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Navigating the fog of (trade) war

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After two months of financial markets being sanguine about the risk of economic disruption from tariffs, this narrative began to darken in the latter half of January. Although risk aversion and volatility are likely to continue rising in the near term, investors would do well to stay invested given robust global growth fundamentals. We recommend a nuanced response of curating risk exposure to markets with strong domestic drivers, to counterbalance tariff risks. Portfolios can be further protected by owning certain defensive assets like gold, as well as using idle cash to generate durable income to stabilize portfolio returns.

Financial markets have in the last two weeks begun to downplay the perceived policy put, and price in the growing risk of policy error. After the result of the US presidential election in November, the market narrative was largely that the risk of market selloffs would constrain the Trump administration from engaging in policies that might prove too economically disruptive. Over the last two weeks, however, expectations have darkened: The VIX equity volatility index has risen from under 15 to a high of 22; and the yields on both the 10-year US Treasury and 10-year TIPS have fallen 41bps and 32bps, respectively, reflecting rising growth concerns. More recently, the S&P 500 has joined in, falling as much as 4.6% in the last six sessions. Should investors still hold the course, or head for the hills?

In a nutshell, investors need to do both, to some extent. Complexity and uncertainty generate two-way risks, along with elevated levels of volatility. We have updated our key Messages in Focus to help investors navigate the current turbulence while still being well positioned to benefit from the medium-term economic fundamentals and policy support.

Stay invested, with more to go in stocks. Notwithstanding the slight tapering off in US economic momentum reflected in the latest data, we expect that underlying growth in the US will remain robust through the year. This should support global growth and underpins our view of global equities as Attractive. We anticipate MSCI AC World's EPS growing close to 10% this year and next, providing strong support for equities broadly.

Nevertheless, with the threat of tariffs looming, investors need to continue to be geographically selective. We find both the US and Asia ex-Japan Attractive. For the US, the key attractions are robust growth, lower policy rates in 2H, and exposure to artificial intelligence (AI). In Asia ex-Japan, India's robust domestic economy and Taiwan's key role in the AI theme underpin the region's allure.

We now additionally recommend German equities, which we suggest adding via structured strategies. We expect a growth-friendly shift in government policy to drive a broadening of the recent strong-but-narrowly-based rise in the DAX. Easing European monetary policy and bottoming European growth should also prove supportive.

Navigating rising political risks. Regardless of the healthy medium-term prospects for global growth, we believe it is imperative that investors protect their portfolios against the elevated levels of near-term risks. We continue to recommend allocating 5% of balanced USD-based portfolios to gold as a hedge, plus holding oil, and reducing the duration of bond segments of portfolios.

In response to recent developments, we have added a thematic basket of European stocks that are most exposed to six catalysts for robust performance. These are: (1) A cyclical economic recovery in Europe, (2) Post-election beneficiaries in Germany, (3) Rising security investments (defense and cyber), (4) Rebuilding Ukraine and a recovery in Eastern Europe, (5) Beneficiaries of lower energy costs in Europe, and (6) Globally active European companies with limited global trade risks (like service providers and firms focused on home markets).

Supplement returns with durable income. Investors holding excess cash should seek more diverse and durable sources of portfolio income, which can serve as a stabilizer for portfolio returns during volatile periods. We believe that high grade and investment grade bonds offer a compelling risk-reward tradeoff, while diversified fixed income strategies (like senior loans, and private credit, and equity income strategies) can help boost portfolio incomes while incurring lower levels of volatility.

Yields on high grade and investment grade bonds have started falling as markets start to price in growth concerns. While yields remain elevated, investors should optimize their cash holdings and lock in these yields at attractive levels.

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