Inflation Focus Q2

19 June 2025

Key Points

- Tariffs and elevated uncertainty will weigh on economic growth, but a sharper downturn should be avoided
- Inflation should continue to grind lower, with goods deflation and slowing services inflation still in place
- US tariffs are likely to be disinflationary for most regions, with the US the key exception
- Central banks retain their focus on inflation, which is critical amid the shifting geopolitical and political landscape

Inflation is well behaved, with limited tariff impact so far

Inflation data have been encouraging over the past quarter, surprising modestly to the downside in many regions. Disinflationary trends have been bolstered by the low oil price and the weaker US dollar, which have helped to keep prices in check. US inflation data have shown only modest tariff impact so far, with non-tariffed components including rents and other services categories providing a disinflationary offset. Elsewhere, price pressures remain subdued in Asia, amplified by excess capacity and weak demand in China, with producer prices under pressure. Inflation has also moderated somewhat in LatAm, helped by more favourable currency moves and past policy tightening.

We are encouraged by these developments and expect inflation to grind lower, with inflation targets within reach. Developments around US tariffs will be decisive, however, and are likely to drive divergences across regions and sectors in coming quarters.

Tariffs and elevated uncertainty will weigh on growth, but a recession is not expected

US tariffs were raised in a disruptive manner in April, with a 145% tariff on imports from China, triggering turmoil in financial markets and sharp retaliation. Since then, US-China tariffs have been rolled back to a more manageable level, and negotiations around non-tariff export restrictions are ongoing. Other countries saw a broad-based 10% tariff replace punitive reciprocal tariffs, with limited retaliation. This leaves the average US tariff rate close to 15 percentage points higher compared to last year. At this level, impact should be manageable. While growth headwinds will be significant, recession is not expected.

Sentiment rebounds as tariffs are reduced, but pricing power is limited

US CPI data for May provided a first glimpse of tariff impact, which was limited outside of a few specific categories. While this is encouraging, we expect to see some further price pressures emerge, in particular as the front-loading of exports to the US before tariffs were raised was significant, delaying the impact. That said, US consumer sentiment has been extremely sensitive to tariff news, falling to a deeply recessionary level as tariffs were announced. This indicates that households are highly price sensitive, following an extended period of elevated inflation. As a result, the ability of businesses to simply pass on tariffs to the consumer will be curtailed, with profit margins and costs more broadly set to come under pressure.

US tariffs and demand weakness are set to be deflationary elsewhere

The disinflationary impact of US tariffs for the rest of the world has become more visible, with price surveys showing falling input prices in many regions, helped by downward pressure on commodity and oil prices due to demand weakness. Significant price discounts are also being announced, including on autos and food, and producer prices in China have fallen deeper into deflationary territory. Clearly, this is a vastly different pricing environment compared to the Covid period, when demand was boosted by huge fiscal support, production was disrupted, and borders were closed.

The oil price remains contained, despite Middle East conflict

Recent escalation of Middle East conflicts has led to a sharp rise in the price of oil, raising concerns around the inflationary implications. The starting point was low, however, and the oil price remains within the range where it has traded over the past year. Unless it rises meaningfully further, this is unlikely to more profoundly shift the inflation outlook, especially since the US dollar is weak. That said, geopolitical risk is elevated and will continue to drive volatility in economies and financial markets, including around inflation.

Central banks still cautious, despite the better news on inflation

Central banks remain vigilant despite the better news on inflation and tariffs. Gradual rate cuts are forthcoming from many central banks, but guidance around future policy easing is cautious. By contrast, the Fed has abstained from cutting rates further, emphasising that a wait to see approach is the right one given significant uncertainty around the tariff impact on inflation.

While we anticipate further policy easing, including from the Fed, it remains critical that central banks keep their focus on inflation. This should provide an anchor point for inflation expectations and ensure that borrowing costs are at the correct level to avoid a persistent overshoot (or undershoot) of inflation. Indeed, the ability of central banks to set their policy independently will be a key factor to monitor going forward, amid a changing geopolitical and political landscape.

