BBH

Mind on the Markets

2 THEMES SHAPING Q3 MARKETS

2025 Third Quarter Outlook

CONTENTS

TARIFFS

Under pressure

Insights from Win Thin

Growing uncertainty over tariffs, weakening consumer sentiment, and an increasingly troubled global geopolitical backdrop present mounting concerns for US investors, central bankers, and government policymakers.

Uncertainty is set to extend into Q3. While the US economy has held up relatively well so far, we believe ongoing uncertainty regarding tariff and fiscal policies will start to really impact growth.

We are already seeing some impact on the labor market and consumption, and that will only get worse as uncertainty continues. Here, we discuss the state of the economy as well as the drivers that are making it so difficult for firms and households to make investment and spending decisions.

We believe cracks in the US outlook are widening and this will surely test the Fed's resolve to remain on hold. Indeed, several Fed officials clearly would like to cut rates sooner rather than later, suggesting that they too see some worrying signs. This supports our call for a weaker dollar in H2.

Tariff policy

We are skeptical that any significant trade deals can be completed before the 90-day pause on reciprocal tariffs ends on July 9. Indeed, some studies suggest the average time to reach a trade deal is 18 months.[1] The recent G-7 summit in Canada ended with no deals announced except for the UK and US reiterating plans to implement their framework agreement from May. Will President Trump go ahead with the tariff rates announced April 9? Will he announce another pause? Or will he calculate new ones?

The tariffs are in legal limbo. While the Federal Appellate court has allowed the existing tariffs to remain in effect ahead of arguments scheduled for July 31, plaintiffs have asked the Supreme Court to take up the case on a fast track. If the Supreme Court hears the case, there's no telling when or how they will rule. Why would any country make major concessions now when the tariffs may not remain in place?

Even with reciprocal tariffs on pause, the effective US tariff rate has risen sharply due to the 10% baseline tariffs and the 30% rate on China. Yale's non-partisan Budget Lab policy research center

estimates that the 2025 tariffs through June 6 bring the overall US average effective tariff rate up to 15.8%, the highest since 1937.[2]

There is no doubt that stagflation risks have risen. Indeed, the Yale Budget Lab estimates that higher tariffs will lower real GDP growth by -0.5 ppt in 2025 and increase consumer prices by 1.5% in the short-run. Lastly, tariffs are estimated to raise the unemployment rate by 0.3 ppt by end-2025. If even higher tariffs are enacted, the impact could tip the US economy into recession.

Geopolitical risks

As if the tariff and fiscal uncertainty weren't enough, markets now have a healthy dose of geopolitical uncertainty to deal with. Middle Eastern tensions are running high after Israel launched a pre-emptive attack on Iran. Iran has responded in kind, and now the US has become directly involved.

Markets now have to contend with uncertainty regarding the potential response by Iran or its proxies, such as Hezbollah. Such a response could be a military one or perhaps a cyberattack, or even a potential closure of the Strait of Hormuz. There is also uncertainty on whether Iran's nuclear capabilities were destroyed or merely damaged, in which case there is the risk of further attacks on Iran.

1 https://www.piie.com/blogs/trade-and-investment-policy-watch/how-long-does-it-take-conclude-trade-agreement-us
2 https://budgetlab.yale.edu/research/state-us-tariffs-june-17-2025

Fed policy

Due to ongoing uncertainty, the US Federal Reserve (Fed) remained on hold in June for the fourth straight meeting. Its Chair, Jerome Powell, was uncharacteristically hawkish in the press conference. He reiterated that the Fed is well positioned to wait for greater clarity before considering any adjustments to the policy stance. Powell warned "We expect a meaningful amount of inflation to arrive in the coming months."[3] Indeed, the 2025 projections for Personal Consumption Expenditures (PCE) and core PCE inflation were revised materially higher.[4]

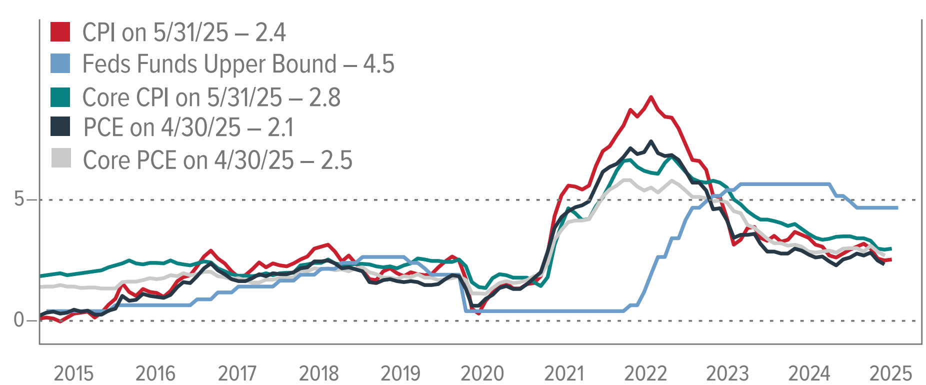
Powell spent much of his time on tariffs, noting while it may take some time, they are likely to boost prices. Powell said he is starting to see some effects and expects more as firms are expected to pass on the costs. He also noted near-term inflation expectations have moved up recently. Powell stressed that the size, amount, and duration of the tariffs are highly uncertain.

