# QUARTERLY INVESTMENT OUTLOOK

APRIL 2025

STONEHAGE FLEMING

NOW AND FOR FUTURE GENERATIONS

## EXECUTIVE SUMMARY

In our April letter, we outline the following core views that underpin our investment strategy;

- **US sentiment has swung from fiercely optimistic in late 2024 to distinctly negative, as consumers, businesses and investors try to digest volatile tariff announcements.** In contrast to the widely held expectation of a US market friendly pro-growth agenda, President Trump's second term has begun with a clear prioritisation for aggressive reform.

- **US tariffs have created a 'confidence shock'.** Equity markets have declined as a result, as valuations re-price to lower multiples. Yet, the point of maximum uncertainty is likely marked by 'Liberation Day'. Further policy volatility is inevitable, but given multiple constraints facing the administration, a reprieve in trade hostilities can restore an expectation for US economic and corporate health from extremely low levels.

- **The US economic cycle has matured to a slower pace of employment and consumption growth than during 2021-2024 post-pandemic phase**. This gradual softening began before President Trump was elected. Signs of an imminent recession remain absent, but the risk of a US (and global) recession have undoubtedly increased.

- **Whilst the US economy is likely to slow, we see greater risks for those on the receiving end of punitive tariffs**. Europe and China, whose economies were already fragile against a backdrop of a weak manufacturing sector and soft consumer growth, now face a material headwind.

- **The geopolitical and fiscal shift in Europe is well-grounded, yet the sharp revival in market enthusiasm underestimates the challenges that remain**. Time is needed to see the evidence of structural reform and the associated economic benefits. Meanwhile, the region contends with Chinese industrial dominance and the impact of US tariffs.

- **Global equity markets are expected to experience shifting leadership and high volatility**, offering a more fertile environment for highly rated active managers than in recent years. The AI theme has evolved, with specialist investors capturing strong long-term opportunities outside of the early winners.

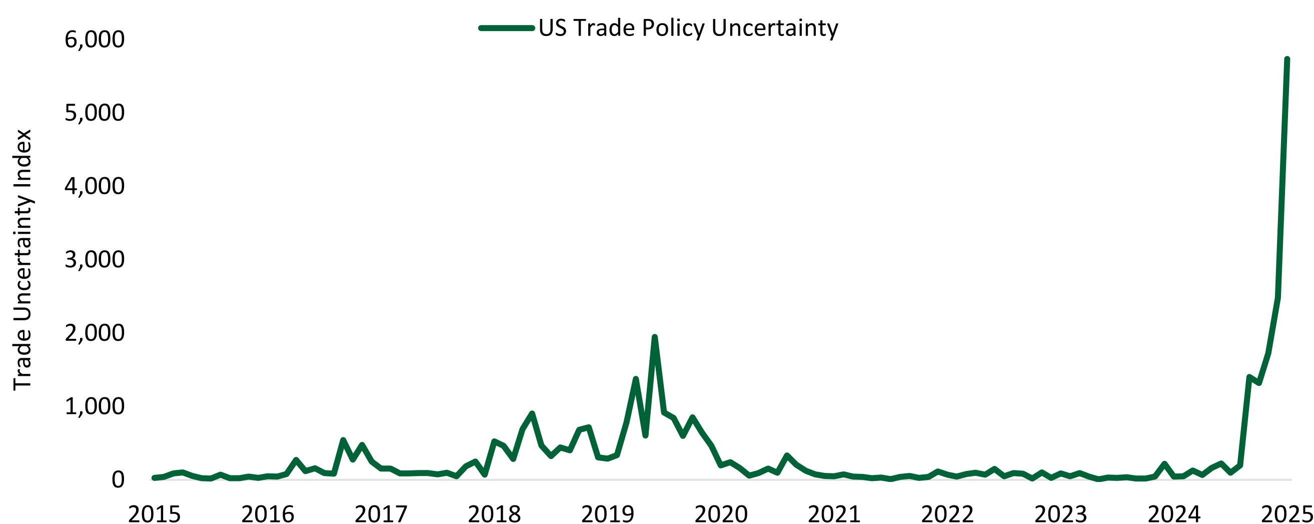
- **Our investment strategy retains a defensive character and we have taken steps to reduce investment in smaller, more economically sensitive companies in recent months.** Portfolios have benefited from key allocations to high quality sectors such as healthcare and insurance. This defensive bias extends beyond equity allocation, including physical gold and 7-10-year duration US Treasuries, which have risen strongly in recent weeks.

- **We retain conviction in the long-term potential of our diversified capital allocation,** and are highly alert for further developments in economic, geopolitical and policy landscape with key implications for our strategy.

## INTRODUCTION

In contrast to the widely held expectation of a US market friendly pro-growth agenda, President Trump's second term has begun with a clear prioritisation for aggressive reform. At this early stage, he has targeted geopolitical realignment, protectionism and government efficiencies (i.e. 'DOGE'). The somewhat erratic approach to government has lifted uncertainty to levels unseen since the onset of the 2020 pandemic (chart 1[1]), culminating in 'Liberation Day' announcements of draconian tariff policy. In addition, the investment landscape is evolving rapidly; the superiority of the US equity market is maturing, with competitive advantage within technology harder to sustain.

