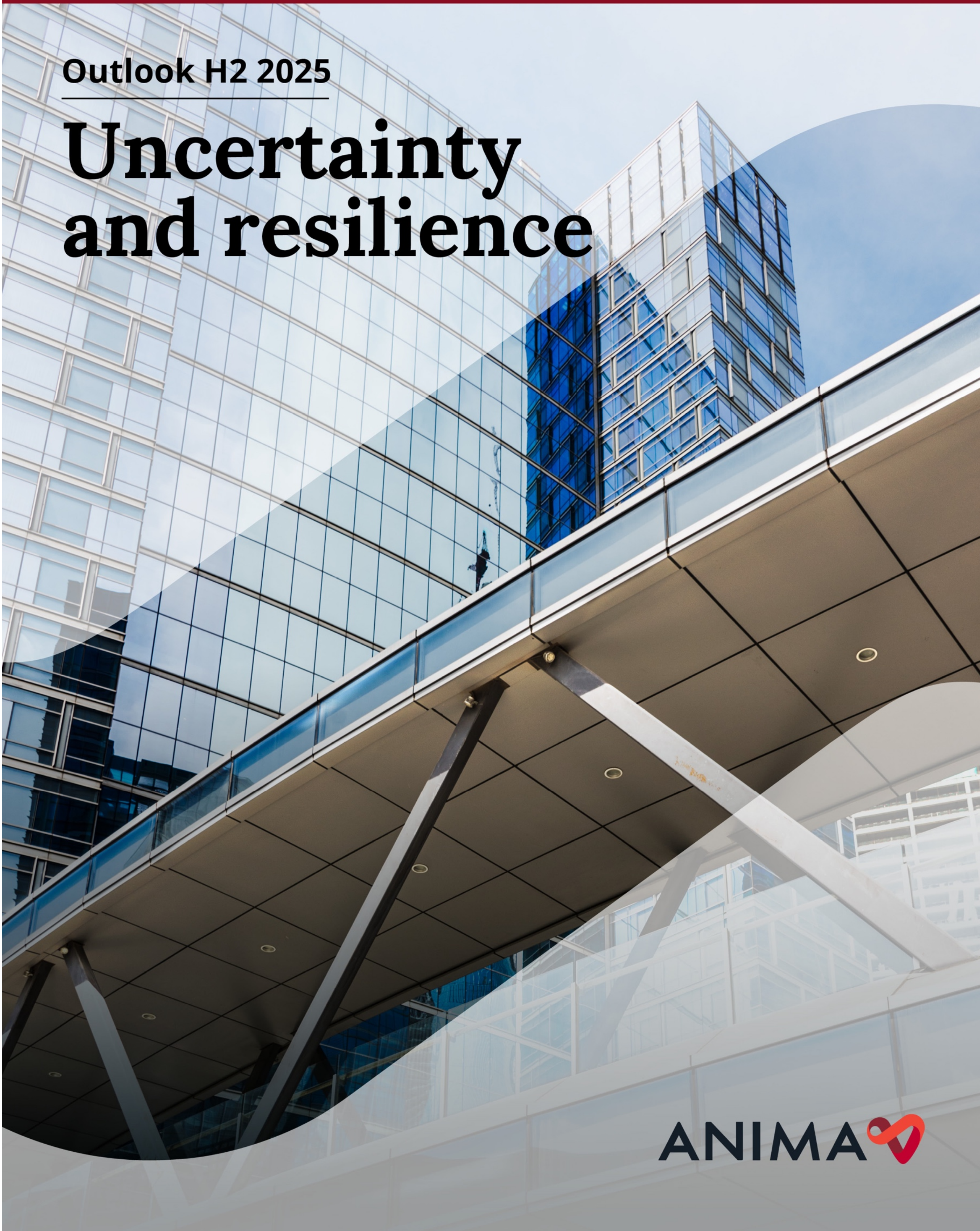
ANIMAResearch

Outlook H2 2025

Uncertainty and resilience



ANIMA

Uncertainty and resilience

Fabio Fois
Head of Investment Research & Advisory
fabio.fois@animasgr.it

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OVERVIEW

The first six months of 2025 were anything but uneventful. Various forces came into conflict, creating a general sense of uncertainty comparable only to that experienced during the Covid pandemic.

Donald Trump began his term with a significant coercive action, particularly in trade policy, which, in hindsight, turned out to be more aggressive on a multilateral level than anticipated. In fact, although the trade restrictions imposed on China were partially rolled back if compared to the initial threats, the idea of applying a universal sanctions framework that would burden trade with all US partners was considered only in our worst-case scenario. Geopolitically, the war between Russia and Ukraine is far from being resolved quickly, contrary to what President Trump had anticipated, and tensions in the Middle East, thought to be easing by some analysts, have once again escalated dramatically following the outbreak of conflict between Iran and Israel and American military intervention.

Yet, despite the initial circumstances, the broader macroeconomic outlook has proven remarkably resilient. Particularly in the United States, where domestic demand remains strong and inflation is under control, thanks to still-robust income levels, a sharp rise in inventories built up by companies to anticipate tariff increases, and a sharper-than-anticipated easing in service inflation earlier in the year, economic momentum has proven more resilient than expected.

We expect the second half of 2025 to follow a largely similar path. On one hand, it is reasonable to assume that the Trump Administration will continue to dominate headlines, keeping market attention high but limiting the appetite for one-sided engagement. On the other hand, despite some volatility, the macroeconomic outlook is likely to show a sustained consumer spending and a gradual convergence of inflation towards the target.

Against this macro backdrop, we maintain our base case scenario, which sees central banks continuing to ease their restrictive measures and pursue a cycle of rate cuts that remains 'disinflationary', with the aim to avoid excessive tightening of financial conditions in real terms, based on expectations of a planned inflation slowdown and a measured deceleration in growth.

In light of these considerations, our central scenario for 2025 remains broadly aligned with the one described in late 2024, including in terms of risk.

Regarding regulatory risks, in particular, attention remains focused on the economic policy of the Trump Administration. Decisions regarding national and sectoral tariffs, immigration, and taxation could negatively impact growth and/or inflation. This might result in a stagflationary equilibrium, which on one hand would prompt American households to significantly cut back on spending amid a likely rise in unemployment, and on the other hand cause the Fed to drastically reduce monetary easing, worsening the weakening of the macroeconomic dynamics. More broadly, extended uncertainty about US economic policy could lead to weaken investors' confidence in dollar-denominated assets, especially if Trump decided to replace Federal Reserve Chair Jerome Powell with someone more aligned with his own political views.

GROWTH

US – Puzzle completion

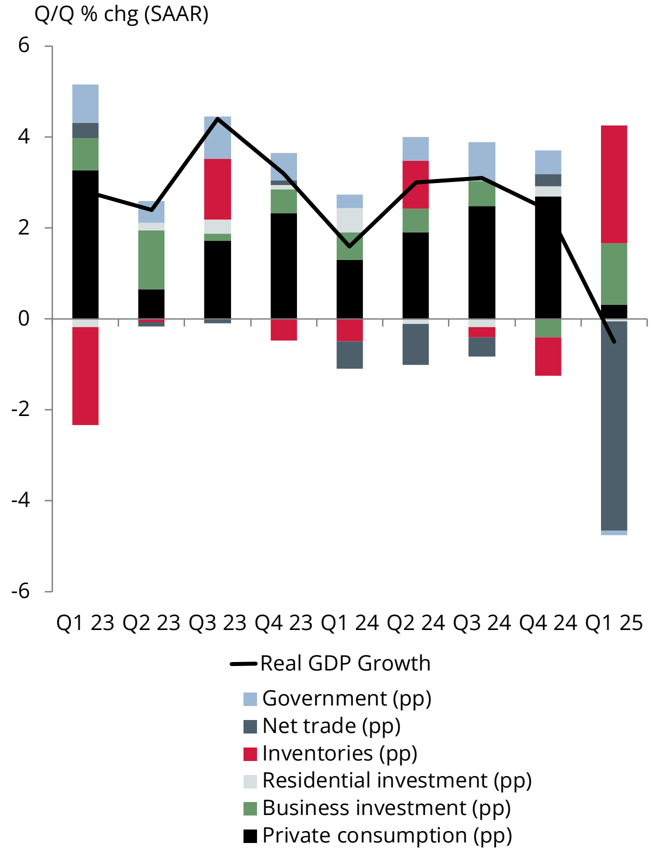
Gauging the economy's true momentum remains challenging because of large front-loading effects. Nevertheless, we maintain the view that the US economy will slow in the coming quarters but will avoid a recession this year.

