CIO PERSPECTIVES

25 March 2025

Turbulence zones: What to expect?

Key points

- *The US equity market experienced a significant correction, dropping 10% in just 22 days—the 6th largest correction in 75 years. This reflects market doubts about the optimistic assumptions surrounding Donald Trump's second term, which has recently focused on disruptive policies. We now anticipate a slowdown in US economic activity in 2025, without giving into pessimism, as fears of recession seem exaggerated. We have revised our growth estimates from 2.3% to 1.9% and adjusted our inflation expectations from 2.7% to 2.9%. Despite this, we still foresee two Federal Reserve (Fed) rate cuts in 2025.*

- *Although our outlook on the US economy remains constructive, equity markets may remain volatile in the short-term in the absence of significant policy changes (from Trump or the Fed). In this uncertain environment, we have reduced our conviction on risky assets, shifting our position on US equities from a slight overweight to neutral. Concurrently, we are raising European equities from a slight underweight to neutral, while staying vigilant about potential tariff impacts. We maintain a positive bias towards emerging markets, particularly in Asia.*

- *We continue to approach duration with caution, keeping a slight underweight on US and European government bonds. Quality credit remains the most attractive segment in the bond markets. Additionally, we maintain a positive stance on the dollar, viewing it as a hedging asset in our portfolios, and continue to appreciate gold.*

Turbulence in US markets: Total Eclipse of the "Trump Trade"

The election of Donald Trump had aroused some euphoria in US markets fuelled by expectations of pro-growth policies (deregulation measures and accommodative fiscal policy). These measures suggested a solid outlook for a US economy that already benefited from strong GDP growth of more than 2%, expected disinflation and Fed rate cuts. These very optimistic expectations were quickly confronted with a Trump 2.0 focused mainly on measures deemed rather negative for US growth: higher tariffs, reduced federal spending and lower immigration.

The nerve point for the markets was tariff policy. Our scenario included, since November 2024, the introduction of tariffs on China, around 20% (which has been announced so far), while we saw the announcements on Mexico and Canada more as negotiating tactics. Indeed, the impact of the increase in tariffs is twofold: less growth and more inflation. As a result, we expected Donald Trump to have a limited approach to tariffs so as not to derail the good momentum of growth and disinflation. In general, the market hypothesis was based on the famous "Trump Put,"[1] the idea that Trump would backtrack on disruptive political measures if the US equity market were to react negatively.

1 « Trump Put": The perception among investors that President Trump's economic policies and statements could influence the stock markets in a way that limits their decline.

However, the "short-term pain, long-term gain" rhetoric of the Trump administration has challenged this assumption. From a long-term perspective, two objectives seem to emerge: revitalising the American manufacturing sector and lowering long-term US interest rates to manage debt sustainability dynamics. For the latter, one of the key measures has been the creation of DOGE[2], led by Elon Musk, aimed at drastically reducing US government spending. In this context, tariffs appear to play a more significant role in Trump's policy than markets expected, with multiple uses: rebalancing the trade deficit, protecting domestic businesses from international competition, generating revenue to fund certain fiscal measures, and serving as leverage in negotiations. In the short-term, this includes discussions on issues like fentanyl and immigration with Canada and Mexico. In the medium-term, the negotiations are also strategic; for example, the idea of a "Mar-A-Lago Accord" where the US would attempt to negotiate a dollar devaluation with its key trading partners.

Additionally, these measures put increased pressure on the Federal Reserve, which might find itself compelled to activate the well-known "Fed Put,"[3] potentially lowering interest rates if US growth prospects deteriorate significantly—a scenario that might actually align with the Trump administration's goals. This has been a key factor in recent market developments. Although the S&P 500 saw a 10% correction in March, several developments align with Donald Trump's objectives: tariffs on China have increased by 20% (with reciprocal tariffs anticipated), the administration continues to build leverage for future negotiations, US 10-year Treasury yields have dropped by nearly 60 basis points (bps) since their mid-January peak, and both the dollar and oil prices have declined—outcomes Trump explicitly aimed for during his campaign.

