Economic and Inflation Outlook

July 2025

As we write this in July 2025 there are many similarities with the backdrop three months ago when we penned our last outlook. At that point in early April markets were faced with a fluid and uncertain environment as US President Trump announced huge tariffs on imports, before subsequently rowing back somewhat with a temporary suspension of all tariffs above the 10% base line for 90 days. With the 90-day period coming to an end and the hope that more trade deals can be concluded, the US administration has issued a new deadline of 1st August. Accordingly, the situation remains much the same today, there is considerable uncertainty around tariffs and the implications for trade, growth and inflation. In contrast, the troubling deterioration in fiscal rectitude in many developed world economies continues unabated, most notably in the US.

Over the second quarter markets have also grappled with rising levels of geopolitical risk as Israel and the US bombed Iranian nuclear facilities, and other conflicts rumbled on. Israel is still struggling to find an exit from Gaza; India and Pakistan traded blows across the Line of Control between the two countries; and the Russia-Ukraine conflict continues despite the efforts of the US to arrange a ceasefire. Against this volatile backdrop the most recent NATO meeting in June saw nearly all member countries agree to increase defence spending to 5% of GDP, a decision with potentially significant implications for government finances, growth and inflation going forward.

Despite the unsettled background, risk assets have performed well over the quarter, with equity markets recovering quickly from an early April sell-off. Nonetheless we can observe from market shifts that the re-evaluation of "US Exceptionalism" continues to be an underlying theme. Nowhere is this more evident than in the depreciation of the US dollar over the past quarter, and indeed over the first half of 2025. With the Dollar Index (DXY) down almost 11% in the six months to end June, this makes the period the worst first half of a calendar year for the currency since 1973[1]. Although it was a good quarter for equities, global bond markets also generated positive returns over the quarter with the FTSE World Government Bond Index rising 4.6% in US dollar terms. This was clearly at least in part driven by the aforementioned weakness in the Dollar, but even in USD-hedged terms the return on global government debt was positive despite some nervous rumblings over recent months around the trajectory of government debt in a number of major developed economies. Local currency emerging market bonds continued to perform strongly over the quarter, rising by 7.6%, outperforming their developed world counterparts. Colchester has argued for some time that valuations in this sector have been particularly attractive, and year to date local currency emerging market debt is up an impressive 12.3% in US dollar terms.

Although headline making events often create immediate price impacts on financial markets, in most instances this impact fades relatively quickly. At Colchester, whilst diligently following events and monitoring their impact on markets, our investment decisions are influenced only by what their potential impact (if any) will be on medium term inflation and how such events may affect the financial stability of the countries involved. Towards that end our focus has been on (i) the potential inflationary consequences of the various military conflicts, most notably via changes in oil and other commodity prices, (ii) the impact of the US tariff policy on inflation and growth, and (iii) the balance sheet implications of increased defence spending and fiscal largesse around the world.

