Concessions yes… but the fallout is coming

15 April 2025

Key points:

- The 2025 economic outlook has taken a dramatic turn for the worse since 'Liberation Day'. The pause announced by President Trump last week is welcome news, and these offsetting forces combined with further concessions over the weekend likely means the US market remains in a broad trading range for a while. On the positive side, the pause on reciprocal tariffs show that the administration is willing to change course which seemed unlikely a few days ago, but the Fed is on hold and policy uncertainty remains extreme as a trade war between the two largest global economies could still be a disaster – particularly as it is hard to see where the off ramps are for either the US or China.

- For a second consecutive bear market, US government bonds have proved to be a less reliable diversifier of equity risk. In 2022, US equities declined -25% peak to trough and US fixed income recorded its largest capital losses in 150 years within that period. In 2025, US bonds have traded sideways and delivered anaemic diversification benefits, and history has demonstrated conclusively that decades with above-average inflation have the worst average real bond market return. As such, investors might need to re-examine their diversification strategy and any over-reliance on government bonds (and illiquid assets). Strategies that offer positive convexity during turbulent times (like bought equity put options) should also be considered when attractive risk reward opportunities present in markets.

Details:

In some ways, markets are more powerful than the US President

No one knows what the long-term consequences of President Trump's trade war will be, but we are getting a better handle of what the best- and worst-case scenarios might look like. The latter for the US economy and global financial markets would be the implementation of Trump's Liberation Day tariffs – the US imports USD3.4 trillion of goods and services, and the tariffs announced on April 2nd would represent a circa-$900 billion tax increase or ~3% of GDP. However, today's hyper-financialised world saw the global bond market force the US President's hand to issue a 90-day moratorium for countries to offer the US new trade deals (which normally take about two to three years to negotiate, if they are successful). Tariff rates during the moratorium are close to the best-case, but there are grave doubts about what can be arranged in the next 3 months, and whether Europe and China will agree to anything of note. On the positive side, the pause on reciprocal tariffs demonstrate that the administration is willing to change course which seemed unlikely just a few days ago, but policy uncertainty remains extreme.

