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Portfolio response to risk: Diversification with direction

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The first week of the new Trump administration has seen a recovery in risk assets. But the setback following the release of DeepSeek's lower-cost AI offering is a reminder that risks remain. Maintaining portfolio discipline via diversification and balance is imperative in this period of elevated uncertainty. Also, we would focus on some key areas with the potential to do well over the medium to long term, in addition to implementing defensive measures against spikes in risk aversion.

In the first trading week of the new Trump administration, risk appetite in markets recovered somewhat. The equity volatility index VIX fell from around 16 to below 15 (before jumping to 19 on the DeepSeek reveal), the S&P 500 rose 1.7%, and the broader MSCI ACWI rose 2.1%. These came amid a lack of immediate action on tariffs, which might have encouraged hopes of a less-disruptive tariff outcome.

We would, however, caution that such optimism is likely premature. Risks to the market remain, as shown by the slide in US tech stocks following the release of DeepSeek's lower-cost AI offering. In addition, we still expect volatility as the US negotiates over tariffs. But at the same time, there are clear signs of resilience in the US economy and the US Federal Reserve and other major central banks remain in easing mode. This creates an environment of heightened uncertainty and two-way risk

We believe that the best response to such unpredictability is to maintain discipline via a well-diversified portfolio. While diversified portfolios could in the short term underperform many asset classes and single securities, it should be remembered that this a “feature” and not a “bug.” By amalgamating asset classes with different drivers, and also uncorrelated returns, diversified portfolios tend to experience lower risk per unit of portfolio returns. This tends to lead to a smoother path of growth, a smaller magnitude of drawdowns, and faster recoveries.

Diversification though, can and should be improved via tactical fine-tuning. We suggest that investors focus their portfolios on some of the following key areas.

Equities still attractive, but be selective. Equities remain Attractive in our view, especially in the US and Asia ex-Japan. US equities are Attractive owing to robust growth, lower Fed rates ahead, and exposure to artificial intelligence (AI). Asia ex-Japan's resilient growth and youthful demographics gives its equities an appealing earnings growth profile, with 13% growth forecast in USD terms for 2025.

In terms of sectors, we continue to expect AI to be among the best investment opportunities this decade. While DeepSeek's aggressive pricing strategy questions the need for high capex intensity, its training methodology remains somewhat opaque, and its models are more limited, compared to the frontier models from big tech. Companies across the AI value chain look set to generate over USD 1.1tr in revenue by 2027. We recommend investors take advantage of extreme volatility through structures and buy the dip in quality stocks. The strong growth in AI is also set to spill over onto the power and resources segment, which is set to benefit from the ongoing global shift toward electrification and renewable energy. Electrifying of the global economy will require around USD 3 trillion in annual investments by 2030, driven by increasing electricity demand from AI data centers, electric vehicles, and industrial processes. This presents a significant opportunity for long-term investment returns.

But remember to guard against risks. Notwithstanding the solid US growth outlook, the less-cyclical, income-generating components of a diversified portfolio have a key role to play. We expect medium-duration high- end investment-grade bonds to provide a consistent income stream and help steady portfolios in 2025. Elevated yields offer an attractive chance to lock them in. We also like diversified fixed income and equity income strategies for sustainable yield and diversification.

Gold is another important way to bolster portfolios against a spike in risk aversion; we would allocate 5% of a balanced USD-based portfolio to gold, as a hedge. We expect gold to gain on geopolitical uncertainty, a longer global rate-cutting cycle, and strong ETF demand. Central bank demand for diversifying from the USD should also support the price of gold, as should a worsening US debt profile. We also see value in holding silver, which has a strong positive correlation with gold. Silver should also benefit from lower real US yields and stronger global industrial production in 2H2025.

Navigating political risks in the near term. With more details on Trump's trade policies likely to emerge in coming weeks, there are a few key strategies to reduce portfolio volatility and downside risks. Capital preservation strategies can be employed to help to limit losses while staying invested in stocks in markets most sensitive to US trade policy (especially Asia). These include using structured investment vehicles to protect against downside, and to add exposure in key structural themes like AI on selloffs. We would also concentrate our bond exposure to high-grade bonds around the five-year duration.

The risk from rising geopolitical tensions also warrants both going long USDCNY for 7.50 (to hedge the impact of tariffs on China), and selling downside risks in the price of oil (to hedge against reduced access to Russian and Iranian supply). Gold remains a key all-weather portfolio hedge against spikes in risk aversion.

Investors should not miss the opportunities in the ongoing volatility, but these should be accessed in a structured, systematic fashion via a balanced, diversified portfolio.

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