US
No sign of tariff induced inflation yet

Both headline and core inflation ticked down from 0.2% MoM in April to a modest 0.1% MoM in May. This led to a small pickup in annual inflation from 2.3% to 2.4% Core inflation remained at 2.8% YoY. Similarly, producer prices show few signs of a tariff-induced acceleration. While some lagged price effects are likely, and we don't yet know where tariffs will ultimately be set, it is reassuring that price pressure has hardly picked up outside of a few specific goods like toys or furniture despite the broad-based tariffs on US imports that were implemented more than a month ago. Importantly, core services were also soft as rents took a step down, a trend that is expected to continue in the months ahead. Another large decline in airline fares further weighed on service inflation. Longer-term consumer inflation expectations have receded somewhat in June following the recent spike, but they remain elevated.

The combination of stable inflation with few traces of a tariff-induced pickup and a softening labour market will make it easier for the Fed to justify further rate cuts in the second half of the year, but for now they are likely to remain on hold. The small tick up in supercore inflation (CPI excluding food, energy and housing), will be closely watched.

UK
A government induced inflation pickup

Inflation reaccelerated in April, but this was largely expected as it was driven by higher energy and water bills, a pass-through of national insurance employment tax, a rise in the national living wage, and broader price re-setting at the start of the financial year. Headline CPI picked to by 1.2% MoM, lifting the annual rate from 2.6% to 3.5%. Core CPI accelerated from 3.4% to 3.8% YoY, while service inflation rose to 5.4% YoY, emphasising the Bank of England's challenge in bringing inflation rates back to target.

Inflation moderated slightly in May, but the annual rate remains too high, at 3.4%. Price pressure is, however, likely to fade in the months ahead as the growth environment deteriorates and the labour market softens as indicated by the latest batch of employment data. Nevertheless, while wage growth has slowed a little in recent months, it remained elevated at 5.2% YoY in April despite the pickup of the unemployment rate to the highest level since July 2021. The combination of stubbornly high core and services inflation and a weakening growth outlook, further exacerbated by ongoing global trade uncertainty, makes it difficult for the BoE to navigate the coming months, though further rate cuts in the second half of the year are likely.

Eurozone
Inflation is back below the ECB's inflation target

There continues to be good news on slowing Eurozone inflation. The most recent inflation print showed prices rising at a YoY pace of 1.9% in May. This is below the ECB's 2% inflation target and allowed it to cut rates for the eighth time this cycle in June. The central bank's deposit rate now stands at 2%. Core inflation remains above target, most recently at 2.3% YoY, while closely-watched services inflation has now convincingly broken below the 4% level and has fallen to 3.2% YoY. These should both continue to decline over the course of this year. The ECB now forecasts inflation to average 1.6% for 2026, significantly below their target, before rising back to 2% in 2027.

We see another ECB cut this year, but it is conditional on further evidence of weaker inflation and negative news on economic activity. The path from there is complicated as there are persistent risks to the upside for inflation in the longer run. The significant German fiscal policy boost and broader commitments to defence spending across the EU should significantly boost demand. Geopolitical tensions also increase the pressure to re-shore and build robust, rather than cost-efficient, supply-chains, alongside growing demand for ever-greater defence expenditure.

Switzerland
Deflation returns, but is not yet engrained

Inflation turned negative in May, for the first time since 2021, in part reflecting negative base effects. Headline inflation fell to -0.1% YoY and a measure of CPI excluding rents fell by -0.7% YoY, down from -0.3% last quarter. Deflationary pressures are not engrained in the broader economy, however, with core CPI still rising at an annual pace of 0.5% and monthly inflation at +0.1%. Domestic producer prices are also holding up, broadly flat compared to a year ago. By contrast, deflation continues to be largely imported, with prices of imported consumer goods falling at a steep pace of -2.4% YoY. Looking forward, it is likely that CPI inflation will turn positive again, potentially already in Q3, as base effects wane, while domestic price pressures hold up. Though the negative print in May does not necessarily imply a return to persistent deflation, risk to inflation is firmly to the downside amid the strong currency, tariff headwinds, and weak external demand.

Appreciation pressure on the franc has moreover intensified again, given escalating conflicts in the Middle East and ongoing tariff concerns. This helps to explain why the SNB continued to cut rates in June, taking the policy rate to 0%. While we do not expect any further rate cuts, rate risk is to the downside, similarly to inflation.

