Global Macro Research – Global Economic Outlook

Q3 2025

#Global / #Forecasts / #Scenarios

Trade and fiscal policy on trial

The global trade shock has moderated and the risks of a tariff spiral have receded, so we've upgraded some of our growth forecasts and reduced the probability of a US recession. But uncertainty has not dissipated and concerns over fiscal policy have grown, risking a sharp sell-off in long-dated developed market bonds.

US trade and fiscal policy remain sources of deep uncertainty for the global economy, even though our forecasts of the size of the tariff shock have scaled down.

The US-weighted average tariff rate currently stands at 12%, and we are now conditioning our baseline forecasts on this rising only slightly from here (see Figure 1).

Legal challenges to President Donald Trump's reciprocal tariffs were always likely, but the strength of the ruling of the US Court of International Trade against the president's ability to use the International Emergency Economic Powers Act (IEEPA) still came as a surprise.

Whether the administration wins its appeal will in large part come down to a ruling on the 'major questions doctrine' – effectively whether the executive branch can impose such sweeping changes without Congress signing off on it – and a judgement will likely be made in the next few months.

Should US courts uphold the decision, this has the potential to shift the power balance on tariff setting more in favour of Congress, which would reduce the risks of substantially higher tariffs. But the raft of alternative legislative options (Sections 122, 232, 301, 338) suggests that tariffs will remain an active policy lever of the executive branch. Bipartisan support for a "tough on China" approach in particular mean that we are assuming tariffs on Chinese imports rise back to 40% or more.

In any case, while the softening in trade actions and rhetoric has helped stabilise many markets, the economic consequences are only just beginning. Data is likely to be scrambled over coming months, with US Q1 GDP contracting due to a surge in imports ahead of tariff imposition, but an offsetting boost to inventories and sales likely to show up as a strong Q2.

However, looking through the noise, uncertainty will weigh on hiring, investment, and durable goods consumption, while weaker real income growth will also slow the economy over H2. That said, we have lowered our 12-month US recession probability to around 30%, from almost 50%.

But while markets are less concerned about the tariff shock, they are increasingly on edge about US, and developed market more generally, fiscal policy.

Reconciliation of the "One Big Beautiful Bill Act" (OBBBA) could be concluded by 4 July, or soon after, and we expect this to push the US fiscal deficit above 7% of GDP over the next two years, even if most tariff revenues find their way into government coffers (see Figure 2).

The risks are skewed towards an even larger worsening of the US deficit, in part because tariff revenues could be lower (the flip side of a less aggressive tariff policy, or faster trade re-routing), or because a greater share could be used to offset some of the damage caused by the trade war.

Markets may also have fiscal concerns elsewhere. European fiscal policy is being loosened to boost defence spending, the UK's fiscal rules are likely to be broken again given little appetite for higher taxes or lower spending, and Japan may add some stimulus following the upper house elections.

Long-end yields may therefore remain under pressure worldwide, as higher issuance is running into structurally lower demand from fully funded pension schemes.

All of this means the Federal Reserve remains in a tough policy environment, with pressures on both sides of its dual mandate and financial markets likely to remain skittish. We now expect the Fed to cut just once this year in December as the moderating trade shock and still uncertain fiscal policy reinforce a "wait and see" approach. But should the data deteriorate rapidly, then more aggressive easing would be on the cards.

Elsewhere, the shock from US policy remains disinflationary. We expect this will spur one more cut by the ECB, taking policy below the neutral 2% mark. More cuts would occur if a 50% US tariff is confirmed on 9 July.

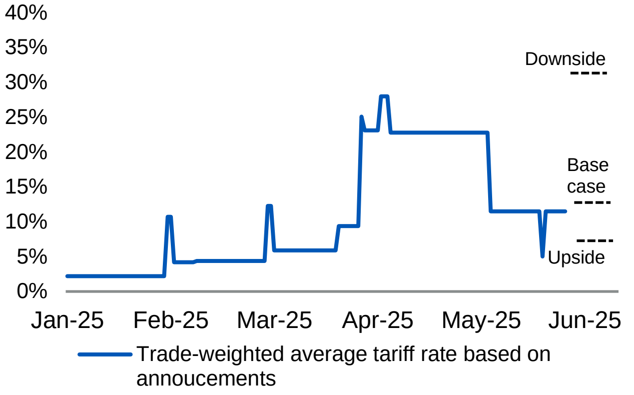
The tariff détente achieved following the US-China meeting in Switzerland on 11 May means we now forecast a more gradual and modest sequential growth slowdown in China than previously. This will tone down the scale and urgency of further policy easing, but we still expect that the authorities will need to do more to support the economy.

The difficulty of securing a trade deal with the US, and existing legislation (232, 301) that provides an easy route for the US to raise tariffs on China, still points to decoupling being a long-lasting headwind to Chinese growth.

Emerging markets have escaped fairly unscathed from recent pressure on DM long-end yields; the EMBI sovereign spread is little changed, for example. That said, EM policymakers still have to contend with the uneven effects of US trade policy and market sensitivities to their own fiscal slippage.

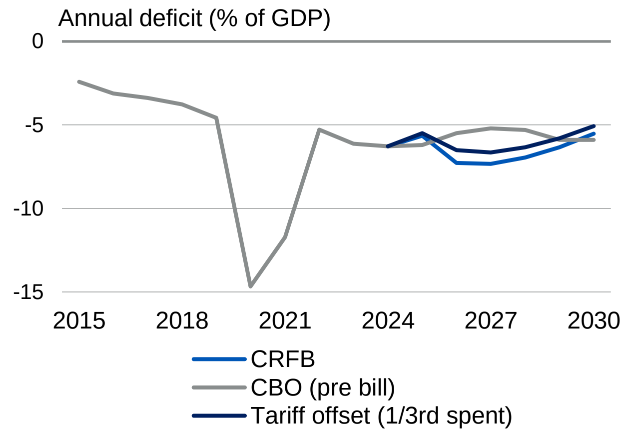
Stepping back, US exceptionalism remains under pressure. Certainly, the IEEPA court ruling offers a reminder of US institutional strengths. But the policy mix still points to slowing potential growth, while uncertainty remains high. Losing reserve currency status is still very unlikely, but policy mistakes - such as following through on Section 899 within the OBBBA, which threatens retaliatory taxes on foreign investments – risk souring foreign appetite for US assets.