Growth shocks

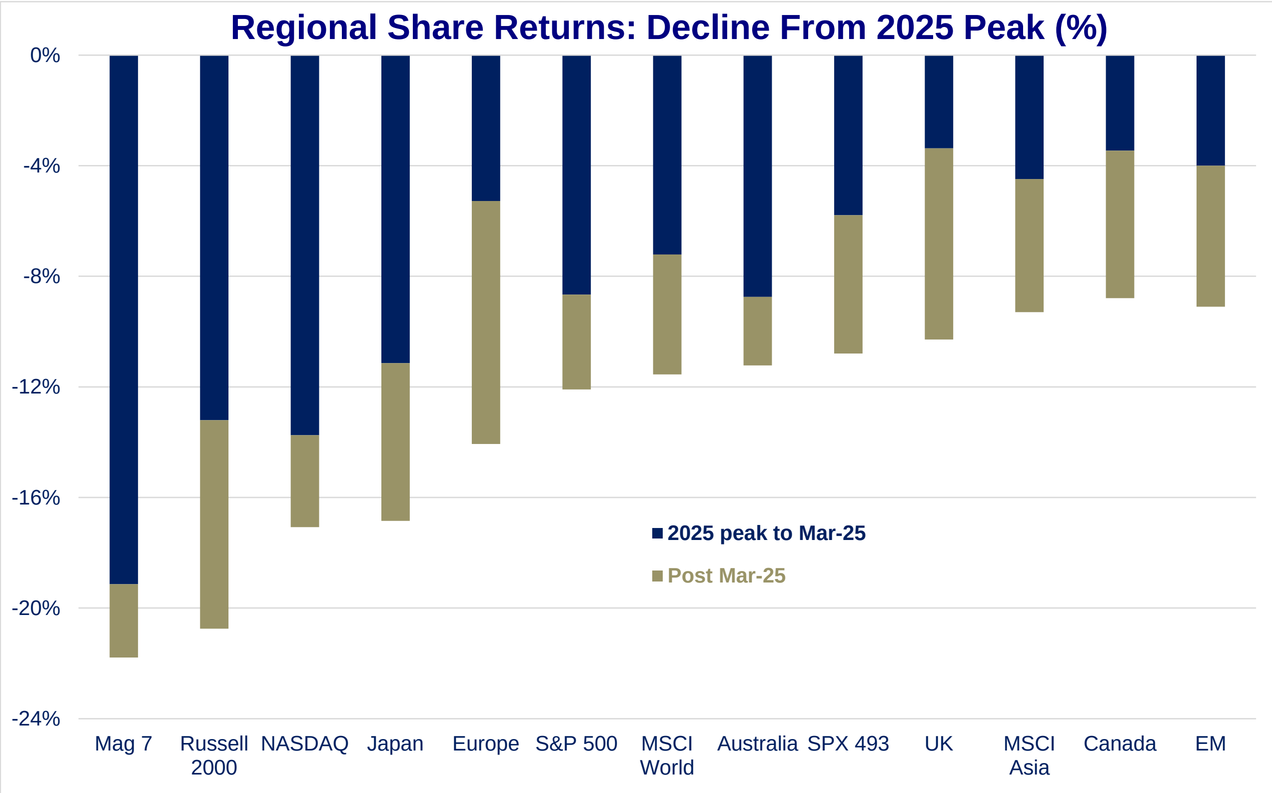
Following the pause, the temporary tariffs (125% for China and 10% for the World ex-China) are less onerous (implying an average tariff rate around 15% raising about $500 billion, but this excludes tariffs on pharmaceuticals and semi-conductors, which are coming). Nonetheless, there remains enormous uncertainty about where tariffs and the global economy will ultimately land. If tariffs hold at the moratorium level after 90 days, they would still be very close to the levels seen under the Smoot Hawley Tariff Protection Act of Jun-1930, which exacerbated the banking crisis and recession which led to the Great Depression. Moreover, its impact in the current cycle would be much larger, as imports' share of US GDP has risen 4 times to 11%.

The situation remains very fluid, so having any confidence in the outlook is more a case of being "courageous" than insightful. That said, US recession risks have risen to about even-money even if the best case holds, as the two countries involved in the world's largest bilateral trade relationship still would face a sudden and exorbitant tax increase, a deadweight production loss, a major decline in capex and higher unemployment, with downside risks amplified by the large-scale decline in private sector sentiment. This would have clear implications for equity and credit markets.

Bear markets in the US, and corrections everywhere else

On the 7th April, the US sharemarket entered (intraday) bear market territory for the first time in 2½ years, underpinned by the fears that Liberation Day tariffs would represent the largest US tax increase since 1942 and plunge the US economy into recession. The selldown this year has had two stages – initially the equity market drawdown began in mid-February reflecting a combination of weak US economic data and DeepSeek demonstrating that high-performance AI models could be developed independent of Nvidia's complex and expensive hardware. This sparked an orderly fall in tech sector valuations to end-Mar-25, with only one trading session (of 31) recording a decline of greater than -2%.

Chart 1: Regional sharemarket declines until April were tech-led

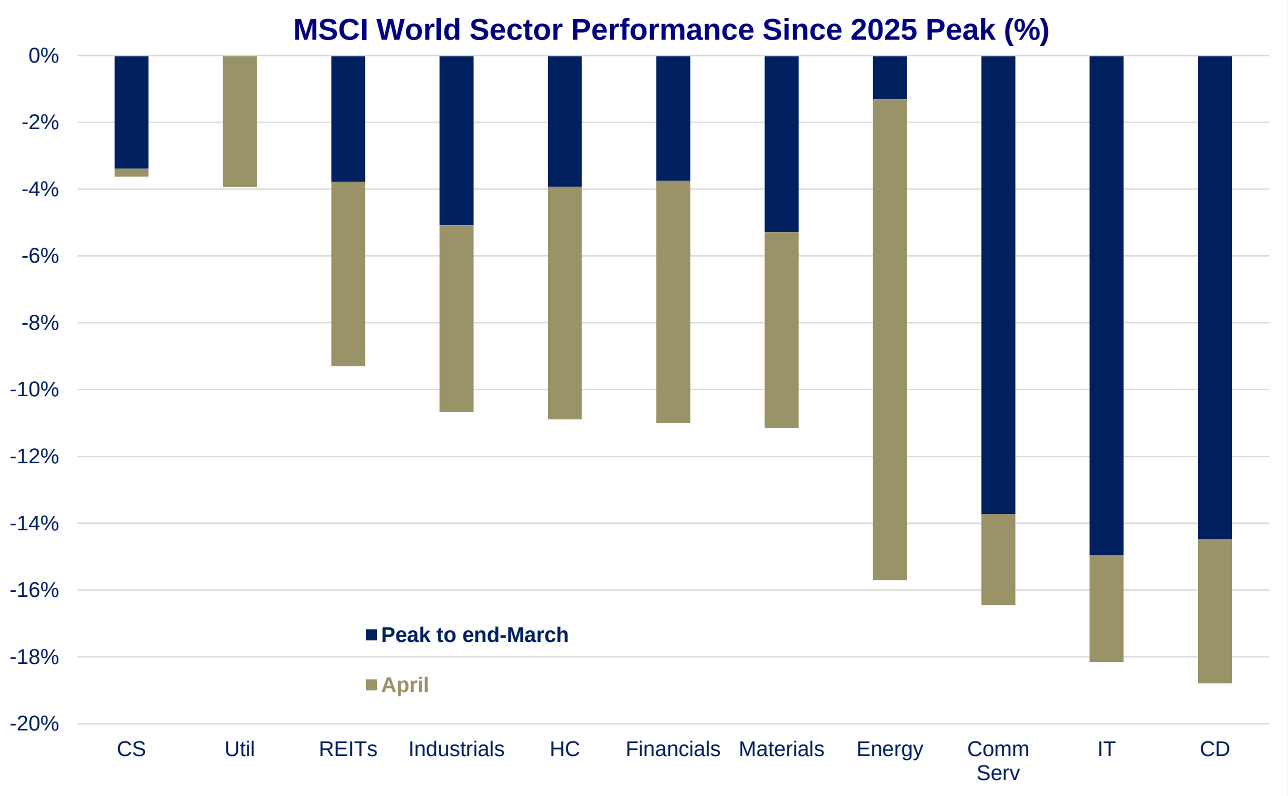


Source: Bloomberg as at 13th April 2025.

... but then it spread to other sectors, regions and assets, given sharply rising recession risks

The US share price decline until end-March had a similar dynamic to the tech-bust in 2001-03 with the Magnificent 7 off -19.1% (and Nasdaq down -14%), but the remainder of the index (the SPX493) was down a more modest -6%. Other regional equity markets initially shook off the US selldown, but the 'Liberation Day' tariff announcement engulfed all markets (Chart 1) and the more cyclical parts of the US and global sharemarket such as energy, financials, materials and industrials (Chart 2). Credit has also been impacted as weaker growth and higher inflation trump stable leverage and below-average M&A activity, with high-yield spreads materially widening. In our judgement this widening is not yet enough to compensate investors for the heightened recession risk ahead. However, there will be little US hard data out until early June to potentially demonstrate how the US tax hike has impacted the private sector – until then, we can only rely on surveys which have been poor predicters of growth post the pandemic. Irrespective of which tariff regime is implemented after the 3-month moratorium expires, a US recession starting in the next year is now a coin toss at best, especially as US long-end rates have risen 50 bpts in the last week.

Chart 2: Global investors have quickly become concerned about the profits outlook



Source: Bloomberg as at 13th April 2025.

What is President Trump's aim?

President Trump is attempting to change the global order of China using cheap labour to produce goods which are exported to US consumers who collectively pay for the goods through debt which is funded by China through the purchase of US-denominated bonds. This is a monumental change and would represent a far more radical change than the turmoil which engulfed markets when President Nixon took the US Dollar off the Gold standard in 1971 and implemented a 10% tariff in an attempt to address the ballooning US trade deficit (which primarily reflected the huge cost of the Vietnam War). Accordingly, Trump is undertaking a major economic re-alignment the likes of which has not been attempted in over 50 years. Against this backdrop, the significant rise in US sharemarket volatility is not surprising.

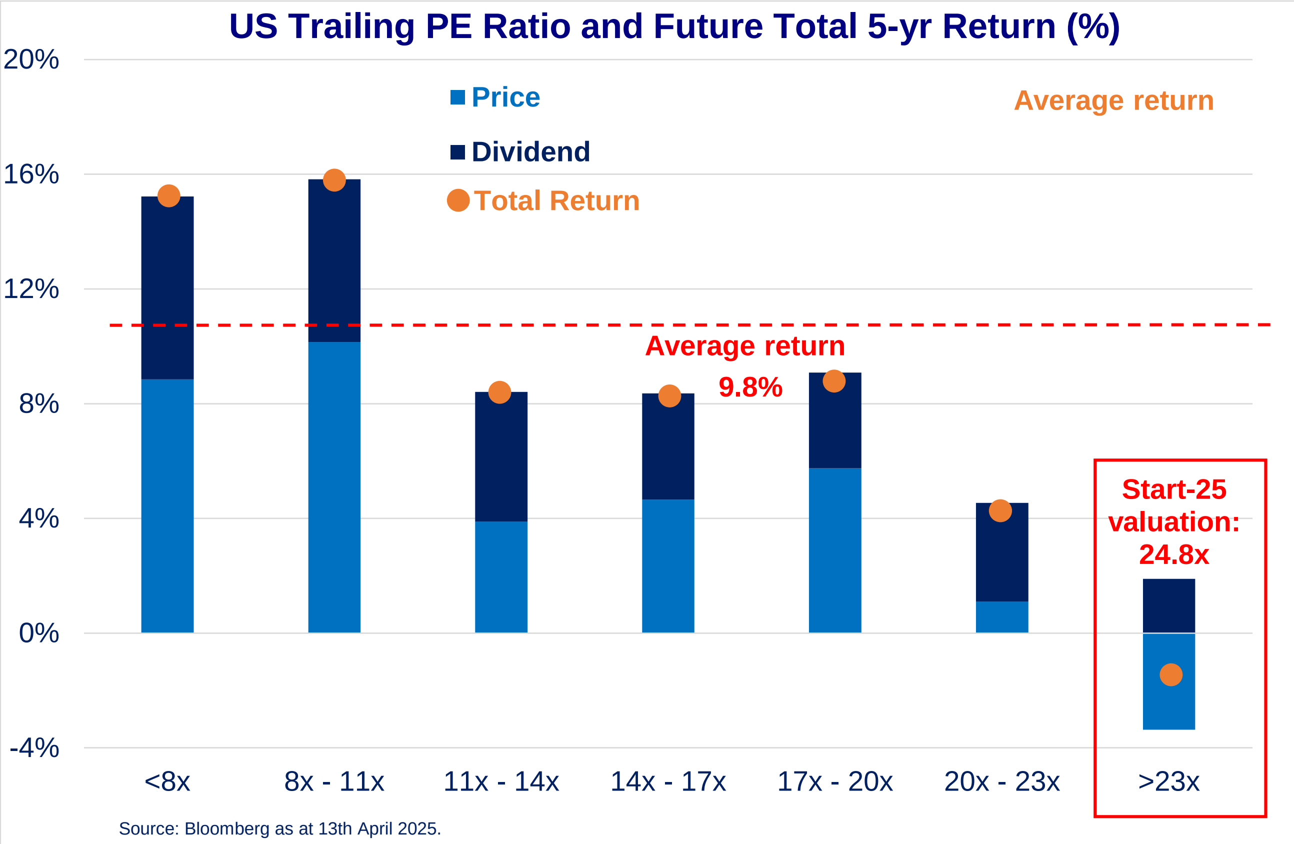
It's hard to see global growth much above +2% this year and the risk of a global recession has risen markedly

