Inflation Strategist

Separate paths

01 July 2025

Fixed Income Research
Global

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US TIPS: Hedge for different risks

We hold our long breakeven view through 10y breakeven (BE) and 2y3y inflation swap. Long BE is a hedge for a dovish Fed, geopolitical conflict, and persistent inflation. We also update our BE and real yield forecasts alongside nominal rate revisions. *– M. Swiber*

Euro IL: Some trade ideas just won't stay closed

We closed a US-Euro 2y3y inflation spread trade in May. It has narrowed since, and we would re-enter, based on the realised history and on forces for a larger more persistent inflation difference. We close our recommendation to receive the BTPei 2033-to-'39 forward yield and reiterate the case for OATei 2038s/53s real flatteners. *– M. Capleton*

UK IL: From front to back

The May print increases our confidence that RPI 1s2s can flatten further. Curve shape and historical convexity benefits argue for a UKTi 2058s/68 real flattener. *– M. Capleton*

EM IL: EEMEA – front-end receivers are largely over

We do not see value in EEMEA front-end receivers. The market pricing of policy rate paths is slightly more hawkish than, or in line with, our expectations in all EEMEA countries except Czechia. The Czech National Bank (CNB) is likely to adopt a stop-and-go approach to easing from here, making receivers volatile, in our view. *– M. Liluashvili*

US Economics: Another month another soft print

The May CPI inflation report surprised to the downside, with broad-based disinflation. The impact of tariffs was smaller than expected in May. We expect to see it more clearly starting next month. *– S. Juneau*

Euro Area Economics: Persistent undershoot

We forecast headline inflation of 1.8%, 1.5% and 1.8% in 2025, 2026 and 2027 (including the effect of ETS2), respectively. We expect small core inflation undershoot, starting in the last part of this year, with yearly averages of 2.1%, 1.8% and 1.8% in 2025, 2026 and 2027, respectively. *– Ruben Segura-Cayuela*

UK Economics: Progress in underlying inflation continues

Progress in underlying services continued in May and supports the view that April strength was noisy. We expect 2025, 2026 and 2027 inflation at 3.1%, 2.2% and 2.0%, respectively. Underlying inflation risks are likely to lower post tariffs. We expect cuts in August/September/November. *– S. Punhani*

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For a complete list of our open trades and those closed over the past 12 months, see our latest Global Rates Weekly

Timestamp: 01 July 2025 12:11PM EDT

US TIPS

Inflation – US

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- We hold our long breakeven view through 10y BE and 2y3y inflation swap.
- Long BE is hedge for a dovish Fed, geopolitical conflict, and persistent inflation.

Expect upside to forward inflation

Alongside our mid-year forecast revisions (see our Global rates mid-year report), we refresh the decomposition of real yield (RY) vs. breakeven (BE) inflation (Exhibit 1). We hold our breakeven forecasts steady over the time horizon and reflect small tweaks to nominal rates in real yields.

Exhibit 1: Decomposition of nominal forecasts between RY and BE
Expect more upside to forward inflation

		Level (%)						Change (BPS)				
		Q3 25	Q4 25	Q1 26	Q2 26	Q4 26	Q4 27	Q3 25	Q4 25	Q1 26	Q2 26	Q4 26
	2y Govt	3.8	3.75	3.75	3.75	3.75	3.75	0	0	0	0	-10
	5y Govt	3.9	4	4.05	4.1	4.2	4.25	-15	-10	-10	-10	-5
	10y Govt	4.4	4.5	4.5	4.5	4.5	4.5	0	0	-5	-10	-25
Nominal	30y Govt	4.9	5	5	5.05	5.15	5.15	10	10	5	5	5
	2y Govt	2.7	2.6	2.6	2.6	2.6	2.5	0	0	0	0	0
	5y Govt	2.5	2.5	2.5	2.5	2.5	2.5	0	0	0	0	0
	10y Govt	2.4	2.4	2.4	2.35	2.35	2.35	0	0	0	-5	-5
Breakeven	30y Govt	2.3	2.3	2.3	2.3	2.3	2.3	0	0	0	0	0
	2y Govt	1.1	1.15	1.15	1.15	1.15	1.25	0	0	0	0	-10
	5y Govt	1.4	1.5	1.55	1.6	1.7	1.75	-15	-10	-10	-10	-5
	10y Govt	2	2.1	2.1	2.15	2.15	2.15	0	0	-5	-5	-20
RY	30y Govt	2.6	2.7	2.7	2.75	2.85	2.85	10	10	5	5	5

Source: BofA Global Research, Bloomberg

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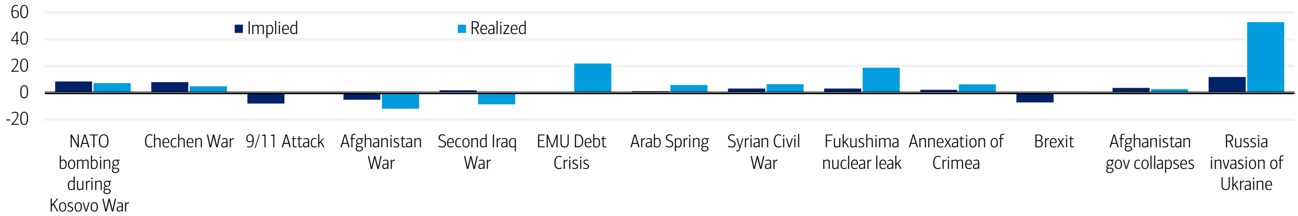
Our forecasts for BEs were close to what was realized for Q2 (assuming constant maturity), as we anticipated a steeper inflation curve, with the front end moving lower and forwards shifting higher (see the report, Not so fast and furious). We closed our 1y inflation swap short (see the report, Close 1y inflation swap short) but maintain our 2y3y long (current = 2.33%, initial = 2.24%, target = 2.5%, stop = 2.05%). The risk is a downturn that lowers inflation compensation. As we discuss below, we continue to see room for inflation to price higher in forwards and hold a long in spot as a hedge to geopolitical risk re-escalation.

Hedge for different risks…

As discussed in the report, US rates & geopolitical risk, we initiated a 10y BE long to hedge geopolitical risk. Our justification: 10y BE underperformed beta to oil as geopolitical tensions escalated but historically tends to outperform oil beta during geopolitical shocks (Exhibit 2). While the market has priced a de-escalation since then, we hold the position as a hedge (current = 2.28%, initial = 2.34%, target = 2.55%, stop = 2.20%). The risk is risk-off flow that sees oil decline.

Exhibit 2: Implied vs realized 10y BE move 1m following geopolitical events (bps)
BEs often move more than what beta to oil would imply on geopolitical events



Source: BofA Global Research, Bloomberg

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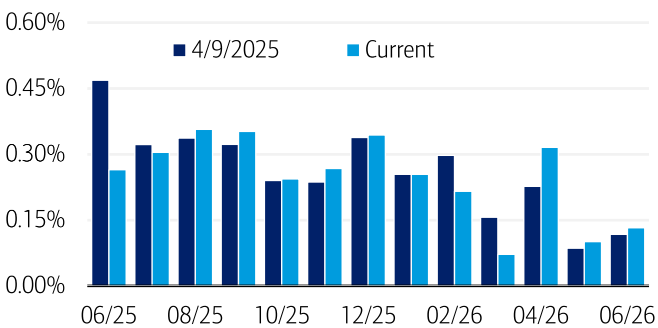
Beyond geopolitical risks escalating, we also think that long BE is a way to hedge risk of a growing divide between policy views at the Fed. A split between the core and more dovish members could see the market begin to question how much weight will be put on potentially sticky inflation in future policy debates. We think that this concern could help generate a bid for BEs across the curve and in forwards.

Where is market pricing peak tariff risk?

Since the peak in front-end inflation on April 9, the market has lowered and pushed out the seasonally adjusted (SA) headline MoM inflation peak from June to August/September (Exhibit 3). This is consistent with expectations for a lower effective tariff rate and view that tariff passthrough may take longer to appear in prices. Compared to our US Economics team's base case, the market is pricing a very similar outcome over the next 3 months but modestly more persistence through the end of the year and into start of next year (Exhibit 4).

Exhibit 3: Market pricing of SA headline MoM CPI
Market is pricing lower and later inflation peak



Source: BofA Global Research

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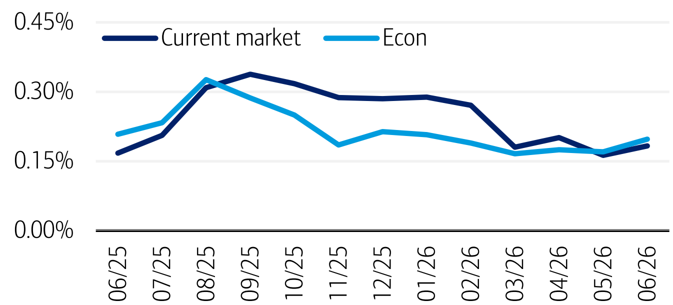
Exhibit 4: Market & US Econ SA headline CPI, 3-month rolling
Market is consistent with US Economics over next 3 months, larger divergence could comes in Q4 and 1H 2026



Source: BofA Global Research

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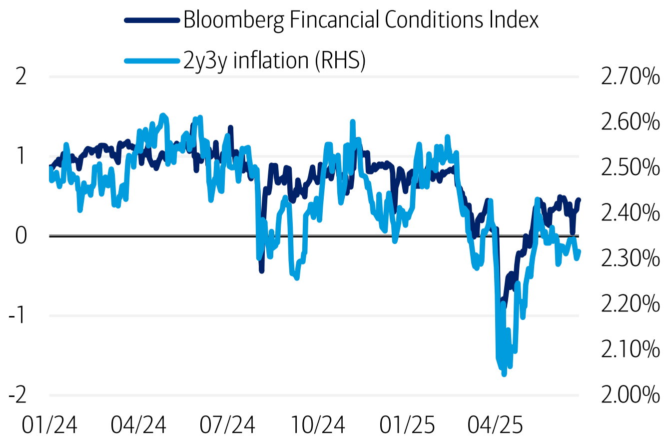
Forwards determined by financial conditions

Financial conditions have recovered from the recent lows observed around "Liberation Day" but are tighter than the levels observed in 2024. We similarly see that 2y3y inflation has recovered from lows but modestly less than financial conditions would imply (Exhibit 5). We historically see a strong relationship between financial conditions and 2y3y inflation (Exhibit 6). We acknowledge that a core risk to long 2y3y inflation trade is a tightening in financial conditions but believe that the prospect for persistent inflation alongside a dovish Fed offset this concern.

