Are you ready for 2025?

MONETARY POLICY

FX RATES

GEOPOLITICS

TRADE

FEB 2025

Trump, tariffs and trade update

convera

SMART MONEY MOVES

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Introduction

Hope for the best, prepare for the worst

Global growth looks steady into 2025, but risks and uncertainty have grown post Trump

Three months is a long time in politics — particularly the final three months of 2024. Since we published the first edition of "Are You Ready for 2025?" in October last year, US president Donald Trump's election win has seen a seismic effect on financial markets.

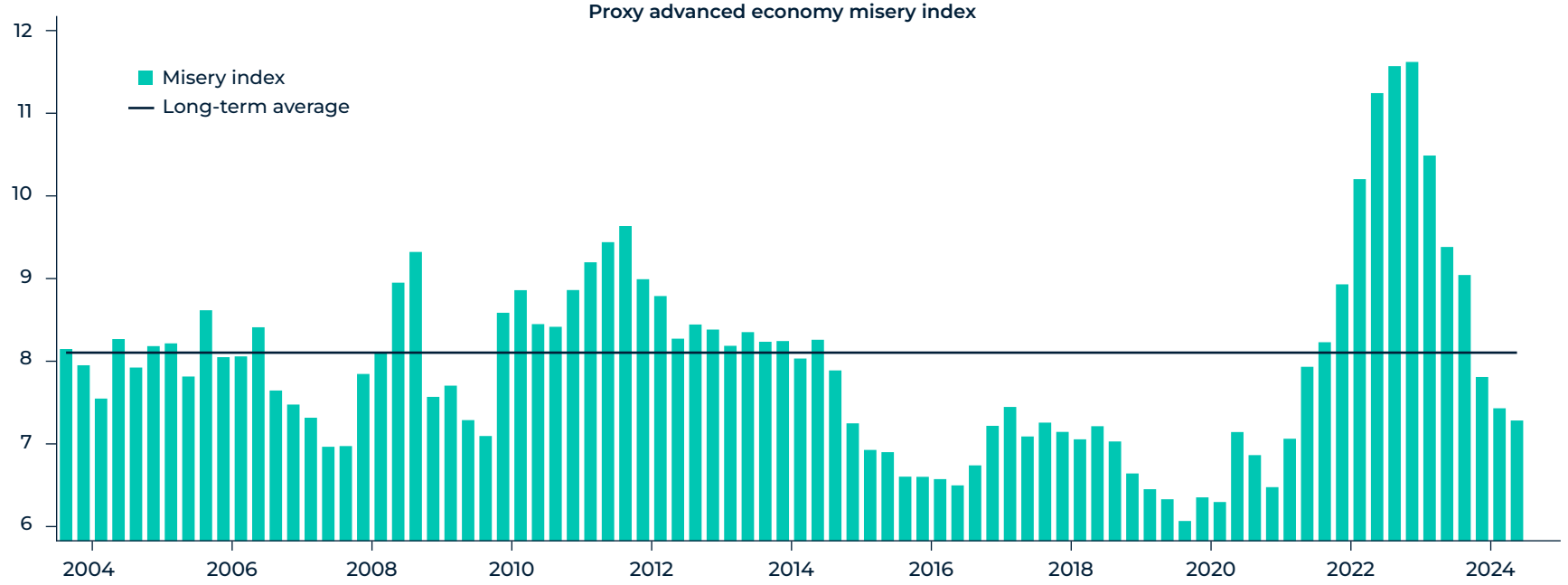
While the political outlook has changed, the economic outlook continues to suggest a continuation of the steady, if unspectacular, growth seen over the last three years. Despite worries about the impact of higher interest rates, growth has been surprisingly stable. Global GDP is expected to expand by just under 3% for a third consecutive year in 2025.

Financial markets have also been calm — mostly. The US's Dow Jones index hit a new all-time high on more than 20 occasions in 2024 in a sign of overall investor confidence.

The VIX, also called the "fear index", produced by Chicago Board Options Exchange, fell to the lowest level since July 2018 last year — although volatility spiked higher in August as the Japanese yen carry trade reversed sharply. Since then, however,

Misery index back below pain zone but "vibecession" persists[1]

Proxy advanced economy misery index



the VIX has fallen back to low levels — even after Donald Trump's election win.

Global GDP is expected to expand by less than 3% for a third consecutive year in 2025.

Looking forward, a neutral fiscal impulse, with governments easing Covid-era spending but reluctant to make more significant cuts, cooling inflation, lower interest rates and rising real wage growth could underpin the continued expansion of the world economy.

However, if the last five years have taught us anything, it's to be cautious about a future that looks too rosy. What risks could upset the metaphorical apple cart?

Businesses and consumers remain cautious. Economic data has improved, with the so-called "misery index" — which combines inflation and unemployment — showing a sharp improvement in conditions over the last 12 months. However, consumer and business confidence numbers remain well below historical averages. This has been called a "vibecession" — a disconnect between economic data and economic sentiment.

In this report, we note that further weakening of the labor market — critical for economic growth — and the ongoing impact of trade disputes, which are key for global trade stability, will be two key economic risks to keep in mind going into 2025.

In terms of geopolitics, tensions in eastern Europe, the Middle East and between the US and China remain heightened and can also impact markets, especially in the commodity space.

Of course, Donald Trump's election win had a notable impact on the global economy due to an increase in uncertainty around trade and tariffs. This uncertainty has seen the US dollar climb to two-year highs and trade-sensitive currencies like the Australian and Canadian dollars fall to multi-year lows following the US election. In the first edition of this report, we flagged trade tensions as a potential risk to growth. Now, trade tensions have moved from the "possible" to the "certain".

In FX markets, the dominant theme over the last five years was the sharp reduction in interest rates in 2020 and the rapid increase in 2023. Looking forward, 2025 might be defined by a loosening in monetary policy and whether central banks can adjust policy with the appropriate agility.

Are central banks at risk of cutting rates too early and encouraging a resurgence of inflation even before price pressures have returned to target? Or have central banks waited too long, sparked an inexorable rise in unemployment, and set up economies for a hard landing in 2025?

If the last five years have taught us anything, it's to be cautious about a future that looks too rosy. What risks could upset the metaphorical apple cart?

PART I

Global themes

Global themes

Modest expansion to continue

Real wage growth and a procyclical recovery key to forecasts

The world economy is now about 15% larger than it was in 2019, mostly due to post-pandemic stimulus.

Last year has turned out better than expected as the United States powered through one of the most aggressive tightening cycles in recent decades — thanks mainly to the resilience of the consumer.

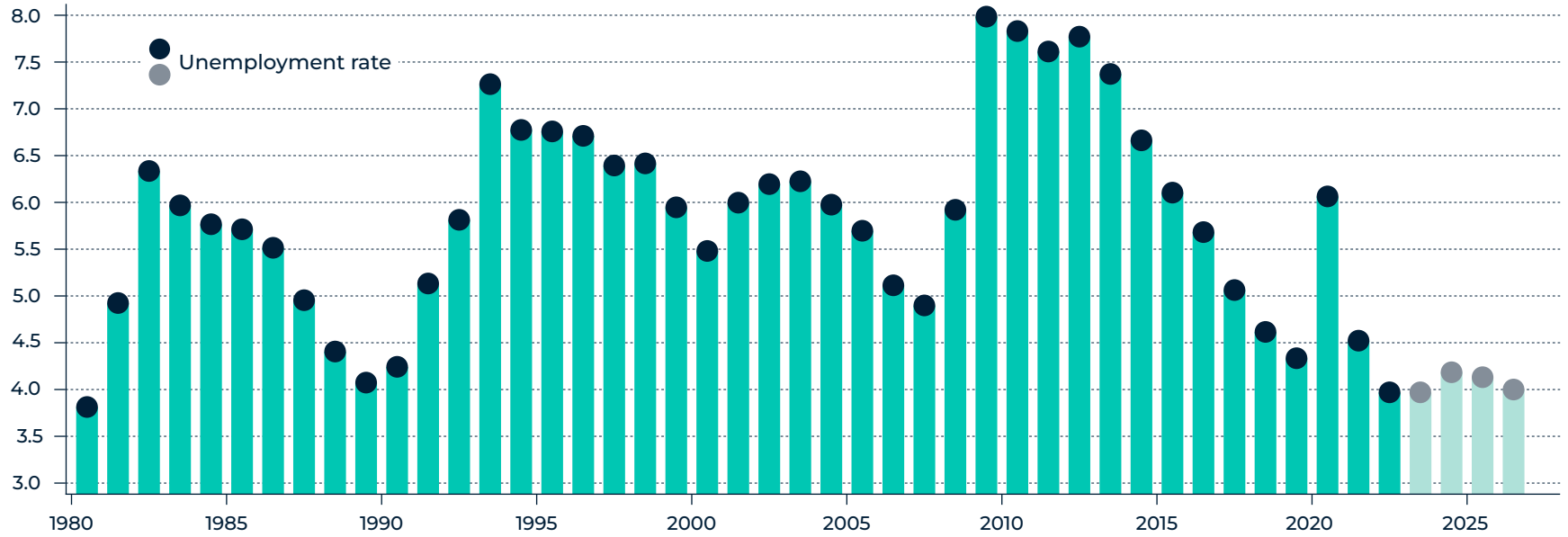
Most surprising has been the continued tightness of the global labor market. The unemployment rate in the developed world fell below 4% in 2023, for the first time since the early 1990s, and is only expected to pick up marginally in 2025.

Overall, growth has been surprisingly stable with global GDP expected to expand by around 3% for a third consecutive year in 2025. However, high interest rates took a toll on world trade and the property market, which affected procyclical regions like the Eurozone and China the most. Both have underperformed expectations, with 2024 having been the worst year for the Chinese housing market in over a decade.

Global trade volumes have stagnated since the beginning of 2022 and the industrial complex in Europe and Japan, down 4% and 9% since

Labor markets are as tight as 40 years ago[2]

Unemployment rates in advanced economies since 1980



2021, has suffered from multiple headwinds. This is due to, (1) Policy makers in Beijing tried to compensate for the property slump by overly supporting exports; (2) The energy spike due to Russia's invasion of Ukraine, and (3) the burden of decade-high interest rates which has made reinvesting into projects more expensive.

Both Europe and Japan have seen the number of monthly bankruptcy filings rise to the highest level since 2015 and 2013, respectively. As monetary policy becomes easier, the pace of new insolvencies should slow as we head into 2025 and 2026. The competitive disadvantage versus China remains.

The unemployment rate in the developed world remained below 4% in 2024 and near a 35-year low.

Consumer confidence is slowly recovering as the rise in nominal wages and falling inflation rates leads to a boost in real spending power. Our global index combining consumer confidence for 40 countries continued to improve, despite remaining below its historic average and pre-pandemic levels. We see this trend continuing into 2025 as wage negotiations catch up with past inflation rates to compensate workers for the lost purchasing power.

Both Europe and Japan have seen the number of monthly bankruptcy fillings rise to the highest level since 2015 and 2013, respectively.

A neutral fiscal impulse, falling interest and inflation rates and rising real wage growth could underpin the continued expansion of the world economy. This is where the risks come into play. We have flagged an excessive weakening of the labor market and rising trade disputes as two tail risks to keep in mind for this year. The assumption of rising consumer spending in the developed world could come under scrutiny if the unemployment rate starts to go up materially. This would partially negate the effect of improving real wage growth.

Further tariff hikes as outlined in our trade theme will dampen the recovery of the industrial sector, which should otherwise benefit from falling interest rates in Western economies. Both monetary and fiscal policy will only slowly impact the global economy as they shift from expansive to more neutral levels. This will take time, and the impact will likely be felt more in 2026 than this year.

The recent increase of the greenback, through the slower Federal Reserve easing cycle and geopolitical uncertainties acts as a drag on trade and overall growth.

Our baseline of world real GDP expanding by around 2.7% next year, slightly below the pre-pandemic mean of 3.1%, masks the elevated tail risks associated with that forecast.

Disinflation not without uncertainty

Inflation expected to fall in absence of trade shocks

Inflation has been a dominant problem for governments and economic policymakers in recent years. Two years after having peaked in the developed world at around 7.5%, inflation has now halved as supply chains normalized and the growth of goods prices slowed. However, sticky services inflation seems to have anchored global inflation above 3%.

Over the past four years, inflation in the developed world has been more volatile than in the past four decades, leading to sustained corporate pricing power and an easier passthrough from producer to consumer prices. By late 2024, only a quarter of central banks globally are meeting the 2% inflation target, compared to 40% four years ago.

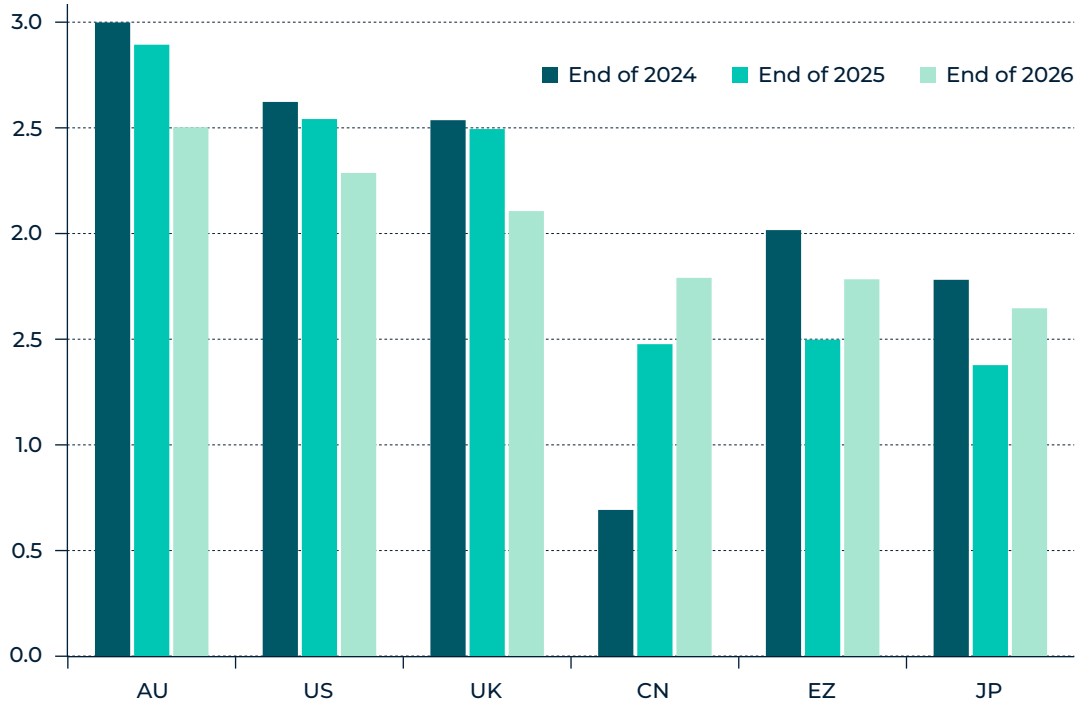
Forecasting inflation into 2025 and beyond requires a global perspective as external shocks like geopolitical disruptions have led to a synchronized rise and fall of prices in the era of global value chains. The inflation trajectory will be crucial to determine the development of most asset classes next year. A return to the low-inflation regime seen before the pandemic would come with vastly different implications for central banks and fiscal policy compared to inflation settling at higher rates.