Growth was extremely volatile at the beginning of 2025, but key incoming data, which play a key role in our forecasting framework, remain solid, particularly those related to aggregate private domestic demand.

Don't judge an economy by its cover. The real GDP print for Q1-25 reported a deceleration to -0.2% q/q SAAR. However, we hesitate to interpret Q1 print at face value as a signal that the US economy is on the brink of collapse. GDP is an expenditure-based estimate of production, which makes it difficult to measure growth accurately in quarters characterised by large swings in components that are inherently challenging to assess, such as inventories and net exports. Indeed, both components experienced particularly large fluctuations in Q1. A surge in imported goods ahead of anticipated tariff implementation more than offset a solid increase in gross domestic purchases (C+I+G), resulting in a decline in output in Q1. Meanwhile, private final domestic demand remained resilient at 1.9% q/q SAAR (**Figures 1 and 2**).

Figure 1

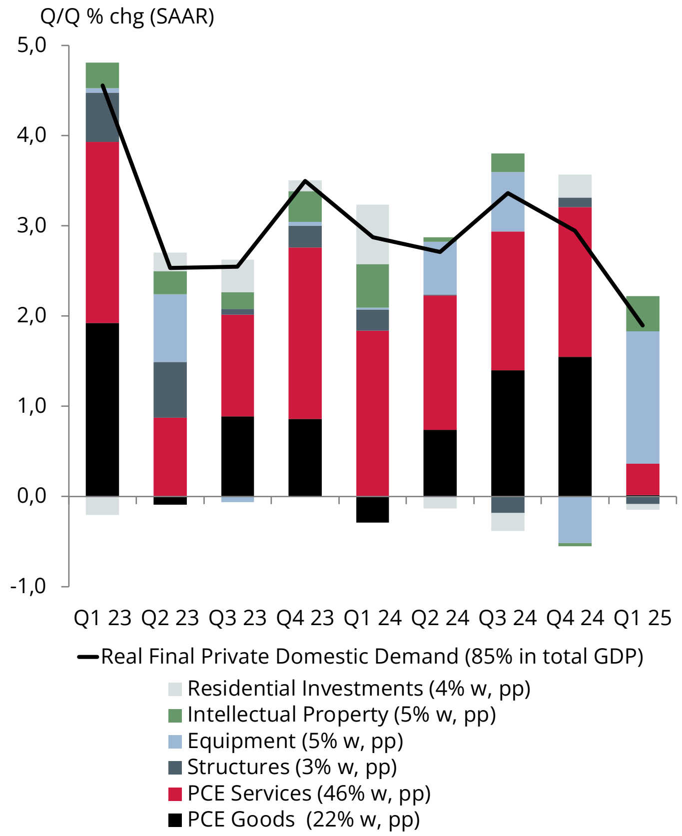
Q1 GDP figure should not be taken at face value



Source: Haver Analytics, Anima Research

Figure 2

Domestic demand remains solid



Source: Haver Analytics, Anima Research

Technical rebound. We expect real GDP growth to post a technical rebound in Q2, primarily driven by a reversal in net trade, as imports were significantly affected by tariff-related front-loading in Q1.

Consumption continues to hold its own. Through April, real consumption expenditure increased by an average of 0.1% on a monthly basis over the last three months, while real services spending (which accounts for 70% of total expenditure within the PCE) grew by an average of 0.2%. Although Q1 spending was revised downwards, it is important to note that the revisions were mainly concentrated in the January and February readings, reflecting that this adjustment mainly mirrors a normalisation after the exceptionally strong 4.0% quarterly SAAR in Q4 2024. In March, consumer spending posted a sustained surge due to the front-loading effects of tariffs, with durable goods spending delivering a vigorous rebound of 3.9% m/m, which was, however, subsequently more than offset between April and May. Spending on services remained resilient between March and April, but in May it showed tentative signs of a slowdown. For the end of the second quarter of the year, we still expect consumers to keep spending as long as they have the means (i.e. while labour income remains resilient). However, we believe that the recent softening on services spending should be observed with caution.

Personal income growth remains supportive. The overall sequential trend in income growth remains robust, both in nominal and real terms. Beyond one-off, for instance, in April, a key driver was a notable surge in transfer payments from the US government, largely reflecting disbursements related to the Social Security Fairness Act - labour compensation, the core driver of income, continues to be healthy. This was confirmed by the May personal income and outlays figure, where labour income remained solid at 0.4% m/m in line with the previous month.

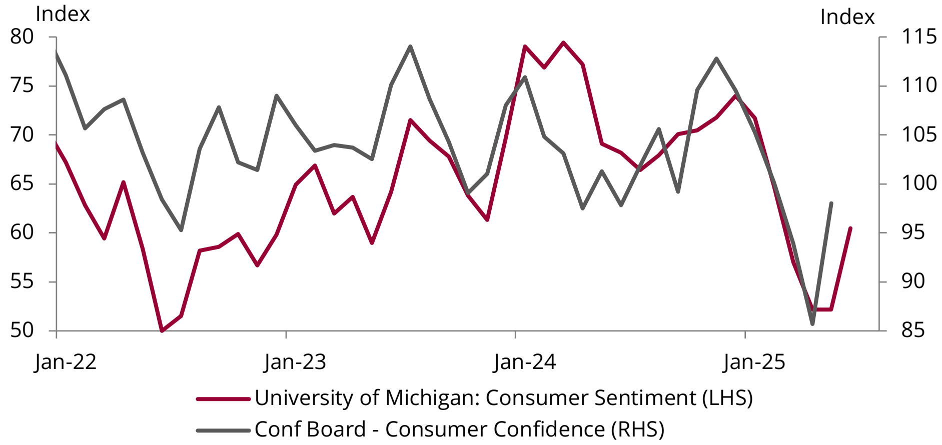
The labour market continues to hold up despite tariff-related headwinds. Until the end of Q2-25, the job market remained stable with little sign that we are on the edge of widespread layoffs. The private service sector continues to account for the bulk of non-farm payroll (NFP) growth, mainly within the healthcare and leisure and hospitality sectors, while labour demand data remains broadly balanced.

Government sector employment appears to be undergoing internal rebalancing. Recently, outflows from federal government payrolls have been offset by inflows into local government payrolls. In our view, this may reflect what we previously referred to as the "washing machine effect", whereby workers laid off at the federal level are reabsorbed at the local level.

Consumer sentiment remains closely tied to trade policy. Following the de-escalation of tariff pressures in late spring, and roughly after five consecutive months of decline, consumer sentiment showed the first signs of moderate recovery (**Figure 3**), coinciding with a temporary ceasefire in the trade dispute. More importantly, consumers remain confident about their income prospects in the coming months. However, despite the improvement, sentiment remains near the lower end of its recent range. Further gains are likely to depend on sustained easing of trade tensions.

Figure 3

Consumer sentiment remains tied to trade policy



Source: Haver Analytics, Anima Research

Domestic trends matter more than international ones. Total overseas travel to the US collapsed in March amid heightened political uncertainty but rebounded above its historical average in April. Given this volatility, forecasting the future trajectory of inbound travel remains challenging. Earlier this year, several airline companies withdrew full-year guidance due to concerns about demand and broader economic uncertainty. In addition, President Trump's sweeping new travel ban, barring entry to citizens of 12 countries, along with recent policy changes from the new US administration, may further disrupt inbound travel and potentially reduce the flow of international university students.

What might be the implications for the US economy? Our analysis shows that foreign travel to the US accounts for just 0.8% of nominal personal consumption expenditure (PCE). When including medical tourism and education, this figure rises to approximately 1% of nominal PCE. As such, a hypothetical 10% decline in overseas visitors would reduce nominal PCE by only 0.08% (8 basis points), and GDP by even less, approximately 0.05% (5 basis points). In fact, roughly 90% of spending in the travel and tourism sector originates from domestic tourists, and recent data suggest that domestic tourism remains robust. While inbound international travellers are economically relevant, their overall impact is relatively modest compared to domestic demand.

