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Wait for dips to buy into medium-term positives

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Markets enjoyed a revival in optimism at the end of last week, with the VIX falling sharply and the S&P 500 ending a negative week strongly. Investors should remember that we might be on the cusp of an intensification of tariff tensions, which could lead to a rise in volatility and risk aversion. For now, investors should stay invested but focus on geographical areas and sectors that might be better able to withstand the impact of tariffs.

After around three weeks of bearishness, markets enjoyed a reprieve at the end of last week and on Monday. The VIX, after having risen from under 15 to an intraday high a little below 30, ended the week under 22. The S&P 500, meanwhile, seemed to bottom out after falling 8.6% over the 13 sessions to Monday, before ending the week up slightly after a strong 2.1% rise on Friday. This apparent bottoming out in sentiment came against the backdrop of a partial de-escalation in US-Canada trade tensions, progress toward a ceasefire in Ukraine, and the US averting a government shutdown. Because we expect the tariff uncertainty to stabilize and ebb over the coming months, should investors look to add exposure to risk assets in this rally?

The renewed volatility in markets on Tuesday serves as a reminder that confidence among investors remains fragile. Notwithstanding the likely upward trajectory over the medium term, investors can afford to be patient in the near term given the risk of volatility from additional tariffs in April. The episodic recoveries in risk appetite serve as reminders of the structural, medium-term positives that can come to the fore should the fog of the trade war dissipate. Additionally, the prospect of "policy puts" might also serve to limit the lasting impact of the trade war. We have of late adjusted our house view in preparation to buy the dips that might emerge over the coming quarter.

Narrower focus for equities. While we have raised the probability assigned to our downside scenario (of stagflation or a cyclical downturn) from 20% to 30%, our base case (at 50% probability) remains for aggressive tariff policy that still leaves the effective tariff rate for US imports below 10%, with rhetoric and action on government spending cuts cooling by 3Q25.

This in turn argues for a maintenance of global equities as Attractive, in addition to US equities, which we think will continue to rise through the year (end-2025 S&P 500 target of 6,600) on the back of robust economic momentum and AI-related investment spending. However, the rising tariff risks, especially for Asia and Europe, warrant a removal of the Attractive label from Asia ex-Japan (MXASJ) for the time being. Despite downgrading Asia ex-Japan, however, Taiwan and India remain as markets we consider Attractive given their respective strengths of exposure to the AI theme and robust domestic demand.

Focus on sectors less vulnerable to tariffs. Although the post-election rise in German equities (DAX) has led us to rescind our tactical recommendation to invest in it via structured solutions, we have nonetheless sought to maintain exposure to the improved economic and investment climate in Europe. We have opted to do this via a preference for segments within European equities that are relatively insulated against the threat of trade tariffs, offer exposure to structural growth trends, and can benefit from European monetary and fiscal support. This supports our sector preferences for industrials, IT, utilities, health care, and real estate.

Another driver is the likely rise in security investment beyond the current levels of around 2% of GDP, after years of underspending before the Ukraine war. Infrastructure and materials companies in Europe could benefit from investments in housing, transport, and energy, in our view. Additionally, a ceasefire and eventual peace deal in Ukraine could lead to lower energy costs—we believe a 50% fall in gas prices could boost European corporate earnings by 2% and raise European GDP growth by 50bps. Beneficiaries from this scenario would likely include the industrials, chemicals, and automotive sectors in Europe.

Wait for dips to buy EURUSD. The pair has been a clear beneficiary of the optimism from expectations of a wind-down in hostilities in Ukraine. The EURUSD rose 5.5% to a high of just under 1.0950 in the first seven sessions in March and was hovering around 1.08-09 through the latter half of the week. Both EURUSD sentiment and fundamental outlook have improved, so the currency pair is likely to be more resilient. We have therefore reduced the expected size of the potential tariffs-related dip in the EURUSD in 2Q25 to 1.06 from 1.02 previously. However, we advise against chasing the EURUSD rally, as the ongoing tariff risks means a material pullback is still very possible. Further out, we expect much of the actual increase in Germany's fiscal spending, and the consequent improvement in European economic data, to come in 2H25. We therefore raise our 1Q26 expectation for the EURUSD to 1.12 from 1.07; we see the EURUSD trading in a 1.05-1.12 range and look to buy the EUR on dips.

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