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What to watch: The Fed facing stagflation risks, the five stages of (tariff) grief, and the climate cost of defense spending

Ludovic Subran
Chief Economist
ludovic.subran@allianz.com

Lluis Dalmau Taules
Economist for Africa and Middle East
lluis.dalmau@allianz-trade.com

Maxime Darmet
Senior Economist for UK, US and France
maxime.darmet@allianz-trade.com

Jasmin Gröschl
Senior Economist for Europe
jasmin.groeschl@allianz.com

Bjoern Griesbach
Senior Investment Strategist & Eurozone Economist
bjoern.griesbach@allianz.com

Françoise Huang
Senior Economist for APAC
francoise.huang@allianz-trade.com

Hazem Krichene
Senior Climate Economist
hazem.krichene@allianz.com

Ano Kuhananthan
Head Corporate Research
ano.kuhanathan@allianz-trade.com

Maria Latorre
Sector Advisor
maria.latorre@allianz-trade.com

Gvanca Kirvalidze
Research Assistant
gvanca.kirvalidze@allianz.com

Giovanni Scarpato
Research Assistant
giovanni.scarpato@allianz.com

John Goulet
Research Assistant
john.goulet@allianz-trade.com

In summary

Fed: Stuck in a stagflation trap. With inflation still stubbornly above target (+2.8% y/y in February), the Fed is likely to remain on pause next week, even as steep tariff hikes, soaring policy uncertainty and deteriorating consumer sentiment are raising risks for US economic growth. We do not expect US GDP to grow at all in the first half of 2025. With tariffs set to push inflation further above target for most of the year (peaking at 3.5% in Q3), we expect the Fed to prioritize bringing inflation back under control over supporting economic growth, with one 25bps cut likely in November, followed by back-to-back 25bps cuts in Q1 2026. However, it could be forced to act earlier if trade tensions do not wane by mid-year as recession risks intensify. Markets are positioned for three rate cuts by the end of this year, discounting inflation risks for now.

The five stages of (tariff) grief. The US global tariff rate is expected to land at around 8% – the highest since the 1940s. Markets and policymakers are going from denial and anger to acceptance and adapting to the new economic reality. However, the cost of uncertainty is already extremely high and retaliations create escalation risks. US businesses are also in the acceptance stage and frontloading: US imports jumped by an impressive +11.9% in January, increasing for the third consecutive month, and we expect this trend to continue as long as tariff talks worsen. Beyond tariffs, currency markets are also under unprecedented risks from the US administration's unorthodox ideas to depreciate the USD in exchange for security guarantees (the "Mar-a-Lago" Accord). Other governments may resort to bargaining by purchasing more US goods (e.g. agrifood, natural gas, military products, transport equipment), lowering trade barriers, negotiating deals on critical topics (e.g. minerals, sustainability regulation or data). Europe could leverage services trade as a bargaining chips as the US has sizable trade surplus in services.

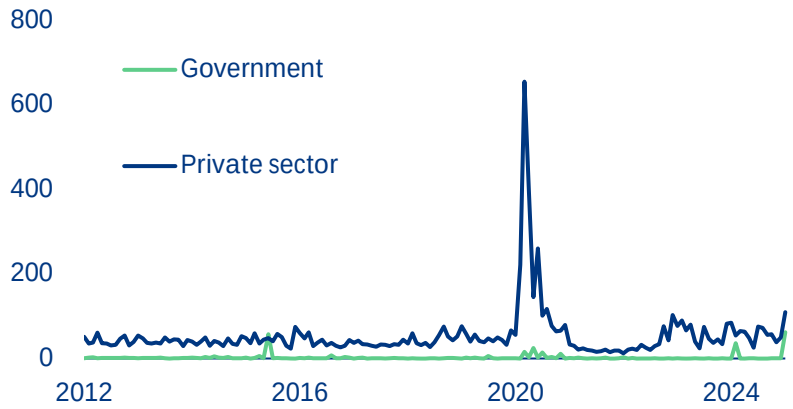
The climate taboo: the silent cost of war. Increasing military spending could have major climate consequences as the defense sector already accounts for 5.5% of global emissions, and wars often generate as much emissions as entire nations. In this context, ramping up defense spending to 3.5% of GDP could send France's and Germany's emissions surging by 38 $MtCO_2e$ and 65 $MtCO_2e$ within a year. This would set France and Germany back by five and three years, respectively, in their paths to reaching net-zero by 2050. To offset this, Europe will need to increase the defense sector's reliance on renewable energy while improving efficiency in military infrastructure and vehicles, besides developing a comprehensive strategy that integrates defense and climate considerations, upgrading military buildings and facilities to be more sustainable and embedding sustainability principles in procurement and research.

Fed: Stuck in a stagflation trap

Despite weakening economic activity, with inflation still stubbornly above target, the Fed is likely to remain on pause at its next meeting on 18-19 March. The Fed is facing off a very challenging environment of both rapidly weakening growth and stubborn inflation. The February CPI report showed inflation at +2.8% y/y, down from +3% in January due to softer services inflation. However, the last time US CPI inflation was below 2% was in February 2021 – four years ago. And the breakdown of the CPI report was not at all encouraging, with goods prices increasing at their fastest pace (+0.7% m/m) since January 2022. Meanwhile, inflation expectations show some signs of de-anchoring.

Steep tariff hikes, soaring policy uncertainty and deteriorating consumer sentiment are putting a severe brake on the US economy. The new US administration has moved swiftly and strongly to increase tariffs. As of 12 March, the US average tariff rate stood at 7.7%, up from 2.5% before the trade war. Moreover, more tariff hikes are looming, with the US Commerce Secretary set to release its memorandum on reciprocal tariffs on 1 April. We expect tariffs to be imposed on EU imports, which will drive the US effective tariff rate above 12%. In this environment, policy uncertainty is also soaring: In February, the US trade policy uncertainty index climbed way above its prior peak reached in 2018, and the NFIB uncertainty index for SMEs was close to the recent peak reached in October 2024 in the run-up to the election. This combined with the Trump administration's plans to roll back the Biden-era CHIPS Act subsidies is clouding the outlook for businesses, which are likely to hold back on investments. Meanwhile, consumer sentiment has also deteriorated, especially according to the University of Michigan survey, amid worries over higher tariffs leading to higher prices, as well as persistently high interest rates and significant layoffs of federal civil servants. In February, the Challenger job cut announcements increased noticeably, with half of the pick-up driven by government layoff announcements (Figure 1), though the increase in the private sector looked contained. Moreover, it was not matched by a corresponding increase in initial jobless claims. We find that the US labor market remains relatively solid. Labor shortages have moderated but are still significant, which should limit the expected rise in the unemployment rate. However, the sharp sell-off in stock markets could compound the downward pressure on the US economy. Plunging stock valuations risk denting sentiment even further.

