JUNE 2025

Midyear Outlook 2025

What Lies Ahead in the *Next* 100 Days?

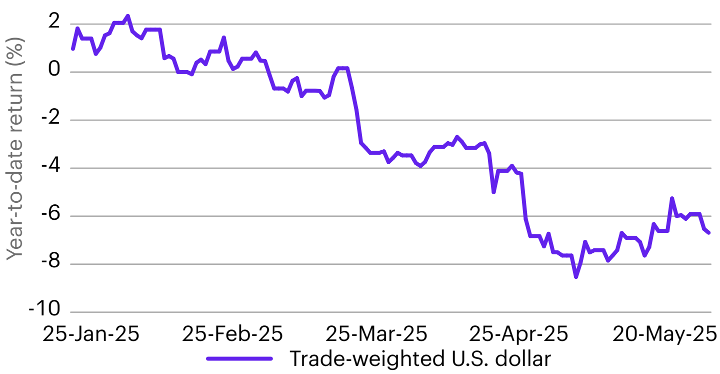
Amid global trade tensions and new questions about how economies will interact going forward, the path ahead lacks clarity. For now, *uncertainty* may play a lead role in how global economies and markets perform—until the fog begins to clear.

Top 3 risks

01 U.S. TARIFF-INDUCED INFLATION SPIKE

With a 10% base tariff on all imports and additional sectoral and reciprocal tariffs on targeted goods, U.S. inflation expectations could rise sharply over the next year. Higher import costs may reduce profits for U.S. companies.

U.S. DOLLAR HAS WEAKENED THIS YEAR RELATIVE TO OTHER COUNTRIES' CURRENCIES



Sources: Allspring and Bloomberg Finance L.P.

Trade-weighted U.S. dollar = a measure of the value of the U.S. dollar relative to other world currencies

MACRO BACKDROP

Before tariffs captured news headlines this year, U.S. inflation was trending down and economic growth was robust. Consumers and businesses felt relatively optimistic about the future. Now, as we approach midyear, the situation has shifted: U.S. growth turned negative for the first quarter due to a surge of imports into the U.S. ahead of the tariffs' start dates, and consumers' inflation expectations have risen sharply. Although there is ongoing uncertainty regarding the legality of the U.S. tariffs and how extensively they'll be applied, we expect them to stay for now. Given their importance as a trade-rebalancing tool, they could become a cornerstone of U.S. economic policy.

In the current environment, the U.S. outlook appears more stagflationary to us, with tepid growth and short-term higher inflation. Market volatility is likely to continue as interest rates remain higher. Tariffs will increase costs for U.S. companies that rely on imported goods and components, pressuring earnings. A weaker U.S. dollar may take a toll as well.

The likely scenario to us is that the costs of higher tariffs will be passed on to consumers. Should this occur, it will put the Federal Reserve (Fed) in a tricky situation: On the one hand, growth is slowing, which would call for more rate cuts—but on the other hand, the medium-term consequences of higher inflation expectations are difficult to assess due to a lack of details regarding what lies ahead for U.S. tariffs. Their initial implementation and the countermeasures taken by other countries have led to confusion and worry among investors—and to sharp market swings since the tariffs were announced.

While the market currently is pricing in three U.S. rate cuts this year, the Fed might be more cautious and cut only twice (or even fewer). This would disappoint investors in U.S. bonds and likely make U.S. bond and equity valuations more challenging. That said, inflation's underlying long-term trend has been pointing lower, and any positive surprise suggesting lower tariffs could encourage the Fed to return to rate cuts more quickly. Although consumers are likely to save some of the coming fiscal stimulus, its positive impact overall shouldn't be underestimated.

It's also important to consider that the Fed has a dual mandate—closely monitoring and managing the levels of both employment and inflation. It must determine how best to use its monetary policy tools to achieve its target goals of both 2.0% annual inflation and maximum employment. How the Fed decides to proceed likely will take both mandates into account.

