Global Macro Views

TARIFFS COULD MEAN EURO AREA DISINFLATION

INVESTMENT VIEWS
FROM THE BNY INVESTMENT INSTITUTE

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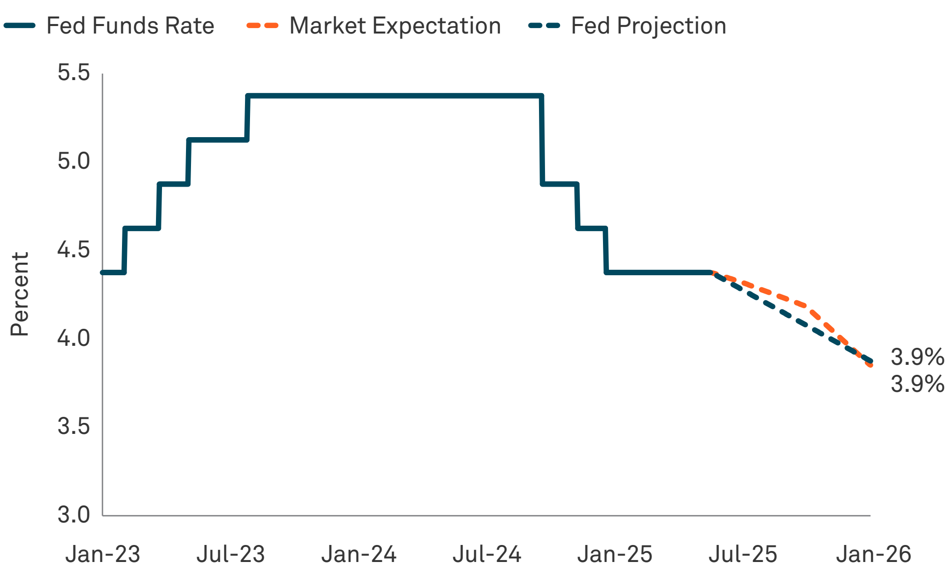
The BNY Investment Institute has upgraded their view on government bonds to slightly favorable from neutral and downgraded their view on cash to neutral. Expectations that growth in Europe may cool and inflation may fall because of US tariffs could lead to support from the European Central Bank (ECB), translating to our relative preference now for international sovereign debt.

1. Euro area growth may be cooling, and inflation falling, leading to ECB support.
2. U.S. inflation is expected to remain elevated, suggesting the U.S. Federal Reserve (the Fed) may keep rates steady.
3. We expect global central banks such as the ECB to ease more significantly than the Fed. This may lead to relatively lower yields among international sovereign debt, translating to greater capital appreciation.

Tariff Shock Changed the U.S. Outlook

FED PROJECTIONS VS. MARKET



Source: BNY Investment Institute as of May 20, 2025. Projections based on latest Summary of Economic Projections (SEP). Chart is for illustrative purposes only. **Past performance does not guarantee future performance.**

On April 2, the U.S. announced broad tariffs that hit global markets hard. U.S. stocks dropped over 12% in a few days, and bond yields surged. Even though some tariffs have been reduced, trade tensions remain high, especially with China.

Our base case is 'slowdown,' with 'stagnation' (slow growth coupled with sticky inflation) now at a 30% probability.

As a result, we expect the Fed to stay on hold or cut rates a maximum of one time this year.

Trade war history lessons

Meanwhile, Europe may face disinflation. The last major episode of elevated tariffs occurred in 2018, when the effective U.S. tariff rate on China was around 18%. This led to a significant decline in Chinese exports to the U.S.

Given structural similarities with the U.S. (i.e., large consumer market, developed infrastructure and logistics, being technologically advanced) and a similar demand profile (9 of the top 10 import categories overlap), the euro area was an important alternate destination for redirected final Chinese exports during the 2018 trade war.[1] More importantly, the redirected goods saw lower price tags.[2] Should history rhyme, trade redirection paired with lower import prices could be disinflationary for the euro area.

At the same time, the euro area is exposed to global trade — more than 75% of its economy depends on imports and exports. That makes it vulnerable to global slowdowns.

Tariffs will likely hurt demand for European goods and increase uncertainty for companies and consumers. April surveys already show weaker hiring and investment plans, especially in Germany and France. And while Germany is rolling out a fiscal stimulus plan, real growth benefits may not show up until 2026.

With falling inflation and the need to support near-term growth, the ECB is likely to cut rates. In fact, the central bank just eased in April, and we think it may cut rates an additional two to three times this year.

	% of Total Imports	
Import Categories* from China	**U.S.**	**Europe**
Electrical Machinery & Equipment	28%	31%
Machinery & Mechanical Appliances	19%	19%
Toys, Games & Sports Equipment	7%	3%
Plastics & Articles Thereof	4%	3%
Furniture	4%	4%
Vehicles ex. Railway	4%	5%
Articles of Iron or Steel	3%	2%
Medical or Surgical Instruments	3%	3%
Apparel & Clothing Accessories	2%	2%
Footwear**	2%	2%

Sources: U.S. Census Bureau, Eurostat, BNY Investment Institute as of May 8, 2025.
* Categories ranked by top 10 U.S. imports from China. ** Not a top 10 import category for Europe. Chart is for illustrative purposes only.

A meaningful time to complement U.S. fixed income with international fixed income for a global exposure

While tariffs are usually associated with rising prices, they may have the opposite effect in Europe by slowing global trade and pulling in cheaper goods. Combined with already weak growth and fading inflation, this makes a strong case for more central bank support in the euro area — and for investors, a closer look at international bonds to complement U.S. bonds for a global exposure.

About the BNY Investment Institute

Drawing upon the breadth and expertise of BNY Investments, the Investment Institute generates thoughtful insights on macroeconomic trends, investable markets and portfolio construction.

[1] U.S. Federal Reserve, Global trade patterns in the wake of the 2018–2019 U.S.-China tariff hikes, April 2024. European Central Bank, “The implications of U.S.-China trade tensions for the euro area — lessons from the tariffs imposed by the first Trump Administration,” March 2025.

[2] SSRN, The Impacts of the U.S. Trade War on Chinese Exporters, accessed April 2025.

Past performance is no guarantee of future results.

All investments involve risk, including the possible loss of principal. No investment strategy or risk management technique can guarantee returns or eliminate risk in any market environment.

Fixed income investments are subject to interest-rate, credit, liquidity, call and market risks, to varying degrees. Generally, all other factors being equal, bond prices are inversely related to interest-rate changes and rate increases can cause price declines. Investing in **foreign denominated and/or domiciled securities** involves special risks, including changes in currency exchange rates, political, economic, and social instability, limited company information, differing auditing and legal standards, and less market liquidity. These risks generally are greater with emerging market countries.

Disinflation is a slowing down in the rate of price increases. Stagnation is a period of slow economic growth with high unemployment and high inflation. Sticky inflation refers to a persistent economic scenario where prices for goods and services do not adjust quickly to changes in supply and demand dynamics.

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