Exhibit 5: Financial conditions and 2y3y inflation
Financial conditions have recovered more vs. 2y3y inflation



Source: BofA Global Research, Bloomberg

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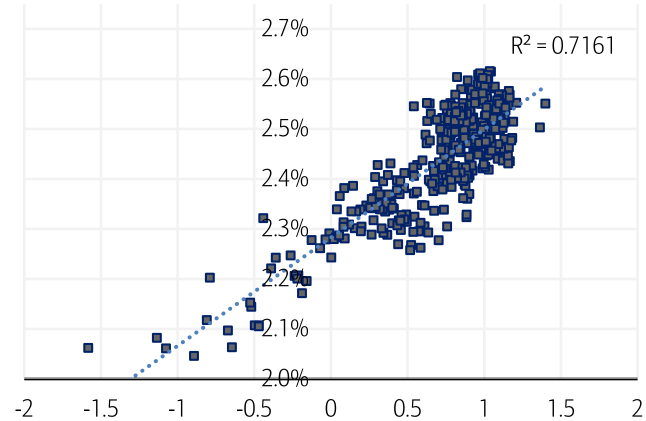
Exhibit 6: Financial conditions (x-axis) and 2y3y inflation (y-axis)
Historically tight relationship between financial conditions and 2y3y inflation



Source: BofA Global Research, Bloomberg

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Euro IL

Mark Capleton
MLI (UK)

- We closed a US-Euro 2y3y inflation spread trade in May. It has narrowed since, and we would re-enter, based on the realised history and on forces for a larger more persistent inflation difference. We close our recommendation to receive the BTPei 2033-to-'39 forward yield and reiterate the case for OATei 2038s/53s real flatteners.

Some trade ideas just won't stay closed

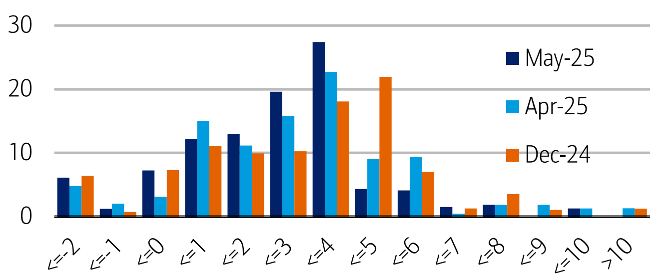
We reopen our US vs. Euro 2y3y inflation spread widener

In the 7 March Global Rates Weekly (see the report), we recommended a US-Euro 2y3y inflation spread widener at 28bp, targeting 50bp with a stop-loss at 15bp. Then at the end of May, we closed it at the 50bp target (see the report, Global Inflation-Linked Alpha, 30 May 2025). Although the current spread, at 38bp, is wider than our previous entry level, we think that it is time to revisit the theme – this time with a more ambitious target.

Underlying Eurozone disinflation progress intact

Disinflationary progress in the Eurozone continues at a steady pace, which can be seen in the ongoing shift left in the entire distribution of core component inflation rates (Exhibit 7). Most striking perhaps is the rapid shrinkage of the upside tail, with the proportion of core CPI recording inflation above 4% falling as fast as it rose (Exhibit 8).

Exhibit 7: Core HICP component inflation rates shifting left…
Weighted dispersion of core HICP component inflation rates, %



Source: BofA Global Research, LSEG Data & Analytics
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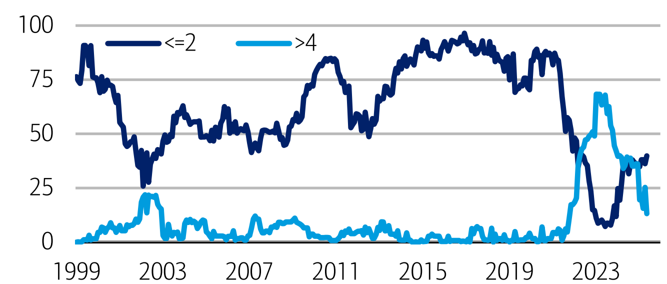
Exhibit 8: …driven mainly by collapse of upside tail, %
Proportions of core basket recording inflation rates below 2% and above 4%



Source: BofA Global Research, LSEG Data & Analytics
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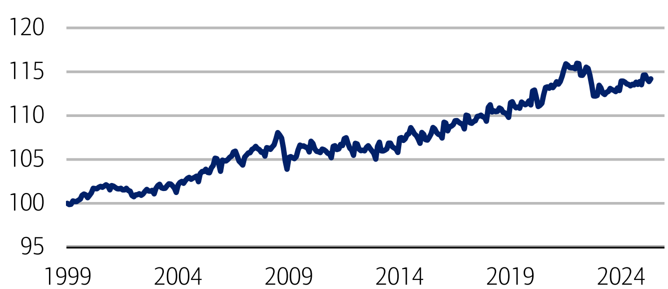
Since EMU began, the average realized US-Euro inflation spread has been 51bp

Exhibit 9: US/Euro CPI ratio – noise around a strong trend
Ratio of linking indices (CPURNSA/CPTFEMU), rebased to Jan 1999=100



Source: BofA Global Research, LSEG Data & Analytics
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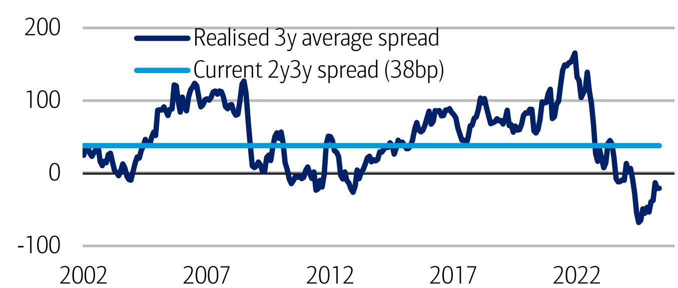
Exhibit 10: Rolling 3-year average inflation spread, based on Exhibit 9
Current 2y3y rate of 38bp comfortably below realized historical average.



Source: BofA Global Research, LSEG Data & Analytics
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For the cross-market trade, perhaps the most compelling argument is the history. Since European Monetary Union in January 1999, the annualized average inflation spread between the two linking indices has been 51bp, and a simple plot of the ratio of the indices shows that there has been a steady trend, rather than one or two short bursts that explain the entire difference (Exhibit 9). This trend component reflects structural measurement differences (compositional and methodological) between the two indices as well as any genuine underlying differences in inflation experienced.

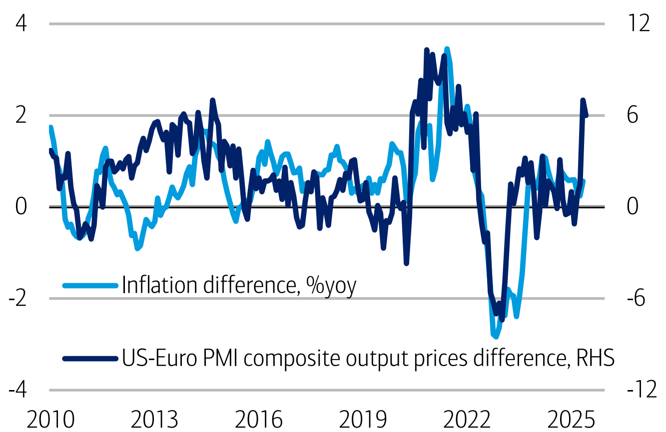
Why re-enter the trade now?

Aside from what we perceive to be the underlying value in the trade, the prompts for reinstating it now are several. For instance, the sharp jump in June US PMI output prices, and the associated gapping wider in the spread between the US and Euro PMI composite output price series, is noteworthy and provides a degree of confidence in US tariff pass-through (Exhibit 11).

Also relevant, we believe, and possibly captured to some extent by the PMI spread, is the strength in the EUR exchange rate. This is something we have long believed the market underplays, given the general view that both the US and Eurozone are relatively "closed" economies, but the bilateral exchange rate showed a good fit with the goods price inflation difference until about ten years ago (Exhibit 12). We do not think that the exchange rate influence can have gone away, but rather its significance has been masked by other forces.

Then there are the intangible issues that seem to point the same way, such as the possibility that a future change in Fed leadership shifts its emphasis towards its growth mandate or that US fiscal sustainability concern morphs into inflation concern.

Exhibit 11: PMI output prices point to widening US-EZ inflation spread
US PMI Composite Output prices less Euro equivalent vs. inflation difference.



