect, or due to other aggressive policy action from the new administration, including on immigration and fiscal policy.

Policy: The Fed left interest rates on hold at its first meeting in 2025 and signalled it is not in a hurry to cut further. Renewed inflation risks from the administration's policy agenda make the case for a more cautious easing cycle, even amid signs of slowing activity. Indeed, we think the Fed will wait until September to deliver its only cut this year, as it looks to balance competing risks around its inflation and employment mandates. However, should the central bank see signs of distress start to emerge in the labour market, it would cut rates sooner and by more.

Figure 4: US core PCE set to remain stubbornly above target in the face of an inflationary policy agenda.



Source: Aberdeen, Haver, March 2025

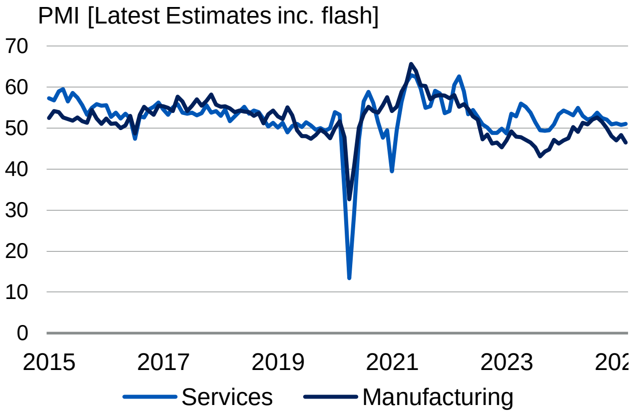
UK

Activity: The trend in activity growth remains weak but just about positive, while surveys are consistent with stagnation (see Figure 5). The increase in the National Living Wage appears to be weighing on labour demand and sentiment. The combination of higher bond yields and weaker growth has seen the government's headroom against its fiscal rules disappear, and tighter spending plans are set to be announced. There appears to be a bit more impetus behind the government's growth agenda. However, the extent of planning reform is relatively modest, and in any case would take years to boost potential growth.

Inflation: Headline inflation is set to trend higher over coming months because of higher energy prices, unfavourable base effects, and the large cost shock this spring. Underlying inflation pressures remain elevated but are still moderating, and the most recent services inflation came in below the BoE's forecast. The big question remains how much firms will be able to pass through rising costs, and the impact of the higher National Living Wage on the rest of the wage distribution. If the economy remains relatively weak, firms' pricing power, and so the wider inflationary consequences, may be limited.

Policy: The BoE is currently guiding towards "gradual and careful" cuts. We think this is likely to cash out as a continuation of the current quarterly rate-cutting pace, with three more 25bps cuts this year. However, there is a clear path to more rapid easing. Already two policymakers are in favour of more aggressive easing, while others have sounded concerned about the growth environment. However, any acceleration in the pace of easing would probably have to wait until later this year, when the full impact of the upcoming cost shock is clearer.

Figure 5: UK activity surveys remain weak, with the manufacturing sector in deep contraction



Source: Aberdeen, Haver, March 2025

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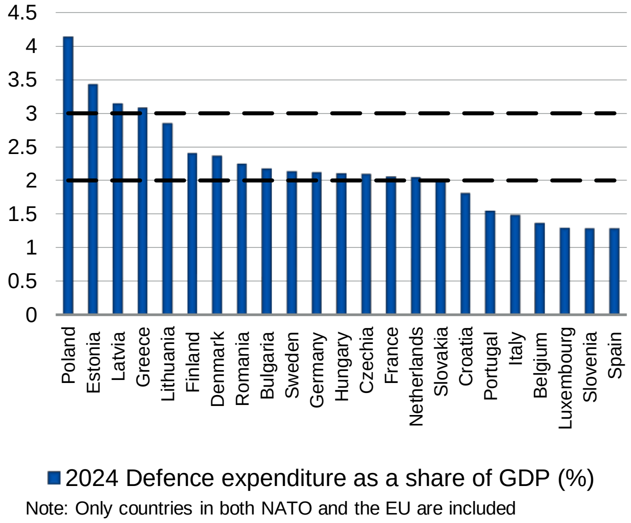
Eurozone

Activity: Two offsetting shocks have changed the Eurozone's growth outlook and introduced new risks around our forecast. On the one hand, trade disruption arising from the US has turned out to be worse than we initially thought. This pushes our Eurozone growth forecast down by 0.4ppts in 2025 and 0.2ppts in 2026. On the other hand, a large boost to defence spending and, in Germany, infrastructure investment should boost growth (see Figure 6). This fiscal expansion pushes our 2026 growth forecast higher by 0.4ppts and will support potential growth over the long-term.

Inflation: The rollover of labour markets in France and Germany is pushing domestically generated inflation pressures down. We expect core disinflation trends to continue given the weak near-term growth outlook. In addition, the recent decline in energy commodity prices and the strengthening of the euro should keep a lid on goods inflation. Overall, our confidence in a prompt and sustainable return of inflation to target has increased. However, fiscal expansion could push up on inflation in the medium term if it is more aggressive and impactful than we currently expect.

Policy: The two offsetting shocks to growth pose a policy dilemma for the ECB. If not for the expected fiscal expansion, the case for taking interest rates into an outright accommodative stance would be strong given weak activity data. But the fiscal impulse will likely keep policymakers more cautious. First, because fiscal easing will help close the output gap, making the need for monetary accommodation less pressing. Second, a boost to potential growth might push the neutral rate higher. On balance, we expect the ECB to reduce rates to 2.0% by September, with two-sided risks to this forecast.

Figure 6: European countries could move to bring defence spending near to 3.0% over coming years



Note: Only countries in both NATO and the EU are included

Source: Aberdeen, Haver, March 2025

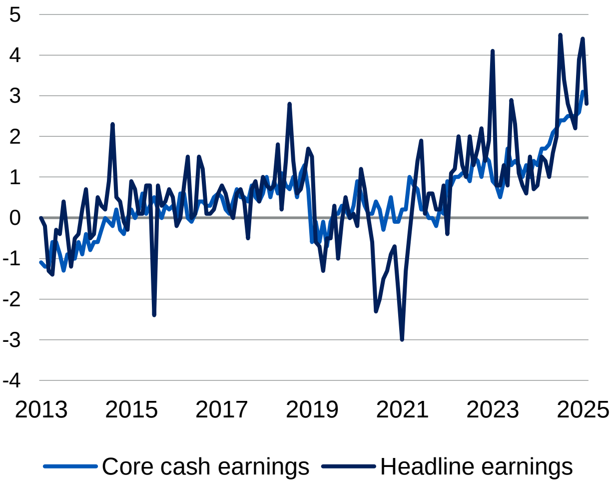
Japan

Activity: Q4 GDP was revised lower to 1.1% as consumption disappointed. Although nominal wage growth has improved significantly, real wages have deteriorated as food costs accelerated in recent months. Sticky inflation may dampen household confidence and hinder the recovery in domestic demand and core inflation. Fears over tariffs and trade barriers will be reflected in the Q1 Tankan survey due in April. Japan's critical role in the global value chain and track record of being adept at negotiating exemptions to President Trump's previous tariffs may help dampen the impact on trade activity.

