Parmenion
Investment Management

Q2 Macro Outlook

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Summary

US and global growth are slowing as tariffs and DOGE take their toll on US business and consumer confidence

A global trade war continues to threaten global growth, while US fiscal policy has shifted from tailwind to headwind. However, pro-growth elements of Trump's plan, like tax cuts and deregulation, are still on the agenda.

Risk of stagflation or even recession challenges the concept of US exceptionalism, as government policy turns inward

Core inflation remains elevated, with risk of near-term spikes. The Fed is wary of unpredictable government policy and the need to focus on re-establishing their inflation fighting credibility.

A change in the world order is underway, with the EU learning to stand on its own two feet

Rising defence and infrastructure spending in Europe is shifting the GDP growth trajectory. Fiscal prudence is now giving way to fiscal expansion.

Rotation is shifting market leadership and investment opportunities

Improving earnings growth outside the US, and cheaper valuations are leading investors to rebalance towards previously lagging markets.

China remains investable and counter cyclical - useful in a diversified portfolio

DeepSeek reminded investors that the US does not have a monopoly on AI. Coordinated Chinese government policy support is slowly rekindling business and consumer confidence.

Income as a style is set to shine in a lower return environment

In an uncertain, slower-growth world, reliable income offers diversification, resilience, and stability for portfolios.

For financial professionals only

What's the outlook?

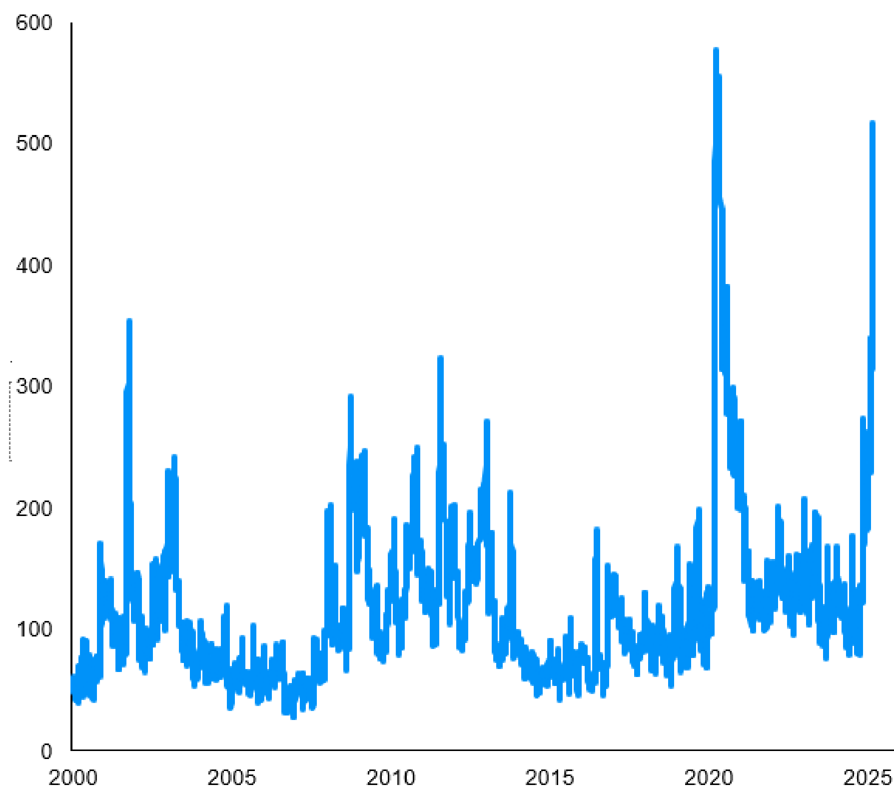
Global growth is becoming increasingly uncertain.

The US, once a source of stability and leadership, has turned inward - leading to a drop in domestic business and consumer confidence. At the same time, the EU is undergoing a major fiscal shift. Together, these developments are creating both risks and opportunities for investors.

