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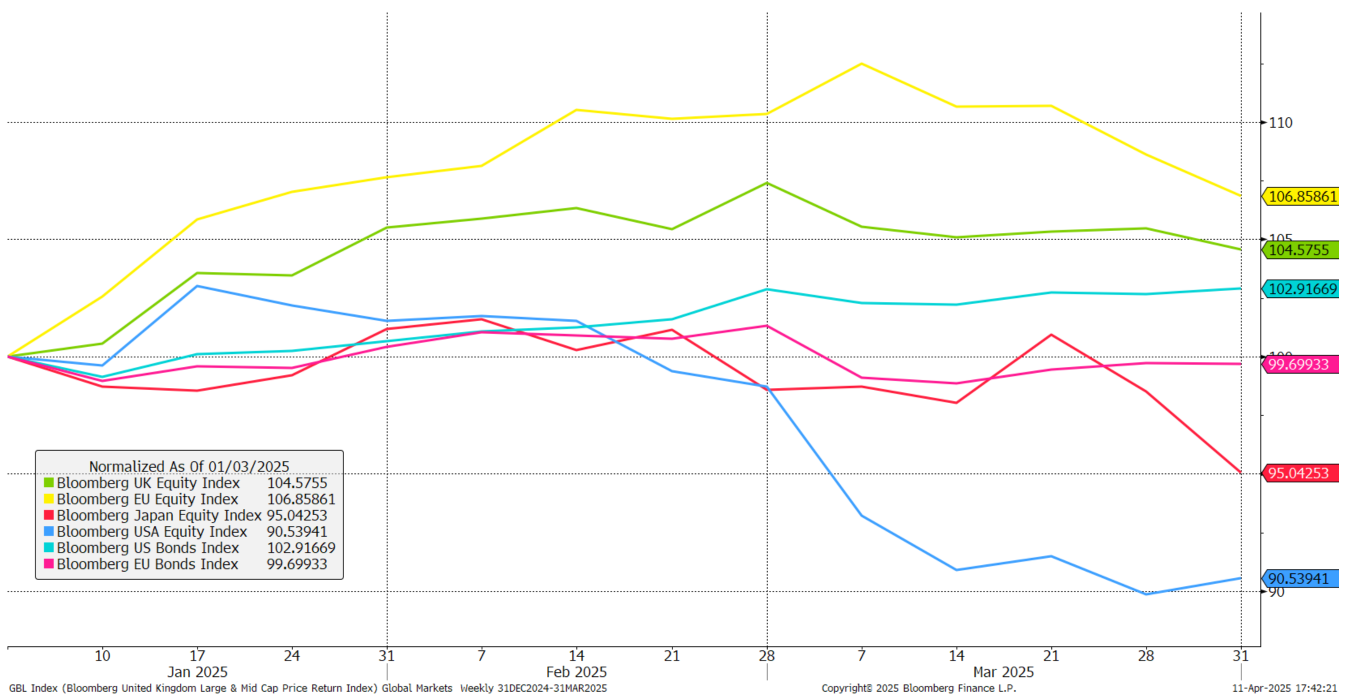
Introduction and Market Overview

As we entered 2025, we were mindful that markets might be underestimating the risks associated with early policy signals from the new Trump administration. The campaign's emphasis on trade tariffs raised concerns that these measures, if enacted, could reignite inflationary pressures and weigh on global growth prospects. Nonetheless, many investors appeared reassured, believing that a Republican-led government would reinforce the theme of US exceptionalism.

That confidence was soon put to the test. Rising policy uncertainty quickly dented sentiment and renewed fears of a US recession. By contrast, Europe saw a significant uplift in investor confidence, as Germany's shift towards a more expansive fiscal regime marked a turning point. This divergence in political direction triggered a notable decoupling in global equity and bond markets.

US equity markets initially picked up where they had left off in 2024, with the S&P 500 reaching an all-time high in February. However, this momentum faded as growth stocks reversed course, and many of 2024's standout performers saw sharp declines. Tariff concerns resurfaced and cast a shadow over market sentiment. On the positive side, US bonds rallied as concerns about economic slowdown outweighed persistent inflation and fading hopes of imminent interest rate cuts by the Federal Reserve.