Figure 1: Challenger job cut announcements (000s people, last outturns: February 2025)

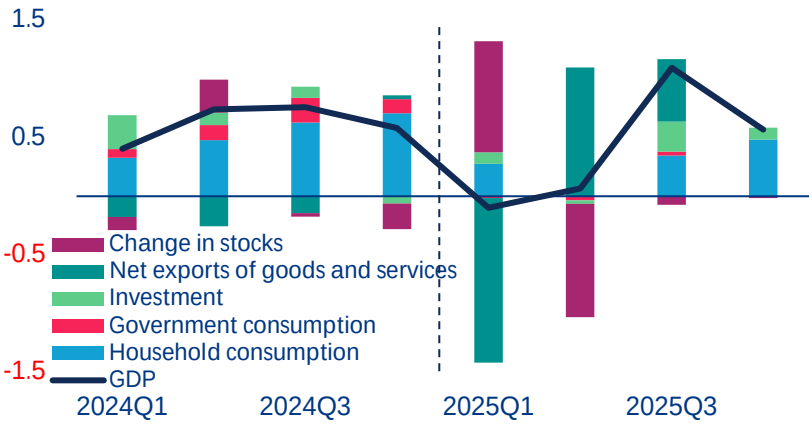


Sources: LSGE Workspace, Allianz Research

We expect US GDP to barely grow at all in the first half of 2025 and to bounce back in the second half of the year – provided the US, Canada and Mexico reach a trade deal by June. The Atlanta Fed's GDP nowcast for Q1 signals a drop of around -2.5% q/q (annualized), the result of a large negative contribution from net trade as businesses rushed to beat tariff increases, driving up imports. Oddly, though, the latest available data from January did not show a corresponding sharp increase in inventories, which should have offset some of the negative net trade contribution. Furthermore, others nowcasts are not pointing to a drop in GDP in Q1. In all, we have penciled in a -0.4% GDP decrease for Q1 annualized (-0.1% non-annualized, Figure 2) as we expect stronger inventory builds in February and March. For Q2 (current quarter) we expect GDP to grow at very weak pace of +0.3% (+0.1% non-annualized). We forecast underlying growth to weaken substantially, driven by a substantial slowdown of consumer

spending. In all, we expect US GDP to barely grow at all in the first half of 2025. The outlook should brighten up in the second half of the year, consistent with our expectation that the US will unwind most of the tariffs on Canada and Mexico. But there are clear downside risks to this scenario.

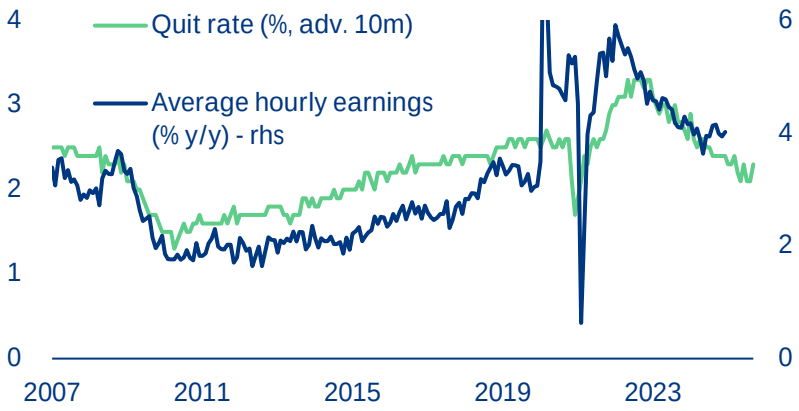
Figure 2: US GDP growth forecast (% q/q, non-annualized)



Sources: LSGE Workspace, Allianz Research

Steep tariff hikes will push **inflation further above the Fed's target** for most of 2025. To preserve credibility, we think the Fed will prioritize its fight against inflation over support to economic activity. Prolonged elevated inflation has thus far not eroded the Fed's anti-inflation credibility credentials, as indicated by the private sector's relatively well anchored medium-term inflation expectations and cooling wage growth. However, there are signs that the private sector – notably households – is starting to question the Fed's capacity to bring inflation back to target, especially as tariffs are set to increase (goods and food) prices further. Short-term (12 months) inflation expectations have shot up across all surveys, which is uncommon given that in the meantime oil prices have dropped. Medium-term (five-year) household inflation expectations also rose in February in the University of Michigan survey, though they remained anchored in the New York Fed survey (three-year). In this context, households are bidding for higher wages. It is noteworthy that despite a loosening of the labor market (as indicated by a lower private quit rate), wage growth has stabilized instead of cooling down (Figure 3). In this context, there is a material risk that wage growth and inflation feed into each other. We expect headline CPI inflation to peak to around 3.5% y/y in Q3 2025, before gradually pulling back as weak spending starts to bear down on prices – under our expectation that the Fed will remain on the sidelines for most of 2025, meaning that it is ready to accept a period of weak activity to bring inflation back under control. We expect the Fed to deliver a 25bps rate cut in November, cautiously shifting its focus away from inflation towards support to the economy. We would expect the pace of Fed rate cuts to accelerate in early 2026, with three 25bps rate cuts penciled in for the first three meetings of the year. In contrast, markets appear more complacent about inflation risks and are positioned for a Fed more focused on downside risks to growth, with three rate cuts expected by the end of this year and largely nothing in 2026 and 2027 combined (terminal rate at 3.60%).