Coming into 2025, investors were excited about Trump's pro-growth policies and the prospect of a 'soft landing'. Moderating inflation raised expectations that the Fed (Federal Reserve) could cut interest rates steadily through the year. The introduction of tariffs and policies to cut back government inefficiency was known about but not focused on.

What actually happened is that pro-growth policies of tax cuts and deregulation (that need congressional approval and therefore take longer) have taken a back seat. Executive order driven policies of tariffs, immigration and government cost cutting in the form of DOGE (Department of Government Efficiency) have been prioritised.

The result: a softening of growth momentum in the US, upward pressure on near term inflation and a weakening of sentiment. It's not surprising that investors have started to question the sustainability of US exceptionalism and the valuation premium that comes with it.



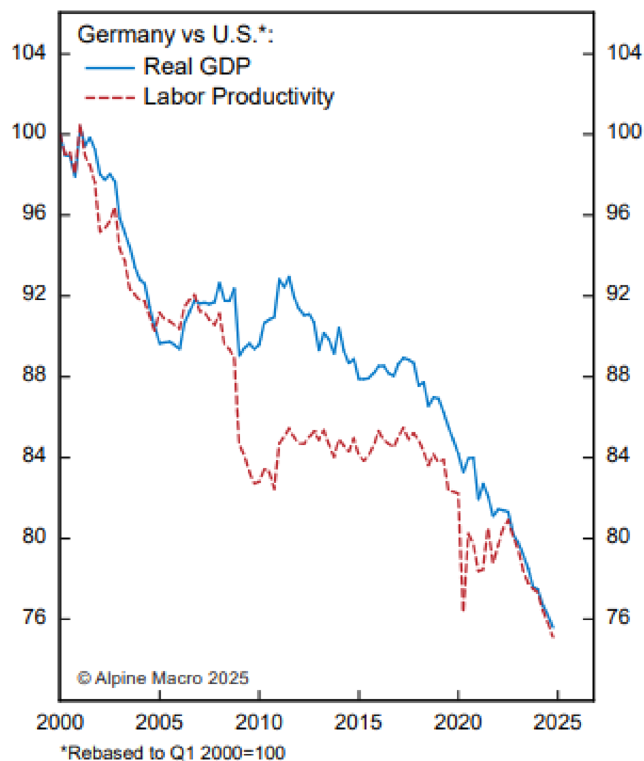
Source: Baker, Bloom and Davis, 17 March 2025.

Diverging fiscal policies

While US fiscal policy contracts, European fiscal policy is turning decisively expansionary, spearheaded by the relaxation of Germany's 'debt brake'. The election of Friedrich Merz' CDU party, plus the need for Europe to stand up on its own two feet from a defence perspective, has led to greater EU cohesion and a focus on stimulative defence and infrastructure policies.

Defence expenditure greater than 1% of GDP can now sit outside the German Bundestag debt rules. Sixteen states that previously needed balanced budgets can now run deficits of up to 0.35%. A new €500bn infrastructure fund has been created. These moves are forecast to add about 1% to German GDP growth per year over the next decade, more than doubling recent growth rates.

History shows that defence expenditure, which tends to be technology oriented, positively spills over into private sector productivity. Given this has been a problem for EU growth, we could now see a significant shift in the economic outlook for the region. And with the EU Commission also announcing a €150bn loan package for defence investment, EU coordination and solidarity appears to be strengthening.



Source: Alpine Macro, March 2025.

As growth differentials narrow globally, both in GDP and corporate earnings, asset allocators will look to rebalance portfolios to lean in to relatively attractive international opportunities. We believe the era of TINA (there is no alternative) is behind us, supporting our long-term belief in global diversification.