Major Markets Total Return in Q1 2025 (%, rebased to 100)



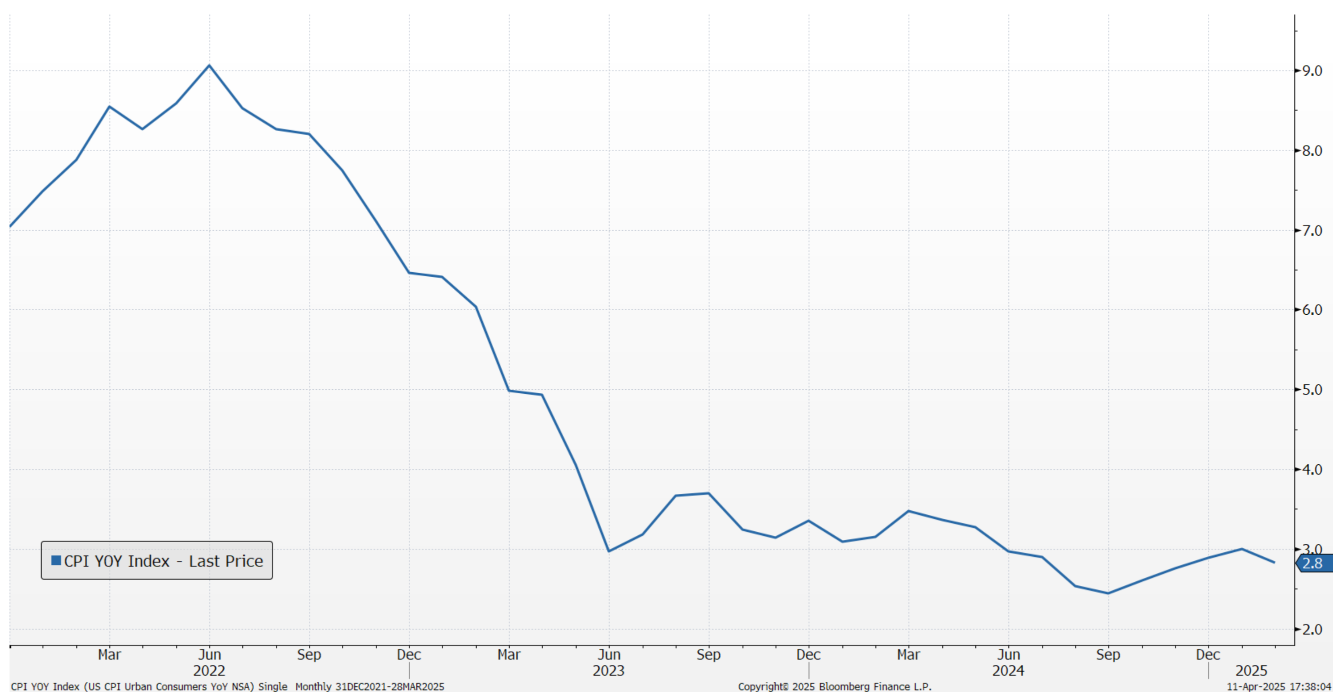
Source: Bloomberg

The Fed opted to hold rates steady through the quarter, though in its March meeting, Chair Jerome Powell indicated that future rate cuts remained on the table. This signalled a greater concern about downside risks to growth than the threat of further inflation.

Meanwhile, January's breakthrough in artificial intelligence by China's DeepSeek led to a broad reassessment of positioning in US large-cap technology stocks. Investors began to rotate out of concentrated holdings and into underappreciated areas of the market. Concerns also grew around the potential impact of new trade tariffs and proposed public sector job cuts by the newly established Department of Government Efficiency. These changes could put pressure on US consumers, who remain the backbone of the economy.

