UBS House View

Monthly Letter | 24 July 2025 | Chief Investment Office GWM, Investment Research

Riding high

Equity markets have rallied to record highs. But with risks remaining, we recommend preparing for potential near-term market volatility.

Long and variable lags

The impact of tariffs is feeding through to the US economy. However, we would expect a tariff-led economic slowdown to be mild and short-lived, rather than recessionary.

Fed in focus

Questions about the Federal Reserve's independence have moved back into focus for investors. We believe such concerns add to headwinds for the US dollar.

Asset allocation

In equities, we like structural growth themes such as *AI, Power and resources,* and *Longevity.* We also favor quality bonds and gold, but see the US dollar as Unattractive.

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Quiet...too quiet

It's quiet...a little too quiet.

Movie fans will know that feeling of tension when the hero steps into supposedly dangerous new territory only to find nothing there. Many investors are feeling a similar sense of unease about current market highs, listening for the sound of the "TACO" trade going "crunch" underfoot.

We're dealing with the highest tariffs since the 1930s, fears about government debt sustainability, geopolitical uncertainty, and threats to Federal Reserve independence. Yet economic activity has so far held up. After a brief shock in April, equity markets have moved higher, with global stocks now trading at record levels. Rate volatility has declined, and credit spreads are tight. Even the US dollar—one exception to this period of "quiet" in markets—has stabilized after its recent swings.

In this letter, we consider some of the key risks to markets over the coming weeks, including the potential for the recent optimism over trade deals to be challenged, evidence of a larger economic impact from tariffs, and wrangling about Fed leadership. In the context of bullish market sentiment, we believe that some combination of these is likely to contribute to market volatility in the weeks ahead.

Nevertheless, we would expect market swings to be temporary. We believe trade negotiations will ultimately lead to moderate policy (albeit with high tariffs by historical standards). We would expect a tariff-led economic slowdown to be mild and short-lived, rather than recessionary. While a shift toward more dovish Fed leadership may unnerve investors temporarily, we believe that the Trump administration understands the cost of a steeper yield curve. Meanwhile, we believe structural trends, notably AI, will remain supportive of corporate earnings over the medium and longer term.

UBS

We recommend strategies to prepare for potential market volatility in the near term.

To prepare for potential near-term volatility, we believe those investors already invested in equities in line with their strategic benchmarks should consider implementing short-term hedges, while those underallocated to stocks should prepare to add exposure on potential market dips. Our preferred areas within equities include the US technology, health care, financial, and utilities sectors, while in Asia, we like the Chinese tech sector, India, and Singapore. In Europe, we favor Swiss high-quality dividend stocks, European quality, and our "Six ways to invest in Europe" theme. We also like the Brazilian market. We believe market dips would offer a good opportunity for investors to build exposure to our Transformational Innovation Opportunities of *Artificial intelligence, Power and resources*, and *Longevity.*

In fixed income, our preference is for high grade and investment grade bonds. We believe tight credit spreads and risks of changes to the market narrative around economic growth make the risk-return for both high yield bonds and senior loans less appealing at this stage. Although we expect 10-year bond yields in most major markets to be lower by year-end, from a duration standpoint, we continue to favor intermediate maturities (five to seven years) given the risk of higher volatility at the long end of the curve.

We expect further US dollar depreciation in the months ahead. We target EURUSD at 1.23 and USDCHF at 0.76 by June 2026. But the significant interest rate differential between the USD, and the euro and Swiss franc in particular means that hedging or underweighting the US dollar is expensive. We believe this is an important time for investors to ensure their strategic currency allocations are appropriate for their personal situations and recently published a guide on how to do this (see "A practical guide to currency allocation" for more).

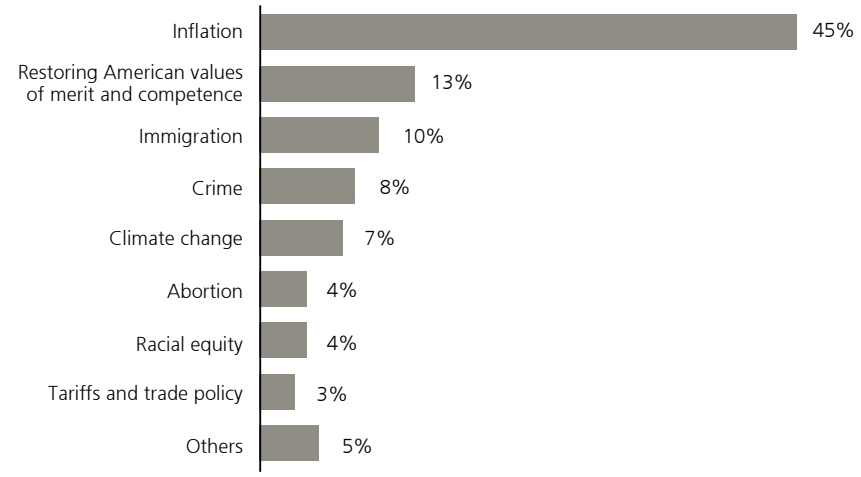
The "TACO" (and "WACO") trade

Markets have continued to rally despite tariff threats.