Before looking forward, let's look back. The post-pandemic inflation surge can be explained in various ways, but two key models are the interaction between demand and supply or the interplay of monetary and fiscal policies.

Goods inflation looks to have bottomed out in some parts of the developed world even as shipping costs remain well above their historic averages. However, most supply chain pressure indicators have fallen enough to be consistent with headline inflation staying at around 2% in Europe and the United States. Furthermore, only 33% of commodities, a key input in goods

Global disinflation with regional discrepancies[3]

Headline inflation rates for selected countries (Forecast)



production, have risen over the past 12 months, putting us in a disinflationary environment. There is some empirical evidence showing that second-round effects of a shock in goods prices seem to be modest, meaning that the focus on the labor market and services inflation side of the equation should remain the primary concern of central banks.

On the demand front, most countries such as the US, UK, Canada and Germany have seen their vacancies per unemployed ratio — a gauge for the tightness of the labor market — return to pre-pandemic levels. Unemployment rates remain low but are on the rise, highlighting this point.

On the monetary policy front, both the current trajectory of the balance sheets, and money supply in the developed markets point to downside risks for inflation going into 2025. The latter has turned positive annually, as global central banks' balance sheets grow, but we expect growth rates to be contained to their pre-pandemic trend.

The same holds true for fiscal policy. G7 deficits are expected to be slightly higher in the '25–'26 period (~4%) than before the pandemic (~3%). However, the 10% budget overhang of 2020 that contributed to the inflation surge was a historical rarity and unlikely to be repeated.

As a result, looking with either a demand/supply or monetary/fiscal lens, inflation drivers have cooled substantially. We expect headline inflation to settle below 2% in the Eurozone, Japan and China absent any trade shocks. The US, UK and Australia are more likely to display inflation rates of above 2.5% in 2025 and slightly above 2% in 2026. Therefore, regional differences complicate the otherwise global disinflation picture.

The largest uncertainty surrounding our view of global inflation rates falling remains the trade view.

On the demand front, most countries such as the US, UK, Canada and Germany have seen their vacancies per unemployed ratio — a gauge for the tightness of the labor market — return to pre-pandemic levels.

The largest uncertainty surrounding our view of global inflation rates falling remains the trade view. Further escalation between China and the West could reinflate the supply chain and push goods inflation higher. Beyond 2025, signs of a more fragmented world trade order and less prudent fiscal policy are likely to anchor inflation volatility above the level seen during the previous decade. Inflation looks set to remain higher for longer.

Divergence to drive moves

Desynchronization to spur pockets of volatility

The great balancing act of central banks to stimulate the economy whilst controlling inflation has triggered spikes in monetary policy uncertainty over recent years. Historically, monetary policy uncertainty can lead to FX volatility. We saw an unprecedented spike in monetary policy uncertainty over 2022–2023, when over 600 rate hikes were delivered globally to combat the inflation shock. The average G10 policy rate peaked at 4% in January 2024, in line with the decade before the GFC, but a repeat of the post-2008 experience to an era of permanently lower interest rates is highly unlikely.

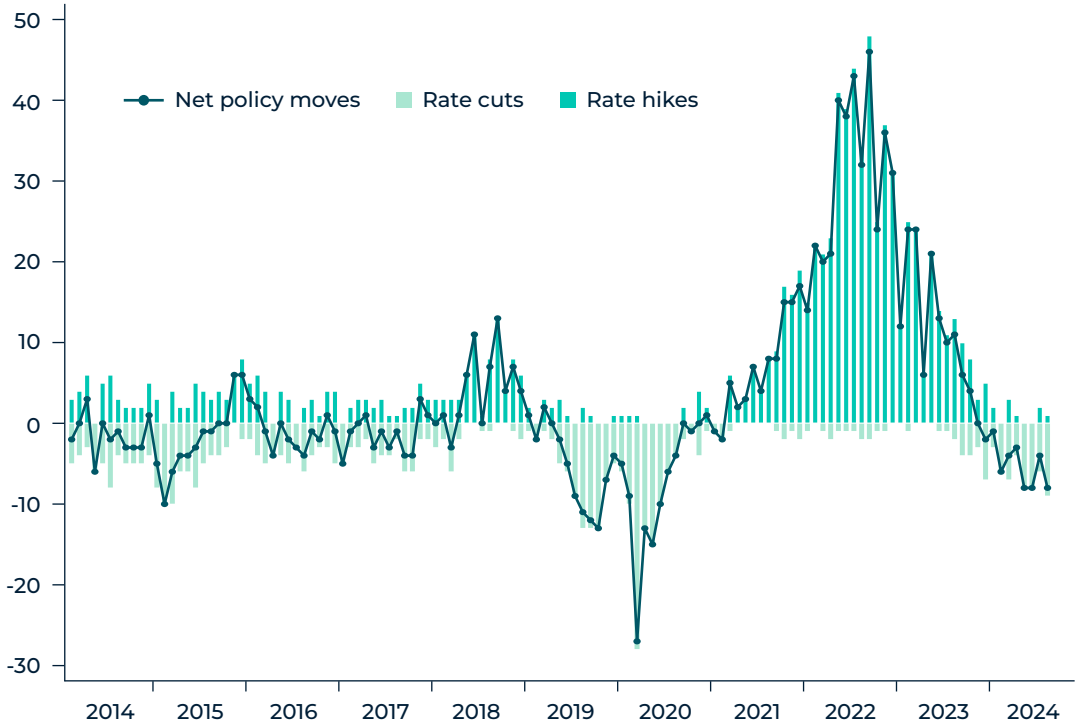
In the latter stages of the recent tightening cycle, a key motivation for raising rates was to minimize the risk of inflation becoming unanchored. Indeed, many policymakers pushed back against expectations for aggressive cuts coming into the year, which made market expectations particularly volatile over this cycle. And despite more than 150 cuts worldwide last year, the bottom line is that interest rates have not fallen as fast, or as much, as when they climbed.

The last year also saw an end to the highly synchronized policy cycle we saw after the pandemic. Central banks in emerging markets have been ahead of the curve, with Brazil, Mexico, Hungary and the Czech Republic having all cut rates multiple times this year. This has dampened demand for their respective currencies due to weakening rate differentials. In developed nations, the Fed delayed rate cuts compared to the BoC, ECB and BoE, and the US dollar has been stronger as a result.

China and Japan have also been in the spotlight, but for a different reason; going against the grain. During the global tightening cycle, China was cutting rates to stimulate economic growth and Japan held

Global easing cycle is underway[4]

Number of central banks hiking/cutting rates globally



rates at record lows, dragging the yuan and yen to multi-decade lows. Now, during the easing cycle, Japan has started hiking rates, reducing the allure of the yen as a funding currency in the carry trade, which has already sparked sizeable market gyrations, such as the yen's 10% appreciation in July. Looking forward, with inflation pressures less of a concern, policymakers' reaction functions are shifting back to supporting labor markets and growth. With both seemingly cooling too, central banks are expected to continue cutting. With the global monetary impulse expected to decline further, this should be a net-negative for market volatility. But we're wary of elevated monetary policy uncertainty going forward.

The eventual bottom for interest rates is set to be far higher than the historic lows of the last decade.

Importantly, the factors that for decades had made it easier to maintain low average inflation, including globalization, demographics, and fiscal restraint, may have gone into reverse. These mega-shifts in the structure of the global economy might require a tighter monetary policy stance than in the past. As such, the historic downtrend in the so-called neutral rate, which neither stimulates nor slows growth, could reverse too. Therefore, the eventual bottom for interest rates is set to be far higher than the historic lows of the last decade.

Another area of concern is the shrinking of central banks' balance sheets. For the first time, the developed world's top central banks are engaging in joint quantitative tightening (QT), although the reduction in balance sheets has not been a one-way path. The withdrawal of the liquidity pumped into economies during the pandemic crisis could trigger more spikes in volatility in 2025.

Fiscal discipline back on the radar

Is growth at risk if governments pullback on spending?

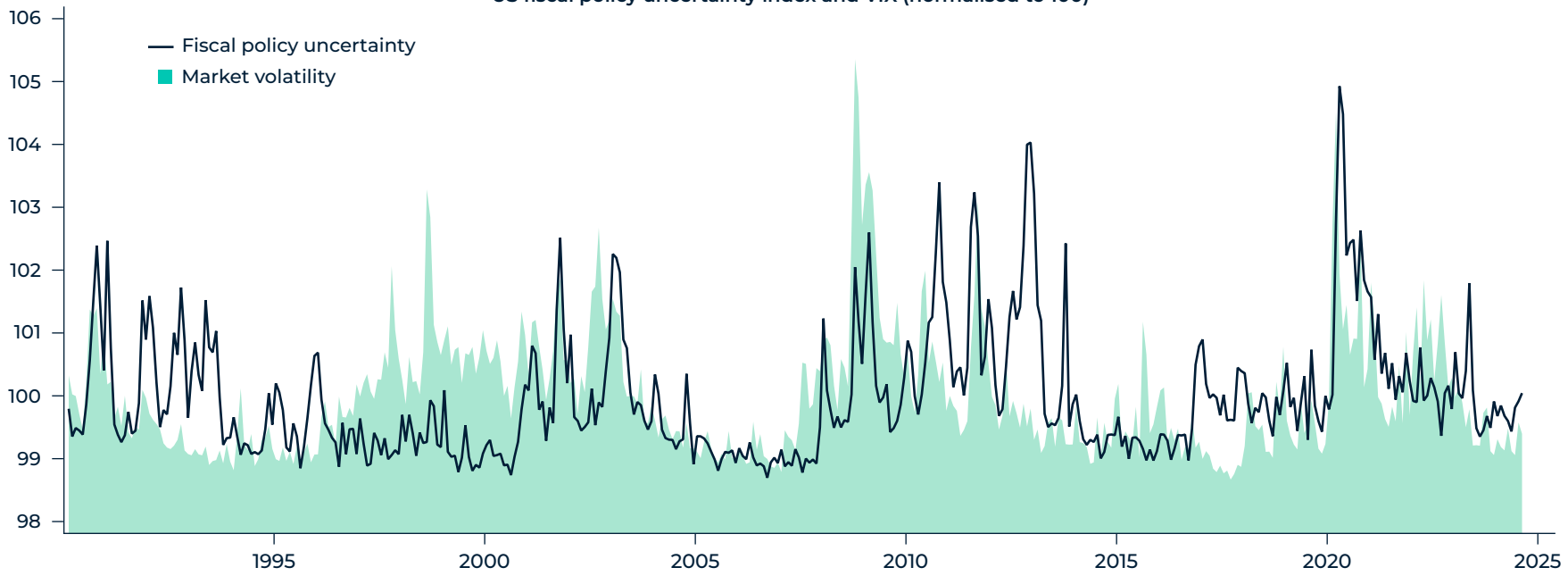
In the wake of the COVID-19 pandemic, government spending — fiscal expansion — has been crucial for global economic resilience, particularly as central banks raised interest rates. This fiscal imperative has helped stave off recessions, supported stock market gains, but also contributed to elevated inflation. In the US, government spending has boosted GDP growth by 25bps above the pre-pandemic average over the past year, offsetting the restrictive effects of tighter monetary policy.

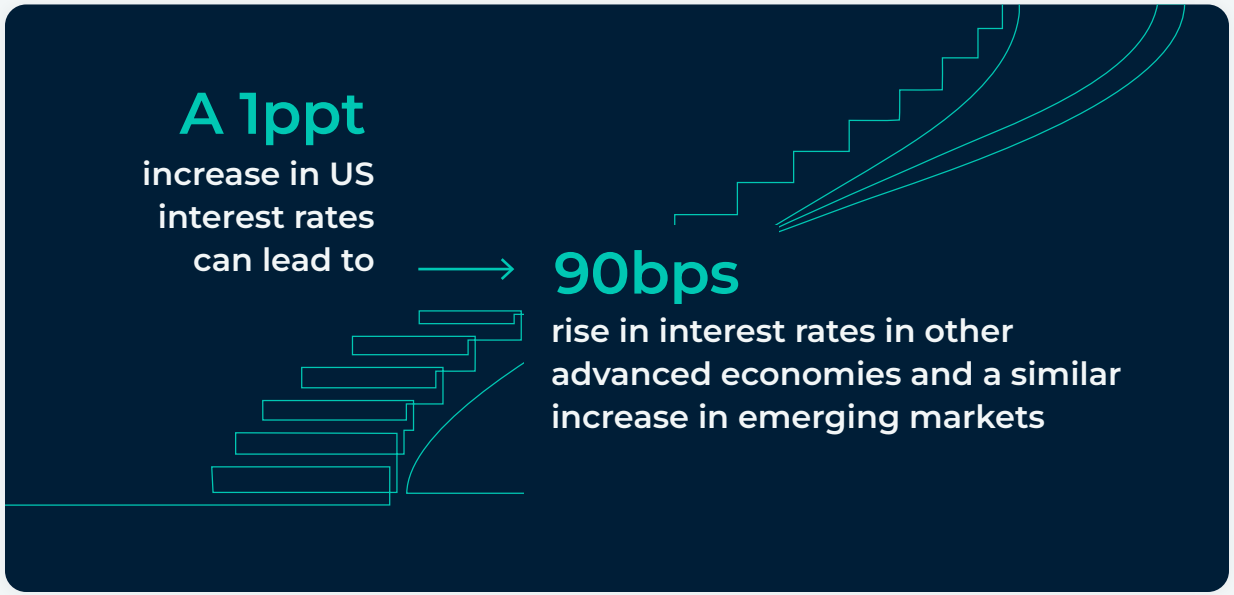
This supportive fiscal stance is expected to diminish by 2025. The US Congressional Budget Office (CBO) projects the federal deficit to widen from 5.6% of GDP in 2024 to 6.1% in 2025, driven mainly by rising interest expenses rather than primary deficits. This distinction is important because deficits due to interest expenses are less stimulative to the economy than those caused by expanding primary deficits.

In contrast, the UK faces a different fiscal challenge. A recent Treasury review revealed unrealistic public spending plans and overly optimistic growth forecasts. These issues could force a new Labour government to implement austerity measures, leading to a negative fiscal impulse.