Trump's stagflationary tariffs

Under the guise of a national emergency, Trump issued a tsunami of executive orders including trade tariffs initially on Canada, Mexico and China, and then more universally on 'liberation day' on 2nd April. The increase in costs this represents for domestic and foreign businesses selling into the US is not yet known but will be significant. Just as challenging is the unpredictability about how permanent the tariffs will be and at what level. Previous assumptions that Trump was using tariffs as a short-term negotiating tool seem to be mistaken. Instead, investors are adjusting to the fact that Trump will see this through and there will be some pain, but that it will be worth it in the long run.

> "There'll be a little disturbance, but we're OK with that."
> President Donald J. Trump

The implication is that inflation will rise in the near term as higher costs are passed through, weighing on consumption, slowing corporate revenue growth, reducing capital expenditure, which will slow economic growth and - raise the prospect of stagflation. 10-year US Treasuries have already started to reflect this trend, with yields compressing down towards 4.0%.

Key to the outlook is the resilience of the US consumer. As long as the labour market holds up, the US economy is expected to muddle through, just at a slower pace. However, if labour hoarding by corporates reverses – along with mass federal redundancies under Musk's DOGE programme – there's a real risk unemployment will spike. That would trigger the Sahm rule - historically a reliable indicator of an impending recession.

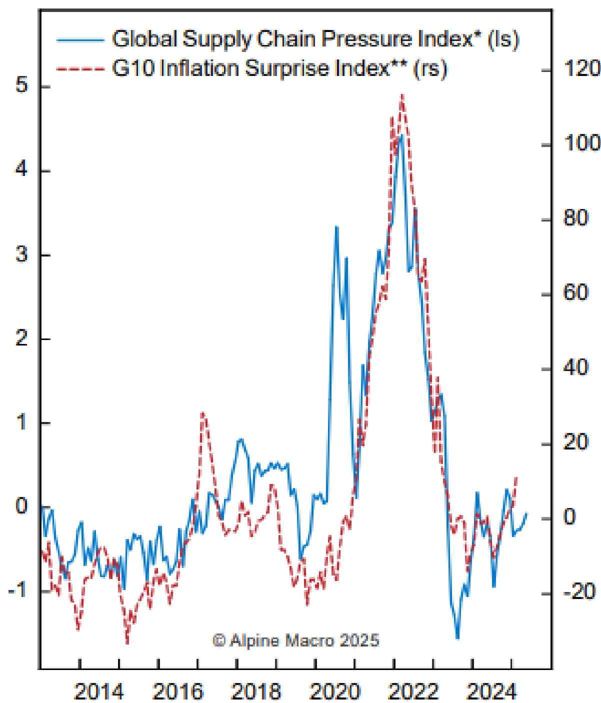
We're watching this closely but for now, our base case is not a recession. However, to protect against the risk we continue to lean into global government bonds. These typically do well in a slower growth environment.

Fed put?

'Fed put' is when the Fed step in to buoy markets if prices fall below a certain level. US inflation is way down from the post Covid spikes of 2022/23, yet still far above the central bank target of 2%. The cause, primarily, is sticky wage inflation, courtesy of strong labour markets. This appears to be abating in the US and EU, but not in the UK. If it does persist in the US and the shelter component (which makes up 18% of the core CPI basket) continues to decline, the Fed will be in a better position to cut rates - at least in line with market expectations - by the end of 2025.

Source: Macrobond and Columbia Threadneedle Investments, 25 March 2025.

However, any Fed put is complicated by the rollout of tariffs, especially if other countries retaliate - triggering a global trade war. Global supply chains are expected to be affected, inflating input costs and potentially driving long term inflation expectations higher – as occurred post Covid. This would threaten the Fed's message that tariff effects are one-offs and 'transitory'. They may need to move more cautiously to protect their inflation fighting credibility.



Source: Federal Reserve Bank of New York and Citi, February 2025.