Against this backdrop, looking ahead to the second half of 2025, we expect growth momentum to slow, but not to fall into recessionary territory. The primary drivers of the slowdown are the direct effects of tariffs, which act as a tax on consumption and capital. We expect the peak of consumer weakness to occur in late Q3 and Q4, when a temporary spike in inflation will weigh on consumer purchasing power. In terms of spending drivers, we anticipate a more significant slowdown in goods spending than in services, as goods prices absorb the bulk of the tariff-related cost pass-through. Durable goods are most affected in our forecast, partly due to pull-forward spending on autos, which likely brought forward demand, and also due to higher prices. We assume limited pass-through from higher goods prices into services, though not enough to result in declines in real services spending, which continues to form the backbone of total consumer expenditure. On the Capex side, following the front-loading of investments in Q1, we expect that, amid ongoing political uncertainty, business investment will remain constrained between Q3 and Q4.

ANIMA baseline. Our full-year 2025 real GDP growth forecast stands at 1.5%. Our tracking estimate for Q2-25 real GDP stands at 2.1% q/q SAAR, while for Q3-25 our baseline projects GDP growth at 0.8% q/q SAAR and 1.0% for Q4-25.

EA – Caution in the air

The new US tariffs along with increased uncertainty surrounding ongoing negotiations, are expected to weigh on economic growth during 2025. Although the year began with a stronger-than-expected real GDP growth print in the first quarter, it is important to note that distortions stemming from anticipatory behaviour related to US tariffs and country-specific factors (notably Ireland) were significant. Beneath the surface, domestic demand remains weak. Consequently, growth is expected to slow in the second and third quarters of 2025, as the unwinding of the frontloading of exports in Q1 is compounded by new tariffs and heightened trade policy uncertainty.

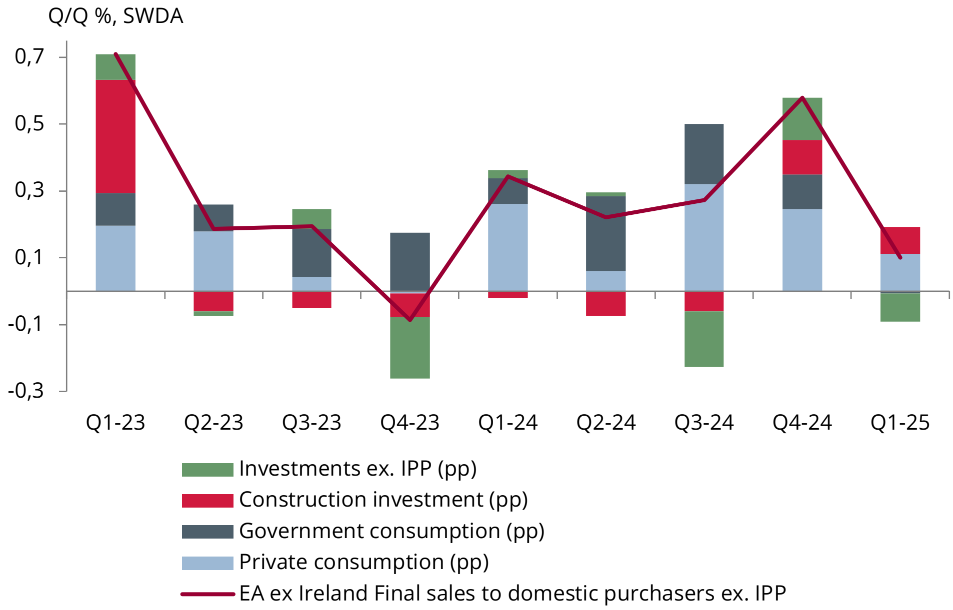
In the medium-term, activity is expected to strengthen, supported by a gradual decline in uncertainty, a recovery in foreign demand as the adverse effects of tariffs fade, and expansionary fiscal policy in Germany.

Looking through the Irish fog. The first quarter of 2025 reported higher-than-expected activity growth. Indeed, area-wide real GDP growth for Q1 2025 came in at 0.6% q/q, according to Eurostat's final release, up from the **0.3%** pace reported in Q4 2024. The strong Q1 print largely reflected a significant upward contribution from Ireland, which in turn was driven by a sharp rise in exports to the US ahead of tariffs.

Excluding Ireland, signs of weakening domestic demand are more evident. Stripping out the notoriously volatile Irish data, euro area real GDP rose by 0.3% q/q in Q1, up from 0.1% in Q4 2024. Granted, the growth composition was weaker than the headline number suggests, given that (a) private consumption growth slowed following a strong end to 2024, (b) frontloading likely contributed to strong export growth (albeit more moderately than in Ireland), and (c) the improvement in investment growth largely reflected a rise in intellectual property investment, while machinery capex and construction investment were softer (Figure 4).

Figure 4

Excluding Ireland, EA's growth outlook appears less favourable

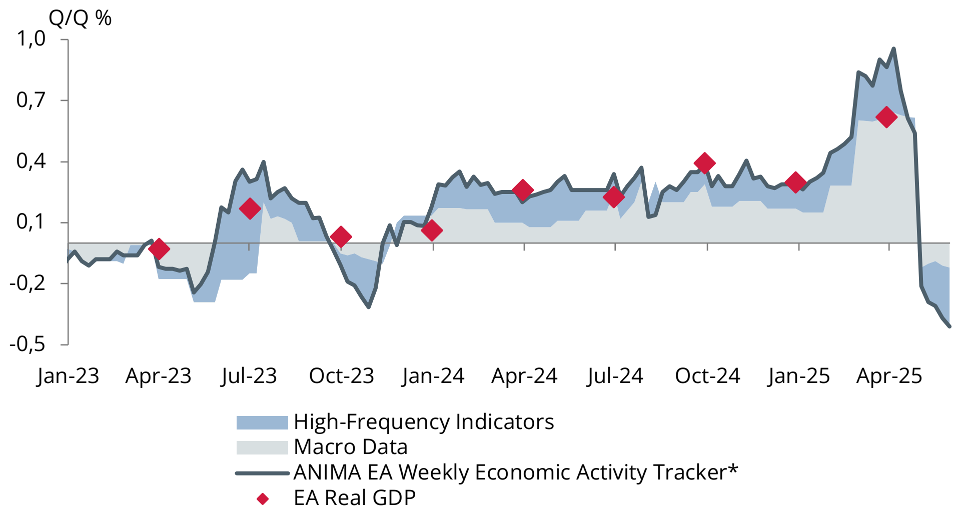


Source: Haver Analytics, Anima Research

A slowdown is expected in the coming quarters. Data released so far continues to indicate a deceleration in economic activity in Q2 (Figure 5).

Figure 5

Entering Q2 with a limp



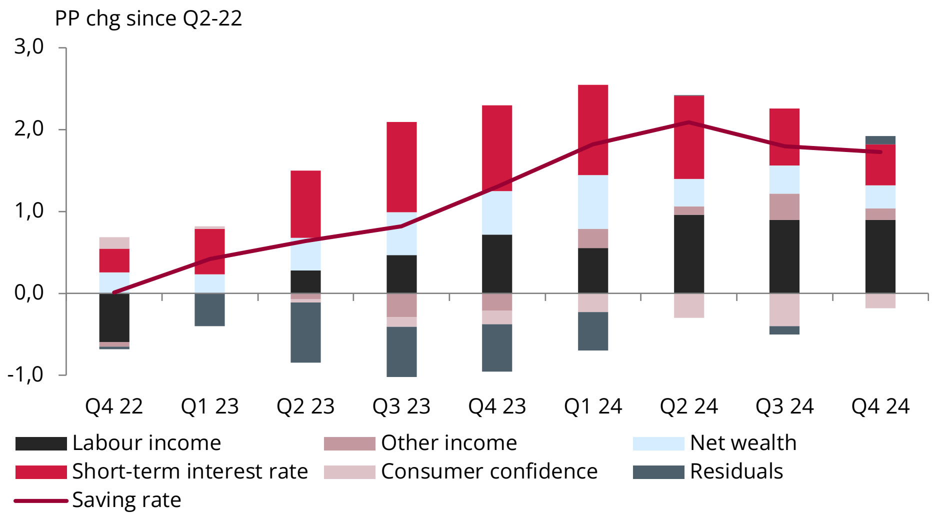
Source: Haver Analytics, DBnomics, Google, Anima Research

Note: Our Activity Tracer is built in a similar way to the Bundesbank German WAI. The high-frequency indicators include weekly data from Google Trends, Electricity Consumption, Truck Toll Mileage, air-cargo volumes and financial variables.