Evolution of our macroeconomic scenario: A slowdown, not a recession

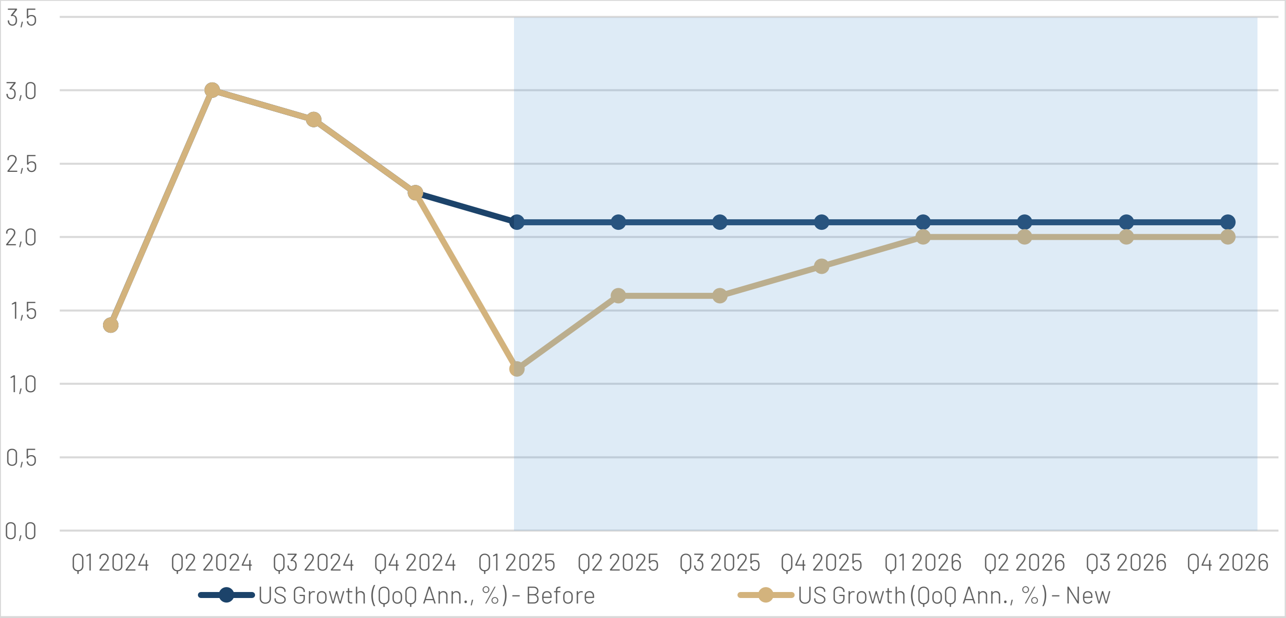
Considering that Donald Trump seems prepared to accept more short-term disruptions, we now anticipate him being moderately more aggressive with his tariff policy, increasing the average rate on US imports to 10% (up from 7% in our February 2025 scenario). Additionally, the omnipresence nature of Trump's tariff policy generates greater economic uncertainties, which could eventually impact consumer spending and affect companies' investment and hiring plans. Simultaneously, higher tariffs are likely to temporarily increase inflation and reduce household purchasing power.

Taking these factors into account, we revised our growth expectations for 2025 at the beginning of March, from 2.3% to 1.9% (Chart 1), and inflation expectations from 2.7% to 2.9%. Therefore, we now anticipate a moderate slowdown in US growth in 2025, with annualised quarterly GDP growth fluctuating sequentially between 1% and 2%. It is clear that, Donald Trump's focus on policies detrimental to growth, implies that downside risks to our growth scenario persist. It is also important to remember that, although sentiment surveys have deteriorated in recent weeks, reflecting increasing uncertainty, current economic data remains resilient. In this regard, note that in recent years, surveys have not always been reliable predictors of actual economic dynamics. Thus, although the risk of recession has indeed increased in recent weeks, the alarmist discourse on a US economic recession appears somewhat exaggerated.

[2] DOGE: Department of Government Efficiency.

[3] The 'Fed Put' is the idea that the US Federal Reserve will intervene with accommodative monetary policy to support the markets if prices fall too rapidly."

Chart 1: US growth scenario 2025 (annualised quarterly scenario, %)



Source: Bloomberg, Indosuez Wealth Management.

