Thoughts on the Markets – Brace for Impact

6th May 2025

Key points

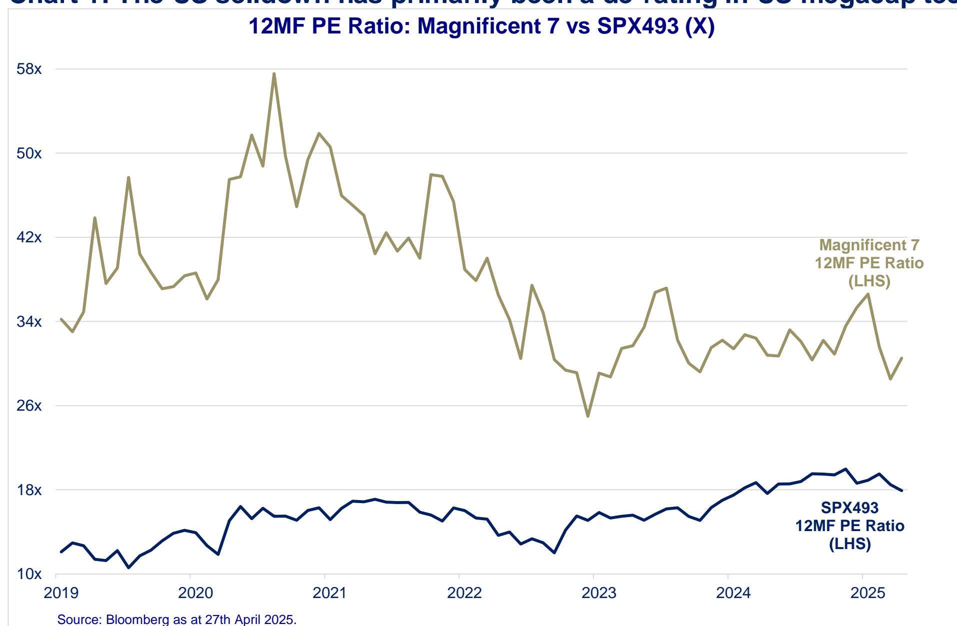
- President Trump has recently lowered his rhetoric around tariffs and the US Fed, which has helped calm markets for the time being. But the trade war, if sustained, will be detrimental to US growth and lift US core inflation in the next two years. US equities have declined -8% from its Feb-25 peak but look disconnected from the growth damage that is ahead, and are in a phase where optimism about trade deals is rising, and weakness to the economic data is not yet visible, and may not be for a while. Notwithstanding this, 12MF PE ratios are still 86th percentile and forecast 12MF EPS growth nearly double the historic average, so US equity markets are a long way from pricing material growth risks. With elevated uncertainty, a prolonged adjustment timeframe ahead, and the Fed 'put' in hibernation, risk premia in US equity and credit markets needs to be rebuilt from the anaemic levels of today. This rise would risk the US market retesting its Apr-25 bear market lows in coming months.
- For a second time in three years, US bonds have provided insufficient diversification during an equity bear market, with US 10Y yields rising +25 bpts since Mar-25, whereas the US Dollar has depreciated -7%. Losses in US equities, US bonds and the US Dollar are a rare combination having occurred in only 5% of months during the past two decades, but it may signal reduced foreign appetite for US denominated assets. Long-dated US Treasuries may be less attractive to hold as US core inflation is likely to be considerably higher than that of the developed World ex-US. As such, investors might need to rethink their over-reliance on government bonds and long-duration illiquid assets and focus on strategies that offer positive convexity during turbulent times.

Details

A welcome, but short, reprieve

Over the past few weeks, President Trump has lowered his rhetoric around US tariffs and the US Fed, and US data have been solid. Trump's less aggressive tone has temporarily calmed markets, but the -8% US equity selldown since its Feb-25 peak has primarily reflected a valuation de-rating of US megacap tech stocks (-11% to a 12MF PE ratio of 30x, relative to a -5% decline to 18x for the SPX493 - Chart 1). Both metrics are expensive relative to history, so US equities are far from capitulating.

