

Macro Matters: Fed Carefully Balances Growth and Inflation

Macro Matters provides a concise, comprehensive look at macroeconomic themes that matter to clients.

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Date

10/1/2025

Topic

Market Events

Key takeaways

- **Growth:** We expect U.S. growth to pick up toward the end of the year, while international growth continues its recovery.
- **Inflation:** U.S. core inflation has remained persistent, while China has experienced deflationary pressures.
- **Rates:** The Federal Reserve (Fed) is expected to cut rates again before year-end to support the labor market.

Economic growth: Lower rates may benefit consumers

United States

U.S. economic growth is showing signs of resilience as we approach year-end. Tariff uncertainty has continued to recede—though we are likely to see more sector-based tariffs in the future, with the pharmaceutical sector as the latest target of the Trump administration. Nevertheless, consumer activity has remained unfazed, underpinned by a strong labor market and strong real income to support consumption. Retail sales exceeded expectations in September, and a low personal savings rate points to continued consumer confidence. There are early indications of a softer labor market with companies avoiding hiring for new jobs after the uncertainty from earlier in the year. Manufacturers and homebuilders face headwinds from higher interest rates, while the services sector has been a steady contributor to overall growth.

Eurozone

Overall growth is low across the eurozone, but the recovery continues, supported primarily by the services sector. Manufacturing, meanwhile, faces persistent challenges, including weaker external demand and elevated energy costs given a lack of cheap Russian oil. Despite these obstacles, labor markets have been stable across the region, and real incomes have remained robust.

China

In China, momentum has slowed compared with earlier in the year. While the information technology sector has fueled robust gains in equity markets, consumer sentiment remains cautious amid declining property values. The manufacturing sector continues to be pressured by global trade and tariff uncertainties amid the push to diversify exports as its top priority.

Inflation: A gradual moderation

United States

Core inflation in the U.S., as the Federal Reserve's (Fed) preferred measure, was 2.9% in August. We don't see a lot of price pressure from tariffs, which should come as good news for the Fed. The main drivers are persistent price pressures in core services (excluding food and energy), while goods prices have generally been deflationary. Slower wage growth, resulting from a cooling labor market, is expected to affect overall labor sentiment negatively. The Fed upgraded its inflation forecast for 2026 to 2.6% and expects slower progress toward its 2% inflation target in the long run.

Eurozone

Inflation in the eurozone remains close to the European Central Bank's (ECB) 2.0% target. The ECB forecasts predict inflation to undershoot down to 1.6% in the long term, allowing room to consider future rate cuts if economic conditions warrant it. Recent wage agreements have been lower, also easing price pressures and providing a path to cut interest rates next year by another 25 basis points (bps; 100 bps equal 1.00%).

China

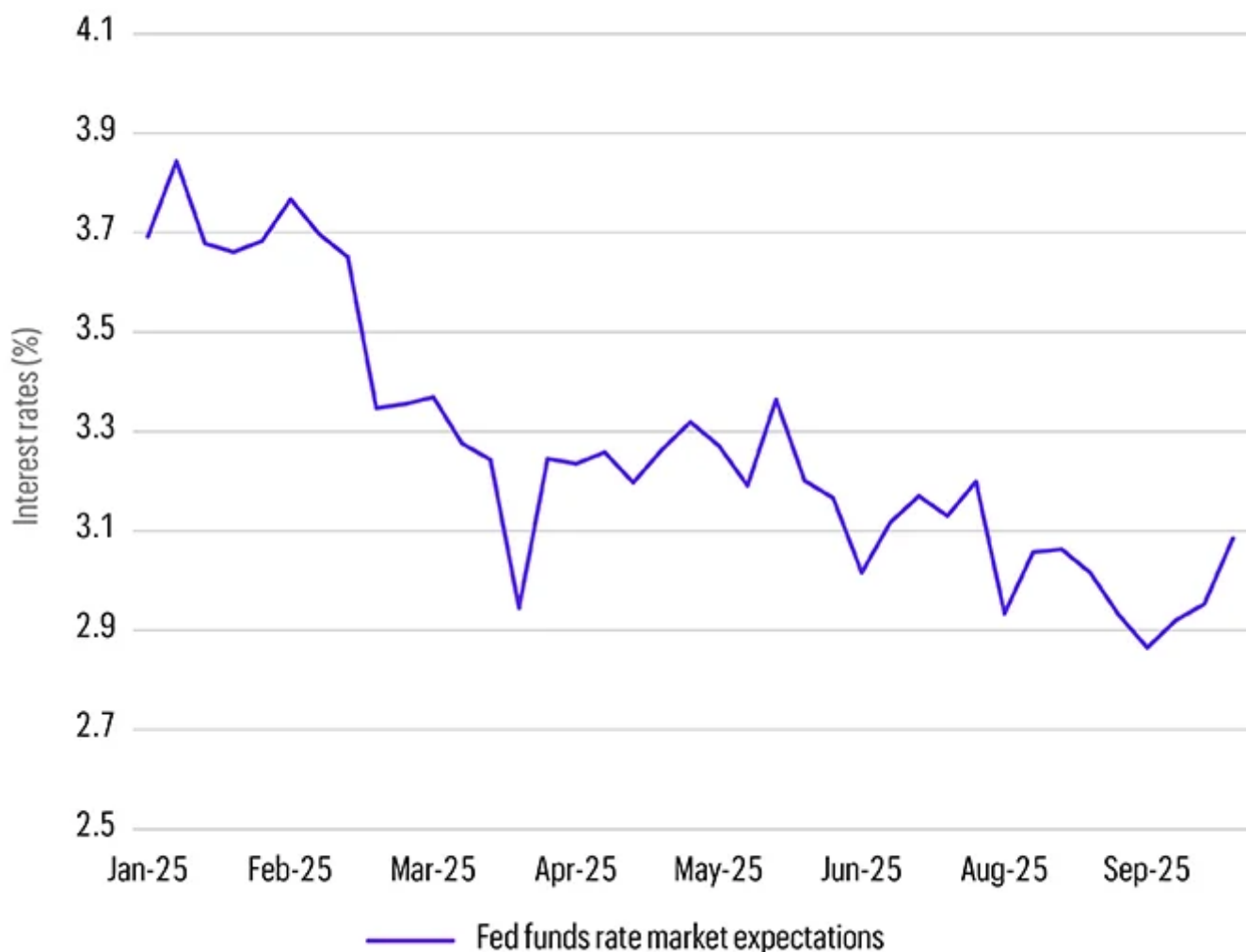
In China, prices turned negative again, with headline inflation falling to -0.4% year over year. This decline is largely attributed to falling prices in consumer goods and the property market. Weak consumer spending has weighed on inflation, and further monetary stimulus may be necessary to support the government's 5% growth target.

