What Trump's U-turn means for our forecasts

Dr. Jörg Krämer [AC]

Donald Trump's U-turn on Wednesday evening shows that he is, after all, impressed by the slump in the financial markets. We see our main scenario confirmed with regard to Trump and adjust our forecasts for the western economies and the financial markets only moderately. We now expect not only two, but three interest rate cuts for the Fed and the ECB.

The announcement of massive reciprocal tariffs on Wednesday last week led many investors to believe that Donald Trump would accept a collapse of the stock markets in order to reduce the high US trade deficit and generate tariff revenues to finance tax cuts. Instead, we stuck to our main scenario that Trump is primarily interested in making deals and is not left cold by the massive increase in recession risks and the sharp drop in stock market prices. We therefore did not change our economic forecasts last week, but merely pointed out that risks had increased.

Trump's U-turn on Thursday confirms our main scenario

Trump's U-turn on Thursday evening confirms this main scenario. Under the new policy, a standard rate of 10% will apply to reciprocal tariffs (with the exception of China) for 90 days, rather than the higher country-specific rates that apply to the EU, for example (20%). Sectoral tariffs of 25% will continue to apply to automobiles, auto parts, aluminum and steel.

Both his actions and his statements suggest that the stock market slump played a role in his turnaround on tariffs: 'Well, I thought that people were jumping a little bit out of line; they were getting yippy,'. He also seems to be concerned about deals: In his view, a deal can be made with everyone, even with China. The fact that he also mentioned China is noteworthy in view of the fact that he had recently raised tariffs on Chinese goods to 145 percent.

