



# Global Macro Research – Global Economic Outlook

Q4 2025

#Global

/

#Forecasts

/

#Scenarios

## Under pressure

The US economy has slowed, and tariff-driven inflation is set to rise further, but policy rates will resume their move lower. However, with the Fed under significant political pressure, there is a risk of a slide into fiscal dominance. China's anti-involution campaign is unlikely to materially boost the nominal growth environment. Medium-term European prospects are supported by coming fiscal expansion.

US activity growth slowed through the first half of the year, as tariff uncertainty weighed on sentiment and deterred firms and households from spending and investment decisions. The labour market is weakening, even relative to the lower breakeven rate of payrolls growth, and further procyclical downward revisions to the jobs data are possible.

However, peak trade uncertainty has probably passed (see Figure 1). Admittedly, the legal battle around the president's use of IEEPA to impose tariffs creates some residual uncertainty. But the likely landing zone for the new trade regime is seemingly clear. Reduced uncertainty may lead to a mini growth pickup, as pent-up demand is unleashed.

The passthrough of tariffs into inflation has been slower than we expected due to inventory run-down, transshipments, and administrative issues. But as these factors fade, we expect core inflation to rise to 3.6% in coming months.

Real income growth will be squeezed by this higher inflation, weighing on consumption. But ultimately the inflation shock is likely to prove a one-off hit to the price level, especially as a weaker labour market makes it harder for households to negotiate pay increases. All told, we are forecasting US GDP growth of just 1.6% next year and 1.8% in 2027, and inflation averaging 2.9% in 2026 and then 2.1% in 2027.

But the weakening in the labour market has opened a new downside scenario, in which self-reinforcing stall speed dynamics kick in and the US enters a recession.

At the best of times, the combination of weaker growth and higher inflation would present a policy dilemma for the Federal Reserve (Fed). But with the central bank facing significant politicisation, the policy environment is even more challenging.

We expect the Fed to cut rates by 25bps in September and December, and a further 75bps next year (see Figure 2). It is possible there are dissents in favour of a 50bps cut at the September meeting as Donald Trump's influence starts to be felt.

The big picture risk is that the extent to which the administration is attempting to influence monetary policy makes a profound restructuring of the conduct of monetary policy possible. The president has couched his argument for lower interest rates in terms of reducing government funding costs, increasing our concerns about fiscal dominance.

So even as front-end rates come down, this could trigger a bond market rout scenario where long maturity bonds sell off sharply. In the limit, a politicised Fed may use its balance sheet to pin down yields through yield curve control.

In China, the tariff shock has been somewhat mitigated by export strength outside the US. But, with transshipment tariffs now in place, the hit to activity is likely to increase. Meanwhile, falling house prices and weak sentiment continue to weigh on consumption and investment.

The anti-involution campaign may help reduce excess capacity in sectors like EVs and solar power. But we think it will fall short of what is needed to bring inflation to target. And more generally, the degree of policy easing looks insufficient to materially boost nominal growth.

By contrast, the easing in European fiscal policy is set to boost growth from the backend of 2026 and into 2027, even if leakages from defence spending are likely to be high.

While inflation is likely to fall back below the European Central Bank (ECB)'s target in coming months, the eventual impact of fiscal easing should keep the central bank content about the medium-term path of inflation.



So, we think the ECB has reached the end of its cutting cycle, and the next move may be a rate hike at the back end of our forecast horizon.

If Europe can combine fiscal easing with some of the supply-side reforms envisioned in the Draghi report, then this could unlock a European spending surge upside scenario.

We don't expect a near-term ceasefire in Ukraine because of incompatible negotiating. But in an upside scenario, such a deal could also support European growth via energy prices, sentiment, reconstruction spending, and even greater defence spend depending on the terms of the deal.

UK inflation is set to increase further in coming months, peaking around 4%, so the risk the Bank keeps rates on hold for an extended period has increased. But on balance we still expect a cut in November and quarterly cuts next year, given the ongoing deterioration in the labour market. Fiscal policy will tighten again in the budget, with a variety of inefficient tax tweaks likely.

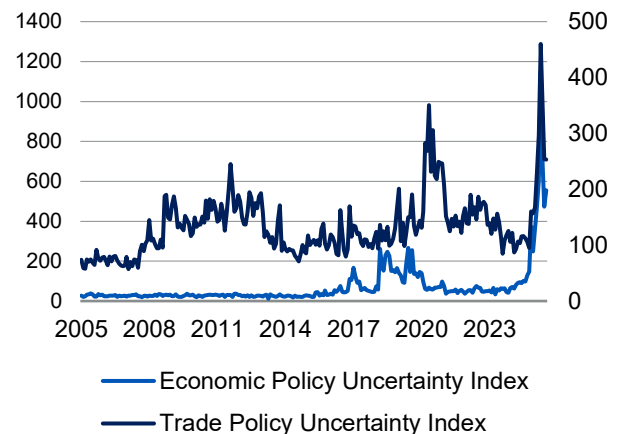
We expect the Bank of Japan (BoJ) to next hike rates in January 2026. An earlier hike is possible, but we think ongoing trade and political uncertainties will see the central bank wait a little longer to better assess domestic inflation trends.

India faces a 50% tariff rate on exports to the US following the additional 25% imposed as punishment for Russian energy imports. We expect a face-saving compromise before year-end. In this environment, the Reserve Bank of India (RBI) would probably keep rates on hold this year. But if such a deal is not made, this would undermine India's appeal as a supply-chain relocation hub.

The broader emerging markets outlook has improved as tariff uncertainty has peaked. The EM cutting cycle continues, and we expect more central banks to deliver cuts

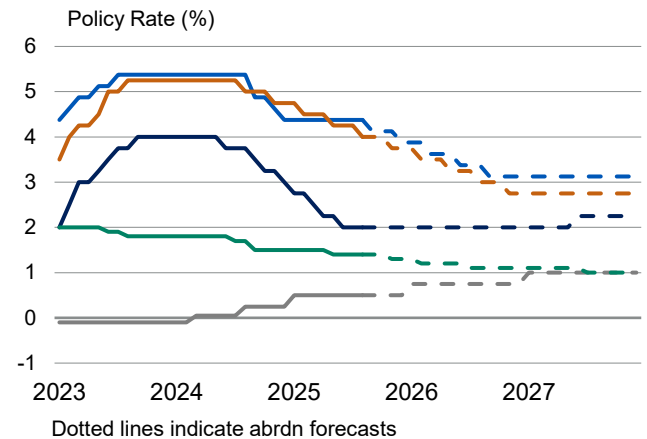
as the focus shifts from containing inflation to supporting growth, and the Fed resumes easing.