*Chart 1: Policy Uncertainty Surges*




The speed of these developments has shaken market confidence in the first quarter of 2025. **US sentiment has swung from fiercely optimistic in late 2024 to distinctly negative, as consumers, businesses and investors try to digest volatile tariff announcements.** Having risen 25% in 2024, the S&P 500 Index declined c. 8% so far this year[2], led by weakness in the 'magnificent 7' technology stocks, whilst the US Dollar has also depreciated c. 6%[3].

Meanwhile, commonly made predictions of a persistent European slump appear misplaced. The US agenda has revived European appetite for fiscal expansion, targeting stronger defence capabilities and higher investment. 'Peak pessimism' towards the region appears to have passed, with depressed equity valuations supporting a c. 4%[4] return to start the year, despite tariff-related volatility.

In late 2024, we interpreted the upward adjustment of US growth expectations with a healthy dose of scepticism, noting in January how "*we consider a moderation in US growth and inflation, with elevated volatility in investor sentiment, as the most likely environment for 2025.*"

**Today, the imposition of severe tariffs by the US has created a considerable macro headwind, with yet unclear implications for the global growth and the broader investment picture.** In our April Investment Outlook, we explore the potential economic impact of these tariffs and outline how we are positioned to reflect a more defensive stance.

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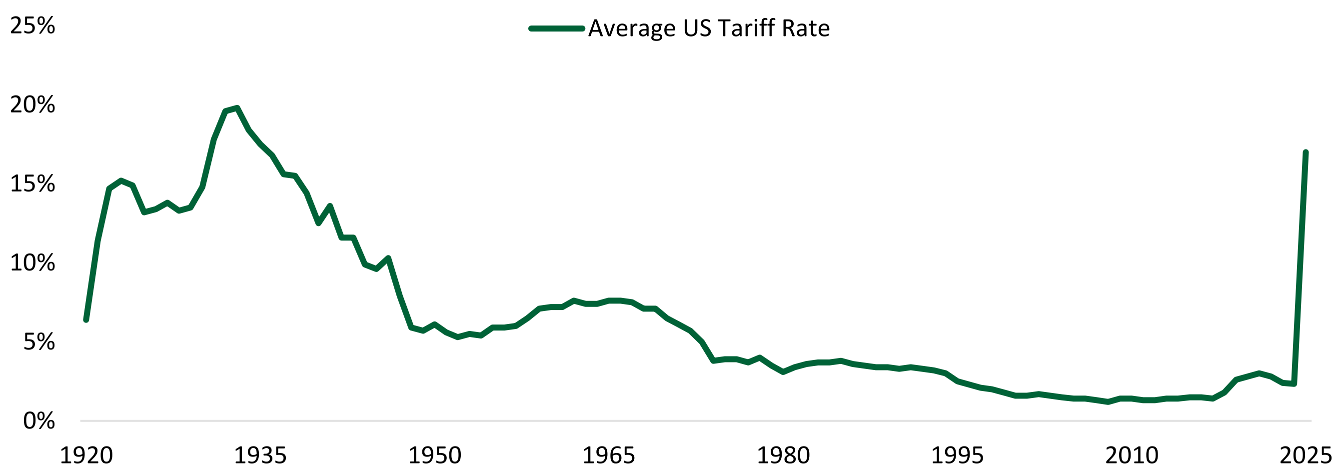
*[1] Source: Bloomberg, Baker Bloom & Davis, Feb 2025*
*[2] Source: Bloomberg, USD, 03 April 2025*
*[3] Source: Bloomberg, trade-weighted USD index, 03 April 2025*
*[4] Source: Bloomberg, EUR, 03 April 2025*

## Section 1. Tariffed: Navigating Trump 2.0

Whilst President Trump's agenda is multi-faceted, the most pressing consideration for investors is the accelerating trade war with allies and adversaries alike. Following the rollout of a 10% universal tariff, plus much higher levies for key trade partners (i.e. China, Europe, Vietnam), the effective import tax has risen 8 times, to c. 17% (chart 2[5]). As Michael Gapen, Chief US Economist for Morgan Stanley argued[6], the announcement is "*probably the biggest attempt to fundamentally reshape the tax-trade structure in the U.S. since Nixon took us off the gold standard in the early 1970s*."

*Chart 2: US Protectionism Returns to the 1930s*




With this context, there are three primary considerations; What are the implications for the US economy, in absolute terms and relative to others? What constrains President Trump from a 'maximalist' approach? How should investment strategy reflect these developments?