(i) Middle East Conflicts put focus on the Oil Price

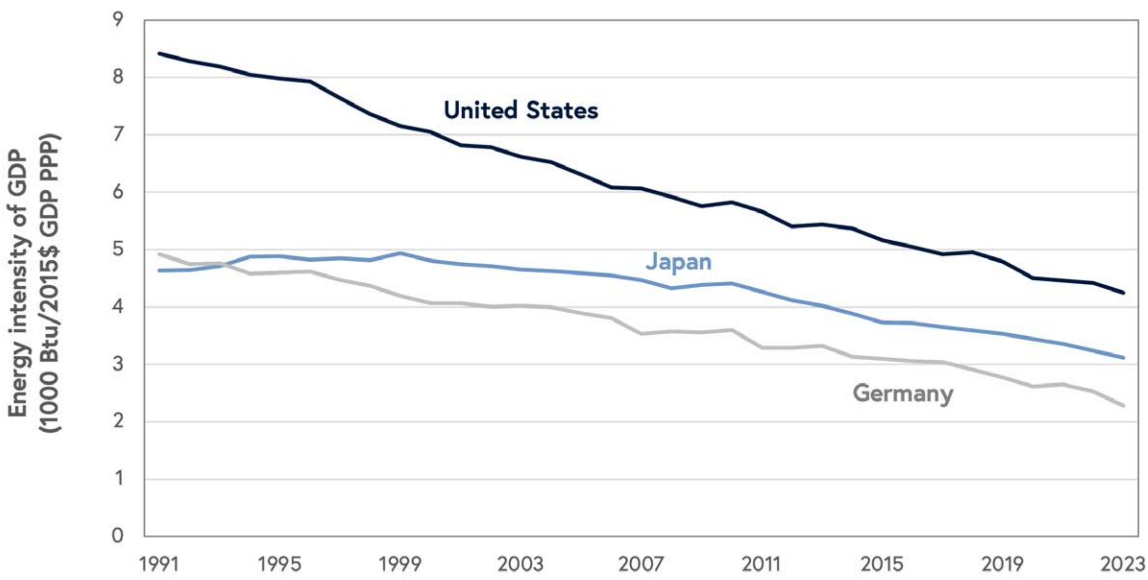
Recent events in the Middle East have renewed focus on the price of oil, a key variable for the global economy and in particular for inflation. Following Israel's airstrikes on Iranian nuclear facilities in mid-June, Brent crude prices surged over 11% to reach $78 per barrel. This spike was driven by fears of potential disruptions to oil supplies, particularly through the Strait of Hormuz, a critical passage for global oil transit. Approximately 60-70% of all global oil trade is transported by sea, and of that, 20-30% passes through the Strait of Hormuz. By late June however, tensions between Israel and Iran had eased, and the feared scenario of Iran blocking the Strait of Hormuz did not materialize. As a result, oil prices swiftly retreated back to pre-conflict levels of around $67 per barrel.

[1] Source: Bloomberg, Colchester Global Investors.

Oil price shocks can have significant macroeconomic consequences. On the one hand, higher oil prices translate into higher prices and therefore inflation; on the other, they act as a drag on economic activity. This dynamic was starkly evident in the 1970s, when two oil crises triggered global recessions and soaring inflation. Oil affects inflation through direct and indirect channels: directly, through higher fuel and energy prices feeding into consumer price baskets; and indirectly, by raising firms' transportation, input and production costs which may then be passed onto final consumer prices.

Importantly, today's global economy is far less oil-intensive than it was in the 1970s. Significant productive efficiencies have been achieved and the shift from industry-based to service-oriented economies has reduced oil's role in consumption and production in a number of developed world economies. Take the United States as an example: in the 1970s, it was heavily dependent on imported oil, making it vulnerable to oil shocks that triggered double-digit inflation and multiple recessions (monetary policy responses also had a hand in this). Since the shale revolution of the 2010s however, the U.S. has become a major producer and net exporter of petroleum, helping to insulate its economy from oil price spikes. Meanwhile, countries like Germany and Japan – still largely dependent on oil imports – have taken steps to diversify their energy mix. Germany now generates a significant share of its electricity from renewables and has reduced oil intensity in its industrial sector. Japan has expanded its use of solar power and liquefied natural gas (LNG) to reduce reliance on oil.

Chart 1. Energy Intensity of GDP has declined



Source: U.S. Energy Information Agency (EIA). Data as of end 2023.

Nonetheless, oil remains an important inflation driver, even if it no longer wields the disruptive force it once did in the 1970s. Structural shifts toward service-based economies, diversified energy sources, and improved macroeconomic management – particularly in developed economies – have strengthened resilience to oil price shocks. A broad IMF study[2] investigating the impact of global oil price movements on domestic inflation since the 1970s finds a 10% oil price shock adds approximately 0.4pp to inflation on average, with the impact diminishing after 2 years. However, the magnitude of this pass-through varies widely across countries. Economies with a high fuel share in consumption experience larger inflation impacts, while those more service-oriented see milder effects. Other factors include whether the country is a net importer or exporter of oil, its structural reliance on energy, and its policy response.

