AXA Investment Managers

30 April 2025

Investment Institute Macroeconomics

Monthly Op-ed

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Persistent damage

Key points

- US concessions after "Liberation Day" still leave a massive shock on US tariffs. Unless negotiations prove successful quickly, a brush with recession in the US later this year is our baseline
- D. Trump backtracked on his attacks on the Fed, but the new style of government in Washington is eroding the status of the US dollar as the dominant reserve currency
- Allocation to US assets under threat
- Higher risk premiums needed
- US dollar could move lower

This will leave scars

Sketching out quantified scenarios is a somewhat vain exercise in the highly volatile policy environment in the US. We can however adjust our assessment of the macroeconomic impact of the US trade policy to the latest news. The temporary concessions on 9 April have changed the distribution of the shock for the rest of the world (less tariffs on almost everyone, but a much bigger one on China), but even after factoring in the reprieve on Chinese electronic goods (also only temporary, at least in principle), the weighted-average tariff in the US as of early May stands at 25%, 10 times the "pre-Trump" level.

Given the share of US consumption directly or indirectly linked to imports, this would in the first-round result in a c.2% shock on the Consumer Price Index (CPI). True, US consumers will benefit from a decline in oil prices – the usual reaction when the market expects a slowdown in world demand – but this is likely to be offset by the depreciation of the dollar. We continue to think that, unless a very positive outcome to the trade negotiations emerges quickly, the US will experience a brush with recession in the second half of 2025 (2H 2025).

The awareness of the damage – at a time when polls are nose-diving – is likely to trigger more inflections in the White House's position in the months ahead and we suspect that the final tariffs will be smaller than those announced in April, and noises around trade negotiations are of course welcome. Yet, sheer uncertainty alone, unless the talks resolve very quickly, will take its toll on business capex, financial conditions and consumption.

Indeed, the "trade policy uncertainty index" has skyrocketed. This is consistent with scaling up the uncertainty impact on business capex estimated by Matteo Lacoviello at the Federal Reserve (Fed) during the first trade war on 2018-2019 by a factor 3, which would result in a reduction in business investment of 3-6% from baseline. The deterioration in consumer confidence continues at full speed. When looking at the expectations component of the Michigan University survey, what is striking is that even Republican-leaning respondents are reporting a decline in their level of confidence – even if it remains still slightly above its long-term average. The plunge in Independents' confidence is very similar to Democrats'. The loss of optimism is now pervasive.

The market is expecting significant Fed cuts by the end of this year, reflected in the drop in 2-year yields which, together with the widening in corporate spreads, suggests that investors take seriously the risks of a recession in the US triggered by the new trade war. However, long-term treasury yields have been resilient. This counter-intuitive steepening of the US curve in pre-recession times strongly hint at the emergence of a substantial risk premium on US government bonds. Issues of a technical nature, e.g. the growing share of US Treasuries held by Hedge Funds in the context of base trades, have magnified the tension on the long-end of the curve by triggering counter-productive gyrations in market liquidity, but the root cause lies outside the "plumbing" of the US financial system. Expectations of a further drift in fiscal deficits are probably playing a role, but doubts on the Fed's future independence, and consequently the possibility to see the normally one-off price shock turns into persistent inflation, are dominant in our view.

President Trump backtracking on earlier comments on "terminating" J. Powell at the Fed has brought some measure of calm to the market, but we do not think the issue is settled. Before its summer recess the Supreme Court may release its decision on the termination of officials in other independent federal agencies with potentially crucial ramifications for the Fed. Should the Court open the door to terminations over policy disagreements – something which since 1935 has not been possible – then the mere risk that policy conflicts could lead to dismissal would dent the central bank's independence, even if the President does not effectively act on it. However, if the Court confirms the high level of protection Fed leaders enjoy, then influence via nominations under the normal timeline should have fewer radical implications: on top of J. Powell, only one other member of the board is due to be replaced by the end of 2028. The committee would still be dominated by "old" Governors and the Presidents of the regional Feds – who are not appointed by the President. Still, irrespective of the Court's decision, there is a shift in the US in the conception of government. The debate between "big" and "small" government" is giving way to "free" versus "restrained" government, with consequences for policy predictability in the US and its status as the world's dominant issuer of risk-free assets.

Investors had become accustomed to a slow and relatively predictable policymaking machine in the US, with a large measure of checks and balances within the executive branch. An independent central bank would act as a natural limit to excessive fiscal shifts and unsustainable policies. Seen from the current administration's point of view, this is a recipe for paralysis, at a time when the competition with China calls for a nimbler executive branch. Yet, the cost of such "free government," with strong presidential capacity for action, is an "unrestrained government," with more radical changes and policy signals. There will be plenty of occasions for the US administration to moderate its tone and return to more traditional policymaking, but before we get there, our baseline is that tangible damage on the US economy – and consequently on the world economy – will need to materialise.

Lower for now, or lower for good?

It is not clear yet whether we are going through a temporary or more permanent shift in the way global investors look at the US. It is clear that preferences have been impacted by President Donald Trump's more adversarial stance on political and trade alliances. The general decline in the value of the US dollar this year suggests this has had an impact on asset allocations. However, it is not certain that global investment portfolios are shifting to a permanently lower allocation to US dollar assets.

For benchmark investors, the sheer weight of US assets in global equity and bond indices makes it difficult to substantially reduce exposure within existing risk limits. The weight of US equities in the MSCI World index, for example, is 72%. The so-called *Magnificent Seven* US technology stocks account for 20% of that index. On the fixed income side, the US accounts for 54% of the ICE Global Bond Market index. The dollar is the world's reserve currency and, because of the US trade deficit, the rest of the world is" long dollars". Substantial reductions in weightings towards US assets are unlikely. Yet the very fact that US assets make up such large weightings and the rest of the world is" long" creates the opportunity for even modest reductions in allocations to have large effects on market pricing.

US market risks

It is prudent to take time to understand the risks around the US's role in global financial markets. The US dollar is the reserve currency; the Treasury market is the biggest bond market in the world; and US equities have provided the strongest returns - and have financed the greatest advances in technology the world has seen. But there is an argument the US has suffered from the rest of the world taking advantage of its huge consumer market and it being the destination for foreign savings. The Trump administration wants to see a lower trade deficit and is using tariffs as its core tool in trying to achieve that. For the sake of argument, imagine the trade deficit declined. This would, through the balance of payments identity, be associated with a lower surplus on the capital account side. In other words, net inflows into US bonds and equities would decline. More global capital would remain within countries that were historically providers of capital to the US, and there would be a natural rebalancing of asset allocations with the US declining and allocations to European, Asian and emerging markets increasing as a result.

Such a process is unlikely. Trade deficits reflect more than just the prevailing tariff regime. They represent differences in competitive advantages and relative savings and investment balances. Using a blunt instrument like tariffs to achieve a lower deficit is unlikely to be successful and will be disruptive to global growth, inflation and supply chains. And this disruptive approach, which has a politically antagonistic complexion, can lead to shifts in preferences. It is what we have seen so far this year, with the dollar decline reflecting this. Certainly, financial market commentary, including from some asset managers, suggests allocations to US assets are being reduced as long as policy uncertainty clouds the outlook for the US economy, the stability of policy and the appropriate valuation of US assets.

Competition

These concerns may ultimately recede and policy orthodoxy could be restored. A period of reduced allocation to US assets could be a good choice for global investors. After all, US equities have been relatively expensive for some time and have outperformed. Today, we are faced with potential upside for European markets given the shift in spending priorities there towards security and infrastructure. Moreover, the hegemony that US companies appeared to have in artificial intelligence has been challenged by new developers in Europe and Asia. The US administration's political standoff with China is both restricting US technology companies doing business there and providing the impetus for Chinese competitors to grow quickly.

On the fixed income side, remarkably Treasury yields are not much changed from the beginning of the year. Volatility is higher though. The Bank of America MOVE index, which measures option volatilities on US Treasury bonds, increased to its highest level since the Fed started its tightening cycle in early 2023. Investors in US Treasuries have to contend with real and perceived risks. These include higher US inflation as a result of tariffs, potential political pressure on the Fed, the deterioration in the fiscal outlook and the threat of other foreign investors reducing holdings of Treasures. While we do not foresee China quickly accelerating its reduced holdings of Treasury bonds, Beijing does hold the cards in threatening to do so. For other investors, holding their capital in their own currency bond markets might be a safer option. In Europe, there will be increased calls on domestic capital to fund the increases in bond issuance necessary to boost European growth and security.

It's not easy to be dollar bullish

Reports of the dollar's death are premature. The world will continue to hold dollar assets and there is no viable near-term alternative to the greenback as a reserve currency. A regime shift which sees the euro or the renminbi be used more broadly in international trade and investment will not happen overnight, even if, over the long term, a more balanced global monetary system emerges. However, the ongoing need for foreign capital to finance the US deficit against a backdrop of policy uncertainty, political belligerence and increasingly unstable fiscal dynamics means that higher risk premiums on US assets – and an even lower value for the dollar – are likely to be needed.

The US is the home to world-leading companies. There will continue to be significant investment in technology, in data centres and in renewable energy generation. These are the sectors – not some mythical return of manufacturing – that will generate the greatest return on capital and underpin the US's superior productivity performance. But the last few weeks have changed the world. The rest of the world is responding to a less co-operative US and investors should adjust their portfolios accordingly. Sentiment and technical factors have driven recent market moves but macro trends and valuations will determine future asset allocation decisions. On that, the scorecard for the US does not look particularly good for the foreseeable future.

And there remain risks. Trump has backed away from his most extreme position on tariffs and has toned down his comments about Fed Chair Jerome Powell. But his unpredictability and tendency to resort to extreme rhetorical positions on economic policy may again lead to adverse market reactions. If global growth is going to be weaker, as most forecasters agree, then investment returns are likely to be lower in the next couple of years. Under such circumstances mitigating risk is essential. From a global macro point of view, the US is the source of major risks.