On the demand side, households spending prospects remain poor. Incoming data on consumption activity show a gradually decelerating trend. The support from real disposable income is fading as the drivers of wage and non-wage income continue to weaken. The saving rate, despite having passed its peak, remains stuck well above its pre-COVID norm, reflecting the fact that household lending rates remain somewhat above the historical average and access to credit is still tight (Figure 6). Moreover, ongoing political uncertainties and geopolitical turmoil keep consumer confidence depressed. Against this backdrop, we do not expect significant tailwinds for the consumer outlook during 2025.

Figure 6

The saving rate remains structurally high



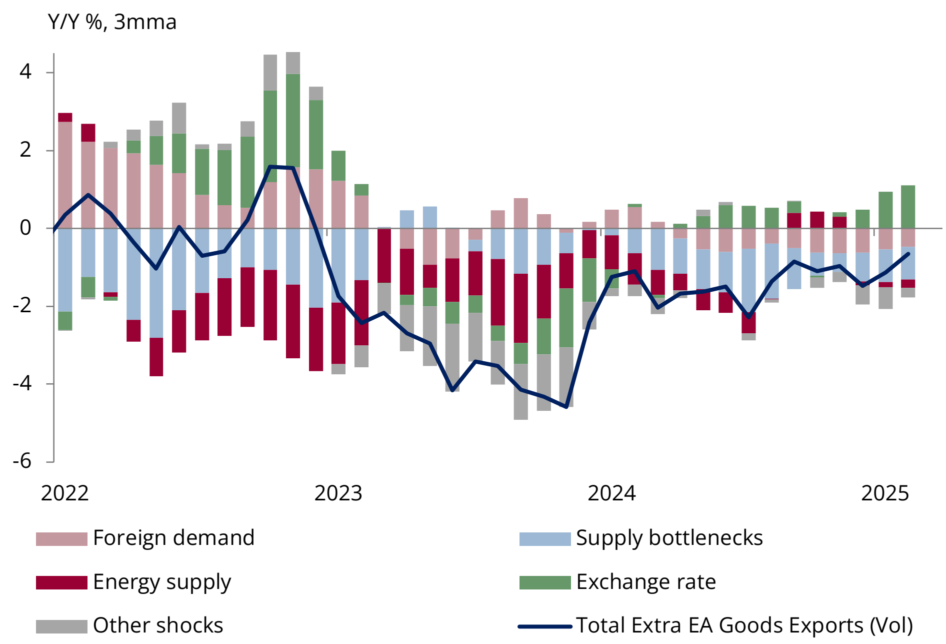
Source: Haver Analytics, Anima Research

Note: error-correction model for private consumption, including real household labour and other income, real net wealth, real interest rate and HHs confidence.

On the supply side, the boost from tariff front-loading is beginning to unwind. The relatively strong industrial production figures for the first three months of the year primarily reflected multinational activity, particularly pharmaceutical exports to the US. With front-loading activity exhausted, industrial output is expected to return to sluggish territory.

A payback in net trade lies ahead. Higher tariffs, elevated uncertainty and competitive pressures, particularly stemming from the appreciation of the euro, are expected to weigh on the euro area's export prospects. Tariffs on euro area exports to the United States, which account for 17% of the euro area's total goods exports, cloud the outlook for exports. In the first quarter, exports increased markedly as firms frontloaded orders in anticipation of US tariffs. However, export growth is expected to moderate, with euro area exports struggling to keep pace with global demand as the frontloading is unwound (Figure 7).

Figure 7
After the Q1 blip, exports are expected to remain subdued



Source: Haver Analytics, ANIMA Research
We use a BSVAR model (normal-Wishart with 4 lags) with sign restrictions on impact: (1) foreign demand, (2) bottlenecks, (3) energy supply, and (4) nominal effective exchange rate shocks. The variables are: euro area synthetic energy price index 3:(+); euro area energy-intensive to non-energy-intensive industrial production 2:(+), 3:(-); world imports 1:(+), 2:(-), 3:(-); EA HICP 1:(+), 2:(+), 3:(+), 4:(-); supply chain pressure 1:(+), 2:(+); euro area exports 1:(+), 2:(-), 3:(-), 4:(-); nominal effective exchange rate 1:(+), 4:(+). Shocks are shown as deviations from the steady state. Methodology is in line with ECB Economic Bulletin, Issue 6/2023, "The euro area current account after the pandemic and energy shock".

Beyond 2025, in the medium-term real GDP growth is expected to strengthen, supported by the gradual decline in uncertainty and a recovery in foreign demand as adverse tariff effects fade. The resilient, albeit cooling, labour market and the assumed gradual recovery in consumer confidence towards its historical norm over the medium term should support private consumption growth. Investment is projected to gradually strengthen, mostly reflecting a gradual dissipation of uncertainty, the deployment of NGEU funds and improving demand conditions. Moreover, recently announced measures related to defence and infrastructure spending should modestly bolster growth in the medium term. However, on this front, several implementation risks loom, including the level of European debt and the unclear political capital of governments and institutions at the forefront of fiscal expansion. Finally, in addition to the weakness in foreign demand, trade policy uncertainty (via weaker global investment and an unfavourable composition of foreign demand with respect to euro area exports), together with the appreciation of the euro which compounds the protracted euro area competitiveness issues, implies continued losses in export market shares over the medium term.

ANIMA baseline. Our annual forecast for 2025 stands at 1.1%. For Q2 2025, we project a deceleration to 0.0% q/q, reflecting a more pronounced payback from "excess Q1 growth" than initially anticipated. Our forecast for Q3 2025 stands at 0.1% q/q) and for Q4 2025 at 0.2% q/q.

China – Trade war de-escalates as domestic momentum disappoints

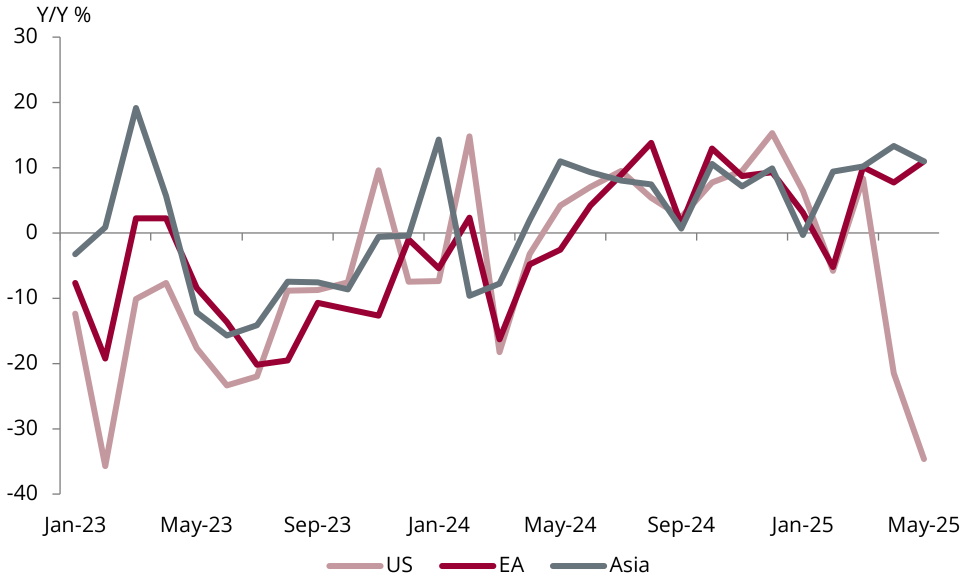
China's Q2 data highlight weak domestic demand and persistent structural imbalances, with soft data signalling contraction. Despite de-escalating US-China trade tensions, exports to the US continued to fall sharply, dragging overall trade performance and China's growth momentum. Domestic challenges, including low consumption and underdeveloped service sectors, continue to fuel deflationary pressures. Investment and savings remain high, while service consumption lags. Without stronger policy support, especially to boost services, economic recovery risks stalling. Although a modest export rebound may emerge in late Q3, we continue to think sustained growth depends on ongoing reforms and a shift towards consumption-led policies.

Hard data for Q2 show that domestic demand remains subdued, suggesting that China's economic momentum weakened in Q2. The country's two main manufacturing PMIs reflected softening trends: both the Caixin manufacturing PMI, which focuses on smaller, export-oriented private firms, and the official NBS manufacturing PMI fell below 50 in Q2, signalling contraction and declining economic momentum across both export-led firms and larger state-owned enterprises. Modest output improvements were limited to industries such as food processing, equipment manufacturing, shipbuilding, rail transport, and aerospace production.