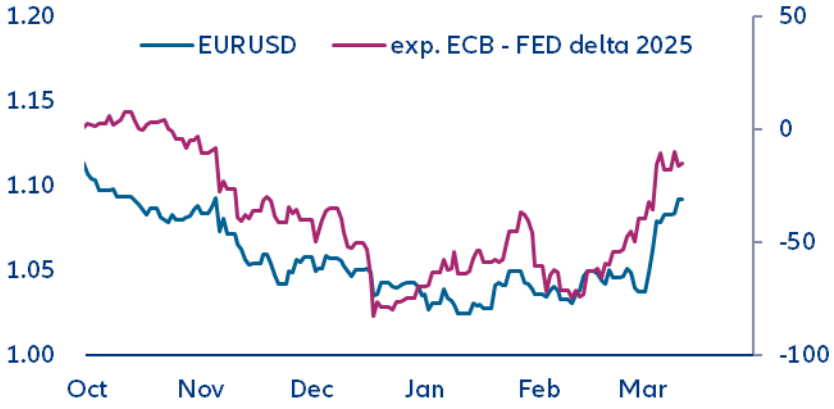
Figure 3: Wage growth & quit rate



Sources: LSGE Workspace, Allianz Research

The USD has weakened against the euro in line with market expectations of a more dovish Fed versus a more hawkish ECB. The increasing divergence in 2025 with respect to a more hawkish ECB pricing is part of the driver for the stronger euro, which has surpassed 1.09. Markets are now pricing 50bps of ECB hikes in 2026 and 2027 combined, after still aiming for 45bps more cuts in 2025, which leads to a terminal rate around 2.5% up from 2.0% a few weeks ago. The fact that we do not see any hikes in 2026 for the ECB and less cuts for the Fed in 2025 would justify not being overly bullish on the euro. We rather see a slight reversal or at least a halt in the EURUSD move.

Figure 4: EURUSD (lhs) and market expectations of ECB vs FED rate cuts in 2025 (rhs)



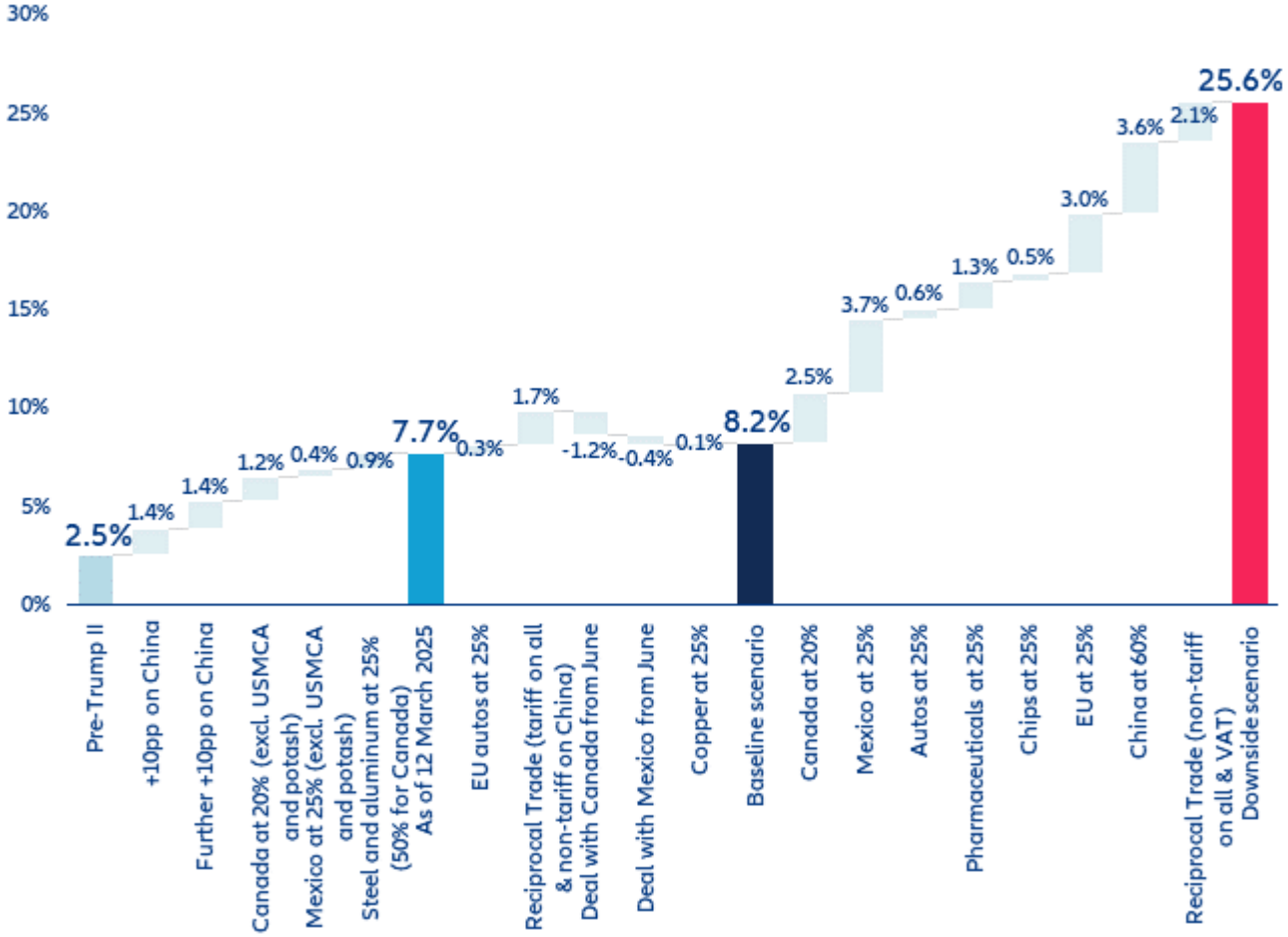
Sources: Bloomberg, Allianz Research

The five stages of (tariff) grief

We expect the global tariff rate to eventually land at around 8%, the highest level since 1942. Since Trump's return to the White House, the US has announced and implemented several tariff hikes on imports from China, Canada and Mexico (with the scope going back and forth) and on imports of steel and aluminum globally. Other measures are still pending, including the "Reciprocal Trade and Tariffs" memorandum and threats against the EU. We estimate that the US global effective import tariff rate stood at 7.7% as of 12 March 2025 – the highest level since the 1960s. Ultimately, we expect that it will rise to 8.3% (the highest level since the 1940s), assuming that the US will reach a deal with Canada and Mexico (reversing the tariffs put in place in March), while the "Reciprocal Trade and Tariffs" memorandum will be implemented partially and imports of autos from the EU will be tariffed at

25%. In a downside scenario of a full-fledged trade war, all threats that had been formulated in the past would be implemented and the global rate would exceed 25% (the highest since the early 1890s).