### 1.1 US Recession Fears: on the precipice?

Before investigating the economic impact of recently announced tariffs it is worth reflecting on how distorted this economic cycle has been. Conventional signals of recession, particularly the sharp rise in interest rates in 2022, proved to be unreliable. What many analysts and investors missed was the importance of excess savings that drove reopening service spending, and the abundance of job vacancies making it easier for workers to find employment and negotiate higher wages. This 'economic insulation' meant that higher rates could be absorbed by the consumer, and inflation could fall without the widely predicted recession.

**Since the pandemic, our investment strategy has been predicated on a recognition that the US household sector is more resilient to economic shocks than widely assumed**. As we noted in October 2022 "*excess savings are estimated at c. $1.4trillion, or 5.6% of GDP. This gives consumers a powerful cushion against higher costs*".

Over the course of time, pandemic distortions have been largely resolved. This means that excess savings have been spent, job vacancies have normalised, and higher interest rates are starting to bite. In other words, the 'powerful cushion' of 2-3 years ago is not as convincing as it once was.

**Does this mean we should expect an imminent recession? Not in isolation. The US economic cycle has matured; growth is in the process of moderating as the prior momentum in consumer spending and employment growth fades.** This is not alarming in itself; the economy has been growing well above historical norms and a modest slowdown to longer term trends should not overwhelm households or impede quality companies' ability to grow earnings over time.

[5] *Source: Strategas Research Partners, 03 April 2025.*
[6] *Source: Wall Street Journal, Morgan Stanley, 03 April 2025.*

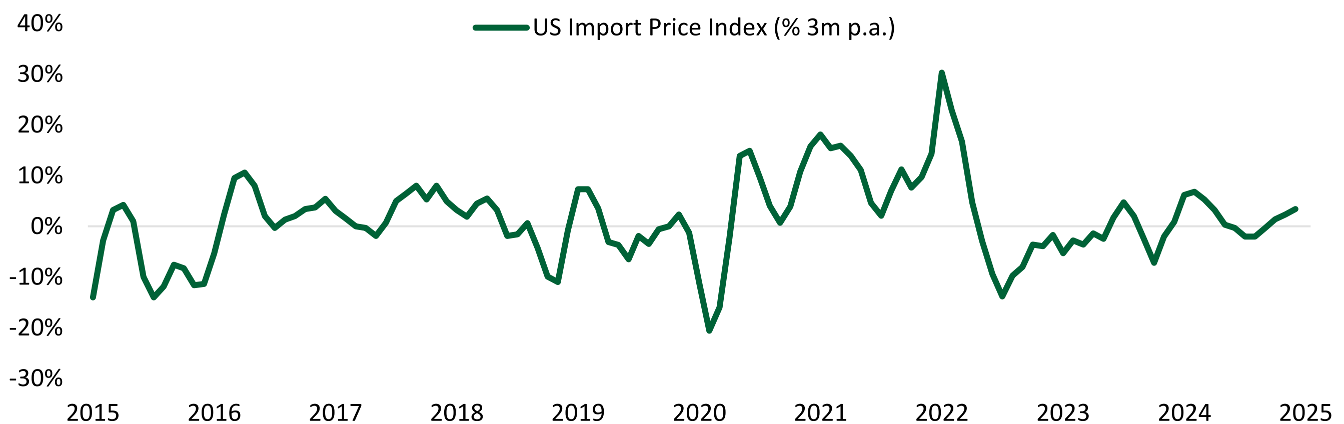
However, the outlook is muddied by the uncertainty surrounding the US political agenda and impact of tariffs. As Jan Hatzius, Chief Economist of Goldman Sachs recently explained[7] having downgraded 2025 growth forecasts "*the main reason for the downgrade is not the recent data, and the US economy benefits from several tailwinds. The reason for the downgrade is that our trade policy assumptions have become considerably more adverse and the administration is managing expectations towards tariff-induced near-term economic weakness*."

The question that follows is whether the imposition of tariffs will act to derail the economy, leading to a broad contraction in activity. We approach this through the impact on prices and consumer spending.

### 1.2 Inflation contained

Having spiked in 2022, import prices have made little progress since, increasing at an historically typical rate in recent months. The concern is that tariffs lift import prices meaningfully, feeding a broader trend of higher inflation (chart 3[8]).

*Chart 3: No Signs of Life in Import Price Inflation (yet)*




There are three mitigating factors which we believe can prevent sustained upward inflation.