Markets have proven resilient to most of the recent tariff threats, as investors have grown accustomed to the idea that, faced with market volatility or potentially painful retaliation from counterparts, one side can be expected to back down. The "TACO (Trump Always Chickens Out) trade"—a term that was popularized after first being described in the *Financial Times* in May—and its counterpart, the "WACO (World Always Chickens Out) trade," encapsulate this view.

The trade has been working well for investors in recent weeks, with a US trade deal with Japan (setting tariffs at 15%) and media reports that a similar deal with the European Union is "close" helping global markets break new record highs. And ultimately we do not believe the US administration wants tariffs so high that they choke off trade, risk pushing the economy into recession, or reignite inflation. Inflation remains a key concern for US voters: In a recent Harvard CAPS/Harris poll, 45% of respondents cited inflation as the most important issue to them personally, while only 3% cited tariffs and trade policy.

Figure 1
Inflation remains an important concern in the US
Most important issue, % of respondents



Source: Harvard CAPS/Harris Poll, UBS, as of July 2025

Meanwhile, the high degree of dependence on US technology services and on security and defense means that we believe the EU will also be keen to reach a deal (while embarking on longer-term self-sufficiency initiatives).

Nonetheless, the degree of confidence markets appear to have in inexorable progress toward trade deals suggests that near-term disappointments are possible if deals fail to materialize, are subsequently revisited, or if other sector-level tariffs prove more aggressive than expected. Indeed a key challenge with the "TACO/WACO" trades is that buoyant equity markets may embolden negotiating parties to take aggressive stances.

The long and variable lags

We expect the effective US tariff rate to settle close to 15%.

We believe that while trade policy still has the power to shock, the range of potential tariff outcomes has become narrower. A 10% tariff on imports into the US appears to have become well established as a "floor" for most countries. Equally, with various agreements already in place, we also see it as unlikely that the overall US effective tariff rate will exceed 20%. In our base case, we expect it to settle close to 15% by year-end.

Although lower than the 28% that was threatened in the immediate aftermath of "Liberation Day," this still represents a sixfold increase on tariff levels in 2024 and is evidence that, in a bigger-picture context, Trump doesn't "chicken out." The scale of the impact on both the US and global economy remains to be seen.

Tariffs are likely to weigh on US economic growth and boost inflation.

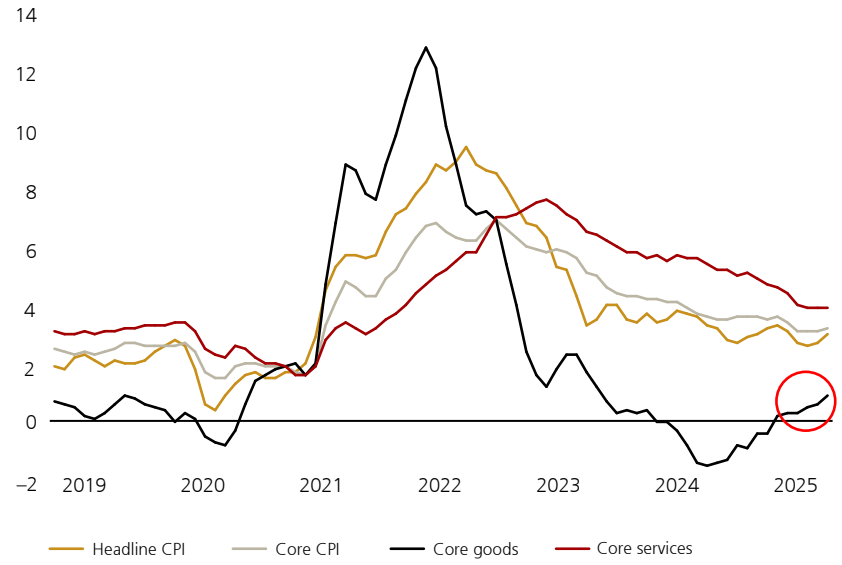
In general, we believe that tariffs will have a negative impact on US growth and will boost US inflation. Beneath the headline inflation rate, there were signs of tariffs feeding through into the June consumer price index data, with core goods inflation rising to a two-year high. While the tariff impact may surprise markets as

it starts to bite, we believe the resilience of the US consumer should help the US economy avoid recession. Retail sales rebounded in June. The University of Michigan measure of consumer sentiment has bounced off its low in April, while inflation expectations have come down from their highs. And in aggregate, household balance sheets remain strong.