Figure 1: We expect the US average tariff rate to ultimately settle a little higher than its current rate



Source: Aberdeen, Haver, June 2025

Figure 2: The US deficit is already extremely large for this point in the cycle and will increase further



Source: Aberdeen, CBO, CRFB, June 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	1.9	3.0	3.0	2.6	2.3	4.375	4.125	3.375	3.125
UK	1.1	1.0	1.1	1.5	2.5	3.2	2.3	2.1	4.75	3.75	2.75	2.50
Japan	0.2	0.7	0.2	0.5	2.8	2.9	2.0	2.0	0.25	0.50	0.75	1.00
Eurozone	0.8	1.0	0.8	1.5	2.4	1.9	1.6	1.8	3.00	1.75	1.75	2.00
Brazil	3.0	2.6	1.4	2.4	4.4	5.4	4.5	3.8	12.25	15.25	12.50	10.00
India	6.6	6.9	6.0	6.0	4.9	3.4	5.3	4.7	6.50	5.50	5.75	6.00
China	5.0	4.7	3.9	4.2	0.2	0.0	1.3	1.6	1.50	1.30	1.10	1.00
Global	**3.3**	**3.0**	**2.9**	**3.2**	**5.8**	**4.1**	**3.6**	**3.5**				

Source: Aberdeen, June 2025

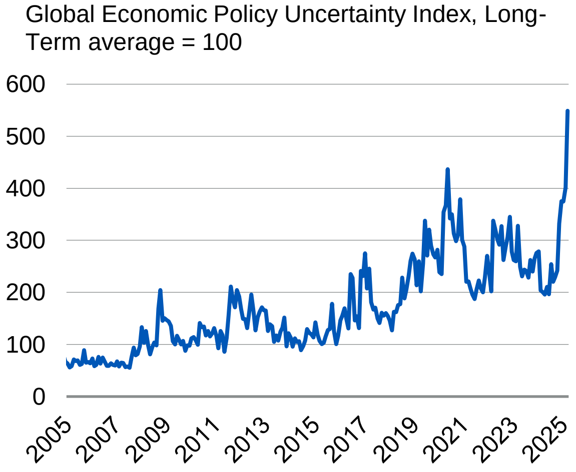
US

Activity: Tariff policy has scrambled US GDP data. We are forecasting a strong Q2 rebound following the contraction in Q1. But more fundamentally, given our base case expectation for the weighted average tariff rate to settle around 13%, we think elevated uncertainty (see Figure 4) and lower real incomes will weigh on the cyclical growth outlook, while protectionism will push down on potential growth. Uncertainty is most likely to show up in hiring, investment, and durable goods purchases. We expect the budget reconciliation process to increase the fiscal deficit to around 7% of GDP, but we think the stimulative impact will be largely crowded out by higher yields.

Inflation: Ironically, trade policy may have had a disinflationary impact on recent inflation data through lower portfolio management fees. But the April inflation reports, which represented the second consecutive month of target-consistent inflation, are likely to represent a local low. Even with tariffs likely to settle at a lower rate than once seemed plausible, we think the roughly 10 percentage point increase in the average tariff rate will be a sharp levels shock to goods prices. With inflation expectations having increased sharply, the risk of second-round price effects is significant.

Policy: Because we think recession risk has moderated to around 30% over the next 12 months, and with the Federal Reserve (Fed) in “wait and see” mode, we now expect just one rate cut this year, in December. Should the data deteriorate more rapidly, then more aggressive easing is possible, with the Fed likely to be especially sensitive to a sudden weakening in the labour market. When Chair Jay Powell’s term expires in May next year, there is some risk President Trump appoints a chair who delivers inappropriately accommodative policy, but the immediate risk of Powell being sacked has faded.

Figure 4: US uncertainty has spiked sharply and remains elevated even as the tariff rate has come down



Source: Aberdeen, Haver, June 2025

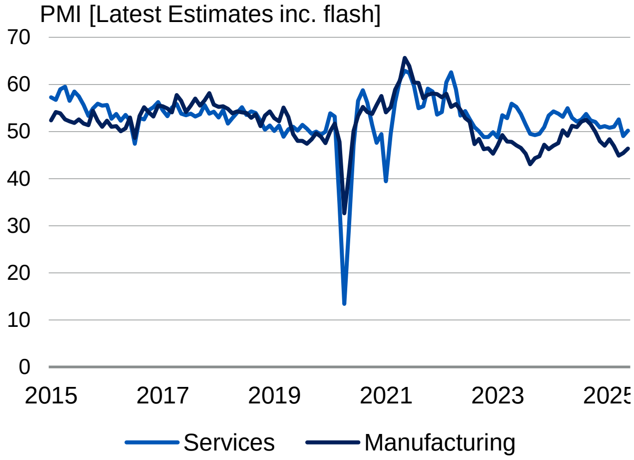
UK

Activity: Q1 GDP was strong, expanding by 0.7%. But this flatters the underlying health of the economy, and we forecast growth to slow through the rest of the year. PMIs have dipped and the composite measure is in contractionary territory (see Figure 5). Payrolls data suggest the labour market was slowing in anticipation of higher national insurance. Rising longer maturity gilt yields and fiscal slippage mean we expect the current fiscal rules will be breached again in the autumn. With limited political appetite for higher taxes or lower spending, higher borrowing is very likely, and this may put further pressure on gilts.

Inflation: Headline CPI picked up sharply to 3.5% in April. While higher administered and indexed prices were always going to see inflation jump, underlying inflation pressures do look stronger. We think inflation will pick up a little further over coming months but should then trend down for much of H2 due to weaker energy prices and stronger sterling. Input costs are now rising sharply following the increase in the national living wage and national insurance. However, firms appear to have limited pricing power, wage growth is moderating, and we expect the tariff shock to be disinflationary for the UK.