Growing fiscal uncertainty increases market volatility[5]

US fiscal policy uncertainty index and VIX (normalised to 100)





Debt consolidation, essential for long-term debt sustainability, may gain renewed attention in 2025. The US federal deficit continues to grow with the CBO forecasting it will exceed $1.9 trillion in 2025, up from $1.6 trillion in 2024. Similar pressures are evident in other advanced economies like the UK and Japan. In Europe, countries such as France, Italy, and Poland face the challenge of aligning with newly reinstated fiscal rules, necessitating primary surpluses exceeding 1.5% of GDP to reduce public debt ratios, a stark contrast to their 2023 deficits.

China, although less exposed to global markets due to domestically held debt, also faces significant fiscal imbalances. A slowdown in Chinese growth could reduce global demand for imports and disrupt supply chains, affecting countries reliant on trade with China.

Despite these fiscal challenges, markets have remained optimistic. Throughout 2024, bond auctions in the US, Europe, and the UK have seen strong demand, with bid-to-cover ratios exceeding five-year averages. This optimism reflects market confidence in economic growth and expectations of a soft landing by the Federal Reserve. However, a sustained negative fiscal impulse could challenge the resilience of such optimism.

One of the early critical tests for markets will be the US debt ceiling debate. The Fiscal Responsibility Act of 2023 suspended the debt limit, but it will be reinstated in January 2025, potentially leading to another round of fiscal brinkmanship in Congress. Failure to address the debt ceiling promptly could raise the perceived risk of US default, leading to higher borrowing costs, reduced economic growth, and increased market volatility. Historical precedents, such as the 2011 and 2013 debt ceiling crises, show that delays in addressing the debt ceiling have cost the federal government hundreds of millions of dollars in higher interest payments.

A slowdown in Chinese growth could reduce global demand for imports and disrupt supply chains, affecting countries reliant on trade with China.

The repercussions of higher US borrowing costs extend beyond its borders. A 1ppt increase in US interest rates can lead to a 90bps rise in interest rates in other advanced economies and a similar increase in emerging markets. This spillover effect could tighten global financial conditions, exacerbating economic challenges in countries already struggling with high debt levels and slowing growth.

Geopolitical alignment matters

World trade at record highs threatened by fragmentation

The rise of globalization has connected the world economy; however long gone are the days of calm geopolitical waters. The intensity of conflicts worldwide is at the highest level since the end of the 1980s.

The list of countries turning more protectionist is one reason why geopolitical stakes have increased drastically since around 2018.

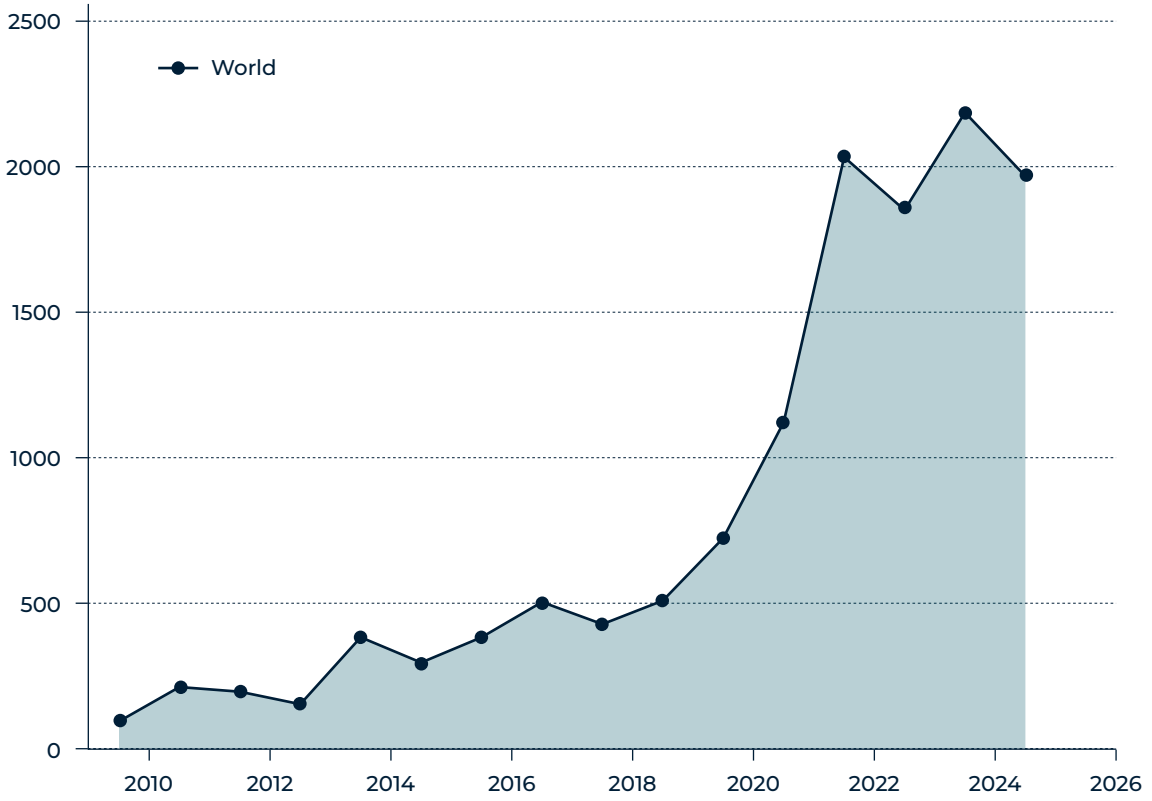
Annual trade interventions have risen more than tenfold since the mid-2010s with most new policies passed after 2019. The securitization of the global supply chain is staging a comeback with around 2000 industrial subsidies implemented last year alone. Most of these highly trade distorting and heavily centered around North America, Europe and East Asia. The list of countries turning more protectionist is one reason why geopolitical stakes have increased drastically since around 2018.

The United States and China, which account for 40% of global GDP, have been leading the tariff war for over six years now. The European continent has attempted to stay neutral for some time but has now leaned into both tariffs (Chinese EVs) and the implementation of industrial policy (European Chips Act). Investors have been indifferent towards these developments as equity markets — apart from the ones affected by the outbreak of wars — have been driven by other macro factors.

This masks the real concern arising from heightened geopolitical tensions and renewed protectionism, the fragmentation

Around 2000 interventions added every year since 2021[6]

Total number of implemented interventions since November 2008

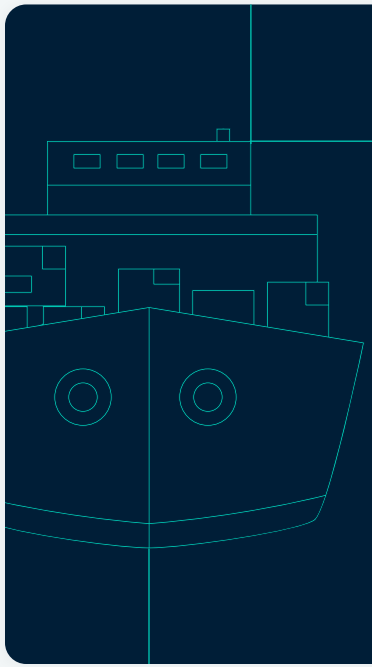


of world trade. Such a drastic development does not happen overnight. The volume of goods and services traded globally is still near an all-time high. However, the trend towards national policies benefiting the domestic producer base has been clear as sentiment towards globalization changes.

Two examples strengthen this point. First, the sole consideration of maximizing profits has given way to companies making political decisions. Friend-shoring has been prominently featured in earnings calls across Europe and North America as the US-China trade war, Russian invasion of Ukraine and the China-Taiwan spat make geopolitical alignment a key concern.

Both Western and Chinese brands have faced boycotts due to geopolitical alignment or the failure to distance themselves from geopolitical topics in recent years.

Second, rising geopolitical tensions have also impacted the perception of consumers and companies towards the “other side” negatively. Chinese consumers continue to display the trend of switching from foreign to domestic goods. More than 60% of



The volume of goods and services traded globally is still near an all-time high. However, the trend towards national policies benefiting the domestic producer base has been clear as sentiment towards globalization changes.

European companies surveyed by the European Central Bank see China as a potential risk to their sector's supply chains. About 71% of Australian respondents said they worry about possible Chinese military threats, according to a Lowy Institute poll.

Both Western and Chinese brands have faced boycotts due to geopolitical alignment or the failure to distance themselves from geopolitical topics in recent years. This trend is likely to continue. Political polarization in the West and leaders in Russia, India, and China facing domestic pressures at home will likely lead to more industrial policies and subsidies favoring domestic producers.

China’s overcapacity and oversupply in the industrial space will remain a concern as Europe’s share in global trade diminishes. We have seen that wars and trade disputes have the potential to move markets. However, what is more important is for companies to adapt to this new reality and seek diversification.

PART II

Regional themes

Regional themes

US. Captain Exceptional

Expectations of a US recession and substantial monetary easing by the Federal Reserve (Fed) in 2024 were overblown. Instead, the US economy has grown by more than 2% (in annual terms) in eight of the last nine quarters. Markets were forced to rapidly scale back Fed easing bets, supported by four consecutive months of upside US inflation surprises and a resilient US labor market. As a result, the US dollar index rose 7% in 2024, thanks to its high growth and high yield appeal.

The outperformance of the US economy can be explained mainly through the lens of fiscal stimulus during the pandemic years and distortions in the labor market. That said, tight monetary policy has impacted the procyclical part of the US economy such as the industrial and housing sector. However, the slowdown in these sectors has been fully compensated for by the outperformance of US households.

The ratio between surprises for consumer data versus procyclical data hit the highest level since 2011 in May this year, emphasizing how the US outperformance was also the function of a surprisingly strong consumer.

Consumer spending is likely to remain a driving force for activity as real household incomes improve with falling inflation and interest rates as well as the wealth effects materializing from gains in the stock market.

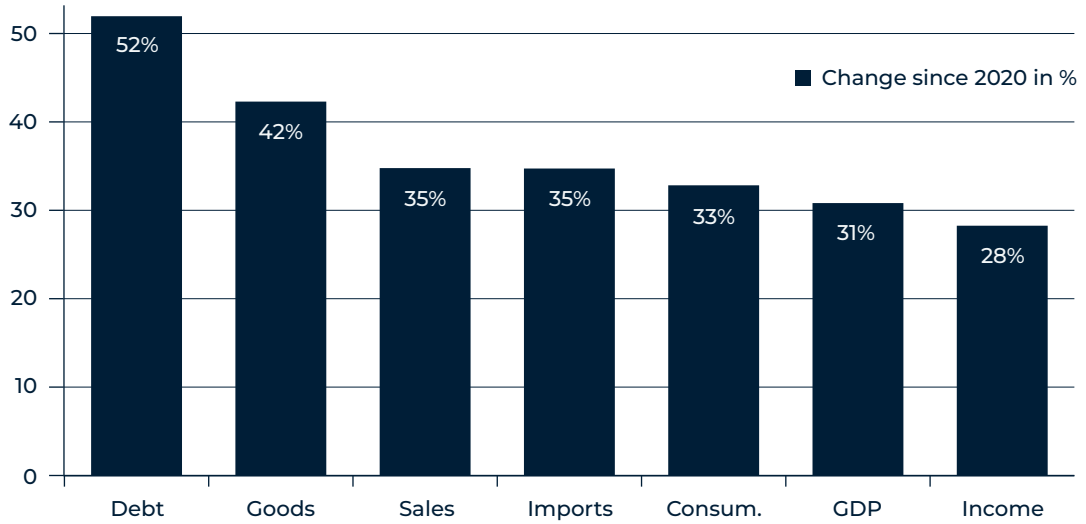
The US labor market has also been robust. The six-month change in monthly job growth remains above the pre-pandemic trend as we witness the second-longest streak of positive jobs growth on record. Granted, the recent rise in the US unemployment rate has breached the Sahm rule — a closely watched recession indicator.

But in this case, higher unemployment is mostly a supply-side phenomenon, driven by increases in the workforce, rather than firms laying off workers. This suggests that the rise in unemployment is less worrying than the headline numbers indicate, potentially providing a false recession flag.

Indeed, fixating on one indicator to predict a recession is unwise as rules can be broken. For example, the inverted yield curve has been pointing to a recession for the past two years, its longest streak on record, and yet the US economy has grown robustly over that period.

Expansive policy has pushed the US into its own league[7]

US indicators on nominal household spending and income



Overall, the consensus forecast, according to Bloomberg (6 February 2025) is for US GDP to rise more than 2% again in 2025, as the economy is transitioning into a more sustainable pace of growth.

The economy is transitioning into a more sustainable pace of growth. While manufacturing remains in a soft patch and housing market activity remains depressed amid elevated interest rates, some of these pressures should abate as the Fed continues its rate-cutting campaign. With the labor market coming back into balance and the disinflation trend back on track, 2025 is expected to be the year of policy normalization and the Fed trying to get the fed funds rate closer to its long-run neutral rate.

Interestingly, markets are pricing in just 40 basis points of cuts by the end of 2025 though, given robust economic growth, resilient labor market and heightened fears of reflation in the wake of Donald Trump's victory in the US election. The uncertainty around fiscal, trade, and immigration policy could create a headache for the Fed and weaken its bias to ease policy.

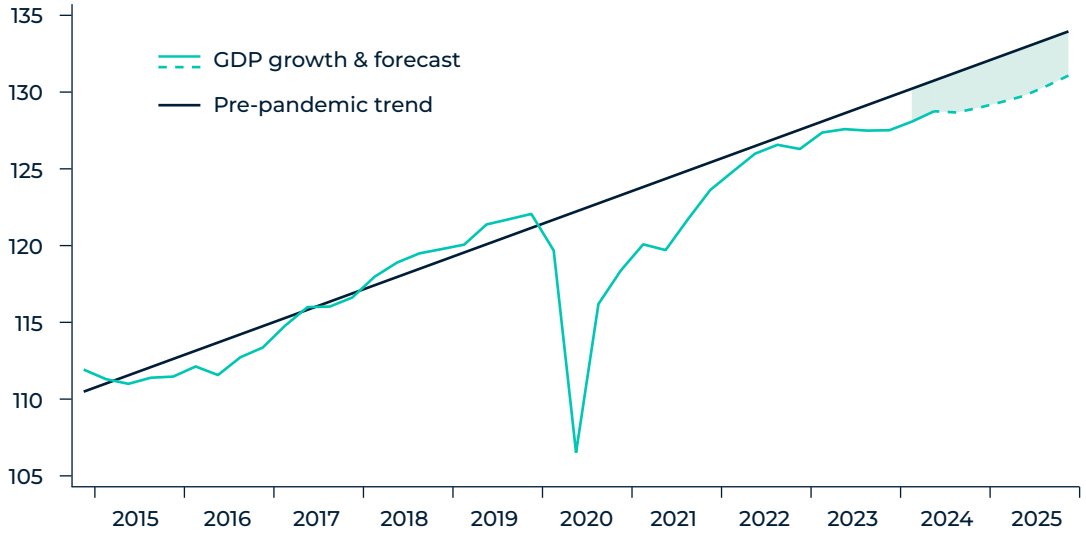
Canada. Trade worries to weigh on growth

Household spending on services has driven Canada's economy in 2024, with GDP growth modestly surpassing expectations in the first half of the year. However, Canada's economic growth remains around 3% below its pre-pandemic trend as restrictive monetary policy has constrained activity. Thus, with inflation pressures subsiding, the Bank of Canada (BoC) became the first of the G7 central banks to kickstart its policy easing cycle by cutting interest rates in June last year.