[2] IMF Working Paper WP/17/196 (2017), Oil Prices and Inflation Dynamics: Evidence from Advanced and Developing Economies.

The post-COVID oil shock serves as a good illustration of the differences in inflation outcomes across countries. In advanced economies, oil price pass-through to headline inflation was significant, but core inflation remained relatively contained. For example, in the United States, gasoline prices surged by over 50% in mid-2022, pushing headline CPI above 9%. However, core inflation rose more moderately, anchored by monetary tightening and less reliance on oil in services-led sectors. In contrast, European countries, highly dependent on imported fossil fuels (especially natural gas from Russia), experienced a surge in both oil and gas prices that fed directly into household energy and transportation costs. In the Euro Area, headline inflation peaked at 10.6% in October 2022, with energy inflation exceeding 40% year-on-year at its peak. Countries like Germany, despite progress in renewable energy, saw record inflation due to sharp increases in gas and electricity prices. However, core inflation remained more moderate – around 5% – as governments implemented energy subsidies, price caps and used windfall taxes to cushion households and businesses. These measures helped limit second-round effects, although core inflation did rise gradually as cost pressures spread into food and services.

Across emerging markets, the inflationary impact of the post-COVID oil price shock was more pronounced in countries with high fuel weights in CPI baskets and weaker monetary frameworks. In Brazil, headline inflation exceeded 12% in 2022, with core inflation also rising above 10%. Although Brazil is an oil producer it imports refined fuels, making domestic prices sensitive to international markets. Moreover, unlike some of its peers, Brazil did not introduce universal fuel subsidies or cap prices, allowing for more direct pass-through. The central bank responded with aggressive rate hikes, which helped bring inflation back to single digits by early 2023.

Macroeconomic frameworks have also played a crucial role in reducing the impact of oil price shocks. Countries with a stronger commitment by their central banks to maintaining a low and stable rate of inflation, better conduct of monetary policy and inflation targeting policies, have tended to fare better in response to unexpected inflation shocks, such as an oil price shock. Furthermore, many countries now have strategic petroleum reserves and coordinated emergency response mechanisms to mitigate short-term supply disruptions. Energy subsidies in some countries are also being used to help dampen the pass-through of global oil price increases to domestic inflation.

And Potentially Impacting on Supply Chains

As alluded to above, there are a number of simmering global conflicts which have varying potential to impact on financial markets and economic activity. One such situation which warrants monitoring closely is the threat to shipping transiting the Red Sea given its potential to impact global supply chains and disrupt inflation. Houthi rebels in Yemen have recommenced attacks on commercial ships despite a ceasefire agreement with the US agreed in May. Many ship operators have already deserted the Suez Canal route between Asia and Europe, and instead take the far longer journey around the Cape of Good Hope. The longer distance increases costs. Similarly, for operators which continue to use the Suez Canal/Red Sea route insurance costs have surged again in early July following attacks on two vessels in recent days. Should longer shipping times and higher insurance costs become more permanent, then this is likely to underpin higher inflation going forward.

(ii) Trade and Tariff Uncertainty continues

President Trump first announced "reciprocal" tariffs on April 2nd, only to pause them on non-retaliating countries a week later after equity markets had dropped precipitously and long-end US Treasury yields spiked higher. Trade tensions with China persisted into May with the US announcing escalating tariff rates up to 145% on imports from China before an agreement was reached with the US rate falling to 30%.

With the bulk of the "reciprocal" tariffs paused, and a deadline of August 1st for most countries to reach a deal with the US to prevent a tariff hike, the exact shape of the new global trading landscape remains uncertain. The pattern of dramatic and unconventional pronouncements from the President has continued as Trump announced a new tariff of 50% on copper imports in early July. He also threatened 35% tariffs on imports from Canada, 50% on imports from Brazil, and said he was considering a 200% levy on pharmaceuticals.