With regards to the real economy, Powell sounded upbeat. He noted that labor market conditions remain solid and that the economy appears to be growing at a rate of about 1.5-2.0%. Powell did acknowledge that there is some cooling in the job market but nothing concerning. Indeed, he said that the labor market "is not crying out" for a rate cut.

With regards to policy, Powell said the Fed will likely get to a place where rate cuts are appropriate. However, he added that the Fed wants to see some tariff effects on inflation before making any policy judgments. Powell said there was strong support for the decision to hold rates but added that there was a healthy diversity of view on the Federal Open Market Committee (FOMC).[5]

The Fed's Dot Plots were largely unchanged, with two cuts still seen in 2025, one cut (down from two in March) seen in 2026, and one cut still seen in 2027. However, the distribution of dots reveals a more cautious tone, with a growing number of officials (seven versus four in March) now project-

US Inflation, y/y



Median Fed Forecasts from June (March)				
	2025	**2026**	**2027**	**Longer Run**
GDP Growth	1.4% (1.7%)	1.6% (1.8%)	1.8% (1.8%)	1.8% (1.8%)
PCE	3.0% (2.7%)	2.4% (2.2%)	2.1% (2.0%)	2.0% (2.0%)
Core PCE	3.1% (2.8%)	2.4% (2.2%)	2.1% (2.0%)	n/a (n/a)
Fed Funds Rate	3.9% (3.9%)	3.6% (3.4%)	3.4% (3.1%)	3.0% (3.0%)
Unemployment	4.5% (4.4%)	4.5% (4.3%)	4.4% (4.3%)	4.2% (4.2%)

Source for both charts: Bloomberg, June 2025

3 https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20250618.pdf
4 https://www.federalreserve.gov/monetarypolicy/files/fomcprojtabl20250618.pdf
5 https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20250618.pdf

ing no rate cuts this year. Inflation and unemployment forecasts were nudged higher, while growth forecasts were nudged lower.

The key takeaway is that it seems that despite little or no tariff pass-through to inflation, the Fed is not inclined to cut rates. Since the decision, however, several Fed officials have come out in favor of cutting rates sooner rather than later, perhaps as soon as the July 29-30 FOMC meeting. Specifically, Governors Waller and Bowman as well as Chicago Fed President Goolsbee are sounding much more dovish than Powell.[6] The market is pricing in nearly 25% odds of July cut now vs. less than 10% odds right after the hold. Furthermore, a September cut is now fully priced in vs. 70% right after the hold.[7]

Fed independence

President Trump has started to criticize Fed Chair Powell more openly. However, we continue to believe that Powell will serve out his term ending May 2026. We are more concerned about who will be chosen to be his rreplacement, with the search likely beginning in earnest this fall.

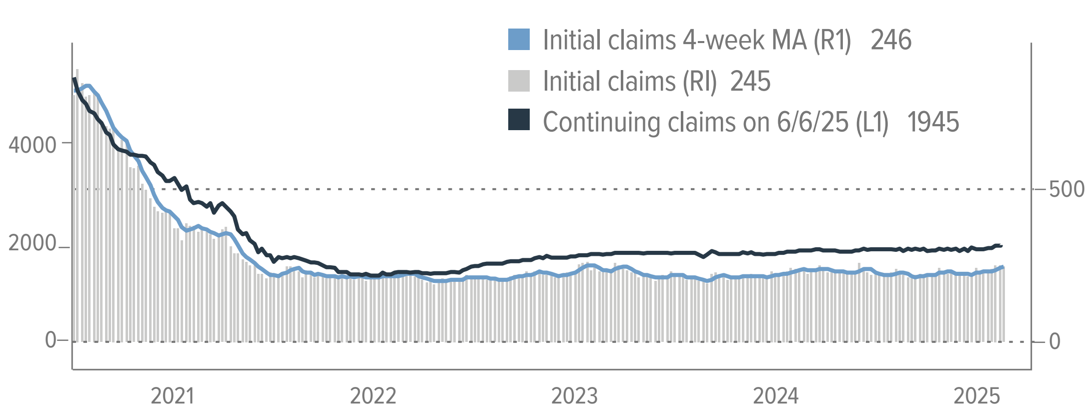
Trump cannot simply pluck someone out of thin air to serve as Chair. The Chair must be chosen from the Board of Governors and then confirmed by the Senate. Governor Kugler's term on the board ends in January 2026 and so her replacement is likely to be nominated to be the next Chair. Of note, Powell's term on the board ends January 2028. When asked if he would serve out his term on the board after his term as Chair ends, Powell would not comment.