The BoC has delivered 175 basis points of rate cuts from its Spring 2024 peak of 5% to 3.25%. By cutting rates quickly relative to global peers, the BoC has shown it's concerned about the weaker growth outlook and wants to strengthen demand, eliminate slack, and keep inflation close to the 2% target. The disinflationary trend has supported this dovish shift. Headline CPI is at a three-year low, back within the BoC's 1–3% target range, and several key measures of underlying inflation have cooled further. Though inflation might edge up in early 2025 due to base effects, lower shelter costs,

Growth expected to remain below trend[8]

Canada GDP rebased, 2008=100



house prices, weaker wage growth, and a further decline in global oil prices should pull inflation back down to the BoC's 2% target by mid-2025.

Canada's pending federal election in 2025 has prompted the minority Liberal government to introduce vote-buying fiscal stimulus though and more is on the way. But a possible Conservative majority election win would usher in a sea change to the nation's economic and fiscal agenda and could materially affect the outlook for the Canadian economy in 2025 and beyond.

By cutting rates quickly relative to global peers, the BoC has shown it believes the balance of risks has shifted away from a recession.

The start of the Trans Mountain Pipeline and a weaker Canadian dollar will boost exports, which along with strong government spending should provide a modest buffer to falling private-sector domestic demand. However, it's the swelling wave of mortgage renewals at higher rates that is a major concern, as many homeowners will see interest payments as a share of income rise in 2025, constraining household budgets and thus consumption.

Canada's savings rate has risen since mid-2022, and in early 2024 reached the highest level, outside of the pandemic period, in nearly 30 years. Although drawing down on these excess savings should cushion the blow of higher mortgage payments on the horizon, it could arguably also reflect that Canadians are pessimistic and preparing for a potential economic downturn.

The elephant in the room though is the "tariff man" - Donald Trump. The Canadian economy would fall into recession this year and inflation will spike if Trump follows through on his recent threat to impose 25% US tariffs on all Canadian imports.

Europe. Failure to launch

The eurozone economy showed moderate growth in 2024, expanding by around 0.75% after a prolonged stagnation since the energy crisis in late 2022. However, this fell short of ECB projections, was uneven across member states, and domestic demand remained subdued.

While Italy and France delivered some gains, Germany was the primary drag, suffering its first back-to-back annual contraction since early 2000s.

German soft data, like confidence for example, has been in negative territory since the start of 2022. The industrial sector of Europe's biggest economy has been down more than 20% from the pre-pandemic trend, due to unobtainable cheap Russian gas, subdued foreign demand and loss of competitiveness to China. This gradual decline has not gone unnoticed by voters, as the far right continues to gain traction in Germany.

The broader challenges facing the bloc highlight the structural issues at play. The Eurozone has underinvested in innovation and seen its competitiveness eroded well before new challenges arrived. From 2015 to 2022, Europe's largest companies spent roughly half as much on R&D as a share of revenue and invested less than their US counterparts.

We remain pessimistic towards the Eurozone on a structural level, versus most other advanced economies, with growth expected to average under 1.5% per year. High-frequency indicators have underperformed since last summer, with weaker-than-expected growth drivers and a larger-than-anticipated drag from past monetary and fiscal tightening presenting downside risks to the growth outlook.

December-quarter sentiment data generally disappointed, Eurozone PMIs have stagnated since June, while Germany and France face outright contraction. Business sentiment, as reflected in the Ifo and Sentix indices, has deteriorated sharply and labor market conditions, which were robust in H1 2024, have rapidly softened. The decline in firms' hiring intentions — particularly in the services sector — signals a sharp contraction in labor demand, which previously cushioned industrial weakness. Wage growth is expected to moderate sharply in 2025, according to Oxford Economics, posing additional risks to the ECB's inflation target.

We expect inflation to undershoot the ECB's forecast and the 2% target in 2025. That said, September headline inflation fell to a three-year low of 1.7%, but has since risen to 2.4% in December and firms' price expectations have also been trending higher over the last few months.

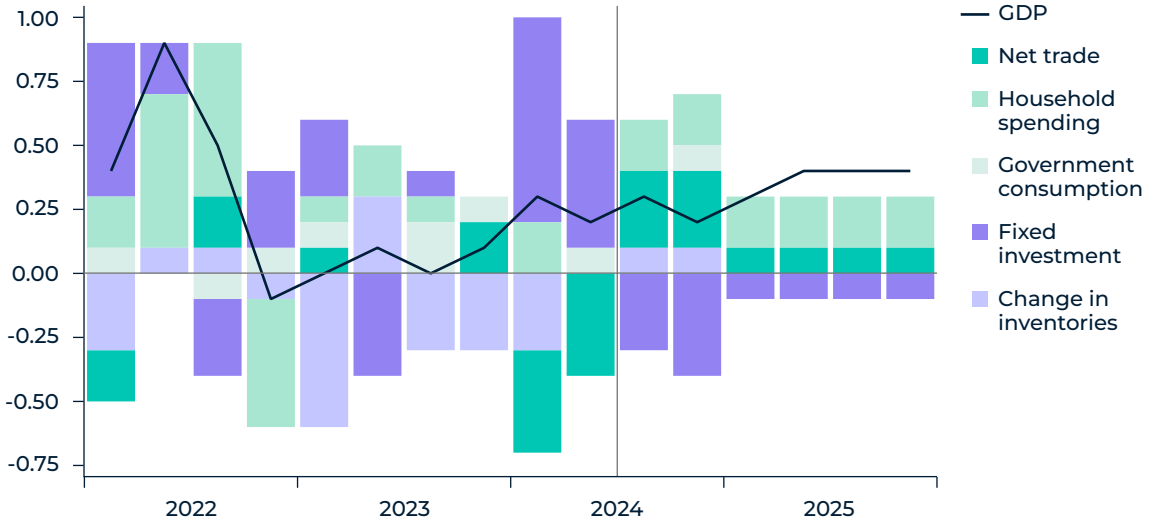
Consumer spending is expected to gradually improve, driven by real income growth and a cooling inflation environment, but this hinges on further ECB rate cuts. The central bank cut rates by 25bps four rimes in 2024 and is expected to proceed with cuts at a quarterly pace. However, we foresee a more dovish outlook and expect the ECB to accelerate policy easing towards a neutral setting to support growth.

Continued ECB hawkishness and delays in rate cuts risk overtightening and could derail the recovery. A stronger bounce in consumer optimism or external demand may lift near-term growth, but this is unlikely to be sufficient for a self-reinforcing recovery given structural difficulties.

Fiscal policy will increasingly drag on growth as government priorities shift from support to deficit reduction. Concerns about fiscal sustainability leave less room to maneuver, raising the chances of tensions in sovereign markets, with France and Italy being the main sources of risk.

Recovery hinges on consumer and businesses[9]

Eurozone real GDP forecast for 2025, by contribution



UK. Growth moderating, but the ship steadies

Defying recession expectations, the UK economy staged the strongest growth in the G7 group of advanced economies over the first half of 2024. The second half was not so rosy though as the British economy showed no growth in the three months to November 2024 and most indicators of UK near-term activity have declined.

The Bank of England (BoE) now expects zero GDP growth in 2024 Q4, weaker than the 0.3% that had been incorporated in the November Monetary Policy Report.

After spending all of 2023 in contraction territory, the UK manufacturing sector briefly returned to growth in early 2024 before sliding into contraction in Q4. The dominant services sector has been in expansion for over a year, but is also at its weakest level in over a year.

Headline inflation returned to the central bank's 2% target, even turning lower than that of the US and Eurozone in May, but turned higher in Q4, raising stagflation fears. Services inflation, an area of concern for the BoE, has proved more persistent, still well beyond its long-term average of 3.3%.

This has tempered BoE easing expectations, boosting the pound's rate differential and helping it climb to two-year highs versus the USD and EUR in Q3 2024. Services inflation pressures are expected to gradually ease and surveys show firms are raising prices much less aggressively than they were, however inflation expectations are at one-year highs.

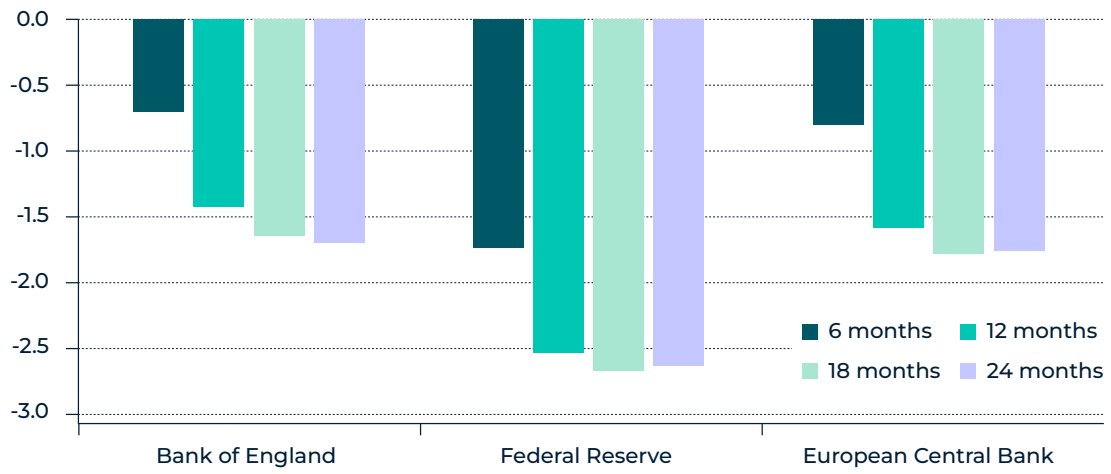
A key reason for the stickiness of services inflation is the strength of pay growth in those sectors. The UK government has signed off on pay rises of 5%–6% for many public sector workers, so further strong real wage gains over the coming year are plausible. Nominal wage growth should ease though, not only because actual inflation is lower, but because the number of job vacancies continues to fall. The vacancies per unemployed ratio — a gauge for the tightness of the labor market — has returned to pre-pandemic levels.

The unemployment rate has risen slightly above its post-pandemic average of 4.3%, but there is skepticism of the data given issues with response rates. Indeed, the BoE's own surveys show that recruitment difficulties have eased considerably over the past couple of years. Thus, the stage looks set for further, but gradual, rate cuts by the BoE. The BoE has cut rates by 25bps two times in this easing cycle and markets are only fully pricing in two more this year, but we lean more dovish and expect the Bank Rate (currently at 4.75%) to be below 4% by the end of 2025.

The boost in real household incomes from the fall in inflation and lower interest rates on the horizon should result in an above-trend

Bank of England viewed as the least dovish G3 bank[10]

Market expectations for central policy rates



growth rate. However, a downside risk is that the impact of past monetary policy tightening will continue to surface as the transmission to household interest rates, such as refinancing fixed-rate mortgages at much higher rates, is protracted.

Potentially cushioning this impact though is the excess savings built up by British households since the pandemic. The Office for National Statistics estimate households saved 11.1% of their income in the first three months of this year — the highest rate since 2010, excluding the start of the pandemic. A decision to spend past savings or a lower savings rate in the future would boost consumer demand.

Other constructive factors for the UK's economic outlook include, its favorable demographic profile compared to most other Western European economies, and its strength in faster-growing areas of private services. The newly elected Labor Party's large majority also brings with it the prospect of political stability, as well as closer trade links with the EU. However, given the rise in gilt yields to 14-year highs, fresh concerns around UK fiscal sustainability have emerged. This could result in trimming back public spending in the March fiscal update, which would drag on the outlook for growth and create extra questions over whether the spending plans are plausible.

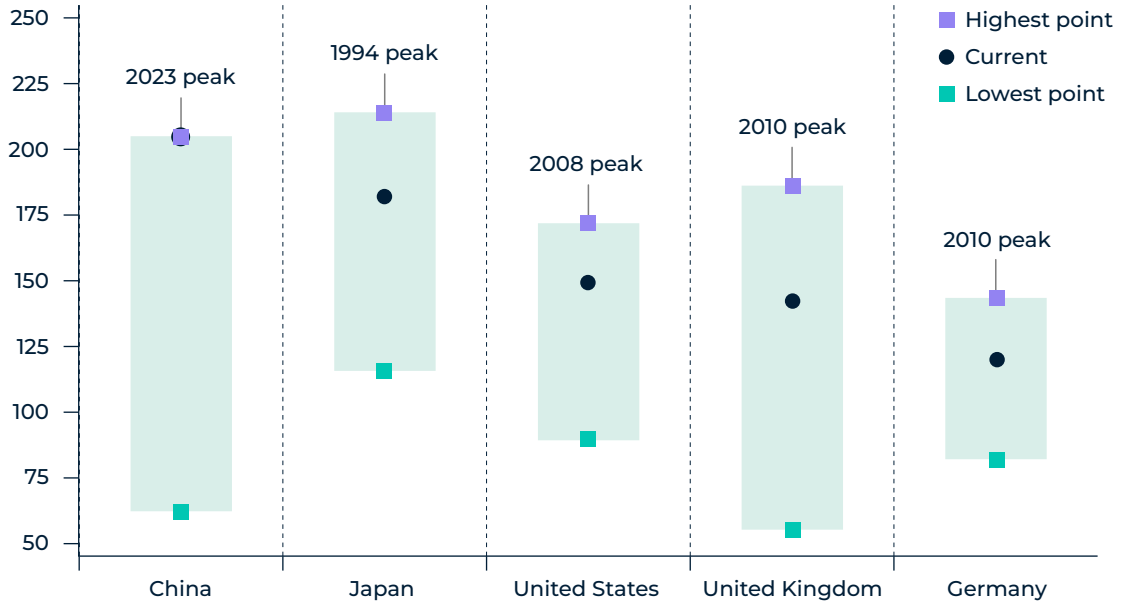
China. Demographic challenges drive tough policy choices

In 2024, China's economic growth continued to face headwinds, with GDP likely expanding at a modest pace of 5.2%. Looking ahead to 2025, forecasts suggest growth will slow even more to 4.5%, according to Bloomberg (6 February 2025). This outlook reflects ongoing structural challenges, particularly demographic shifts and their impact on various sectors of the economy.