Policy: The Bank of England (BoE) cut Bank Rate by 25bps to 4.25%. With the Bank keeping its “gradual and careful” guidance, we continue to forecast a further two 25bps cuts in the second half of the year, with the next move in August. However, if the labour market does deteriorate significantly in coming months in response to the various shocks hitting the economy, then there is a clear path to more rapid easing. There has been some speculation that policymakers will dial back on asset sales in September, but this seems unlikely given the Bank’s preference to run down its gilt holdings.

Figure 5: UK PMIs suggest activity growth was very weak at that start of Q2



Source: Aberdeen, Haver, June 2025

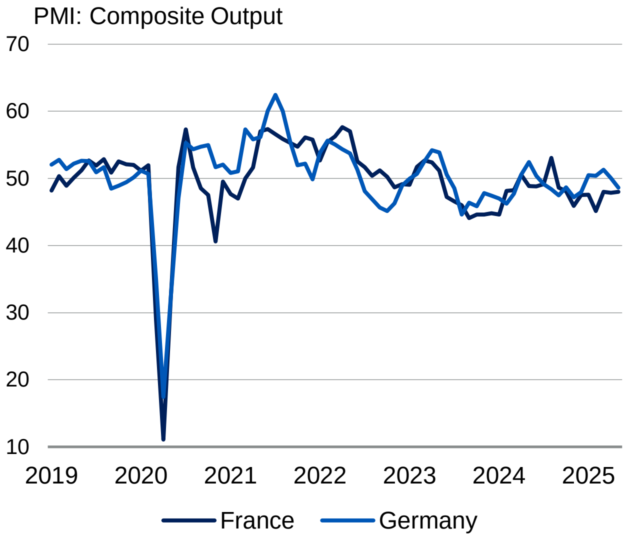
Eurozone

Activity: The Eurozone economy continues to be something of a global laggard, led by weakness in France and Germany (see Figure 6). And US tariff policy is further weighing on near-term growth prospects. So, our GDP forecasts for this year and next remain subdued. The hit to growth will even bigger if Trump's threat of a 50% tariff on EU goods materialises, raising recession risks to uncomfortable levels. However, the outlook is brighter over the medium term, when fiscal stimulus starts to come online, so we are forecasting stronger growth in 2027.

Inflation: Price growth has now slipped below the European Central Bank (ECB)'s 2.0% target. Weaker demand, a stronger euro, and cheaper energy prices should drive further disinflation from here. Given the limited scope of the EU's proposed retaliatory tariff measures and the US' relatively small share of total EU imports, we don't expect the trade war to reignite inflation in the Eurozone. Overall, we are forecasting inflation to remain below target for the rest of the year. However, fiscal expansion could push up on price pressures over the medium term.

Policy: The ECB's rate cutting cycle has nearly concluded, with monetary policy settings now neutral. However, we think that the negative demand shock from US tariff policy justifies some further easing, so we are forecasting a final 25bps reduction in September. Cuts could be deeper and more urgent in the unlikely event that a 50% US tariff rate is confirmed on 9 July. Further ahead, because we think fiscal easing will start to drive a recovery in 2026 and 2027, we've tentatively pencilled an ECB hike back to a neutral 2% at the back end of our forecast horizon.

Figure 6: Germany and France carried poor momentum into the recent trade shock



Source: Aberdeen, Haver, June 2025

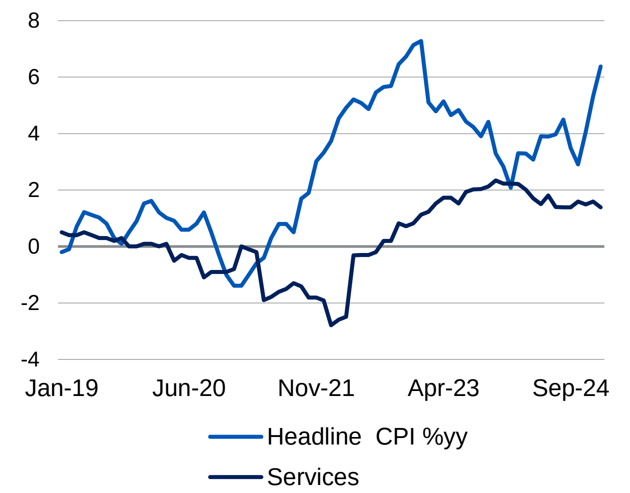
Japan

Activity: Japan's Q1 GDP contracted by 0.2% quarter over quarter. Consumption was unchanged while corporate capex picked up. While nominal wage growth has improved significantly, real wages have deteriorated. Negotiations between the US and Japan began well, but the tone from Japan has hardened. Pressure ahead of the upper house election means we think the path to a trade deal will not be smooth. But we expect fiscal stimulus to protect households and corporates from the impact of tariffs. The service sector appears to be holding up and overall Japan should just-about avoid a recession, despite our forecast for slower growth.

Inflation: National CPI remains elevated as rice and energy costs continue to soar. The government plans to intervene to contain surging rice inflation – which has hit almost 100% year over year – and we think this should bring core inflation back to 2% over coming months. Core base pay growth decelerated in Q1 due to calendar effects and a decline in hours worked, but these distortions should unwind in coming months and we expect the impact of stronger wage talks will become evident in H2 wage growth.

Policy: The Bank of Japan (BoJ) left rates on hold in May while significantly downgrading its growth and inflation forecasts. The BoJ will be reluctant to be drawn into supporting the yen as part of any trade deal with the US. The timeline of tariff talks, domestic politics and fiscal events means we think the BoJ will wait until January 2026 to resume hikes. Debt dynamics have come under increased scrutiny as long-end JGB yields surged. Heavy long-end issuance and waning domestic demand played a role in the sell-off. Ministry of Finance issuance plans may be updated following consultation with dealers.