Reports have emerged recently that Treasury Secretary Scott Bessent is in the running for Fed Chair. National Economic Council Director Kevin Hassett has also been mentioned as a possible choice.[8] Neither one would be taken well by the markets, as installing a sitting cabinet member as Fed Chair would be seen as a further erosion of Fed independence. We would prefer former Governor Kevin Warsh but he is likely to be viewed by President Trump as being too hawkish and perhaps too independent.

US economic outlook

Despite Powell's upbeat view, we fear the US economy is starting to show bigger cracks. Retail sales were mostly weaker than expected in May, while weekly jobless claims have been moving steadily higher. Indeed, the 4-week moving average for initial claims is the highest since October 2023, while continuing claims are the highest since mid-November 2021. The household labor survey showed -696 thousand jobs lost in May. The only reason that the unemployment rate didn't move higher was the offsetting -625 thousand drop in the labor force, which was largely due to the administration's immigration policies.

Weekly Jobless Claims, 000s

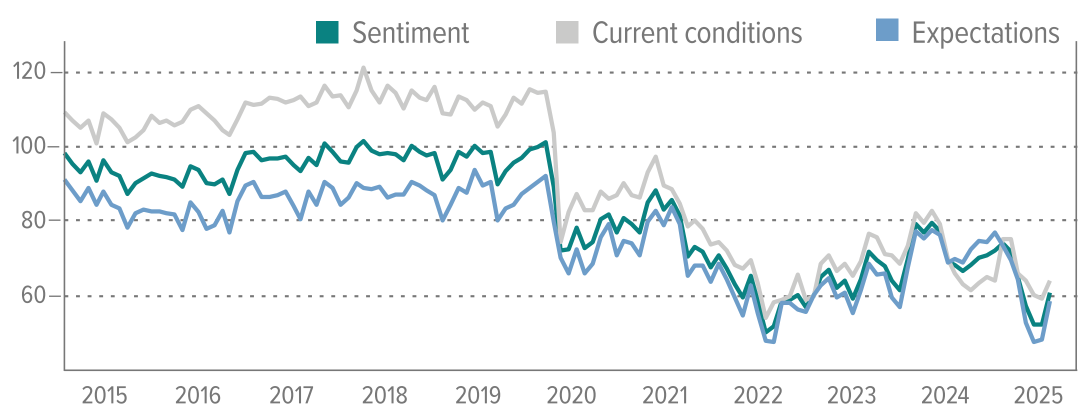


6 https://www.cnbc.com/2025/06/20/fed-governor-waller-says-central-bank-could-cut-rates-as-early-as-july.html
7 Bloomberg, June 2025
8 https://www.reuters.com/world/us/trump-says-he-is-considering-three-or-four-candidates-next-fed-chair-2025-06-25/

President Trump recently suspended immigration raids on agriculture, hotels, and restaurants. While the raids were later reinstated, that pause was the clearest acknowledgment yet that the deportation program was having a much wider impact on the economy and supported our view that the labor market is starting to crack. By resuming these raids, we believe those cracks will widen further.