Three key factors have influenced China's economic performance in 2024. First, the global manufacturing slowdown has weakened demand for China's exports, especially from major industrial economies, and impacted the country's manufacturing sector. Second, domestic property market adjustments, as the real estate sector, which is a significant contributor to China's economy continued its multi-year correction in 2024. Third, demographic pressures, with China's aging population and declining

Private debt in China on par with Japan's 1990 bubble[11]

Private sector credit-to-GDP ratio



workforce weighing on productivity and economic dynamism.

These factors are expected to continue shaping China's economic landscape in 2025. The property market remains a key area of concern. In 2024, policymakers implemented measures to support developers and stabilize the market, including programs to help digest excess inventory. While these efforts have shown some success in tier-one cities, the nationwide property market is expected to take longer to fully stabilize. The transition from a property-driven growth model to a more balanced economy will likely continue to create near-term headwinds in 2025.

Deflationary pressures have been a persistent theme in 2024, with the GDP deflator remaining in negative territory for much of the year. This trend is expected to continue into 2025, with nominal GDP growth forecast at just 4.9%, barely above the real GDP growth rate of 4.5%. This suggests ongoing challenges in achieving price stability and robust economic growth simultaneously.

Returns on investment have deteriorated in recent years. This trend is likely to persist in 2025 as China grapples with the need to maintain growth while transitioning away from its traditional investment-led model. The challenge for policymakers will be to improve capital allocation efficiency while managing the inevitable slowdown in overall investment growth.

The challenge for policymakers will be to improve capital allocation efficiency while managing the inevitable slowdown in overall investment growth.

External factors will play a crucial role in China's 2025 outlook. Stabilizing and growing exports will be crucial for economic performance. However, geopolitical tensions and potential trade disputes, particularly with the United States, remain a risk factor that could impact economic performance.

To address these challenges, Chinese policymakers are expected to focus on several key areas. First, boosting domestic consumption, including potential increases in social welfare spending, may help offset weaknesses in investment and exports. Second, continued emphasis on high-tech manufacturing and strategic industries is likely, as China seeks to move up the value chain and reduce reliance on traditional low-cost manufacturing.

Third, targeted fiscal measures, potentially including infrastructure investment and support for key industries, may be employed to stabilize growth. Fourth, the People's Bank of China is expected to maintain an accommodative stance, balancing the need to support growth with concerns about financial stability and currency pressures. Lastly, structural reforms to address long-term challenges, including pension system reforms and measures to boost productivity, may gain increased attention.

While these policy measures are expected to provide some support, in 2025 China's economy will likely continue its gradual transition towards a more sustainable growth model. While near-term challenges persist, the country's policy choices and ability to adapt to structural changes will play a crucial role in shaping its long-term economic prospects. Investors and businesses operating in China should remain attentive to policy developments and be prepared for a period of economic adjustment as the country navigates this important transition phase.

Australia. Fighting to stay afloat

The Australian economy spent 2024 fighting to keep its head above water, with GDP falling from 1.9% in mid-2023 to 0.8% by Q3. While this rate broadly equates to many other developed economies over the last year, for the so-called "Lucky Country", it's a bitter pill to swallow.

Australia has been the beneficiary of China's industrialization over the last 25 years — lucky indeed. But with Chinese growth moderating, a persistent inflation problem and tough talk on interest rates from a belligerent central bank, has Australia's luck run out?

Domestically, Australia has been mainly impacted by the shock of higher rates due to increases in 2022–23 that saw the benchmark rate climb from 0.10% to 4.35%.

Most central banks will use interest rates to control monetary policy but the environment they operate in differs markedly across countries. In Australia, traditionally "variable" home loans mean that higher rates rapidly impact mortgage holders, but other parts of the population are less affected. Around one-third of Australian households carry mortgages.

According to Australian National University research published in late 2023, mortgage-holding households spending more than 30% of their income on mortgage payments — a marker of cashflow stress — climbed from 27% in 2019 to almost 50% in 2024.

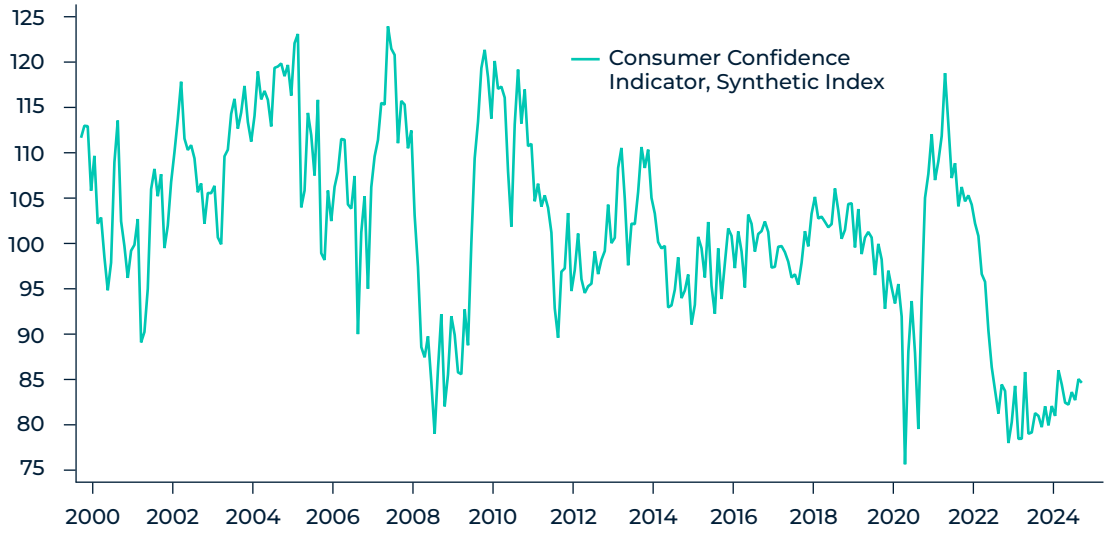
The hit to disposable income has seen consumer confidence stuck at levels not seen before the pandemic, although the Roy Morgan confidence reading has recently improved due to tax cuts and energy subsidies.

The Australian employment market remains broadly positive with unemployment at 4% in the December report — historically any number below 5.0% is seen as "full" employment in Australia — but this number is still above the 2024 lows at 3.7% in a sign that momentum has turned more negative.

One final question for the local economy is how it copes with a slowdown in migration that has been a driver of economic growth but also responsible for political tensions around housing and cost of living pressures. Australian net migration reached an all-time high of 528k in 2022–23 but is forecast to more than halve to 260k in 2024–25.

Feeling lucky? Not really[12]

Australian consumer confidence



Looking to the external sector, China's slowdown has impacted Australia, but the local economy has managed to avoid a recession seen in many other China-exposed countries over the last year (notably, Germany and New Zealand).

One reason for the Australian economy's resilience, is that it was forced to pivot away from exports to China due to collateral damage during the US-China trade war of 2018–19 and then direct disputes as a result of the trade freeze post-Covid (former prime minister Scott Morrison's call for a World Health Organization inquiry into the origins of Covid sent Australian-Chinese relations from bad to worse).

As a result, between 2021 and 2023, exports to China fell from 42% of all exports to 33%, while exports to Japan climbed from 11% of all exports to 18%.

Australia's main commodity exports have also been relatively well supported, although prices were beginning to fall towards the end of 2024. Of Australia's top three commodity exports, iron ore remains near ten-year averages, thermal coal remains well above ten-year averages while liquefied natural gas neared ten-year lows near the end of 2024.

Looking forward, without an improved performance from China, a significant rebound in commodity prices, or a 180-degree turn from the RBA, the Australian economy might continue to underperform in 2025.

REGIONAL THEMES: KEY TAKEAWAYS

United States

IN 2025, THE FORECAST IS FOR US GDP TO RISE

1.9%

Canada

BY LATE 2025, POLICY RATE SHOULD FALL TO

2.25%

Europe

DUE TO A CYCLICAL UPTICK, GDP IS PROJECTED TO REACH

1.4%

United Kingdom

UK GDP GROWTH IS FORECAST AT

1.8%

China

NOMINAL GDP GROWTH IS FORECAST AT

4.9%

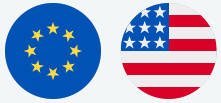
Australia

IN 2025, NET MIGRATION IS FORECAST TO HIT

260K

PART III

Forecasts



FORECAST

EUR/USD

← LOOK BACK

The first half of 2024 was a tightly controlled but unpredictable ride in the FX market. After reaching a near-decade high in 2022, realized FX volatility dropped significantly in 2024, hitting five-year lows. Volatility expectations also fell, with few major events structurally disrupting the FX landscape. Despite some notable fluctuations, they were much smaller than the swings seen over the last two years. For example, EUR/USD traded within a narrow range of $1.06–$1.10 on 91% of days, and despite brief rallies, failed to break through the 30-month resistance level of $1.12. Mean reversion strategies dominated the market and proved effective.

Monetary policy, particularly expectations of Fed-ECB rate divergence, was the primary factor influencing EUR/USD. In early Q1, EUR/USD fell to $1.06 as market optimism for a dovish Fed was tempered by concerns over US inflation. Meanwhile, the ECB signaled rate cuts before the summer recess which weakened the euro. However, by mid-Q3, signs of a cooling US labor market weakened the dollar. Despite deteriorating Eurozone fundamentals, EUR/USD took precedence before reversing at this $1.12 level yet again.

Political events also played a role. In June, a political deadlock in the French elections widened the OAT-Bund spread, a key election risk indicator, to nearly double its two-year average. This triggered a 1.5% drop in EUR/USD within a week. In the US, President Biden's underperformance in the first presidential debate initially boosted the dollar through "Trump trade" optimism. The EUR/USD tumbled after Donald Trump's election win, however, as polls between new Democratic candidate Kamala Harris and Trump narrowed, the dollar's rally lost steam.

LOOK AHEAD →

We expect the mean-reverting pattern of EUR/USD to persist into 2025. The pair's movement will depend on the relative pace of rate cuts by the ECB and the Fed. Markets currently lean towards a front-loaded Fed easing campaign. Meanwhile, ECB rate cut expectations have stayed steady, with a gradual 25bps reduction expected each quarter.

However, we anticipate the ECB will accelerate rate cuts in 2025, just as the Fed begins to slow, limiting EUR/USD upside in the medium term. Weakening Eurozone activity raises concerns about its economic performance, whilst slowing wage growth has increased confidence that services inflation will normalize in 2025, likely leading headline inflation to undershoot the 2% target. Together, both factors may prompt more easing by the ECB, undermining euro's appeal.

A key risk to this outlook is the ECB's cautious approach, having delayed rate cuts until convinced by quarterly macroeconomic forecasts. Additionally, the Fed, with a 270bps real rate buffer, has more room to maneuver than the ECB, which has just 95bps, giving the Fed greater flexibility to adjust policy.

Continued softening of the US economy and shifting market expectations toward a dovish Fed validate the bullish euro-dollar narrative. However, political risks in Europe, such as potential fallout from the French budget plan failure, could still drag on the euro. If France fails to comply with EU budget rules this autumn, it risks bond downgrades, causing volatility in European bond markets and further weighing on the euro.

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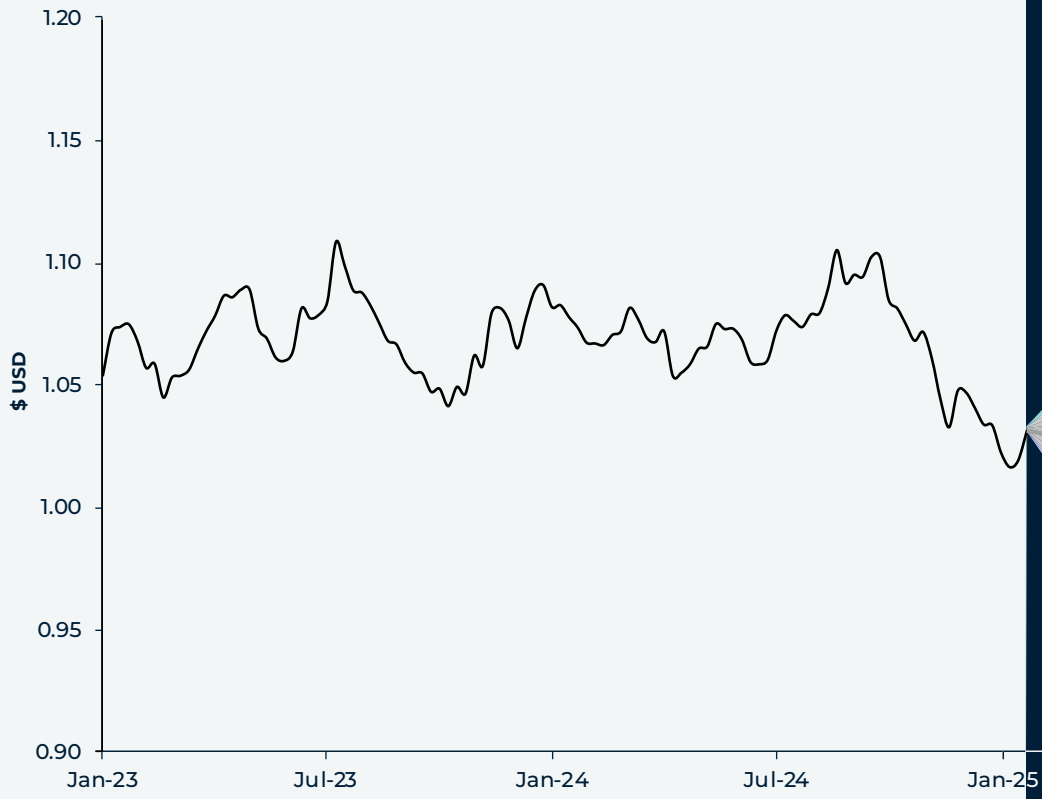
FORECAST

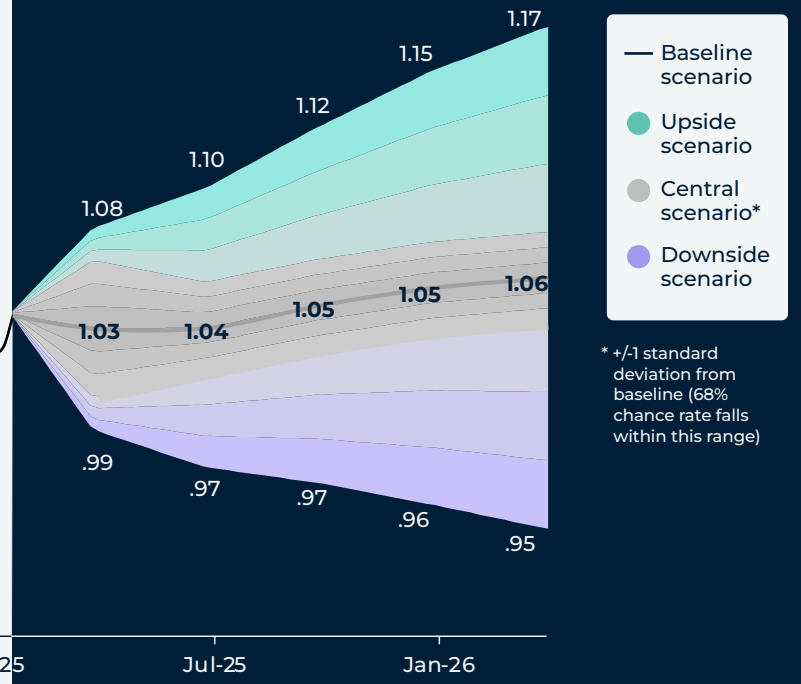
EUR/USD

Europe's economic malaise to cap gains[13]

Historical volatility of the EUR/USD exchange rate



Convera-Oxford Economics projected scenarios for EUR/USD



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

FORECAST GBP/USD

← LOOK BACK

In 2024, the British pound appreciated against more than 70% of the world's currencies and, on average, gained more than 5% against these peers. This was driven by a more supportive domestic economic landscape, reduced political premium, relative yield differentials and a healthy risk environment. Better-than-expected UK data saw the UK-US economic surprise differential climb to three-year highs by the summer, correlating with GBP/USD's rebound from its year-to-date low of $1.23. Meanwhile, the Labour Party's UK election victory saw markets begin pricing in closer trade ties with the EU. The USD received a short-lived bounce, but overall relative political stability has benefited the pound.