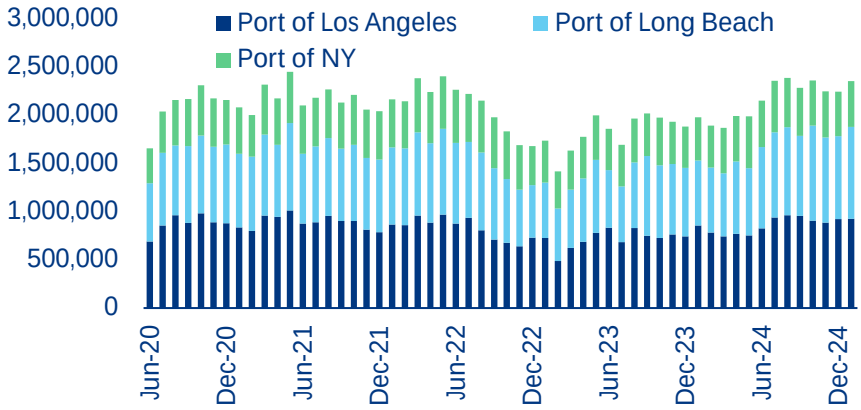
Figure 5: US global effective import tariff rate (weighted-average, %)



Sources: WTO, USITC, ITC, Allianz Research

In response, business are in the acceptance stage and are frontloading and stockpiling to safeguard non-tariffed inventories, to ensure production capacity and avoid any supply-chain disruption before further trade policy shifts. US imports rose by an impressive +11.9% m/m in January, the third consecutive month of increases since November (compared with -1% on average in the previous three months). Demand for industrial supplies was particularly strong, rising by +32.7% m/m in January. The Los Angeles and Long Beach ports, which make up about 40% of US imports and are directly linked to China, reported an increase of +5.5% m/m and +22.7% y/y in the volume of handled goods in January (Figure 6). In terms of traffic, these ports together reported an +18% jump in the number of vessels arriving in the first 10 days of March. Meanwhile, the port of New York, the third largest in the country (15.5% of US imports) and primarily engaged in trade with Europe and Latin America, recorded a +7% y/y growth in traded volumes in January, also underscoring that companies are preparing for more complex trade dynamics with European peers.

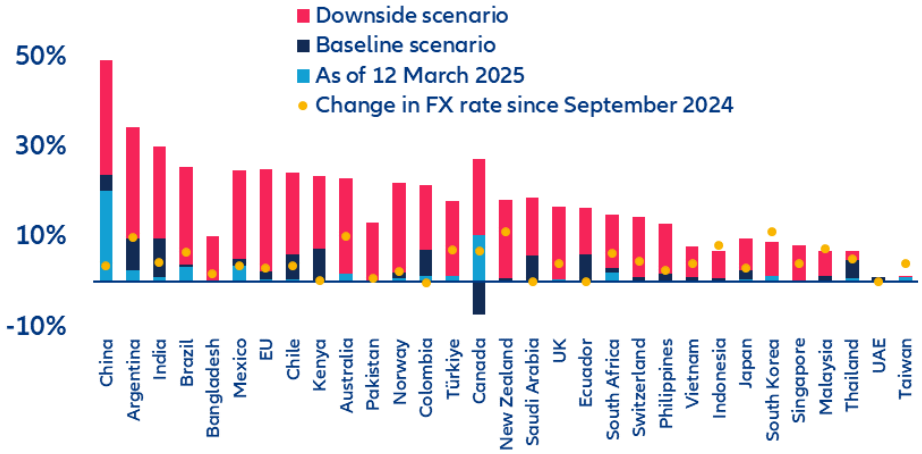
Figure 6: Container volume (TEUs) handled at US major seaports, monthly



Source: Bloomberg, Allianz Research

Beyond tariffs, currency markets are also under unprecedent risks of the US administration unorthodox ideas to depreciate the USD. Since September 2024, as markets began pricing in Trump's likely electoral success, the currencies of EU countries, Canada, Argentina, Brazil and Chile started depreciating, partly offsetting the effects of future tariff hikes (Figure 9). While currency movements have been very volatile since January, with some currencies appreciating against the USD, depreciation is likely to intensify as markets adapt to new tariff adjustments, partially offsetting the White House's policy goals. To address this, US policymakers are considering unorthodox and interventionist tools, such as the already popularized "Mar-a-Lago" accord, referencing the 1985 Plaza Accord, where major economies would agree to depreciate the dollar to address trade imbalances. This tit-for-tat strategy would involve exchanging security guarantees for a controlled appreciation of the partner's currency against the dollar, which would require the Fed to buy vast amounts of foreign currency, or by other countries selling their large USD reserves. This would be accompanied by an increase in US Treasury holdings, primarily zero coupon long-term "century bonds or perpetual." Countries in North America, the Middle East and East Asia, which are the largest holders of USD reserves, have been rumored to be pressured into the plan. However, the move would likely face opposition both inside and outside Washington. Treasury Secretary Bessent continues to support a strong dollar system, contradicting President Trump and Vice President Pence. Moreover, it is not guaranteed that all large holders of USD would be open to such an exchange. However, opposing the exchange could likely result in increased tariffs or a loss of the security umbrella provided by the US military. Other proposals are also being considered such as debt restructuring to make the USD less attractive, a tax on foreign officials holding USD, or aims to secure US debt funding for those with favorable trade relations with Washington.