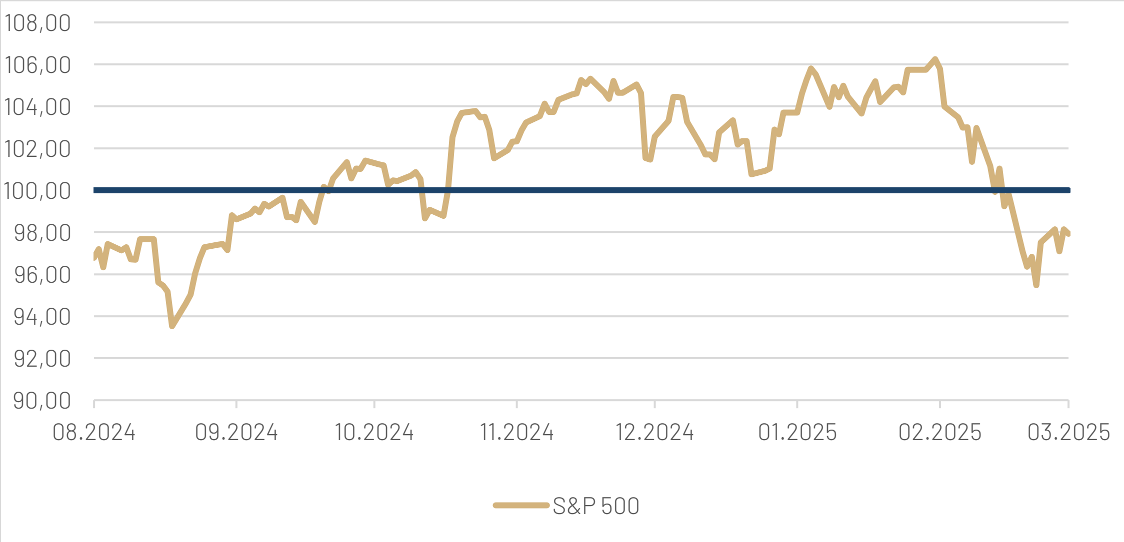
Furthermore, although Trump's second term has initially focused heavily on policies perceived as negative for growth, the Trump administration is expected to eventually shift its attention towards more growth-friendly policies (deregulation, tax cuts, attracting foreign investments). This would justify a medium-term outlook of sustained growth dynamics in the United States, reflected in our expectations of 1.9% growth in 2026, while inflation should decelerate to 2.7%. We view the impact of higher tariffs on inflation as temporary. This temporary nature supports our key assumption that the Fed should proceed with two additional rate cuts in 2025, focusing more on downside risks to employment. In this context, inflation expectations, which have remained generally anchored so far, will be crucial in assessing the Fed's ability to continue its monetary normalisation cycle. This message was reiterated by Fed Chairman Jerome Powell during the March meeting.

What implications for markets?

Our outlook on US economic prospects remains constructive, although short-term volatility may remain elevated. Notably, uncertainty may persist as we approach 2 April, when the Trump administration is expected to implement its reciprocal tariffs. There is still doubt about the scope and scale of the tariffs to be announced. If the tariffs are based solely on the trade barriers imposed by trading partners on US imports, the impact would be relatively moderate. However, there is a risk that the Trump administration could include other factors in its tariff approach, such as value-added taxes, currency manipulation, or perceived unfair trade practices, leading to a significant increase in the announced tariffs.

In this context, equity market volatility could remain high. Although the S&P 500 fell by 10% in March, it is only 2% below its pre-election levels of Donald Trump (Chart 2). Meanwhile, market expectations for the Fed indicate only three rate cuts by the end of 2025; in other words, the market does not anticipate a recession. In our view, US equity markets have largely moved past the "Trump Trade" and the optimistic expectations surrounding Trump's second term, remaining cautious due to the prevailing economic uncertainty.

Chart 2: The S&P 500 fell below its pre-election levels (100 = 05.11.2024)



Source: Reuters, Indosuez Wealth Management.

