

Market View February

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Executive Summary

- Our overall take: In anticipation of more market swings this year, we are advising investors to trim risk exposure to a level where volatility is manageable; hold additional cash to take advantage of potential mid-year corrections; and not assume the bull market is coming to an end in 2025.
- In the past two months, equity markets have entered a phase of heightened volatility, driven by uncertainty surrounding US President Trump's policies and ongoing disruptions in the tech sector.
- Trump's brinkmanship with Mexico and Canada has ended for now, with no new tariffs imposed in exchange for largely symbolic concessions. While markets have rightfully remained indifferent to tariff risks, we maintain a cautious stance and believe these risks have not yet been fully priced in.
- Artificial intelligence (AI) competition has become a two-country race between the US and China. Although Chinese company DeepSeek has made notable progress, it is unlikely to mark the end of the AI boom. Instead, it is expected to drive the shift from semiconductors to software, and from the mega caps to the broader market.
- The US economy continues to perform well, setting aside the political noise surrounding Trump. The US Federal Reserve (Fed) put remains in place, though weaker than in 2024.
- We see signs of a supply squeeze in gold as it marks new highs and is among the best-performing assets in recent months, contributing nicely to our portfolios.

Monthly Review

TRUMP'S "GOLDEN AGE" OF VOLATILITY

- In January, the MSCI World Index posted a volatile 3.6% USD total return to hover near all-time highs. The range of potential market outcomes is now wider as tariff-driven uncertainty around US economic policy surges, as measured by the Baker, Bloom and Davis Index.
 - Mid-cap stocks outperformed large and small caps, while the "Magnificent 7" tech giants lagged and large-cap value stocks surged.
 - The S&P 500 Tech Sector Index fell 2.9% its worst month since April 2024 – largely due to Nvidia's sharp decline amid emerging AI-commoditization risks from DeepSeek.
- Market sentiment is more fragile, with leading indicators – like the Bank of America (BofA) Sell Side Indicator (see chart)– pointing to a potential sell-off in the coming months. The rising risk of tariffs only compounds this vulnerability.
- Fed Chair Powell confirmed the December shift from preemptive to reactive easing, signaling that interest rate cuts would only be made following actual growth downturns.
- The US economy remains resilient. Manufacturing is gaining momentum with orders and inventories up, as highlighted by the recent Institute of Supply Management (ISM) report. The Fed's Q4 Senior Loan Officer Survey also indicated robust demand for commercial lending, reinforcing a strong credit cycle and further improvement.

Market Development

WORLD

- Trump's policy approach appears to be more about deal-making than substantive change – as the delayed tariffs on Mexico and Canada suggest. But the additional 10% tariff on China did take effect, prompting immediate (though largely symbolic) retaliation.
 - China's countermeasures are set to kick in on 10 February, leaving room for negotiation. Although Trump communicated his intent to speak with President Xi, our take is that the US-China trade war isn't over.
 - Goldman Sachs estimates that tariffs will cause a one-time 0.5 percentage point boost to the year-on-year core PCE price index.

- The gold rally of 2024 – initially fueled by central-bank purchases, notably from China – is shifting toward the US, where Commodity Exchange (COMEX) stockpiling is accelerating with the fastest increase since the pandemic.
- According to the World Gold Council, the weekly gold loan interest rate rose to about 10% p.a. versus the previous rate of 2-3% p.a., an indication of scarcity.
- Historically, spikes in COMEX inventories have coincided with rising gold prices. We maintain our forecast that gold will reach a price of USD 3,000 per ounce this year.

EUROPE

Europe is likely the next target for US tariffs, with auto imports seemingly most at risk. We think a deal could be struck involving greater imports of US natural gas into Europe and higher NATO contributions from European members. In the case of escalation, however, we don't expect another resolution within 24 hours. Meanwhile, Europe stands to gain from global deregulation. A global upswing in manufacturing and services, as measured by the PMI index, would particularly benefit export-driven economies like Germany.

SWITZERLAND

Swiss equities, which were among last year's underperformers, have started the year strong as indicated by the SPI's +8.2% CHF total return in January. We maintain our outlook and expect Swiss equities to outperform in 2025. Earnings growth is set to exceed that of the Stoxx 600, driven primarily by insurers and pharmaceutical companies.

The outlook for the Swiss franc remains shaped by opposing forces. While a dovish SNB policy suggests downside risks, ongoing concerns over tariffs, economic conditions and geopolitical uncertainties continue to support defensive foreign exchange positioning. Overall, we anticipate largely sideways movement from here against EUR and USD.

FAKE THREATS AND SHALLOW DEALS – OR ESCALATION?

Trump has delayed the threatened Mexico and Canada tariffs until March. If fully implemented, the average US tariff rate would reach its highest level since the 1940s. With over 75% of Canadian and Mexican exports reliant on the US, this would likely push the two economies into recession and raise concerns over stagflation in the US.

In the current earnings season, corporate sentiment has been torn between pro-business hopes and perceived tariff risks. The market is still adjusting to the president's erratic statements and social media posts.