Inflation: National CPI remains elevated at 4% year over year, driven by food prices. However, western core, which excludes food and energy, and core services slowed as underlying domestically generated inflation remains muted. Soaring food prices should subside into H2. The Shunto wage negotiations got off to a strong start, with increases in small business wages particularly encouraging. This should support underlying inflation pressures if sustained. Indeed, core base pay growth at 3.1% is in line with the BoJ's inflation target (see Figure 7).

Policy: After raising rates by 25bps to 0.50% in January, BoJ board members have maintained a neutral tone on the likely path of policy. Policymakers have expressed optimism over the prospect of spring wage negotiations filtering into a virtuous cycle for wages and prices, but they also remain cautious over the uncertainties arising from the impact of tariffs. We expect the BoJ to hike by another 25bps to 0.75% in October, when the Economic Outlook publication will again help steer communication. We also expect another hike in mid-2026 to 1% and then to 1.25% in early 2027.

Figure 7: Japanese wage growth is moving in line with the BoJ's outlook



Source: Aberdeen, Haver, March 2025

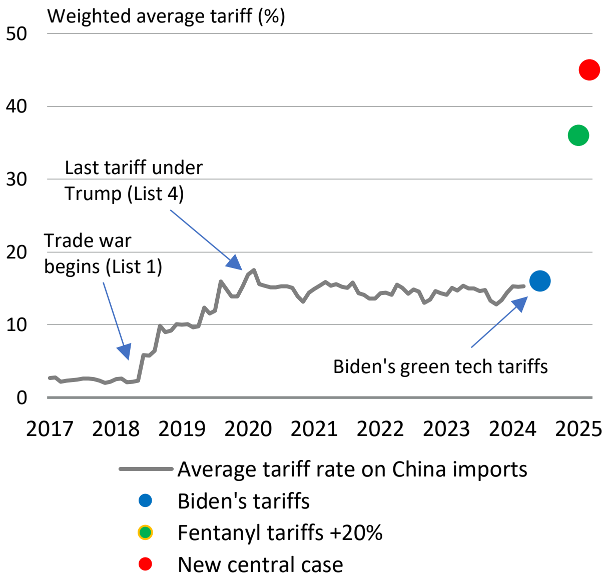
China

Activity: China's "two sessions" confirmed a relatively ambitious "around 5%" GDP growth target for 2025, despite the escalating trade war with the US. We expect that the strong end to 2024, ongoing support from the policy loosening since September and further easing should generate growth of 4.6%, close enough to the target. That said, stimulus is unlikely to be aggressive enough to fully offset the trade shock. US tariffs have risen much more sharply than during the first trade war, and there is a risk that tariffs are pushed higher than our new base case (see Figure 8).

Inflation: The ongoing supply-side bias to Chinese policy, combined with headwinds from the trade war, suggests the nominal environment will remain weak. The shifting timing of Lunar New Year makes judging underlying inflation particularly tricky right now. But the downside surprise in the February print has led us to mark down our 2025 annual forecast to only 0.2%, down 0.5ppts and well short of the new 2% target. Absent a rebound in March, and the authorities condoning an FX depreciation to offset some of the shock to trade, there is a risk of deflation returning.

Policy: Fiscal plans outlined at the "two sessions" suggest that the total government deficit is likely to expand by 1.5 – 2% of GDP, broadly in line with market expectations and suggesting a non-trivial boost to 2025 growth, which will significantly reduce downside risks. Indeed, the authorities stand ready to enact further stimulus to "counteract domestic and external uncertainties". China's retaliation 'playbook' is unlikely to dissuade Trump from pushing ahead with higher tariffs after the US trade review on 2 April. This escalation could be enough to overturn policymaker objections to an FX depreciation.

Figure 8: We have marked up our forecast of where US tariffs on China will settle by 5ppts to 45%



Source: Aberdeen, U.S. Census Bureau, USTR, WITS, March 2025

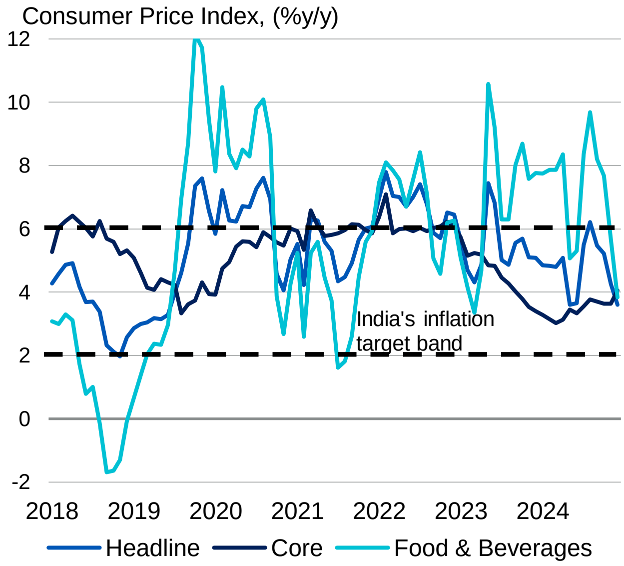
India

Activity: India's economy will continue to grow around 6.0%, but struggle to maintain a much stronger pace given planned fiscal tightening over the coming years. Fading food inflation and some monetary easing should boost domestic demand. And the economy is likely to avoid major growth shocks from US-led trade disruptions due to its reliance on service exports, with potential benefits from supply-chain shifts away from China. However, a pick-up in reform momentum or easier fiscal policy will be necessary to regain the growth levels delivered in 2023.

Inflation: Headline inflation cooled more than expected in early 2025, as the disinflationary effects from receding food prices proved large. This softer pace of price growth led us to lower our full-year forecast to 3.9% (Figure 9). Underlying inflationary pressures remain modest, and we expect the combination of stronger household demand, rupee depreciation, and eventual steadying of food prices to keep headline inflation around the Reserve Bank of India (RBI)'s target mid-point of 4.0%.