Interest rates: The Fed remains data dependent

United States

As expected, the Fed cut its key interest rate to a range of 4.00–4.25%. This move was described as a "risk management" cut to protect against a potential slowdown in the labor market. Consumer and producer price data for August continued above trend, but growth weakened enough to provide some slight relief. Markets are broadly anticipating two more rate cuts by the end of the year and further cuts into next year down to 3.25%. However, if economic growth proves stronger than expected, the Fed may be more cautious. Given inflation remains closer to 3% than the 2% target, current rates seem appropriately restrictive. We anticipate the Fed will continue rate reductions this year, potentially pausing toward year-end.

FED FUNDS RATE EXPECTATIONS (12-MONTH FORWARD-LOOKING)



Sources: Allspring and Bloomberg Finance L.P., as of 30-Sep-25

Eurozone

In the eurozone, the ECB has cut its interest rate in half since early 2024, bringing the current deposit rate down to 2.00%. The central bank is closely monitoring how much support the latest cuts will provide. The market does not anticipate further cuts, as growth appears to be stabilizing and external demand has been improving. This should support exports, which remain the primary engine of growth, while consumer spending is likely to stay cautious due to strained government budgets. The Bank of England is also maintaining its current stance, as prices in the U.K. have proven more persistent than in Continental Europe. Additional cuts are probable next year, with consumers continuing to save ahead of potential tax increases by the U.K. government.

China

We expect the People's Bank of China to continue easing interest rates in response to persistent deflation and subdued domestic demand. Additional rate cuts and targeted lending programs could support the property sector and encourage economic stability. Tariff negotiations are ongoing. Although a broad agreement is likely, pressure on exports and imports from sector-specific tariffs is expected to persist.

Investment implications

Fixed income

We believe U.S. bond markets should benefit from renewed interest rate cuts. However, sticky

inflation may put upward pressure on yields for longer-term bonds. Yields remain attractive overall, while international central banks are likely to be on hold for now to assess the effects of recent rate cuts. We believe U.S. bonds will remain range-bound and earn the yield carry. Positive surprises in economic growth could make the Fed more cautious, potentially reducing the number of rate cuts anticipated. However, without a recession, corporate bond spreads are likely to remain tight. We favor higher-quality U.S. bonds with low- to medium-term durations, as they are less sensitive to interest rate and growth volatility. International bonds have also remained attractive, supported by stronger currencies and positive inflation developments.