De-dollarisation

Typically, higher tariffs lead to a stronger currency. Curiously, since announcing the plan to introduce tariffs the US dollar has weakened. Slower growth, lower interest rate differentials and asset allocators reducing US overweight exposure are just some of the factors that help explain this shift. However, there is a more structural dynamic underway, which is foreign central banks reducing their holdings of US Treasuries and increasing their purchases of other safe assets, including gold.

The west's confiscation of Russian overseas assets following the invasion of Ukraine made it a priority for foreign governments and central banks to reduce exposure to US dollar-based assets. Central banks have shifted from buying on average 500 tonnes of gold per annum to just over 1,000 - a trend that looks likely to persist.

Also, while the US dollar is unlikely to lose its global reserve currency status, the mounting debt and expanding fiscal deficits projected by the Congressional Budget Office are leading investors to seek alternative safe haven assets. That puts additional downward pressure on the dollar.

Wealth effects work both ways

Since the global financial crisis, the US has enjoyed a prolonged period of capital market appreciation. Superior growth, productivity, technology leadership and execution have justified this, and the entrepreneurial zeal of the country means it won't simply disappear. There's also a strong equity savings culture in the US , so the average

US household has benefitted from the market rise. However, if the market declines for a period of time, with the average US household more exposed to the US market than ever, those currently buoyant customers may start to experience a sinking feeling, referred to as a negative wealth effect.

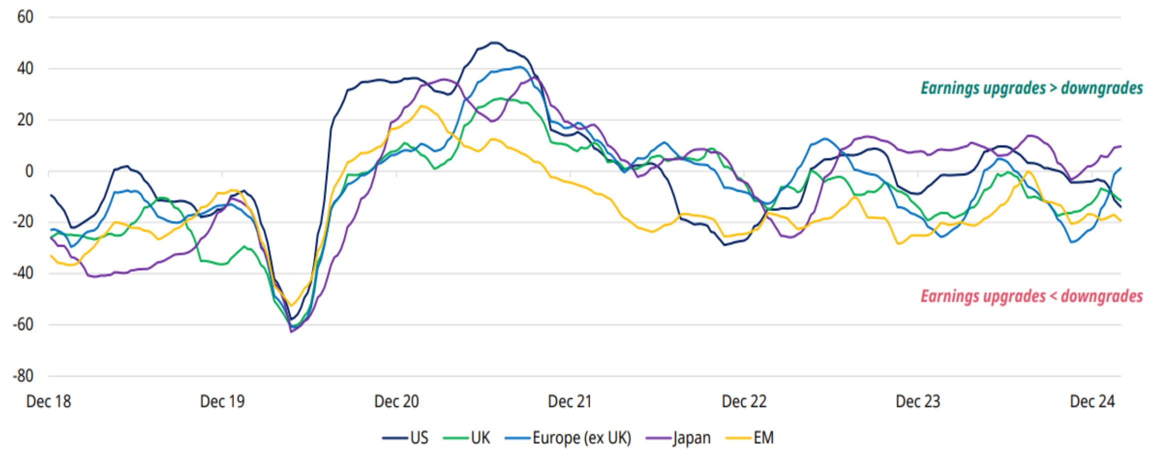
Source: Federal Reserve, LSEG Datastream and Schroders, Q2 2024.

Where are the opportunities for investors?

The great rotation

European outperformance year-to-date has been driven by a combination of valuation re-rating, earnings growth and increased asset allocations. With further upward revisions to earnings forecasts expected, Europe looks well placed to benefit from improving sentiment and positive flow of funds.

The change in market leadership has been stark but represents a healthy correction. US underperformance has been led by the Magnificent 7 as their valuations have fallen from a toppy 32x forward PE (price-to-earnings) to 26.6x. Further downgrades are likely as uncertain US government policy leads to a moderation in growth forecasts. By contrast, scope for relative upside surprise in non-US markets is capturing investors' attention, led by Europe and Japan.

