



STRATEGY UPDATE • APRIL 2025

Beyond Tariffs: What's Really Driving Market Volatility?

KEY TAKEAWAYS

- While it is easy to attribute the recent equity market downturn to trade war developments, we question whether tariffs are merely a convenient pretext for a correction driven by more fundamental factors.
- US bonds have outperformed US equities so far this year, reinforcing the view that President Donald Trump's preferred market metric may now be the 10-year US Treasury yield rather than the S&P 500 Index, at least in the short term.
- This shift suggests that the Trump put on the stock market might have been redefined at a much lower threshold than previously assumed. We remain cautious and see no urgency to buy into the weakness.
- The decline in US small caps, occurring alongside falling interest rates, is particularly concerning, especially given the leveraged nature of their balance sheets. However, credit spreads on bonds funding listed business development companies (BDCs) – a rare pricing indicator for the private debt market – remain stable, providing some reassurance.
- Beyond the US, we see attractive opportunities in German and Japanese equities, and remain constructive on China, particularly as another trading window may emerge in the second half of the year.

US BONDS HAVE OUTPERFORMED US EQUITIES YEAR TO DATE

Since mid-February, market conditions appear to have shifted significantly. The recent correction is widely attributed to the Trump administration's more **aggressive approach to tariffs** than previously expected. While recent market activity has been volatile and unpredictable, the strong rally in the final trading hours of February – despite heightened geopolitical uncertainty following the Oval Office fallout between President Trump and President

Zelensky – was particularly noteworthy. Surprisingly, the S&P 500 Index rebounded over 2% in just two hours, limiting its February loss to -1.4%. However, those gains were quickly erased the following Monday as markets reacted to the confirmation of tariffs on Mexican and Canadian imports, along with an additional 10% increase in tariffs on China.

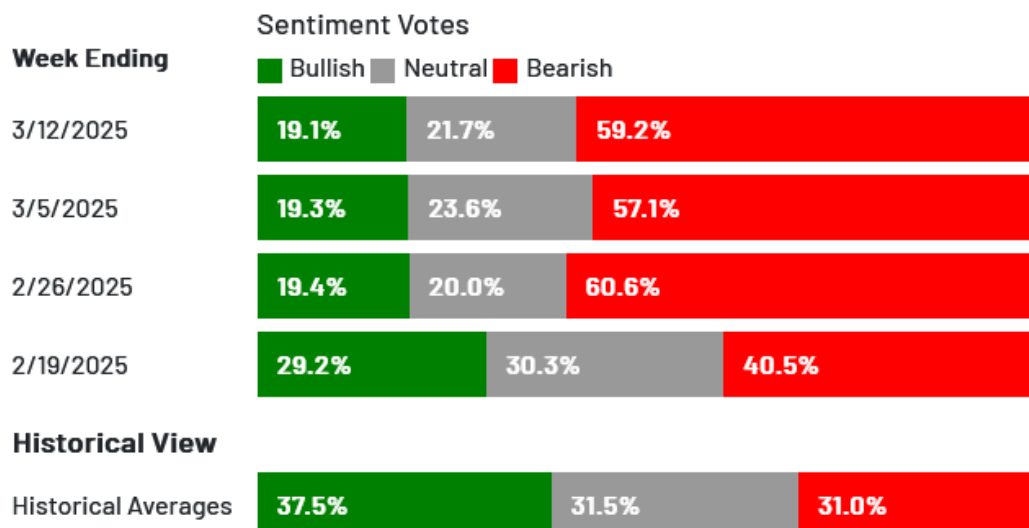
While it is tempting to attribute the recent market correction solely to trade war headlines, we believe these developments are more symptom than cause. Underneath the daily news flow, a more **deliberate shift in US economic strategy is taking shape** – what officials themselves have described as a **radical fiscal rebalancing**. Treasury Secretary Scott Bessent recently referred to this process as a necessary “detox,” acknowledging that the US economy has become addicted to large-scale government spending and must transition back toward private-sector demand. At the heart of this policy pivot is a belief that excessive fiscal expansion over the past decade – culminating in a cumulative primary deficit exceeding 35% of GDP between 2016 and 2023 – has contributed to rising trade imbalances and structural dependence on foreign capital. In contrast, the eurozone’s comparable figure is just 10%. The Trump administration appears to be pursuing a broad realignment of the international financial and trading systems, as outlined by economist Stephen Muran, now chair of the Council of Economic Advisers. In a widely discussed 2024 essay, Muran argues that the persistent overvaluation of the US dollar – driven by global demand for US reserve assets – has become a liability, reducing export competitiveness and increasing import dependence. Tariffs, in this context, are viewed not simply as a protectionist tool but as a fiscal instrument that can generate revenue with limited inflationary impact when offset by currency adjustments. This thinking draws directly from the 2018–2019 trade war playbook and helps explain the administration’s apparent comfort with heightened volatility. If successful, this strategy could reduce the structural US trade deficit while fostering a more balanced growth model – but not without turbulence along the way. As a consequence, the extended US equity bull market appears to be losing momentum. Going forward, two broad paths are emerging: either a **soft landing**, in which growth slows and capital rotates toward international markets, or a **harder landing** that results in a full-blown recession and ushers in a wider bear market. Much depends on the resilience of the US consumer in the face of fiscal tightening. If inflation flares up again due to tariffs – thereby limiting the Fed’s ability to ease – or if falling asset prices trigger a negative wealth effect, recession risks will increase. That said, **the likelihood of a deep contraction remains low**, given the overall health of private sector balance sheets.