**Figure 1: Peak trade uncertainty has passed**



Source: Aberdeen, Haver, September 2025

**Figure 2: US monetary easing will start again soon**



Source: Aberdeen, Haver, September 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	1.9	1.6	1.8	3.0	3.0	2.9	2.1	4.375	3.875	3.125	3.125
UK	1.1	1.2	1.1	1.5	2.5	3.4	2.5	2.1	4.75	3.75	2.75	2.75
Japan	0.1	1.1	0.3	0.6	2.8	2.9	1.6	2.0	0.25	0.50	0.75	1.00
Eurozone	0.9	1.2	0.8	1.5	2.4	2.0	1.7	1.8	3.00	2.00	2.00	2.25
Brazil	3.0	2.5	1.4	2.4	4.4	5.2	4.3	3.8	12.25	15.00	12.50	10.00
India	6.7	7.2	6.0	6.1	4.9	2.7	4.9	4.7	6.50	5.50	5.75	6.00
China	4.9	4.8	4.0	4.2	0.1	0.0	1.0	1.3	1.50	1.30	1.10	1.00
<b>Global</b>	<b>3.3</b>	<b>3.2</b>	<b>2.9</b>	<b>3.1</b>	<b>5.7</b>	<b>4.1</b>	<b>3.5</b>	<b>3.4</b>				

Source: Aberdeen, Haver, September 2025

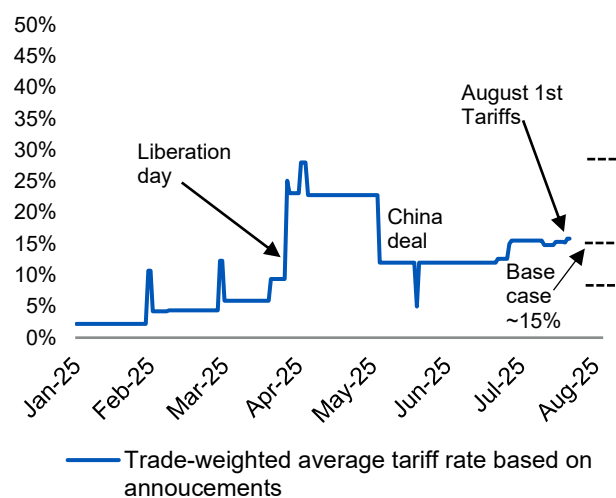
## US

**Activity:** The underlying pace of growth slowed through H1 amid tariff volatility, and our forecasts incorporate subdued growth over the coming few years. Peak tariff uncertainty has passed, and there may be a mini-cyclical pickup from the period of very weak hiring and investment. But higher inflation will weigh on real income growth, which should keep medium-term activity sluggish, and over the longer-run higher tariffs will push down on potential growth (see Figure 4). It is possible the slowdown in the labour market triggers stall speed dynamics, tipping the economy into recession, but this is a downside risk for now.

**Inflation:** The tariff-driven pickup in inflation has been a little slower than we anticipated, but we still expect core inflation to peak at 3.6% later this year, well above the Fed's target. The delay in the inflation pickup is explainable in terms of inventories being worked down, transshipments, and other issues collecting tariffs. These are set to pass, and firms are reporting being able to pass on higher input costs to preserve margins. As long as inflation expectations remain anchored, this should be a one-off level shock, with inflation coming down again. But politicisation of the Fed risks entrenching higher inflation.

**Policy:** We expect the Fed to deliver two 25bps rate cuts this year, in September and December. It is still plausible that large upside surprises in inflation and/or employment derail these cuts, but it's also possible that a further slowing in activity leads to more cuts. The medium-term outlook will depend on how much Trump is able to shape the direction of policy. Clearly, the administration is willing to spend political capital on changing personnel and shifting the "Overton window" to lower rates. In the limit this could involve fiscal dominance and yield curve control, but this is still some way off.

**Figure 4: Peak tariff uncertainty has passed, but the new US trade regime involves a huge increase in tariffs**



Source: Aberdeen, White House, September 2025

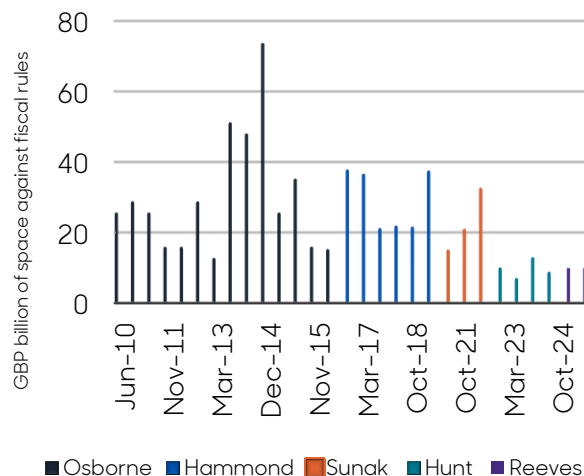
## UK

**Activity:** Despite the downbeat perception of the UK economy, GDP looks to have grown above trend through H1. However, the headline rate almost certainly flatters the underlying pace of growth. We expect the labour market to cool further, as the impact of the spring cost shock continues to work through the economy, especially in low-paid employment. Real wage growth is likely to slow further, also weighing on demand. Fiscal policy is set to tighten in the autumn budget. The chancellor's narrow headroom against the fiscal rules has probably entirely disappeared, so taxes will need to increase again (see Figure 5).

**Inflation:** Headline inflation is set to rise further in coming months, peaking around 4% in September before starting to slowly fall. Government policy and administered prices seem to be driving much of the pickup in inflation, rather than a fundamental aggregate supply/demand mismatch. Indeed, underlying inflation pressures look to be slowly moderating. However, nominal wage growth is still elevated, and a further deterioration in the labour market is likely necessary to sufficiently cool wages. And, given the salience of currently elevated food prices in setting household inflation expectations, there is a risk inflation expectations drift structurally higher than a target-consistent rate.

**Policy:** We expect the Bank of England (BoE) to continue with its quarterly cadence of rate cuts, with the next reduction in November. Certainly, the risk of an extended pause is elevated, given the hawkish shift among BoE policymakers and possibility of inflation expectations becoming unanchored. But we think weak labour market conditions will push down on inflation in time, while fiscal policy will further weigh on activity growth, requiring a further reduction in monetary tightness. Indeed, we think policy rates are still comfortably above equilibrium, and so rates are set to fall towards 3% over 2026.