Japan
Inflation continues to run hot despite weak growth

Inflation remains sticky in Japan, with the headline figure hovering between 3-4% for the first half of 2025, while core CPI excluding fresh food and energy has been above the BoJ's target since October 2022 (except for July last year). Rice prices, at an all-time high and rising nearly 90% YoY due to tight supply, have put political pressure on the incumbent party and dented PM Ishiba's approval ratings, while also contibruting to the strong inflaiton prints. First quarter GDP posted a slight negative print, dragged down by net exports as Japan's industrial sectors were hit by US auto, steel, and aluminium tariffs, with prospects for an imminent trade deal with the US now also waning. Consumer spending inched slightly positive in Q1, reflecting fragile sentiment amid slightly negative real income as inflation outpaces wage rises.

The BoJ is in a wait-and-see mode, with growth weakness potentially holding them off from further rate hikes, despite solid inflation prints. Market pricing for a 2025 rate hike has diminished significantly. We think the case for another rate hike this year is a tight call, depending on tariff negotiations and inflation data.

China

No escape from deflation in sight

China continues to grapple with deflationary pressures. In May, CPI inflation was negative for the fourth month in a row. While services inflation stayed slightly positive, consumer goods prices are falling, suggesting persistent weakness in demand. Although May's retail sales data surprised to the upside versus market expectations, it remains to be seen if the momentum will last given the still gloomy property market and depressed consumer sentiment.

Meanwhile, overcapacity continues to drag on the industrial sector, with producer prices (PPI) falling deeper into negative territory in May, from -2.7% to -3.3% YoY. In sectors such as electric vehicle (EV) production, the price war is intense, with leading producers like BYD slashing prices by more than 30% for many models. While the recent stimulus measures, including modest rate cuts and increased consumer support through the durable goods trade-in program, are encouraging, China's economy will need bolder stimulus to meaningfully lift consumer confidence and eventually prices.

EM Asia

Weak price pressure suggests further rate cuts

In ASEAN, inflation continues to trend lower, with the average CPI for the ASEAN-6 (Singapore, Malaysia, Indonesia, Thailand, the Philippines, and Vietnam) now around 1.6%. This disinflationary trend suggests further scope for policy easing. Central banks across the region have actively pursued rate cuts, aided by a weaker USD which provides some relief on the FX front. As a trade-oriented region, US tariff headwinds will likely impact growth notably. The central banks of Indonesia and the Philippines appear to have the largest scope to deliver additional 50bp cuts by year end.

India's headline CPI decelerated to 2.9% YoY in May while core inflation excluding gold has remained below 4%, staying comfortably within the lower end of the Reserve Bank of India's (RBI) target range. With growth moderating, inflationary pressures remain subdued, providing the RBI with more flexibility to cut rates. In May, the central bank delivered a 50bp policy rate cut and a 100bp reduction in the cash reserve ratio, injecting substantial liquidity into the banking system. We think the RBI may pause in August, but it still has room for another 50bp cut if growth does not improve significantly.

Brazil

Aggressive monetary policy tightening is starting to pay off

Inflation in May came in at 0.3% MoM, down from 0.4% in April and below expectations. On a yearly basis, headline inflation eased from 5.5%. to 5.3% Despite higher electricity tariffs due to reduced rainfalls, a broad disinflationary trend was observed, particularly in core inflation. Accordingly, the Central Bank of Brazil's (BCB) average core CPI indices showed the first annual deceleration in nine months, with May's reading at 5.2% YoY. More importantly, inflation expectations have steadily declined since peaking in Q1, following the sharp de-anchoring triggered by the currency depreciation last December.

The BCB's aggressive monetary tightening—raising the MPR by 425 bps to 14.75% in just nine months—is beginning to show results. The BRL has benefited not only from a weaker USD but also from strong positive rate differentials, helping contain the currency and tradable goods inflation. While the economy remains resilient, rising lending rates are starting to weigh on retail demand. In this context, we expect the BCB to maintain a cautious stance ahead, potentially opening the door to a gradual easing cycle by year end.