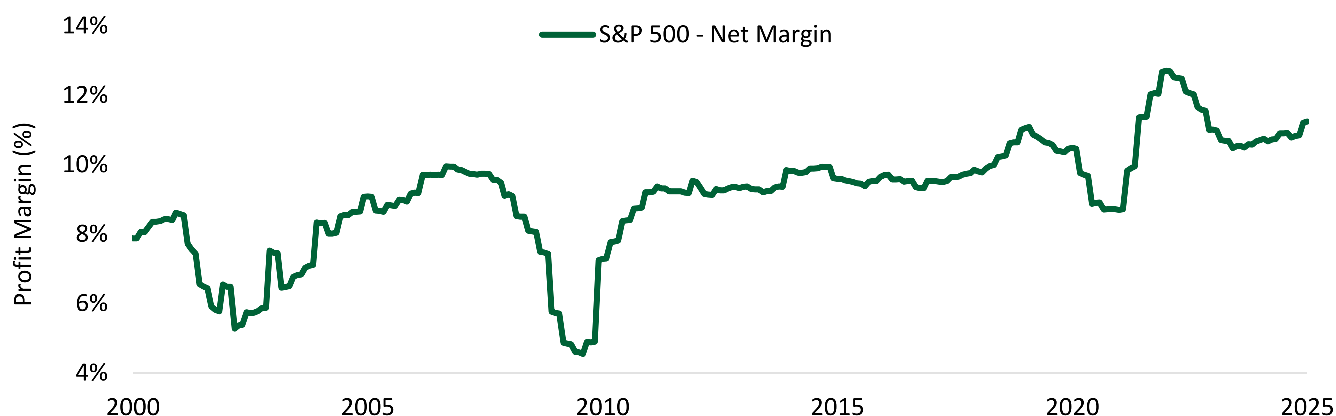
**Firstly, the extent that higher inflation expectations drive realised inflation is primarily down to the health of the labour market.** In an environment when employers are struggling to retain and recruit staff, higher expected inflation gives workers more bargaining power in wage negotiations. This was particularly the case in 2022, and a key driver of the 1970's stagflation environment.

The difference today is that the labour market is softening, with declining job vacancies and employment growth, while layoffs have risen (partly a consequence of 'DOGE' actions). Even if 'tariff noise' is driving up expected inflation in the years to come, there is limited evidence of workers being able to use it to their advantage. The link with realised inflation is rather tenuous in this case.

**Secondly, US corporations are in a strong position to absorb higher import costs, with historically high profit margins (chart 4[9]).** The complexity of global supply chains and uncertainty that still surrounds import levies will prevent widespread restructuring, yet we anticipate an element of 'offset' by global US businesses. This should limit the pass-through to consumer prices.

*[7] Source: Goldman Sachs Global Investment Research, March 2025, "Global Views: From Above to Below", excerpt shortened.*
*[8] Source: Bloomberg, April 2025.*
*[9] Source: Factset, March 2025*

*Chart 4: Tariffs Imposed When Profitability is High*



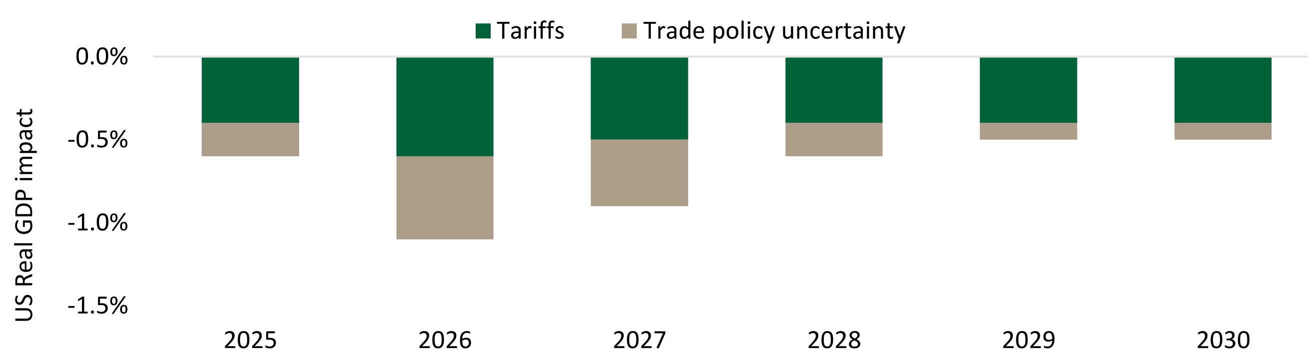

**Finally, the Federal Reserve remains in a 'restrictive' setting, which means that interest rates are set to slow growth and inflation**. Beyond the initial impact of higher import costs, slower consumer activity should continue to act as a headwind to price pressures. In other words, as Federal Reserve Chair Powell recently summarised "*we expect the (tariff-induced inflation) trend to be short-lived and not embed itself into the broader economy*[10]*.*"

**Our outlook assumes that the consequences of tariffs are not 'systemically inflationary',** with broader disinflationary drivers, particularly the labour and housing market, still in-tact. **We suspect lower interest rates will follow sooner than widely expected, as it becomes clear that a repeat of 2022 is not unfolding.**

### 1.3 The cost of uncertainty

In addition to potentially higher prices, the US economy is also facing a sharp uncertainty shock. Given the volatile nature of President Trump's policy announcements, businesses have largely abstained from strategic decisions concerning capital investment, hiring or supply chain structure in recent months. As the IMF modelled in October last year, high policy uncertainty acts as a meaningful drag on economic growth (chart 5[11]).