Sterling also retained an attractive yield advantage with the BoE taking a more cautious approach to policy easing. The premium of UK government bond yields over the rest of the G10 reached 120 basis points in late 2024, compared with an average of 30 basis points over the last 10 years. Specifically, the two-year UK-US yield spread turned positive this summer, helping GBP/USD climb above $1.30 after its second ever longest stint below this psychologically important level. Finally, with one of the strongest correlations with global stocks out of the G10, the pound has thrived in this low volatility and risk-on climate for the best part of 2024.

However, the US election result, coupled with firm US data and rising US yields, marked the start of a trend reversal for GBP/USD in Q4 2024. In fact, the pound only appreciated against circa 1/3 of its global peers, that quarter, in a sign of broad-based pessimistic towards UK assets. GBP/USD ended the year almost 2% lower, and 6% below its 2024 peak.

LOOK AHEAD →

Before the US election, we held a more bullish view on sterling, but after the weakening of GBP/USD in Q4, we've revised down our forecasts. This relates to the ongoing US exceptionalism narrative, reduced Fed rate cutting bets and Trump's policies, meaning the cyclical and tariff-related path of least resistance continues to favor the US dollar.

Bullish drivers that justified the positive GBP/USD trend throughout most of 2024 face difficult questions in early 2025. The UK economy's weak finish to 2024 heightens concerns about a potential technical recession. An improving UK economy is predicated on a fiscally neutral assumption, and the prospect of fiscal tightening via tax hikes has already jeopardized this and contributed to sterling's decline.

The gilt market meltdown at the start of this year highlights the lack of investor confidence in fiscal policy and the negative structural challenges (rising debt burdens) facing the UK economy. This is clearly highlighted by the diverging paths of UK-US rate differentials and GBP/USD over the past few months.

Meanwhile, the UK's slower growth trajectory can further sway Traders to ramp up expectations of more monetary easing which will likely weigh on sterling via the yield narrative. At this stage, we wouldn't rule out a test of the $1.20 handle in the first quarter.

For the pound to recover the higher realms of the $1.20s, UK data must improve, alleviating the risk of stagnation or even recession. GBP/USD is also at the mercy of the US dollar of course. A turn in the USD, cyclically or tariff driven, would provide a firmer footing for GBP/USD to reclaim $1.25 and break out of its four-month downtrend. However, with the unpredictability of Trump and the ongoing underwhelming UK economy, it's difficult to gauge when sterling's troubles will ease.

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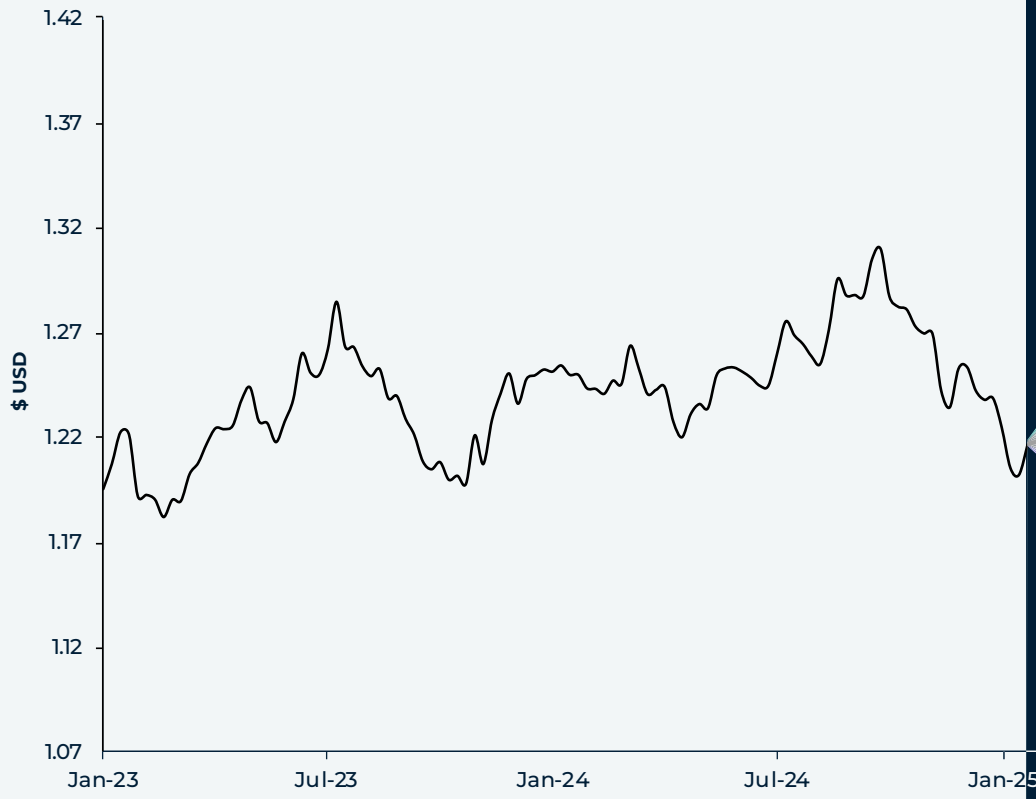
FORECAST

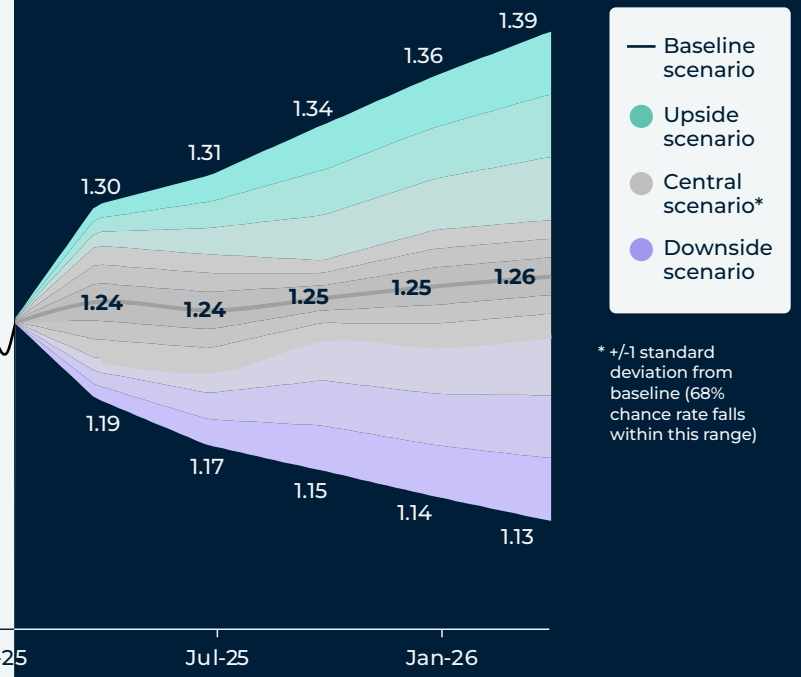
GBP/USD

BoE's inflation worries could help sterling higher[14]

Historical volatility of the GPB/USD exchange rate



Convera-Oxford Economics projected scenarios for GBP/USD



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

FORECAST GBP/EUR

← LOOK BACK

Sterling retained an edge over the common currency throughout 2024, with GBP/EUR staying in positive territory all year and clocking fresh two-year highs near €1.22. Favorable yield and growth differentials, coupled with upbeat market sentiment and relative political stability were the main drivers of the uptrend.

The difference between the UK and German two-year yields widened to their highest in decades, reinvigorating demand for the higher yielding pound. Why? Because markets are anticipating more rate cuts by the ECB compared to the BoE over the next couple of years. Indeed, after the ECB cut rates for the first time in June, GBP/EUR climbed beyond its 10-year average of €1.19. In parallel, the UK-Eurozone economic surprise differential entered positive territory, highlighting the stronger UK macroeconomic backdrop relative to the Eurozone. However, this turned negative in Q4, when UK started disappointing more than European data, exacerbated by the lack of confidence in the wake of the UK's autumn budget statement.

The pound tends to benefit more from a healthy risk environment where equities markets are rallying. Hence, the only major period of GBP/EUR weakness in 2024 occurred during the global equity sell off in early August. The pound suffered its biggest two-week slide against the euro since early 2023 but rebounded off key weekly moving averages around the €1.16 area. GBP/EUR's low volatility in 2024 is quite striking. GBP/EUR has spent 90% of the year oscillating between €1.16 and €1.19, not once moving into overbought or oversold territory. In fact, the spot price range of less than 6% year-to-date is the narrowest among all EUR- and GBP-related exchange rates in the G10 universe.

LOOK AHEAD →

The outlook for the pound is mired by headwinds from concerns over stagflation, fiscal sustainability, and external concerns about a potential trade war. However, the euro is not without its own challenges. Lackluster growth, political woes in France and Germany, and weak demand from China are all drags. Still, with yield spreads expected to continue favoring the pound through the global easing cycle, the GBP/EUR uptrend could extend into 2025, despite the 2% drop we've seen in January to five-month lows. Supporting this bullish assumption is increasing political polarization across Europe and concerns about fiscal sustainability which could increase structural headwinds for the common currency in the long term. However, recent fiscal worries in the UK rising stagnation and recession fears will also keep any additional pound strength limited.

A key risk to our GBP bullish outlook is if the BoE steps up its easing narrative, weakening the pound's yield advantage. There is more room for dovish BoE repricing relative to ECB pricing which would weigh on UK-German yield spreads and could drag GBP/EUR under €1.16.

From a technical perspective, long-run weekly moving averages are pointing upwards, and the currency pair has held above its 100-month moving average for the longest period since the 2016 referendum. We view these as meaningful bullish GBP signals but note the psychologically important €1.20 level remains a key barrier for GBP/EUR to hold above. The exchange rate has only been above this key level for 5% of the post-EU referendum era and has previously shed 5–10% within the six months that followed a failure to hold above it. This highlights how significant breaking beyond and holding above the €1.20 handle will be for the pound to build on its gains over the past two years.

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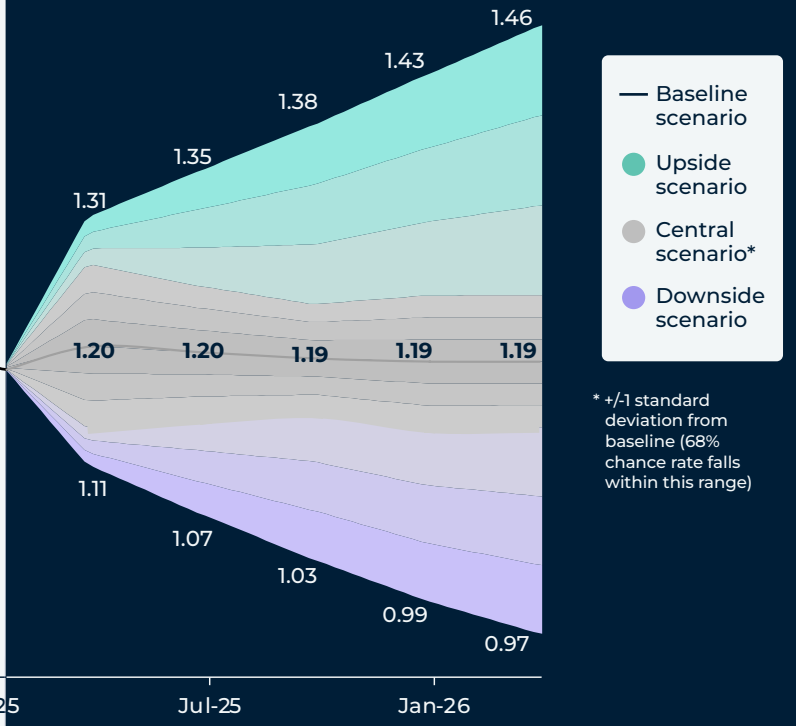
FORECAST
GBP/EUR

UK's improving growth profile to boost GBP[15]

Historical volatility of the GPB/EUR exchange rate

Convera-Oxford Economics projected scenarios for GBP/EUR



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

FORECAST
USD/CAD

← LOOK BACK

Despite the Loonie being the least volatile G10 currency, spending an unprecedented 85% of 2024 trading within a 400-pip range centered around C$1.36, volatility spiked during an eventful fourth quarter marked by domestic political turbulence, trade threats, and monetary policy divergence. In Q4 2024, USD/CAD broke the C$1.39 resistance, reaching a five-year high of C$1.4467.

A major driver of the upward trend was the divergence in monetary policy between the Bank of Canada and the Fed. The BoC's progress in combating inflation, aided by its flexible 1–3% inflation targeting framework, allowed it to be the first of the G7 to cut interest rates. In June, the policy rate was reduced from a 20-year high of 5% to 3.25%. In contrast, the Fed maintained a higher-for-longer stance until September 2024, when it implemented a 50-bps cut. This was followed by two consecutive 25-bps cuts, keeping the Fed Funds rate at 4.25%.

The divergence between central banks and the macroeconomic environment led market participants to sell the CAD, resulting in record levels of short bets by late July. The August stock market drawdowns and subsequent margin calls triggered widespread liquidations of short CAD positions, with 50% unwound in just four weeks. This fueled a 3% rally in the Canadian dollar during mid-August, despite otherwise quiet market conditions.