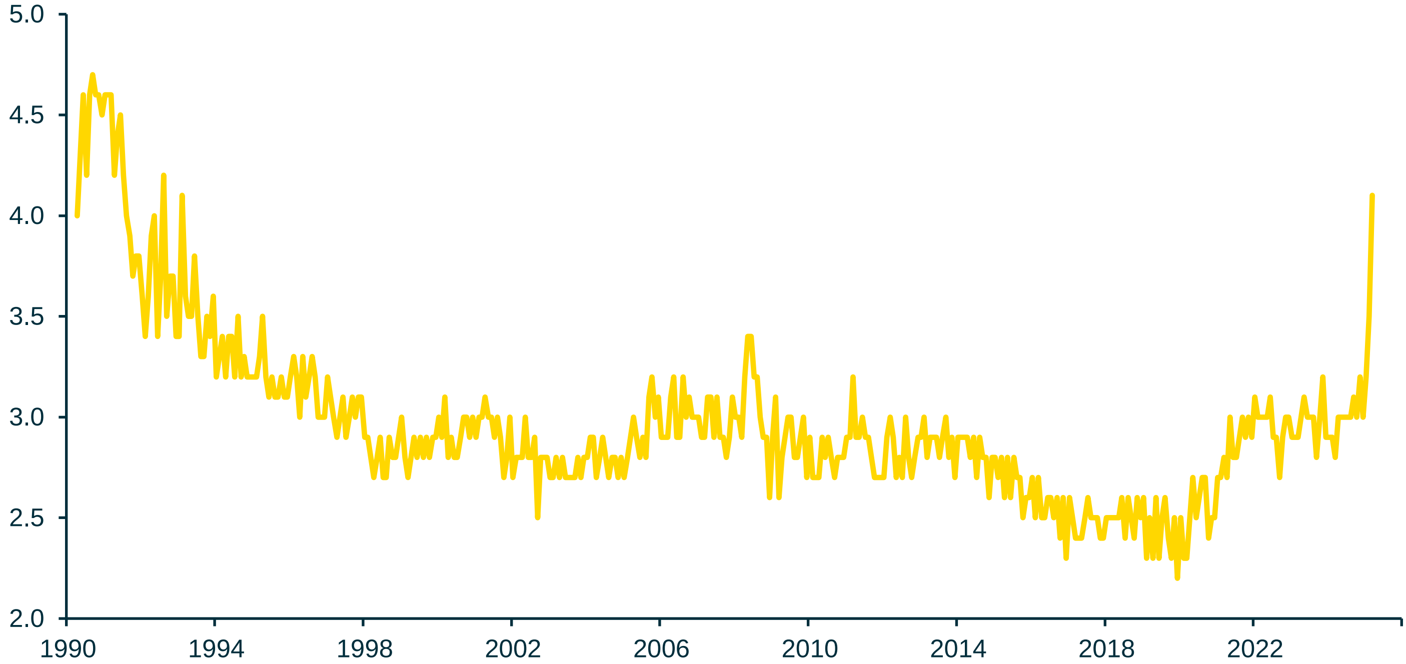
No major changes to our US forecasts

Because we see our main scenario as confirmed, namely that Trump wants to avoid a slump in the economy and the stock markets, we decided against a massive reduction in our US economic forecast at our monthly forecast meeting. We only lower the 2025 US growth forecast from 2.0 percent to 1.7 percent – due to the recent back and forth over tariff policy that increases uncertainty and weighs on US corporate investment. Nevertheless, the economy should remain sufficiently far from the recession threshold, precisely because Trump wants to avoid a recession and the US economy still has a lot of momentum. Gross domestic product has grown by at least 2.5 per cent in each of the last three years.

We had previously expected the Federal Reserve to cut key rates twice by 25 basis points each in the winter half-year 2025/26. Here, too, we are making only a moderate change and expect three interest rate cuts at quarterly intervals from September. The upper limit of the US key interest rate corridor would then be 3.75% in March 2026. The fact that we do not expect a recession and that US consumers expect massively higher inflation in the future due to tariffs **(Chart 1)** argues against aggressive interest rate cuts. To prevent this from becoming a self-fulfilling prophecy, the Fed can only reduce its key interest rate to a level at which its monetary policy still has an inflation-reducing effect.

Chart 1 - Are US inflation expectations becoming disconnected?

University of Michigan's consumer sentiment survey, inflation expectations for the next 5 - 10 years in %



Source: S&P Global, Commerzbank Research

Euro area: lower inflation in 2026...

When we lowered our 2025 growth forecasts for the euro area and Germany five weeks ago due to the tariffs, we had assumed that the tariffs would be partially reduced again through renegotiation. This is what happened yesterday. In addition, companies in the eurozone are benefiting from the fact that their Chinese competitors are losing price competitiveness in the US market due to the much higher tariffs. In this respect, we continue to expect the euro economy to grow by 0.7% this year (Germany: 0.0%). We have lowered the forecast for 2026 by only 0.1 percentage points to 1.2% (Germany: 1.4%).

As for inflation in the euro area, we confirm our inflation forecast for 2025 of 2.1% (Germany: 2.5%). However, we are lowering it for 2026 by 0.3 percentage points to 2.1% (Germany: 2.2%). This is mainly because Trump is taking tougher action against the geopolitical rival China than against most other countries. In this respect, China is likely to try to sell some of the goods that it can no longer sell in the US in the euro area. The increased supply should gradually push down euro area inflation from late 2025 onwards, although we expect inflation to remain above the ECB target of 2% in the long term due to demographics, decarbonization and deglobalization.

... which argues for an additional ECB interest rate cut

At times, it looked as if our forecast of a cut in the ECB deposit rate to 2.0% by the summer was too aggressive. We maintained it because we expected core inflation to fall further due to the weaker economy and because we believe that the ECB Governing Council is dominated by monetary doves anyway.

Because inflationary pressure is continuing to fall due to increased supply from China and core inflation could temporarily fall below 2% around the turn of the year, we now expect not just two, but three further ECB key interest rate cuts of 25 basis points each. In September, the deposit rate would then be 1.75%.