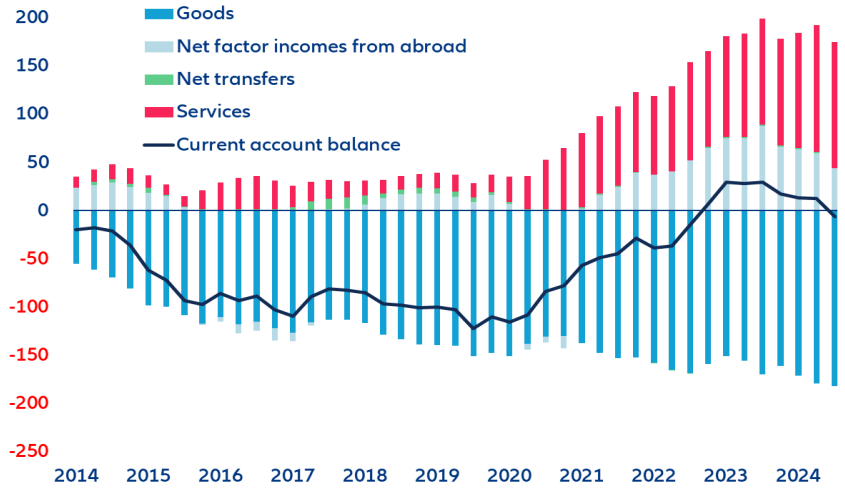
Figure 7: How currency moves are offsetting looming tariffs



Sources: WTO, USITC, ITC, LSEG Datastream, Allianz Research

Other governments may resort to bargaining by implementing policies to level their trade balance with the US. For emerging markets, reviewing tariff rates on US products has so far been the main practice, India in a sign of good will tariffs on heavyweight motorcycles and bourbon, as well as agreed to increase energy purchases from USD15bn to USD52bn. Brazil is considering a cut in tariffs on basic foods, Thailand and Vietnam are also looking into boosting to agricultural imports from the US. For Europe, negotiations must go beyond goods as it has become clear that Trump uses tariffs as a pressure tactic to assert his positions. But the situation is more complex than during Trump's first term. Europe is now more reliant on the US, particularly for liquefied natural gas (LNG), and has not fully implemented the tariff reductions promised in the past. In response to the 25% aluminum and steel tariffs (affecting EUR26bn or 5% of EU exports to the US, leading to EUR6bn in additional import tariff payments), the EU is reinstating counter-measures worth a similar amount: EUR8bn in a first round on motorcycles, Bourbon whiskey, jeans, boats, peanut butter and the like, followed by goods worth around EUR18bn in the second step. However, the EU must signal its willingness to negotiate while asserting itself from a position of unity and strength. One option could be to propose a trade conference and aim for a free-trade agreement with the US, which might appeal to Trump's dealmaking approach. Furthermore, Europe could also leverage services trade in its negotiations with the US. Despite the significant trade deficit in goods with Europe, the relationship is more balanced when considering services trade – the US enjoyed a USD105.9bn surplus vs the Eurozone cumulatively over four quarters in Q3 2024 – and US asset holdings of USD35.8bn (Figure 8).