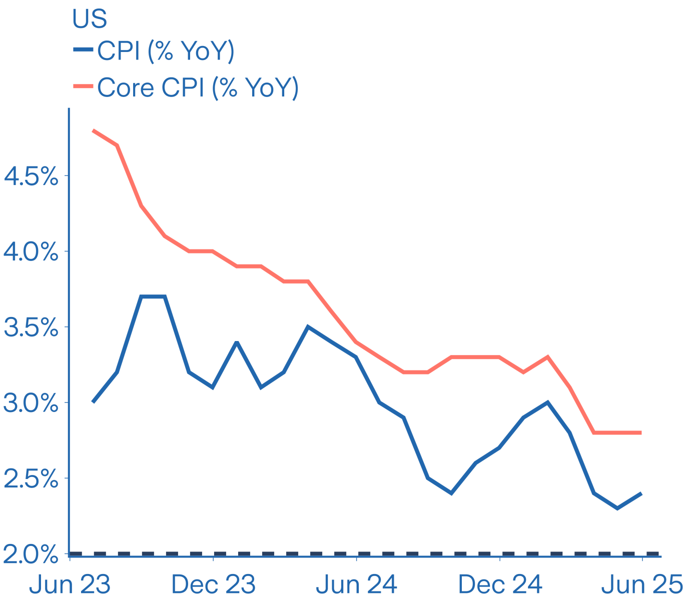
LatAm

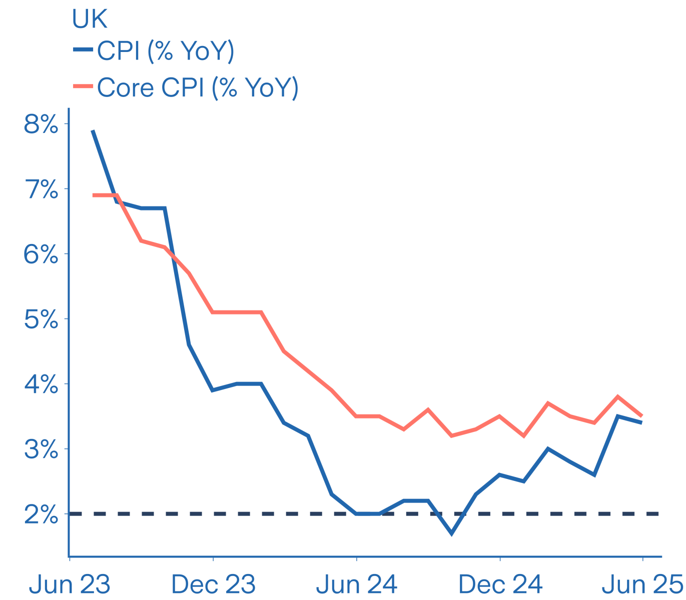
Diverging inflation paths: Mexico accelerates, Chile stays on track

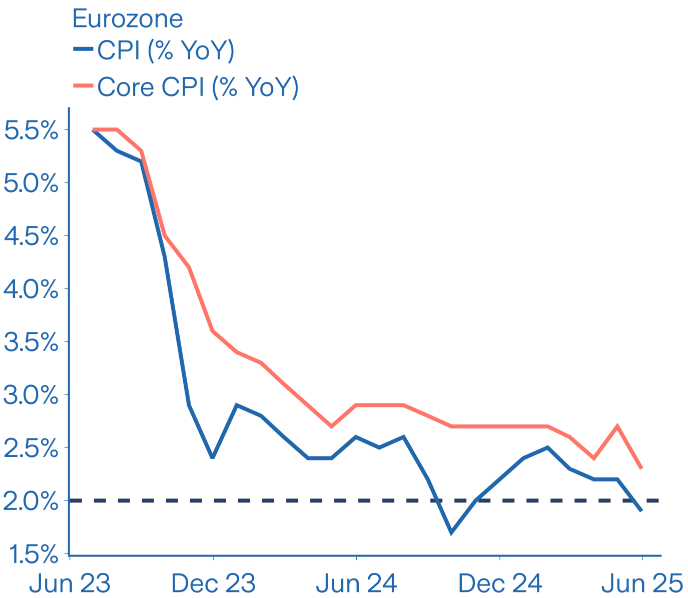
In Mexico, inflation accelerated in H1, with May's headline CPI at 4.4% YoY (up from 3.9% in April), exceeding the Central Bank's 2–4% target range. Noticeably, the rise was mainly driven by non-core inflation, fueled by higher agricultural prices due to adverse weather conditions and sanitary restrictions on meat. Core inflation remained more contained. Despite these dynamics, we expect Banxico to proceed with its easing cycle in upcoming meetings, given the cooling economic backdrop and the still highly restrictive monetary stance. However, recent upside CPI surprises may induce the Central Bank to a adopt a more cautious pace going forward.