Source: BofA Global Research, Bloomberg

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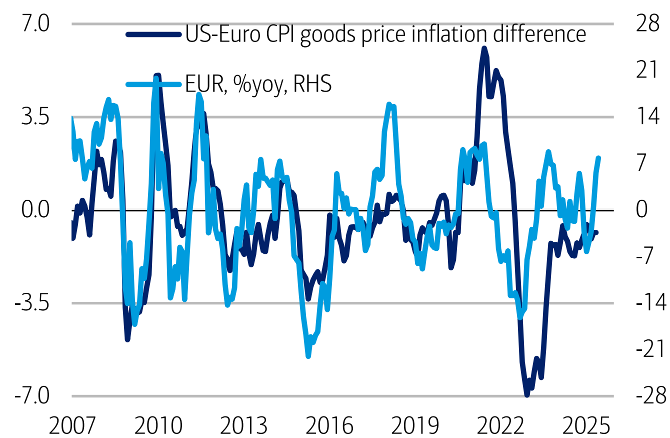
Exhibit 12: US-Euro goods price inflation spread and the currency
A close link until 10 years ago, which has been masked by other forces since



Source: BofA Global Research, LSEG Data & Analytics

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As before, the cross-market trade ties in naturally with our bullish stance on 2y3y US inflation (see the US TIPS section) and our ongoing recommendation to enter 2y3y/5y5y EURi steepeners. This steepener was entered at 20bp in early May with a target of 35bp and a stop-loss at 10bp (currently 23bp). Risk to the trade is stalling disinflation. See the report, 'Learning curves', Inflation Strategist, 2 May 2025.

We recommend US-Euro 2y3y inflation spread wideners at 38bp, setting a target of 70bp and a stop-loss at 20bp. Risk to the trade is a sharp US economic slowdown.

Close BTPei 2033-39 real rate received trade

In the April Inflation Strategist, we recommended receiving the forward real yield between BTPei 2033 and BTPei 2039, then at 358bp, setting a target of 300bp and stop-loss at 400bp. We saw the risk to the trade as being a material cheapening of Italy on a spread to core Euro. The current forward yield is 320bp. The trade combined a view that Euro real yields were cheap, that Italy as a credit was cheap, and that the BTPei 2039 issue was cheap on an RV basis. See the report, 'Spring forward', 1 April 2025.

We followed this up in mid-May with a recommendation to combine a 5y5y €str position with a 5y5y Euro inflation swap position in order to receive a 5y5y "real €str" rate of 74bp, setting a target of 25bp and a stop-loss of 100bp (currently 69bp). Risk to the trade is robust economic growth in the Eurozone. See the report, 'When exorbitant privilege meets exorbitant need', Liquid Insight, 14 may 2025.

While conscious that we were doubling up on our real rate view, we were keen to have a "pure" real rate expression, given that some might not want the additional idiosyncratic Italy risk. Now, given that the BTPei forward has fallen 38bp while the real €str forward has declined by only 5bp, it is clear that most of the reduction in the BTPei forward relates to Italy spread compression. **We are now more neutral on the future path of Italy spreads and close the BTPei 2033-2039 forward at the current level of 324bp.** We retain our conviction that 5y5y real euro rates will fall further.

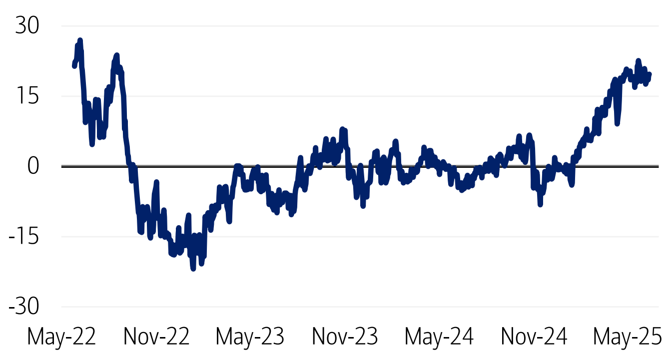
OATei 2053's convexity value looking oversold

This next section first appeared in the Inflation-EU section of the Global Rates Weekly, 13 June 2025. Levels have been updated where appropriate.

At 22bp, the OATei 2038/'53 real yield spread is within a basis point of where it closed on the launch day of 2038s three years ago. It has climbed back to its opening spread (see Exhibit 13) even though the outright yield level is obviously very much higher.

That's the observed spread move, but how would an actual steepener or flattener position have fared? A steepener would have done better than a flattener, but it would have been close. With daily rebalancing to keep a position duration neutral, the carry contribution would have been equivalent to 18bp of steepening. But convexity delivered the equivalent of 16bp of flattening, by our calculations (Exhibit 14 and Exhibit 15).

Exhibit 13: OATei 2038/2053 yield spread back to the launch pad, bp
Spread only a basis point shy of May 2022 opening at the launch of 2038s



Source: BofA Global Research, Bloomberg

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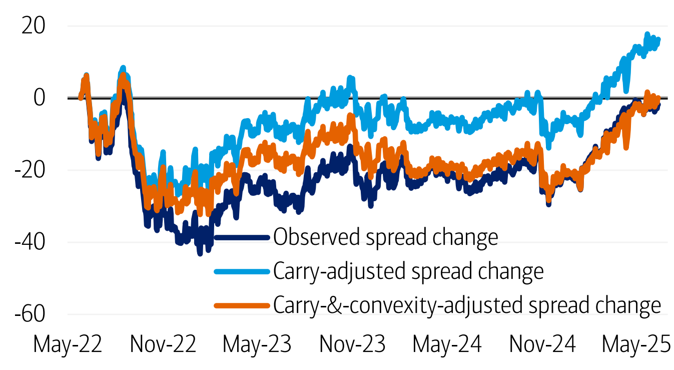
Exhibit 14: Cumulative spread change, with impact of carry & convexity
Carry favoured the steepener, but convexity cancelled carry benefit.



Source: BofA Global Research, Bloomberg

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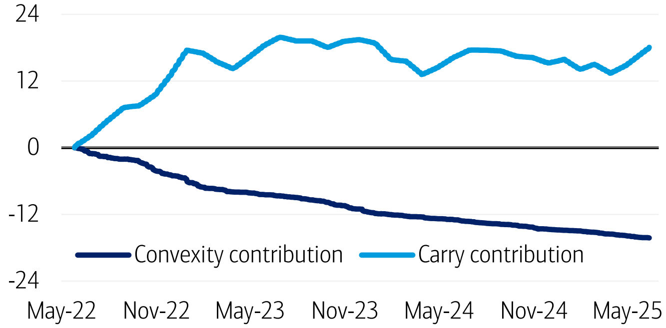
However, Exhibit 15 also shows that the carry advantage for the steepener was all about 2022, when inflation was very high. Carry has tracked sideways since, with the convexity benefit to flatteners catching up. In the subdued inflation environment we expect in the future, convexity should have the upper hand, accreting steadily in the background. It now looks underpriced to us, and in the above-linked Global Rates Weekly, **we recommended entering an OATei 2038/2053 flattener at 20bp, targeting 0bp with a stop-loss at 30bp** (currently 22bp). Risk to the trade is heavy supply of 2053s that is poorly received.

Exhibit 15: Hare & the tortoise: carry started fast, convexity caught up
Cumulative contributions from carry and convexity, bp



Source: BofA Global Research, Bloomberg

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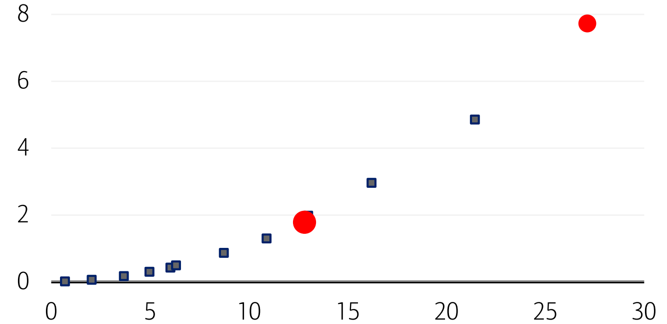
Exhibit 16: 2053's advantage – a much higher convexity/duration ratio
Convexity vs. modified duration, highlighting OATei 2038s and 2053s.



Source: BofA Global Research, Bloomberg

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From front to back

RPI 1s2s flattener – still a good mix of macro and RV

Our favourite front-end expression remains the one entered in late May, when we recommended a 1s2s RPI flattener. We entered the trade at +7bp, targeting -30bp with stop-loss at +25bp. The current spread is -9bp, relative the original base date (i.e., allowing for the fact that inflation swaps have rolled twice since then).

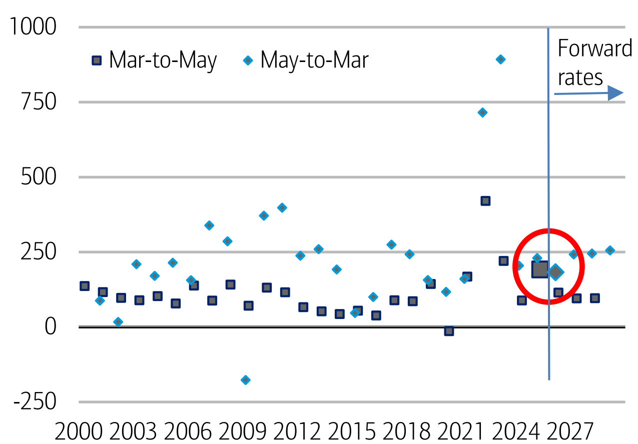
We saw the main risk to the trade being falling energy prices, so energy prices having actually risen a little (with wild gyrations) has been marginally supportive. See the report, ‘After the April print, the 1s2s RPI curve should be inverted. Enter flatteners’, UK Rates Alpha, 23 May 2025. We regard both the macro and the RV arguments for the trade as still very valid.