Figure 8: US current account with Eurozone

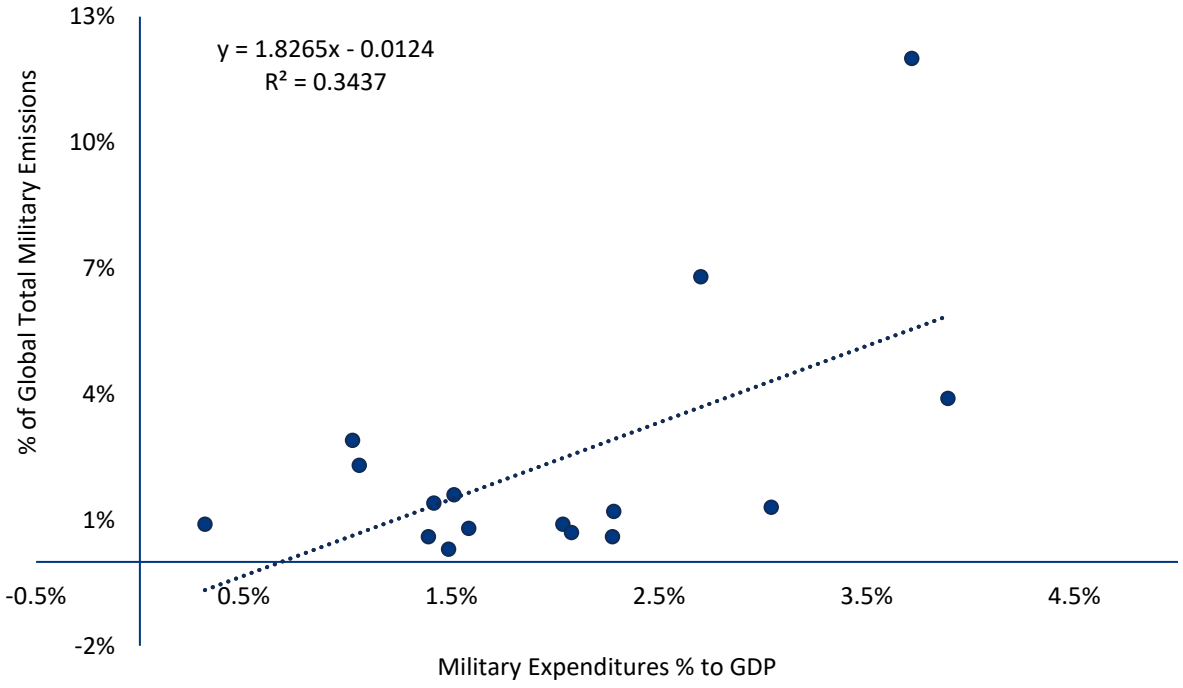


Sources: ECB, BEA, Allianz Research

The climate taboo: The silent cost of war

Increasing military spending will challenge **Europe's climate ambitions.** With the growing threat of conflict on Europe's borders, the region aims to ramp up military spending to strengthen its defense capabilities. A shift from the NATO baseline of 2% GDP defense spending to 3.5% could stimulate economic growth – offering an annual GDP boost of between 0.2pp to 0.5pp on average for the Eurozone per year from 1% of GDP additional defense spending – and strengthen Europe's industrial base, particularly if investments prioritize high-tech, domestically manufactured weaponry. This would not only bolster technological development and create jobs but also reduce dependence on foreign defense systems, reinforcing strategic autonomy. But the broader implications of this policy shift extend well beyond economics. Notably, the climate consequences are huge. The defense sector is among the largest carbon emitters, with military operations, equipment manufacturing and supply chains responsible for an estimated 2,750 $MtCO_2e$ (megatons of CO_2 equivalent), or 5.5% of total global emissions. If it were a country, it would rank as the fourth-largest emitter in the world, surpassing Russia's total carbon footprint[1] and the whole Africa continent (1,900 $MtCO_2e$). NATO countries' contribution to military emissions is about 8.5%, with reported emissions of 233 $MtCO_2e$ in 2023. In this context, expanding domestic weapons production would increase the carbon footprint of several hard-to-abate industries such as steel and aluminum[2]. Figure 12 highlights the strong positive correlation between a country's military expenditures and its share of global military CO_2 emissions, based on a sample of the largest military spenders. According to these estimates, if France and Germany were to align their military spending with the 3.5% benchmark, their emissions would rise by 38 $MtCO_2e$ (equivalent to 47% of France's total emissions) and 65 $MtCO_2e$ (22% of Germany's total emissions), respectively.

Figure 9: Military spending and associated emissions



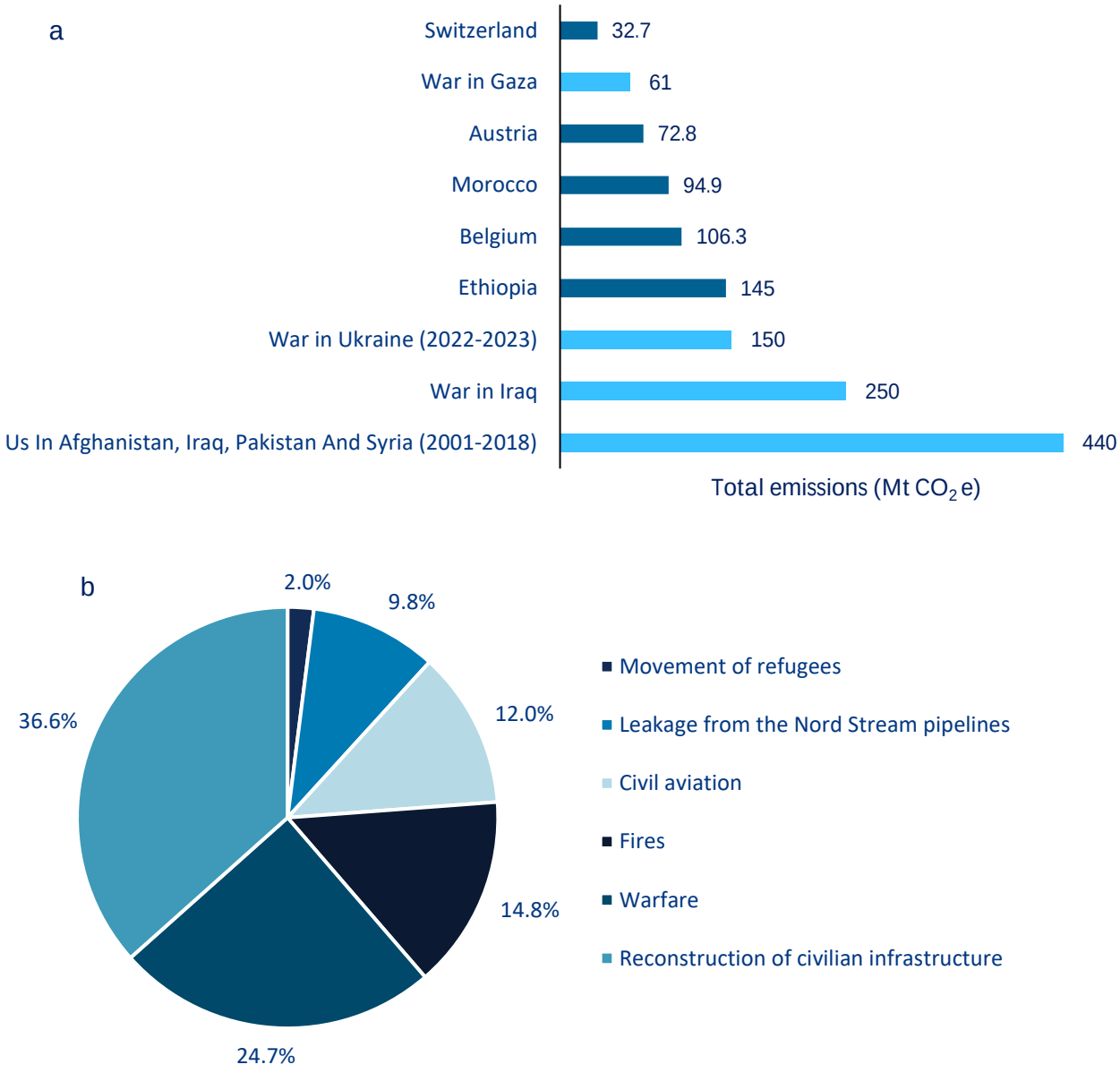
Sources: CEOBS, Allianz Research

Beyond their devastating human cost, conflicts impose a severe and often overlooked burden on the climate, generating as much emissions as entire nations. Over the past two decades, armed conflicts, responsible for the deaths of over 1mn people, have contributed an estimated 901 $MtCO_2e$ to global greenhouse gas emissions. This staggering figure is three times higher than the entire NATO military industry's emissions in 2023 and equivalent to

[1] SGRCEOBS-Estimating_Global_MIlitary_GHG_Emissions_Nov22_rev.pdf
[2] Allianz | Strategies for transforming Europe's industrial sector

half of Africa's total emissions in the same year. When comparing the carbon footprint of war to national emissions, the scale of impact is striking (Figure 10a). For example, just three major conflicts – war in Ukraine, the Syrian civil war and the war in Iraq – have generated more greenhouse gas emissions than several European nations, including Belgium, Austria and Switzerland. Meanwhile, the conflict in Gaza has produced emissions twice that of Switzerland in 2023 alone. A closer look at the conflict in Ukraine reveals that 88% of war-related emissions stem from four main sources (Figure 10b). The largest share, 36.6%, is attributed to the reconstruction of destroyed civilian infrastructure, underscoring the long-term environmental damage of warfare. This is followed by direct warfare operations (24.7%), fires caused by attacks (14.8%) and civil aviation (12%).