As we have stated previously, our primary concern with respect to trade tariffs is their potential impact on inflation. Whilst the magnitude, breadth and duration of tariffs remains uncertain it is difficult to be precise about the inflationary consequences, but we maintain our view expressed three months ago that US inflation is likely to increase, whilst the impact on inflation in other economies will vary, and in some instances could be disinflationary. Thus far, there has been little evidence of tariff impacts on US inflation, although it is still early days. In June the year-over-year increase in the CPI stood at 2.7%, only slightly above the level prevailing in March prior to the reciprocal tariff announcements. However, there are delays between the tariffs being announced and their implementation, and a further lag between when importers pay them and consumers are impacted by them. This concern around the potential future impact of tariffs on US inflation would appear to be one of the reasons for the cautious approach taken by the Federal Reserve in holding rates unchanged since late last year.

Complicating the outlook further, the price rises caused by the tariffs are going to act like a tax on consumers and a negative income shock reducing demand and therefore economic growth. Whilst this may ultimately impart a disinflationary force, other secondary impacts such as the disruption of supply chains, non-tariff barriers such as the limits placed on rare earths, the potential impact on inflation expectations and subsequent wage setting process, are all likely to be inflationary. The final impact on inflation will be a complex function of all these factors and will take time to play out.

Even though the greatest inflationary impact of the US tariff policy is likely to be felt in the US, it is having global repercussions. For one thing we have observed in recent data the extent to which companies sought to avoid upcoming tariffs by bringing forward imports into the US in the first quarter. One of the more remarkable effects of this was seen in GDP data for Ireland which showed the economy expanding by 7.4% quarter-on-quarter in the first three months of this year. Goods exports increased by 18.3%[3] compared to the final quarter of 2024, with this astonishing growth attributed to a surge in pharmaceutical exports to the US.

The most consequential of all the trade negotiations under way between the US and its global trading partners is undoubtably that with China. While the Chinese economy is struggling with a number of structural challenges – whether that is overcapacity and deflationary pressures, or stagnant consumption – that's not to say China doesn't have significant leverage in these negotiations. This was demonstrated in the restrictions they placed on rare earth exports. China dominates these markets[4], most notably for "processed" rare earths. It seems that most western companies did not have sufficient stockpiles and were caught short on alternative sources, resulting in a dislocation in production and disruption in supply chains, not dissimilar to what occurred during the "Covid shock". The term "rare earth" is something of a misnomer as they are not particularly rare, instead they tend to be widely spread but only in trace amounts making commercial mining and processing difficult. Processing, rather than possession, is where China currently dominates.

An example of this is neodymium, which is a rare earth metal that is mined in the United States and Australia, with untapped reserves in countries like Brazil and Vietnam, but by far the largest production occurs in China. Neodymium is an essential component in powerful permanent magnets that are used in electric motors, wind turbines, consumer electronics, and military technology. Now that exports have been curtailed by the Chinese it is starting to cause shortages that are impacting the companies who depend on the metal. There appears to be no quick fix to this problem unless the Chinese are happy to start boosting supplies again.

[3] Source: Irish Central Statistics Office (cso.ie).

[4] See page 20 of the Colchester Sustainability Report December 2022 - https://colchesterglobal.com/wp-content/uploads/colchester-sustainability-report-dec-22.pdf