Figure 2

Tariff impact revealed beneath headline inflation

US headline, core, commodities ex-food and energy (core goods), services ex-energy (core services) CPI, y/y %



Source: Bloomberg, UBS, as of July 2025

Economic data in the weeks and months ahead will be key.

Data in the weeks and months ahead will be key to determining the validity of our assessment. Several factors remain unclear. Although tariffs have been implemented since April, the effect of stocking and destocking, and the time lags inherent in supply chains, mean that the true economic impact of tariffs will be hitting the shelves around now. It remains unclear how exporters, importers, or consumers will divide the economic costs. And we do not yet know how much extended and new tax cuts in the One Big Beautiful Bill (partly funded through tariff revenue) may act as an offsetting stimulus.

We will therefore be closely watching retail sales, inflation, and consumer spending data, and listening for comments in the ongoing second-quarter earnings season about whether suppliers, companies themselves, or consumers are expected to bear the cost of tariffs.

The risk cases are that tariffs either have a larger-than-expected impact on inflation (which would both hurt consumer spending and make the Fed's position more difficult) or that companies accept a larger-than-expected hit to margins to

retain volumes (weighing on corporate profits). With equities having proven sanguine about the potential economic costs of tariffs so far, evidence of either of these trends emerging could quickly change the optimistic market narrative.

In the Eurozone, we expect tariffs to dampen activity in export-related sectors and weigh on business confidence. However, an expansionary fiscal package from Germany, together with modestly less restrictive fiscal policy in other parts of the bloc, should help offset some of the negative impact. Low interest rates, a robust labor market, and high levels of precautionary savings should also support domestic demand.

China's economy is likely to grow by around 4.7% this year.

In China, second-quarter GDP growth was stronger than expected amid front-loaded exports and resilient consumption. We still expect growth to slow in the second half of the year, and Beijing is unlikely to introduce stimulus measures in the near term. Nonetheless, we now see full-year GDP growth reaching around 4.7%, with the potential for upside if targeted policy support for the property sector and tariff-affected industries is put in place.

Whose committee is it anyway?

President Trump has repeatedly criticized Fed Chair Powell.

Few things are certain in markets. One thing that comes close is that Jerome Powell will no longer be the chair of the Federal Reserve in 10 months' time. The way in which he ends his term may have a bigger bearing on markets than the fact that it will end.

President Trump has returned to the subject frequently. In recent weeks, he has stepped up criticism of the Fed chair, claiming that Powell is a "knucklehead," "doing a lousy job," and calling for interest rate cuts of "3 points." Reports also suggest that President Trump showed some House Republicans a draft letter firing Powell. The President later stated that it was "very unlikely" he would fire the Fed chair.

From here, several scenarios are possible. Powell could be allowed to continue until the end of his term in May 2026 and be replaced by a (supposedly) more dovish but experienced central bank practitioner. Powell could be allowed to continue and be replaced with a Trump loyalist. Trump could move to undermine Powell before the end of his term, for example by attempting to remove him, or by naming a successor—either from within the Fed or externally—who would effectively act as a "shadow Fed chair." At an extreme, the President could try to push through legislation to change the Fed's mandate or its independence, though this would be unlikely to pass given the required 60 votes in the Senate.

We do not believe external political interference with the Fed will make a material difference to monetary policy. Decisions are made by committee, of which the chair is just one member, and we believe that committee members will remain focused on their stated mandate. And while the president does nominate

members of the committee, meaningfully changing its composition takes years, likely stretching beyond Trump's term.

Our base case is for 100 basis points of interest rate cuts over the next year. Although we expect the US economy to hold up relatively well in the face of tariffs, growth is still likely to remain below-trend (supporting the case for a reduction in interest rates), and we believe the Fed will likely look through a one-time inflation increase from tariffs. It's also worth noting that, politics aside, the rotation of regional Fed presidents, existing governors, and the forthcoming departure of Governor Adriana Kugler in January is set to shift the composition of voting members on the FOMC in a more dovish direction next year.