Policy: We think lower inflation will spur the RBI to take a more supportive stance towards growth, delivering a further 50bps in cuts, taking rates to 5.75% by year-end. Headline inflation is set to undershoot the RBI's forecast of 4.4% in Q1, setting the path to another cut in April. As the year progresses, fiscal consolidation and a modest growth path will likely prompt the RBI to cut again to support domestic demand. Governor Sanjay Malhotra appears more tolerant of rupee weakness than his predecessor and thus, we see chances of more cuts if growth disappoints.

Figure 9: India's inflation problems are easing



Source: Aberdeen, Haver, March 2025

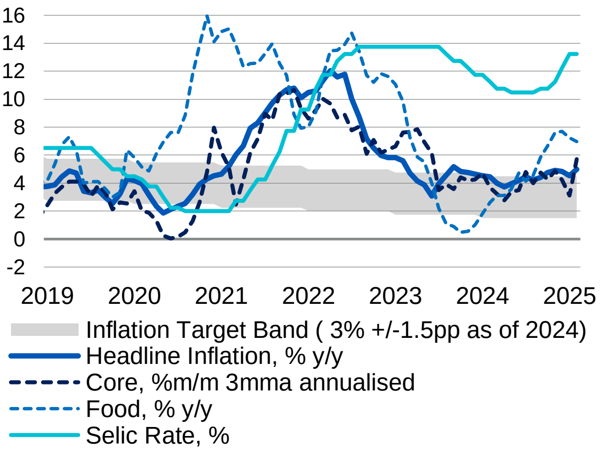
Brazil

Activity: Brazil's economy entered 2025 on a weaker than expected footing. Real GDP growth slowed to 0.2% quarter over quarter in Q4 from 0.7% in Q3. The slowdown was due to a 1% contraction in private consumption amid resurgent inflation and tighter financial conditions. Policymakers must now grapple with whether this slowdown proves transitory or is sustained. Higher real interest rates will cap near-term activity, while we anticipate previously expansionary fiscal policy to become more neutral. But political considerations before the October 2026 general elections could see further fiscal stimulus blunt the impact of monetary tightening.

Inflation: Inflation has remained above the Banco Central do Brasil (BCB)'s target range since October (see Figure 10), and a sustained return to the target is unlikely until Q1 2026. Rebounding food inflation has coincided with continued stickiness for price growth, which, together with a weaker currency, will see inflation fluctuate in the 5-5.5% range for much of 2025. Constraints on domestic demand should provide a cap on how far inflation can rise in the coming months and eventually facilitate greater disinflation over 2026. But volatility in agricultural prices and renewed currency depreciation pose upside risks to overall inflation.

Policy: The BCB's hiking cycle is nearing its end. Despite the weaker Q4 GDP, other factors that motivated the return to monetary tightening since September including resurgent price pressures and inflation expectations and market concerns about fiscal policy will see further tightening until May at least. The risks to our terminal Selic rate forecast of 15% are still skewed to the upside. This backdrop will prevent the BCB from cutting before early 2026, unless growth and inflation cool more significantly. Potential for renewed fiscal largesse ahead of the 2026 elections could further limit the extent of monetary easing next year.

Figure 10: Price and market pressures in Brazil will likely prevent the BCB from further cuts until 2026



Source: Aberdeen, Haver, March 2025

Mexico

Activity: Mexico's economy started 2025 in a particularly fragile position, with real GDP having contracted by 0.6% in Q4 and volatile US trade policy clouding the near-term outlook. Surveys point to a deceleration of GDP growth from 1.5% in 2024 to 0.8% in 2025 (see Figure 11). Further tariffs are a major downside risk, and their precise implementation and duration will determine the outlook for exports and the broader economy. Investment will be constrained until the USMCA is put onto a firmer footing. But if it is, Mexico is well positioned to benefit from nearshoring over a multi-year horizon.

Inflation: Mexican inflation will face a bumpy path over the near term. There has been more progress on services disinflation in early 2025, with tepid domestic demand likely to limit any increases over coming months. However, prices for agricultural products remain prone to weather-related fluctuations. Upside risks stem from potential for import price growth to be exacerbated by renewed peso weakness. The Banco de Mexico (Banxico) forecasts average inflation of 3.5% over 2025 and a return to the 3% target in Q3 2026.

Policy: Banxico's Governing Board retains a dovish bias, having cut its policy rate by 150bps since August, despite the peso's depreciation. The Board has signalled a willingness for further 50bps moves, "albeit maintaining a restrictive stance." Still elevated real rates provide scope for further cuts to 8-8.5% by year-end. The timing and extent of cuts will however be highly USMCA-dependent. A more aggressive trade policy from Washington or hawkish Fed would restrict Banxico's capacity to cut aggressively in the near-term. Ultimately, though an adverse reset of US-Mexican trading relations would facilitate greater easing in Mexico.

Figure 11: Subdued domestic demand and US-related uncertainty are weighing on Mexico's prospects

Source: Aberdeen, Banxico, Haver, March 2025

Alternative global macro scenarios

aberdeen Investments

Trump unleashed

The Trump administration and Congress deliver aggressive policy changes that materially damage aggregate supply and so boost inflation and interest rates

The US policy mix changes dramatically under the Trump administration. This leads to a large negative hit to supply that is not fully offset by easier fiscal policy. Indeed, fiscal largesse leads to renewed concerns about US fiscal sustainability.

The US pursues rapid decoupling from China, with an effective tariff rate of 50-60% and limits on technology and financial flows. Trade policies are also designed to target countries rerouting trade from China or hosting Chinese corporates. A broadly defined reciprocal tariff is imposed that targets both tariff and non-tariff barriers, while USMCA is abandoned. The US' effective tariff rate rises above highs from the 1930s (see Figure 12).

Trade partners retaliate, leading to a material increase in global tariff rates. This protectionism sees global trade volumes decline, leading to a large cyclical slowdown that tips Europe back into recession. Global potential growth slows due to less specialisation.

US immigration policy is tightened significantly, with deportations totalling 8 million (3% of the US population) over the next four years. This sees net migration fall deeply negative (see Figure 13) causing a large fall in labour supply. Sectoral shortages in agriculture and construction are particularly acute, leading to wage and price pressure.

