BEHIND THE HEADLINES

with **Ronald Temple**, Chief Market Strategist

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The Week Behind

1. **The Federal Open Market Committee (FOMC) held rates constant and highlighted a highly uncertain outlook with risks to the upside for inflation and unemployment and to the downside for growth.**

   The outlook: I expect no rate cuts from the FOMC in 2025, as increased tariffs translate to higher inflation that precludes the Federal Reserve from cutting rates even while GDP growth slows and unemployment increases. Over the last four years, the Fed indicated repeatedly that price stability is a precondition for achieving maximum employment, effectively prioritizing inflation over employment. As a result, I expect the FOMC to be constrained if inflation rises due to tariffs.

   In the last two months, the average US tariff on imports has increased from 2.7% to just over 9% with further increases likely on 2 April. Every 100 basis points (bps) of US tariff increases equates to about a 10-bps increase in core inflation. That implies that the tariffs already enacted should lead to over 60 bps of increased inflation later in 2025. Given that many companies front-loaded imports from China after the November 2024 election, the tariffs have not been evident yet in pricing (as companies deplete lower-cost inventories). However, I expect to see the inflationary impacts of tariffs beginning in Q2-25 with core Consumer Price Index (CPI) inflation exceeding 3.5% by year end.

   The details: The FOMC made no changes to rates but did announce that it would slow the run-off of Treasury holdings from $25 billion per month to $5 billion. The Summary of Economic Projections (SEP) still showed a median expectation for two rate cuts in 2025, but the array of forecasts shifted to be more hawkish with most participants expecting fewer cuts than they did at the last forecast in December 2024. GDP growth forecasts declined, while expectations for unemployment and inflation increased. When participants were asked to indicate if the risk of error was to the upside or the downside, almost all indicated that the risk to GDP is to the downside while the risk to unemployment and inflation is to the upside.

2. **US retail sales were weaker than expected at a headline level but better for the control group.**

   The outlook: I expect retail sales momentum to soften going forward as consumer anxiety regarding inflation and further tariff increases is likely to hit discretionary spending. This month's data were neutral, but it remains too early to see the ultimate impact of tariffs.

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The details: Headline retail sales were weaker than expected, and the prior month's results were revised downward. However, the control group, which excludes food services, gas stations, auto sales, and building materials was stronger than expected. Spending at restaurants stood out in the report for its weakness with a decline of 1.5%. Over the last three months, spending at restaurants has declined at an annualized rate of 8.5% which suggests to me that belt tightening by consumers is starting to affect one of the most discretionary parts of spending.

February US Retail Sales	Consensus	Actual	Prior Month	Revised
Retail Sales m-o-m	0.6%	0.2%	-0.9%	-1.2%
Retail Sales ex-Auto m-o-m	0.3%	0.3%	-0.4%	-0.6%
Retail Sales ex-Auto and Gas m-o-m	0.4%	0.5%	-0.5%	-0.8%
Retail Sales Control Group	0.4%	1.0%	-0.8%	-1.0%

Source: Bloomberg, U.S. Census Bureau

3. **China's year-to-date (YTD) economic data was more resilient than expected.**

The outlook: Data over recent months have been encouraging, but investors should be wary of getting too optimistic as industrial production has benefited from front-loading of exports to avoid tariffs. Given the still insufficient level of fiscal stimulus offered by the central government amid the ongoing real estate crisis in China, I expect sluggish growth through the first half. In the second half, I expect additional stimulus measures as the government strives to deliver 5% real GDP growth.

The details: Industrial production, fixed asset investment, and retail sales were higher than expected in the YTD period through February. (China does not report January and February data on an individual month basis due to Lunar New Year holiday distortions each year.) Property development metrics remained weak and underperformed expectations. New home starts declined 29.6% year-on-year (y-o-y) versus a decline of 23.0% in December. New home completions were down 15.6% in YTD February versus a decline of 30.5% in December. Real estate investment fell 9.8% in the YTD February period versus a decline of 13.5% in December. Given how large real estate development remains as a portion of total GDP, the ongoing property challenges combined with a building trade war with the United States suggest another weak year of GDP in China.

February China Economic Data		Consensus	Actual
Industrial Production	YTD y-o-y	5.3%	5.9%
Retail Sales	YTD y-o-y	3.8%	4.0%
Fixed Asset Investment	YTD y-o-y	3.2%	4.1%
Property Investment	YTD y-o-y	-8.9%	-9.8%
Residential Property Sales	YTD y-o-y	*	-0.4%
New Home Prices	m-o-m	*	-0.14%
Used Home Prices	m-o-m	*	-0.34%

Source: Bloomberg, National Bureau of Statistics
* No consensus estimate available on Bloomberg.