May print should reduce idiosyncratic risk for the trade

Entering the trade in May, the 1y and 2y legs of our trade referenced future March prints, with a March 2025 RPI base. The RV aspect of the trade, we contended, was that the April print had been so large, month on month, that the implied balance for the remaining 11 months looked unusually low, despite expecting that Easter-related firmness in airfares, etc, would be reversed.

The now-known May print should have dealt with the purely transitory elements, yet still we see the balancing change in RPI priced for the ten unknown months now remaining of the 1y rate as low, relative to what has gone before and what is priced for the future. The market prices a 1.8% (non-annualised) increase in the RPI from May 2025 to March 2026, which compares to a realised 2.3% for the prior May-March period and 2.4% priced for the subsequent one (May 2026 to March 2027); see Exhibit 17. Our contention is that if May 2025 to March 2026 does price at or below 1.8%, than the entire front end of the inflation curve would shift lower, helping rather than hindering our trade.

Exhibit 17: RPI change for the balance of original 1y rate looks too low
March RPI y/y rates split into March-to-May changes and April-to-March changes, bp; components making up our original 1y RPI swap rate circled red



Source: BofA Global Research

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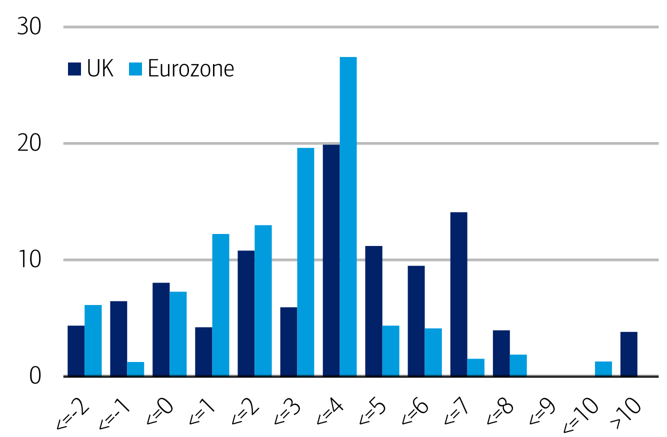
Exhibit 18: UK in the slow lane on the road to inflation target
Weighted core CPI component inflation rate dispersion in UK & Eurozone, %; Eurozone has only 13% of basket recording rates above 4%, UK has 40%



Source: BofA Global Research, LSEG Data & Analytics

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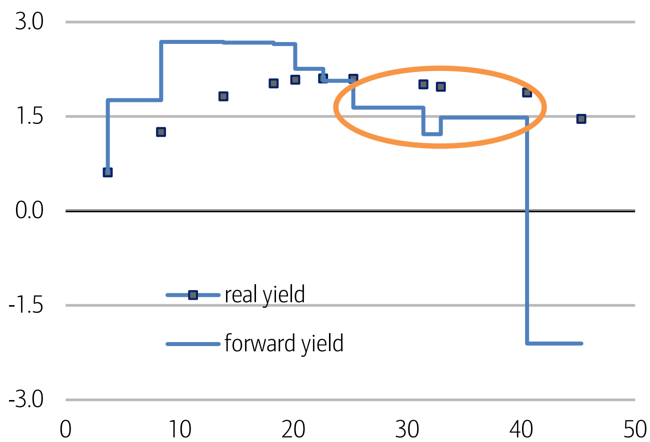
The macro case for our 1s2s RPI inversion view remains simple. Unlike the Eurozone, which is on a fast track to the inflation target, for the UK it will likely be a slow grind (Exhibit 18 provides one perspective). Barring sharp falls in energy prices, the Bank of England CPI forecasts and our own seem consistent with a flatter 1s2s RPI curve.

Ultras looking cheap again, especially UKTi 2068s

Exhibit 19: Path of forward yields suggests UKTi58s/68s too steep
Spot and forward UKTi real yields vs. modified duration (March maturities only). 2052s to '68s circled, %



Source: BofA Global Research, Bloomberg

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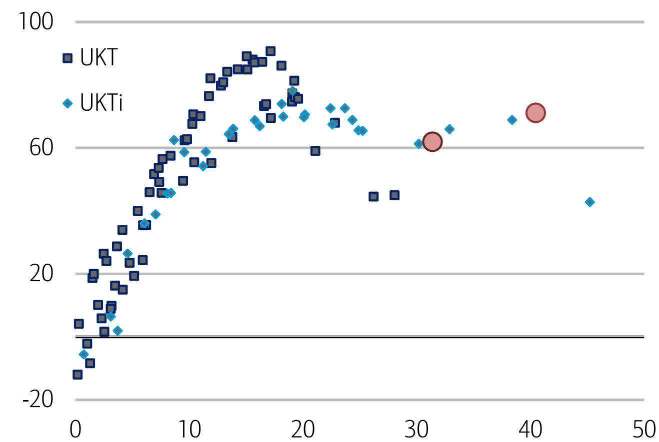
Exhibit 20: UKTi 2068s looking cheap on the z-spread curve
UKT and UKTi z-spread curves vs. modified duration, highlighting UKTi 2058 and UKTi 2068, bp



Source: BofA Global Research, Bloomberg

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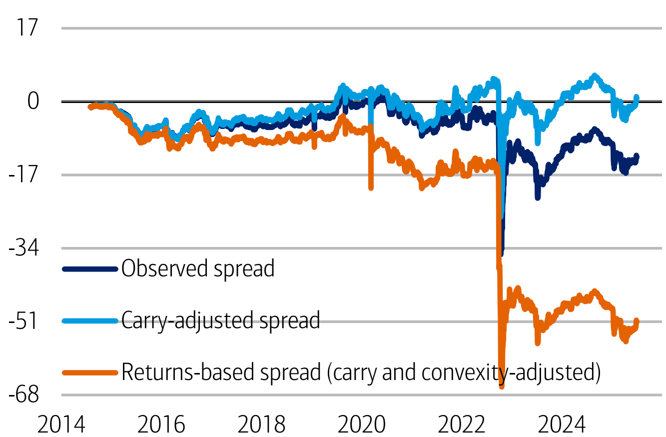
Exhibit 19, using March maturity issues, shows a forward path of real yields that is quite inverted immediately before the UKTi 2052s and very inverted beyond UKTi 2068s but almost horizontal in between. We argue that the UKTi 2058s/68s forward should show a bigger "step down" to be consistent with the rest of the curve. UKTi 2068s also looks cheap relative to UKTi 2058s on a z-spread basis, we argue (Exhibit 20).

It was inevitable that we would bring up convexity…

Exhibit 21: UKTi 2058/68 yield spread, with impact of carry & convexity
Carry favoured the steepener, but convexity cancelled carry benefit



Source: BofA Global Research, Bloomberg

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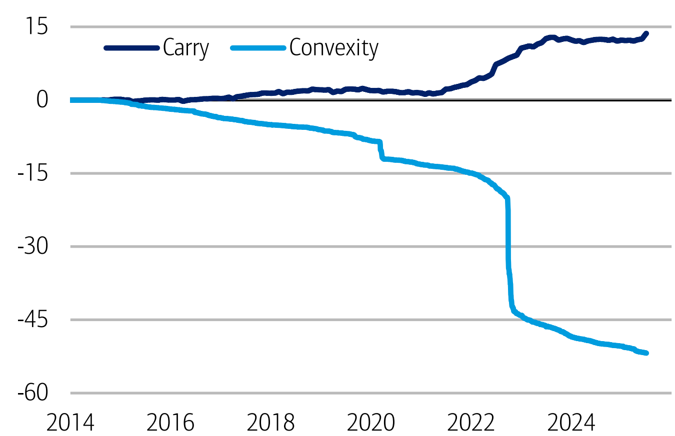
Exhibit 22: Convexity dwarves carry for a UKTi 2058/68 position
Cumulative contributions from carry and convexity to curve position, bp



Source: BofA Global Research, Bloomberg

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In the Euro IL section, we discuss the impact of carry and convexity on an OATei 2038/2053 position. These equivalent charts for the UKTi 2058/2068 yield spread use the same methodology, over a longer time span (because the bonds have both been around for longer). Being further out along the curve than our France example, carry becomes less important and convexity more important (Exhibit 22). The bout of high inflation did nevertheless deliver carry favouring the real curve steepener, while it lasted, but the extreme yield volatility through the 2022 Liability Driven Investment crisis provided a large convexity windfall for the real flattener, as the chart shows.

With a relatively stable inflation outlook, any carry implications for a UKTi 2058s/68s real flattener should be minimal, in our view, while convexity should tick away in the background, providing a steady favourable contribution, if the 11-year span shown in Exhibit 22 is a guide, without having to assume a return of higher yield volatility.

We recommend entering a UKTi 2058/2068 real yield flattener at -12.7bp, setting a target of -22bp and a stop-loss at -7bp. Risk to the trade is poorly received ultralong supply.

EM IL

Mikhail Liluashvili
MLI (UK)

EEMEA: front-end receivers are over

We do not have any strong convictions on the direction of EEMEA front-end rates from here. All of them look broadly fairly priced.

Poland: front end is fairly priced; no receiver trade for now

The market pricing of the front end in Poland is in line with our baseline forecast for the policy rate. We expect 25bps steps in a cutting cycle with on-hold decisions at some meetings. This, coupled with a National Bank of Poland (NBP) that often changes the bias, makes a receiver trade unattractive to us.