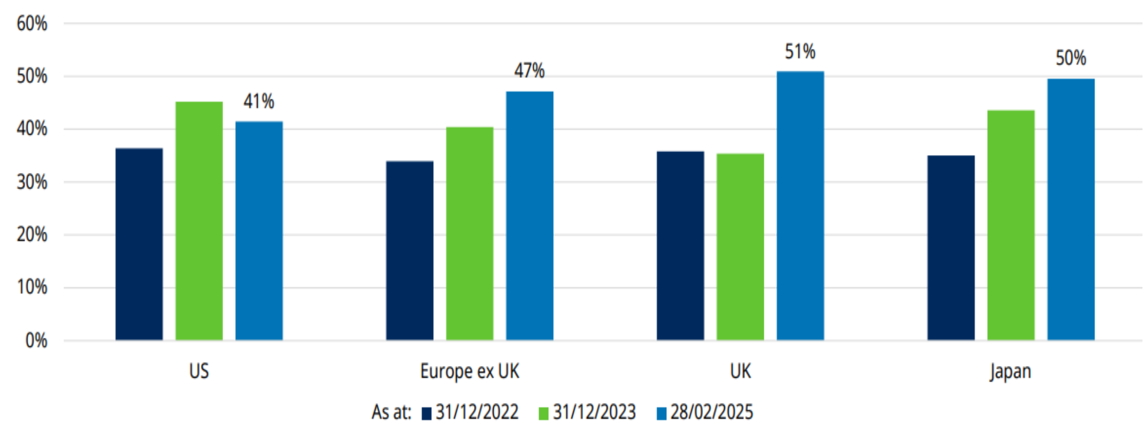


Source: LSEG Datastream and Schroders Strategic Research Unit, 28 February 2025.

There's also been a notable shift in leadership in investment style, with value outperforming growth and momentum losing its dominance.

Non-US markets have greater exposure to financials, healthcare, industrials and materials, so this shift in investor bias is aiding their relative returns.

At a market level, valuations are not compellingly cheap. Beneath the surface, there are selective opportunities to be found, though, with potential sources of alpha for good active managers. This applies just as much to the US as it does globally, reinforcing our belief in a genuinely diversified portfolio.