Figure 7: Japanese inflation has surged due to food prices, prompting government plans to intervene



Source: Aberdeen, Haver, June 2025

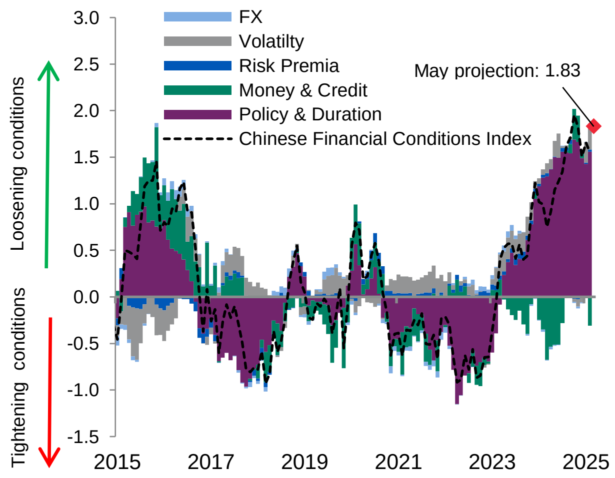
China

Activity: The sudden reduction in tariffs following the US-China meeting in Switzerland (11 May) will give a reprieve for manufacturing, meaning that we now forecast China's sequential growth slowdown will be more modest and begin somewhat later than we previously assumed. However, bipartisan support for a "tough on China" approach and the potential for section 122, 232, 301 and 388 tariffs to substitute for IEEPA mean we aren't changing our expectation for the tariff endgame, even if IEEPA is struck down in the courts. We are conditioning on US tariffs on China settling around 40%. We forecast 2025 and 2026 Chinese GDP growth of 4.7% and 3.9% respectively.

Inflation: The moderating headwinds from the trade war provide modest support to our annual CPI inflation forecasts. Damage to trade and inward investment is now likely to be slower to materialise, suggesting the authorities are unlikely to condone FX depreciation until next year. Even then, a weaker currency will do little to support inflation because of the ongoing supply-side bias to Chinese policy. China might narrowly avoid CPI deflation this year (0%), but the GDP deflator will likely show a more marked fall in whole-economy prices, keeping pressure on leveraged corporates and government finances, while risking rising ex-ante real rates.

Policy: Chinese policymakers announced a raft of easing measures ahead of the meeting between Vice Premier He Lifeng and US Treasury Secretary Scott Bessent in Switzerland (-10bps 7-day reverse repo, -25bps PSL, -50bps RRR, RMB 1.1 trillion relending quota expansion), which was followed up by 10bps cuts to the one-year and five-year loan prime rates (LPR), and cuts to bank deposit rates. The US-China détente is likely to tone down the scale and urgency of further easing, but with a deal likely to take months to discuss, we still expect more steps aimed at loosening financial conditions (see Figure 8).

Figure 8: Chinese policy support will remain attentive, but will scale up and down with moves in US tariffs



Source: Aberdeen, Haver, Bloomberg, June 2025

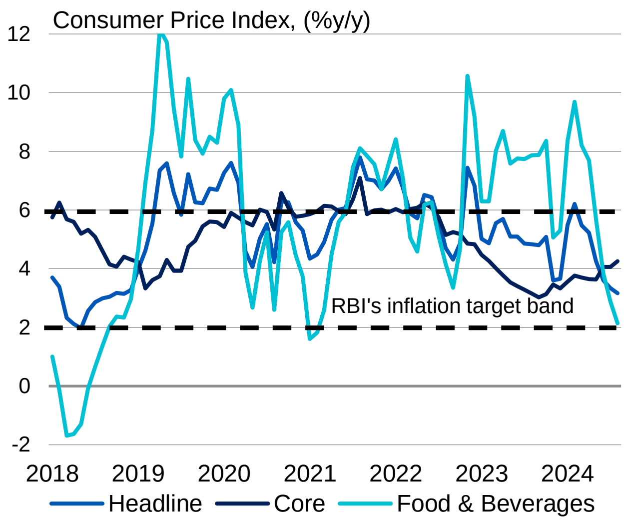
India

Activity: India's economy is growing better than we had expected, but the breakdown of the Q1 GDP print gives reason for caution. Domestic demand contracted through the quarter and a sharp decline in imports was key to the strong net exports contribution. We expect some unwind of the net exports boost while household demand gradually picks up. Tailwinds include rising real incomes and easing monetary conditions, while government capex should rise. As such, we think India can post growth of 6.9% this year but expect annualised sequential growth to return closer to 6% over the coming quarters.

Inflation: Headline inflation continues to cool, helped by large disinflationary effects from receding food prices (see Figure 9). Lower global energy prices and rupee stability should also keep inflation under the Reserve Bank of India (RBI)'s target mid-point of 4.0%. Core inflation has however picked up and strong domestic demand should support this. Nevertheless, we think economic slack remains, which should keep underlying inflationary pressures in check. All told, we forecast headline inflation to average 3.4% through the year but expect core inflation to be somewhat higher.

Policy: The RBI delivered a further 50bps cut in June, taking its policy rate to 5.50%. The central bank will also inject liquidity into the banking system, lowering its cash reserve ratio by 100bps from September to November. This marked the end of the RBI's accommodative stance, held since April, with the shift back to neutral signalling further easing is unlikely. We expect the RBI to maintain its stance at least through to the second half of 2026. However, there is now a risk of an earlier rate-hiking cycle if the economy responds better than expected to the monetary easing.

Figure 9: India's inflation problems are easing



Source: Aberdeen, Haver, June 2025

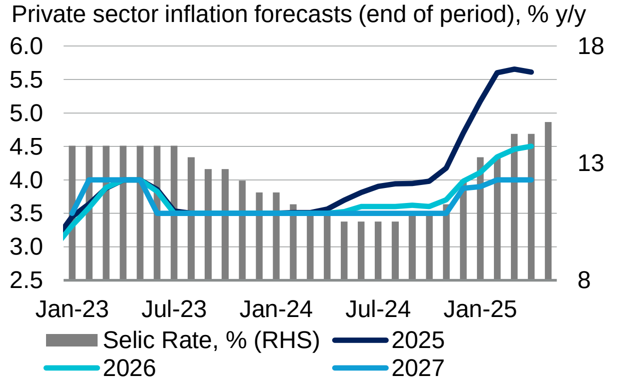
Brazil

Activity: Brazil's real GDP growth rebounded from 0.1% quarter over quarter in Q4 to 1.4% in Q1, led by upswings for private consumption and investment despite elevated inflation and aggressive monetary tightening. 2025 growth will be buoyed by labour market strength alongside Brazil being comparatively insulated from sifting US trade policy. The lagged effects of interest rate hikes and a global slowdown however slow H2 growth in our forecast. Fiscal stimulus will likely increase before the October 2026 general elections as Lula seeks to regain popular support, but we think this will also limit scope for the Banco Central do Brasil (BCB) to lower rates.