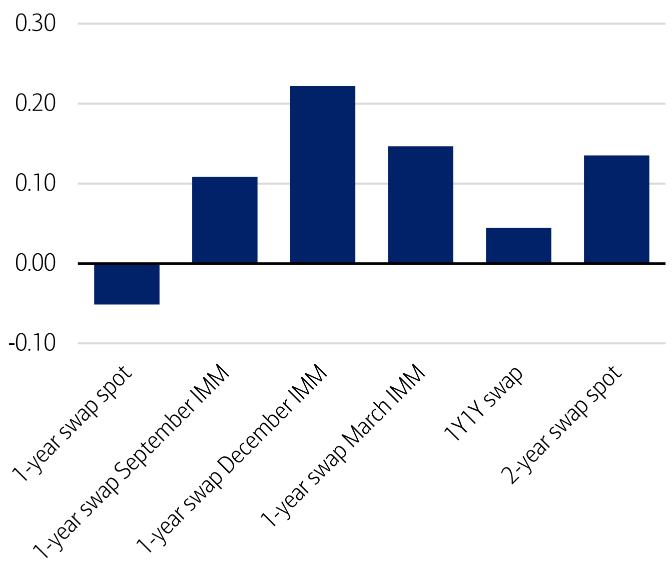
Czechia: rates can go lower, but volatility is likely to be high

The market pricing of the policy rate is a bit more hawkish than our baseline forecast. However, the Czechia National Bank (CNB) is hawkish, which sets a high bar for additional hikes, in our view. As a result, receiver trades are likely to be volatile.

Hungary: stay neutral front-end rates

Our policy rate forecast for Hungary's front end is slightly more hawkish than market pricing, but there is a risk that the National Bank of Hungary (NBH) delivers more cuts than we expect, especially if the environment for EM assets remains bullish. Paying rates in Hungary also offers unattractive risk/reward. The expected return is low, as the market is unlikely to price in a hiking cycle, while the downside is high if the NBH starts cutting sooner than priced in.

Exhibit 23: Our forecast is slightly more hawkish than market pricing
BofA Global Research expectation minus market pricing of front-end swaps (Hungary)



Source: Bloomberg, BofA Global Research
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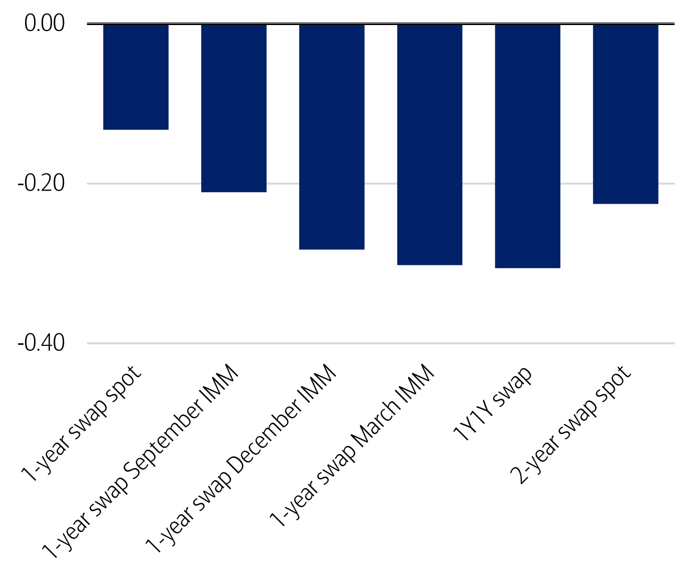
Exhibit 24: Our forecast is more dovish than market pricing
BofA Global Research expectation minus market pricing of front-end swaps (Israel)



Source: Bloomberg, BofA Global Research
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South Africa: no strong mispricing in front-end rates now

We do not see any room to pay or receive rates in South Africa. The market is slightly more dovish relative to our baseline forecast, which does not include lowering of the inflation target. It seems that the market is pricing the weighted average of two scenarios: 1) the inflation target stays at 4.5%; 2) the inflation target is gradually reduced, starting from Q3/Q4 this year.

Lower inflation target is partially in the price, according to breakeven

Currently core inflation is at circa 3%, and spreads between breakeven and core inflation are at 10y on average, which is a lower level than in 2021, when core inflation was also around 3%. We see small room for the spread to compress further when the lower inflation target is announced as expected inflation volatility falls.

Israel: terminal rate probably too low, but the rally has been strong recently

Our baseline forecast is more dovish than market pricing. The market prices the terminal rate at around 3.6%, while the neutral nominal rate is likely to be around 3.25-3%. However, it will take time for the market to go to 3% terminal rate pricing, in our view, given the recent very strong rally and risks to the ILS coming from weaker US equities.

US Economics

Stephen Juneau
BofAS

Another soft CPI print

The May CPI report was weaker than expected, as headline and core both printed at 0.1% m/m. On an unrounded basis, core CPI came in at 0.130% m/m vs. our below-consensus forecast of 0.24% m/m. Y/y headline CPI picked up to 2.4%, while y/y core CPI was unchanged at 2.8%. While the report reflects less inflationary pressure from tariffs than we were expecting, we continue to believe that the bulk of the impact is still in the pipeline.

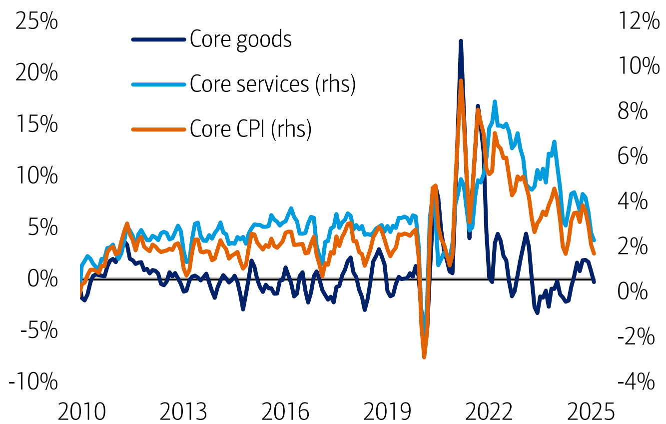
Deflation in core goods

Inflation was soft across the board in May. Core goods came in at -0.04% m/m. This reflected a 0.3% decline in auto prices, while core goods ex autos rose a mild 0.03%. There was a hint of tariffs in the data, as prices of a few line items with significant imports—household furnishings, medicinal drugs, IT commodities, and toys—accelerated in the month. But broadly, the tariff impact on goods prices was smaller than expected.

Core services were benign

Core services rose by 0.17% m/m and have averaged a 0.19% m/m increase in the last three months, following a noisy 0.51% print in January. Shelter came in particularly soft, with both rent and OER moderating substantially relative to the previous two months. We also saw continued declines in airfares and lodging away from home, which may be indicative of weakening demand for discretionary services.

Exhibit 25: CPI aggregates 3-month annualized % change
Core CPI has slowed sharply in the last three months



Source: BLS

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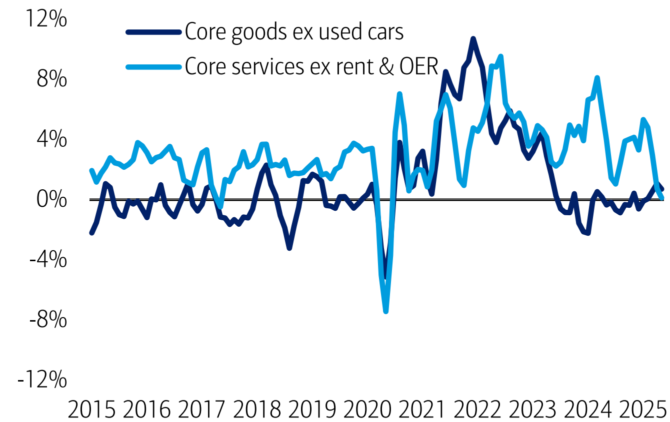
Exhibit 26: CPI aggregates 3-month annualized % change
Core services ex rent and OER has slowed sharply on weaker discretionary services; core goods ex used cars is back in inflation territory



Source: BLS

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US CPI Forecast table

Exhibit 27: US CPI monthly forecast table
Below are our monthly forecasts for US CPI