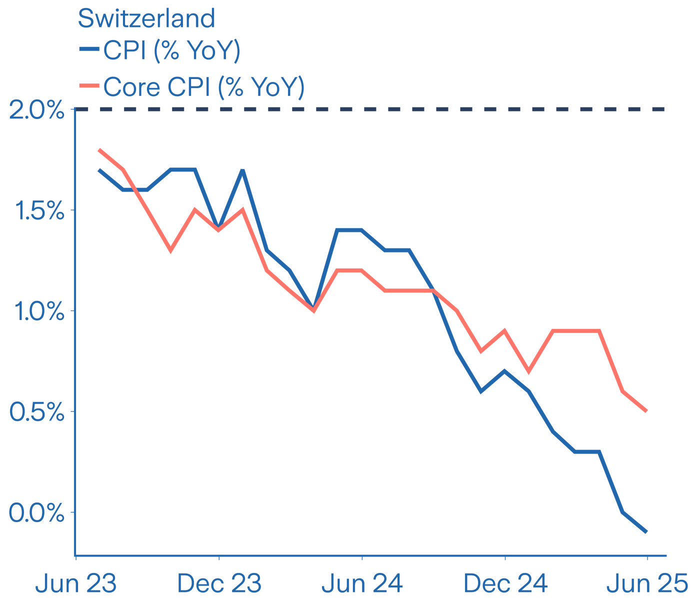
In Chile, following a sharp inflation spike in January that was driven by a one-off increase in electricity tariffs, price pressures have steadily eased through H1, reaching 4.5% YoY as of May. This disinflationary trend remains in line with Central Bank guidance, supported by a strong peso and lower energy prices. We expect inflation to continue moderating, likely falling below the 4% YoY threshold in H2. This should create room for the BCC to resume its monetary easing cycle. However, the timing of rate cuts will likely depend on the trajectory of US monetary policy, given the narrow interest rate differential with the Fed.