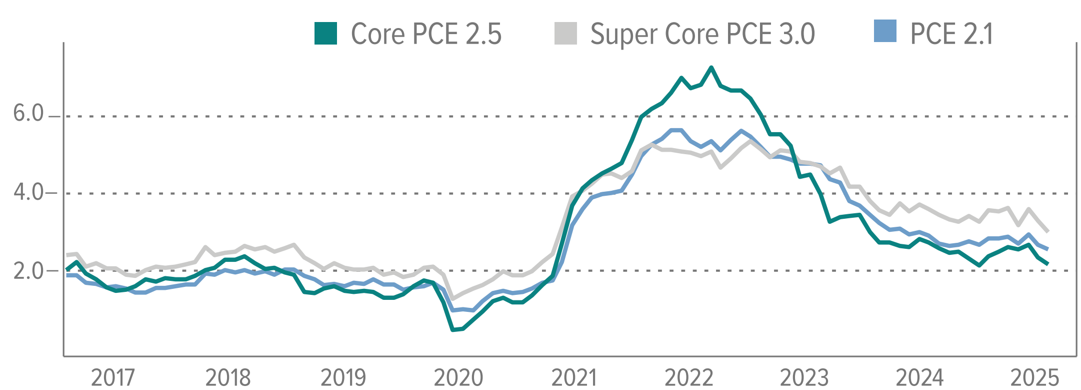
US consumer sentiment has also weakened sharply, mostly as a result of tariffs and rising inflation expectations. Despite this drop, consumption remained firm in March and April but this was a distortion as many sought to front-run the tariffs. May retail sales were mostly weaker and may be giving us the cleanest read yet on post-tariff consumption patterns.

University of Michigan Consumer Sentiment



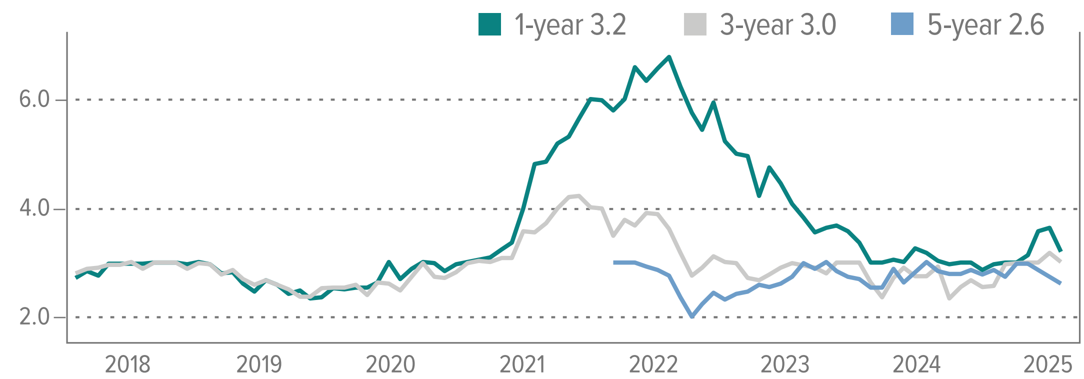
Inflation has remained surprisingly subdued. Headline PCE is running close to the Fed's 2% target despite the tariffs.

US Inflation, y/y



While most Fed officials seem to view the tariff impact on prices as a one-off, it's clear from Powell's hawkish tone that many are also worried about higher inflation expectations becoming too entrenched. Recent expectations readings have come down from the highs, mostly due to the tariff pause. If this drop is sustained, perhaps the Fed will feel more comfortable about cutting rates again.

New York Fed Inflation Expectations



Fiscal policy

The House of Representatives narrowly passed the Trump administration's so-called Big Beautiful Bill. The non-partisan Congressional Budget Office now estimates that the package would expand the budget deficit by $2.8 trln over the next ten years, up from $2.5 trln previously due to so-called dynamic accounting.[9] Elsewhere, the Penn Wharton Budget Model puts that number at $3.2 trln, while the Tax Foundation has it at $3.1 trln.[10]

The Senate is trying to pass a drastically different bill. It calls for much more aggressive cuts to Medicaid spending then the House bill.[11] The Senate bill also keeps the cap on state and local tax (SALT) deductions at $10k vs. $40k in the House bill. Both of these are considered deal-breakers for the Senate moderates. Republicans need a minimum of 50 votes along with the tie-breaker cast by Vice President Vance. With 53 seats, the Republicans can only afford to lose three votes but already more than three have expressed problems with the bill.

If and when the Senate bill passes, the two houses will then try to reach a compromise. However, it will be very difficult to satisfy both the conservative and moderate holdouts in the Republican party, so the Trump-imposed deadline of July 4 seems too optimistic.

Of note, the Yale model estimates that tariffs will bring in $2.3 trln in revenue over 2026-2035, with $360 bln lost when considering dynamic revenue effects. This would bring total net revenues to $2.0 trln.[12] Elsewhere, the Congressional Budget Office (CBO) estimates increased revenues would reduce primary deficits by $2.5 trln over ten years. It also sees interest payments falling $500 bln due to the smaller deficits, leading to a total net fiscal benefit of $3 trln.[13] Tariffs are expected to finance a large part of the tax cuts. But if these tariffs were to be ruled illegal, the entire fiscal outlook would be upended.