Inflation: Price pressures remain elevated in Brazil, with inflation having been above the BCB's target band (3% +/- 1.5ppts) since October and a sustained return unlikely until Q1 2026 on our numbers. Although currently high food inflation should peak in Q3 and decline gradually thereafter due to base effects, we think core disinflation will be hindered over H2 by continued labour market tightness buoying demand for services and non-food goods. Fiscal stimulus before the 2026 elections risks amplifying demand-side pressures. Market perceptions of fiscal largesse could also renew *real* depreciation and raise import prices. Overall, the risks to inflation remain weighted to the upside.

Policy: The BCB raised the Selic rate by 425bps from September to May, aiming to rein in runaway inflation expectations (see Figure 10). The upside surprise in Q1 growth and rising core inflation reinforce the case for a final hike of 25bps or 50bps in June, in our view weighted towards the latter. Outside of an earlier and sharper cooling of demand-side pressures, we do not anticipate a pivot to monetary easing until Q1 2026 at the earliest. Cuts thereafter will be cautious and could be more limited by pre-election fiscal policy impacting inflation and the *real*.

Figure 10: High inflation expectations and economic resilience will keep Brazilian monetary policy tight



Source: Aberdeen, BCB Focus survey, Haver, June 2025

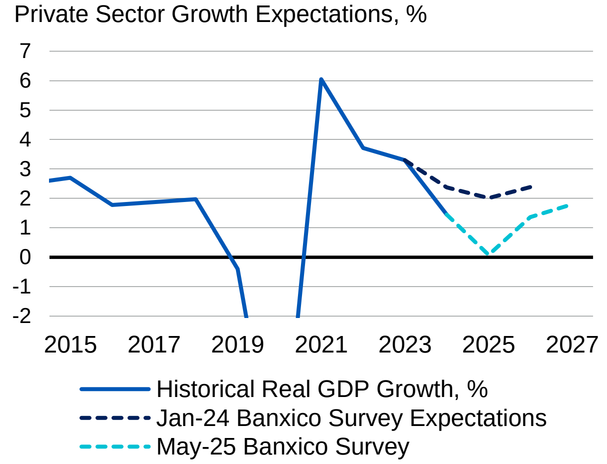
Mexico

Activity: Mexico's economic momentum remains fragile. A technical recession was avoided in Q1 as an agricultural rebound offset continued weakness in industry and services. But USMCA-related uncertainty and a post-election fiscal retrenchment will pose headwinds over the coming quarters. Private sector expectations for near-term growth remain weak (see Figure 11), and we forecast growth of just 0.1% in 2025 and 1.0% in 2026. The potential for a 2026 recovery will be determined by upcoming USMCA negotiations. Despite short-term tensions, we retain our core view that Mexico is well placed to benefit from US nearshoring over a multi-year horizon.

Inflation: Mexican inflation slowed sharply over 2024, but progress towards Banco de Mexico (Banxico)'s 3% target has stalled in recent months. But following a recent uptick to 3.9% year over year as of April, we think core inflation should resume a gradual overall downtrend over H2 amid muted demand-side pressures. However, price fluctuations for agricultural products pose risks of hindering disinflation over the coming quarters. Banxico anticipates a convergence to target by mid-2026, viewing risks to the peso and inflation tied to the US as two-sided.

Policy: Banxico's board has cut policy rate by 250bps since August to 8.5% as of May, and retains a dovish tone. The central bank lowered its growth forecast in May to 0.1% for 2025 and 0.9% for 2026 (down from 0.6% and 1.8%, respectively), citing a slowing US economy and tariffs as exacerbating domestic weakness. We forecast year-end policy rates of 7% for 2025 and 6% for 2026. However, risks are weighted towards more frontloaded easing to revitalise ailing activity, with Banxico having shown a willingness to cut rates despite external volatility.

Figure 11: Domestic and external headwinds continue to stymie Mexico's short-term growth prospects



Source: Aberdeen, Banxico, Haver, June 2025

Alternative global macro scenarios

Trump pivots towards orthodox policies

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

A combination of i) diminished executive control of tariffs and/or ii) pressure from “market vigilantes”, results in a pivot towards a far more conventional and growth-friendly style of governance in the US.

The Supreme Court upholds the decision that the president cannot impose sweeping tariffs using IEEPA, reducing the scope of protectionist trade policies. Greater congressional control of tariffs puts more onus on striking deals that improve market access for US companies and setting out a durable framework that reduces trade uncertainty, even if Trump retains some latitude to declare deals as wins.

While the window is very narrow, recent bond market pressure and a curtailed executive branch help sway lawmakers to pass a less expansive “Big Beautiful Bill”. Even a modest (credible) reduction in deficit projections (see Figure 12) could turn bond markets around, particularly if combined with a pivot to more orthodox, less inflationary, policies.

Immigration policy is also less damaging than feared to labour supply, as a pared back version of the H.R.2 is passed. Net migration is still lower than in recent years, but deportations remain in line with norms from previous administrations (see Figure 13).

Rallying equities, falling yields and improved political polling encourage the Trump administration to lean into a “strong markets, strong economy” narrative, which turbo-charges the deregulatory push (see Figure 14).

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.

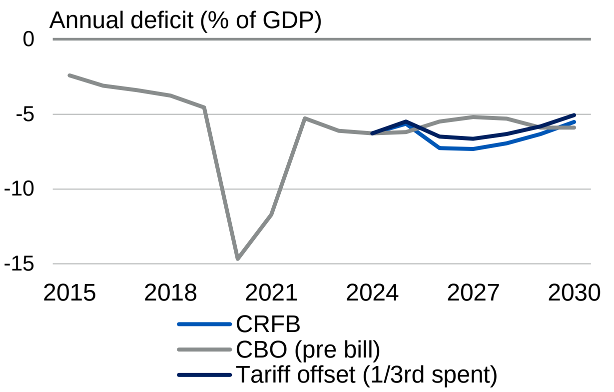
The Fed eases policy more rapidly than in the base case. In the long run, stronger potential growth pushes up modestly on equilibrium rates. Reduced inflation risk and debt issuance compared to the base case helps debt dynamics improve.