- While a record 61% of US companies expressed optimism in their Q4 earnings calls, mentions of tariff-related concerns surpassed their 2018 peak.

We do not believe tariffs are just a bargaining tactic. Investors should expect more negotiations and, in many cases, weak trade deals with minimal impact on reshoring or reducing the US trade deficit. Trump is unlikely to miss any opportunity to declare victory, even if symbolic – just as he did in his first term with the USMCA, replacing NAFTA, and the Phase One trade deal with China.

As long as the markets see tariffs as a negotiation strategy, equity markets though volatile may trend upward. But an even higher US dollar, lower yields and lower equities would indicate that markets are taking tariffs more seriously. The problem with tariffs is that they tend to be sticky once implemented (recall that Biden largely retained Trump's first-term tariffs).

It's also worth noting that trade escalation in 2018 led to S&P 500 drawdowns of 12% and 20%. Yet since trade accounts for only about 25% of US GDP, tariffs alone are unlikely to cause a US recession though will slow growth. US real GDP growth in Q4 slowed to 2.5% YoY, the weakest since Q1 2023 and below pre-COVID trends. While investment stagnation remains a concern, consumer resilience continues to support the economy.

Several structural factors should keep US growth ahead of other developed economies in 2025, including:

- Strong household and corporate balance sheets
- An income-driven business cycle with limited Fed policy rate exposure
- Low dependence on cyclical manufacturing
- Powell's focus on achieving a soft landing (though the 2025 Fed put is weaker than in 2024, with a more data-driven and less predictable policy approach)

A NEW CYCLE OF DEREGULATION?

Just a few weeks into Trump 2.0, the biggest potential upside is a global deregulation trend. The resignation of Michael Barr, Fed Board Vice Chair for Supervision, provides an opportunity to appoint a strong supporter of deregulation. Raising the supplementary leverage ratio (SLR) – an idea debated since the 2023 Silicon Valley Bank crisis – could unlock a wave of US Treasury purchases by banks. The easing of capital requirements would give banks more leeway to buy government bonds, helping suppress long-term rates.

DEEPSEEK AND AI DISRUPTION

Amid rising political uncertainty, China's DeepSeek has not only challenged the idea that massive computer power is the fastest route to super AI, but also exposed structural cost inefficiencies. With lower entry barriers, smaller players can now compete and potentially erode the scale and funding advantages of the US tech giants. But we expect the "Magnificent 7" to integrate DeepSeek's innovations to ultimately accelerate AI adoption while maintaining their leadership. We anticipate a capital rotation from hardware ("picks and shovels") to software and AI applications, with a shift from market-weight to a more equal-weighted positioning. While new trends will emerge, we do not see the overall AI cycle slowing down.

Positioning

The bull market is aging, but we don't see it ending in 2025. While macro conditions still favor risk assets, heightened uncertainty around policy means more volatility ahead. Despite the noise, we remain cautiously bullish for Q1. We are, however, further reducing risk exposure, now maintaining only a slight overweight in equities.

We believe that market swings will continue testing both bulls and bears. Still, with ample liquidity and strong buying interest on -5% dips, we see no reason to turn outright bearish.

Nonetheless, a new trade war appears to be brewing, making risk management critical. Trump's 10% tariff on Chinese imports, though far lower than the 60% he once floated, signals a less aggressive stance than feared. In our view, more tariff hikes are likely along with a potential tit-for-tat dynamic with China. We expect US-China headlines to keep markets on edge in the coming weeks.

The "Magnificent 7" remain AI's power players. Meta's open-source AI model strategy, Amazon's dominance in cloud infrastructure and Apple's push into "edge AI" position them well. Google and Microsoft face more uncertainty despite their strong cloud businesses. Nvidia's outlook has dimmed slightly as fears of AI commoditization grow.

US equities can absorb some tariff impact as long as credit spreads and long-term inflation expectations stay in check, which we expect through the spring. But valuations – which were key drivers of 2023-24 returns – are elevated, making a repeat performance of 2024 unlikely.

We expect the continuation of a policy-driven, choppy market regime that culminates in a deeper correction by summer. Inflation could unexpectedly rise then, prompting concerns about fiscal sustainability and triggering a market pullback. However, we would likely view this as a buying opportunity, not the end of the bull market, as we think Trump would scale back aggressive policies and shift the focus to market support.

With this in mind, we are raising some cash in Q1 and aiming to seize the opportunity if (and when) a potential correction comes.

BofA sentiment indicator nears first sell signal since December 2021



Source: Bank of America

The Bank of America (BofA) Sell Side Indicator measures Wall Street strategists' market sentiment to identify extreme sentiment as contrarian investment signals. These are based on a rolling 15-year average ± 1 standard deviation. A value above the red line triggers a sell signal while below the green line triggers a buy signal. The indicator is now just 1 point away from a sell signal.

Sources: Bloomberg, Morgan Stanley, Bank of America, Goldman Sachs, The Macro Compass, The Market Ear, Steno Research, 42Macro, JPM, Hightower Naples, Strategas, FT, LBBW, BCA Research

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