**Figure 5: The Chancellor's limited fiscal headroom is likely depleted, so tax increases are coming**



Source: Aberdeen, OBR, September 2025

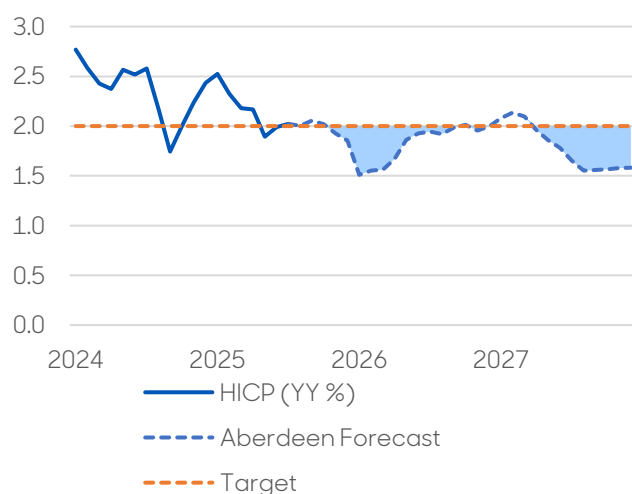
## Eurozone

**Activity:** With the EU's new trade regime with the US largely settled, headwinds from trade uncertainty should fade, even if higher tariffs will be a drag. The flaring up again of political risk in France may be a drag on sentiment, especially if new elections are held, and bond markets are likely to continue to treat French bonds more like peripheral than core debt. However, a deeper fiscal crisis remains unlikely for now. Indeed, tailwinds from fiscal stimulus on defence and infrastructure spending should start to boost activity from the back end of 2026 and through 2027.

**Inflation:** Inflation looks set to drop back below 2% in coming months, perhaps falling as low as 1.5% by early next year on the back of weak demand growth and a strong euro (see Figure 6). Inflation could fall even further if gas prices decline following a ceasefire in Ukraine, although the EU would continue to phase out Russian gas in that scenario. However, services inflation remains elevated at 3.1% and is likely to return only slowly to a target-consistent rate. So, over the medium term, inflation should move towards target, especially as fiscal stimulus hits economies already around full employment.

**Policy:** We think the ECB has finished its easing cycle. The policy rate is now at a neutral level, and the Governing Council is keen to keep it there for an extended period. A cut into accommodative territory is possible if demand-side risks crystallise. But it is also possible the ECB starts hiking again by the end of our forecast horizon in response to fiscal easing. Monetary policymakers will be keen to avoid intervening in government debt markets in response to the political uncertainty in France, but, in a crisis, liquidity support would be available.

**Figure 6: Eurozone inflation is set to dip below target before picking up in the medium term**



Source: Aberdeen, Haver, September 2025

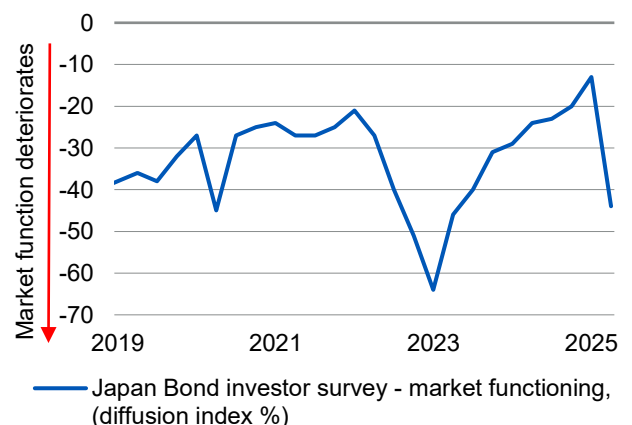
## Japan

**Activity:** Japan's Q2 GDP grew by 0.3% quarter over quarter. Exports were the main driver of growth, with automakers responding to tariffs by sharply lowering export prices. The US-Japan trade deal removes more extreme downside risks but still represents a significant shock, and uncertainty is likely to linger. For example, the terms of Japan's \$550 billion investment into the US and the extent to which Japan is really opening its market to US rice remain somewhat unclear. Domestic political uncertainty clouds the outlook for fiscal policy. Overall Japan should just about avoid a recession, despite our forecast for slower growth.

**Inflation:** National CPI remains elevated and above target as rice costs continue to hover close to record highs. But price pressures should ease in the coming months due to energy subsidies. At Jackson Hole, Governor Kazuo Ueda focused on the structural changes in the labour market that would drive wage growth over the long term. This is in line with a very gradual rise in policy rates. For now, core base pay growth appears to have stabilised around 2%, but real wage growth is still negative, providing little incentive for the BoJ to hike in earnest.

**Policy:** With the LDP-led coalition having no majority in either house, there will be more pressure to increase spending on social security, childcare, and education. This has unnerved JGB markets leading to greater market distortions and evaporating liquidity (see Figure 7). The BoJ at least has the tools to manage bond market dislocation, and we think disinflationary pressure from tariffs implies the BoJ will wait until January 2026 before resuming hikes. Indeed, Governor Ueda emphasized trade and political uncertainties are clouding the data at the July meeting.

**Figure 7: The Q2 Japan bond investor survey shows a sharp deterioration in market functioning**



Source: BoJ, Aberdeen, September 2025

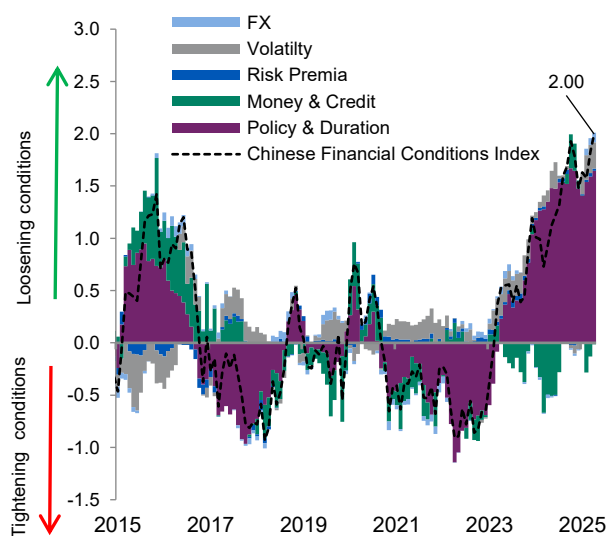
## China

**Activity:** Export strength outside of the US has helped China ride out the tariff shock thus far, while higher-than-expected tariffs in the rest of APAC reduce the additional levies Chinese exporters face. That said, transshipment tariffs will curtail the ability to re-route exports going forward, while the recent sharp weakening of investment partly reflects firms reassessing their supply chains. Household consumption also continues to be weighed down by falling house prices and negative perceptions about job prospects. As such, we forecast growth to slow in the coming quarters, with full-year growth of 4.8% in 2025 and 4% in 2026.