*Chart 5: Uncertainty Exacerbates the Impact of Tariffs Themselves*




**However, in the absence of an acute crisis, the transmission of higher uncertainty to consumer activity is not immediate or straightforward.** The health of the labour market is critical in this respect. It will take time for businesses to adjust hiring plans, compensation gains and announce layoffs should their outlook deteriorate. Only 8 weeks ago the economy was evidently robust, with real consumption growing at 2.5-3.0% per annum.

Much will depend on further announcements, particularly retaliatory measures from major trading partners. **Yet we retain our view that the US economy is slowing, not collapsing.** At the current time the widespread pessimism that has been reflected in market pricing may be overstated.

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*[10] Source: Federal Reserve Chair Jerome Powell, 19 March 2025 press conference.*
*[11] Source: IMF Economic Outlook, October 2024.*

### 1.4 Too Bearish, Too Soon

Scott Bessent, US Treasury Secretary, was reported as saying that the latest tariff proposals are a ceiling, with the potential for downward negotiation.[12] There are good reasons to be cautious on any expectation of future Trump policies, but is the president constrained from unleashing further havoc?

**Whilst President Trump may have a strong desire to reshape global trade at all costs, there are multiple constraints that will likely contain the severity of future policy shifts.** Economic deterioration, stock market decline and voter disapproval cannot simply be ignored. Already, we note the rhetoric from some members of Trump's administration shifting towards "fairness" and a baseline for negotiations. There is also evidence that some Republican senators are aligning with Democratic resolutions. Whilst symbolic at this stage, such action could threaten President Trump's majority in Congress.

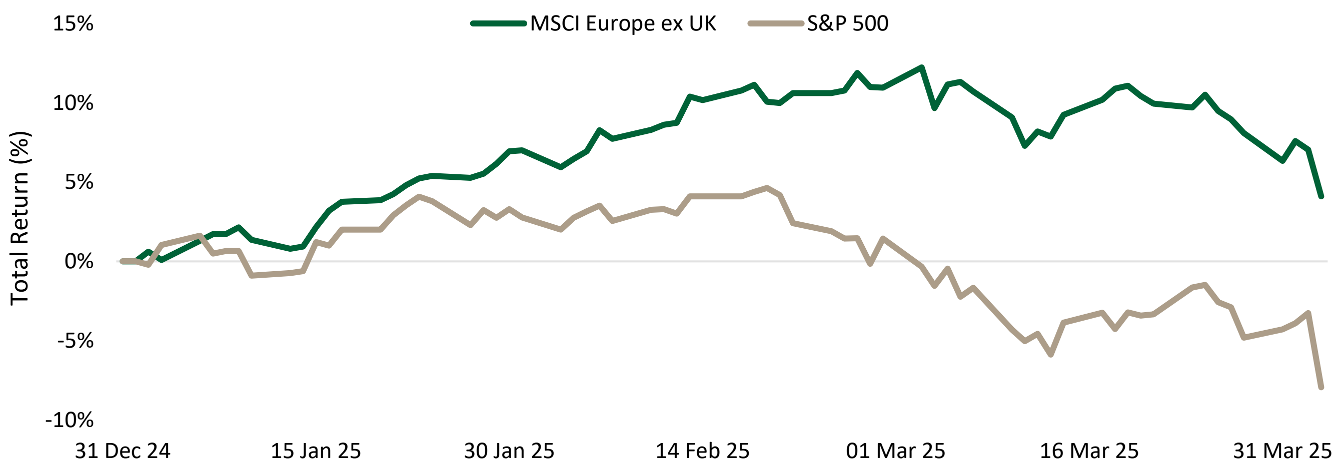
**From the perspective of investors, markets often find support when uncertainty is at its highest point**. We are reminded of how the 23rd March 2020 marked the lowest point in equity markets, when widespread lockdown policy began (to the day for the UK). As Marko Papic, Chief Strategist at BCA Global Research argues, "*Our take is that April 2 will be remembered – 6-12 months from now – as the peak in the "de-globalisation" thesis. Markets react to the delta of bad news, not bad news in the absolute*."

### 1.5 European Renaissance: Turning point?

Despite widespread pessimism at the start of the year, the European equity market has meaningfully outperformed the US so far this year (see chart 6[13]).

**This unexpected revival has been driven primarily by two things**; firstly, a significant divergence in **sentiment and valuation** at the start of the year, and secondly, signs of **a well-grounded geopolitical and fiscal shift** that could support a structural improvement in European growth potential.

*Chart 6: European Equities Have Held up Well*




**Under the leadership of CDU leader and presumptive Chancellor Friedrich Merz, the German political landscape is shifting towards a more expansive fiscal approach.** The newly formed coalition recently passed a monumental €500 billion fiscal package dedicated to defence and infrastructure spending. This package represents approximately 2% of Germany's GDP, which is substantial in a historical context (see chart 7[14]), and marks a significant departure from the conservative status-quo.