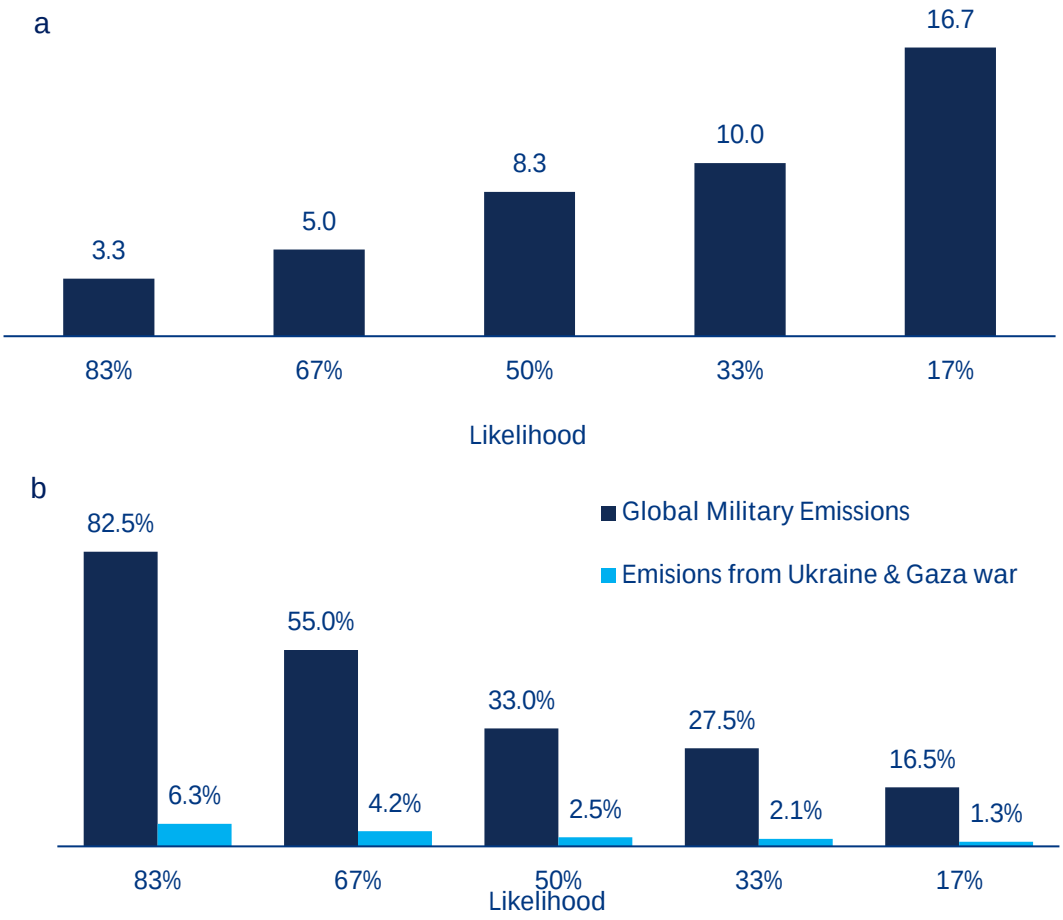
Figure 10: Carbon emissions from conflicts: a) Comparison to the total emissions of selected countries; b) decomposition of emissions following war in Ukraine (18 months of war)



Sources: UNFCCC, ClimateFocus, Allianz Research

A continued escalation in military activity would further erode the limited carbon budget left to achieve the Paris Agreement targets, directly undermining global climate goals. To have a 50% chance of meeting the Paris Agreement target of limiting global warming to below 1.5°C above pre-industrial levels, the world has a remaining carbon budget of just 250bn tons (Gt) of CO_2 for 2020-2050, equivalent to only 8.3 Gt of CO_2 per year (Figure 14a). However, this budget shrinks significantly depending on the level of certainty we aim for in staying below 1.5°C. For a more risk-averse approach, ensuring an 83% chance of staying within the 1.5°C threshold, annual emissions would need to be capped at just 3.3 Gt CO_2 until 2050, while they stand today already at around 41 Gt CO_2. Yet, the combined emissions from ongoing wars in Ukraine and Gaza, along with global military industry emissions, have already consumed around 89% of this stricter carbon budget, making the 83% certainty scenario increasingly unattainable (Figure 14b). Even under the least conservative scenario, where the probability of limiting warming to 1.5°C drops to just 17%, military-related emissions have still consumed 18% of the available carbon budget. This reality raises serious concerns about the recent EU push for re-militarization, which signals preparations for potential future conflicts. The cost of war extends far beyond the battlefield, not only claiming lives and livelihoods but also jeopardizing humanity's ability to combat climate change, the greatest existential crisis of our time. At a moment when urgent climate action is needed, diverting resources and emissions toward militarization risks undoing years of progress, leaving future generations to bear the consequences of both conflict and environmental crisis.