Indicative economic shocks:

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

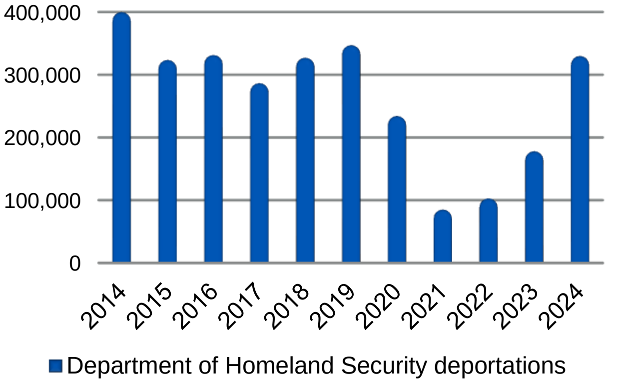
Inflation gets to the Fed’s 2% target as soon as 2026, allowing the central bank to normalise interest rates towards neutral settings.

Figure 12: Returning to something akin to CBO pre-Bill deficit projections could turn around market sentiment



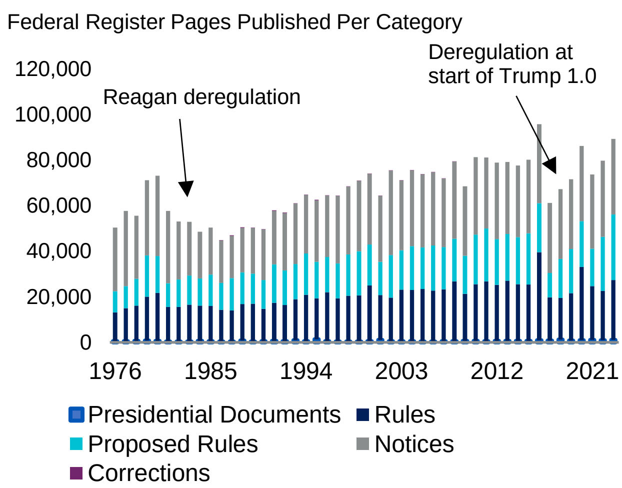
Source: Aberdeen, CBO, CRFB, June 2025

Figure 13: Past administrations have seen deportations of 100-400k, rather than the millions Trump proposes



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

Figure 14: A deregulatory push could plausibly deliver productivity improvements and boost sentiment



Source: Aberdeen, Federal Register, June 2025

US confidence collapse

Trump's trade war re-intensifies, leading to recession in the US and its major trading partners, and less appetite for US assets

Trump wins his court appeal allowing IEEPA legislation to be used for sweeping tariffs. A broadly defined reciprocal tariff is re-imposed that targets both tariff and non-tariff barriers across major trading partners, while USMCA is abandoned, and US-China talks fail. In this downside scenario, the US' effective tariff rate rises above highs from the 1930s (see Figure 15).

Trade partners retaliate, leading to a material increase in global tariff rates. This protectionism sees global trade volumes decline abruptly, leading to a large cyclical slowdown that tips Europe back into recession and which Chinese policymakers struggle to offset.

Financial conditions tighten (see Figure 16) as equity prices rapidly re-price and bonds are whipsawed by concerns over inflation and the medium-term growth outlook.

In the initial phases, inflation surprises to the upside in the US, reflecting a non-linear dynamic taking hold as supply-chains suffer extreme stress (see Figure 17) and firms fully pass costs through. The Fed faces a difficult trade-off and is slow to deliver rate cuts, worsening the downturn.

This lack of immediate monetary easing leads to pointed criticism of the Fed from the Trump administration. The president attempts to fire Powell, triggering a legal standoff and institutional uncertainty. This prompts significant market volatility, even higher inflation expectations and term premia, and a weaker USD.

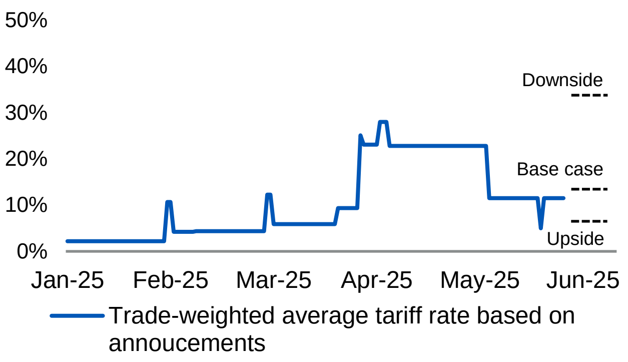
The US-led global recession, very elevated policy uncertainty around trade policy and central banks independence, and widespread speculation about the end of US exceptionalism, trigger a sharp move out of US assets.

Indicative economic shocks:

US-led global recession. Peak-to-trough contraction of US GDP of 1.5% over three quarters.

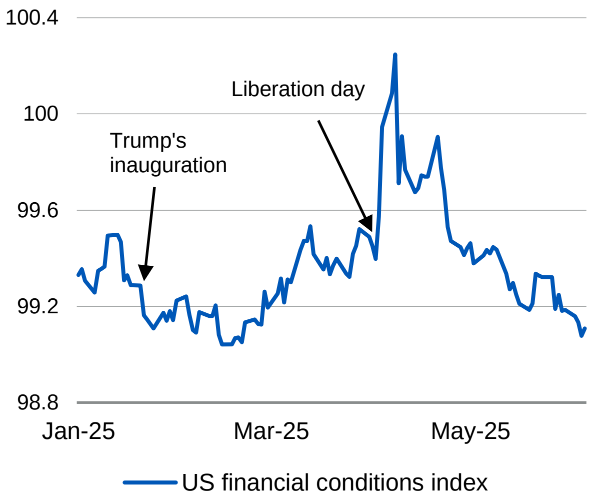
Fed slow off the mark with rate cuts, but the eventual fed funds rate is well below neutral.