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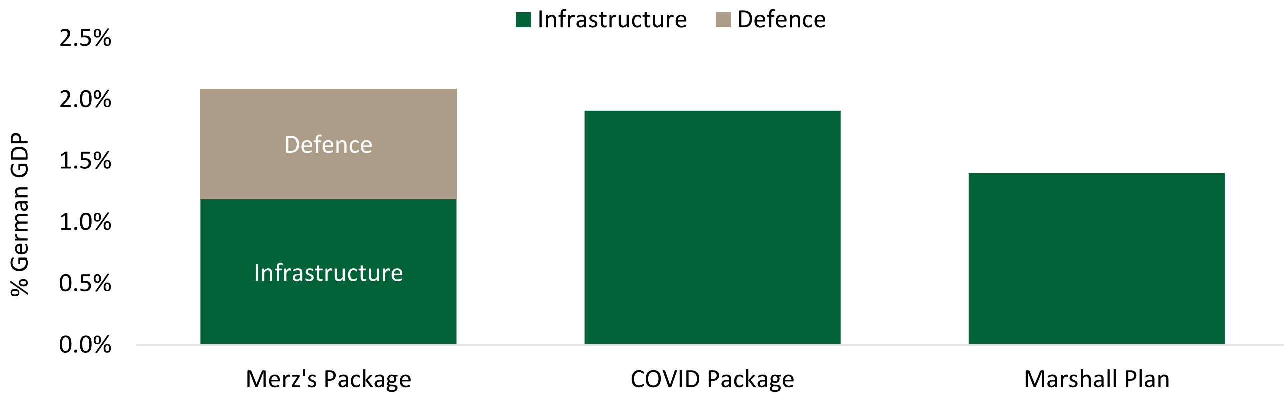
[12] *Source: Wall Street Journal, 03 April 2025.*
[13] *Source: Bloomberg, local currency, 03 April 2025.*
[14] *Source: Factset, TS Lombard, SFIM estimates, March 2025*

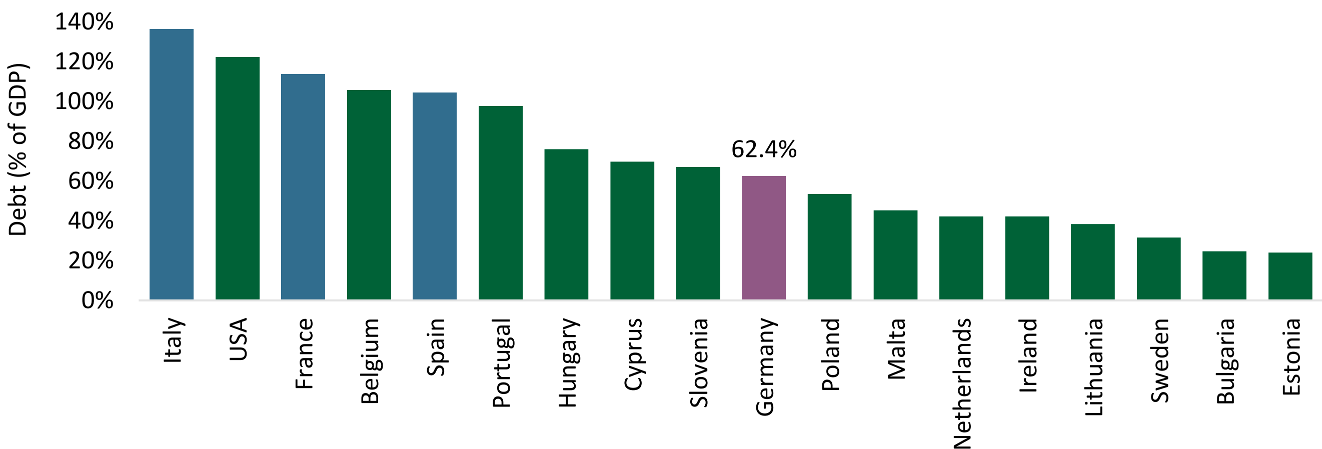
*Chart 7: Unprecedented German Fiscal Package*




**Recent progress towards a Ukraine-Russia ceasefire has also boosted consumer and business confidence.** Although a resolution of the conflict is only likely over several stages, reduced hostilities and the potential return of Russian natural gas could lower energy prices. This would support German manufacturing, which has faced significant challenges over the past three years.

**Over the long term, we consider these developments as potentially supportive for European economic and market performance.** Yet, there are a few qualifications to make. Importantly, other major European countries such as Italy, Spain and France do not share Germany's borrowing capacity (chart[15]). Further alignment is also needed between Southern and Northern economies regarding potential financing tools, be it EU bonds, defence bonds, cheap loans, or grants, illustrating the political challenges that lie ahead.