In March, the Federal Reserve lowered its 2025 US growth forecast from 2.1% to 1.7%, citing increased policy uncertainty. At the same time, it nudged its inflation outlook up to 2.7%. Inflation has come down markedly since its highs in 2022 but has remained stubbornly above the 2% Fed target and has been showing signs of creeping up recently.

US CPI Inflation (% YOY)



Source: Bloomberg

While US policymakers grappled with the conflicting demands of economic support and inflation control, European leaders surprised markets with a coordinated and ambitious fiscal response. Germany's likely new Chancellor, Friedrich Merz, proposed a €500 billion infrastructure plan and relaxed fiscal rules for defence spending. Simultaneously, the European Commission unveiled an €800 billion defence spending initiative, a major policy shift that helped lift European equities.

Despite this optimism, the increased likelihood of substantial debt issuance provided a headwind for European sovereign bonds, even after the European Central Bank delivered two 0.25% rate cuts. Chinese equities outperformed during the quarter, climbing 12%. Government stimulus measures, including rate cuts, support for the property sector, and liquidity injections, stabilised the economy and restored confidence. In addition, DeepSeek's AI breakthrough elevated the market's view of China's technology sector and rekindled optimism about the country's long-term growth prospects.

In the UK, equities posted solid gains, largely driven by stronger performance from large-cap companies. However, small and mid-sized firms continued to struggle amid ongoing concerns around economic resilience and fiscal headroom. The UK Spring Statement added to these concerns. Chancellor Rachel Reeves announced £8.4 billion in spending cuts to remain compliant with fiscal rules, raising further questions about the UK's ability to stimulate growth in the near term. Despite narrowly avoiding a technical recession at the end of 2024, investor sentiment remained cautious.

UK GDP Growth (% YOY)

Source: Bloomberg

Bond markets reflected these diverging economic narratives. US bonds performed well, supported by growing recession risks. In contrast, European bond returns were held back by expectations of increased issuance. UK gilt yields ended the quarter slightly higher, reflecting a mix of stagflationary concerns and fiscal vulnerability.

The more confrontational stance of the US administration had a galvanising effect on European policymakers, while in the US, richly valued technology and consumer stocks, heavily represented in passive indices, experienced significant declines. We maintained only modest exposure to these names in client portfolios, favouring instead a more defensive tilt and holdings with more attractive valuations. This approach helped preserve value during the quarter's turbulent conditions.