Fiscal policy is eased inefficiently. The US corporate tax is cut to 15%, federal taxes on tips are abolished, the SALT cap is removed, and there is a more generous child tax credit. Higher tariff revenue would offset some of these cuts. But alongside higher defence spending, the deficit would be 7.6% of GDP by 2028. This puts upward pressure on the term premium, crowding out private sector investment, while fiscal sustainability concerns become increasingly pressing.

Monetary policy needs to remain tighter than the base line for the next few years. This lack of monetary easing leads to criticism of the Fed from the Trump administration. The president may attempt to fire Chair Jay Powell, triggering a legal standoff and institutional uncertainty. This prompts significant market volatility and even higher inflation expectations and term premia.

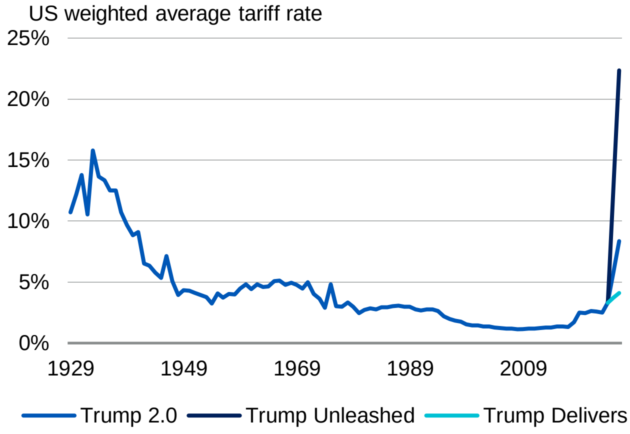
All told, US GDP is lower and inflation higher than in the baseline (see Figure 14).

Indicative economic shocks:

US GDP is close to a percentage lower by 2027 compared to the current baseline forecast.

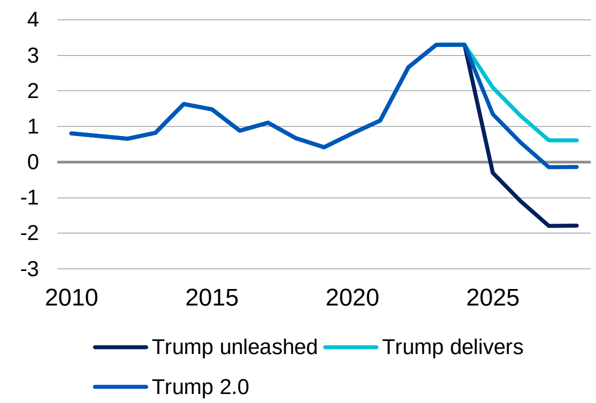
US inflation reaccelerates into the 3-4% range, with the price level some 2.5ppts higher by 2027 compared to baseline expectations.

Figure 12: We are expecting a meaningful increase in US tariffs in our base case, with risks they go substantially higher still



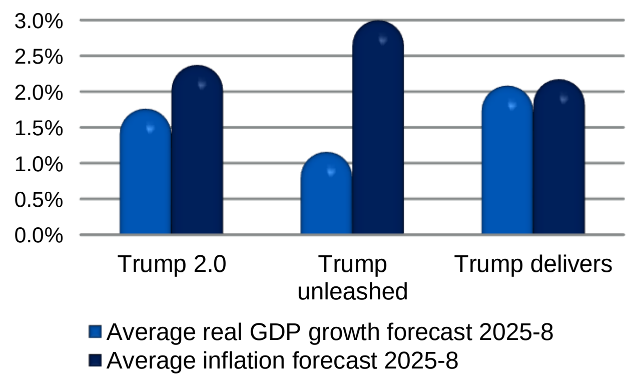
Source: Aberdeen, Haver, March 2025

Figure 13: US net migration would be deeply negative if deportations reach the level Trump has talked about



Source: Aberdeen, CBO, March 2025

Figure 14: US growth would be lower, and inflation higher, under this policy mix



Source: Aberdeen, March 2025

Trump delivers for markets

Trump focuses on the most market friendly aspects of his agenda, while pulling back from more growth-damaging and inflationary policies

The Trump administration pivots towards a far more conventional and growth-friendly style of governance, due to concerns about "equity market vigilantes".

The administration pursues a systematic, coherent strategy of deregulation, using the end of the Chevron deference to dismantle aspects of the regulatory state. The Federal Trade Commission (FTC) takes a more permissive approach to merger activity. Bank capital requirements are eased rapidly. And executive orders are used to significantly increase oil and gas permitting.

The turn to protectionism is much less pronounced, as the risk of higher inflation, political unpopularity and market weakness stay Trump's hand. Nonetheless, the latest 20% tariff increases on China stick.

Fiscal policy is more focused on reforming the tax code than passing further large-scale stimulus. The fiscal cliff is avoided, and there is a small corporate tax cut, alongside even more favourable treatment of investment and R&D. This would see the deficit broadly moving sideways at around 6.6% of GDP in 2028 (see Figure 15). This means there is limited crowding out of private sector capital formation compared to the base case.

A pared back version of the H.R.2 is passed, and net migration is lower. But deportations remain in line with norms from previous administrations (see Figure 16). Labour supply is higher than in the base case.

Trump restrains from further criticising Fed policy, and when Powell's term expires in 2026, he is replaced by a highly credible individual.

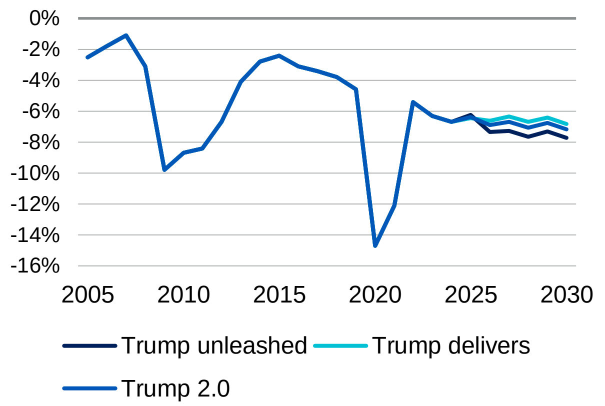
This policy mix supports aggregate supply growth, without a large aggregate demand injection. This means the boost to nominal GDP occurs mostly via stronger real growth rather than inflation. The Fed eases policy more rapidly than in the base case (see Figure 17). In the long run, stronger potential growth could push up on equilibrium rates. Reduced inflation risk and debt issuance compared to the base case means term premia are lower.