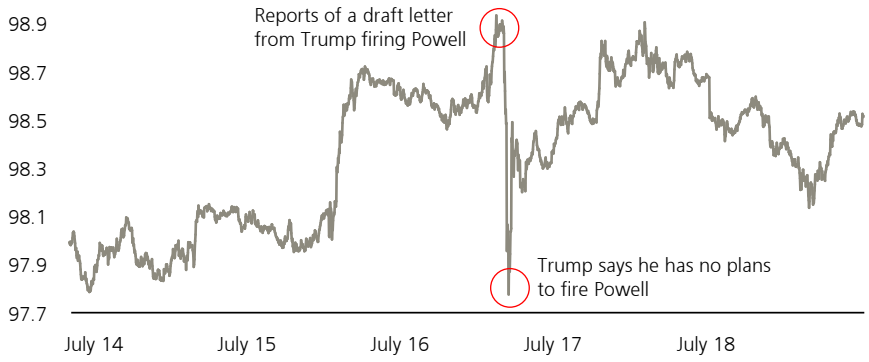
We continue to see the US dollar as Unattractive.

We expect lower interest rates, combined with fears about political interference, to affect the US dollar. We continue to see the US dollar as Unattractive and favor reviewing currency allocations to reduce excess US dollar holdings. Given the US's twin fiscal and current account deficits, it is reliant on marginal foreign buying to keep the dollar and bond yields stable. Central bank independence provides overseas investors with a sense of reassurance that short-term political expediency will not interfere with the long-term stability in inflation and the value of the currency. A 1% sell-off in the US dollar trade-weighted index on 16 July, corresponding to a 20ppt increase in the probability of Trump firing Powell, according to Polymarket, gives a sense of scale on the potential impact of interference.

Figure 3

The US dollar has been sensitive to concerns about Fed independence

DXY index, Monday 14 July to Friday 18 July



Source: Bloomberg, UBS, as of July 2025

Investment ideas

Market volatility may resurface in the near term amid low volumes.

The next few weeks are potentially risky. Investor sentiment toward equities is optimistic (the American Association of Individual Investors' survey has recorded a net bullish reading in recent weeks), and positioning has rebounded from the depressed levels seen after "Liberation Day." We are entering a quiet summer period for trading volumes in the US and Europe. And, as we have highlighted, several risks remain on the table, any or all of which could contribute to market volatility amid low volumes.

At the same time, we continue to believe these risks will ultimately prove short-lived, and in 12 months' time, we would expect equity markets to be higher and most government bond yields to be lower.

How to navigate this environment?

Prepare for market volatility. After a strong run for global equities and with risks on the horizon, we believe investors who are already allocated to equities in line with their strategic benchmarks should consider implementing short-term hedges, while those underallocated should prepare to add exposure on potential market dips in the weeks ahead. We see the S&P 500 reaching 6,500 by June 2026. Within US equities, we like tech, health care, utilities, and financials. In Asia, we favor China's tech sector, India, and Singapore. In Europe, we like Swiss high-quality dividends, European quality, and our "Six ways to invest in Europe" theme. We also like Brazil.

Invest in transformational innovation. We expect structural growth ideas—*AI, Power and resources*, and *Longevity*—to deliver attractive returns in the years ahead and would use any dips to build exposure. In *AI*, diversified exposure across infrastructure, semiconductors, and applications should capture accelerating adoption and monetization. We expect *Power and resources* to continue to benefit from surging electricity demand. Meanwhile, *Longevity* is supported by demographic shifts and rapid innovation in health care, medtech, and wellness.

We favor high grade and investment grade bonds.

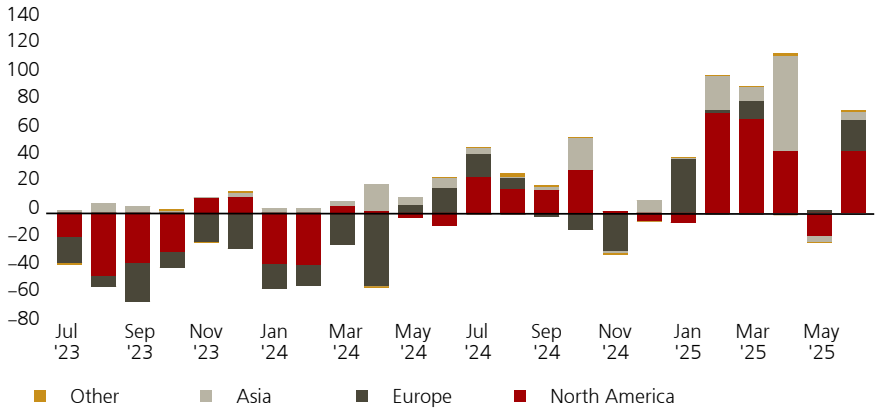
Buy quality bonds. We see an attractive risk-reward in quality (high grade and investment grade) bonds. Yields remain relatively high. We believe the risk-return for high yield bonds and senior loans looks less appealing at this stage owing to tight spreads. From a duration standpoint, we continue to favor medium duration (five to seven years), given the risk of higher volatility at the long end of the curve.