Trade tensions eased, but the outlook is still uncertain. Although bilateral trade tensions notably de-escalated in May, the broader trade conflict between China and the United States has not been fully resolved. The latest round of trade talks, held in London, may mark a critical turning point. However, no final agreement has yet been signed by President Trump and President Xi. Nonetheless, the talks were seen as a positive step for China, as they alleviate some of the previously anticipated negative impact on the country's net exports over the remainder of the year. The newly agreed average tariff rate of 55% remains close to the 48% level used during the earlier 90-day truce. At this stage, we believe further reductions in tariffs are still possible, depending on political developments and compliance with the agreed terms.

Trade performance set to disappoint in 2025 despite unexpected tariff relief. China's broad trade data for Q2 came in weak, despite the easing of a significant portion of tariffs under the May agreement reached in London. Export growth decelerated to 1.7% year-to-date in May, down from 8.3% in 2024. This slowdown was driven primarily by a significant decline in shipments to the United States, which fell by double digits year-to-date in May and by a dramatic 34% y/y (Figure 8). Exports to other regions, however, remained relatively stable. On the import side, performance was also weak, with a -3% year-to-date contraction in May compared to 1.3% increase in 2024. Much of the decline was due to reduced imports from the US, likely reflecting both trade disruptions and weaker domestic demand. Despite the soft trade performance, China's trade surplus continued to expand by 12% year-to-date, although this was much slower than the 32% increase in 2024, largely due to the trade war with the US.

Figure 8
Exports to the US collapsed as a result of the trade war



Source: Haver Analytics, ANIMA Research

Structural imbalances persist, keeping pressure on fiscal policy and authorities' intervention. Despite some areas of industrial strength, China's domestic economy continues to struggle with long-standing structural imbalances. The disparity between production, consumption, and investment remains pronounced, contributing to weak demand and persistent deflationary pressures. The GDP deflator has remained negative since Q2 2023, prompting policymakers to prioritise domestic consumption. In 2023, household consumption accounted for just 39% of GDP, well below the global average of 56%. By contrast, investment (41%) and savings (44%) as shares of GDP remain elevated. This model, characterised by high investment and low consumption, has fuelled growth but deepened structural imbalances. These underlying challenges underscore the importance of continued, and potentially expanded, fiscal support measures. We expect domestic demand to remain fragile in the coming quarters, with the housing sector showing further signs of weakness through Q2. The shortfall is particularly pronounced in service consumption: while goods consumption is now roughly in line with global norms, services remain significantly underrepresented (18% in China vs. 46% in the US), due in part to under-reporting, under-pricing, and under-development, especially in healthcare, education, legal, and financial services. Without more proactive policy support, particularly in services, the risk of a prolonged slowdown increases, especially if external demand also weakens. Indeed, expanding service sector offers dual benefits: it boosts employment and raises income, particularly as many services are labour-intensive. This contrasts with advanced manufacturing, which is capital-heavy and tends to generate fewer high-quality jobs.

Policymaker intervention remains the only silver bullet to support growth through 2026. China's leadership has acknowledged these priorities, as reflected in recent policy meetings. Yet progress has been slow due to institutional inertia. Policy continues to lean heavily toward investment, despite growing recognition of the need to support consumption. A durable transition from investment-led to consumption-led growth will require a fundamental rethinking of the government's role, from directing growth to delivering public services. While gradual liberalisation is underway, more must be done to fully unlock the service sector's potential.

Looking ahead, we expect the drag from exports on overall growth to lessen somewhat in the second half of the year. Although near-term trade data remain soft, we anticipate that early signs of a recovery in exports to the US may begin to emerge by late Q3, provided current conditions remain stable and additional tariff relief materialises.

ANIMA Baseline. Against this backdrop, we expect GDP to slow to 4.9% y/y in Q2 2025, further decelerating to 4.5% in Q3 2025 before bottoming out at 4.7% y/y in Q4 2025. We anticipate annual growth in 2025 to slow slightly less than previously expected, coming in at 4.9%, the same pace as in 2024.

INFLATION

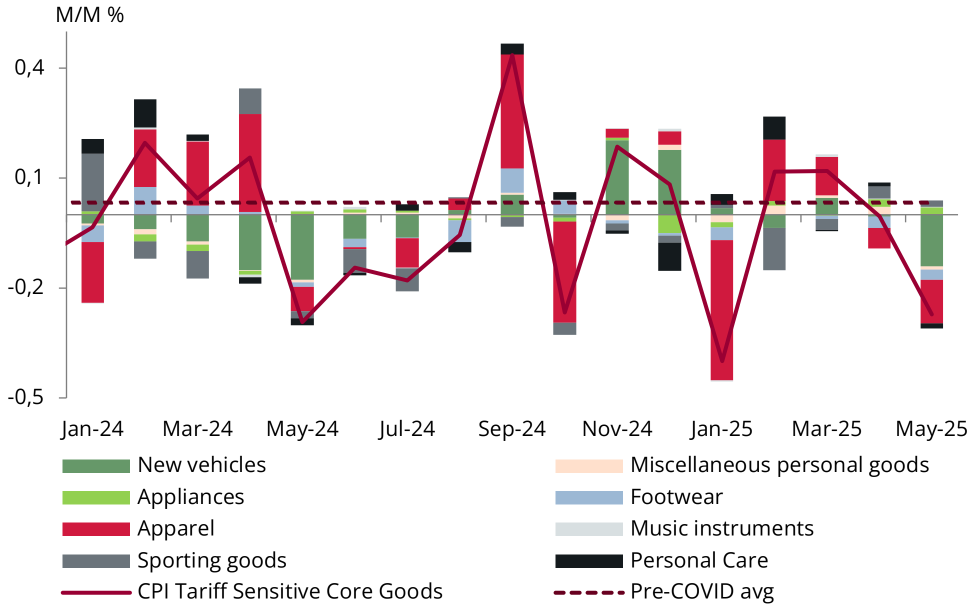
US – Tariff pass-through not yet detected

As of May, no significant evidence of tariff pass-through to consumer prices has been reported. This aligns with our initial assumptions that the disinflation trend would persist through the summer, supported by Q1 restocking. We continue to expect tariff-driven inflation momentum to build in June and peak over the summer, as businesses deplete inventories accumulated prior to the tariffs taking effect. That said, we maintain our view that the projected increase in goods inflation will be temporary. From Q4 onwards, we expect core services' disinflation to resume its dominance in the inflation outlook, allowing overall inflation to return to target by Q2 next year.

Awaiting tariff pressures on prices. The May inflation data still show no significant evidence of tariff pass-through to consumer prices (Figure 9). Accordingly, the early-stage tariffs introduced in January, February, and March have yet to produce measurable effects at the CPI level. This remains consistent with our initial assumption that the disinflation trend would persist through the summer.

Figure 9

No tough tariffs came into effect before May



Source: Haver Analytics, Anima Research

Note: We categorize the most tariff-sensitive items using an Input-Output table methodology, converting NAICS industry/commodity codes with BEA's PCE Bridge data.

Tariff pass-through to retail prices expected to peak over the summer. The current trade-weighted effective tariff rate for the US stands at 14–15%, a significant increase from the 2.5% level in place until last year. As a result, we expect tariff-driven inflation momentum to accelerate in June and peak over the summer.

There are several reasons why we expect a somewhat delayed pass-through to prices, relative to when the tariffs took effect. First, there was substantial front-running of consumer goods imports through March, as reflected in the Q1 GDP data. Some of these imports contributed to inventory build-up, while the rest likely flowed directly into consumer spending or equipment investment. To the extent that firms have sufficient inventory buffers, price pass-through may be delayed. Second, consumer spending was also heavily front-loaded in Q1, particularly for durable goods. As such, demand for these goods is expected to moderate in the coming months, which should help ease demand-pull pressures on prices. Finally, anecdotal evidence suggests that some firms are in "wait-and-watch" mode until early July, when the pause on differentiated reciprocal tariffs is set to expire. These firms are therefore hesitant to adjust menu prices. Similarly, according to the Federal Reserve's latest Beige Book (covering April 15 to May 23), *"Notably, those businesses that expect to pass along tariff increases expect to do so within the next three months, so if there is going to be an impact it should happen soon"*.