Indicative economic shocks:

US GDP is close to 1ppt higher by 2027 compared to the current baseline forecast.

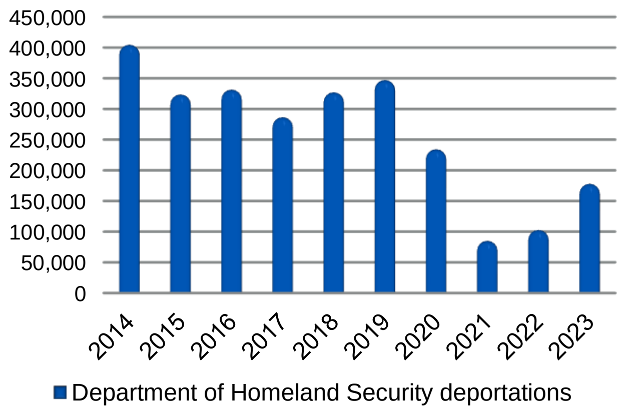
Inflation gets to the Fed's 2% inflation target as soon as 2026, allowing the central bank to normalise interest rates towards neutral settings.

Figure 15: With the deficit so large already, the upside scenario for markets would involve avoiding the fiscal cliff rather than further large-scale stimulus



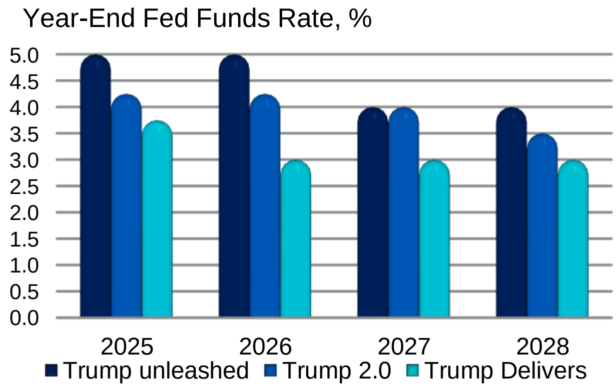
Source: Aberdeen, CBO, Haver, March 2025

Figure 16: Past administrations have seen deportations of 100-400k, rather than the millions Trump proposes



Source: Aberdeen, Office of Homeland Security Statistics, March 2025

Figure 17: The fed funds rate would come down more materially under a more orthodox Trump presidency



Source: Aberdeen, March 2025

US confidence collapse

US business and consumer confidence falls sharply in response to elevated policy uncertainty, causing the economy to slide into recession

On-again off-again tariffs and other rapid swings in the policy outlook cause uncertainty to stay elevated for an extended period. Combined with the delivery of materially higher trade restrictions, this leads to a large hit to sentiment (see Figure 18). This in turn causes households and firms to pull back from investment and durable goods consumption and increase precautionary saving.

Inflation expectations remain elevated in anticipation of tariff effects on the price level (see Figure 19).

The labour market starts to roll over. Federal job cuts driven by DOGE lead to an initial spike in joblessness and softness in payrolls growth (see Figure 20). This weaknesses spreads both to federal contractors, who face significant uncertainty about the future of contracted projects, and then the labour market more generally.

Q1 activity growth delivers the large annualised contraction indicated by the latest nowcasts, with the weakness broad-based and consistent with a genuine slowdown rather than technical quirks. This causes a further hit to sentiment, with recession fears mounting.

The Trump administration isn't especially responsive to the souring of sentiment, as it argues that a period of adjustment is necessary to get to what it mistakenly thinks will be a strong growth environment driven by the private sector.

Financial conditions tighten as equity prices fall further in response to elevated uncertainty and limited progress on the more growth friendly aspects of the Trump administration's policy agenda.

The Fed is unable to immediately respond to the weakness of demand growth given concerns about inflation expectations being less well anchored. This slower easing means recessionary forces become entrenched and the economy contracts through H1 2025.

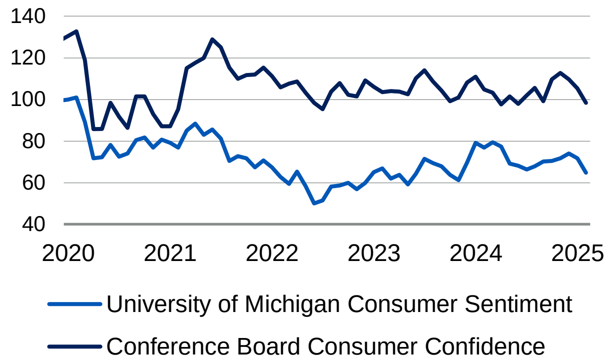
More rapid easing commences towards the end of the year as growth concerns dominate lingering inflation issues, with rates eventually falling below neutral.

Indicative economic shocks:

US recession, with peak-to-trough contraction of 1.5% over three quarters, starting from Q1 2025 GDP.

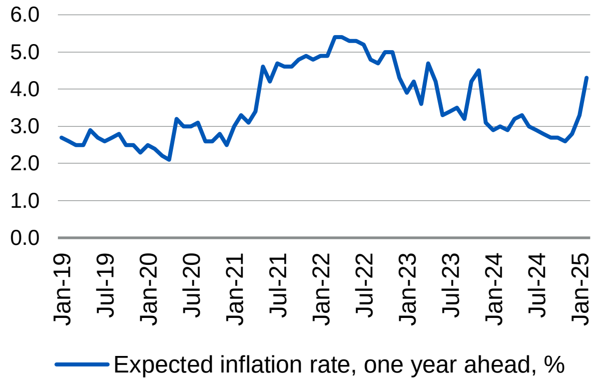
Fed cuts 25bps in June and September, before shifting to 50bps cuts. Terminal rate is 2%.

Figure 18: Consumer confidence has already been hit by increased policy uncertainty



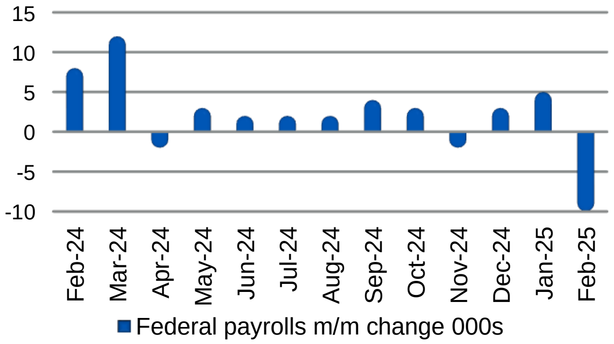
Source: Aberdeen, Haver, March 2025

Figure 19: Inflation expectations have picked up materially and could increase further as tariff measures start to be felt



Source: Aberdeen, Haver, March 2025

Figure 20: Federal job losses are starting to pick-up and this is likely to increase further



Source: Aberdeen, Haver, March 2025

European spending splurge

Higher European-wide defence spending and investment lead to a significant cyclical upswing, while implementation of the Draghi plan boosts potential growth

The combination of the German election result and the shifting geopolitical order proves to be a galvanising event, which pushes Europe towards a sustained increase in defence and other spending that is even larger than in our baseline (see Figure 21). Meanwhile, structural reforms that help deliver an improvement in trend growth are introduced.