Navigate political risks. Gold remains an effective hedge against political risks, in our view. Although the Iran-Israel conflict has lessened in severity in recent weeks, geopolitical risks remain. And gold can also be an effective hedge against potential fears of external political interference at the Fed, elevated budget deficits, and the risk of higher-than-expected inflation. We maintain our USD 3,500/oz target and do not rule out the potential for prices to exceed this level if political risks escalate.

Figure 4

Demand for gold exchange-traded funds (ETFs) recovered after outflows in May

Net gold ETF flows by region, in metric tons



Source: World Gold Council, UBS, as of July 2025

Reduce excess dollar exposure. Questions about Fed independence and rising US debt levels continue to undermine the US dollar's traditional role as a perceived "safe haven" during periods of market uncertainty and as a "default" currency for many international investors. While high US interest rates make hedging dollar exposure expensive, we believe that investors should respond to the changing nature of global currencies by reviewing their currency allocations and aligning them with those required to meet liabilities or spending plans.

We recommend investors consider an allocation to alternatives.

Diversify with alternatives. Uncertainty about the diversifying power of defensive havens like US Treasuries and the US dollar increases the importance of alternative portfolio diversifiers. We recommend that investors consider an allocation to alternatives including hedge funds, private credit, value-oriented buyouts, and quality global real assets to help deliver returns, but also expose investors to a broader array of return drivers and enhance portfolio resilience. Investors should be aware of the various risks and drawbacks when investing in alternatives, including illiquidity, limited transparency, and the use of leverage.

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Global forecasts

Economy

Real GDP y/y, in %

	2024	2025E	2026E
US	2.8	1.5	1.4
Canada	1.2	2.0	2.0
Japan	0.2	0.5	0.5
Eurozone	0.9	0.7	1.0
UK	1.1	0.8	1.1
Switzerland	1.4	0.9	1.4
Australia	1.0	1.7	2.1
China	5.0	4.7	3.8
India	6.5	6.4	6.7
EM	4.5	4.2	3.9
World	3.3	2.9	2.8

Inflation (average CPI), y/y, in %

	2024	2025E	2026E
US	3.0	2.9	3.3
Canada	2.4	2.2	2.1
Japan	2.7	3.4	1.9
Eurozone	2.4	2.1	1.8
UK	2.5	3.3	2.1
Switzerland	1.1	0.2	0.5
Australia	3.2	2.4	2.7
China	0.2	-0.2	-0.1
India	4.6	3.2	4.5
EM	8.0	4.0	3.1
World	5.7	3.4	2.9

Source: Bloomberg, UBS, as of 24 July 2025. Latest forecasts available in the *Global forecasts* publication, published weekly.

Asset classes

	Spot	June-26
Equities		
S&P 500	6,359	6,500
Eurostoxx 50	5,344	5,600
FTSE 100	9,061	9,000
SMI	12,077	12,600
MSCI Asia ex-Japan	829	864
MSCI China	82	86
Topix	2,926	3,050
MSCI EM	1,265	1,310
MSCI AC World	1,118	1,150

	Spot	June-26
Yields, in %		
USD 2y Treasury	3.88	3.75
USD 10 year Treasury	4.38	4.00
CHF 2y Eidg.	–0.11	0.00
CHF 10y Eidg.	0.42	0.50
EUR 2y Bund	1.84	1.50
EUR 10y Bund	2.64	2.25
GBP 2y Gilt	3.88	3.50
GBP 10y Gilt	4.64	4.25
JPY 2y JGB	0.83	0.90
JPY 10y JGB	1.59	1.30

Currencies		
EURUSD	1.17	1.23
GBPUSD	1.36	1.40
USDCHF	0.79	0.76
USDCAD	1.36	1.32
AUDUSD	0.66	0.70
EURCHF	0.93	0.94
NZDUSD	0.60	0.64
USDJPY	146	136
USDCNY	7.16	7.00

Commodities		
Brent crude, USD/bbl	68.5	68
Gold, USD/oz	3,388	3,500

Source: Bloomberg, UBS, as of 24 July 2025. Latest forecasts available in the *Global forecasts* publication, published weekly.

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In addition to the risks that apply to alternative investments generally, the following are additional risks related to an investment in these strategies:

- Hedge Fund Risk: There are risks specifically associated with investing in hedge funds, which may include risks associated with investing in short sales, options, small-cap stocks, "junk bonds," derivatives, distressed securities, non-US securities and illiquid investments.
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