4. **The German Bundestag and Bundesrat passed legislation to reform the constitutional debt brake.**

   The outlook: I believe the passage of this constitutional reform could be a watershed moment not only for Germany, but also for Europe in total. Building a military-industrial complex in Europe will take time, but the benefits of these reforms could be felt within a few months as underutilized auto factories are converted to munitions production and as governments begin signing long-term procurement contracts for weapons produced in Europe. Longer-term, I would highlight the ancillary benefits of military spending such as technological innovation that can accelerate growth in the private sector. It is important to remember that some of the most important innovations in the United States were either directly or indirectly attributable to Pentagon spending, e.g., GPS navigation.

   The details: The German legislation could ultimately result in an additional €1 trillion of spending on defense and infrastructure over the next 12 years, while the European Commission's (EC) decision to allow use of the "escape clause" to increase defense spending could add hundreds of billions of euros to defense budgets outside of Germany. The German Constitutional Court is likely to review the constitutional changes, but it appears unlikely that the Court will object to the provisions.

5. **Japan's headline and core CPI inflation modestly exceeded expectations.**

   The outlook: Japan's headline inflation has been boosted lately by surging rice prices. Over time, rice supplies will recover to more normal levels which should lead rice prices lower. More importantly, core inflation (which in Japan excludes only fresh food) and core-core (which excludes food and energy) are likely to be sustained as higher wage growth translates to higher prices. I continue to believe Japan is in a multi-year normalization process that when combined with stronger corporate governance standards and a more shareholder-friendly takeover code should lead to positive equity market results.

The details: Rice prices rose 81% y-o-y and 10% month-on-month (m-o-m) contributing to the upside headline CPI surprise. Private sector services inflation, a focus area for the Bank of Japan (BoJ) remained over 2%. Electricity and gas price control measures were reimposed in February which lowered energy inflation to 6.9% y-o-y in February from 10.8% in January.

Japan February CPI	Consensus	Actual	Prior Reading
Headline y-o-y	3.5%	3.7%	4.0%
CPI y-o-y ex-fresh food (core)	2.9%	3.0%	3.2%
CPI y-o-y ex-fresh food and energy (core-core)	2.6%	2.6%	2.5%

Source: Bloomberg, Japan Ministry of Internal Affairs and Communications

6. **The BoJ held policy constant as expected with BoJ Governor Kazuo Ueda indicating prices and wages are progressing as expected.**

   The outlook: The BoJ remains on a path toward normalizing interest rates. However, there is no urgency to raise rates as the BoJ is eager to avoid snatching defeat from the jaws of victory after over two decades of deflationary pressures. I expect one additional 25-bps rate hike by year end.

   The details: The BoJ decision was unanimous to keep rates on hold. In the press conference after the meeting, Ueda indicated that the early readings on the *shunto* wage negotiations have been in the range of BoJ expectations but slightly on the high side within that range. He also indicated that the BoJ does not think it is appropriate or necessary to raise interest rates to address rice inflation. Unsurprisingly, the BoJ will be watching US trade actions, especially the likely imposition of tariffs on 2 April on auto imports, to see how these decisions might affect Japanese inflation and growth going forward. Finally, Ueda indicated that the rise in long-term Japanese Government Bond (JGB) yields is to be expected given global bond market developments and the normalization of monetary policy in Japan. As a result, the BoJ sees no need to intervene in the JGB market to try to cap interest rates.

7. **The Bank of England (BoE) held rates constant and maintained guidance for a "gradual and careful approach" to policy easing.**

   The outlook: Markets are forecasting two 25-bps BoE rate cuts by year end, but I suspect the BoE will ultimately deliver more than two cuts as the US trade war escalates and slows global growth. On top of global trade policy volatility, the United Kingdom is also likely to face moderate fiscal tightening when the government releases the Spring Statement next week. Any meaningful reduction in government spending could add impetus for BoE easing.

The details: Eight BoE members voted to hold policy constant while one, Swati Dhingra, voted to ease by 25 bps. In February, Dhingra and Catherine Mann had both voted to ease by 50 bps, so it was surprising to see Mann shift to a hold vote in this meeting. Between now and the 8 May BoE Monetary Policy Committee meeting, there will be two more UK inflation reports that could tip the balance in favor of earlier rate cuts. Markets currently ascribe a 65% probability of a 25-bps cut in May with an 83% chance of one rate cut through the 19 June meeting.