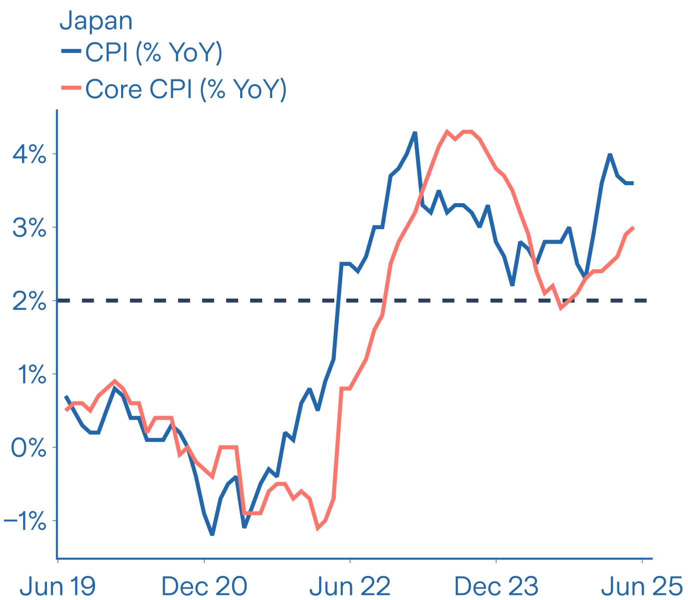
Current and historic inflation

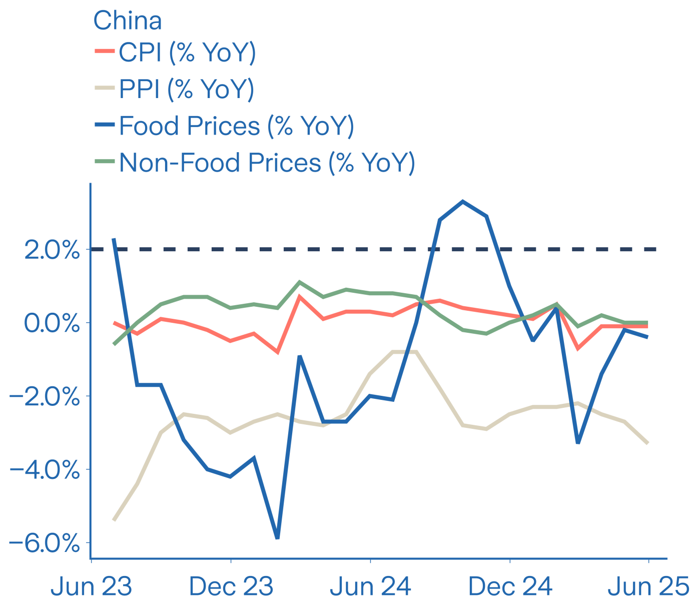








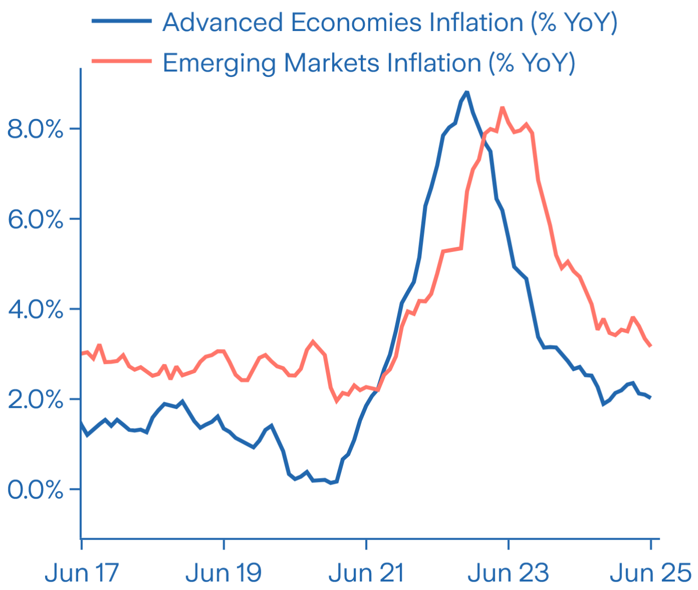


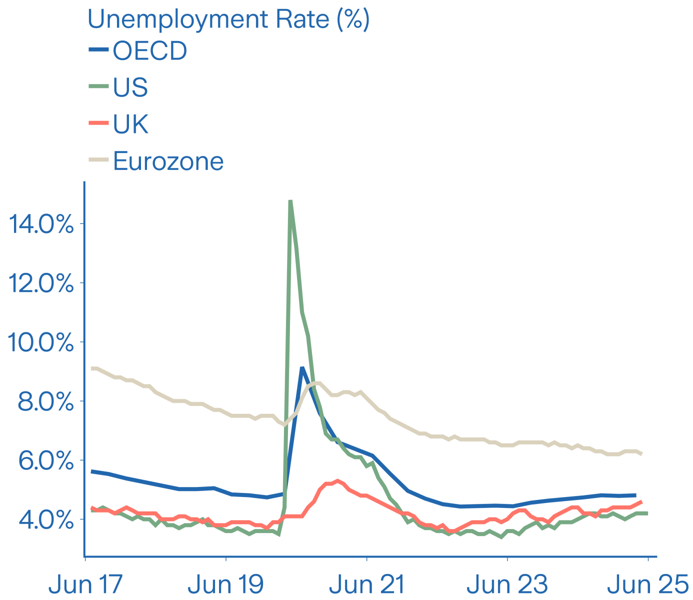


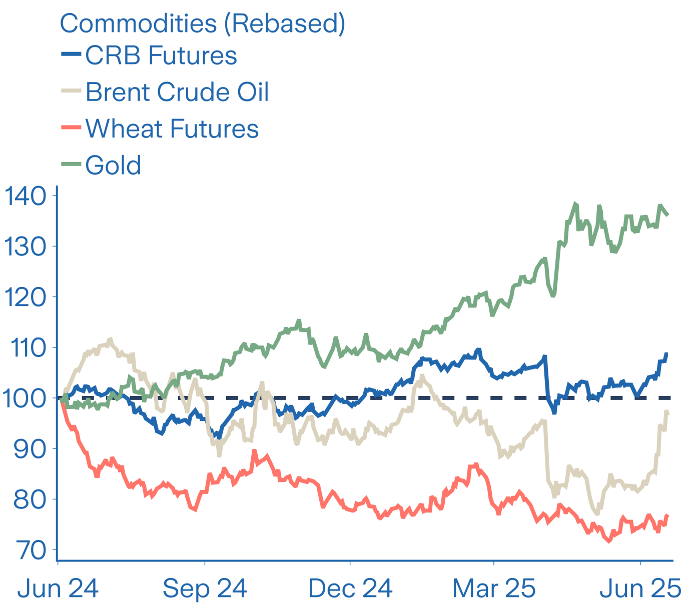
Source: Bloomberg, ZIG

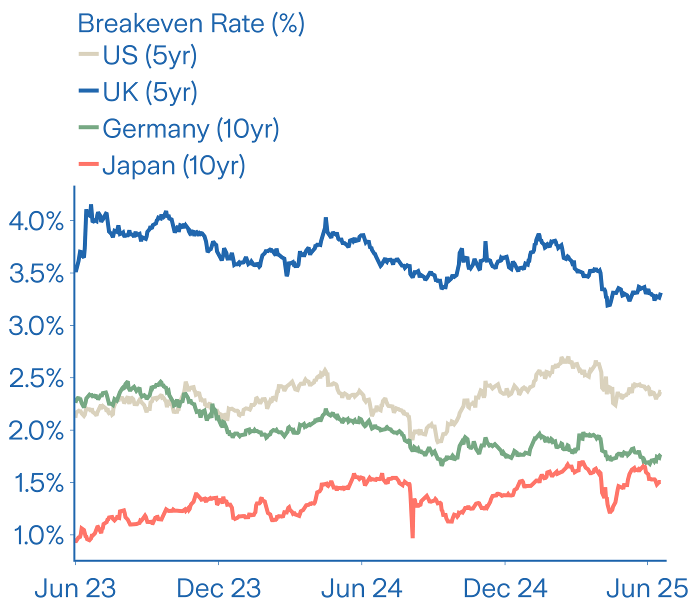
Key Indicators