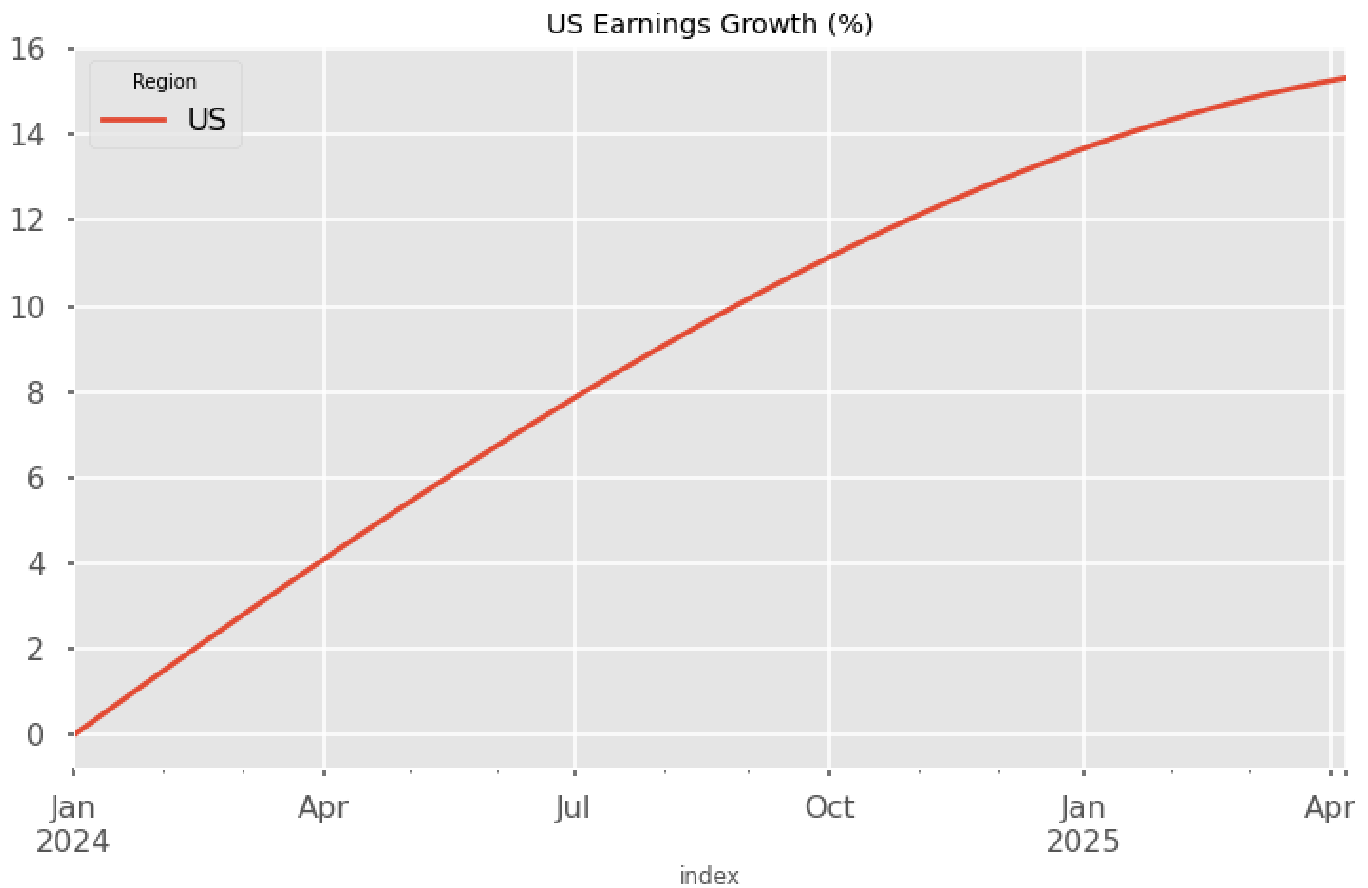
Value Stocks and Growth Stocks Total Return in Q1 2025 (%)

Source: Bloomberg

Looking ahead, the volatility seen at the start of 2025 seems unlikely to fade in the near term. Markets are adjusting to the shifting landscape of government policy, and investors should prepare for continued fluctuations. However, there is cause for optimism: diversification has started to pay off once again. This was evident in both equity and bond markets during the first quarter. Falling bond yields in the US helped offset equity losses, while in Europe, strong equity performance partially counterbalanced bond market headwinds. At the regional and sector levels, the return of market breadth has given us more tools to build resilient portfolios.

Despite negative returns for US equities, corporate earnings were generally strong in the first quarter. Manufacturing activity also showed signs of a recovery, possibly reflecting increased business activity and inventory restocking ahead of anticipated tariffs. While tariff-related headlines have dominated the narrative, potential tax cuts and deregulation later in the year could provide more market-friendly news and support equity markets.