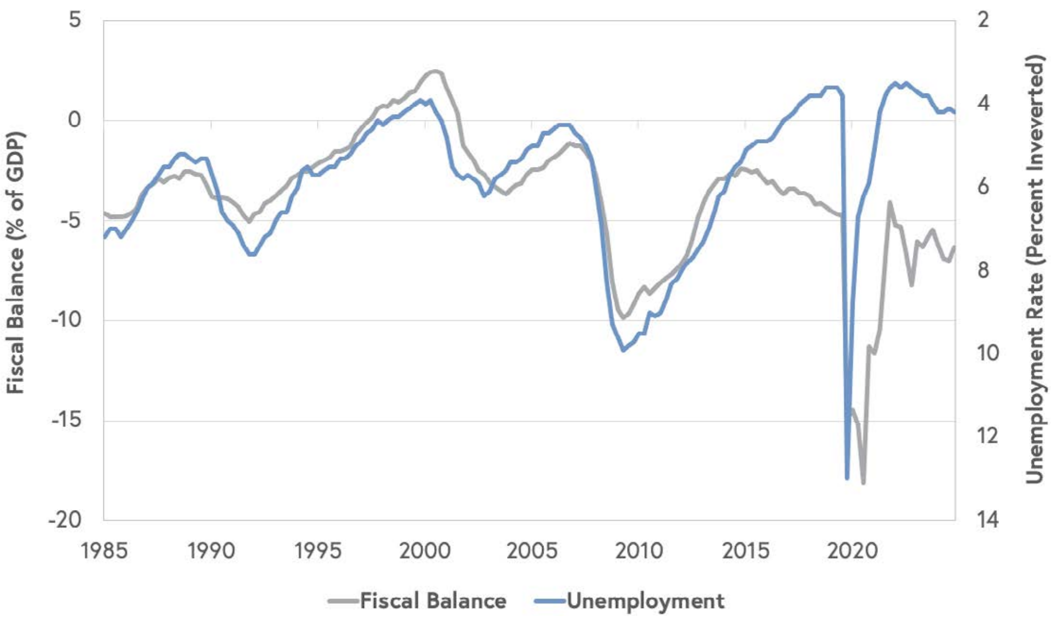
Setting up new mining and processing facilities, although not massively complicated, does take time and is costly. If work was to start on a new plant today it could still be a number of years before it would come online, whilst demand for the product is growing. By restricting rare earths China is not only increasing the price of these products, but it is also destabilising supply chains, adding both friction to the manufacturing process and potentially increasing prices for the end consumer.

(iii) Creaking Sovereign Balance Sheets

The Global Financial Stability Report published by the IMF recently identified a number of vulnerabilities in the current economic and financial landscape, with one of them being the possibility of further turbulence in sovereign bond markets, especially in jurisdictions where debt levels are high. Investor concerns around public debt sustainability have bubbled up on a handful of occasions recently, most consequently perhaps in the US in April. Many analysts have concluded that it was the turmoil in US Treasury markets which led President Trump to back down and pause some of the most aggressive tariffs at that point. The UK gilt market has also experienced bouts of volatility recently, suggesting an underlying fragility caused by concerns around the level of public debt, and the political will to reduce deficits.

The specifics of the "One Big Beautiful Bill Act" and the watering down of the UK government's welfare reforms in July are perhaps less important than the conclusion that developed country governments are either unwilling or unable to meaningfully tackle unsustainable fiscal deficits. This has potential balance sheet and inflation implications, the former via upward pressure on the risk-free interest rate level (in other words what the government has to pay to borrow more debt) and the latter, via higher nominal activity than would otherwise have been the case and increased pressures on resources.

Chart 2: US Fiscal Deficit and Unemployment Rate



Source: Bureau of Labor Statistics, Bloomberg. Quarterly Data from Q2 1985 to Q1 2025

Within our investment framework, Colchester looks at the "Financial Stability" of each country we invest in. A part of that is assessing the trajectory of public debt and a key variable in that assessment is the cost of servicing debt i.e. the interest rate a government pays to borrow. With interest rates now back to more "normal" levels and unlikely to return to zero in any of the major economies, this is putting a strain on government financing. According to the Peterson Institute, in the US for example, federal interest payments as a percent of federal revenues are likely to be 18.4% by the end of 2025, exceeding the previous high set in 1991[5]. Fiscal pressures in the US and elsewhere appear to be growing.