	Non-seasonally Adjusted						Seasonally Adjusted											
	Headline CPI			Energy			Headline CPI					Core CPI				
	Level	m/m	y/y	Level	m/m	y/y	Level	m/m	y/y	q/q saar	y/y (quarterly)	Level	m/m	y/y	q/q saar	y/y (quarterly)
2024: Jan	308.42	0.54	3.1	270.42	0.39	-4.6	309.79	0.34	3.1			314.39	0.37	3.9		
2024: Feb	310.33	0.62	3.2	276.33	2.19	-1.9	311.02	0.40	3.2			315.56	0.37	3.8		
2024: Mar	312.33	0.65	3.5	285.00	3.14	2.1	312.11	0.35	3.5	3.7	3.2	316.76	0.38	3.8	4.2	3.8
2024: Apr	313.55	0.39	3.4	290.76	2.02	2.6	313.02	0.29	3.4			317.60	0.26	3.6		
2024: May	314.07	0.17	3.3	290.14	-0.21	3.7	313.14	0.04	3.2			318.05	0.14	3.4		
2024: Jun	314.18	0.03	3.0	286.68	-1.19	1.0	313.13	0.00	3.0	2.8	3.2	318.34	0.09	3.3	3.1	3.4
2024: Jul	314.54	0.12	2.9	287.87	0.42	1.1	313.57	0.14	2.9			318.93	0.19	3.2		
2024: Aug	314.80	0.08	2.5	282.61	-1.83	-4.0	314.13	0.18	2.6			319.84	0.28	3.3		
2024: Sep	315.30	0.16	2.4	275.74	-2.43	-6.8	314.85	0.23	2.4	1.4	2.7	320.84	0.31	3.3	2.4	3.3
2024: Oct	315.66	0.12	2.6	272.81	-1.06	-4.9	315.56	0.23	2.6			321.69	0.27	3.3		
2024: Nov	315.49	-0.05	2.7	268.21	-1.68	-3.2	316.45	0.28	2.7			322.62	0.29	3.3		
2024: Dec	315.61	0.04	2.9	267.96	-0.09	-0.5	317.60	0.36	2.9	3.0	2.7	323.30	0.21	3.2	3.4	3.3
2025: Jan	317.67	0.65	3.0	273.05	1.90	1.0	319.09	0.47	3.0			324.74	0.45	3.3		
2025: Feb	319.08	0.44	2.8	275.87	1.03	-0.2	319.78	0.22	2.8			325.48	0.23	3.1		
2025: Mar	319.80	0.22	2.4	275.73	-0.05	-3.3	319.62	-0.05	2.4	3.8	2.7	325.66	0.06	2.8	3.5	3.1
2025: Apr	320.87	0.34	2.3	277.96	0.81	-4.4	320.31	0.22	2.3			326.48	0.25	2.8		
2025: May	321.95	0.34	2.5	279.67	0.62	-3.6	321.00	0.21	2.5			327.43	0.29	2.9		
2025: Jun	323.52	0.49	3.0	286.54	2.46	0.0	322.39	0.43	3.0	2.2	2.6	328.46	0.32	3.2	2.7	3.0
2025: Jul	324.17	0.20	3.1	283.49	-1.07	-1.5	322.99	0.19	3.0			329.67	0.37	3.4		
2025: Aug	325.16	0.30	3.3	281.98	-0.53	-0.2	324.25	0.39	3.2			331.06	0.42	3.5		
2025: Sep	325.50	0.10	3.2	275.22	-2.40	-0.2	325.04	0.25	3.2	3.6	3.2	332.28	0.37	3.6	4.4	3.5
2025: Oct	325.89	0.12	3.2	269.89	-1.94	-1.1	325.82	0.24	3.2			333.51	0.37	3.7		
2025: Nov	325.38	-0.16	3.1	265.12	-1.77	-1.2	326.42	0.19	3.2			334.18	0.20	3.6		
2025: Dec	325.28	-0.03	3.1	263.17	-0.74	-1.8	327.42	0.31	3.1	3.1	3.2	334.86	0.20	3.6	3.9	3.6
2026: Jan	326.55	0.39	2.8	265.13	0.74	-2.9	328.01	0.18	2.8			335.50	0.19	3.3		
2026: Feb	327.65	0.34	2.7	264.92	-0.08	-4.0	328.38	0.11	2.7			336.14	0.19	3.3		
2026: Mar	329.33	0.51	3.0	272.86	3.00	-1.0	329.10	0.22	3.0	2.4	2.8	336.81	0.20	3.4	2.4	3.3
2026: Apr	330.43	0.33	3.0	277.45	1.68	-0.2	329.84	0.22	3.0			337.52	0.21	3.4		
2026: May	331.20	0.23	2.9	278.37	0.33	-0.5	330.22	0.12	2.9			338.23	0.21	3.3		
2026: Jun	332.51	0.39	2.8	285.46	2.55	-0.4	331.34	0.34	2.8	2.4	2.9	338.98	0.22	3.2	2.5	3.3
2026: Jul	332.72	0.06	2.6	282.56	-1.02	-0.3	331.54	0.06	2.6			339.73	0.22	3.1		
2026: Aug	333.16	0.13	2.5	281.28	-0.45	-0.2	332.26	0.22	2.5			340.48	0.22	2.8		
2026: Sep	333.18	0.01	2.4	275.00	-2.23	-0.1	332.68	0.13	2.4	2.1	2.5	341.23	0.22	2.7	2.7	2.9
2026: Oct	333.19	0.00	2.2	269.79	-1.89	0.0	333.09	0.12	2.2			342.03	0.24	2.6		
2026: Nov	332.71	-0.14	2.3	265.12	-1.73	0.0	333.76	0.20	2.2			342.84	0.24	2.6		
2026: Dec	332.68	-0.01	2.3	263.38	-0.66	0.1	334.84	0.32	2.3	2.1	2.3	343.64	0.24	2.6	2.8	2.6

Source: Bureau of Labor Statistics, BofA Global Research

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Euro Area Economics

Ruben Segura-Cayuela
BofA Europe (Madrid)

Alessandro Infelise Zhou
BofASE (France)

Mid-year review – persistent undershoot

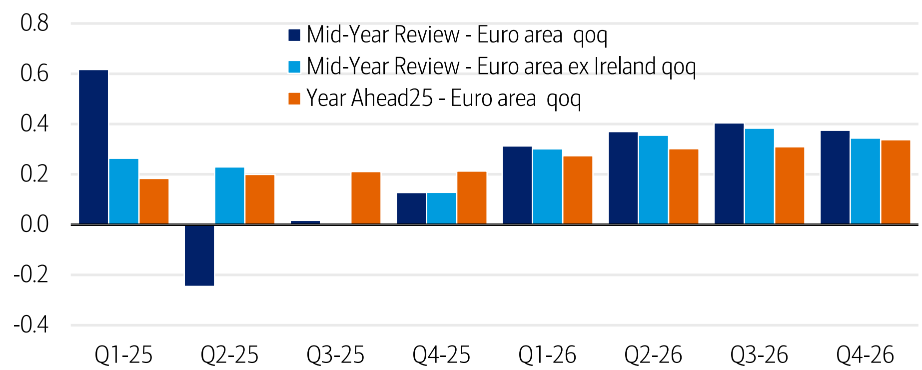
- We forecast headline inflation of 1.8% (+10bp), 1.5% (+10bp) and 1.8% in 2025, 2026 and 2027 (including the effect of ETS2).
- We expect a small core inflation undershoot, starting in the last part of this year, with yearly averages of 2.1%, 1.8% and 1.8% in 2025, 2026 and 2027, respectively.
- Further downside risks are German VAT, German electricity and China/Asia goods disinflation.

Growth: a tale of two halves

Our growth forecasts are 0.9% in 2025 and 2026 (10bp lower for 2026). We now expect growth at 1.4% in 2027. Our Euro area growth profiles foresee pretty much no growth in 2H25 (Exhibit 28), while it should accelerate towards 1.5% annualised in late 2026 and through 2027. This is large by European standards, but not immediate. In the near term, tariffs and uncertainty should be significant drags.

Details matter. Since our year ahead report, the tariff shock has been larger than we expected. But the persistent uncertainty shock we included was not far from expectations. The biggest surprise was the announcement of the German fiscal package, a proper paradigm shift (see the report, Euro Area Watch: Germany: game changer). We still assume that the 90-day "pause" on reciprocal tariffs will become permanent, making a hike to US import tariffs on EU products to 20% a risk scenario. But we think that a tariff level around 10% is a reasonable base case from here.

Exhibit 28: Lower Euro area growth in the short term, stronger recovery should follow in 2H26
Euro area GDP growth profiles – Mid-Year Review vs Year Ahead 2025



Source: BofA Global Research, Eurostat

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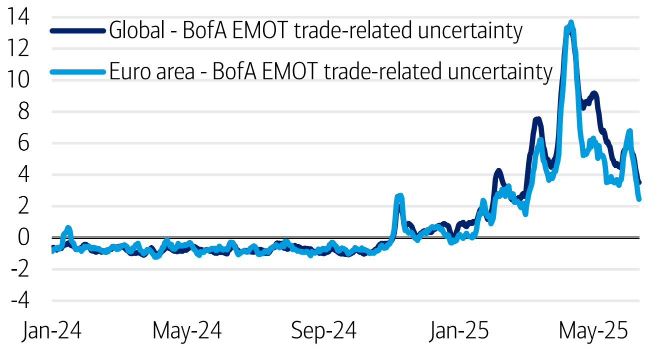
Timing and lags also matter. Trade developments should hit growth for the next few quarters. The German fiscal push will take time to be fully visible in growth. And a swift increase in defence spending is likely to come with high import content initially. Infrastructure spending will probably take until 2H26 to translate into growth, although we now factor in some impact in late 2025 given recent headlines on the budget for this year.

Finally, we still assume that defence expenditure in the medium term will move to a range of 3-3.5% of GDP in a structural way for the region, with some form of mutualisation (one-third mutualised somehow, one-third through cuts elsewhere, one-third via more debt). But near term, as we have argued, there are plenty of pools of money that have not been used, hence our assumption of little new money.

Exhibit 29: Trade-related policy uncertainty still well above normal
BofA EMOT trade-related policy uncertainty tracker (7-day moving average)



Source: BofA Global Research, GDELT Project (www.gdeltproject.com). The tracker identified as an EMOT above is intended to be an indicative metric only and may not be used for reference purposes or as a measure of performance for any financial instrument or contract, or otherwise relied upon by third parties for any other purpose, without the prior written consent of BofA Global Research. This tracker was not created to act as a benchmark. Note: data as of 13 June. Normalized over the sample up to 31-Dec-24. For methodology of the tracker, see the report, European Viewpoint: The new BofA European Mood Tracker, 17 September 2021.

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Our conviction on the exact timeline for deteriorating growth is still low. We have seen the impact of inventory buildup in the US in 1Q data, particularly in Ireland. Tariff news since makes it uncertain how quickly that build-up will unwind. Our forecasts excluding Ireland (Exhibit 28) probably better depict what we expect from here in terms of underlying growth momentum.