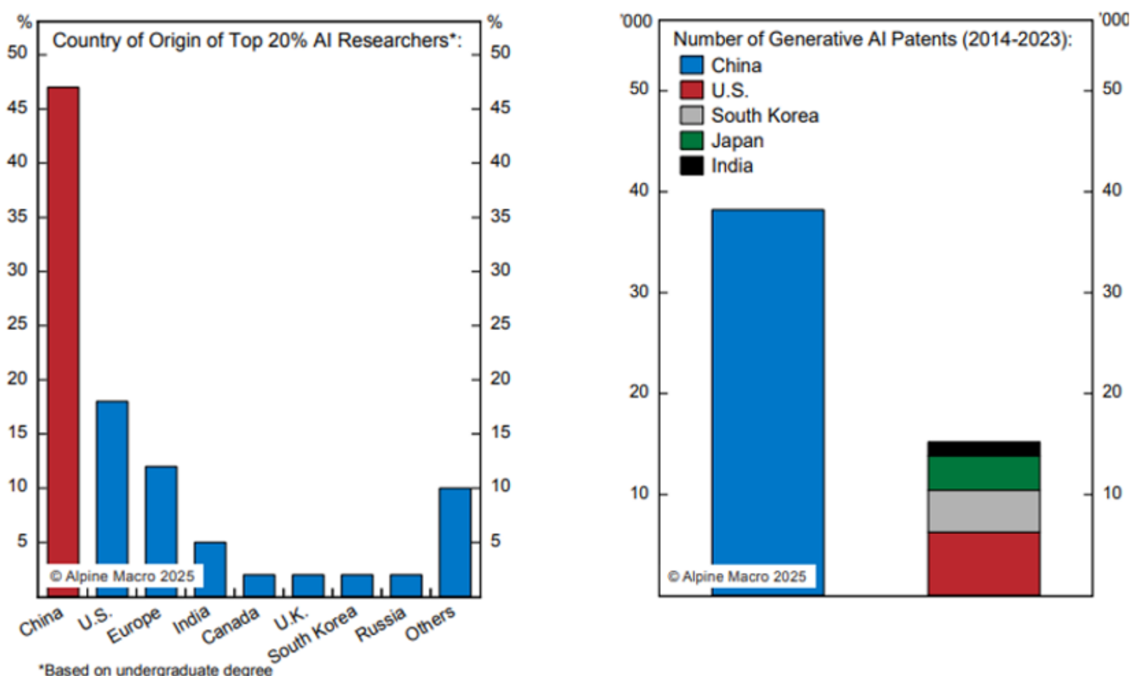


Source: LSEG Datastream, MSCI and Schroders Strategic Research Unit, 28 February 2025.

China's investable and counter-cyclical

Emerging markets had a strong 2024, rising over 14% in sterling terms. Much of this only came through when Chinese policy turned explicitly stimulative at the end of September. The combination of supporting the consumer, high-end manufacturing, infrastructure, property and equity markets reminded investors that China is investable.

In January, DeepSeek's open-source AI capability shone a light on China's technological competitiveness. Their large pool of technology engineers, AI patents and lower cost of production was a revelation for many investors. The irony is that it was limited access to US cutting edge tech hardware and software that forced China to use what they've got – and that turned out to be competitive from an output perspective at a fraction of the cost.



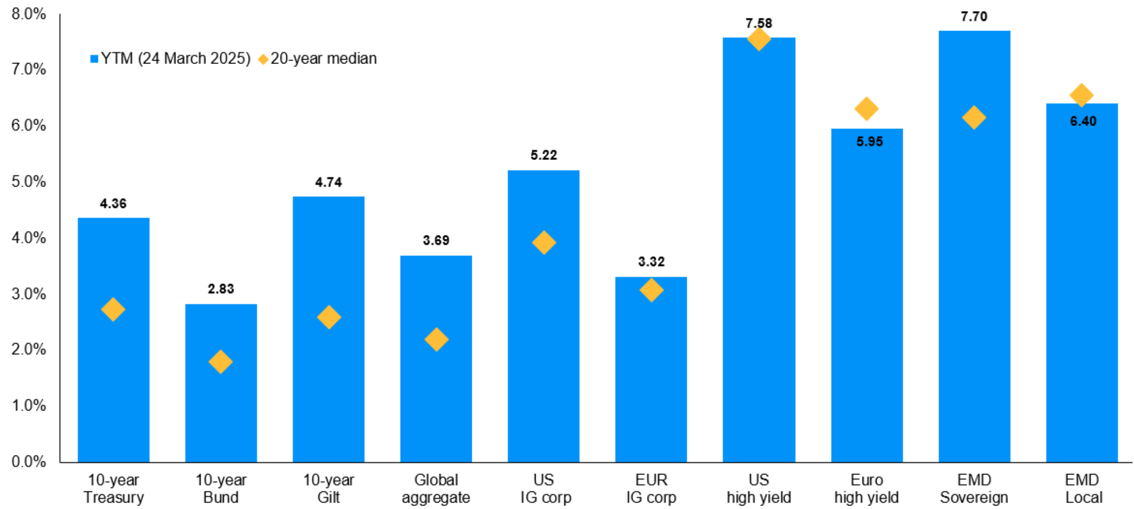
Source: Macro Polo, CSET, UNESCO, WIPO Patent Landscape Report on Generative AI, Alpine Macro, January 2025.

The other notable shift has been Xi Jinping's positive support of the private sector. The new focus on reviving entrepreneurism following the crackdown of 2021 is a welcome change and beginning to show in improving macroeconomic data. As it gains traction, it will reaffirm China's counter-cyclical traits. This is hugely helpful within a diversified multi-asset portfolio.