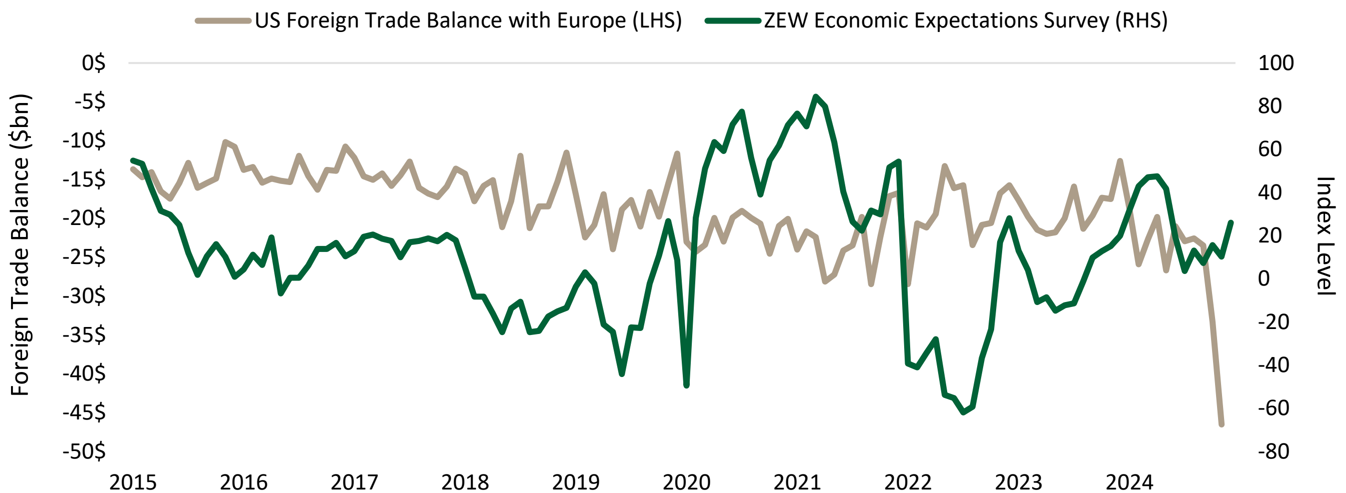
*Chart 7: Major European Economies Have Limited Fiscal Capacity*




**In the near term, US tariffs will weigh on activity, raising recession risks for an economy which, like the US, has a thinner buffer than in recent years.** Encouraging European economic indicators so far this year (see chart 8[16]) may be partly attributed to tariff front-running, which boosts new orders in advance of higher import levies. Stockpiling and increased tariffs are likely to weigh on activity in the coming months, which could also be dampened by rising bond yields and a stronger euro.

*[15] Source: Factset, Dec 2024.*
*[16] Source: Factset, US Census Bureau, March 2025.*

*Chart 8: Economic Recovery Likely to Diminish as Tariffs Take Effect*




### 1.6 Who suffers more?

At a global scale, the imposition of tariffs could either trigger a new round of trade negotiations or escalate further, with severe retaliatory measures. In either scenario, the consequences for global growth are notably negative in the near term.

**Whilst these actions act to weigh on growth for the US, the headwind for Europe and China is likely to be more pronounced.** In Europe, the fallout is expected to hit the automotive, pharmaceutical, and luxury goods sectors hardest. The automobile industry, in particular, is highly exposed, with autos and auto parts forming a major share of EU exports to the US. With already thin margins and weakening order books, European manufacturers are likely to suffer, especially in Germany where the sector plays a vital role in employment and growth.

**China, meanwhile, faces growing headwinds from both reduced global demand and the erosion of benefits previously gained by re-routing exports through countries** like Vietnam—now also subject to sizeable tariff. Consequently, electronics, machinery and textiles will be hurt the most.

**Importantly, export growth is integral to the Chinese growth model, and is central to President Trump's ambition to rebalance global trade**. In response, Chinese policymakers are likely to roll out targeted easing measures to support domestic demand and cushion the economy from the latest tariff shock. Chinese authorities will nonetheless resist sharp currency depreciation, preventing large scale interventions, despite pressures from reduced trade flows.

In summary:

- **Liberation Day tariffs have created a 'confidence shock' for a mature US economy with a thinner consumer buffer than in recent years.**
- **Signs of imminent recession remain absent, but there is little doubt that macro risks have risen**. Inflation should remain on a downward trajectory over time despite higher import costs, which will support lower interest rates from the Federal Reserve. **Our central view remains that US growth is slowing, but it is not collapsing.**
- **Whilst the US economy is likely to slow, we see greater risks for those on the receiving end of punitive tariffs.** Europe and China, whose economies were already fragile against a backdrop of a weak manufacturing sector and soft consumer growth, now face a material headwind.

- **The point of maximum uncertainty is likely marked by 'Liberation Day'**. Further policy volatility is inevitable, but given multiple constraints facing the administration, a reprieve in trade hostilities can restore an expectation for US economic and corporate health from extremely low levels.
- **History guides us to favour continued engagement with equities when uncertainty is at its highest**. Whilst further volatility is inevitable as this trade war develops, we retain conviction in a broadly diversified and defensively tilted investment strategy, with long term structural growth opportunities at the core.

## Section 2. Investment Strategy: Combining Defensiveness with Structural Growth

An important aspect of our long-term strategy is to capture the potential gains in the technology sector, which has seen meaningful rotation of fortunes in recent months.