Internationally, we expect a disinflationary environment—continued low growth and weaker inflation—as exports take a hit due to U.S. tariffs. We'll likely see more rate cuts by the European Central Bank and the Bank of England as well as more easing by China's central bank.

02 GLOBAL RECESSION

The threat of a global trade war coupled with the U.S. government's substantial spending cuts may push the global economy into contraction.

MACRO BACKDROP

Tariffs are likely to remain a feature of U.S. trade policy under President Trump. Over the medium term, the U.S. trade balance will likely shrink, with consequences for both the U.S. and its trading partners. Capital has already begun flowing slowly out of U.S. equities and into international equities.

For years, over 50% of global trade has been collateralized by the U.S. dollar. If there's a sustained trend of fewer exports coming into the U.S., international investors will have fewer U.S. dollars to invest, leading to further weakening of the U.S. currency. To continue running its high budget deficit, higher yields are needed to incentivize domestic savings.

One bright spot for U.S. consumers in the near term could be potential tax cuts. If tariffs stay at their current or higher rates, however, it may wipe out the positive effects of U.S. tax cuts and cause a recession. The odds of a U.S. recession have recently risen, with equity and bond markets' pricing suggesting a 30% probability.

Outside the U.S., economies in Asia and Europe were already showing signs of economic strain in 2024, as witnessed by slowing growth in many European countries and ongoing issues in China's property market.

ECONOMIC OUTLOOK GROWTH PROJECTIONS
(annual % change in real GDP)

		PROJECTIONS	
	2024	2025	2026
World output	3.3	2.8	3.0
U.S.	2.8	1.8	1.7
Euro area	0.9	0.8	1.2
U.K.	1.1	1.1	1.4
Canada	1.5	1.4	1.6
Emerging market and developing economies	4.3	3.7	3.9
China	5.0	4.0	4.0
India	6.5	6.2	6.3
Emerging and developing Asia	5.3	4.5	4.6
Mexico	1.5	-0.3	1.4

Source: International Monetary Fund, World Economic Outlook, IMF.org/pubs
April 2025
GDP = gross domestic product

In many ways, a strong U.S. consumer base was helping buoy the global economy and avoid a global recession. The current global trade war coupled with big spending cuts by the U.S. government and possibly higher U.S. inflation could derail U.S. consumer spending to the point that the global economy contracts for multiple quarters.

03 CHINA DECOUPLING FROM THE U.S. AND OTHER WESTERN DEMOCRACIES

Structurally higher tariff rates, U.S.-mandated divestitures from Chinese military-linked securities, and U.S. restrictions on trade with China in specific sectors—like semiconductor chips—raise the probability of a broad decoupling of China's economy from the economies of the U.S. and other Western democracies.

MACRO BACKDROP

The tariff spat highlights a trend toward trade nationalism. Rather than deglobalization, we're likely to see new trade blocs and alliances shaped. With tariffs beginning to drive trade flows away from the U.S., China will need to find new markets for its exports—and Europe is a prime candidate. That said, an increase in cheap imported goods isn't universally beneficial within Europe because domestic businesses such as auto manufacturers or steel companies will be pressured, likely causing trade protectionism to rise. While the U.S. dollar's recent weakness caught investors' attention, the trade-weighted Chinese renminbi has also weakened, putting more upward pressure on European currencies.

Looking out ahead, we believe decoupling could provide numerous opportunities outside the U.S. to drive growth and expand innovation development globally. This could be especially true for emerging markets, where fiscal and monetary easing could drive increased domestic consumption and help them transition away from a purely export-driven growth model. We also believe that decoupling—along with the weaker growth that generally occurs with trading-partner transitions—could amplify geopolitical risks given that global trade and increased interdependencies are often associated with more peaceful times. Ever since World War II ended, international trade has grown broadly across countries, regions, and continents. The current tariff situation may lead countries in a different direction: toward alliances in which alliance members trade only among other member countries. New trading blocs, however, may provide an exciting opportunity to enhance productivity globally. If new trade alliances do become a reality, what would they look like? That's uncertain.