In a low return environment, income will become more valued

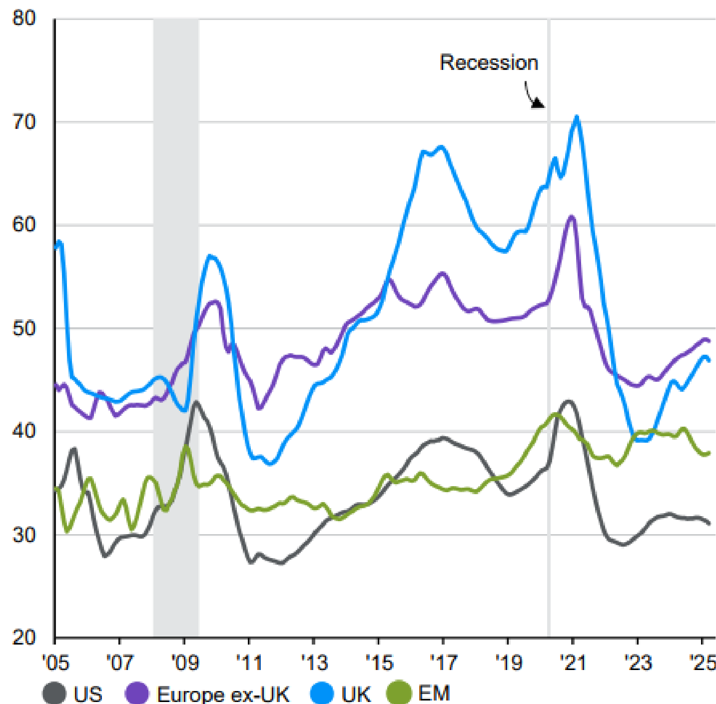
In an increasingly uncertain world, with returns expected to be more modest than in recent years, income is set to play an increasingly important role. While global equity dividends are forecast to grow by over 7% per annum over the next five years, according to J.P. Morgan Asset Management, current yields across government bonds (over 4%), investment grade bonds (around 5%), and high yield bonds (around 7%) offer an encouraging breadth of opportunity for income-focused investors.

Even if global growth falls short, central banks have room to cut rates, which could also drive capital gains. Combined with attractive nominal yields we believe this represents reasonable compensation for the longer duration exposure.



Source: Bloomberg, ICE indices and J.P. Morgan Asset Management, 24 March 2025.

Payout ratios remain modest, share buybacks are on the rise (especially non-US), and resilient, cash generative businesses seem well positioned to work through the ongoing global uncertainty. We expect these high-quality income-generating businesses will increasingly gain favour with investors.



Source: FTSE, LSEG Datastream, MSCI, S&P Global and J.P. Morgan Asset Management, 27 March 2025.

If interest rates do nudge down, a portion of $9+ trillion that's sitting in fixed-term deposits and money market funds globally is likely to rotate into fixed interest and dividend income equities – another increase in demand.

Hedging against inflation spikes

With the US rolling out universal tariffs (Liberation Day), the risk of higher input costs through the global supply chain rises. Combined with aging populations, mounting debts, decarbonisation and geopolitical risks, this elevates the risk of inflationary spikes.

To help protect portfolios, it's important to maintain exposure to real assets like infrastructure, commodities and real estate. While these assets don't remove the risk, they will help to cushion the impact, by providing diversification and returns that don't move in lockstep with traditional markets.

Final thoughts

There's been a big shift in the global world order. The US is turning increasingly inward, while structural changes in Europe's fiscal policies is raising the prospect of faster long-term growth and improved productivity.

For investors, this opens up opportunity – but as always, execution is everything. Markets will have their twists and turns. Staying disciplined and nimble is vital, as is maintaining diversification and avoiding crowded trades.

Switch off from the political noise, keep your focus on the long-term and the power of compounding will help you progress towards your financial goals.

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