China will be harder hit than the euro area

Trump is likely to negotiate with China in the end and reverse some of the massive tariff increases to 145%. But Trump, like most US politicians, presumably wants to use tariffs to slow China's economic, political and military rise. In this respect, the US tariffs on Chinese goods are likely to remain significantly higher than those for the euro area in the end. We are lowering our growth forecasts for China – from 4.3% to 3.8% for 2025 and from 4.0% to 3.6% for 2026.

What does this mean for the financial markets?

As far as German government bonds are concerned, they benefit from lower growth, lower inflation and, most recently, a stronger euro. All of this gives the ECB more scope for rate cuts. In addition, German government bonds benefit from inflows when confidence in US politics declines. We have slightly lowered our forecast for the 10-year Bund yield to 2.60% at the end of the year (previously 3.10%). Our forecast for 10-year US Treasuries is 4.40% (previously 4.60%).

The dollar's status has suffered from the volatile policies of Donald Trump. Moreover, the US administration has more of an interest in a weak currency in the medium term to help it reduce the trade deficit. To this end, Trump could increase the pressure on the Fed to loosen monetary policy again. We are therefore raising our EUR-USD forecast for the end of 2026 from 1.10 to 1.15.

In an initial reaction to Trump's tariff break, the S&P 500 rose 9.5% in a spectacular relief rally on Thursday. This was the largest single-day gain since the 2008 financial crisis. However, we advise equity investors not to react too euphorically to Trump's turnaround. Due to the persistently high political uncertainty in the US, the introduction of a 10% base tariff on US imports and the trade dispute between the US and China, many companies are likely to be cautious in their outlook for the coming earnings season, and analysts' earnings expectations are likely to fall. Therefore, the consolidation on the stock markets should continue for the time being in the second quarter, with high price volatility.

ECB preview: Interest rate cut

Dr. Marco Wagner [AC]

The ECB will almost certainly cut interest rates again next week – and will probably describe its current monetary policy as “neutral”. Due to the dampening effects of US tariffs on growth and inflation, we now expect interest rates to be cut not only in June but also in September.

The ECB cuts interest rates again

The ECB will almost certainly cut interest rates again next week. With the seventh rate cut in a row, the deposit rate would stand at 2.25%. Although no new ECB projections are officially published, the downside risks for economic growth and inflation have increased significantly due to US President Trump's tariff capers. According to a **speech** by ECB President Lagarde in Brussels in mid-March, the ECB's analyses indicate that the tariffs will depress growth in the euro economy by around ¼ percentage point this year. We have also revised our forecasts downwards (see cover story). In addition, the tariff conflict is likely to have a dampening effect on inflation in the eurozone, as Asian exports are more likely to be diverted to Europe. In this context, we have adjusted our ECB forecasts and now expect a further interest rate cut of 25 basis points in September in addition to the previously forecast June cut.

The doves on the rise

The foreseeable consequences of the US tariff policy on growth and inflation for the eurozone should give the doves in the ECB Governing Council the wind beneath their wings. According to our revised Hawkometer – which we use to classify the members of the Governing Council according to their genuine monetary policy stance – the doves are clearly in the majority in the ECB's tower. This is also due to the fact that there are fewer hawks on the Governing Council. Dutchman Knot and Bundesbank President Nagel, for example, have given us sufficient reason to no longer place them in the camp of monetary policy hawks, but to classify them as “neutral” Council members. According to our count, there are now only four hawks to 14 doves.

No clear indication of the next steps

Despite our change in forecast that we now expect a further rate cut, the ECB is likely to be cautious in its communication and leave all doors open. In our view, therefore, no kind of forward guidance is to be expected. This is all the more true as the economic outlook is fraught with all kinds of risks in both directions in view of the immense uncertainty. Much will depend on how the EU reacts to the US tariff policy and whether this results in a negotiated solution.

Apart from this, the ECB is likely to change its communication regarding the assessment of current monetary policy. We assume that monetary policy will no longer be described as "becoming meaningfully less restrictive". Rather, it is now likely to have reached the "neutral range" according to many members of the Council.

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