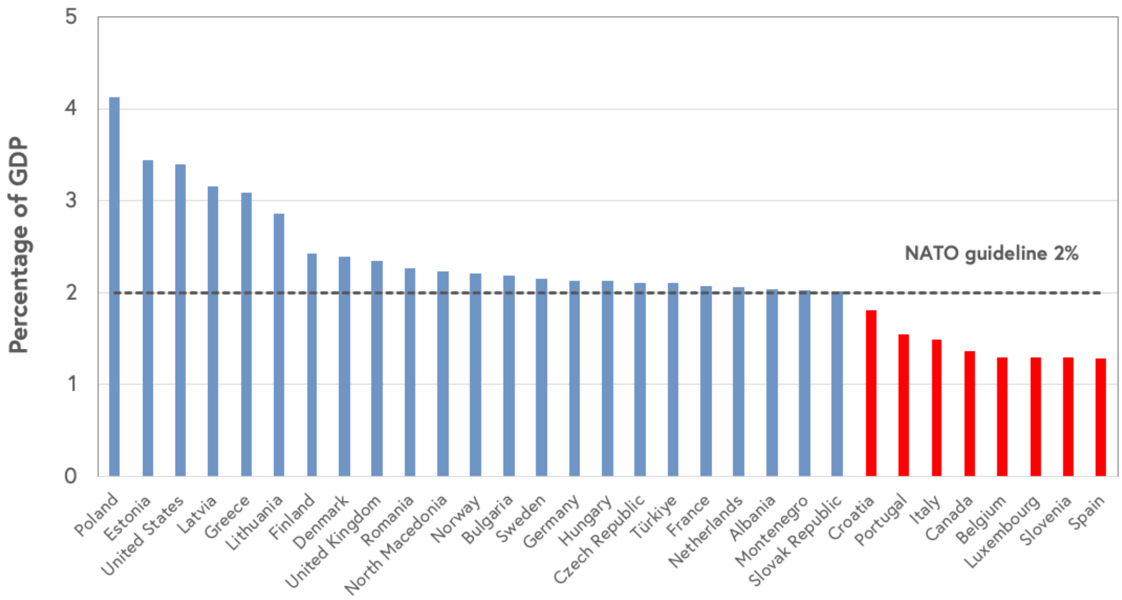
[5] Peterson Institute, "Interest Costs on the National Debt" (2025). https://www.pgpf.org/programs-and-projects/fiscal-policy/monthly-interest-tracker-national-debt/

Defence Spending to add to Fiscal Pressures

Heightened geopolitical uncertainty and the resultant demand for increased defence spending is also putting greater pressure on government spending and debt levels. Last month in June 2025 heads of state and governments of NATO nations assembled in The Hague for the NATO Summit. A new commitment was agreed to spend 5% of GDP on defence by 2035[6]. This new pledge includes spending 3.5% on defence items including weapons and troops and 1.5% on defence related items such as cybersecurity, infrastructure, innovation and resiliency measures. This is in stark contrast to historical commitments of 2% of GDP on defence spending. The commitment made by NATO allies has significant implications, including increased defence readiness and enhanced security and stability for NATO. It involves modernising military equipment and technology, addressing existing gaps, and stimulating economic growth and job creation in related industries through financial investment in the defence sector. Additionally, it strengthens the NATO alliance through collective effort and political cohesiveness.

Since the time of Russia's invasion of Ukraine, NATO allies have planned increases in defence spending. In 2021 just six member states met the 2% of GDP commitment. At that time, some countries faced economic challenges that limited their ability to allocate more funds to defence as health care and social challenges were addressed after the Covid-19 pandemic. By 2024, the number of NATO countries spending 2% of GDP or more on defence had increased to 23 with Poland estimated to have spent 4.1% of GDP on defence in 2024. That being said, there are still eight countries, Spain, Slovenia, Luxembourg, Belgium, Canada, Italy, Portugal and Croatia falling behind the current 2% target, with some already announcing they will be unable to commit to the new 5% target.