The Week Ahead

1. **Purchasing Managers' Index (PMI) data will be released for key developed economies.**

   The outlook: I will be watching for signs of decreasing US activity driven by trade policy volatility while it remains too early to see meaningful benefits resulting from the European fiscal inflection.

March Preliminary PMI Data

Release Date	Country	Index	Consensus	Prior Month
3/23/2025	Japan	Manufacturing	*	49.0
	Jibun Bank	Services	*	53.7
		Composite	*	52.0
3/24/2025	Eurozone	Manufacturing	48.2	47.6
	HCOB	Services	51.1	50.6
		Composite	50.7	50.2
3/24/2025	France	Manufacturing	46.1	45.8
	HCOB	Services	46.2	45.3
		Composite	46.1	45.1
3/24/2025	Germany	Manufacturing	47.0	46.5
	HCOB	Services	52.0	51.1
		Composite	51.1	50.4
3/24/2025	UK	Manufacturing	47.2	46.9
	S&P Global/	Services	51.0	51.0
	CIPS	Composite	50.5	50.5
3/24/2025	US	Manufacturing	51.5	52.7
	S&P Global	Services	50.9	51.0
		Composite	*	51.6

Source: Bloomberg, S&P Global

* No consensus estimate available on Bloomberg.

2. **US Personal Consumption Expenditure (PCE) inflation is expected to be stable versus January.**

   The outlook: The consensus expectation is for a headline increase of 0.3% m-o-m and 2.5% y-o-y while core PCE inflation is expected to rise 0.3% m-o-m and 2.7% y-o-y. Each of these figures is expected to be unchanged versus January except for the core y-o-y increase which was 2.6% in January. As a reminder, the key drivers of PCE are largely known from the CPI and Producer Price Index (PPI) releases, so material surprises are unlikely.

   Personal income is expected to have increased by 0.4% m-o-m in February (versus 0.9% in January) while personal spending is expected to have risen by 0.5% (versus -0.2% in January).

3. **Preliminary inflation readings for France and Spain will be released.**

   The outlook: The Harmonized Index of Consumer Prices (HICP) for France is expected to have increased by 1.1% y-o-y in March versus 0.9% in February while HICP in Spain is expected to decelerate to 2.6% y-o-y from 2.9% in February. Inflation figures for Germany and Italy will be released on 31 March and the Eurozone on 1 April.

   I expect the downward trajectory of prices to be sustained through 2025 in the Eurozone. The ongoing deceleration of inflation combined with the negative effects of tariffs imposed by the United States against European exports are likely to lead the European Central Bank (ECB) to cut rates more aggressively than is currently expected by markets. Swap markets currently anticipate 50 bps of ECB rate cuts by year end. I am out of consensus in expecting 75 bps of easing based on my conviction that US tariffs negatively impact the European economy well before the benefits of much looser fiscal policies are realized. Hence, I expect easier ECB policy in response to trade headwinds while markets appear to be focusing more on accelerating growth from 2026 driven by fiscal policies.

4. **UK CPI inflation is expected to subside modestly on a y-o-y basis.**

   The outlook: The consensus is for headline, core, and services inflation to decelerate in the United Kingdom in February from January on a y-o-y basis. For the BoE, services inflation will be important, as it continues to run far above levels consistent with sustained 2% core CPI.

UK February CPI

	Consensus	Prior Reading
Headline m-o-m	0.5%	-0.1%
Headline y-o-y	2.9%	3.0%
Core y-o-y	3.6%	3.7%
Services y-o-y	4.9%	5.0%

Source: Bloomberg, UK Office for National Statistics

5. **UK retail sales are expected to fall on a m-o-m basis and decelerate on a y-o-y basis.**

   The outlook: After a very strong January report, retail sales are expected to decline sequentially in February. Private sector data such as the British Retail Consortium (BRC)-KPMG Retail Sales Monitor add weight to the expectations for a significant decline in sales momentum with the y-o-y increase in sales falling to 0.9% from 2.5% in January. Given the stagnant economic backdrop in the United Kingdom and ongoing cost-of-living pressure for UK consumers, weaker sales should be expected.

February UK Retail Sales	Consensus	Prior Month
Retail Sales including Auto Fuel m-o-m	-0.5%	2.1%
Retail Sales including Auto Fuel y-o-y	0.4%	1.2%
Retail Sales excluding Auto Fuel m-o-m	-0.4%	1.7%
Retail Sales excluding Auto Fuel y-o-y	0.6%	1.0%

Source: Bloomberg, UK Office for National Statistics

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