Equities

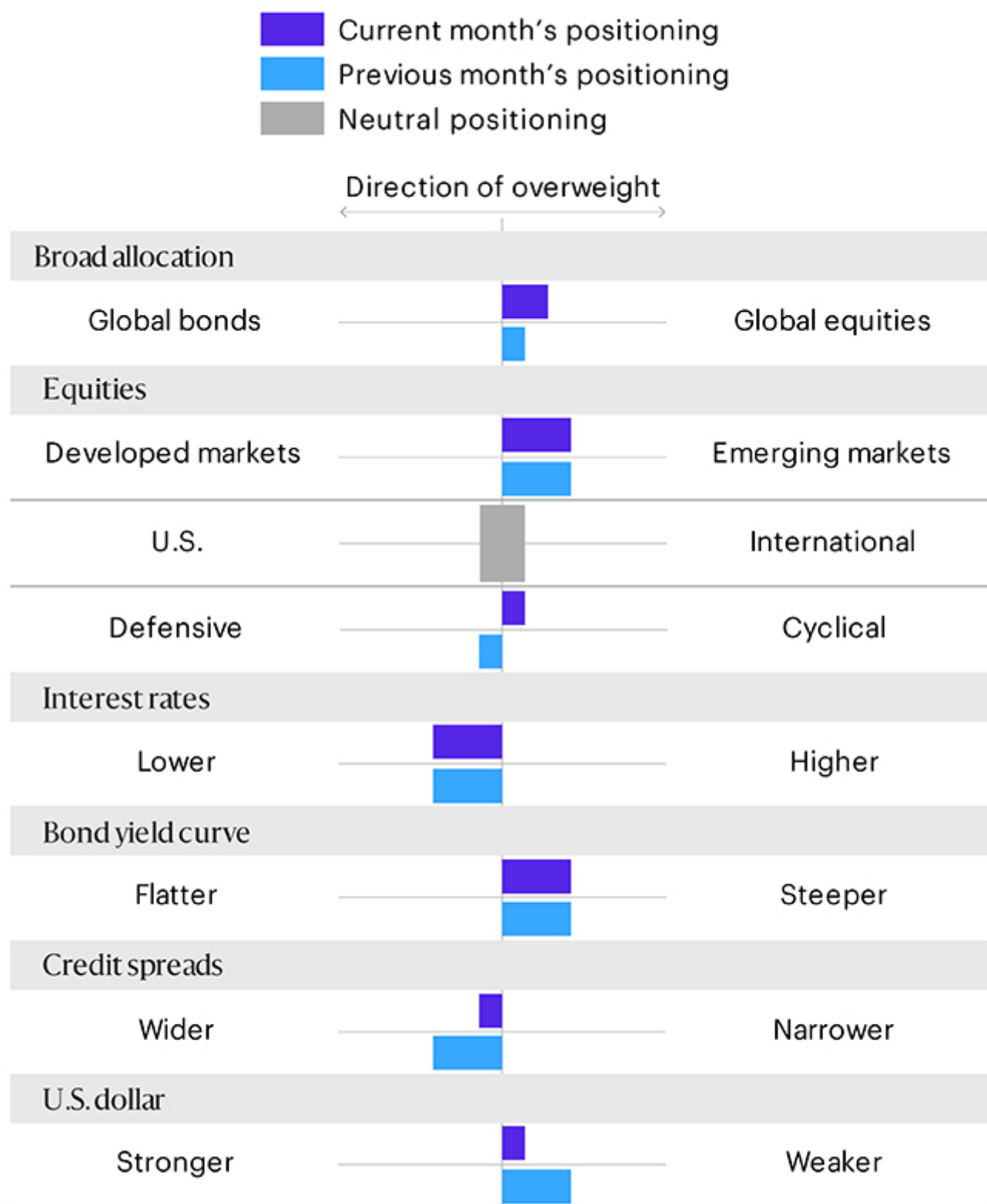
We maintain a positive outlook on equities, particularly in emerging markets and, selectively, more affordable sectors of the U.S. market. Earnings momentum has remained positive, and expectations for the third and fourth quarters have broadly been getting upgraded. We believe a prudent approach is to focus on quality companies and reasonable valuations. Lower real interest rates and potential stimulus may provide further support for global equity markets through year-end.

Multi-asset portfolios

From a multi-asset perspective, we are constructive on global equities, especially in emerging markets and China where valuations appear attractive. Within the U.S., we favor sectors with positive earnings momentum, such as information technology and consumer discretionary. We believe the Fed's focus on supporting growth will bolster equity sentiment. We continue to favor medium-term-maturity bonds over cash. In the U.S., we anticipate further steepening of the interest rate curve as the Fed gradually shifts focus from inflation control to growth support. However, sector-specific tariffs may introduce short-term uncertainties. We believe gold remains attractive, supported by positive demand, strong momentum, and entrenched inflation expectations.

Potential allocations based on today's environment

The table below depicts our views on short-term trends. These perspectives are developed using quantitative analysis of data over the past 30 years overlaid with qualitative analysis by Allspring investment professionals. The positioning of each bar in the table shows the direction and magnitude of an overweight.



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