In fact, the name of the game at this juncture is ***uncertainty***. We expect uncertainty will continue lingering on for at least the next several months, in markets and for businesses—and while this situation presents risks for investors, it also presents potential opportunities.

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So, where should investors look for opportunities in this environment?

Fixed income

INCOME IS YOUR FRIEND

GLOBAL BONDS

Publicly traded global bond markets have been offering more yield than ever before. Higher-income, shorter-duration bonds in U.S. dollars have aligned nicely with higher-quality, longer-duration international bonds to help mitigate risk as well as offer the potential to use income to help drive total returns in bond portfolios.

U.S. MUNICIPAL BONDS

Recent market volatility has repriced U.S. municipal bond yields to levels not seen in nearly 20 years. At current levels, bonds issued by a wide range of U.S. municipalities have been offering attractive tax-advantaged income to individuals subject to U.S. income taxes.

DURATION DIVERSIFICATION

MULTI-SECTOR FIXED INCOME

High-quality and yield-enhanced multi-sector strategies have remained a firm anchor for fixed income allocations. High-quality, core-based strategies have benefited from up-in-quality orientation and deep liquidity. Multi-sector and credit-oriented strategies that are allocated to international markets or that go down in quality may offer opportunities to diversify risk, generate incremental returns, and improve portfolio resiliency.

Equities

INTERNATIONAL EQUITIES

International equities have begun benefiting from the U.S. dollar's weakness, which has led to outflows from U.S. equities due to concerns over the impact of tariffs and fiscal policy. Also, loosening fiscal policy could benefit European equities by helping cushion the blow on earnings caused by U.S. tariffs.

EMERGING MARKET EQUITIES

Emerging market equities, which are currently under-owned by global investors, have lower valuations than the U.S. market and unique domestic growth catalysts that have been minimally affected by U.S. tariff policy.

U.S. SMALL- AND MID-CAP STOCKS

Valuation and growth opportunities for U.S. small- and mid-cap stocks have increased significantly compared with large caps. As of January 31, 2025, the relative valuation gap between small caps and large caps was 59%—a level rarely seen in the past 30-plus years. We believe this represents a compelling entry point for investors willing to diversify by broadening their U.S. market-cap exposure beyond large caps.

Active management

Passive indexes don't discern. Security selection matters, especially in an uncertain environment like today's.

WITHIN FIXED INCOME OVERALL

Active management in fixed income helps shift the balance of power to lenders from borrowers and has tended to benefit risk-adjusted returns over time in portfolios.

WITHIN U.S. EQUITIES OVERALL

U.S. equities are highly tied to changes in macro metrics—such as in economic growth and interest rate policy—leaving ample room for active managers to have differentiated opinions that could drive stock-selection alpha relative to benchmarks.

WITHIN U.S. LARGE CAPS

In volatile markets, active managers focused on identifying quality large-cap companies with competitive advantages, flexible balance sheets, sustainable free-cash-flow generation, and attractive valuations can potentially uncover compelling opportunities amid volatile equity prices.

WITHIN U.S. SMALL CAPS AND MID CAPS

Many market analysts focus primarily on larger companies. As a result, many global small- and mid-cap companies that appear to be attractive candidates have not been vetted. They need careful analysis—the kind of scrutiny that active managers can provide. By focusing on high-quality fundamentals, skilled managers may avoid losers and uncover opportunities hidden in the least-efficient corners of the equity market.

INTERNATIONAL

WITHIN EMERGING MARKETS

Along with potential opportunities, investing in emerging markets comes with heightened risk. Deep fundamental analysis of each company is crucial. Active managers with significant experience investing in emerging markets conduct careful assessments to identify potential opportunities within countries, sectors, and industries.

For further information

We're committed to thoughtful investing, purposeful planning, and the desire to deliver outcomes that expand above and beyond financial gains.

Click or scan the QR code to check out Allspring's insights: