July 1, 2025

BILBoard Summer 2025 – Always wear sunscreen

From the brink of a bear market, US stocks have staged a ten-trillion-dollar rally, bringing record highs within reach. Summer is in full swing in the equity space, with easing tensions in the Middle East and hopes of Fed rate cuts boosting the mood. However, on the hottest days, it's important to have adequate sun protection. At our latest Asset Allocation, we took steps to shield our portfolios, believing that some caution is warranted—particularly in the lower-quality corners of the market.

We did this by decreasing exposure to US Small Caps and using a pullback to top up our gold holdings. Additionally, in fixed income, in order to further limit our USD exposure, we closed positions in dollar-denominated floating-rate notes. We re-directed the proceeds into European investment grade credit, where fixed rates offer more predictable income streams.

The US

The US economy is expected to slow this year, with tariffs, policy uncertainty, inflation risk and softer consumption all posing challenges.

After front-loading purchases to get ahead of tariffs early in the year, US households have started to pull back on spending, and we expect greater price sensitivity throughout the summer. At present, the average effective tariff rate on US imports is at its highest since the 1970s. In monitoring import prices, it would appear that US firms have been shouldering most of the burden until now; the upcoming earnings season, beginning mid-July, will offer a clearer view of how companies have managed amid tariff uncertainty.

The risk is that this uncertainty drags on. With US attention recently diverted by the Israel-Iran conflict, the July 9 deadline for trade negotiations may prove unrealistic. The latest signals from the Trump Administration suggest they now aim to conclude trade discussions by Labour Day on September 1.

Nevertheless, markets are riding high on hopes that inflation is cooling. Indeed, lower-than-expected inflation prints have driven strong inflows into US equities. However, because US firms typically hold about three months of inventory, the full impact of existing tariffs will likely only begin to surface in the data at the end of June. Moreover, a closer look at leading indicators reveals signs of mounting inflation pressure. For instance, PMI figures indicate that output price inflation in the manufacturing sector is at its highest level since November 2022.

Renewed inflation pressure would leave the Fed in a bind, and could ultimately lead to a slower easing cycle than otherwise would have been warranted in a slowing economy. After having misjudged the 2021 inflation spike as “transitory”, policymakers are likely to seek enough data to adequately confirm that tariffs will not sustain upward pressure on prices. This time it really could be different, however; while prices might heat up in the near-term, sustained inflation usually requires strong, consistent consumer demand- something that is far from assured in the current economic environment.

Markets currently expect around two 25bp rate cuts later this year as the economy slows, in line with the Fed’s own projections of about 50bp in cuts. Whether these materialise largely depends on how trade negotiations settle and on how tariffs ultimately feed through to the real economy.

But potential catalysts for the US economy remain. The eventual passing of the "Big Beautiful Bill" (an extension of TJIA tax cuts with possible additional breaks), banking deregulation and productivity gains powered by AI and automation, will support growth. Progress on closing trade deals could also boost corporate sentiment and facilitate decision-making and investment.

Europe

The front-loading of exports to the US helped drive **Q1 growth in the Eurozone**, which came in at 0.6% - the strongest expansion since Q3 2022. The ECB has maintained its **0.9% growth target for 2025,** but said this reflects a stronger-than-expected first quarter combined with weaker prospects for the remainder of the year.

Trade uncertainty and a **strong euro** are creating headwinds for European firms. However, the **downturn in the manufacturing sector continues to ease**, with new orders stabilising for the first time in three years.

Meanwhile, **inflation is below the ECB's 2% target** and appears to be under control. The ECB is expected to pause its easing cycle over the summer, maintaining a neutral stance, before delivering one more 25bp cut before year-end. The growth impact from fiscal spending is likely to take time to unfold.