Reform to the German constitution allows for a significant pick-up in defence spending and infrastructure investment. The full limit of this newly allowed spending is exploited rapidly, with a variety of "shovel ready" infrastructure projects waiting to be funded. Indeed, after years of stagnation, the output gap is relatively large, meaning that there are ample idle resources to be put to work by the stimulus and so crowding out is limited.

And while there is some leakage of higher defence spending, most procurement is done within Europe, so multipliers prove larger than expected here too.

Higher investment spending boosts potential growth by reversing the weakness in capital formation (see Figure 22).

The return of modest Russian gas supplies as sanctions are lifted helps ease the pressure on European industry and inflation more generally, even if there is little desire among most European policymakers to return to pre-2022 energy dependence on Russia.

Large swathes of the Draghi report are implemented, including boosting European competitiveness in the tech industry via simpler, less stringent regulations. Investment in Germany and Italy also helps reverse the weakness in high-speed broadband and other digital services, further boosting the European tech sector (see Figure 23). In addition, full capital markets union and the issuance of joint-EU debt boosts investment more broadly.

European bond yields rise sharply. However, equity prices are well supported, and the euro strengthens. This constellation of asset price moves is consistent with the market pricing a positive demand shock rather than concerns about financing risks.

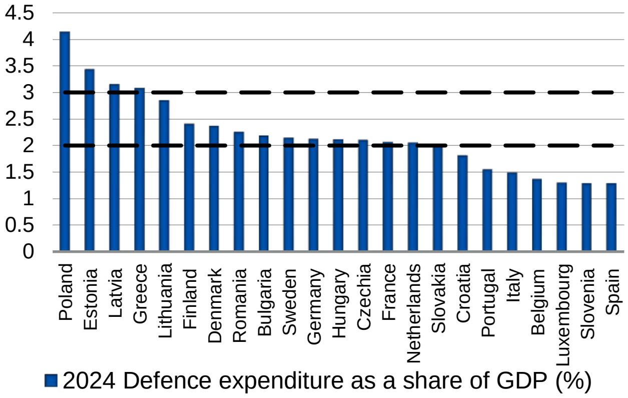
The ECB ends its rate cutting cycle with policy rates slightly above neutral. Meanwhile, higher potential growth estimates cause assessments of r* to increase, with policy interest rates expected to settle permanently higher.

Indicative economic shocks:

Eurozone GDP is 2% higher than the baseline by end-2027, while the price level is 0.75% higher.

The ECB eventually hikes rates modestly, to 2.75% by end 2027.

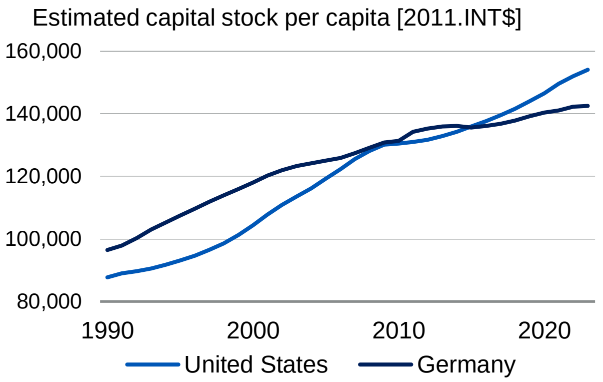
Figure 21: A push towards 3% of GDP on defence spending across the EU would lead to a significant rise in spending



Note: Only countries in both NATO and the EU are included

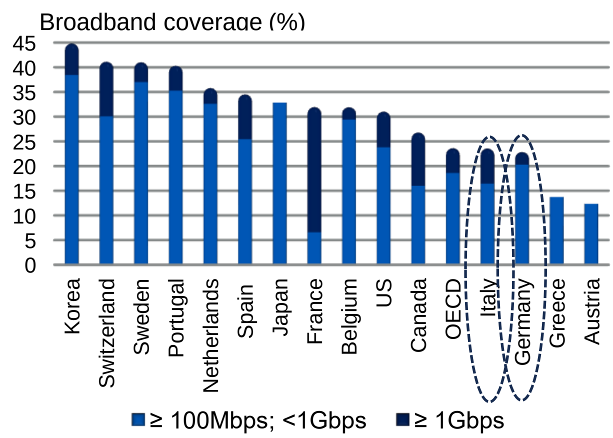
Source: Aberdeen, NATO, March 2025

Figure 22: Growth in the German capital stock has lagged, leading to a fall in productivity



Source: Aberdeen, Haver, March 2025

Figure 23: Limited tech investment has caused digitisation to lag in major European economies



Source: Aberdeen, Haver, March 2025

China opens the policy floodgates

Policy is eased significantly, with housing developer bailouts and a credible plan to boost household consumption. International investor sentiment stays positive

Chinese policymakers become more concerned about domestic momentum and headwinds from US tariffs. Meanwhile, the de-risking agenda is deprioritised, while ideological concerns about supporting consumption and "welfarism" are put aside.

Policymakers therefore deliver a bigger and better-targeted package of stimulus and reform than we are expecting in the base case.

This includes sizeable fiscal stimulus to directly support household consumption, housing developer bailouts, a concerted effort to complete unfinished properties, and additional central government support for local government public finances.

Chinese financial conditions become even more accommodative, as ample liquidity combines with rate cuts and strong credit growth (see Figure 24).

Consumer confidence improves significantly due to direct government transfers, rising house prices, higher income growth and improved employment prospects (see Figure 25).

Expanding the social safety net reduces the need for precautionary saving, so households tap into the excess savings built up from the pandemic (see Figure 26). This provides a large boost to the service sector, both at home and abroad as tourism takes off.

Nominal growth picks up sharply, and China's disinflationary impulse to the rest of the world fades, as export deflators move back into positive territory. Commodity prices also increase as domestic investment spurs demand for raw materials.