The view on core services remains benign. Beyond core goods inflation, we continue to anticipate disinflation in rent/owners' equivalent rent (OER) inflation, creeping toward its pre-pandemic trend of about 0.25% m/m in 2025, and maintained at that pace in 2026. This is consistent with private data on observed rents, which have been trending lower amid an increase in the supply of multifamily units. Supercore inflation (core services ex shelter) has reported a notable easing between Q1 and Q2 of this year (averaging a marked deceleration of about 0.6pp from early 2024 to mid-Q2 2025). We believe that the full normalisation of supercore inflation towards its pre-COVID norm will continue throughout the year, supported by a gradual slowdown in wage growth (**Figure 10**).

Figure 10

Wage growth pressures are expected to continue easing

Source: Haver Analytics, ANIMA Research

Note: The Re-hire Rate Proxy is calculated as (Total Initial Claims over the last 6 months minus Current Continuing Claims) divided by Total Initial Claims over the last 6 months.

ANIMA baseline. We project core CPI at 2.8% for Q2-25. For Q3-25 we expect core CPI to peak at 3.1%, before easing slightly to 3.0% in Q4-25. Our annual average core CPI forecast for 2025 stands at 3.0%.

EA – Core disinflation is advancing

Headline inflation has decelerated substantially so far and fell below target in May. Looking ahead, we expect some volatility as escalating tensions in the Middle East have generated a rise in energy market prices, which should then pass through into the HICP index. On the other hand, core inflation is firmly back on its decelerating trend. Core goods have now normalised to pre-COVID levels, while services inflation - excluding the Easter spike – is on the path of broad, underlying easing. Multiple indicators continue to suggest that the disinflation trend is consolidating. Accordingly, we maintain our baseline forecast that core inflation will continue to decline toward the target by December 2025.

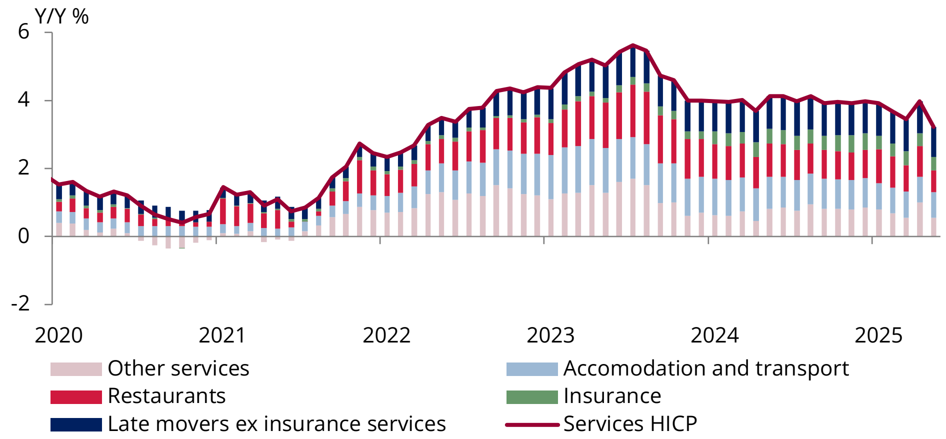
Headline inflation decelerated markedly, but some volatility is still expected. In May, headline HICP inflation decelerated below the target level to 1.9% in annual terms. The deceleration process was mainly driven by deep deflation in the energy component. Over the summer, we expect some volatility as escalating tensions in the Middle East have generated a rise in energy market prices, which should then pass through into the HICP index. On the other hand, we believe that food inflation will remain relatively stable over the coming months, consistent with the European Commission's survey on food and beverage selling price expectations, which correlates well with HICP data and continues to indicate still strong momentum in this segment.

Ongoing core disinflation. Between the last quarter of 2024 and the middle of the second quarter of 2025, core inflation consolidated its disinflationary trend. The deceleration has been widespread. On the one hand, core goods inflation has now fully normalised to its pre-COVID pace, and we expect this trend to continue through the rest of the year. The only factor that could materially disrupt this outlook would be a significant retaliatory tariff response from the EU following the 50% tariffs announced by President Trump, an outcome we currently consider unlikely. On the other hand, services inflation, despite a volatile start to the year, in May 2025 reached its lowest level since March 2022. A large part of this decline was driven by the volatile package holidays and accommodation services and transport services subcomponents, reflecting the reversal of price increases for holiday-related services after Easter. However, excluding volatile categories, the decline in services inflation appears to extend beyond the holiday-related components distorted by Easter timing (Figure 11). Early data suggest a broader softness across services, pointing to a more organic disinflation trend. After averaging 3.9% in 2024, services inflation has declined by 0.7 percentage points between December 2024 and May 2025.

This softness should help to resolve some of the uncertainty surrounding the underlying strength of services inflation this year (initially caused by annual price resets and later by distortions due to the timing of Easter) and confirms that services inflation is indeed moderating.

Figure 11

Services inflation retreats



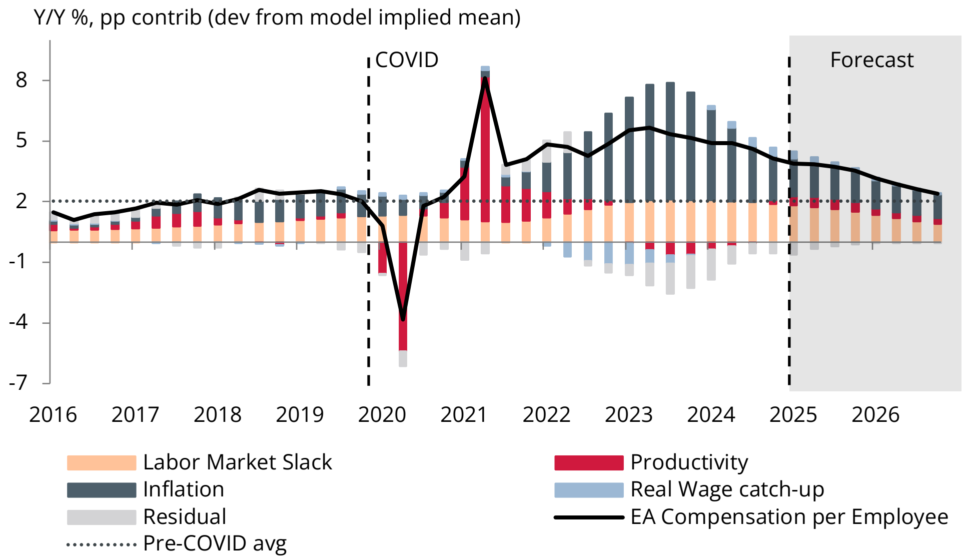
Source: Haver Analytics, ANIMA Research

Note: According to F. Panetta (2024) in his speech "Monetary policy after a perfect storm: festina lente" on 26th June 2024 in Helsinki, the late-movers basket includes a-cyclical and backward-looking items, including rents, insurance, and services provided directly by the public sector (health, education, and post).

Pre-conditions for increased loosening of core pressures are well set. Real wages have settled slightly above levels consistent with labour productivity and, together with slowing consumer price inflation, this will turn into a drag on nominal wage growth. We therefore think that the medium-term outlook for wage growth normalisation remains encouraging (Figure 12). We expect wage growth to slow to 3.4% by the end of 2025 and to 2.4% by the end of 2026. Moreover, domestic inflationary pressures are proceeding to ease: profit margins continue to shrink, along with input prices. Finally, the recent appreciation of the euro could provide some additional support. Several academic studies support the rule of thumb that a 1% appreciation of the euro typically reduces headline HICP by about 0.1% over 6 to 8 quarters (Figure 13).