However, risk sentiment shifted, and the market narrative quickly changed to focus on the economic impact of potential trade tariffs on Canadian exports to the US, which would exacerbate an already troubled economy.

LOOK AHEAD →

The monetary easing divergence between the Fed and the BoC will continue to drag on the Loonie. The BoC has cut rates by 175 basis points and is expected to bring its neutral rate close to 2.25%. The BoC remains dovish, signaling a focus on downside risks to the outlook, provided inflation evolves as forecasted, which we believe is likely. Conversely, the US market has adjusted its expectations for Fed rate cuts in 2025. Uncertainty around the labor market and potential inflation rebound has pushed US government bonds close to panic levels.

With the BoC's terminal rate expected to reach 2.25% in 2025 versus the Fed's 2.75–3% by 2026, the CAD is likely to remain structurally weaker after the current easing cycle ends. Canada's softer economic profile pressured the CAD throughout 2024, with sub-trend growth anticipated to persist into Q4, limiting immediate upside for the currency. Additionally, uncertainty around trade tariffs and a Canadian government without a strong leader means monetary policy alone may not suffice to stimulate consumption and long-term productivity. Fiscal stimulus would be needed, but political paralysis would limit the central bank and majority government actions.

If the Canadian government can renegotiate the USCMA deal with the Trump administration without straining sensitive sectors like energy, manufacturing, and auto, and if a Conservative pro-business agenda takes effect in the second half of 2024, pressure on the CAD may ease off. Furthermore, if global monetary easing revives economic growth, increased demand for commodities could offer additional support to the CAD in the latter half of 2025.

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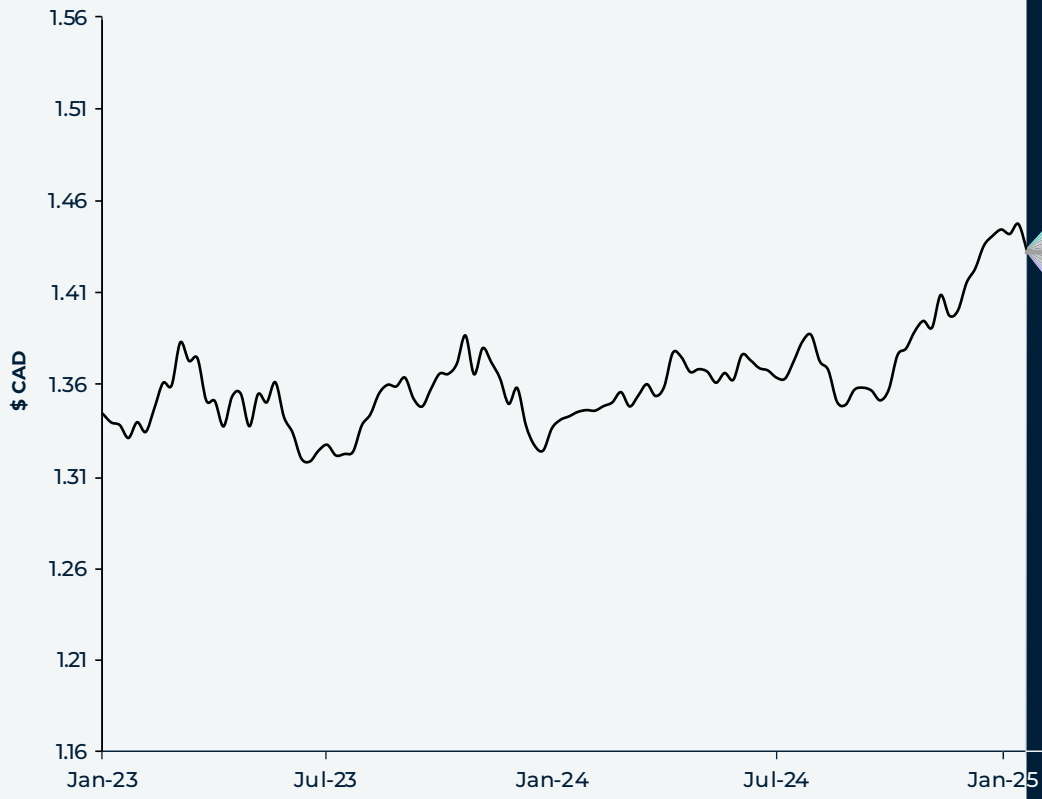
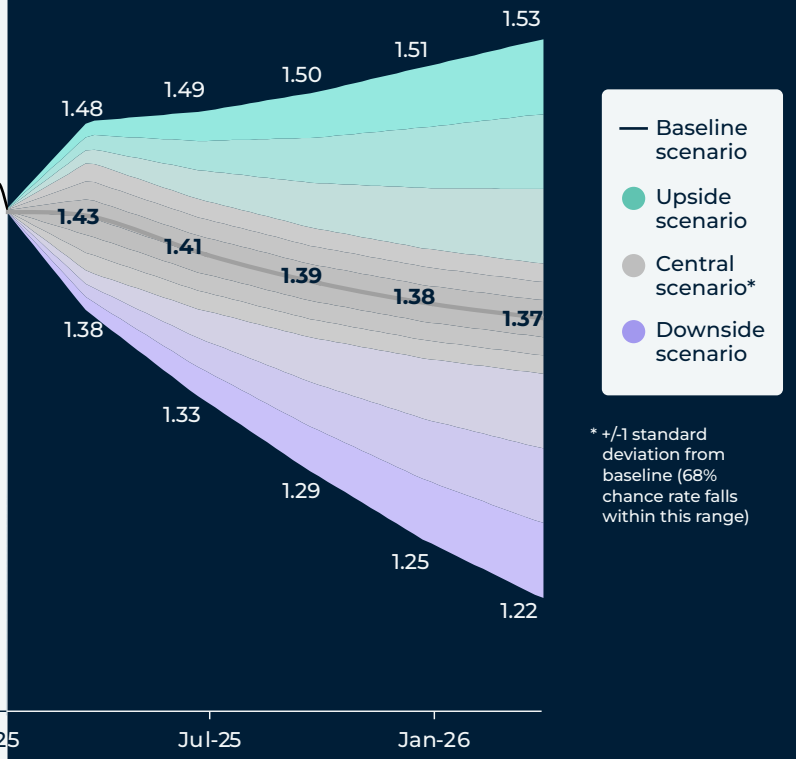
FORECAST
USD/CAD

BoC cuts to weigh on CAD[16]

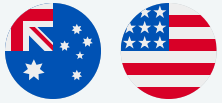
Historical volatility of the USD/CAD exchange rate



Convera-Oxford Economics projected scenarios for USD/CAD



* +/-1 standard deviation from baseline (68% chance rate falls within this range)



FORECAST
AUD/USD

← LOOK BACK

The Australian dollar struggled in 2024 as the impact of relatively lower interest rates and the slowdown in China weighed on the currency.

The AUD has been hit by three key factors. First, Australian interest rates spent most of 2024 below key trading partners — the US, Eurozone and NZ all started the year with interest rates above Australia.

Second, China's inability to gain economic traction as global manufacturing remained sluggish and local demand stayed cautious caused the AUD to remain muted.

Finally, and related to the slowing in both China and global manufacturing, key commodities weakened, with the Bloomberg commodity index falling back to the lowest level since mid-2021.

LOOK AHEAD →

The AUD/USD might remain capped going into 2025, with Australian interest rates likely to remain relatively low versus key trading partners and China unlikely to see any significant reversal of fortunes.

While Australia is currently expected to be one of the last major FX markets to see interest rate cuts (Japan excluded), rates in Australia remain well below US, UK and New Zealand rates, meaning other major markets might need to cut rapidly for the AUD to see any benefit.

Additionally, the Reserve Bank of Australia could pivot to loosening quicker than expected, causing the AUD to weaken.

For now, the spread between US and Australian rates have already climbed from a 30-year low (around 100bps in favor of the US in early 2023 to flat by September 2024), with the AUD/USD unable to gain much traction. This suggests other factors are also playing a part in the Aussie's weakness.

Those factors remain the outlook for China and commodities — both of which are currently weighing on the AUD.

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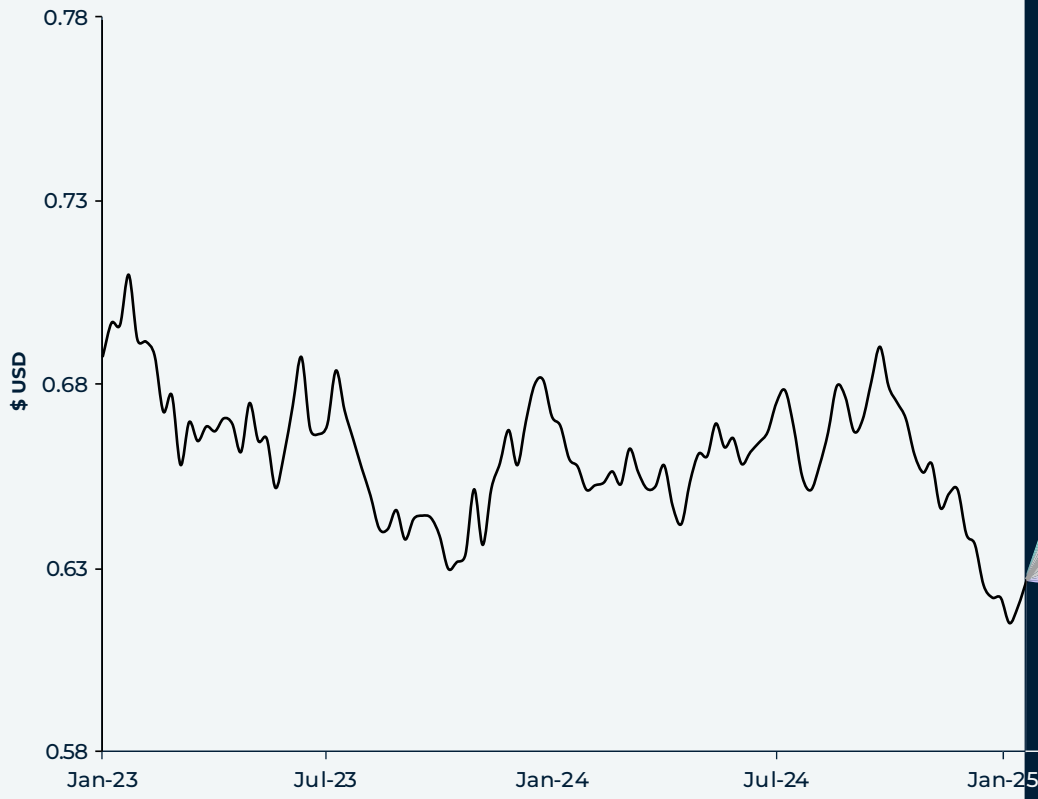
FORECAST

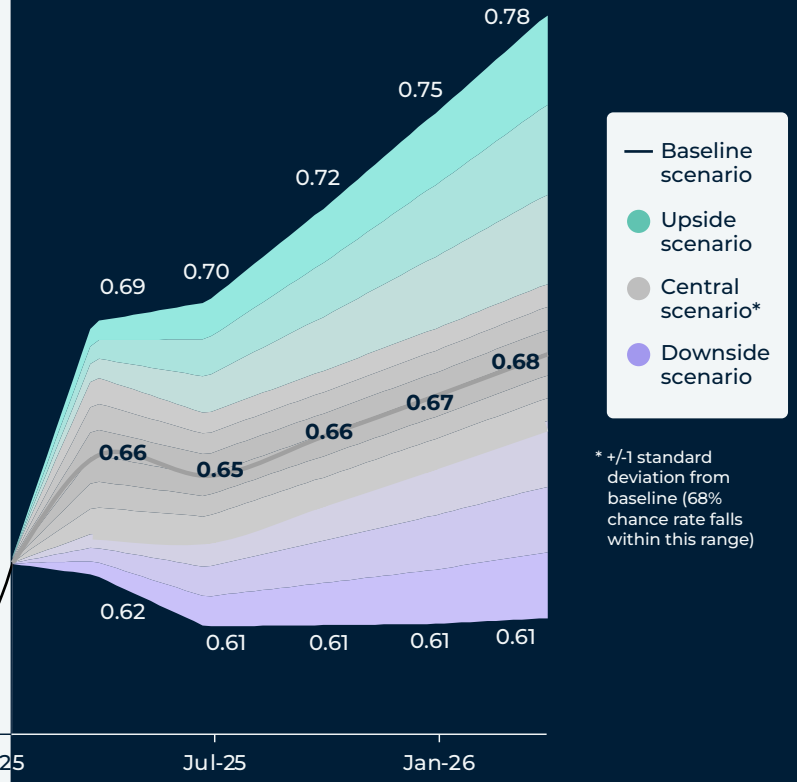
AUD/USD

Aussie's move higher depends on China[17]

Historical volatility of the AUD/USD exchange rate



Convera-Oxford Economics projected scenarios for AUD/USD



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

FORECAST

USD/JPY

← LOOK BACK

USD/JPY exhibited significant volatility throughout 2024, influenced by global economic factors, monetary policy decisions, and geopolitical events. The pair consistently traded above long-term averages, driving the USD/JPY higher, reflecting ongoing monetary policy divergence between the Fed and the Bank of Japan (BoJ).

USD/JPY saw a 34-year high in early July 2024 at ¥161.95, before the market sharply unwound the so-called carry trade positions (borrowing in low-interest Japanese yen) after the BoJ's second rate hike for the year in late July. The BoJ's communications were interpreted as relatively hawkish, leaving room for potential policy adjustments.

Key factors influencing the pair included potential BoJ policy revisions, including possible rate hikes, a significant increase in net JGB Japanese government bond supply, and fewer-than-expected Federal Reserve rate cuts.

The pair experienced occasional selloffs, with notable drops in July and early August. However, structural outflows from Japan persisted, driven by demographic trends and institutional investment strategies, weighing on the JPY. The interest rate differential between the US and Japan continued to play a crucial role, but the spread between US and Japanese ten-year bond yields has come off quite a bit, suggesting the yen is undervalued in the short term.

LOOK AHEAD →

The outlook for USD/JPY in 2025 remains cautiously positive, barring significant shifts in global economic conditions or policy stances. The 10-year JGB yield is anticipated to stabilize around 1.2% by mid-year, influenced by potential further BoJ policy adjustments and continued net JGB supply.

Despite this lift in Japanese yields, US interest rates will likely remain well above those in Japan, providing support to USD/JPY.

Key factors to watch include US economic performance and the risk of recession, pace and extent of Federal Reserve rate adjustments, BoJ's policy normalization trajectory, and global risk sentiment and commodity price movements.

The interest rate differential between the US and Japan will likely continue to be a primary driver of USD/JPY movements. Any significant narrowing of this gap could lead to rapid currency adjustments. Investors should closely monitor global economic growth projections, risk appetite shifts, and potential changes in US currency policy, as these factors could substantially impact USD/JPY performance throughout 2025.

