Article | 8 May 2025

The world is caught like a deer in the headlights

Markets have calmed, but don't be mistaken; we are far from being back to normal. There's a sense that the world is caught like a deer in the headlights, not sure what to do and terrified of what might be about to hit it

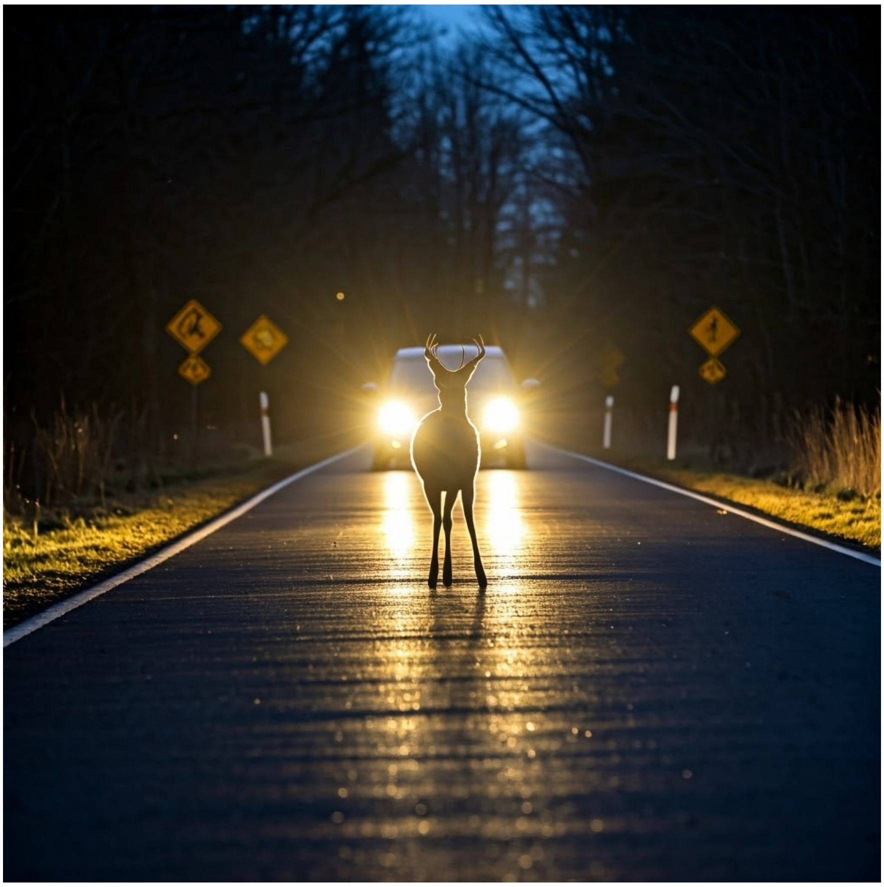

Image generated by AI

Prepare for more economic shocks

After the tariff blast in April, followed by market turmoil and even doubts about the Fed's independence, the start of May has looked like the famous calm after the storm. Some might be tempted to think that the challenges to the global economy have mostly evaporated. I have my doubts.

Let's not forget that despite the back-and-forth on tariffs, the level of actually imposed tariffs is still significantly higher than at the start of the year. The war in Ukraine drags on, and uncertainty is still high, not least about the rule of law and stability of public institutions in the US.

The next few weeks might bring further relief, but I wouldn't count on it. Following the wish-for-the-best-but-expect-the-worst principle, we should prepare for more negative macro news when the direct impact of the April tariff blast shows up in the data. Our base case scenario remains that the current trade tensions will be a supply shock in the US and a demand shock in the eurozone.

Oil is a mitigating factor

Another global economic shock that should be a mitigating factor is the sharp drop in oil prices. Unless you export the stuff, cheaper oil should bring some tailwinds for the global economy. It probably won't be enough to fully offset the tariff-driven inflation surge in the US, but it could help compensate for the adverse effect on eurozone growth and will definitely add to the current disinflationary trend.

In the eurozone and eventually in the US, that may well give both the ECB and the Fed more room to cut interest rates. While lower energy prices and monetary policy could at least partially mitigate the expected negative impact and uncertainty tariffs bring, the longer-term course will still be determined by (geo-)politics.

I won't speculate here about the next steps of the US administration, but will focus on Europe. Recent developments have unfortunately dented previous optimism that the continent will finally seize the opportunity to live up to the new geopolitical challenges by strengthening the domestic economy, instead of waiting like a deer caught in the headlights.

The fact that there is talk that some European countries will try to reach the higher defence spending targets by simply reclassifying spending categories is more than worrisome.

The political drama staged in Berlin on Tuesday, with Friedrich Merz's more than clumsy start as the next German chancellor, was another illustration that the sense of urgency is still not high enough everywhere.

In a weak moment this week, I caught myself secretly hoping that the current calm after the storm is actually the calm before the storm. If this is the pressure needed for Europe to finally go bold and not only talk the talk, so be it.

Our key calls at a glance

US 10% baseline tariffs set to remain in place throughout President Trump's term**.** Reciprocal tariffs – currently delayed for 90 days – are likely to be reduced/eliminated for some US trading partners, though in many cases not until after 9 July (when the pause ends).

US economic growth is set to rebound in the second quarter, given signs that imports are falling rapidly. Noise aside, weaker confidence data suggests we're likely to see a sharp slowdown in the second half of the year. Tax cuts are unlikely to move the needle for US growth this year.

Federal Reserve to keep rates on hold until July at the earliest. Until activity data starts to weaken, the Fed will remain focused on the risks to inflation. The Fed may wait until September before cutting rates further, though if it waits until then, the first cut could be a larger 50bp move.

Eurozone growth is set to stagnate from the second quarter, though a drop in energy prices should help offset the negative impact of the trade war. The German infrastructure package is also a strong tailwind, though its impact probably won't be felt until 2026.

European Central Bank set to cut rates twice more, taking the deposit rate to 1.75%. Lower energy prices and a stronger euro add to disinflationary pressures in the eurozone, enabling the ECB to ease rates further.

Further monetary easing from the People's Bank of China is likely. We anticipate another 20bp of rate cuts and 50bp of RRR cuts this year, with the next move likely to come after the US Federal Reserve resumes its rate cuts.

We expect EUR/USD to trade in a 1.12-1.15 range in the near term. A dovish ECB and a soft eurozone growth story limit the upside.

We expect the US 10-year yield to fall to 3.90% by the end of the second quarter, as the economic data deteriorates; however, the 'Sell America Inc' risk could return in the second half of the year, bolstered by rising inflation and ongoing deficit elevation.

Author

Carsten Brzeski
Global Head of Macro
carsten.brzeski@ing.de