Chart 1: The US selldown has primarily been a de-rating in US megacap tech



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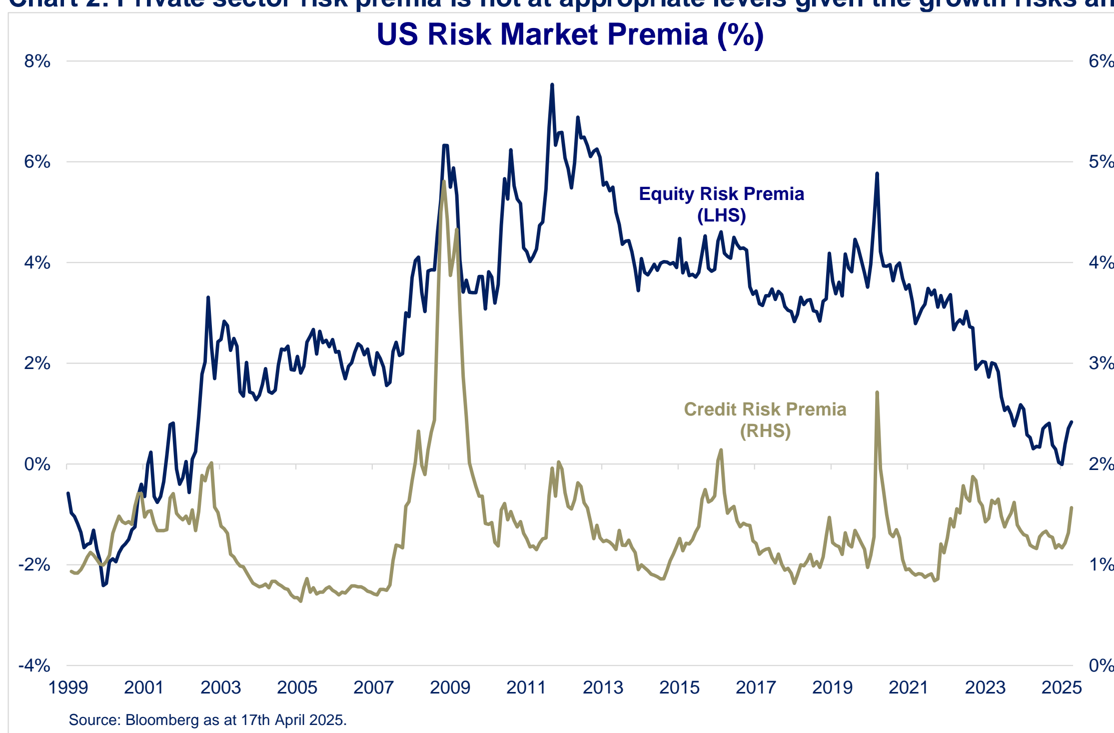
The known unknown

Since 2014, global investors have significantly increased their portfolio holdings of US equities from 20% to 30%, so there is considerable scope for the selling pressures to resume if these investors re-assess the medium-term outlook for US EPS growth and the US Dollar. With tariffs set to substantially weaken US GDP growth and lift core inflation for the next two years, the Trump Administration may seek to accelerate its tax cuts and deregulatory efforts to put a floor under activity. A known unknown at present is how many deals the US will advance during the 90-day moratorium, and for the market to remain calm the deals will need to be with major trading partners such as Europe (18% of US total exports), Canada (17%) and Mexico (16%), rather than minor players such as South Korea (3%) or Israel (0.5%).

Markets need to rebuild 'risk premia'

There is little doubt that supply chains will be disrupted by tariffs and that 2025 US growth will be close to stalling with limited room for policy support, but subtrend US growth could persist for several years. As such, credit and equity market risk premia (Chart 2) needs to be rebuilt especially given the S&P 500 still trades on 83rd percentile valuations and consensus 12MF EPS is forecast to rise a very robust +12.3% to $277 per share. It is hard to justify how anaemic US GDP growth can generate EPS growth nearly double the historic average. Despite a -10% share price decline, it appears that the US market is still priced for perfection despite the highly uncertain landscape ahead. But a higher equity risk premia itself could risk the US sharemarket retesting its Apr-25 bear market lows.

Chart 2: Private sector risk premia is not at appropriate levels given the growth risks ahead



Ouch… what was that?