Chart 3. Defence Spending in NATO Countries



Source: NATO. June 2024

Besides the political considerations of this issue, for sovereign bond investors the economic and fiscal implications are key and will vary across sovereigns. Deficits are likely to increase (unless offsetting spending cuts are made in other areas or taxes/revenue collection increased, but how politically acceptable is that in the current environment?), and so public debt levels may increase, although in theory this will depend on the extent to which greater public spending boosts growth. Starting points vary significantly amongst the major developed markets, with a significant number of them starting from a vulnerable point of high debt and/or large deficits (not least Italy, France and the United States). Germany is something of an exception of course and has the advantage of significant "fiscal space" after years of tight fiscal policy.

[6] The US is estimated to have spent approximately 3.4% of GDP on defence in 2024.

The recently announced German budget includes new investments aimed at reviving the economy and building up the military as the government plans to take on record debt, with borrowing expected to reach EUR 847 billion over the legislative period to reach the NATO target by 2029. This equates to an enormous fiscal stimulus, as spending is expected to increase the deficit to 3% of GDP in 2025 and 4% of GDP in 2026. This front-loading has the potential for an acceleration in real GDP growth in 2025, moving from an expected small contraction of -0.1% to positive 0.5% before accelerating further to close to 2% in 2026. The impact on growth is impressive, and investment in infrastructure has the potential for a positive multiplier effect. On the other hand, the sharp increase in demand may come at a cost of increased inflation. The spending boost has the potential to push Germany, and Europe more broadly, onto a higher growth trajectory and may be a game changer for the continent.

Portfolio Positioning

The volatile nature of the market over the last quarter and the shifting global economic backdrop translated into a number of portfolio changes across our key investment programmes. The upward adjustment in our inflation forecast for the US as a result of tariffs reduced the relative attractiveness of US Treasuries compared to other global bond markets. As a consequence, the global bond programme reduced exposure to US Treasuries and increased its overweight position in Australia, New Zealand and Indonesia, all economies where the inflation outlook remains stable. Inflation in Singapore has been extremely low, running below 1% on recent prints, and the government bond market in the country has rallied strongly. This reduced the prospective real yield we estimate on offer there and as a result we sold down our exposure in the global bond programme. We also reduced exposure to Colombian bonds, as they too rallied despite some negative headlines. The proceeds were invested in Poland which offers attractive value, the UK where we have reduced our underweight position, and in the long end of the yield curve in Japan. Although we remain underweight the Japanese government bond market, thirty-year yields there reached their highest level in over 25 years, at over 3%. This brought yields in Japan close to parity with equivalent 30-year bonds in Germany. Given the steeper yield curve on offer in Japan, and changed fiscal policy in Germany discussed above, this resulted in a meaningful relative valuation shift in favour of Japan that we have taken advantage of.

In the inflation linked bond portfolios we sold a little of our US TIPS position and reduced the overweight in Mexico to add to our positions in Australia and Poland, also reducing our underweight in the UK.

In the emerging market programme, we reduced our overweight in Colombia and Türkiye whilst adding to Poland and Peru.

The most dramatic market movements over the year to-date have been on the currency markets where the US dollar has fallen sharply. This has provided a tailwind to our global bond programme which held a sizeable underweight to the US dollar at the beginning of this year. As the second quarter progressed and the Dollar continued to weaken the rationale for reducing the scale of the position began to grow, prompting a rebalancing in the risk return of the overall portfolio. Consequently, in May we trimmed the underweight in the US dollar by around one third, reducing exposures to currencies which had appreciated such as the Japanese yen, Norwegian krone, and the Swedish krona. We still maintain broadly similar positions directionally, but the sizing has been reduced in line with the shift in valuations.

In the emerging market programme, we trimmed exposure to the Turkish lira, reduced exposure to the South African rand and Colombian peso, and closed out our position in the Egyptian pound. More value is starting to emerge in some of the Asian currencies, so we added to the Indonesian rupiah and Chinese renminbi exposure.

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