Structural factors, such as Japan's aging population and institutional investment strategies, are expected to continue supporting capital outflows, weighing on the Japanese yen and potentially maintaining upward pressure on USD/JPY. However, any significant changes in global risk sentiment or unexpected economic shocks could lead to rapid shifts in these flows, meaning the USD/JPY might remain vulnerable to sharp selloffs.

While structural outflows persist, the BoJ's expected rate hikes and potential interventions may support the yen, leading to a modest appreciation vs. the USD.

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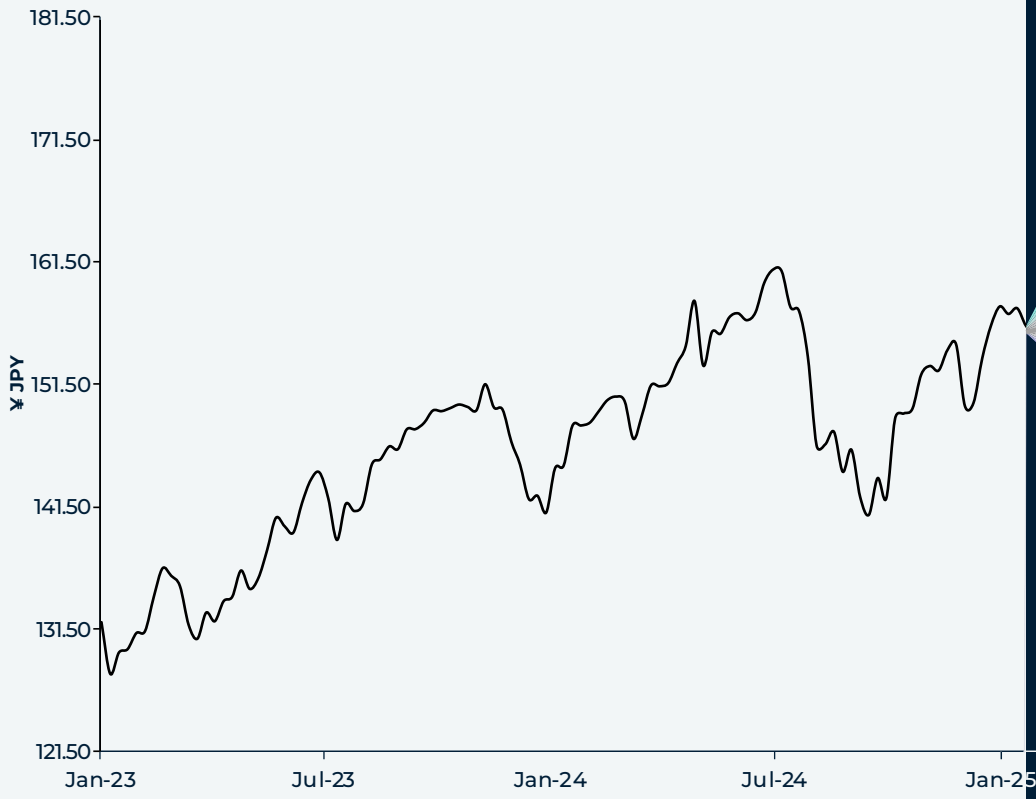
FORECAST

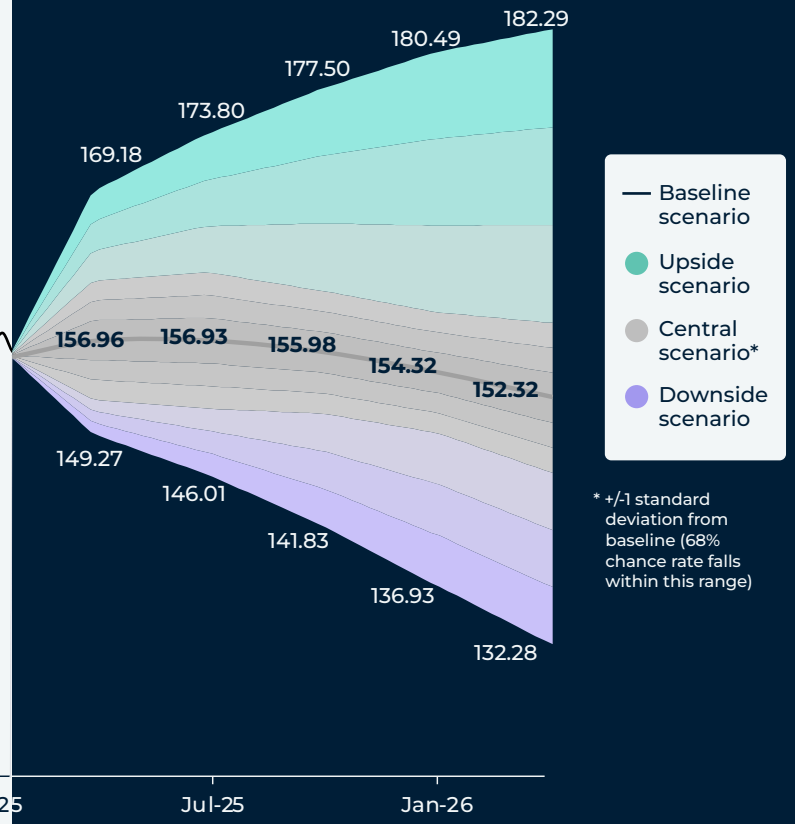
USD/JPY

Yen to gain as BoJ hikes[18]

Historical volatility of the USD/JPY exchange rate



Convera-Oxford Economics projected scenarios for USD/JPY



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

FORECAST

USD/CNY

← LOOK BACK

The USD/CNY experienced significant upward pressure throughout 2024, reflecting divergent economic trajectories between the United States and China. Most notably, the USD/CNY spent most of 2024 at an average of ¥7.2000, indicating significant and sustained weakness for the Chinese currency.

China's economic slowdown emerged as a key factor weighing on the yuan. The upward trajectory of the USD/CNY was driven by growing downside risks to China's annual growth target and metrics such as industrial production, fixed-asset investment, and retail sales which show signs of softness.

The People's Bank of China (PBoC) appeared to carefully manage the yuan's depreciation while maintaining accommodative monetary conditions to support the challenging growth environment. This approach contributed to the bearish bias on the CNY.

Three primary drivers likely influenced the USD/CNY movement. First, divergent macroeconomic cycles between the US and China. Second, China's potential disinflationary trend, widening the yield gap with the US and impacting regional FX performance. Third, a weak financial account due to declining foreign direct investment and portfolio inflows.

Despite pledges of fiscal support and potential rate cuts by Chinese authorities, the persistent upward movement in the USD/CNY rate implies that more policy measures may have been necessary, especially on the demand side, to counter broad-based weakness in consumption and investment.

LOOK AHEAD →

The USD/CNY will likely remain elevated, with a target of 7.50 by year-end, driven by tariff risks, seasonal outflows, and limited PBoC easing.

With China expected to remain cautious about monetary easing, interest rates in China remain well below US rates, meaning other major markets might need to cut rapidly for the CNY to see any benefit. Additionally, the People's Bank of China (PBoC) could quickly pivot to more aggressive loosening, potentially weakening the CNY further.

For now, the three-month interbank rate spread between US and Chinese rates stands at approximately ~300bps, contributing to the USD/CNY's persistent trading at an average ¥7.20 level throughout 2024. This is a key factor supporting USD strength against the CNY.

As a result, the near-term outlook remains more negative. Based on the current trend, a target for 31 December 2025 central scenario could be around ¥7.2200, assuming factors pressuring the CNY persist. However, we may see a moderate decline in USD/CNY in 2025, contingent on improvements in China's economic performance and potential easing by the Federal Reserve.

The potential for increased trade tensions between the US and China remains a key risk factor for 2025. Any escalation could lead to further CNY weakness, potentially pushing USD/CNY above ¥7.50 by the end of 2025. Conversely, a de-escalation of tensions could support CNY strength, though this scenario appears less likely given the current geopolitical climate.

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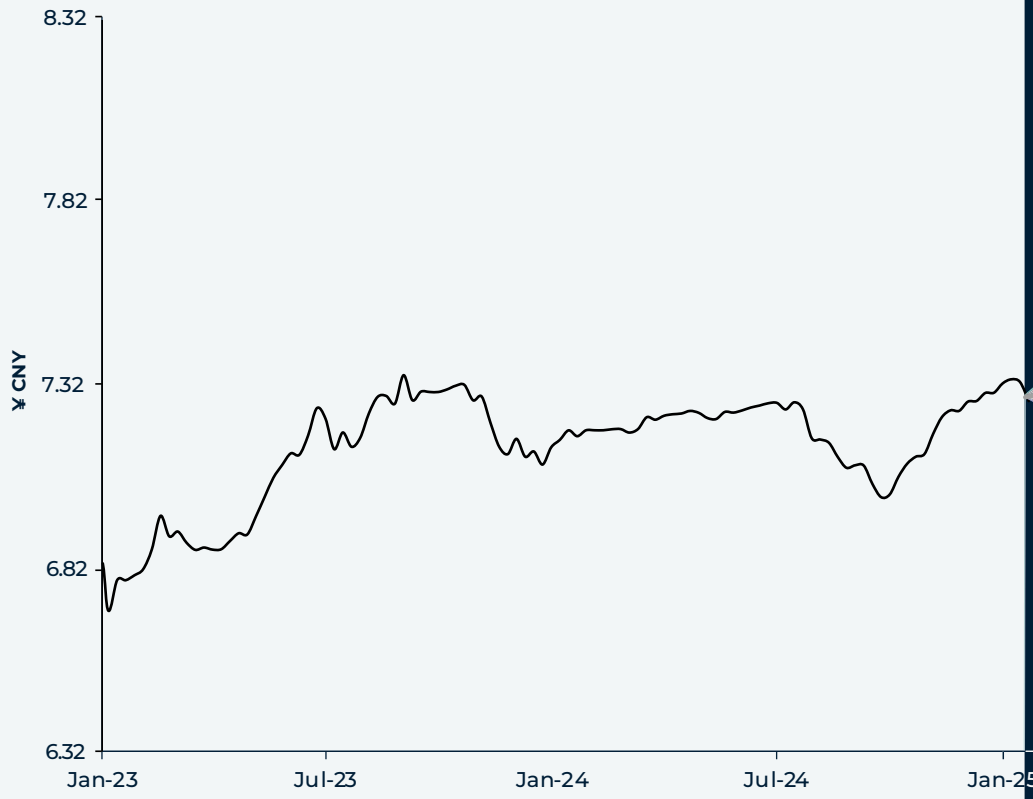
FORECAST

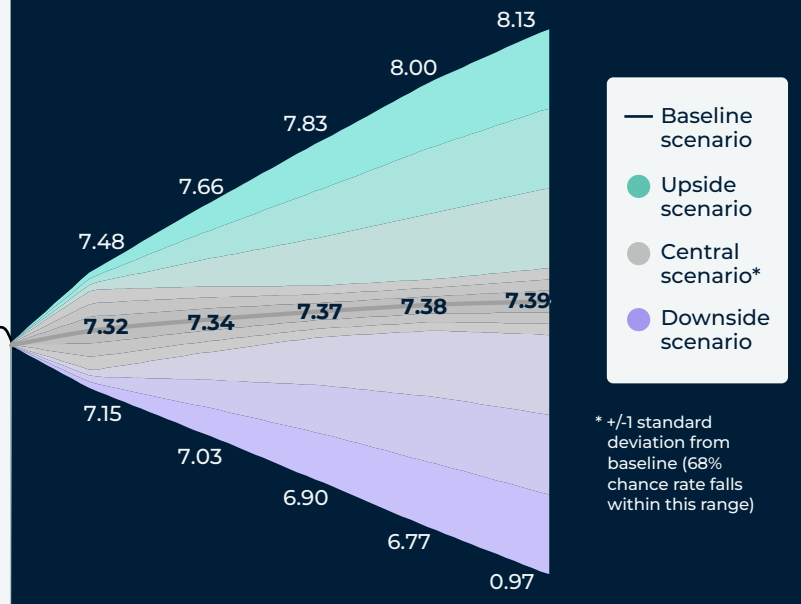
USD/CNY

China's slowdown to pressure CNY[19]

Historical volatility of the USD/CNY exchange rate



Convera-Oxford Economics projected scenarios for USD/CNY



* +/-1 standard deviation from baseline (68% chance rate falls within this range)

Considerations for international business

Risk management explained

A currency risk management strategy could reduce the possibility of unexpected financial losses, make future cash flows more predictable, and potentially provide a competitive advantage against others who may leave themselves exposed to currency risk.

However, any strategy is not simply a collection of financial products that can be used to address specific exposures. Instead, success lies in building an end-to-end approach and risk mitigation culture, taking a holistic and more disciplined attitude to managing currency exposures. This broader approach is especially critical amidst the current market reality organizations face.

In addition, uncertainty around underlying cash flow exposures caused by FX volatility creates separate challenges for risk managers, as critical terms like timing and amounts to hedge can change in an instant should market disruptions or changes to underlying demand for goods or services occur.

Contact our experts today and prepare your business for tomorrow.

convera.com/contact-us/

Identify currency exposures

Using our tools and platforms, we can help you:

- Get full visibility over your future FX payments and exposures.
- Accurately and easily forecast your foreign cash flows.
- Calculate your currency risk against potential market scenarios.

Set your 2025 goals

Review three common goals organizations usually have:

- Protect your financial objectives from adverse currency swings.
- Participate and benefit from favourable currency moves.
- Enhance, outperform competitors or achieve specific targets.

Develop your hedging strategy

You can then create a hedging strategy to help you meet your goals:

- Set a minimum hedging threshold so your business is not left exposed.
- Using market and industry insights, benchmark your strategy against best practices.

Endnotes

1 Convera, Macrobond

2 Convera, Oxford Economics data including a forecast for 2023–2026, Macrobond

3 Convera, Oxford Economics, Macrobond

4 Convera, Macrobond

5 Convera, Macrobond

6 Convera, Macrobond

7 Convera, Macrobond

8 Convera, Oxford Economics, Macrobond

9 Convera, Macrobond, Oxford Economics,

10 Convera, Macrobond

11 Convera, Bank for International Settlements, Macrobond

12 Convera, Macrobond

13 Oxford Economics, Refinitiv, Convera – 19 September, 2024

14 Oxford Economics, Refinitiv, Convera – 19 September, 2024

15 Oxford Economics, Refinitiv, Convera – 19 September, 2024

16 Oxford Economics, Refinitiv, Convera – 19 September, 2024

17 Oxford Economics, Refinitiv, Convera – 19 September, 2024

18 Oxford Economics, Refinitiv, Convera – 19 September, 2024

19 Oxford Economics, Refinitiv, Convera – 19 September, 2024

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