Figure 12

Normalising wage growth

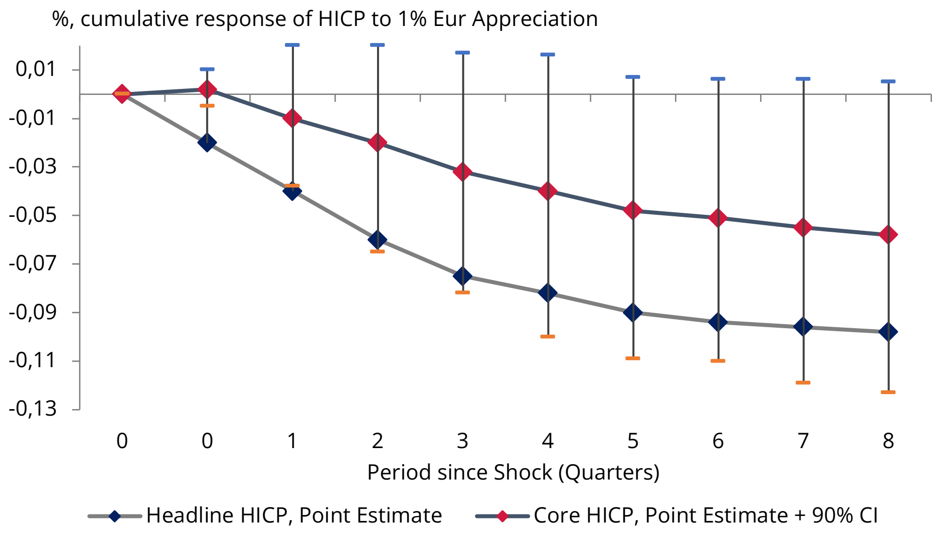


Source: Haver Analytics, ANIMA Research

Note: Model based on an augmented Phillips curve. The real wage catch-up (gap to trend) measures the wage level justified by labour productivity.

Figure 13

Recent EUR appreciation further consolidates the disinflationary trend



Source: Haver Analytics, ANIMA Research
Note: Estimates based on: "Exchange rate pass-through in the euro area and EU countries (ECB, No 241 / April 2020)".

ANIMA baseline. We expect core HICP to end 2025 at 2.2%, with an annual average of 2.4%. Quarterly, we forecast core HICP to be 2.4% in Q2 2025, 2.2% in Q3 2025, and 2.2% in Q4 2025.

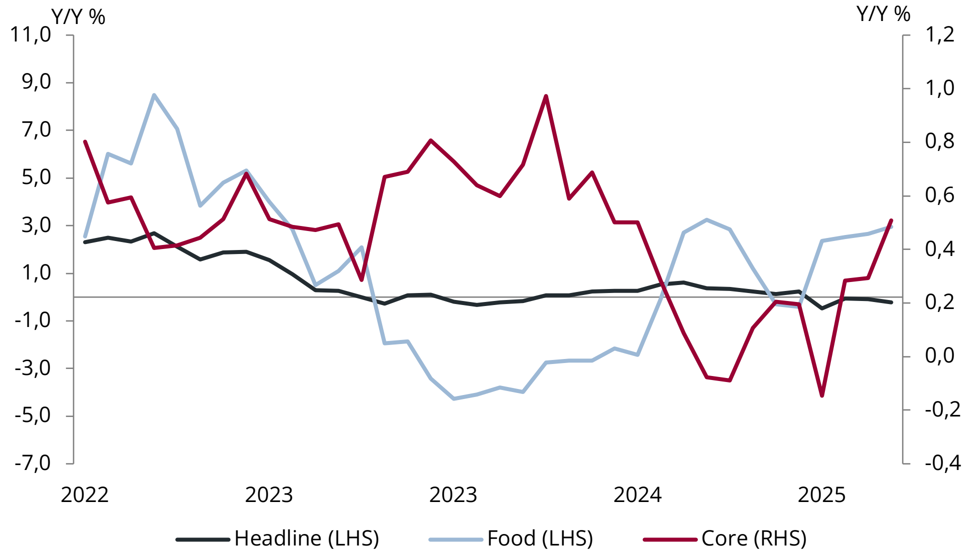
China – Endless deflation

Deflationary pressures in China remain persistent, with Q2 headline inflation at -0.1% y/y and core inflation slightly higher at 0.5%, aided by temporary subsidies. Producer prices have fallen further, reflecting weak business sentiment and trade uncertainty. Domestic demand remains subdued, and external headwinds, such as high US tariffs, continue to weigh on inflation. The housing sector remains the biggest deflationary drag, with falling prices, weak sales, and high inventories. Despite past policy easing, momentum has faded, and destocking has been slow. With limited support from export diversion and manufacturing overcapacity still unresolved, deflationary trends are set to persist through the rest of 2025.

We maintain our baseline view as deflationary pressures persist. We continue to hold our baseline outlook, as deflationary forces remain entrenched in the Chinese economy. For the first five months of 2025, headline inflation averaged -0.1% year-on-year, slightly below the 0.1% recorded during the same period in 2024. Meanwhile, core consumer price inflation averaged just 0.2% year-on-year, down notably from the 0.7% average in the previous year. In May, headline inflation stayed in negative territory at -0.2% year-on-year, indicating persistent weakness in overall price levels. Core inflation, however, edged up to 0.5% year-on-year from 0.3% previously, largely due to a temporary lift from government-backed trade-in subsidies (Figure 14). At the same time, producer price index deflation deepened, with PPI falling by 3.3% year-on-year compared to 2.7% the previous month. This reflects deteriorating business confidence, persistent uncertainty regarding China–US relations, and lower global energy prices.

Figure 14

Domestic deflationary pressures kept headline inflation at zero



Source: Haver Analytics, Anima Research

Housing sector remains the largest source of deflation as the inventory overhang is still large. In Q2, data showed new home prices in 70 cities continued to fall, as did secondary home prices. In annual terms, price declines narrowed slightly, with new homes down 4.1% and secondary homes down 6.3%. Early June data from NBS suggests further secondary price declines are likely. The recent market weakness is expected to persist, as the effects of 2023's policy easing have not completely faded yet and the push from newer supporting measures remains limited. Base effects also are set to turn less favourable in H2. Since 2021, new home starts are down 71.3%, and sales have dropped 53.5%. Inventories remain elevated: homes under construction equal six years of sales; unsold completed units cover six months; and undeveloped land adds another six years' worth. Destocking is essential to end the correction, but progress is slow due to weak incentives and supply/demand imbalances. Near-term efforts will likely focus on idle land purchases, funded by special LGBs, primarily aiding local SOEs. Going ahead, we continue to expect the housing sector to continue to suppress inflationary momentum throughout 2026.

Against this backdrop, we expect broad domestic deflationary pressures to remain in place over the rest of the year. While some price support may come from China's efforts to redirect exports away from the U.S. to alternative markets, this is unlikely to meaningfully reduce the country's growing excess capacity in manufacturing. As a result, we foresee sustained downward pressure on both consumer and producer prices for the remainder of 2025.

ANIMA Baseline. Therefore, we stick to our baseline forecast, expecting full-year inflation for 2025 to flatten at 0.3% up from 0.2% y/y in 2024. On a sequential basis, we project headline inflation to evolve as follows: -0.1% y/y in Q2 2025, 0.2% in Q3 2025, and 1.2% in Q4 2025.

MONETARY POLICY

Fed – Caught between Scylla and Charybdis

At the June meeting, the Fed kept rates unchanged for the fourth consecutive meeting. On the one hand, Chair Powell gave the impression that progress on disinflation might be sufficient to justify resuming the disinflationary rate-cut-cycle; on the other, strong expectations within the Committee that tariff-inflation is coming seem to be keeping the FOMC up at night. We stick to the view that the Fed will cut twice this year, starting in Q3.

At the June meeting, the Fed kept the Fed funds rates on hold at 4.25-4.50% for the fourth consecutive meeting. While, on the one hand, the Fed reinforced its easing bias amid mounting evidence that inflation is moving in the right direction, a strong view that inflation will pick up in the coming months due to tariffs and healthy economic conditions kept the Fed in a wait-and-see mode for yet another meeting.

The FOMC remains optimistic about the economy, indicating that, considering swings in net exports, underlying growth momentum remains solid as indicated by final domestic demand in Q1. Moreover, Chair Powell stressed that labour market conditions remain healthy, with demand and supply of jobs well balanced, and that sentiment indicators, while still at depressed levels, are picking up.

Moreover, the Fed believes that while uncertainty is still elevated, it has diminished since 2nd April and that stagflation risks have declined significantly recently.

Chair Powell also sounded really pleased with progress on inflation achieved thus far. He noted that the last three months' readings were favourable and stressed that aggregate services inflation is basically back at target. Absent tariffs, this level of confidence in the disinflation progress probably would have pushed the Fed to resume its disinflationary rate-cut cycle at this meeting, in our view. But what is keeping the FOMC up at night are strong expectations that inflation will rise due to tariffs. Apparently, the only uncertainty the Fed faces in this respect is the extent to which the shock will be temporary (which is their baseline at this stage), but the FOMC believes that it will learn a lot more about tariffs and their impact on inflation over the coming months and that summer will be very important in that regard.

