Global Fixed Income Strategy

Monthly report

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Global macro strategy

We see two possible scenarios for US growth – Orderly slowdown or recession

Last month, we lowered our US growth projection to below potential. But following the announcement of tariffs and reciprocal trade measures on "Liberation Day" April 2, we have downshifted our outlook further. At this point, like many analysts and companies, we find it difficult to define a clear baseline. Instead, we suggest two possible scenarios going forward, each with roughly equal probability.

The first scenario is a relatively benign, orderly slowdown without a recession. This scenario assumes a quick reversal in trade policy, including tariff exemptions and agreements with key partners. The second scenario, on the other hand, assumes continued aggressive trade policies—making a recession more likely.

In either case, we believe the economy is facing a significant slowdown. This month, we outline the key headwinds driving that deceleration and ask, what would a slowdown look like? We expect several drivers of a potential slowdown to be active in the coming weeks. Our goal is to continuously assess their scale, magnitude, and impact on the economy to determine if we are headed for scenario one or the more severe scenario two.

Multiple factors point to a slowdown

Before we delve into the details, it's important to underscore that the expected slowdown is not solely driven by tariff policy—despite its prominence in the media and policy discussions. Fiscal and labor market policies, along with shifts in global security dynamics, also play a critical role in shaping economic and market outcomes, as we outline below.

First, we expect a decline in real income growth —or a possible contraction. Tariffs raise the prices of imported goods and the domestic products that compete with them. As households face higher prices on everything from electronics to food and cars, their purchasing power erodes. This effect is especially pronounced for lower- and middle-income households, which spend a larger share of their income on tradable goods. At the same time, firms facing higher input costs may reduce hiring or investment, further weighing on household income. Unlike demand-driven inflation, tariff-induced inflation is a cost shock: nominal GDP may remain stable, but real growth takes a hit.

The impact extends beyond domestic prices. US export markets are under pressure from foreign retaliation, weaker demand due to dissatisfaction with US policies, and broader structural shifts. More broadly, there is a growing trend of de-risking from the US, particularly among European and other allies. This includes a shift toward domestic sourcing, investment in local supply chains, and the development of independent military, communication, and payment systems. These changes don't amount to full disengagement, but cumulatively, less reliance on US goods and services may weigh on output. In addition, the tariff war acts as a global demand shock, amplifying export weakness. While some effects may seem modest—like boycotts of US goods or softer tourism flows—they still matter. The US is a major exporter of services, and some of that demand could shift elsewhere. Many of these services are not unique and can be substituted.

Second, the impact of tariffs extends beyond the real income effect—it also disrupts production. If fully implemented, the tariffs recently announced by the US would push tariff rates to their highest levels in nearly a century. Yet today's production is deeply globalized. Goods are often manufactured across multiple countries, with intermediate inputs crossing borders several times. In such an integrated system, this tariff shock could significantly disrupt global production and supply chains. For the US, nearly 40% of imports from China are intermediate goods, so the ongoing slowdown in imports could substantially impair domestic production.[1] Recent reports already highlight tangible disruptions: inventories stranded in China, shipping carriers reluctant to load goods due to uncertainty about US offloading, and concerns that importers lack the cash to pay upon arrival. These issues risk causing shortages of production inputs, or empty shelves at large and small retailers.

Third, policy-induced uncertainty has become a major headwind for the US economy. In addition to the highest tariffs in nearly a century, businesses face a volatile environment shaped by reduced labor supply and availability, the impact of Department of Government Efficiency actions on fiscal transfers, government services, and employment, reversals of prior policies, rising tensions with key allies, and public comments questioning the Fed's independence. This persistent uncertainty makes it difficult for firms to plan ahead, discouraging investment and hiring. Households, too, are affected—many may be pulling forward spending on tariff-exposed goods while growing more cautious about longer-term commitments, such as home purchases.

Finally, another headwind is the tightening of financial conditions—reflected in high interest rates, rising risk premia, and a weakening stock market. Demand for US assets may be softening, driven by reduced overweight positions in US assets and even a broader rotation out of US exposure. The rare simultaneous decline in bond prices, equities, and the US dollar suggests this shift, though its magnitude remains uncertain.

In sum, we believe the US economy is entering a period of pronounced deceleration shaped by multiple, reinforcing shocks: tariff-driven cost increases, production disruptions, elevated uncertainty, and tightening financial conditions. Unlike past slowdowns, this downturn is policy-induced and likely to unfold abruptly, rather than as a gradual build-up. As a result, in our analysis, we are placing greater weight on a broad set of indicators, such as high-frequency data, survey and hard data, and company guidance and qualitative judgment, to assess developments in real time and gauge the trajectory of the economy.