China

The economy has been beating expectations lately, helped again by the **front-loading of exports to the US**, as well as an uptick in **consumption** due to the "618" shopping festival in May, which pulled in record online sales. However, the outlook for the rest of the year remains tepid amid weak external demand. **Trade tariffs of 55% imposed by the US** may be more palatable than the original figure of 145%, but they are still punitive. Factory activity hit a six-month low in May. In terms of fiscal intervention, investors were disappointed by a lack of surprises at the annual financial forum and instead turned their focus to the upcoming **July Politburo meeting** for clearer signals on economic support.

INVESTMENT STRATEGY

Following the most recent changes to our investment strategy, we now hold a slight underweight to equities in our portfolios. Within that allocation, the **US remains our preferred region**, with several supporting factors at play:

- Renewed optimism around AI and strong hyper-scaler investment
- Strong, potentially record-setting buyback activity foreseen for this year
- Favourable technicals, with demand for equities outstripping supply
- Upward earnings revisions and a weaker USD further supporting EPS

However, at the index level, **valuations are beginning to look quite full** again, calling for greater **selectivity**.

As such, we **decided to close our position in US small caps**. The segment tends to be more sensitive to economic slowdowns given that companies therein tend to have less diversified revenue, weaker balance sheets and limited pricing power. While the largest US companies, especially in tech, hold substantial cash reserves, smaller firms have less of a cushion to absorb tariff impacts. Additionally, small cap stocks tend to be more volatile and less liquid, making them vulnerable during periods of market stress when investors seek safety.

Meanwhile, we used the recent pullback to increase our **gold allocation** to 5% across all risk profiles. Gold serves as a hedge against rising US inflation risks and ongoing geopolitical uncertainties. Notably, a recent central bank survey indicates that global central banks intend to continue adding to their gold reserves this year.

In **fixed income**, rates on both sides of the Atlantic currently lack a clear trend. While heavy issuance and external factors have pushed yields higher, historical seasonality suggests new issuance should now begin to ease, offering some respite. The outcome of trade negotiations between the US and the EU remains unclear, but with slower growth expected and inflation under control, the ECB is likely to deliver one final cut and we see little reason to fear much higher yields on the continent.

In the US, President Trump's proposed tax bill is projected to add trillions to US debt over the next decade, forcing the Treasury to issue significant amounts of bonds. While the White House argues that tariffs and higher growth will help reduce the debt, concerns around the fiscal deficit persist and could potentially push the term premium higher.

Given ongoing volatility in US yields, we see better opportunities in European fixed rate corporate bonds. We switched USD floating rate notes into **European credit**, where technicals remain strong, with steady inflows and an active primary market. Fundamentals also look tidy, with credit upgrades significantly outpacing downgrades. Moody's data suggests Europe's default cycle is near its peak.

Swiveling to **Emerging Market (EM) debt**, hard currency spreads have already re-traced much of their recent widening, with sovereigns leading the pack. With the latter now trading tight, we note a strengthened investment case for **local currency bonds as portfolio diversifiers**. Indeed, this has been the best-performing bond segment this year, benefitting from a weaker dollar, with market sentiment having shifted markedly from a few months ago when expectations centred on the business-friendly elements of Trump's agenda that were expected to bring stronger US growth and a firmer dollar.

As a result of our activity this month, our **US dollar exposure has declined.** With the greenback hovering near cycle lows, at present we see little to suggest a meaningful rebound is imminent.

CONCLUSION

Stocks are pushing toward all-time highs, driven in part by a surge of FOMO (fear of missing out). While there is no reason to stay in the shade and sit out the current sunny days on markets, it is prudent to maintain protection. Despite the bullish tone following the Israel-Iran ceasefire, risks persist – from looming trade talk deadlines and tariff impacts on inflation, company profit margins and growth. Investors should just be careful not to get burnt, with diversification and adaptability serving as the ultimate SPF in the investment world.

If you would like help turning any of our insights into tangible trading ideas, do not hesitate to contact your dedicated relationship manager or investment advisor.

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