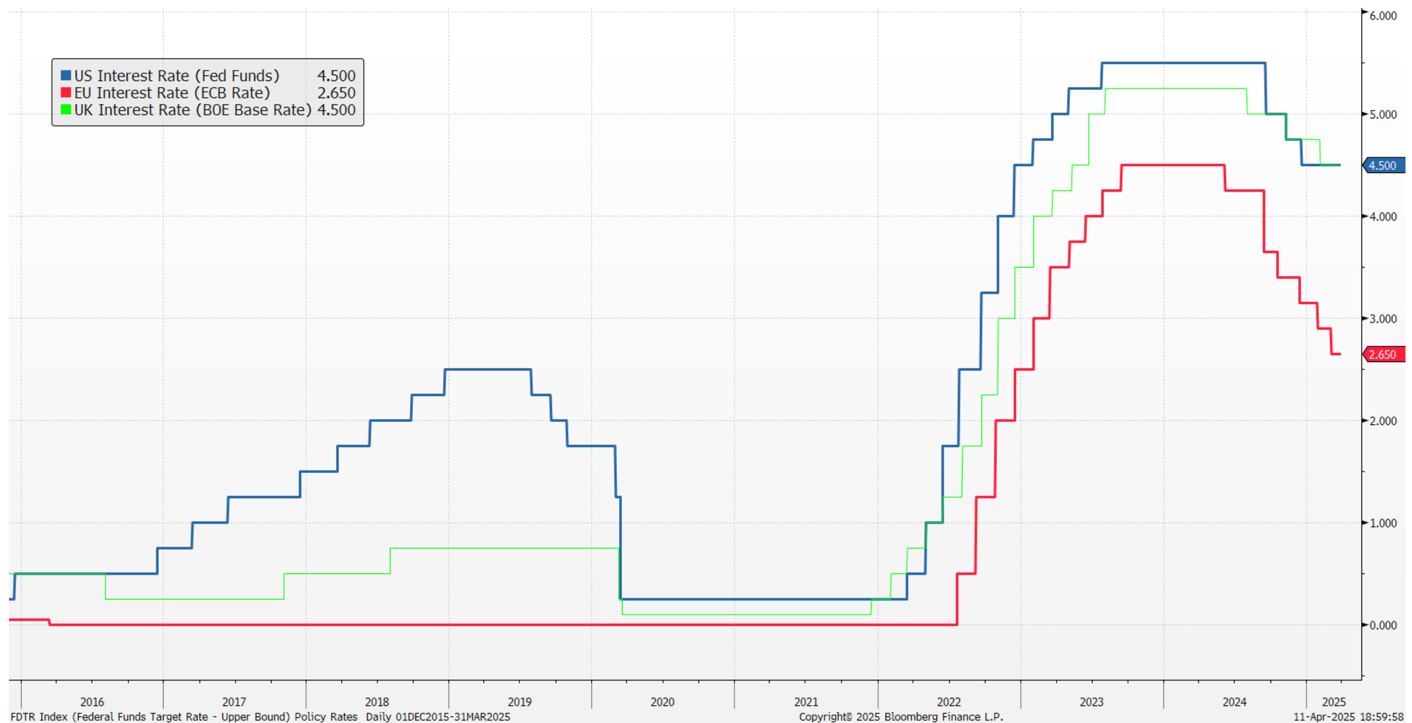
US Corporate Earnings Growth



Source: Bloomberg

Although uncertainty around trade policy remains a near-term challenge, central banks are in a favourable position to respond if conditions deteriorate. Most have room to cut interest rates, which would be a welcome development for consumers, corporates, and governments alike. So far this year, bonds have shown a helpful negative correlation with equities, reinforcing the value of a diversified portfolio. Unless inflation surprises significantly on the upside, this dynamic is likely to persist.

Major Central Bank Interest rates (%)