Consistent with the Fed's rhetoric, the updated June Summary of Economic Projection (SEP) highlighted a still-solid economy and a sanguine view on inflation. The revised projections point to slower growth in 2025 and 2026 compared to March, with GDP now expected to rise by 1.4% in 2025 (down by 0.3 percentage points from 1.7%) and 1.6% in 2026 (down from 1.8%), while the 2027 forecast remains unchanged at 1.8%. Policymakers continue to foresee a resilient labour market, with only marginal upward revisions to the unemployment rate, which is now expected to be 4.5% in both 2025 (+0.1pp) and 2026 (+0.2pp), and 4.4% in 2027 (+0.1pp). Meanwhile, core inflation forecasts were slightly upgraded to 3.1% (Q4/Q4) in 2025 (+0.3pp), 2.4% in 2026 (+0.2pp), and 2.1% in 2027 (+0.1pp).

The June dot plot continues to indicate two rate cuts this year, while from 2026 onwards the cutting cycle slows down, with only one rate cut in 2026 and an additional one in 2027, keeping the Fed fund rates still above neutral in 2027 (3%, unchanged compared to March). Interestingly, the dots also reveal that the Committee is almost split into two camps calling either for zero or two cuts this year. However, Chair Powell highlighted that there is no great deal of conviction behind the forecasts, given the high level of uncertainty.

Against this backdrop, we continue to expect the Fed to cut rates twice this year, starting in Q3.

ECB – (Not so) near the end of the monetary policy cycle

At the June meeting, the ECB cut rates by 25 bp, lowering the deposit rate to 2%. President Lagarde emphasized that rates are now at a good level, implying that the current monetary policy cycle may be nearing its end. We believe the ECB is overly optimistic, as incoming data point to downside risks for both growth and inflation, while the quality of Q1 growth is questionable. Accordingly, we maintain our forecast of two additional rate cuts this year, with balanced risks, given the growing divisions within the Governing Council.

At the June meeting, the ECB cut rates by 25 bp, taking the deposit rate to 2%. At the same time, President Lagarde made a U-turn in rhetoric compared to April and surprised the market by saying that the ECB may be reaching the end of its easing cycle.

Several arguments support this view:

- **Growth has been holding up well lately, led by private consumption and investments**. Looking ahead, the ECB also sounded confident about growth prospects for the region, as rising real wages and expansionary fiscal policy related to an upcoming boost in investment and defense spending should support economic activity momentum.
- **The downward revision to the ECB's March projections for headline inflation largely stems from oil prices and currency assumptions**. Meanwhile, core inflation forecasts were largely unchanged in June compared to March.
- The ECB seems to have incorporated into its baseline that the current tariff truce between the US and the EU will be extended beyond 9th.

We are more cautious than the ECB:

Although the EA economy managed to muddle through lately, growing below potential yet avoiding recession, we are less sanguine about both the reasons and the prospects for that. Incoming data, including Q1 GDP, retail sales and PMIs, suggest that private consumption and investment momentum remain mixed across the region while the ultra-weak contribution of Q1 net trade reflecting corporate spending front-loading ahead of tariffs has been largely offset by a surge of inventories. While the net trade contribution will likely rebound (increase) in Q2, that of inventories is likely to do the opposite. Indeed, the ECB itself does not expect a solid growth path in the coming quarters.

Over the medium term, instead, we remain in a wait-see-mode regarding fiscal policy. It's unclear whether it will become outright expansionary, led by defence and investment spending. Several implementation risks loom, including the level of European debt and the unclear political capital of governments and institutions at the forefront of fiscal expansion, including Germany and the EU.

Two points on inflation. First, against our macro backdrop, projections by the ECB that headline inflation will fall decisively below target and that core inflation will remain close to target at best actually increase the risks that the ECB could undershoot its mandate. Second, the sharp correction of services inflation that has unfolded since December last year (from 4.0% to 3.2%) points to organic easing pressures within the non-tradable sector, rather than a mere unwinding of Easter-related seasonality.

Although we believe that the US and the EU want to reach a deal on tariffs, the risk is that it may take longer than in other jurisdictions, given the idiosyncratic fragmentation of European political capital. Against this backdrop, there is a risk that tariff tensions with the US may be sustained during the summer period.

We remain of the view that the EU will do whatever it can to avoid severe retaliation. Moreover, we remain of the view that tariffs cast different risks for the US and the EA economy. For the Fed, tariffs are a shock that hits inflation and growth – i.e. both pillars of the mandate. For the ECB, instead, tariffs represent a negative (first order) shock mainly through the growth channel. Unless one assumes that the EA retaliates very aggressively against the US, the impact on EA growth (negative) stemming from tariffs would be much larger than that on EA inflation (positive).

The neutral rate is no longer regarded as an anchor for the monetary policy stance, to the extent that the Governing Council did not even discuss it at this meeting. In our view, this means that monetary policy will continue to be data-dependent, possibly even more than in the past.

Against this backdrop, **we expect the ECB to cut rates twice this year, in September and December, taking the deposit rate to 1.50%. We see risks to this call as balanced**, given growing divisions within the Governing Council.

PBoC – Tariff war de-escalation won't alter PBoC's easing bias

In Q2, the PBoC eased policy by cutting the reserve requirement ratio and key interest rate to boost liquidity and support a still weak recovery. Despite a significant easing in the US–China trade tensions, domestic demand remains soft, and further rate cuts are expected later this year. The PBoC is also likely to expand targeted support through structural tools like re-lending facilities to aid priority sectors such as tech, consumption, and small businesses. With modest loan demand and weak home sales, broad stimulus remains necessary. The yuan is expected to stay weak as accommodative policy continues to support exports and growth.

PBoC eased policy in Q2. In early May, the People's Bank of China implemented a notable round of monetary easing, cutting the reserve requirement ratio (RRR) by 50 basis points and lowering the key policy interest rate by 10 basis points. These moves were aimed at bolstering domestic liquidity and supporting the broader economy. Since then, tensions in trade relations between China and the United States have moderated somewhat.

We expect further easing ahead. Looking forward, we anticipate an additional 40 basis points policy rate cut before the end of the year. However, we do not foresee any further reductions in the RRR over the summer. The timing and magnitude of future easing measures will be closely tied to the evolving economic effects of US tariffs. The de-escalation between the US and China should provide the central bank with greater flexibility to assess developments before deciding on the next course of action. In addition to monetary measures, we expect fiscal policy to continue to play a larger role in the second half of the year, as the full impact of external headwinds becomes more apparent.

We expect the PBoC to continue to support targeted sectors, with a focus on the housing sector. Q2's bank loan data indicates only modest overall loan demand, broadly flat compared to Q1 figures. Household loan growth remains weak, mainly due to continued softness in home sales. Meanwhile, medium- to long-term corporate loans are growing at a moderate pace, reflecting subdued business investment. Given this backdrop, we expect the PBOC to increase the use of targeted, or "structural," monetary policy tools to support specific sectors of the economy, such as re-lending facilities aimed at promoting technological innovation, equipment upgrades, trade-in programs for consumer goods, broader consumption, elderly care, and support for small businesses and agriculture. In recent years, loans backed by these re-lending facilities have grown faster than total credit, highlighting their increasing importance in supporting targeted sectors.

Yuan weakness is likely to persist. We maintain our view that the Chinese yuan will remain under downward pressure through the remainder of the year. The PBoC's accommodative policy approach, including further interest rate reductions, will likely continue to weigh on the currency. Although the drag from tariffs may be less severe than previously feared, the central bank will have limited alternatives other than continuing to ease policy and tolerating a weaker yuan in order to support the export sector and offset sluggish domestic demand.

Anima Investment Research & Advisory

Fabio Fois
Head of Investment
Research & Advisory
fabio.fois@animasgr.it

Miriam Berizzi
Head of Investment Advisory
miriam.berizzi@animasgr.it

Valerio Ceoloni
EM and FX Strategist
valerio.ceoloni@animasgr.it

Chiara Cremonesi
Senior Rates Strategist
chiara.cremonesi@animasgr.it

Matteo Gallone
Junior Macroeconomist
matteo.gallone@animasgr.it

Francesco Ponzano
Junior Equity Strategist
francesco.ponzano@animasgr.it

Cosimo Recchia
Senior Equity Strategist
cosimo.recchia@animasgr.it

Paolo Teruzzi
Investment Advisory
paolo.teruzzi@animasgr.it