1. Source: Federal Reserve Bank of San Francisco, "How much do we spend on imports?", Jan. 7, 2019.

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Interest rate outlook

US: Neutral. We have downgraded our US duration view to neutral from overweight. Earlier this year we had expected market participants to lower their growth expectations in the wake of growth-negative Trump administration policies, including tariff and immigration policies. We had expected lower growth expectations to drive long-term yields lower and increase expectations of Fed rate cuts. However, Treasury risk premia have increased for several reasons. The drivers are diverse and include the potential for a larger budget deficit than previously anticipated and uncertainty over the willingness of US domestic investors to step in to buy Treasuries, as foreign investors pull back on their demand. Consequently, it has become much harder to predict the direction of the interest rate market.

Europe: Neutral. We are positive on the European sovereign market, despite the continued rally in bond yields. The European Central Bank is likely to continue to lower rates in anticipation of slower growth and inflation. We expect the new US administration's trade policies to pose a significant headwind to the region's manufacturers, while inflation is likely to be pushed lower by falling import prices, as China potentially reroutes some US exports to the euro area to avoid tariffs. That said, the market now anticipates a terminal official rate of 1.5% in the euro area, which was our expectation at the beginning of the year, so we have moved to a more neutral positioning.[1]

China: Neutral. We expect China to deploy fiscal measures in response to US trade tariffs to mitigate their impact on the Chinese economy. The onshore market had been expecting a potential slowdown in economic activity in the second quarter, though equity market performance has been resilient. While we expect short-term yields to remain anchored by accommodative monetary policy, we see limited room for substantial changes in long-term yields at the current time.

Japan: Underweight. Concerns about the impact of US tariffs and the recent yen appreciation are likely to make the Bank of Japan (BoJ) more tentative about hiking interest rates further. However, the market has already priced out a lot of future interest rate cuts, with just over one 25 basis point cut priced over the next two years.[2] This keeps the distribution of front end yields skewed to the upside, particularly as inflation and wage data over the last month have been generally at or above BoJ expectations. The outlook for long-term yields is more symmetric. Yields on 30-year and 40-year Japanese government bonds (JGB) have actually risen over the last month by approximately 15 basis points, in contrast to 10-year yields, which are down by 20 basis points.[2] This has pushed the yield curve to its steepest level this cycle, with long-term Japanese forwards now well above 3%.[2] The scope for further steepening should be more limited; a further shift lower in global yields should cause Japanese investors to repatriate funds, which should benefit long-term JGBs, which look relatively cheap versus European equivalents, in our view.

UK: Overweight. Price action over the last month has largely been driven by international developments around US tariffs, rather than domestic economic data. Although the UK has only been hit by a 10% tariff and trade negotiations are just starting, the heightened uncertainty and tightening financial conditions have created additional downside to growth. The implications for inflation are more complicated and depend on the extent of supply disruptions and retaliation. However, in the context of lower oil prices, a weakening labour market and a relatively resilient British pound, it is unlikely that the net impact will lead to sustained upside inflation. In the medium term, lower growth will likely be the dominant factor. Recent domestic data have been consistent with the gradual easing cycle of an approximately 25 basis point cut per quarter signalled by the Bank of England (BoE). However, greater downside risk to global growth and tighter financial conditions raise the prospect of faster and deeper cuts, toward a more neutral level of 3%. This leaves some downside risk for short-term yields.

The more difficult question is what happens to the long end of the yield curve. The trend toward a steeper yield curve has been in place for some time, driven by lower demand for long end bonds, concerns about fiscal sustainability and a rise in the global term premium driven by central bank quantitative tightening and fiscal easing in Germany and elsewhere. Over the last month, this trend has accelerated, possibly related to deleveraging amid

1. Source: Bloomberg L.P. Data as of April 25, 2025.
2. Source: Bloomberg L.P. Data as of April 24, 2025.

tariff uncertainty and concerns about disruptions to global capital flows.

The factors driving the curve steepening continue to be in place, but current valuations and changing supply dynamics might moderate the pace and extent of further steepening. Furthermore, the government has reduced long-dated issuance, reducing the supply/demand imbalance in the long end. A major curve flattening is unlikely, but long-dated forwards are starting to look more attractive on an absolute and relative basis, in our view, particularly given the underperformance of European yields over the last month.

Australia: Overweight. The Reserve Bank of Australia (RBA) appears reluctant to ease interest rates rapidly or substantially, however, recent inflation and wage data, combined with increased global uncertainty, have increased the scope for a larger and more front-loaded cutting cycle. Fiscal policy is being used more actively in Australia to support growth, which should reduce the burden on monetary policy, but current interest rates remain in restrictive territory. The RBA will likely seek to normalise rates closer to 3%, which should help pull yields lower.

Long-term rates have lagged the rally in the front end. The steepening of the Australian yield curve is consistent with price action in the US and UK, reflecting a global shift higher in term premium. Australian government bonds have outperformed US Treasuries over the last month, with cross market spreads shifting to the tightest level since December. The scope for further cross market outperformance might be more limited going forward, but, in our view, Australian government bonds offer relatively attractive yields in a jurisdiction with little fiscal risk and subsiding inflation pressures.