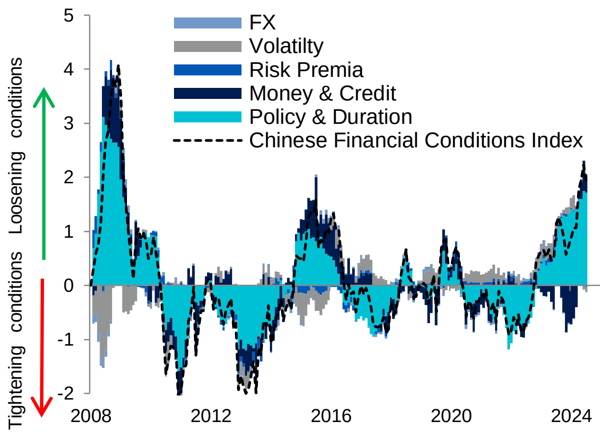
Rebalancing helps to diffuse trade tensions with the US and there is no further increase in US-China tariffs. The recent nascent improvement in international investor sentiment is amplified, resulting in capital flows returning to China. Global equilibrium interest rates modestly increase as reforms translate into stronger potential growth and lower national savings in China.

Indicative economic shocks:

Chinese GDP growth is 6% this year and next.

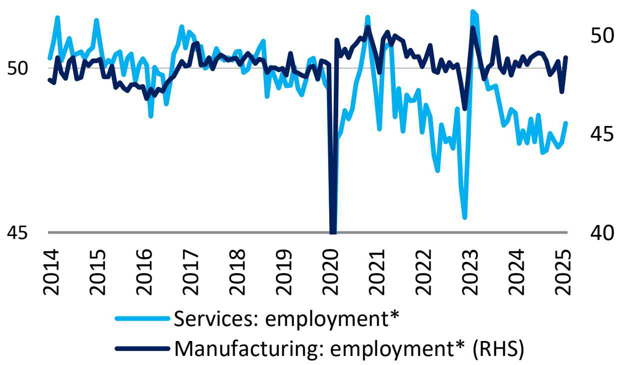
Inflation is at the new 2% target.

Figure 24: China's policy 'bazooka' could be brought out of retirement, which would see our financial conditions index loosening significantly



Source: Aberdeen, Bloomberg, Refinitiv, March 2025

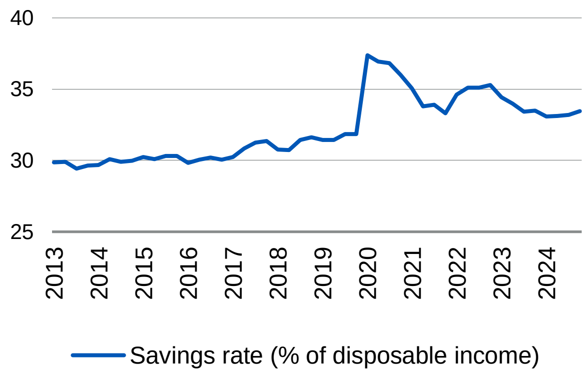
Figure 25: The labour market remains weak, particularly in services, which could prompt bigger stimulus



*Sectoral averages across NBS and Caixin PMIs.

Source: Aberdeen, Haver, March 2025

Figure 26: If the need for precautionary saving is reduced, savings would boost consumption



Source: Aberdeen, Haver, March 2025

China balance sheet recession

China's policy response falls substantially short of what is necessary given headwinds, so the economy becomes trapped at lower rates of growth and inflation

China's cyclical and structural headwinds intensify. There is further retrenchment in the property market and consumer sentiment, while US tariffs increase significantly. Policy support is entirely inadequate to the headwinds, causing China to become trapped in a low growth, low inflation "Japanification" scenario.

Policy announcements significantly disappoint expectations even as activity deteriorates and pressure from US trade policy mounts. In particular, policymakers remain deeply averse to supporting household consumption due to 'welfarism' fears and worry that support to the housing market and local governments will cause progress on deleveraging and derisking to be lost.

House prices continue to fall, leading to further declines in already depressed consumer confidence indices (see Figure 27). The number of new housing starts falls further as the authorities attempt to tackle a large overhang of vacancies (see Figure 28).

Industrial production contracts as domestic growth stutters and Western-owned manufacturers begin to move operations out of China under pressure from US policy. Exports fall sharply, but the authorities do not condone a sufficient FX depreciation due to fears of exacerbating capital flight. Despite the government's recent re-affirmation of the "around 5%" growth target, consensus expectations for Chinese growth are marked down to around 2-3%.

CPI inflation moves back into negative territory, while the GDP deflator continues to fall (see Figure 29). Combined with sharp declines in industrial metals and energy prices, this transmits a disinflationary impulse around the globe.

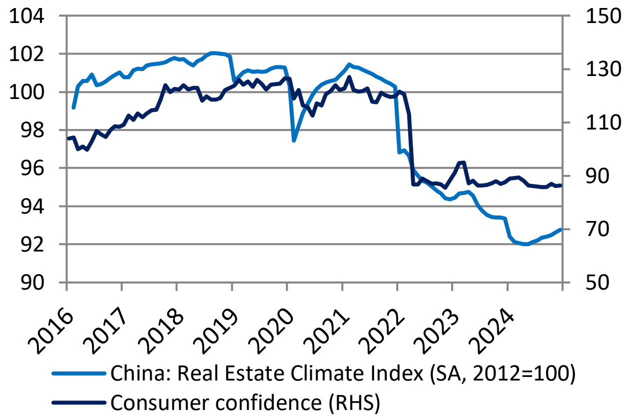
International investor sentiment sours and capital outflows intensify, sparking fears of capital controls being enacted on international investors. The RMB reprices lower in a disorderly manner.

Indicative economic shocks:

Chinese GDP growth is 2-3% over the next several years.

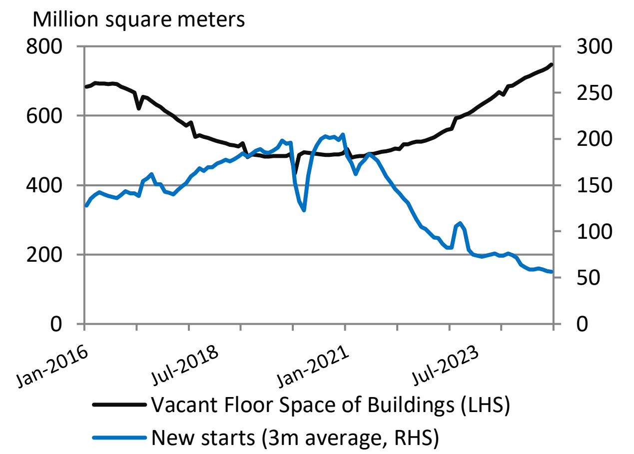
Inflation is around -2%.