Nevertheless, a shift in economic policy tone, whether from Trump or the Fed, could lead to a quicker recovery in market sentiment in the short-term. In the first case, as discussed earlier, if the administration genuinely focuses on its long-term objectives at the expense of short-term dynamics, the implication is that the S&P 500 level at which the Trump administration would reconsider its stance is likely lower than during his first term. So far, the narrative from Trump's team has not changed despite a 10% correction in the US stock market, which Treasury Secretary Scott Bessent has described as a "healthy correction." Therefore, we do not expect a drastic change in Trump's tone in the near term, although the new President remains quite unpredictable, and a reversal in the coming weeks cannot be entirely ruled out. Such a scenario would obviously be positive for US equities and the dollar and would exert upward pressure on US interest rates. Another point to note regarding the “Trump Put” is that it should be considered not only in terms of the market level at which the Trump administration might back down from disruptive policies but also in terms of timing: as time passes, if market and economic conditions deteriorate and the pressure from markets, business leaders, and voters on the administration increases, it is likely that Trump's tolerance for market turmoil would diminish. However, it is difficult to judge if this could happen in the very short-term.

In the second case, a more accommodative Fed would also provide notable support for market sentiment. However, it seems premature to anticipate the “Fed Put” in the very short-term (even though the Fed meeting on 19 March had the feel of a "Mini Fed Put"). Jerome Powell has made it clear in recent weeks that the Fed is not in a hurry to lower rates, reiterating the economy's good health as well as the uncertainty surrounding the impact of Trump's economic policies. During this meeting, Powell downplayed the rise in inflation expectations shown in the Michigan survey, reiterating the view we share that inflation expectations remain anchored for now, adding that the Fed could easily lower rates if the labour market were to deteriorates.

What implications for our allocation?

In this context, the market movements observed since mid-February have highlighted the benefits of diversification. While the US equity market entered a correction phase, European and Chinese equities outperformed. Concurrently, US government bonds have played their role as a hedge against economic slowdown fears. Lastly, gold, which we highlighted in our Global Outlook 2025 as an attractive diversification asset in the current economic environment, has been the best-performing asset so far this year, with a 17% increase.

Given this uncertain environment where volatility in US markets could persist, we have decided to lower our conviction on equities while maintaining a positive bias. Specifically, we are revising our stance on US equities from a slight overweight to neutral. However, it is important to reaffirm that our growth outlook for the US remains constructive: we anticipate a slowdown in the first quarter of 2025, but not a recession.

Beyond relatively encouraging signals on corporate fundamentals, the correction observed in recent weeks has led to a significant decline in investor sentiment and positioning on US equities. Historically, such rapid corrections are often followed by substantial rebounds within a six-month horizon.

Simultaneously, we have also raised our conviction on Euro Area equities to neutral. These have outperformed at the start of the year, and we expect the region to continue benefiting from German and European stimulus plans, positive economic developments, and improved sentiment, although we remain vigilant about potential US tariffs on European exports. Finally, our positive bias on risky assets is reflected in our conviction on emerging market equities. These should benefit from improved Chinese economic prospects and the government's focus on consumption and investment. We also anticipate a broadening of performance beyond Chinese tech stocks and a positive impact on other Asian regions in the coming months.

Within bond portfolios, we maintain a cautious approach to duration. In Europe, the excessive reaction of Euro Area government bonds to fiscal support announcements prompts us to reduce our under-sensitivity to euro rates, despite short-term volatility. In the US, duration is attractive as a hedge against further economic deterioration, but we remain vigilant about long-term inflation risks, which could be penalised by improved economic sentiment if our expectations of resilient US growth materialise. Quality credit appears to be the most attractive segment in bond markets despite tight spreads. We see no immediate catalyst for significant widening of credit spreads in the absence of external shocks, while the asset class should continue benefiting from additional flows related to investors' reinvestment needs.

Finally, we maintain a positive bias on the dollar, which we still consider a hedging asset within our portfolios. In the short-term, the bullish *momentum* could continue for the euro-dollar if sentiment towards the US economy deteriorates further compared to the Euro Area. However, the implementation of tariffs in the coming weeks could support the dollar, as could a potential resurgence of investor confidence in US growth prospects in the medium-term. Despite the strong rally at the beginning of the year, we remain strategically positive on gold, which continues to be supported by strong demand from emerging market central banks and a context of significant political and geopolitical uncertainties.

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