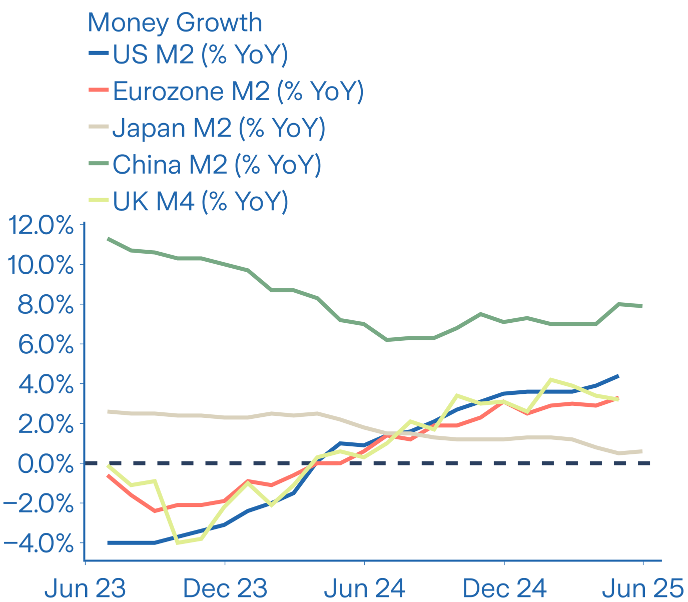
ZURICH

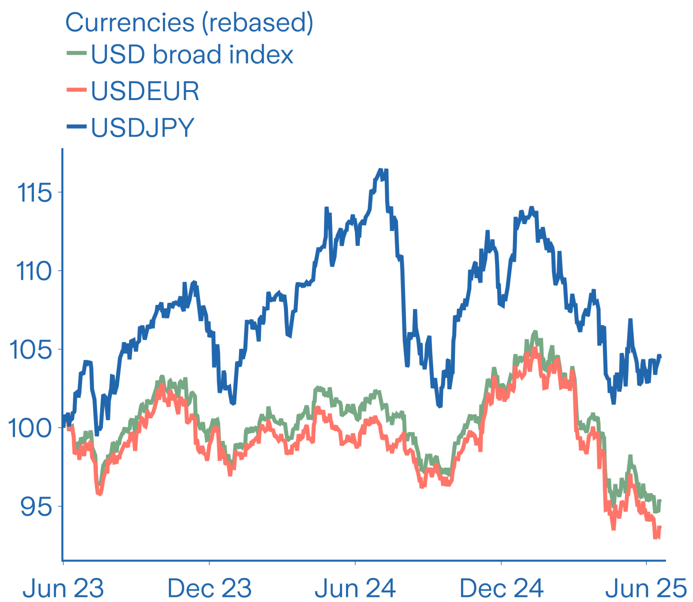












Source: Bloomberg, ZIG

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Zurich Insurance Group Ltd

Group Investment Management
Mythenquai 2
8002 Zurich

173008049 (12/21) TCL

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