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Currency outlook

USD: Underweight. We are underweighting the US dollar against several currencies and anticipate that it will weaken further over time. However, we expect foreign exchange volatility to remain elevated in the near term, with wide swings likely. The immediate trajectory of the dollar will likely be influenced by how aggressively the current US administration pursues its trade agenda and the international community's response. The recent, somewhat more conciliatory stance by prominent government figures has provided support for the dollar. Nonetheless, investors remain cautious and apprehensive due to the unpredictable nature of government policy. International investors, many of whom have been overweight US assets in recent years, may choose to reduce their exposure until there is greater political and policy clarity, placing further downward pressure on the US dollar.

EUR: Overweight. We are overweight the euro and anticipate that it will continue to perform well, despite lower interest rates and a deteriorating growth outlook. The euro has been one of the major beneficiaries of the recent US dollar weakness, rallying significantly. European investors have reduced some US exposure amid market uncertainty and following strong performance in recent years. Given the European Union's capacity to provide fiscal support to the region, cushioning countries from the adverse effects of trade tariffs, and Germany's new inclination toward a more expansionary fiscal policy, we expect the European economy to recover later in the year from what we anticipate to be a soft patch over the coming quarters. This recovery is likely to result in upward surprises in growth relative to expectations, creating an environment conducive to euro strength over the medium term.

RMB: Overweight. We are overweight the renminbi, but we expect the upcoming dividend payment season and US-China trade tensions to keep volatility elevated for the USD/RMB exchange rate in the months ahead. In the medium term, uncertainty over US policies and the reserve currency status of the US dollar are likely to cause the major non-US dollar currencies to outperform. Although the renminbi is less likely to outperform the euro or yen in the near-to-medium term under this scenario, we expect it to perform strongly against the US dollar.

JPY: Overweight. The yen has outperformed the US dollar over the last month but its performance has only been equal to the euro. Looking forward, persistent tariff-related uncertainty is likely to place further downward pressure on growth expectations and risk sentiment, potentially benefitting the yen, as yields in the US and Europe converge further with those in Japan. In addition, lower yields abroad and a steeper yield curve are likely to make capital repatriation and currency hedging more attractive to Japanese investors, who at present don't appear to have made substantial changes to their positioning.

GBP: Underweight. We do not expect the British pound to outperform in the current environment. Although the direct impact of US tariffs on the UK should be modest, given its small manufacturing sector, the UK remains a small open economy, with an increasingly negative international investment position. As such, it is sensitive to a broader retrenchment in global trade and capital flows. We have seen this dynamic over the last month. The pound has outperformed the US dollar and commodity currencies, which are more sensitive to global growth shocks, but has underperformed the Swiss franc, euro and yen. The worsening global growth outlook is likely to lead to faster and deeper BoE rate cuts, removing the major selling point of the pound, which is its relatively high carry. Even if the GBP/USD exchange rate remains supported by capital outflows from the US and Fed cuts, the pound is likely to face downside compared to lower yielding "safe haven" currencies, such as the yen and Swiss franc.

AUD: Neutral. The Australian dollar has outperformed the US dollar over the last month but has depreciated against most major developed market and emerging market currencies. The price action reflects the Australian dollar's strong relationship to equities and Chinese growth expectations. However, current levels of the Australian dollar look relatively cheap compared to interest rate differentials and commodity prices, in our view. The underperformance of the Australian dollar versus European and Asian currencies, which are more likely to be impacted by tariffs, has been striking and might have limited scope to extend further. Similarly, the Australian dollar's 3% depreciation versus the New Zealand dollar over the last month also seems stretched and might reflect a washout of AUD/NZD long positions, rather than any fundamental drivers.[3]

3. Source: Bloomberg L.P. Data as of April 24, 2025.

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Fixed-income investments are subject to credit risk of the issuer and the effects of changing interest rates. Interest rate risk refers to the risk that bond prices generally fall as interest rates rise and vice versa. An issuer may be unable to meet interest and/or principal payments, thereby causing its instruments to decrease in value and lowering the issuer's credit rating.

Non-investment grade bonds, also called high yield bonds or junk bonds, pay higher yields but also carry more risk and a lower credit rating than an investment grade bond.

The risks of investing in securities of foreign issuers, including emerging market issuers, can include fluctuations in foreign currencies, political and economic instability, and foreign taxation issues.

The performance of an investment concentrated in issuers of a certain region or country is expected to be closely tied to conditions within that region and to be more volatile than more geographically diversified investments.

Important information

All information is sourced from Invesco, unless otherwise stated.

All data as of April 25, 2025, unless otherwise stated. All data is USD, unless otherwise stated.

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