Figure 15: A "retaliatory spiral" remains a plausible risk



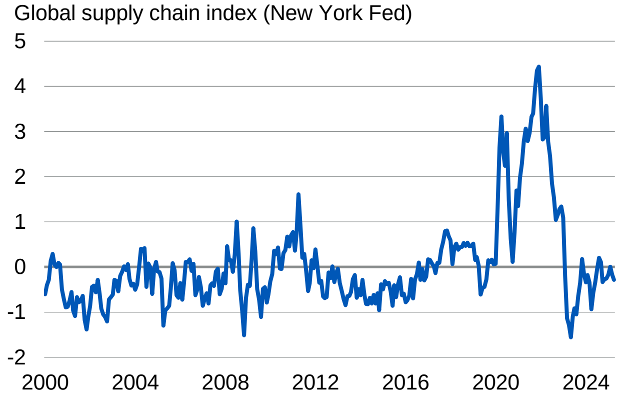
Source: Aberdeen, Haver, June 2025

Figure 16: A re-tightening in US financial conditions could contribute to recessionary forces



Source: Aberdeen, Goldman Sachs Investment Research, June 2025

Figure 17: Renewed supply chain stress could amplify the inflationary impact from tariffs



Source: Aberdeen, Federal Reserve Bank of New York, June 2025

Global bond market rout

DM fiscal largesse, higher inflation expectations, and fading demand for long-dated paper, lead to a sharp rise in global bond yields

The recent rise in long-dated developed market government bond yields turns into a much broader bond market rout, with significantly higher bond yields across the curve (see Figure 18).

US fiscal stimulus ends up even larger than expected, with the Senate undoing various spending cuts in the House budget. Meanwhile, tariff revenue is spent to compensate the losers of tariff policy rather than being used to offset deficit expansion.

This puts upward pressure on US and global bond yields, as investors begin to have genuine concerns about long-term debt sustainability, especially given elevated debt levels among developed market sovereigns (see Figure 19). Moreover, the greater concerns about uncertainty and inflation volatility that result from the policy mix, add further upward pressure on term premia (see Figure 20).

This extra fiscal stimulus, combined with the inflationary consequences of trade policy, leads the Federal Reserve to actively consider a tighter path of policy, and may even see it hike rates.

In Japan, fiscal stimulus in response to the election and drag from US trade policy leads to further concerns about the lack of demand for long-dated Japanese paper. Indeed, Japanese life insurance companies have already become net sellers of government bonds since their duration gap has turned positive.

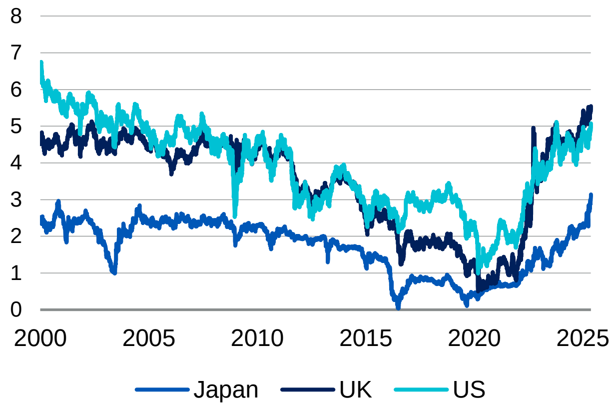
Similarly, in the UK, the government relaxes the fiscal rules given political difficulties in cutting spending further or increasing taxes, which leads the market to price in much higher debt issuance. This is compounded by the funding profile of pension schemes.

Indicative economic shocks:

Higher bond yields push down on equity values and lead to a sharp tightening in financial conditions, which threatens financial stability and weighs on global growth.

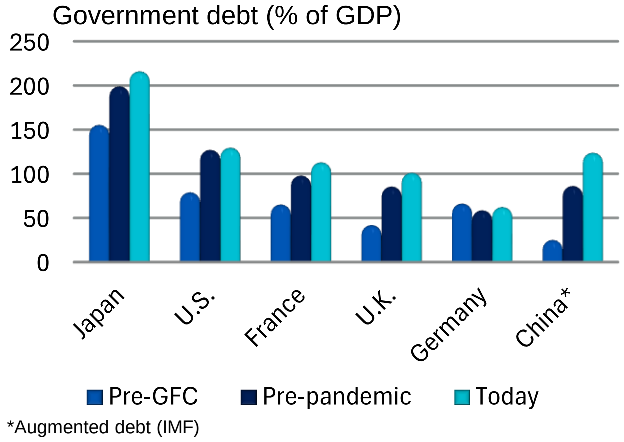
Central banks would eventually deliver liquidity programs to avert stress in bond markets, perhaps with a return to QE in the US and yield curve control in Japan.

Figure 18: Long-dated global government bond yields could rise further given the fiscal outlook



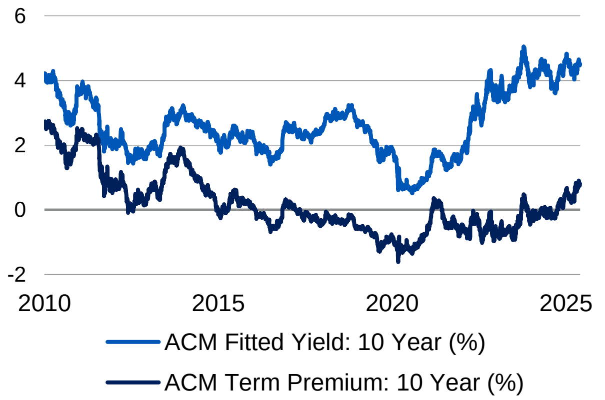
Source: Aberdeen, Haver, June 2025

Figure 19: Government balance sheets have deteriorated, which increases vulnerability to shocks



Source: Aberdeen, Haver, IMF, June 2025

Figure 20: Term premia may increase further due to a number of structural drivers, pushing up on bond yields



Source: Aberdeen, Haver, June 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).

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.