**Inflation:** China's anti-involution campaign should help deal with pockets of excess capacity – for example within electric vehicles and solar – but this is unlikely to be forceful enough to return inflation to the PBOC's 2% target. China's policy mix continues to be biased to the supply side; this is effective at supporting real GDP, but it risks embedding deflation. Indeed, while we expect China to narrowly avoid CPI deflation this year (0%) and expect CPI inflation to rise to 1% in 2026, the GDP deflator will likely continue its record-breaking run (nine quarters below zero) – keeping pressure on corporate and government finances.

**Policy:** The US-China détente has toned down the urgency of further policy easing, but we still expect more steps aimed at loosening financial conditions as a modest growth slowdown unfolds in coming quarters (see Figure 8). The major hydropower project in Tibet is a reminder that large-scale infrastructure projects – particularly related to green power – remain a powerful lever to counteract domestic and external headwinds. We may get clues as to the contours of the 15<sup>th</sup> five-year plan (2026-2030) in the autumn but expect that the reality of consumption support will remain well short of the 'top priority' rhetoric.

**Figure 8: Chinese policy makers remain attentive to the risks of a sharper slowdown**



Source: Aberdeen, Haver, Bloomberg, September 2025

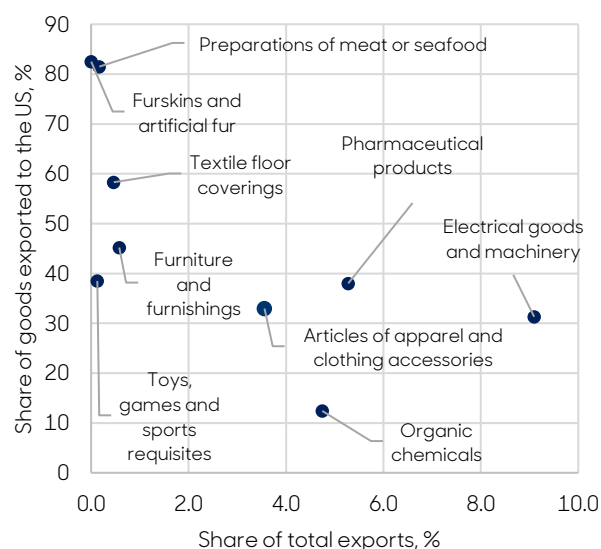
## India

**Activity:** India's economic outlook has been dented by an additional 25% tariff rate on its goods exports to the US. The combined 50% tariff rate will weigh on Indian exports, but the impact should be relatively small in the near term (see Figure 9). We expect a compromise before year-end, which would see the tariff rate reduced and the Indian government's plans to reform its Goods & Service Tax (GST) could provide a 0.3ppts boost to growth. Alongside tailwinds for domestic demand from improving real incomes and easing monetary conditions, we expect the economy to grow 7.2% in 2025, but risks are to the downside.

**Inflation:** Headline inflation has continued to cool, helped by large disinflationary effects from receding food prices. Positive signs around the monsoon season bode well for further food price stability and lower GST rates could further ease inflation. Inflation risks from India shifting away from discounted Russian oil are also small and subsidies could mitigate some of the impact. Nevertheless, core inflation is around target and demand-side pressures are likely to build in Q4, with base effects pushing up headline inflation towards year-end. As such, we forecast headline inflation to rise from an average of 2.7% in 2025 to 4.9% in 2026.

**Policy:** The RBI's neutral stance will be tested by the deterioration in India-US trade relations. Indeed, the central bank's optimism over the economy is likely to be dented, raising the prospect of further cuts before year-end. However, we expect the RBI to remain on hold and focus on its planned liquidity injections into the banking system via lowering its cash reserve ratio by 100bps from September to November. Moreover, fiscal reforms and a weaker Indian rupee will also offset some of the trade shock and ease the pressure on the RBI to cut further.

**Figure 9: India's most US demand-dependent exports are not significant to its overall export basket**



Source: Aberdeen, Haver, TradeMap, September 2025

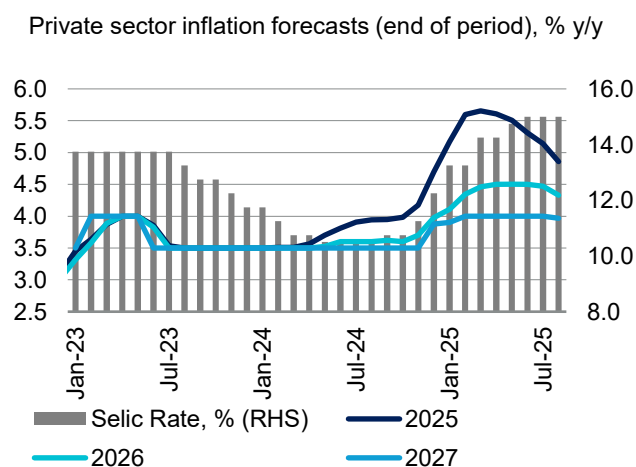
## Brazil

**Activity:** Brazil's economy is showing signs of cooling, with real GDP growth decelerating from 1.3% quarter over quarter in Q1 to 0.4% in Q2. Consumption growth has softened amid historically tight financial conditions. However, resilient growth of jobs and real wages will buoy demand over H2. We expect the 50% US tariff on Brazil (with various sectoral carveouts) to remain until year-end. But we retain the view that the main impact of US trade policy on its economy will be via the tariff-induced global slowdown. The 2026 budget risks seeing politically motivated stimulus measures exceed investors' tolerance for fiscal slippage.

**Inflation:** Inflation is set to remain sticky over the remainder of 2025, with a decline only set to gather momentum from Q1 2026. The trajectory of wholesale agricultural prices bodes well for food disinflation. But core inflation (5.4% in July) will stay elevated over H2 until demand moderates more significantly. Historically tight financial conditions should mean a gradual cooling of price growth next year. However, risks to our inflation forecasts remain to the upside, as politically driven currency volatility (either due to US tensions or uncertainty ahead of Brazil's October 2026 elections) could raise import prices.