9 https://www.cbo.gov/publication/61486
10 https://budgetmodel.wharton.upenn.edu/issues/2025/5/19/house-reconciliation-bill-budget-economic-and-distributional-effects-may-19-2025
11 https://www.finance.senate.gov/imo/media/doc/finance_committee_legislative_text_title_vii.pdf
12 https://budgetlab.yale.edu/research/state-us-tariffs-june-17-2025
13 https://www.cbo.gov/publication/61389

RESERVE STATUS

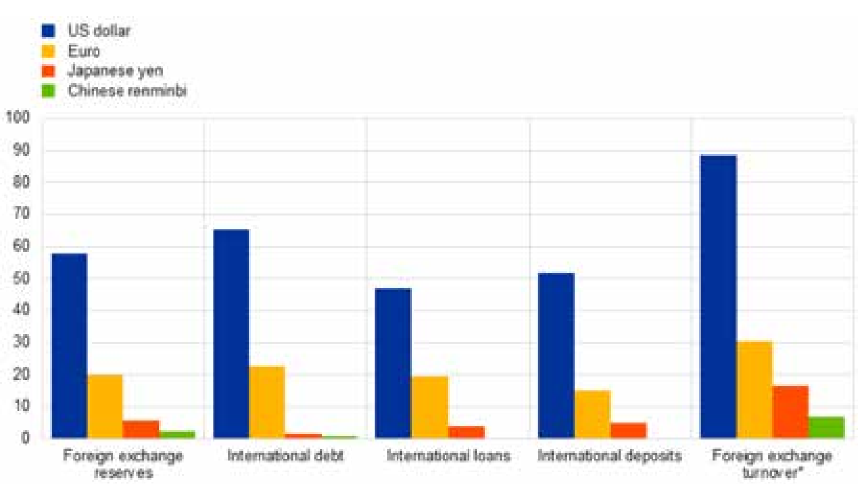
The dollar's soft retreat

Insights from Elias Haddad

While the US dollar is unlikely to lose its place as the number one global currency, other rivals look set to gain ground amid ongoing trade and tariff turmoil.

The US dollar's 80-year reign as the dominant international currency is intact. By all measures the dollar dominates on the international stage as a store of value, medium of exchange, and unit of account. The euro remains a distant second and the Chinese renminbi lags far behind (Chart 1).

Chart 1: USD Dominates Across the Board, %



Source: https://www.ecb.europa.eu/press/other-publications/ire/html/ecb.ire202506.en.html#toc2

Notes: The latest data on foreign exchange reserves, international debt, international loans and international deposits are for the fourth quarter of 2024. Foreign exchange turnover data are as of April 2022 (the latest available data as they come from a triennial survey). *Since transactions in foreign exchange markets always involve two currencies, foreign exchange turnover shares add up to 200%.

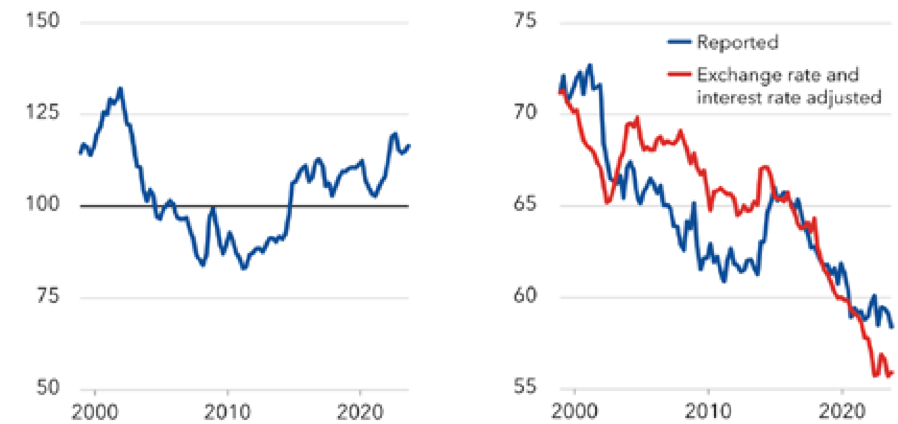
Three important mutually reinforcing developments shaped the role of 'king dollar' on the global stage: Bretton Woods, the Marshall Plan and the Washington Consensus. The 1944 Bretton Woods agreement required participating countries to tie their exchange rates to the dollar, which was convertible to gold. The 1948 Marshall Plan flooded war-torn Europe with dollars to rebuild its economies and boost trade with the US The 1989 Washington Consensus exported market-oriented economic policies and expanded US capital markets.