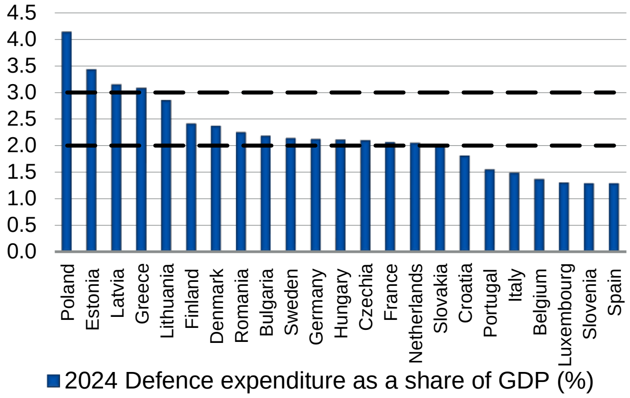
The ECB ends its rate cutting cycle with policy rates at a neutral level. Meanwhile, higher potential growth estimates cause assessments of r* to increase, with policy interest rates expected to settle permanently higher.

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.

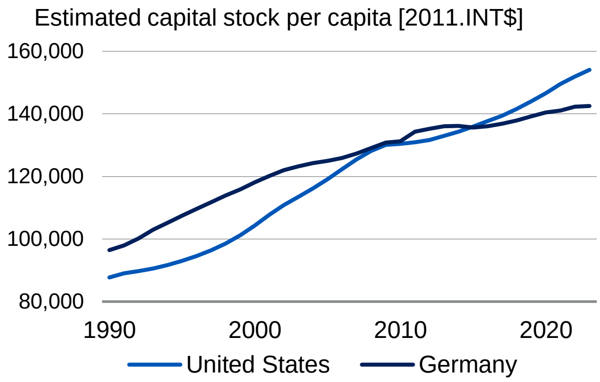
Figure 21: A push towards 3% of GDP on defence spending across the EU would lead to a significant rise in spending



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

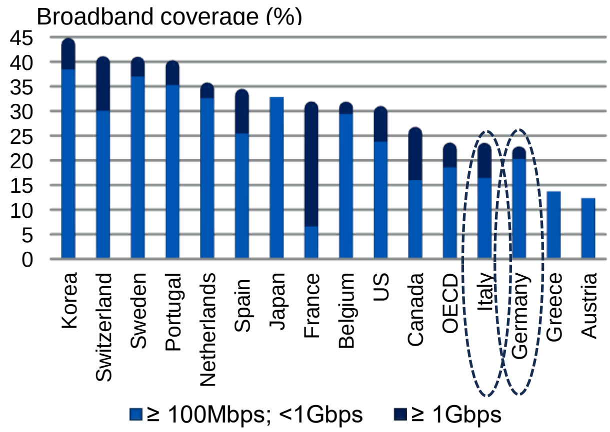
Source: Aberdeen, NATO, June 2025

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



Source: Aberdeen, Haver, June 2025

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



Source: Aberdeen, Haver, June 2025

Conflict risks dominate

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

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 24).

At the same time, this geopolitical shock causes rapid increases in defence spending across vulnerable regions and countries (see Figure 25), putting upward pressure on yields, especially in Europe. However, US defence spending falls as the country 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 26). 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.

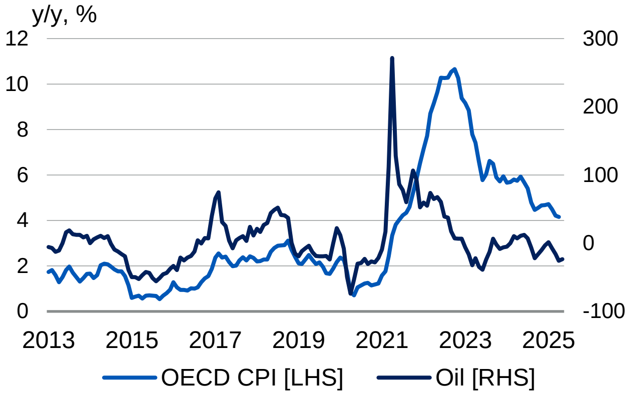
As such, the USD and other safe-haven currencies, such as the yen, strengthen, while emerging markets are put under pressure. In some cases, monetary policy is tightened despite the weaker activity backdrop and increased financial stress, which pushes down further on global growth.

Indicative economic shocks:

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

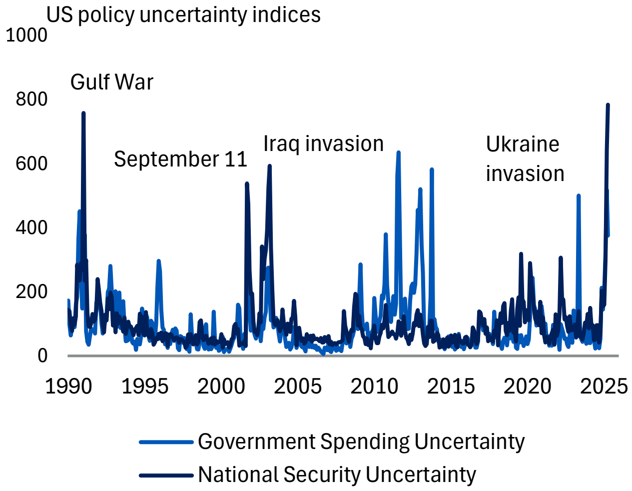
Price level is 1.5% higher.

Figure 24: A sharp rise in oil prices would push up on global headline and core inflation



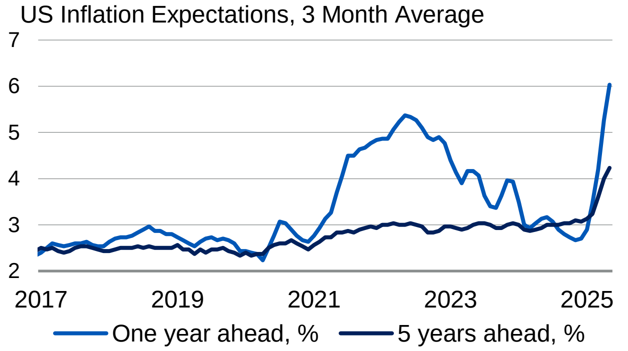
Source: Aberdeen, Haver, June 2025

Figure 25: Conflict and fiscal spending uncertainty are already elevated, and often spike at the same time



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

Figure 26: Already elevated inflation expectations mean central banks would struggle to look through the shock



Source: Aberdeen, Haver, June 2025

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