**Policy:** The bar for the BCB to pivot towards monetary easing will stay high over the coming months. Inflation expectations, though moderating, remain uncomfortably high (see Figure 10). The high Selic rate has helped support the *real* amid ongoing fiscal concerns and US trade tensions, both of which risk mounting before year end, and perceptions of premature easing could renew market volatility. Outside of a sharper deterioration of growth in H2, we retain our core expectation for the BCB to refrain from monetary easing until March 2026, lowering the Selic rate cautiously to 12.50% by the end of next year.

**Figure 10: Inflation expectations, trade tensions and fiscal risks will prevent the BCB from cutting until 2026**



Source: Aberdeen, BCB Focus Survey, Haver, September 2025

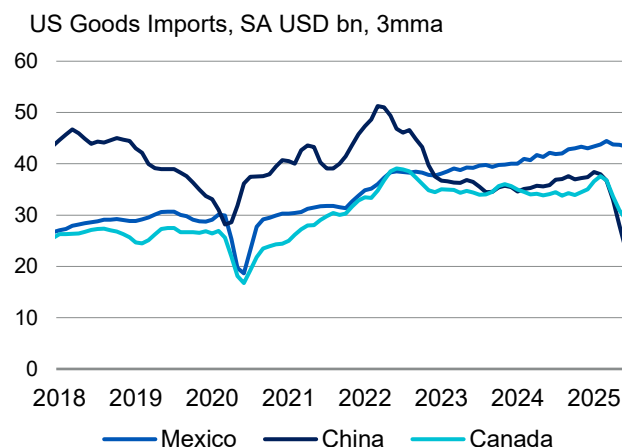
## Mexico

**Activity:** Real GDP growth rose from 0.3% quarter over quarter in Q1 to 0.6% in Q2 amid upticks in industrial activity and services, putting annual growth on track for 0.8%. Mexican exports to the US have remained relatively buoyant versus Canada and China (see Figure 11), with tariff exemptions for USMCA-compliant goods set to provide support over H2. However, sentiment will likely remain muted until the USMCA is on firmer footing, with its review due to commence in July 2026. Growth should accelerate towards 1.2% in 2026 as financial conditions and cross-border tensions ease. But potential for protracted negotiations poses downside risks.

**Inflation:** Mexico's disinflation has faced some bumps in its path, but price pressures remain contained and inflation expectations well anchored. Increases in food and core goods inflation in Q2 briefly pushed the headline rate above Banco de Mexico (Banxico)'s target band (3% +/- 1ppt), but figures for Q3 have shown a more favourable trend across goods. Services prices will likely remain sticky through to year end and agricultural price fluctuations remain an upside risk. Still, muted demand-side pressures will keep overall inflation in check. Respondents in Banxico's economic survey project average inflation of 4.1% in 2025 and 3.8% in 2026.

**Policy:** Banxico has lowered its policy rate by a cumulative 325bps since August 2024 to 7.75%, with further scope for gradual monetary easing into next year. Following four consecutive 50bps cuts, a smaller 25bps cut in August was decided amid stickiness in core inflation. However, the policy statement signalled more cuts ahead, and we retain our forecast for year-end policy rates of 7% in 2025 and 6.25% in 2026. The peso's YTD appreciation versus the dollar, headwinds to domestic demand, and increased expectations for Fed cuts, will underscore Banxico's dovish bias over the coming quarters.

**Figure 11: Mexican exports to the US are holding up comparatively well, but uncertainty remains a headwind**



Source: Haver, Census Bureau, September 2025

## **Alternative global macro scenarios**

## Stall speed

The slowing of the US labour market triggers adverse feedback loops throughout the economy, weighing on sentiment and real incomes, causing a mild recession

The slowdown in the US labour market continues, even after the period of peak policy uncertainty has passed. Payrolls growth runs well below even a much lower breakeven rate, and investors suspect the “true” rate of employment growth may be even weaker given the cyclical nature of payrolls revisions (see Figure 12).

With payrolls growth structurally lower, the chance of a negative payrolls print increases significantly. This acts as coordinating device for investors to become more concerned about the economy “stalling”. Equity markets sell-off in response, tightening financial conditions and further weighing on growth.

Goods price inflation picks-up sharply as the hit from tariffs feeds into final consumer prices more forcefully (see Figure 13), with firms attempting to preserve margins by fully passing on the cost shock. Higher goods inflation bleeds into higher inflation expectations and so other price categories.

With the labour market deteriorating, workers struggle to match higher inflation with higher nominal wages, so real wage growth turns negative, while households increase savings in response to economic uncertainty. Consumption activity slows materially.

Higher inflation and weaker labour market activity create a dilemma for the Fed in the near term. While the central bank eases policy, it does so at a slower pace than it typically would at a time when activity growth is slowing given the risk of locking in higher inflation expectations. This causes financial conditions to tighten further as investors are disappointed by the speed of Fed easing (see Figure 14).

This slow Fed easing leads to further criticism of the Fed from the administration, causing even great policy uncertainty, higher inflation expectations, and capital to flow out of the US.

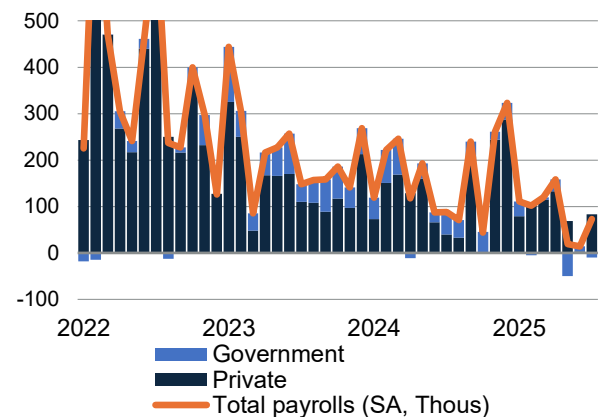
These various forces see the US economy to tip into a mild recession, with large spillovers to global growth, risk sentiment, and commodity prices.

### Indicative economic shocks:

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

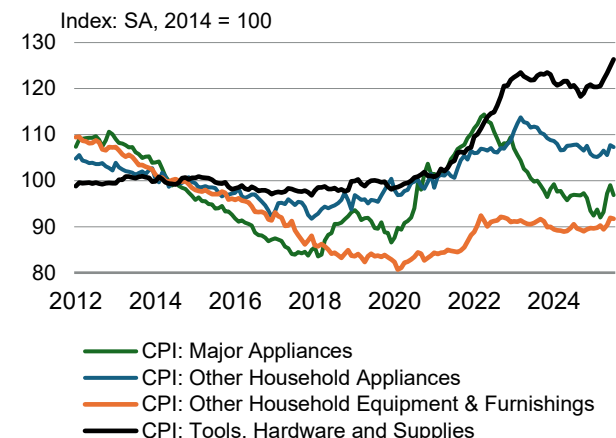
Eventually the Fed starts to ease policy rapidly as the recession becomes more pronounced and inflationary pressures fade, with the policy rate falling well below neutral.