Nonetheless, there has been a steady erosion of the dollar's dominance in international reserves since the turn of the millennium. The dollar accounted for 58.4% of official foreign exchange reserves in the fourth quarter of 2024, down from a high of almost 73% in 2001. The fact that the value of the US dollar has been broadly unchanged over the past two decades, while the dollar's share of global reserves has declined, indicates that the shift away from the US currency has been more pronounced than the headline number indicates (Chart 2). Indeed, as the red line in chart 2 highlights, the dollar's share of FX reserves is probably closer to 55% when adjusted for valuation effects.

In recent years, the decline in the US dollar's share of central bank reserves is mostly due to the shift into the Australian dollar, Canadian dollar, other currencies (Korean won, Singapore dollar, and Swedish krona) and to a lesser extent the Chinese yuan. The share of FX reserves in euro, British pound, Japanese yen, or Swiss franc has been more or less flat (Chart 3 & 4).

CHART 2:

US Dollar Index (Jan 2006 = 100) **US Share of FX Reserves, %**



IMF

Source: https://www.imf.org/en/Blogs/Articles/2024/06/11/dollar-dominance-in-the-international-reserve-system-an-update

CHART 3: World Currency Composition of Official FX Reserves, %

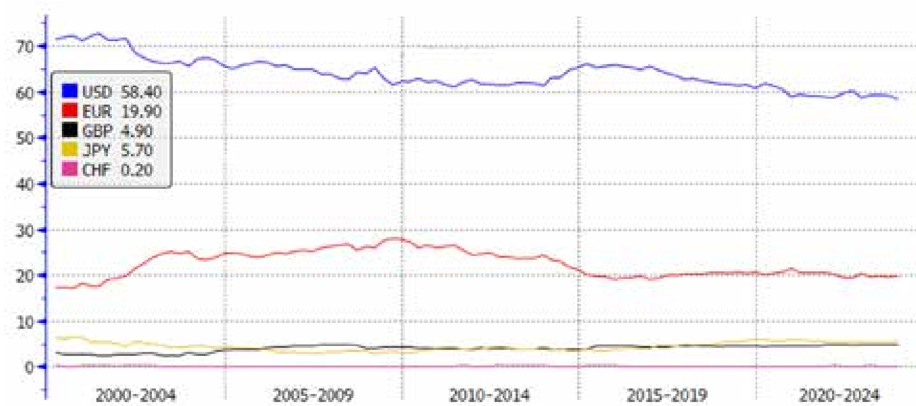
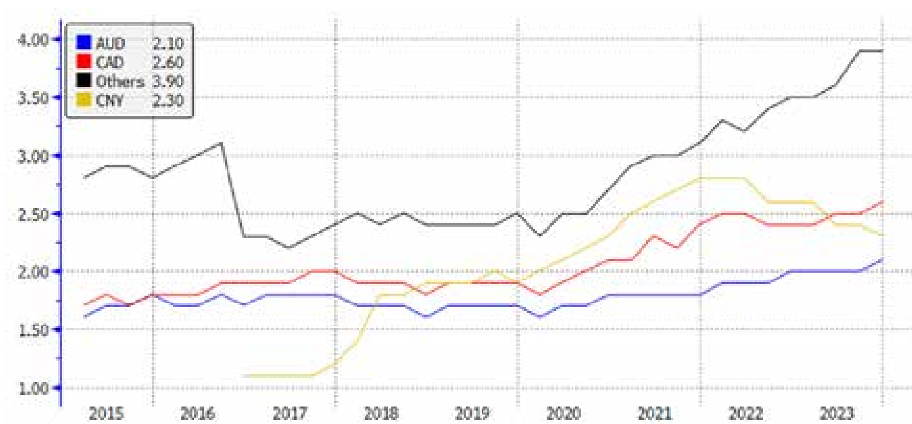


CHART 4: World Currency Composition of Official FX Reserves, %



Going for gold

In parallel, central banks have been ramping up gold purchases following financial sanctions on Russia in 2022. This is to be expected as gold is the safest reserve asset. Gold is free from direct links to the economic policy of any country, resistant to crises, and retains its real value in the long term.

Global holdings of gold by central banks now stand at over 36,000 tonnes, close to the all-time high of 38,000 tonnes reached in 1965 during the Bretton Woods era, led by strategic reserve moves towards gold by the central banks of China and Russia (Chart 5). In our view, the People's Bank of China (PBoC) has ample room to keep piling on its gold holdings, as precious metal makes up just 6.8% of its massive $3.6 trillion in total reserves – well below the global average of 26% (Chart 6).

