Trade and fiscal uncertainty could continue to drive near-term volatility, but longer term, CIO sees further upside in stocks amid structural earnings growth, Fed rate cuts, and greater policy stability. (UBS)

Tariff headlines are in line with expectations for continued volatility

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Equity market volatility has picked up again after further twists and turns in trade talks between the US and Europe. US President Donald Trump on Sunday backed away from a threat to quickly impose 50% tariffs on European Union imports from 1 June following a "very nice call" with European Commission President Ursula Von der Leyen.

Trump is now suggesting a 9 July deadline for new 50% tariffs if negotiations with Europe fail to make progress, allowing several more weeks for talks. Von der Leyen in a statement vowed to "swiftly and decisively" advance talks with the US.

The prospect of renewed tariff escalation dampened the mood in equity markets last week, with the S&P 500 retreating 2.6% after gaining 5.3% in the prior week. Alongside the threat of higher EU tariffs, Trump separately threatened a 25% tariff on any Apple iPhones made outside the US and criticized the pace of trade talks with both Europe and China. Tensions also escalated last week when China accused the US of undermining negotiations by restricting Huawei's access to AI chips.

Even before the Sunday turnaround in EU-US headlines, markets had already priced in some skepticism that the most severe tariff threats would be implemented.

Fixed income markets also saw notable swings, with Treasury yields rising sharply after the House passed a version of President Trump's "One, Big, Beautiful Bill" and a 20-year auction saw weak demand, fueling concerns over US fiscal sustainability. In Japan, disappointing demand at a 20-year government bond auction pushed long-term yields to their highest level since 2000, prompting renewed warnings over the country's fiscal position.

The renewed "will he, won't he" tariff headlines are in line with our expectations for continued volatility, with sentiment remaining susceptible to shifting trade and fiscal narratives. While the latest reprieve for US-EU tariffs offers near-term relief, the risk of further escalation or volatility on new headlines remains clear.

What do we think?

While more time for EU-US negotiations is good news, the speed of the recent rebound in stocks suggests that investors may have become too optimistic on the path for trade discussions. At the start of last week, the S&P 500 had risen to within 3% of its all-time high and was up close to 20% from its low point on 8 April, when worries over the threat of a global trade war were at their most intense.

With high expectations already priced into markets, we recently downgraded our view on US equities to Neutral. President Trump's most recent interjections underline that risks remain, and a successful outcome to discussions cannot be taken for granted.

However, the recent roll-back of tariffs with China supports our view that forceful rhetoric will most likely eventually give way to pragmatism. We are also encouraged that more moderate voices in the administration, such as Treasury Secretary Scott Bessent, have been playing a more prominent role. Our base case is for the effective US tariff rate to end the year around 15%, with the possibility of additional product-specific tariffs. However, with such high levels of policy uncertainty, we see equal odds that tariffs will be higher than this range or lower, depending on the outcome of talks with key trading partners and the outcome of legal challenges to the president's authority to impose blanket tariffs.

Notably, European markets that were open on Friday when Trump made his initial threat saw relatively modest moves, suggesting investors viewed the threat as more of a negotiating tactic. In addition, listed companies typically produce where they sell so actual exports to the US from European listed companies are relatively small.

We also expect the US Treasury market to stabilize after the recent volatility. Despite Moody's decision earlier this month to strip the US of the country's last remaining AAA credit rating, the US's ability to repay debt is not under question, in our view. While there is a risk that deficit fears lead to progressively higher yields in the weeks ahead, we believe that the Fed and/or Trump administration would likely make adjustments in the event of disorderly markets. In our view, this means high grade and investment grade bonds represent good value at current levels for investors seeking portfolio income.

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