At the end of February, long-term US Treasuries (7–10 years) had returned +3.5%, outpacing the S&P 500’s +1.4% year-to-date gain. This **outperformance of bonds over equities** may seem a surprise, but recent weaker-than-expected economic data offers a possible explanation. This has led to a significant drop in 10-year Treasury yields, from 4.57% to 4.3% year to date. Meanwhile, expectations for Federal Reserve rate cuts have shifted markedly, with three cuts now being priced in for 2025, up from just one earlier this year. More structurally, fiscal priorities are evolving. What some have dubbed a ‘radical fiscal rebalancing’ is underway, with government policy aiming to address entrenched social and economic imbalances – notably in housing, regional investment, and industrial capacity. This transition is reinforcing the decoupling between monetary and fiscal levers: where the Fed signals caution, fiscal channels remain expansionary in targeted ways. Yet, **something even more fundamental might be unfolding**. Many still remember Trump’s first term in office, where he frequently pointed to stock market performance as proof of his economic success. Entering his second term, the assumption was that his administration would prioritize stock market stability. However, **recent policy signals suggest a shift in focus from Wall Street to Main Street**, with an emphasis on lower interest rates to support housing affordability and broader economic growth. Notably, US housing payments as a percentage of median income have risen to nearly 40%, up

significantly over the past two decades, placing political pressure on policymakers to bring long-term rates down. This explains why long bond yields, not equity indices, may now be the key policy metric and raises questions about the so-called "Trump put" on the stock market – suggesting that its strike price may now be set much lower than previously assumed.

INVESTOR SENTIMENT

Investor sentiment among US retail traders has deteriorated sharply, as seen in the AAI (American Association of Individual Investors) Sentiment Survey.



The recent selloff appears partly driven by speculative trading in meme stocks (i.e. companies whose stock prices have been heavily influenced by social media hype and online communities) and momentum plays, which unwound in mid-February despite a strong Q4 earnings season. This serves as a reminder that the stock market remains a forward-looking discounting mechanism.

The decline in US small caps, particularly in a falling rate environment, is a red flag. Initially seen as prime beneficiaries of Trump's return, small caps have underperformed since the November election, falling below pre-election levels. Given the high leverage in this sector, we remain cautious.

CREDIT & PRIVATE MARKETS

Similarly, credit spreads on bonds funding listed BDCs – a key signal for private debt health – are closely monitored. Asset managers overseeing these vehicles have seen their stocks decline over 20% from all-time highs, a drop typically associated with bear market conditions. While spreads have remained stable, any signs of stress here would be significant. Nonetheless, the overall credit environment reflects a notable shift toward quality and liquidity – with a growing share of capital allocated to investment-grade debt, sovereign bonds, and real assets.

PORTFOLIO POSITIONING

Despite these risks, **we maintain our overweight position in equities**, as underlying fundamentals remain resilient, particularly in key sectors benefiting from structural growth trends. While volatility has increased, corporate earnings continue to exceed expectations, and labor market strength supports consumer spending. Additionally, **central bank policy remains a critical factor**, with the Federal Reserve signaling flexibility in response to economic conditions, which could provide further support to risk assets. However, we remain selective in our exposure, favoring high-quality companies with strong balance sheets and sectors positioned for long-term stability, such as technology and healthcare. The recent market selloff

has also created opportunistic entry points, particularly in areas where valuations have become more attractive relative to earnings growth. For now, we see no reason to adopt a more aggressive risk stance, as markets continue to adjust to shifting monetary policies, geopolitical tensions, and evolving macroeconomic conditions. Instead, we maintain a disciplined approach, ensuring that our equity allocations are well-diversified and aligned with long-term investment goals. We are also closely monitoring strategic themes such as reindustrialization, fiscal decarbonization incentives, and cross-border infrastructure investment, which are beginning to shape investor behavior across both public and private markets.

At the sector level, we are gradually increasing exposure to select cyclicals in anticipation of the next economic cycle. Among these, we view **industrials** as the most attractive, with a relative preference for the machinery and equipment subsector, which is well-positioned to benefit from an eventual recovery in global demand. Transportation stocks follow closely in our ranking, supported by improving logistics activity and capex normalization. We also see a supportive backdrop for **financials**, particularly US banks, which should benefit from a more constructive interest rate outlook and a renewed deregulatory push that may boost primary market activity. In this context, we prefer US over European financials and consider asset managers with operational leverage and scalable platforms.

Regionally, we continue to focus on developed markets with an emphasis on quality and free cash flow generation. We see particular upside in **German and Japanese equities**, where valuations remain attractive and earnings momentum is improving. German equities stand out given their valuation discount relative to the US and strong projected earnings growth, especially among mid-cap names, which we believe offer catch-up potential in a cyclical rebound. We remain constructive on Chinese equities and expect another trading window to open in the second half of the year. Any near-term pullbacks are likely to represent healthy consolidations rather than structural weakness, and we would use such phases to build positions selectively.

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