**Figure 12: The slowdown in the US job market could become self-reinforcing**



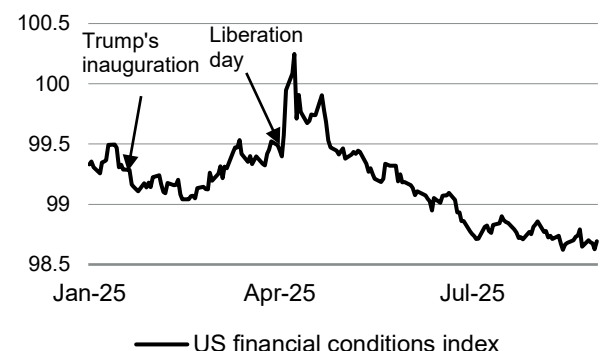
Source: Aberdeen, Haver, September 2025

**Figure 13: If the inflation pass-through of tariffs became significantly larger, this might constrain the Fed**



Source: Aberdeen, Haver, September 2025

**Figure 14: A re-tightening in US financial conditions could contribute to recessionary forces**



Source: Aberdeen, Goldman Sachs Investment Research, September 2025

## Bond market rout

A Trumpified Fed combined with European debt concerns leads to a significant increase in inflation expectations and term premia, causing long-end yields to spike

The combination of personnel changes and pressure from the government leads to a significant reduction in monetary policy independence at the Fed.

Through turnover and firing members of the Board of Governors, the administration creates a majority of sympathetic Fed governors. Then either with this majority, or via changes to the structure of the regional Feds, the administration also gains significant control over the selection of regional Fed presidents.

This new Fed cuts interest rates much more rapidly than implied in the current set of dots, or by standard monetary policy rules given the prevailing macroeconomic conditions. Trump praises these moves explicitly in terms of how much they are saving the US government in debt servicing costs, emphasising the fiscal justification for this policy stance (see Figure 15).

Markets start to discount the policy of short-term rates falling towards the 1% level that Trump has previously indicated he considers appropriate. At the same time, inflation expectations increase significantly in response to the inappropriate policy, causing long-dated bond yields to rise materially (see Figure 16).

Meanwhile, investor concerns about the European fiscal outlook increase. In the UK, political constraints mean the government struggles to either cut spending or materially increase taxes to deal with fiscal slippage against the rules. The fiscal rules are relaxed to allow more borrowing to plug the gap, but the market interprets this as a lack of fiscal sustainability, putting upward pressure on gilt yields and downward pressure on sterling. Talk of an "IMF bailout" increases but this is still not especially likely at this point.

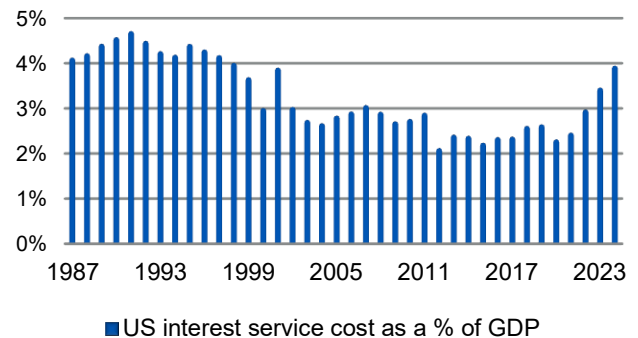
And in France, political instability increases, making it impossible for the government to deliver on the fiscal tightening to which it has committed. French funding costs continue to widen relative to Germany (see Figure 17), and investors begin to contemplate the possibility of an RN presidency. The ECB struggles to intervene to contain the spread widening given the clear political and fundamental drivers of the move.

### Indicative economic shocks:

Front-end yields fall in the US, but long-end yields in the US and other developed markets rise sharply. Financial conditions tighten. Dollar depreciates against safe haven currencies. Gold performs very well.

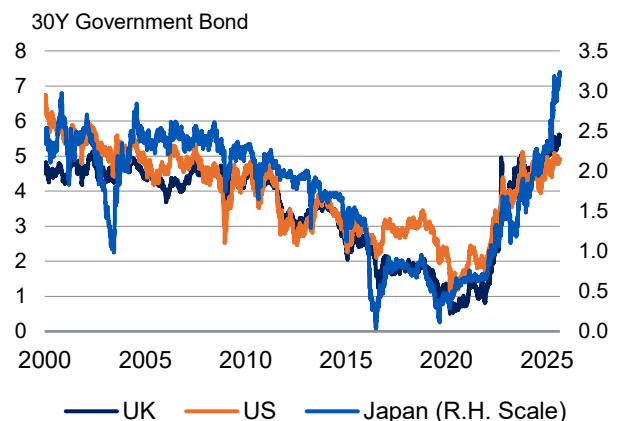
In a full fiscal dominance scenario, the Fed may eventually move to pin down longer maturity bond yields.

**Figure 15: US debt service costs have soared, providing one motivation for politicisation of the Fed**



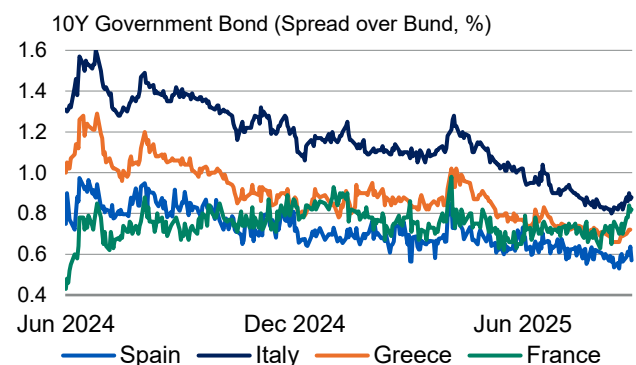
Source: Aberdeen, Haver, September 2025

**Figure 16: Reduced inflation credibility and fiscal pressures could cause long-dated yields to rise further**



Source: Aberdeen, Haver, September 2025

**Figure 17: French spreads over Germany would remain under sustained upward pressure**



Source: Aberdeen, Haver, September 2025

## Supply-side upswing

US potential growth is boosted either by the early impact of AI on productivity or the supply enhancing aspects of Trump's policy agenda

The US enjoys a positive supply shock, pushing up on growth and down on inflation pressures. This could be because the productivity gains from AI start to hit the economy more rapidly than expected (see Figure 18). This would involve output starting to rise much faster than hours worked both through automation of existing roles and through boosting the productivity of existing workers.