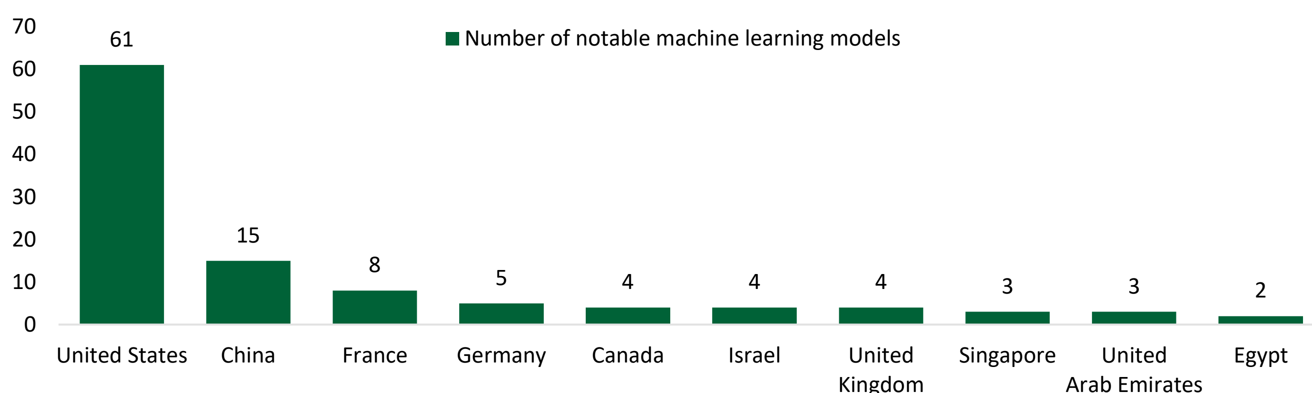
### 2.1 AI and Technology: shifting sands

Technological superiority is recognised as the cornerstone of economic prosperity, military strength, and geopolitical influence. The US has long enjoyed a significant advantage in this domain due to factors such as entrepreneurial culture, network effects, access to capital, immigration, and post-war trends where leading academics moved to the US. However, there are signs this is shifting.

Over the last few decades, other nations, notably China, have made significant strides. A recent report from a leading Australian think-tank[17] tracking innovation based on patents in critical technologies found that the US, having led in 60 of 64 technologies from 2003 to 2007, has fallen to leading in only 7 in the most recent five years (2019–2023). Conversely, China, which led in just 3 of 64 technologies in 2003–2007, is now the lead country in 57 of 64 technologies.

**Despite this, the US has maintained strength in high-impact research in key technology areas** (chart 9[18]). However, these capabilities have become increasingly concentrated in a handful of large technology companies. The US has also recognised China's rise, realising deficiencies in critical minerals required for semiconductor manufacturing, stale defence capabilities, and reliance on Taiwan. This has prompted further investment and policy support, such as the CHIPS and Science Act, reshoring incentives, and recent political rhetoric regarding Ukraine and Greenland.

*Chart 9: US Retains a Lead in AI Development*




For investors, this has important implications. Large US technology companies make up a significant proportion of global equity markets and enjoy strong moats and quality characteristics. However, the release of DeepSeek's new Large Language Model (LLM) challenges the assumption of a strong competitive edge, marking a new phase for the AI industry.

[17] *Source. ASPI's two-decade Critical Technology Tracker: The rewards of long-term research investment. August 2024.*
[18] *Source. Stamford HAI Artificial Intelligence Index Report. 2024*

**While US technological leadership remains strong, it can no longer be taken for granted.** The US and technology sector remain notable allocations within our equity exposure, but selectivity within these areas is critical, recognising that some technology companies' valuations are elevated, and pure market cap exposure leaves investors more exposed than historically to a scenario where these companies and the US lose their dominance. **The active managers we invest in have the potential to navigate this shifting environment and the increased dispersion between winners and losers.**

### 2.2 Leaning Defensive

**The US economic cycle has matured and the imposition of US tariffs creates a macro headwind with yet unknown magnitude or duration.** Our analysis informs us that the US economy has a good chance of withstanding this shock, and we have likely passed the point of maximum uncertainty where tariff policy is concerned.

**Yet recession risks are undoubtedly higher than at the start of the year.** Our positioning has reflected an expectation for moderating growth for the past year, and we have taken steps to reduce investment in smaller, more economically sensitive companies in recent months. Our portfolios have benefited from a defensive character across our multi-asset strategy, with high quality sectors such as healthcare and insurance central to our long-term equity strategy. This defensive bias extends beyond equity allocation, including physical gold and 7-10-year duration US Treasuries, which have risen strongly in recent weeks.

**We retain conviction in the long-term potential of our diversified capital allocation,** and are highly alert for further developments in economic, geopolitical and policy landscape with key implications for our strategy.

**Stonehage Fleming Investment Management**
**Chief Investment Officer Group**
**04 April 2025**

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