Current tariff settings of circa 100% for China and 10% for the World ex-US are likely to bring 2025 US GDP growth down by around two percentage points to circa +0% - +0.5%Y, which will flow through the US corporate revenue and bottom-line EPS growth. Accordingly, downside protection strategies and journey management are likely to be key themes over the remainder of 2025, especially those in retirement or close to it. However, for a second consecutive bear market, US Treasury bonds have not attracted safe haven flows, with US 10Y bond yields rising +13 bpts since Mar-25. Moreover, an index of the US Dollar (the DXY) has depreciated by -4.3% over the corresponding period. An inverse relationship between US bond yields and the US Dollar (Chart 3) in a period of US equity stress, is a rare combination having occurred in only 5% of the past ten years. This is something more readily seen in a risk off event in a developing economy, but it likely signals reduced foreign appetite for US denominated assets.

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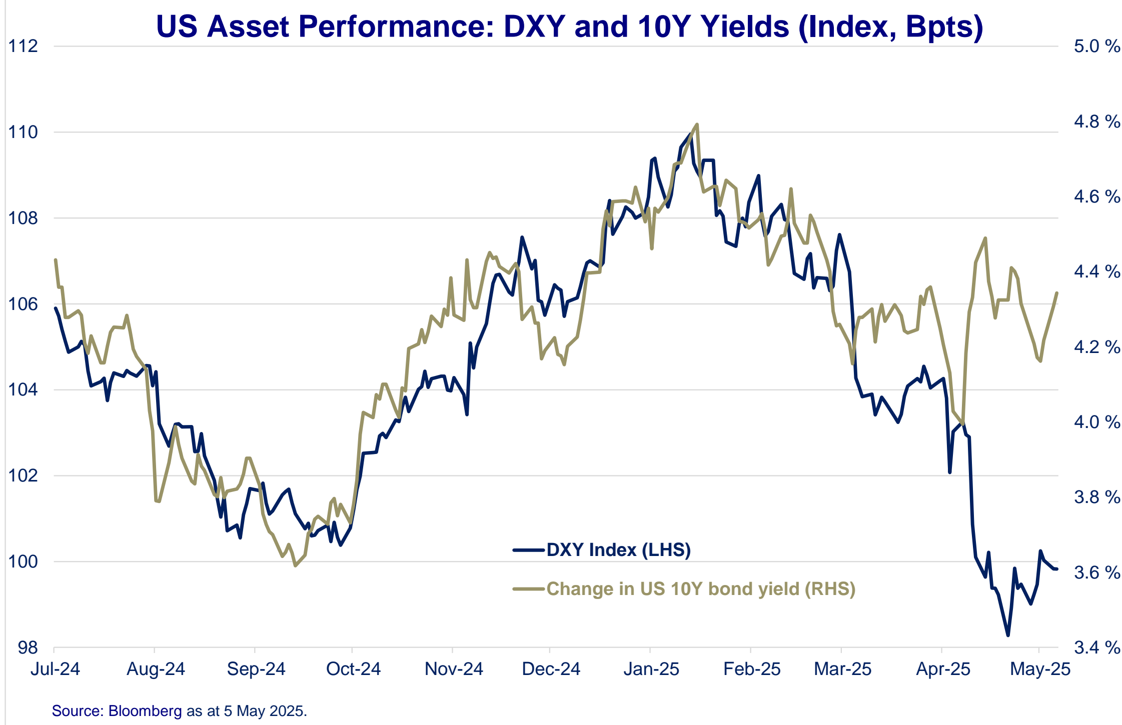
Chart 3: Investors may be diversifying away from US Dollar assets