Figure 11: Global carbon budget: a) annual carbon budget required to limit global warming to +1.5°C under different probability scenarios; b) proportion of war-related emissions relative to the annual carbon budget



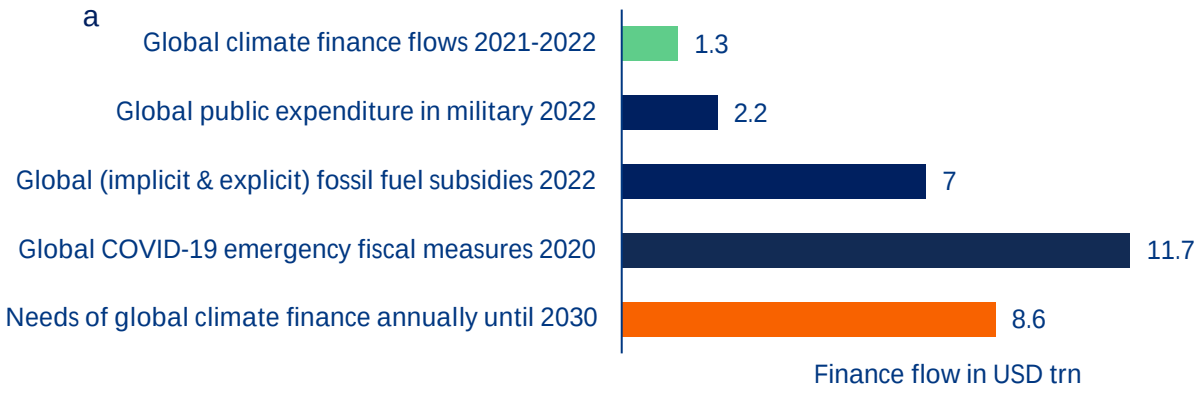
Sources: OurWorldinData, UNFCCC, Allianz Research

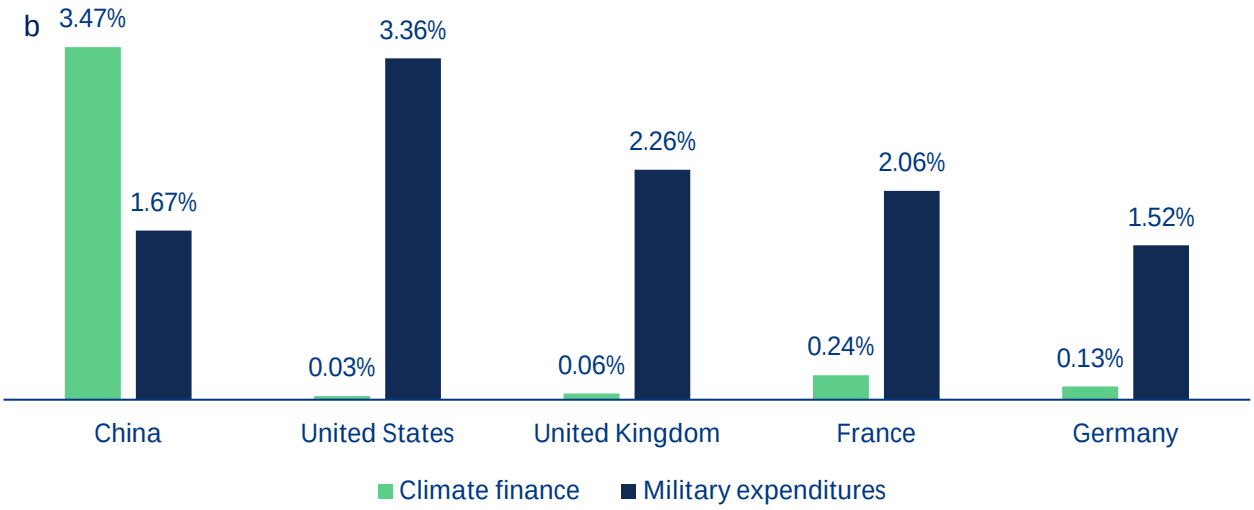
Against this backdrop, climate financing needs to be ramped up significantly for major economies to keep their climate targets on track. In 2022, global military spending reached USD2.2trn, nearly double the total allocated to climate finance (USD1.3trn, Figure 12a). When fossil-fuel subsidies are included, the disparity grows even more alarming. Combined with military expenditures, these subsidies total USD9.2trn, an amount that could fully cover

the USD8.6trn in annual global climate finance needed to secure alignment towards the Paris Agreement targets. At the national level, the gap between military and climate-related expenditures is even more pronounced (Figure 12b). With the exception of China, all major economies allocate significantly more to defense than to climate mitigation and adaptation. The US leads in defense spending, directing 3.36% of its GDP toward military expenditures while investing a mere 0.03% of GDP in climate transition. The UK follows a similar pattern, with 2.26% of GDP funneled into military activities compared to only 0.06% for climate efforts, exposing a severe underinvestment in climate transition. In contrast, China stands apart as the only major economy where climate finance surpasses military spending. In 2022, China allocated 3.47% of its GDP to climate-related investments, largely driven by subsidies for green technologies such as electric vehicles and renewable energy infrastructure, while military expenditures remained at 1.67% of GDP. Nevertheless, its defense sector is responsible for 24% of global military emissions, compared to just 12% from the US, the world's largest military spender. This contradiction arises primarily from China's highly carbon-intensive industrial base, particularly in coal-powered steel and aluminum production, both of which are essential materials for military infrastructure.

Europe's defense sector is starting to factor sustainability into its operations, acknowledging that climate change is set to shape future security landscapes. Military forces and defense firms are aiming to move away from their traditionally high-emission reputation by adopting eco-friendly designs and improving energy efficiency. A new roadmap outlines ambitious targets for reducing the environmental footprint of the EU's armed forces. By 2030, they are expected to cut greenhouse gas emissions by at least 55% from 1990 levels, with the ultimate goal of reaching net-zero emissions by 2050. Although no fixed quotas were mentioned, the defense sector is encouraged to increase its reliance on renewable energy while continuously improving efficiency in military infrastructure and vehicles. To achieve these objectives, the EU has proposed several key initiatives. These include drafting a comprehensive strategy that integrates defense and climate considerations, upgrading military buildings and facilities to be more sustainable, and embedding sustainability principles in procurement and research. Other measures involve expanding renewable energy deployment on military sites, conducting training exercises that simulate energy crises and climate-related threats, and creating an EU center of excellence dedicated to defense, energy and climate issues. Additionally, the EU aims to develop a standardized framework for achieving climate-neutral defense operations, ensuring that sustainability becomes a core component of military strategy and preparedness.

Figure 12: Climate finance flow: a) global climate finance flows in comparison to other major expenditures; b) country-level comparison of climate finance and military expenditures, % of GDP





Sources: CPI, SIPRI, Allianz Research

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