Dollar threat

Going forward, loss of confidence in US trade, fiscal, and security policies, reflected by the recent divergence in the dollar and interest rate differentials (Chart 7), threaten to accelerate the dollar's declining role as the primary reserve currency.

First, the ongoing trade war is leading countries to reassess their economic dependencies on the US. The European Commission presented in May a new Single Market Strategy aimed at reducing barriers currently

CHART 5: World Official Gold Holdings (Tons)

CHART 6:

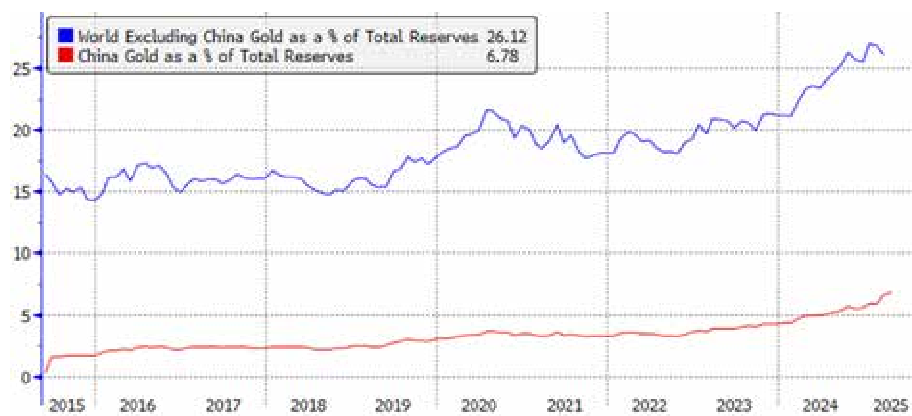
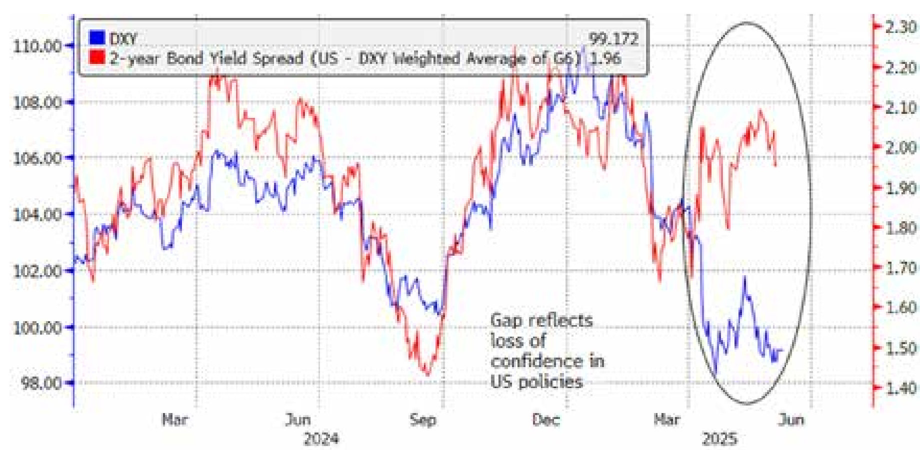


CHART 7:



holding back intra-EU trade and investments. Meanwhile, Canadian Prime Minister Mark Carney promised to remove interprovincial trade barriers by Canada Day – July 1.[1]

Second, the U.S. House of Representatives' reconciliation bill – titled the One Big Beautiful Bill Act (OBBBA) – has raised concerns over the escalating US fiscal burden. The Congressional Budget Office (CBO) estimates OBBBA to add $2.4 trillion to the debt over the next decade, raising the debt-to-GDP ratio from its current level of 97.8% to a record 123.8% – exceeding the CBO's January baseline forecast of 117.1%.[2] In response, the premium investors require for holding 10-year Treasuries (the term premium) rose as high as 0.9% in May - the highest since mid-2014 (Chart 8).

Moreover, Section 899 of OBBBA aims to impose additional taxes on foreign investors from countries deemed to have "unfair" tax practices. If the bill as presently written takes effect, it would deter foreign investment in US assets at a time when the country faces increasing reliance on foreign capital to finance its twin deficit – current account and budget deficits (Chart 9).

Third, the Trump administration's reluctance to provide security guarantees to allies cast doubt on US reliability and alliance commitments.

CHART 8: 10-Year Treasury Term Premium (ACM model), %

CHART 9: US Twin Deficit % of GDP (current account + budget)

Source fro both cahrts: 2025 Bloomberg Finance L.P.