Download the full slide deck of our April Investment Strategy

30 April 2025

Macro forecast summary

Real GDP growth (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
World	3.3	2.6		2.4	
Advanced economies	1.6	1.2		0.7	
US	2.8	1.6	1.4	0.6	2.0
Euro area	0.9	0.7	0.9	0.5	1.4
Germany	-0.2	-0.2	0.1	0.2	1.3
France	1.1	0.3	0.6	0.6	1.3
Italy	0.5	0.0	0.5	0.2	1.0
Spain	3.2	2.6	2.5	2.0	1.7
Japan	0.1	1.1	1.0	0.5	0.9
UK	0.9	0.8	0.7	1.1	1.5
Switzerland	1.3	0.7	1.1	1.0	1.6
Canada	1.3	1.6	1.0	0.6	2.1
Emerging economies	4.2	3.4		3.4	
China	5.0	4.3	4.5	4.0	4.2
Asia (excluding China)	5.4	4.3		4.5	
India	6.7	6.3	6.3	6.1	6.6
South Korea	2.1	0.2	1.3	1.5	2.2
Indonesia	5.0	4.5	4.9	4.9	5.1
LatAm	2.4	1.8		2.0	
Brazil	3.4	1.9	1.9	1.8	2.2
Mexico	1.5	0.0	0.6	0.8	2.0
EM Europe	3.3	2.1		2.0	
Russia	4.1	1.5	1.7	0.9	1.3
Poland	2.9	2.8	3.4	2.9	3.5
Turkey	3.2	3.0	2.9	3.4	3.6
Other EMs	2.8	3.2		3.7	

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 29 April 2025
**Forecast*

CPI Inflation (%)	2024	2025*		2026*	
	AXA IM	AXA IM	*Consensus*	AXA IM	*Consensus*
Advanced economies	2.6	2.7		2.4	
US	2.9	3.4	3.2	3.2	2.3
Euro area	2.4	1.9	2.0	1.6	2.0
China	0.2	0.4	1.3	0.6	1.6
Japan	2.7	2.9	2.0	1.5	1.7
UK	2.5	3.2	2.3	2.0	2.0
Switzerland	1.1	0.2	1.0	0.5	1.0
Canada	2.4	2.4	2.1	2.6	2.1

Source: Datastream, IMF, Bloomberg and AXA IM Macro Research – As of 29 April 2025
**Forecast*

These projections are not necessarily reliable indicators of future results

Forecast summary

Central bank policy Meeting dates and expected changes (Rates in bp / QE in bn)		Current	Q2-25	Q3-25	Q4-25	Q1-26	Q2-26	Q3-26	Q4-26
United States - Fed	Dates	4.50	6-7 May 17-18 Jun	29-30 Jul 16-17 Sep	28-29 Oct 9-10 Dec	27-28 Jan 17-18 Mar	28-29 Apr 16-17 Jun	28-29 Jul 15-16 Sep	27-28 Oct 8-9 Dec
	Rates		-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)	-0.25 (3.25)	unch (3.25)	unch (3.25)
Euro area - ECB	Dates	2.25	05-juin	24 Jul 11 Sep	30 Oct 18 Dec	5 Feb 19 Mar	30 Apr 11 Jun	23 Jul 10 Sep	29 Oct 17 Dec
	Rates		-0.25 (2.00)	-0.50 (1.50)	-0.50 (1.00)	unch (1.00)	unch (1.00)	+0.25 (1.25)	+0.25 (1.50)
Japan - BoJ	Dates	0.50	30 Apr - 1 May 16-17 Jun	30-31 Jul 18-19 Sep	29-30 Oct 18-19 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		unch (0.50)	+0.25 (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)	unch (0.75)
UK - BoE	Dates	4.50	8 May 19 Jun	7 Aug 18 Sep	6 Nov 18 Dec	5 Feb 19 Mar	30 Apr 18 Jun	30 Jul 17 Sep	5 Nov 17 Dec
	Rates		-0.25 (4.25)	-0.25 (4.00)	-0.25 (3.75)	-0.25 (3.50)	unch (3.50)	unch (3.50)	unch (3.50)
Canada - BoC	Dates	2.75	16 Apr 4 Jun	30 Jul 17 Sep	29 Oct 10 Dec	Jan Mar	May June	Jul Sep	Oct Dec
	Rates		unch (2.75)	-0.25 (2.50)	unch (2.50)	-0.25 (2.25)	unch (2.25)	unch (2.25)	unch (2.25)

Source: AXA IM Macro Research - As of 29 April 2025

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Our Research is available on line: www.axa-im.com/investment-institute

About AXA Investment Managers

AXA Investment Managers (AXA IM) is a leading global asset manager offering a diverse range of global investment opportunities in both alternative and traditional asset classes. Through our products we aim to diversify and grow portfolios, while delivering long-term investment performance and value for clients.

AXA IM manages approximately €879 billion in assets*, of which €493 billion are categorised ESG-integrated, sustainable or impact. As an established player in responsible investing, we adopt a pragmatic approach with a view to provide long-term value to our clients, our employees and the broader economy.

Part of the AXA Group, a worldwide leader in insurance and asset management, AXA IM employs over 3,000 employees and operates from 24 offices in 19 countries globally.

**All figures, as at end of December 2024*

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