Figure 27: Consumer confidence has been hit by falling house prices and troubled property developers



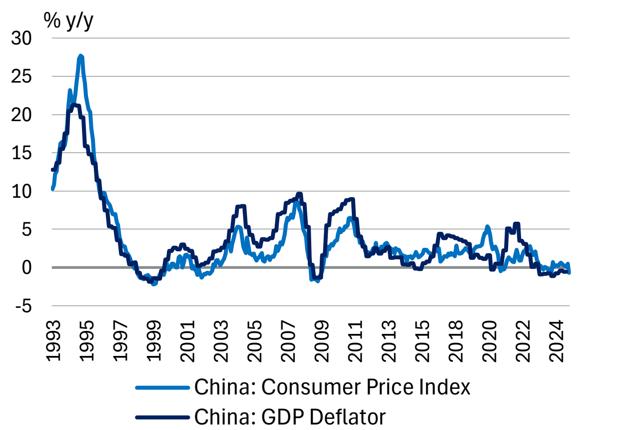
Source: Aberdeen, Haver, March 2025

Figure 28: Property remains a key pillar of vulnerability



Source: Aberdeen, Haver, March 2025

Figure 29: Deflation could become embedded, blunting policy easing by pushing up on real rates



Source: Aberdeen, Haver, March 2025

Conflict risks dominate

Failure of Russia-Ukraine ceasefire shocks energy markets and depresses private sector animal spirits, while rapidly rising defence spending pushes yields higher

The failure of the Russia-Ukraine ceasefire, combined with US military retrenchment worldwide, sparks additional conflicts in the Middle East and elsewhere.

The ceasefire dividend in oil and gas markets evaporates, while Israeli strikes against infrastructure in Iran push oil prices well above $100 per barrel, with peaks around $120 per barrel plausible. Global shipping and trade disruptions amplify the energy price shock.

All of this represents a significant negative supply shock to the global economy, pushing inflation higher and growth lower (see Figure 30).

At the same time, this geopolitical shock causes rapid increases in defence spending across vulnerable regions and countries (see Figure 31), putting upward pressure on yields, especially in Europe. However, US defence spending falls as it pulls back from its global role. Countries that have relied on the US security umbrella such as Taiwan, Korea and Japan are compelled to bolster their militaries.

Heightened uncertainty weighs on corporate capital spending and hiring, while defence spending would likely crowd out government expenditure elsewhere, contributing to a tepid growth backdrop.

Higher inflation, risk and term premia more than offset the effects of weak growth, pushing yields higher while straining debt sustainability metrics.

The recent experience of high inflation means that inflation expectations are less well anchored than normal (see Figure 32). As such, central banks do not feel comfortable "looking through" this shock, limiting the scope for rate cuts.

Risk-off market dynamics add to the dispersion of market outcomes driven by differences in flight to quality characteristics and the pressure on budgets from military enlargement.

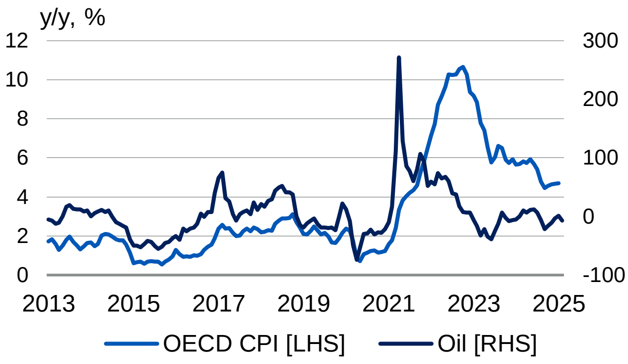
As such, the USD and other safe-haven currencies, such as the yen, strengthen, while emerging markets are put under pressure. In some cases, monetary policy is tightened despite the weaker activity backdrop and increased financial stress, which pushes down further on global growth.

Indicative economic shocks:

Level of global GDP is 1.0% lower than base case.

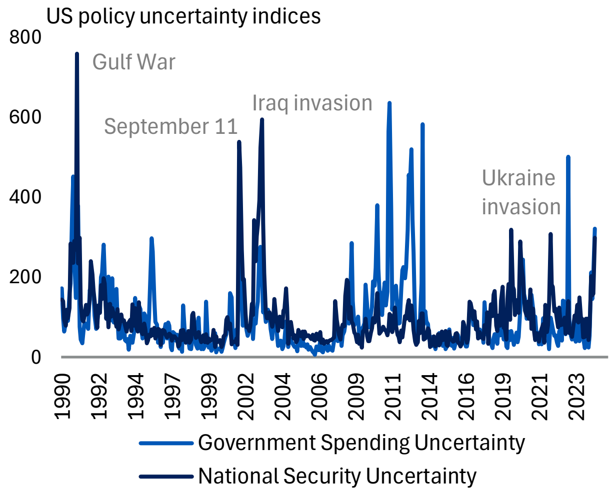
Price level is 1.5% higher.

Figure 30: A sharp rise in oil prices would push up on global headline and core inflation



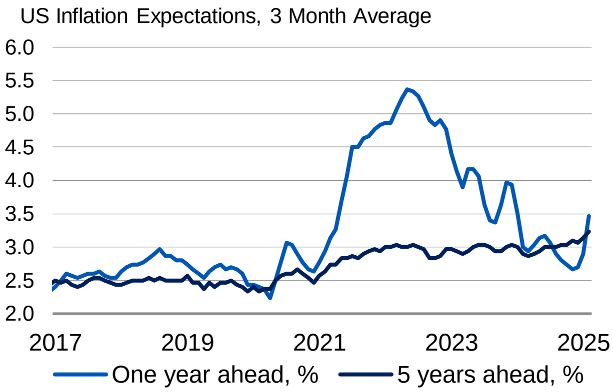
Source: Aberdeen, Haver, March 2025

Figure 31: Conflict and fiscal spending uncertainty are already elevated, and often spike at the same time



Source: Aberdeen, Haver, Economic Policy Uncertainty, March 2025

Figure 32: Already elevated inflation expectations mean central banks would struggle to look through the shock



Source: Aberdeen, Haver, March 2025

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