A persistent inflation undershoot

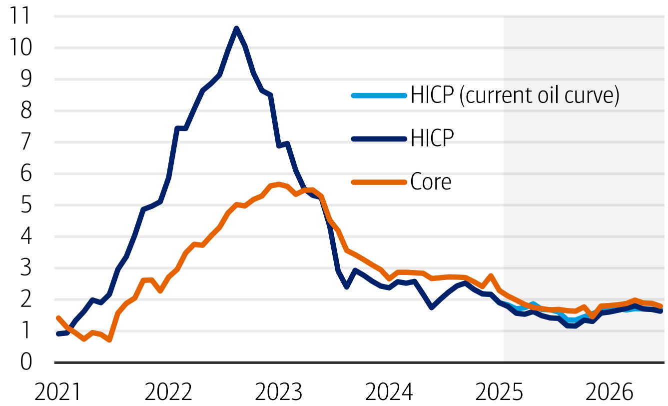
Our inflation forecasts have changed marginally. We now expect slightly stronger headline and core in 2025 and 2026. We forecast headline inflation of 1.8% (+10bp), 1.5% (+10bp) and 1.8% in 2025, 2026 and 2027, respectively. We still expect a small core inflation undershoot throughout, starting in the last part of this year, with yearly averages of 2.1%, 1.8% and 1.8% in 2025, 2026 and 2027. We, like the ECB, include the ETS2 (Emissions Trading System) in 2027, so excluding that effect, the undershoot is more persistent.

We do not need much improvement in core momentum to get to that undershoot. In fact, momentum has been pretty decent already for quite a few months (Exhibit 31).

What has changed? We have argued that a bilateral trade war between the US and the rest of the world, particularly if uncertainty was persistent, would constitute a demand shock for the global economy excluding the US. That was part of our base case in our year ahead, and it is now playing out.

At this stage, we are not taking on board (1) the German VAT cut in early 2026 on select restaurant prices, which could reduce German and Euro area services inflation by 15bp and 5bp, respectively, or (2) the German electricity price cut of EUR 5 cents for corporates and households, which could lower German and Euro area inflation by 30bp and 10bp, respectively. And we do not make any strong assumption on global goods disinflation from potentially higher China (or pan-Asian) goods flows into the EU.

Exhibit 30: Still on the way to a (headline and core) undershoot
Euro area headline and core inflation forecasts (% yoy)



Source: Eurostat, BofA Global Research

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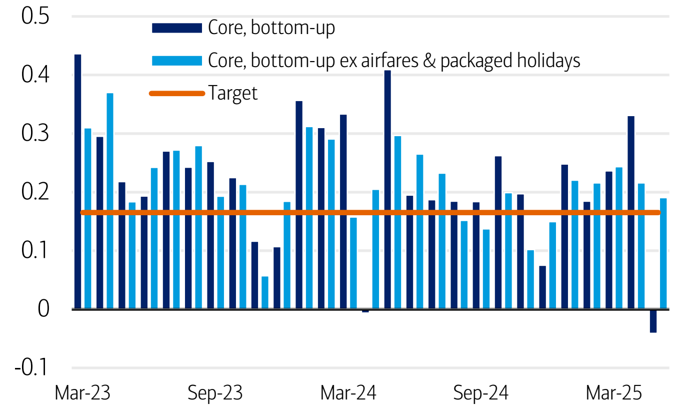
Exhibit 31: Even ex volatile categories, m/m core was close to target
Euro area, m/m% core ex airfares/packaged holidays, SA



Source: BofA Global Research, Eurostat

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ECB: reluctantly cutting

Looking at the Euro area, we see an economy with a negative output gap that is unlikely to close in the near term, with plenty of uncertainty about whether it will happen in the next two years and inflation already below target and likely to stay there for some time. But nothing is so "easy" when it comes to the Euro area and the ECB. We have worked on the assumption that data would need to push the ECB to go lower from here. Given our growth and inflation outlook, we still have strong conviction in at least two more cuts in this cycle. And we can think of many more scenarios in which we might see more than two cuts than we can scenarios with less than two.

Risks: where to start?

US tariffs are still a key asymmetric risk. It is hard to see much smaller tariffs than the region faces today, while it is easy to imagine much worse scenarios.

Geopolitics and energy prices are also key to watch from here, with different angles. First, the region is facing pressure to step up its individual defence effort, perhaps even in the very short term. There is limited fiscal space in national budgets. There is also little appetite for further common borrowing. Faced with a new reality, that could serve as an incentive to do more and better. We think we will get there but not immediately. If we are wrong, and there is more political capital for a joint EU response to the challenges the region faces before the outlook deteriorates, that could be a significant upside surprise.

On the other hand, recent developments increase the risk of a persistent and large oil price shock. We would expect a more “normal-sized” shock than that at the beginning of the war in Ukraine. This would come with less growth and a short-lived bout of inflation. The ECB, facing a more traditional supply-side shock, would probably eventually be inclined to look through it and accommodate the damage to growth. This could delay the cuts we have in our forecasts, particularly if the persistent inflation undershoot takes longer to materialize (Exhibit 30). But we doubt the end point would be different, certainly not higher and, if the shock is large enough, probably lower.

UK Economics

Sonali Punhani
MLI (UK)

Progress in underlying inflation continues

- UK inflation was slightly stronger than expected at 3.4% in May, but services fell more than expected to 4.7%. Progress in underlying services continues and supports the view that April strength was noisy. Core goods and food rose.

- We expect 2025, 2026 and 2027 inflation at 3.1%, 2.2% and 2.0% and core at 3.4%, 2.3% and 1.9%, respectively. We think that underlying risks are lower post tariffs and taxes. We expect the next cut in August and a dovish pivot in H2.

Slightly stronger than expected May inflation

UK inflation was slightly stronger than expected in May, falling from 3.5% (-0.02%m/m SA) to 3.4%, above consensus of 3.3% but in line with the bank of England's (BoE) forecast. Having said that, we note that the unrounded number was 3.36, so not a strong upside surprise. Core fell from 3.8% to 3.5% (-0.01% m/m SA), in line with consensus. More importantly, services fell from 5.4% to 4.7% (-0.19% m/m SA), below consensus of 4.8% and in line with BoE's forecast.

Underlying services fell

Within services we saw a drop in housing services (rent inflation continued to fall from 6.3% to 6.1%), non-catering recreation and communication. Catering services were flat. But the biggest decline was seen in airfares, other transport services and services for personal transport equipment. Airfares inflation fell from 16.2% to -3.9%, driven by a 5% monthly fall between April and May due to the timing of Easter. Transport services ex airfares fell from 8.2% to 4.8%. Services for personal transport equipment (which contains the Vehicle Excise Duty) fell given that the ONS used the corrected figure for VED (which is ~9% lower than the April figure) and lowered services inflation by ~20bps. There was a slight rise in packaged holidays and accommodation. Overall, progress in underlying inflation continues – services ex airlines, packaged holidays and education fell from 5.1% to 4.6%, while BoE's preferred measure of services inflation excluding volatile and indexed components, rents and foreign holidays fell from 4.2% to 4.0%, which should be encouraging for the BoE.

Energy fell, while food and core goods rose

Core goods rose from 1.1% to 1.6%, driven by household goods and small rises in vehicles and other recreations goods. But a large part of the rise in household goods was due to base effects driven by weak May 2024. Food inflation rose as well from 3.4% to 4.4%, perhaps reflecting some impact of rise in employment costs (National Insurance Contributions-NICs/National Living Wage-NLW). Energy fell from -0.9% to -1.7% due to the fall in weekly petrol prices. Our measure of m/m core dropped clearly below target, with flat services prices.

Progress in underlying inflation to continue

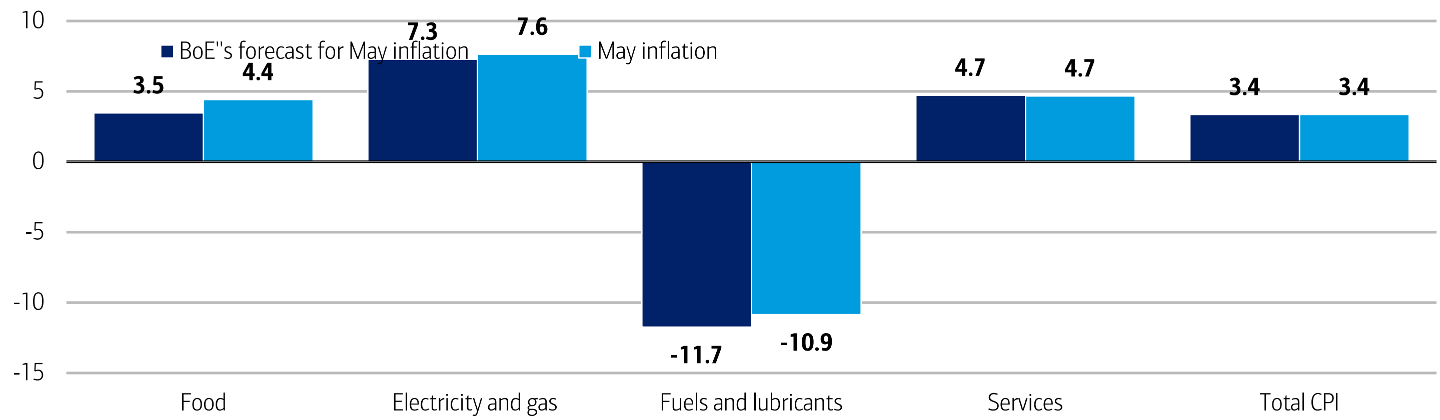
Our 2025 inflation forecast moves up from 3.0% to 3.1% on the back of stronger May food and core goods inflation. We expect 2025, 2026 and 2027 inflation at 3.1%, 2.2% and 2.0% and core at 3.4%, 2.3% and 1.9%. Inflation is likely to be elevated in coming months (with the quarterly peak at 3.4% in Q2/Q3), but we do not expect strong second-round effects. We think that underlying inflation risks are likely lower post tariffs and taxes. We see scope for inflation to be lower than the BoE's estimates on the back of continued progress in domestic inflation/pay growth, further loosening of the labour market, weaker growth, easing inflation expectations and the potential disinflationary impact from tariffs. Inflation and wage expectations continue to grind lower, and BoE Agents 2025 pay settlements are expected at 3.7%, lower than current levels. We expect services inflation at 4.4% and pay growth at ~3.5% at year-end.