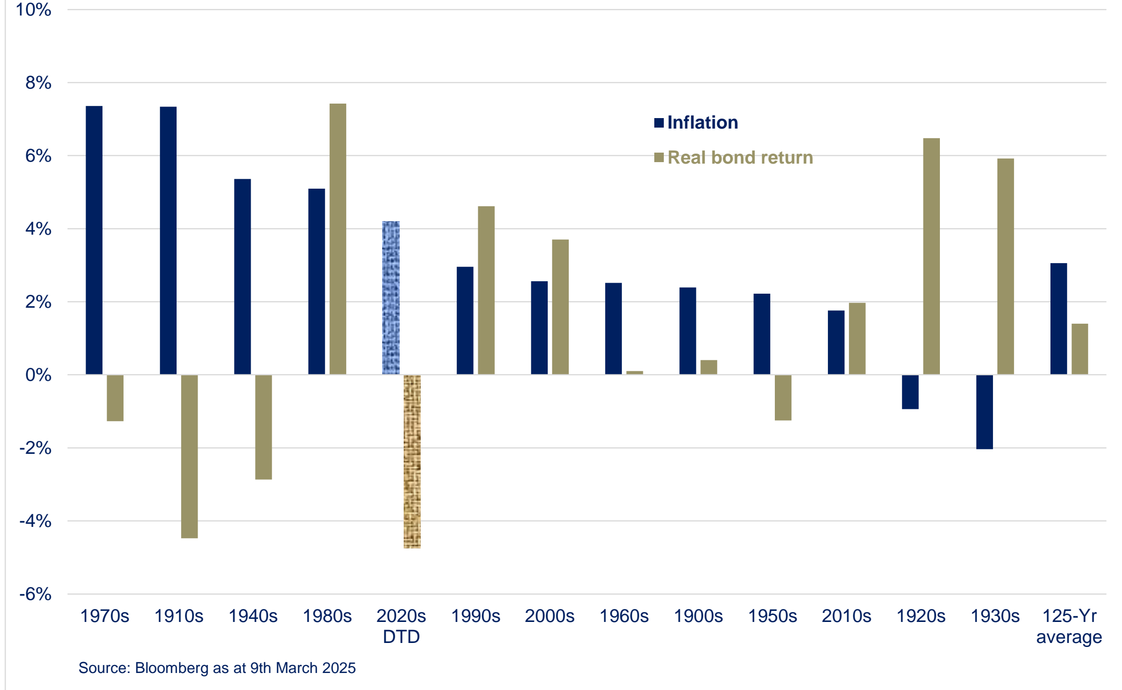


Source: Bloomberg as at 5 May 2025.

Traditional portfolio protection strategies have underwhelmed (again)

From the 1980's to the early 2020s, US (and Australian) government bonds excelled as a portfolio diversifier, offsetting equity risk given falling yields (from 16½% in 1982 to ½% by 2020), declining inflation and negative correlations with stocks (often below -0.5). While government bonds still offer liquidity and relative safety compared to equities, 2025 has been the second US bear market in three years (albeit intraday) that US bonds have failed to provide strong diversification, perhaps because decades with above-average inflation (i.e. above +3.1%pa such as 1910s, 1940s, 1970s and the current decade) have historically delivered the lowest real bond returns (Chart 4).

Chart 4: Above-average inflation has reduced the diversification benefits of government bonds



Source: Bloomberg as at 9th March 2025

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Investors need a broader diversification toolkit

Accordingly, investors need to rethink their over-reliance on government bonds and long-duration illiquid assets and broaden their diversification toolkit to include explicit portfolio protection strategies which can generate positive convexity in periods of stress. This could include the use of bought put options which are best implemented when market complacency is high and implied volatility is low which helps cushion downside risks in equities and facilitates high risk-adjusted returns over the cycle.

This strategy can be used on assets including equities, foreign exchange or even commodities, but need to be implemented at the optimal time as continually buying options, or implementing positions when the cost is high, often works against investors best interest. As such, avoiding expensive equity markets and re-allocating to less popular equity markets, and implementing explicit portfolio protection are two complementary ways of minimising downside risk from the trade war. Unlike government bonds, the judicious use of bought put options have three distinct advantages:

1. The maximum capital loss is capped at the price paid for the option.

2. Put options are a highly reliable equity hedge, where the effectiveness of bonds as an equity hedge depends upon correlations, which been the wrong way around in 2022 and so far in 2025.

3. Owning options is a more efficient capital allocation as investors do not need to sell a potentially high returning asset, like equities, to buy a lower returning hedge, like bonds.

Concluding thoughts

There is little doubt that a new era of globalisation has begun. For market sentiment to remain intact investors need to see the outline of deals from major US trade partners which are traditional US geopolitical partners. However, the US sharemarket remains expensively priced, and 12MF EPS expectations are close to double the historic average, both of which provide a very small margin of safety, especially with an unlikely Fed 'put' unless the US bond market becomes dysfunctional, and US recession becomes the Fed's base case.

An environment of heightened risks to US growth, elevated valuations and still buoyant EPS expectations suggests that diversification and 'journey management' might be key themes in the next 18 months, especially for investors in retirement or approaching retirement. For a second bear market in succession, government bonds have provided investors with much less diversification, and it has become clear that investors need go beyond bonds and long-duration illiquid assets to diversify equity risk with defensive alternatives that have been tried and tested.

Yours sincerely,

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