Hiring shifts towards AI-complementary roles, while admin, support, and repeatable tasks see lay-offs. At the aggregate level, employment remains strong in part due to the boost to incomes creating new wants and needs in the economy. Indeed, vacancy durations might shrink, as AI helps to boost the matching efficiency of the labour market.

Unit labour costs shrink, reducing inflationary pressures, and firms' profit margins widen, encouraging further investment in AI. There is a boom in intangible capex demand including on software and R&D, while demand for data centres, chips, and energy also picks up significantly.

Alternatively, the supply boost occurs due to some of Trump's policy agenda bearing fruit.

Deregulation of financial services, the anti-trust regime, and the permitting system all help to boost corporate profitability and investment (see Figure 19). Domestic energy production increases significantly, putting downward pressure on energy prices. Meanwhile, personal and business tax cuts in the One Big Beautiful Bill provide greater incentives to increase labour supply and the capital stock.

Tariffs prove to be less distortionary and inflationary than expected, as US market power and lack of retaliation from trading partners means most of the burden of higher tariffs is felt overseas. Indeed, onshoring of capital-intensive tradables could help to boost productivity.

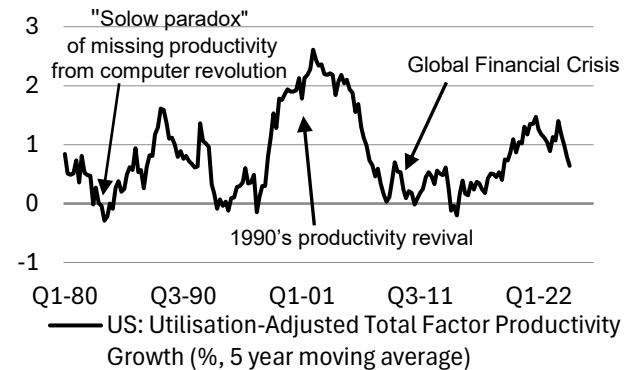
The inflationary impact in the labour market of reducing migration is more than outweighed by lower demand in the housing market. Housing supply is relatively inelastic, so lower demand leads to sustained downward pressure on house prices.

### Indicative economic shocks:

US potential growth rises from sub-2% to more than 3% (see Figure 20).

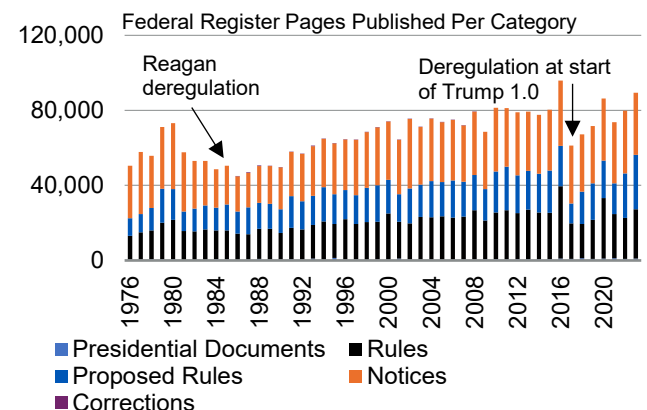
But the lower inflationary impulse allows the Fed to cut more rapidly, further boosting activity growth as demand expands into the extra supply capacity. Over the medium term, higher productivity growth puts upward pressure on  $r^*$ .

**Figure 18: Productivity growth could strengthen if the benefits of AI are realised more rapidly**



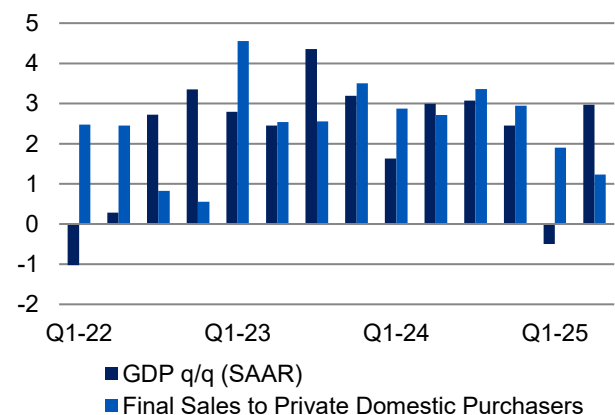
Source: Aberdeen, FRBSF, Haver, September 2025

**Figure 19: Alternatively, Trump's supply-side agenda, including deregulation, could be supply expanding**



Source: Aberdeen, Federal Register, September 2025.....

**Figure 20: Either way, trend growth in the US would pick up from the recent slowdown**



Source: Aberdeen, Haver, September 2025

## European spending surge

Higher European-wide defence spending and investment lead to a significant cyclical upswing, while implementation of the Draghi plan boosts potential growth

Europe delivers a sustained increase in defence and other spending that is even larger than in our baseline. Meanwhile, structural reforms that help deliver an improvement in trend growth are introduced.

A large proportion of the €800bn freed up by a loosening of the EU fiscal rules to fund the higher NATO defence spending target is exploited (see Figure 21). And while there is some leakage overseas, most procurement is done within Europe, so multipliers prove larger than expected.

Meanwhile, the €500bn that Germany has committed to infrastructure spending is used quickly on “shovel ready” projects (see Figure 22). 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.

Higher investment spending boosts potential growth by reversing the weakness in capital formation.

A ceasefire in Ukraine on favourable terms to Ukraine helps boost European risk sentiment and put downward pressure on energy prices, while the need for reconstruction spending also supports growth.

Alternatively, a less favourable deal further galvanises Europe’s willingness to boost defence spending and to direct the vast majority of this spending to help redevelop a European industrial base.

Finally, 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 encourages 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.

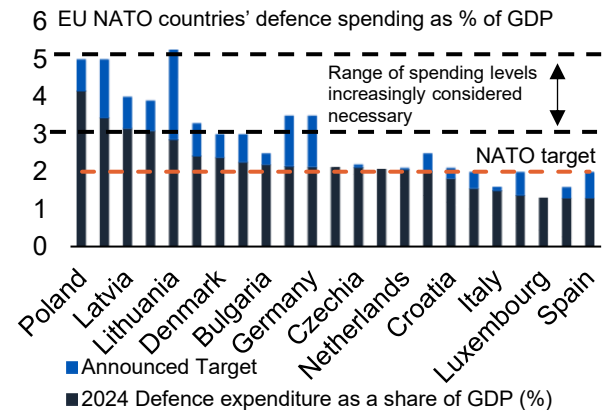
Higher potential growth estimates cause assessments of  $r^*$  to increase, with policy interest rates expected to settle permanently higher.