Markets rallied hard on the 90-day moratorium which delayed some of the tariff impact, but bear markets always have short rallies normally underpinned by short-covering, and this time it lasted only one day. There is no doubt that Trump could get deals with many minor economies such as Israel and Vietnam. But these won't move the needle in relation to the global order, nor provide any cushion to the US economy, as the trading partners which matter such as Europe and China will baulk at the idea of deals which make the US better off at their expense. As such, there appears to be major downside risks to global economic growth this year which makes it challenging to have growth above +2%, and such a backdrop would likely culminate in an earnings downgrade cycle in coming months which would likely keep US and global equity market volatility elevated.

Our changing 2025 US base case – from 2% to barely any growth highlights the risk of a very expensive market

Turning into 2025 we were expecting US growth to slow to around +2% but remain slightly above-trend. However, we were cautious about the outlook for US equities at the start of this year (preferring other markets with much less demanding valuations) as valuations were so extended that medium-term (5 year) returns are likely to be very disappointing. Entering 2025 the trailing PE ratio in the US was 24.8x 12MT EPS. Valuations above 23x have delivered an average 5Y total return of -1.5%pa (since 1900) comprising a price decline of -3.5%pa offset by average dividend of +2%. Liberation Day has crystallised this valuation risk even earlier than we anticipated. We continue to prefer other markets (like the UK and value-based strategies) which have out-performed so far this year.

Chart 3: Entering 2025, the S&P 500's 12MT valuation was aligned with negative 5Yr returns



Downside risks from here

With the best-case scenario for the US economy in 2025 now being barely any GDP growth (zero to +0.5%Y) with rising unemployment and higher inflation, the downside risks from high valuations are potentially far more concerning. High equity valuations are difficult to sustain structurally if there is a trend towards higher inflation and lower EPS growth and that is set to occur when the trade between the two largest economies grinds to a halt almost overnight. Bear markets occur when shocks hit vulnerabilities - the shock has been US trade policy and the vulnerabilities in Jan-25 were both 97th percentile US equity valuations (based on 12-month forward PE) and highly optimistic/unrealistic earnings growth expectations. Against a backdrop of sustained large-scale uncertainty about where tariffs and the economy ultimately lands, combined with the Fed being on the sidelines for the time being, we can expect equity and bond market volatility to remain high. We have been arguing for some time that extreme equity valuations would limit long term returns. President Trump's trade policies, combined with extreme equity valuations, might be the catalyst for a bear market in 2025 that still has some way to run.

Portfolio thoughts

The impact of US trade policy on the global outlook is highly uncertain and very fluid. The impact on growth and inflation ultimately depends on the level of tariffs, how long they remain in place, how the private sector adjusts and what reciprocal actions are undertaken by other countries. That said, trade wars are never won, they are always about who loses the least and while the ultimate result is not known, it is not beyond investor's control. History demonstrates conclusively that expensive markets are more prone to larger losses, so one way of managing risk is avoiding markets who's long-run returns are not commensurate with its inherent risk. In the end, high equity valuations are difficult to sustain structurally if there is a trend towards higher inflation and lower EPS growth.

While every bear market is different, the condition to look out for before a sustained rebound can occur are moderating economic deterioration, significant policy support, attractive valuations and extreme positioning. The first two conditions are necessary for a rebound, whereas the last two are factors you would prefer to have on your side, even though they are not essential. With US trade policy in a state of flux and significant EPS downgrades likely ahead, elevated volatility seems set to persist for the time being, so investors need to maintain their focus on diversification. A second key channel of risk management is implementing explicit portfolio protection through bought options when attractive risk reward opportunities present. This has the advantage over traditional portfolio diversifiers (such as bonds) in that the downside risks are known, they have been a more reliable portfolio hedge in the past decade, and options are a highly efficient capital allocation strategy.

Yours sincerely,

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