Research by the Natural Bureau of Economic Research shows that "military alliances boost the share of the currencies of alliance partners in foreign reserve portfolios by close to 30 percentage points." As such, the security premium enjoyed by the dollar could diminish if the US is increasingly seen as an unpredictable partner.

Is the Euro ready for prime time?

The EU still lacks supply of highly rated assets and has still made little progress towards a capital markets union to aspire to become a dominant currency issuer. However, there is room for the euro currency to have a stronger weight in the share of foreign exchange reserves:

1 https://www.reuters.com/world/americas/carney-says-canada-aims-have-free-internal-trade-by-july-1-amid-us-tariffs-2025-03-21/
2 https://www.cbo.gov/publication/61459

(i) Common EU debt issuance is expected to reach nearly €1 trillion by 2026.[3] This will add a substantial amount to the current supply of low-risk assets in the eurozone area, enhancing the euro's appeal as a reserve currency.

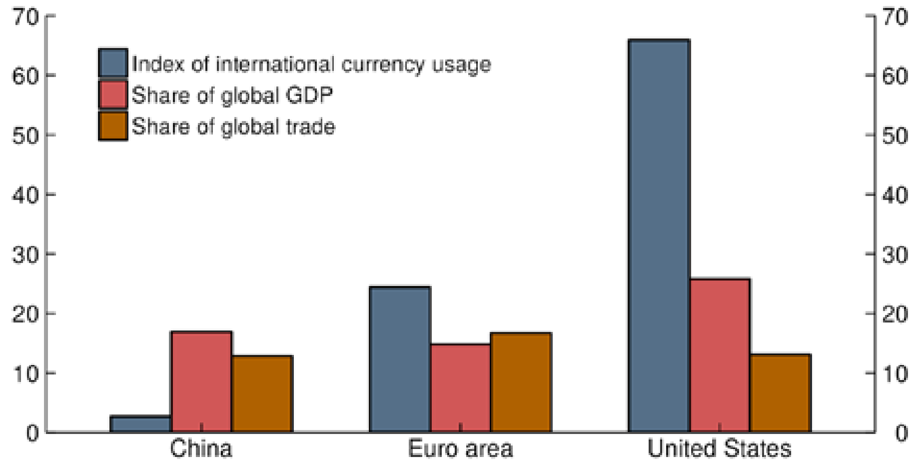
(ii) The European Central Bank (ECB) appears well on its way to issuing a digital euro to simplify cross-border transactions in the single currency. The draft legislative proposal contains specific provisions on the distribution of digital euro outside the euro area.[4] This could ultimately chip away at the dollar's dominance as a medium of exchange.

(iii) Europe is moving to rebuild hard power. In March this year the EU approved an ambitious €800 billion (5% of GDP) defense package called the Re-Arm Europe Plan/Readiness 2030.[5] This can enhance the euro area's diplomatic influence, making trade partners more willing to use the euro in contracts and trade.

Rise of the renminbi

The common narrative is that unlimited access to deep and liquid Chinese capital markets is necessary for renminbi (RMB) internationalization. However, research by the Banque de France shows that despite China's still limited capital account openness, the share of RMB in reserves can rise if Chinese trade and RMB invoicing continue to increase.

CHART 10



Source: FEDS Notes

China has made significant progress in building the infrastructure necessary to increase the international usage of RMB in international trade. In 2015, China introduced the Cross-Border Interbank Payments System (CIPS), which offers clearing and settlement services in RMB, while the PBoC has entered into at least 40 bilateral currency swap agreements with foreign central banks to improve RMB liquidity.

As a result, the renminbi is now nearly at par with the euro as the second most-used currency in global trade finance with a market share around 5%. The US holds a clear lead at nearly 85%. The renminbi also became the fifth most traded currency in 2022 with a market share of 7% – up from 0.9% in 2010. Preliminary results for 2025 FX turnover will be published by the Bank for International Settlements (BIS) in September.

Still, the international usage of the RMB currency is very low compared to China's shares of world GDP and world trade, implying a lot of potential for an increase in its usage (Chart 10).

Bottom line

The US dollar is not about to lose its dominant international currency status. But other currencies, notably the euro, renminbi, and gold are bound to gain a more prominent role. This is a structural drag for the dollar.

3 https://dbrs.morningstar.com/research/452588/morningstar-dbrs-confirms-the-european-union-at-aaa-stable-trend
4 https://www.ecb.europa.eu/press/other-publications/ire/focus/html/ecb.irebox202406_02~453de57477.en.html
5 https://www.europarl.europa.eu/RegData/etudes/BRIE/2025/769566/EPRS_BRI(2025)769566_EN.pdf

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