### Indicative economic shocks:

Eurozone GDP is 2% higher than the baseline by end-2027, while the price level is 0.75% higher.

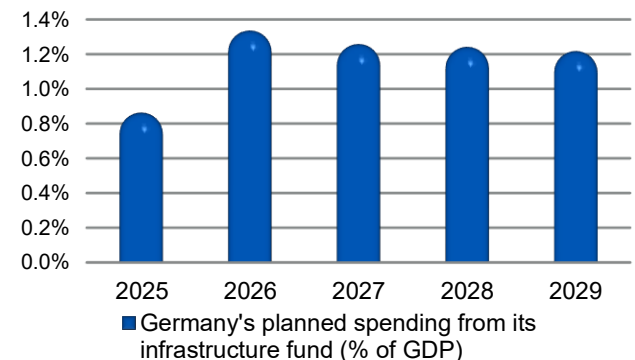
The ECB eventually hikes rates modestly, to 2.75% by end-2027.

**Figure 21: Higher NATO defence spending targets require a big rise in European fiscal spend**



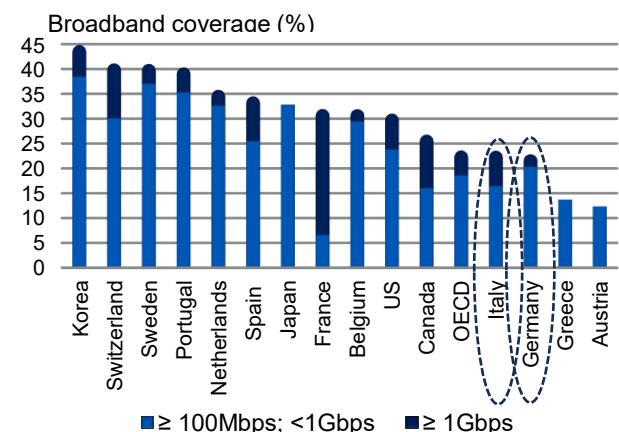
Source: Aberdeen, NATO, September 2025

**Figure 22: German infrastructure spending could be genuinely transformative**



Source: Bundesfinanzministerium, Aberdeen, September 2025

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



Source: Aberdeen, Haver, September 2025

## Conflict risks dominate

### A geopolitical escalation shocks energy markets, pushing up on inflation and depressing private sector animal spirits

This could be triggered by the Trump administration's frustration at slow progress in Russia-Ukraine negotiations leading to efforts to more forcefully cut Russia out of the global oil and gas markets via secondary sanctions and tariffs.

Alternatively, a re-eruption of tensions in the Middle East, such as renewed conflict between Israel and Iran, could cause significant disruption to oil flows through the Strait of Hormuz.

Either way, energy markets convulse at the prospect of reduced global oil supply, pushing oil prices to levels well above \$100 per barrel. Global shipping, trade and supply-chain 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, adding to the upward pressure on yields. Countries that have relied on the US security umbrella such as Taiwan, Korea and Japan are compelled to quickly bolster their militaries.

Heightened uncertainty (see Figure 25) 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.

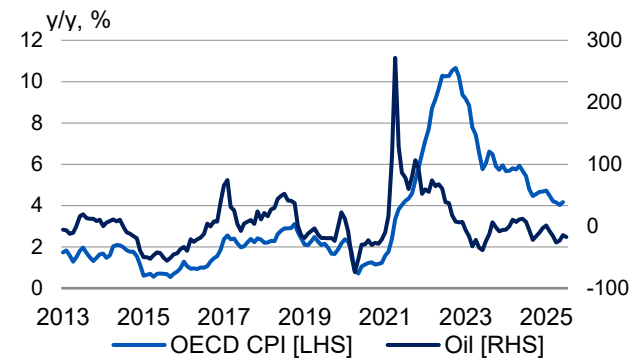
As such, the USD and other safe-haven currencies, such as the yen, strengthen, while emerging markets are put under pressure. In some cases, monetary policy is tightened despite the weaker activity backdrop and increased financial stress, which pushes down further on global growth.

#### Indicative economic shocks:

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

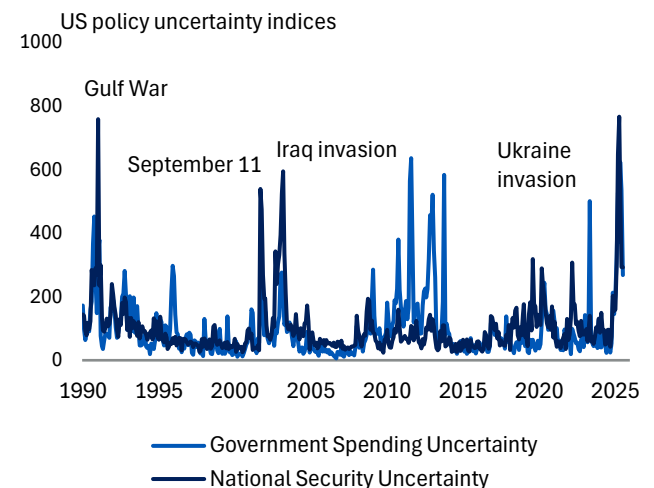
Price level is 1.5% higher.

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



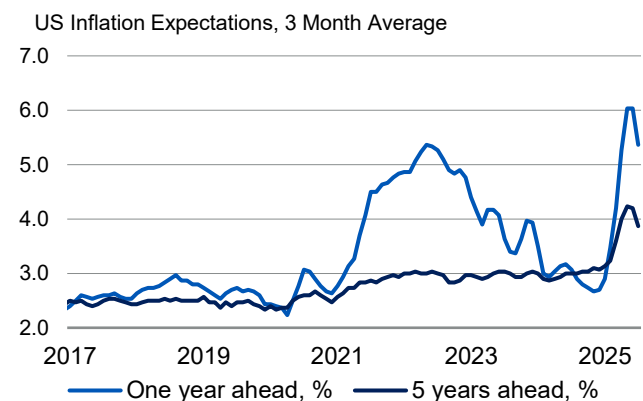
Source: Aberdeen, Haver, September 2025

**Figure 25: Conflict and fiscal spending uncertainty often spike at the same time**



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

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



Source: Aberdeen, Haver, September 2025

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