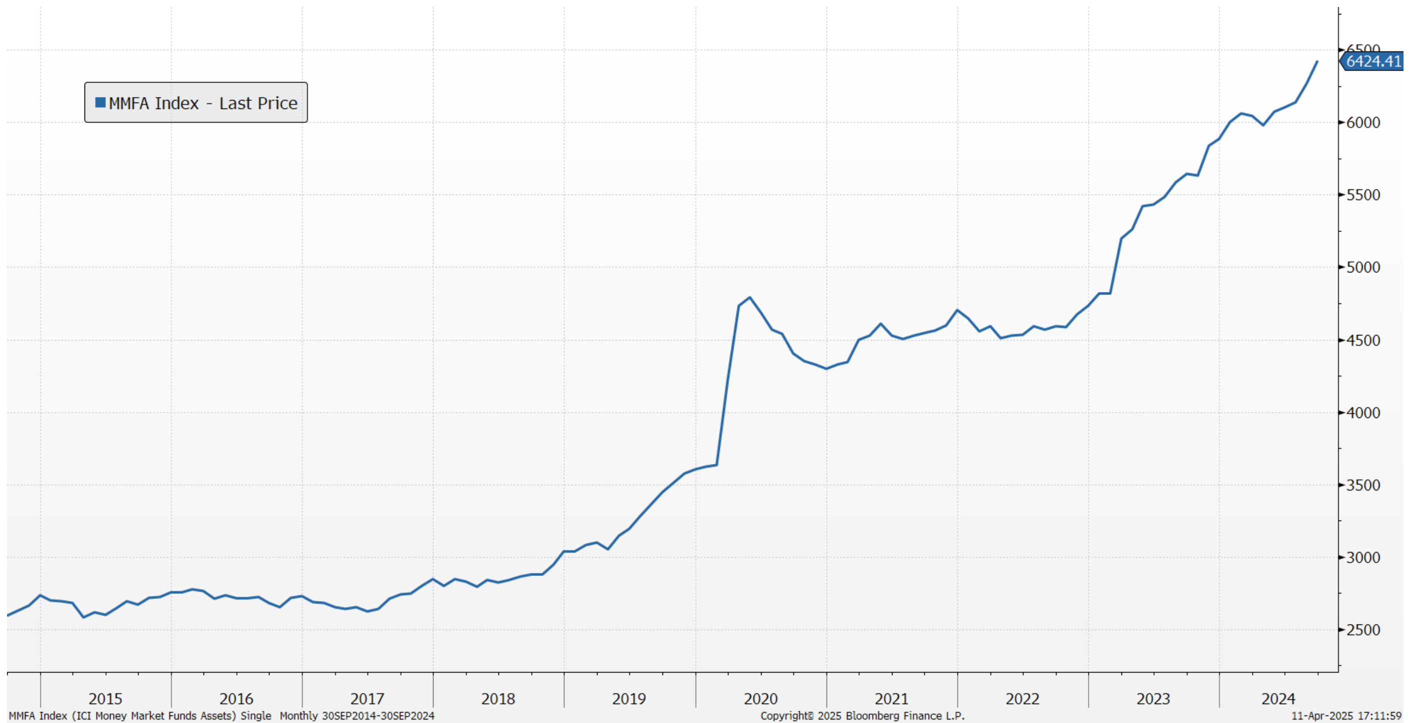


Source: Bloomberg

Importantly, the fundamentals that have supported markets remain intact. Corporate profits are rising, employment remains strong, and consumers are continuing to spend. Central banks, meanwhile, have already started the process of easing. Lower interest rates, paired with potential tax cuts and deregulation from the Trump administration, could help underpin asset prices. There is also considerable cash on the sidelines, around $7.2 trillion in US money market funds, which could be drawn into risk assets as rate cuts progress.

Inflation, while lower than a year ago, remains above central bank targets. However, we believe that monetary authorities will be willing to tolerate inflation above target levels in order to support growth and employment. This should help sustain asset prices.

US Money Market Fund Holdings (USD BN)



Source: Bloomberg

There has long been a belief in a so-called "Fed Put"—the idea that the US Federal Reserve will intervene to support markets if declines become too steep. Since Donald Trump's return to office, some investors have speculated about the existence of a "Trump Put". While President Trump has stated that no such safety net exists, the reality is that neither he nor the Fed can afford to ignore the stock market's role in the broader economy. Consumer spending, which drives around 70% of US GDP, is disproportionately supported by the wealthiest households. These households, who own nearly 90% of US equities, are particularly sensitive to the negative wealth effect that accompanies falling markets. If equity weakness persists, it could eventually curtail consumer activity, which would have broader economic implications. The Fed and the White House will be well aware of this, and we would expect them to step in and provide support if necessary.

History shows that reacting impulsively to market volatility can be detrimental to long-term outcomes. With uncertainty likely to persist, maintaining a diversified allocation and staying invested makes more sense than ever. We also believe that an active approach to portfolio management is the best option in the current environment. Our focus remains on staying diversified, staying invested, and using volatility as an opportunity to bolster long term returns.