We continue to expect next cut in August

Overall, while headline is slightly stronger than expected due to higher food and core goods, the faster-than-expected fall in services should be encouraging for the BoE. We expect the progress to continue, with inflation falling from 3.4% to 3.3% in June and services inflation falling from 4.7% to 4.5%. It adds to the conviction that the rise in April was erratic and that progress in domestic inflation is continuing. We expect cuts in August, September and November to 3.5%, with a dovish pivot in H2 driven by progress in domestic inflation, easing pay settlements and inflation expectations, looser labour market and growth weakness. Though we acknowledge that elevated domestic inflation puts our call for September cut at risk, we think that the bar to cut less than quarterly is high. Recent geopolitical developments also increase the risks of a large and persistent oil price shock, which could cause some delays to cuts. The risks are diminishing, and for now, the moves are relatively muted for it to affect the BoE's reaction function.

Exhibit 32: Headline and services Inflation in line with BoE's forecast, while food is stronger

May inflation vs. BoE's forecast (%y/y)



Source: ONS, BofA Global Research

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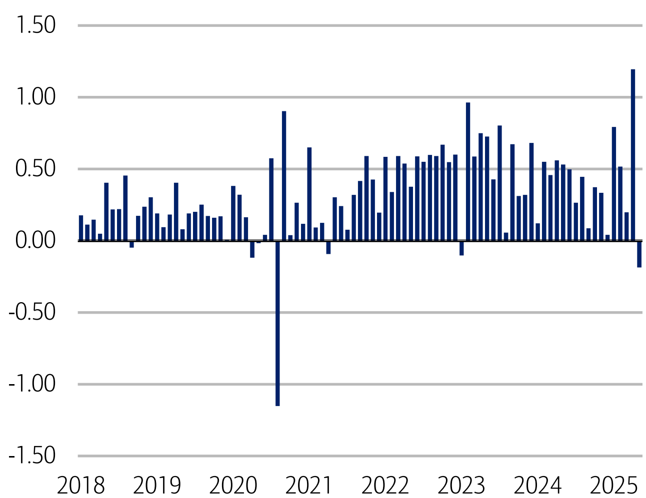
Exhibit 33: Services inflation falls

Services inflation (%m/m SA)



Source: ONS, BofA Global Research

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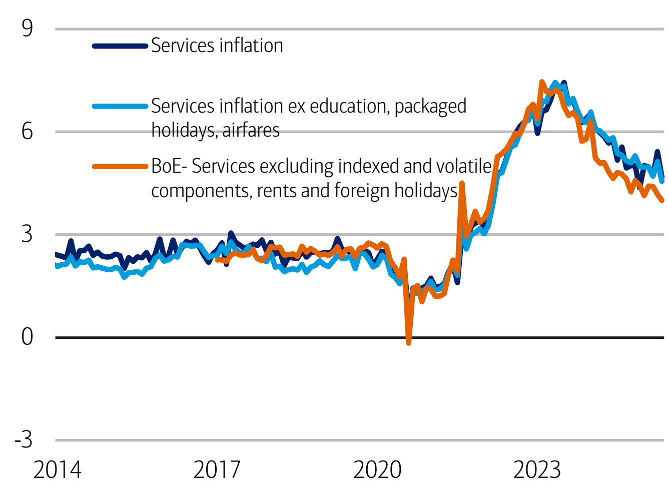
Exhibit 34: Progress in underlying inflation continues – BoE's measure of services inflation falls from 4.2% to 4.0%

Services inflation (% y/y)



Source: ONS, BofA Global Research

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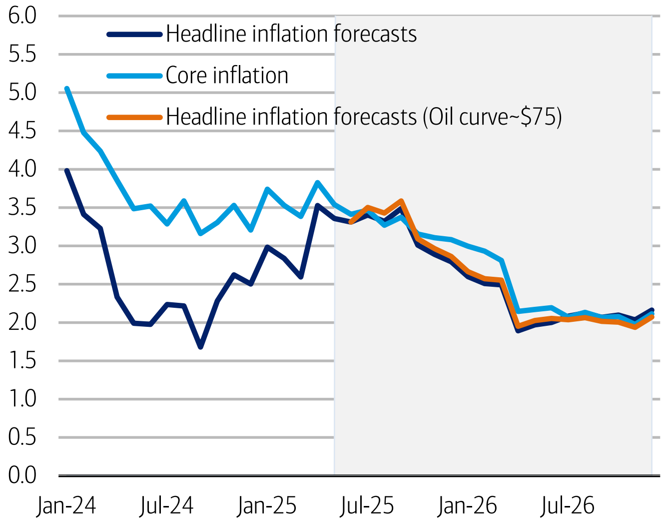
Exhibit 35: Progress in underlying inflation to continue
Headline and core inflation forecasts (%y/y) in grey shaded area



Source: ONS, BofA Global Research

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Exhibit 36: Progress in underlying inflation to continue
BofA Global Research CPI and RPI forecasts (%y/y)

	Headline CPI	Core	Core goods	Services	Food	Energy	RPI	RPI index
			y/y%					Index
Apr-25	3.53	3.83	1.08	5.42	3.43	-0.94	4.47	402.20
May-25	3.36	3.54	1.57	4.68	4.42	-1.68	4.27	402.90
Jun-25	3.31	3.41	1.58	4.47	4.16	-0.78	4.03	402.91
Jul-25	3.40	3.47	1.52	4.58	3.93	0.22	4.17	403.67
Aug-25	3.32	3.27	1.33	4.38	3.96	1.10	4.01	405.53
Sep-25	3.49	3.37	1.27	4.58	3.64	2.88	4.17	404.80
Oct-25	3.01	3.15	0.95	4.42	3.48	-1.40	3.60	404.78
Nov-25	2.89	3.11	0.97	4.34	3.35	-2.03	3.41	404.22
Dec-25	2.79	3.08	0.74	4.43	3.23	-3.02	3.56	406.06
Jan-26	2.60	3.00	0.68	4.33	2.55	-3.97	3.24	404.39
Feb-26	2.51	2.93	0.94	4.07	2.72	-4.39	3.07	406.11
Mar-26	2.49	2.81	0.90	3.90	2.73	-3.28	3.00	407.16
Apr-26	1.89	2.15	0.65	3.00	2.25	-3.88	2.23	411.17
May-26	1.97	2.17	0.44	3.16	2.12	-2.79	2.48	412.90
Jun-26	2.00	2.19	0.62	3.09	2.13	-2.58	2.55	413.16
Jul-26	2.08	2.07	0.37	3.05	2.07	0.47	2.86	415.20
Aug-26	2.12	2.13	0.45	3.10	1.98	0.43	2.90	417.30
Sep-26	2.07	2.07	0.57	2.92	1.89	0.54	2.86	416.38
Oct-26	2.10	2.08	0.61	2.92	2.05	0.62	2.85	416.32
Nov-26	2.03	1.98	0.42	2.87	2.12	0.67	2.85	415.74
Dec-26	2.16	2.11	0.58	2.99	2.32	0.71	2.99	418.18

Source: ONS, BofA Global Research

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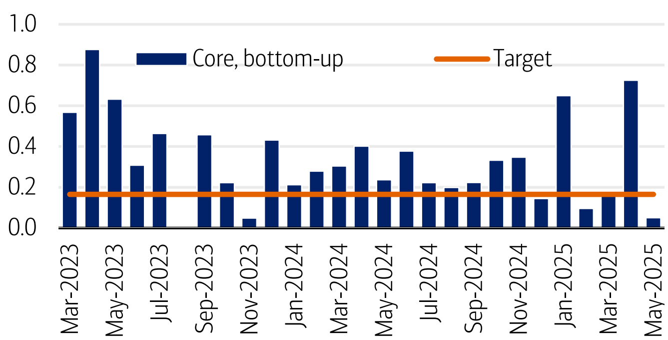
Exhibit 37: UK, core inflation m/m%, bottom-up SA
M/m core inflation back below target in May



Source: ONS, BofA Global Research

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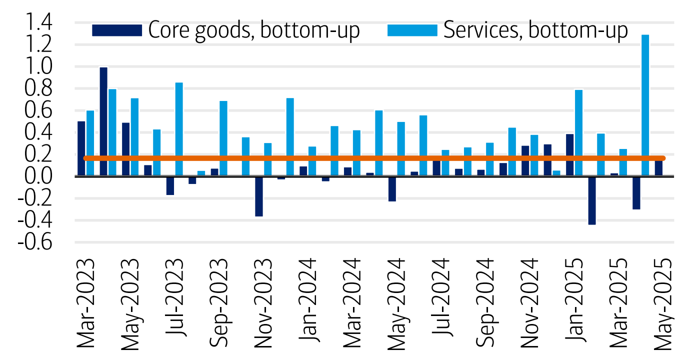
Exhibit 38: UK, core goods/services m/m%, bottom-up SA
Services were more or less flat in m/m SA terms in May



Source: ONS, BofA Global Research

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