MarketSay" sayers

What You Need to Know - February

Month of February: Trade uncertainty gripped markets in February. U.S. stagflation concerns following a combination of soft economic data and sticky inflation data, saw US equities lower. Meanwhile, Europe's better earnings results, hopes of a Ukraine–Russia peace deal and China's technology-driven rally all contributed to the rotation out of U.S. markets. Gold continued to hit record highs.

Policy Watch: The Reserve Bank of Australia cut the cash rate in February as markets had expected. Governor bullock pushed back on market expectations for a series of cuts after the meeting. Other central banks continued to cut rates through February, in line with expectations, as inflation in many parts of the developed world continues to slow.

Inflation Watch: The monthly consumer price index (CPI) rose 2.5% year-over-year (y/y) in January, a touch lower than consensus expectations. US inflation remains above the Fed's target and is threatening to tick higher once more.

Risk Budget: Equity market volatility (as measured by the VIX) rose steadily through the month, through the psychological 20 level.

Our Portfolio: We continued to benefit from our increased position in gold and in alternative credit strategies that benefit from both high running yields and an increase in defaults. Our tactical underweight to equities benefited us as well.

Outlook: The outlook for US trade policy is almost impossible to predict and remains a day-by-day proposition. We do, however, summarise below some broad potential outcomes. Regardless, we expect asset volatility to be elevated in the short-to-medium term as markets second guess trade policy and the impact of trade policy on inflation, growth, and consumer confidence regardless of the outcome.

How to Position: In the immediate, it is difficult to see a strong positive catalyst that brings calm to equity markets, other than a reversal or pause on all US led tariff policy. At the time of writing, that looks very unlikely, with further escalation a more probable outcome. We reiterate that clients should remain nimble to opportunities, use volatility to their advantage via income generating strategies and ensure they have adequate positioning in uncorrelated strategies and alternatives. We see some merit in deploying into emerging markets and Asia over the US and Europe in the short term.

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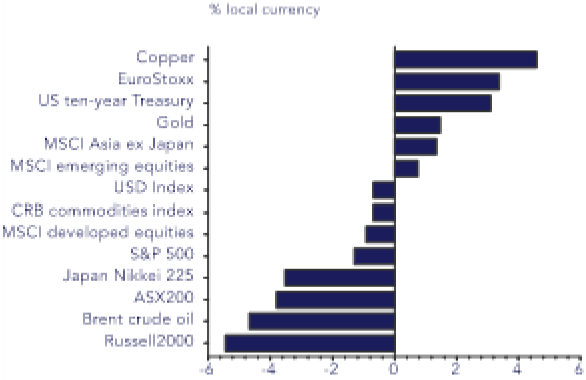
Markets in February

Softening US economic data and sticky inflation data, as well as uncertainties over trade, tax, and immigration policy led to a sell-off in some risk assets. Volatility rose as markets second guessed what the Trump administration would do next on tariff policy.

Chart 1: February Asset Class Performance



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

It was not a typical risk-off period however, with some equity markets rising through the month, such as Europe and Emerging Markets. The USD, a typical safe haven, fell as the Euro strengthened on hopes of a Ukraine–Russia peace deal, a change of government in Germany and the outlook for growth on the back of increased spending.

In the US S&P 500 hit record highs mid-month but quickly reversed. Emerging markets' (+0.9%) outperformance was driven by a strong China market, with MSCI China and Hang Seng delivering 11.7% and 13.4% returns, respectively, buoyed by continued tailwinds from the AI theme and President Xi's meeting with technology leaders including Ali Baba's Jack Ma. MSCI Europe index gained 3.1% and is up more than 10% this year.

Chart 2: Selected Equity Markets Relative Performance (0 = 1 Jan 2025)

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The ASX 200 dropped 3.8%. Cyclical sectors led the losses, with technology (-12.3%), financials (-4.4%) and consumer discretionary (-3.1%) all suffering, while defensive sectors such as consumer staples (+1.5%) and utilities (+3.2%) fared better.

Reflecting the risk-off tone and the more subdued outlook for global growth, U.S. 10-year Treasury yields fell a dramatic 35 bps to 4.19%. Elevated inflation expectations continue to push back expectations on the next rate cut. Spreads on U.S. investment grade bonds were largely unmoved but slightly widened on high yield bonds, suggesting that there some concern in credit markets on US growth prospects, but a recession does not appear to be on the cards, yet, looking at the credit markets.

Australian government bond yields were lower over the month, with 10-year yields down 13 bps to 4.30%. The RBA lowered the cash rate by 25 basis points (bps) to 4.10% in its February meeting. The broad message was mixed, with Governor Bullock also noted the market is "too confident" in pricing additional cuts.

Gold was again a strong performance, with prices hitting another record high of USD 2,835/oz at month-end as tariff risks fuelled demand for the safe-haven asset. Brent crude fell 4.0% to USD 74.05 per barrel.

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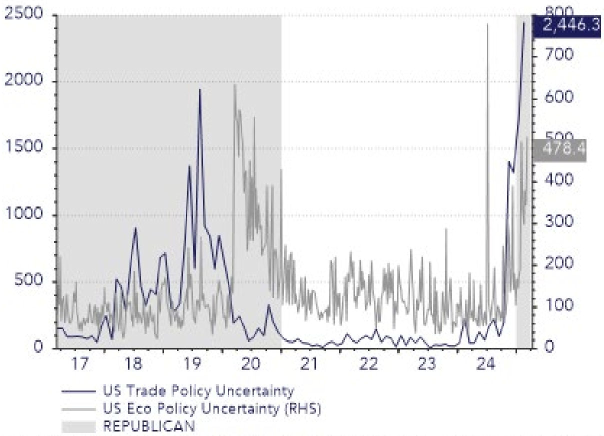
Key Themes

US Economic Policy Uncertainty

US economic and trade policy was, and remains, a day-to-day proposition. It dominated markets in February and continues to now. Decisions made by the Trump administration were often reversed, delayed, or changed. This played havoc with markets during the month. However, a 25% tariff on Mexico and Canada came into force in early March. China gets an extra 10% on top of the 10% that came into force on February 4. Trump says he will slap 25% on European imports of "cars and all of the things".

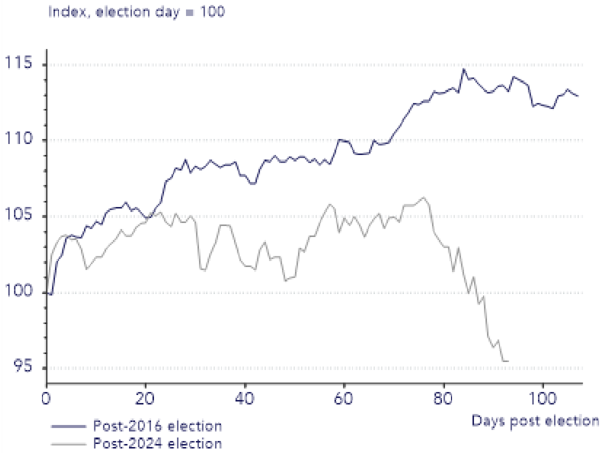
Chart 3: US Policy Uncertainty Spikes



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The "Trump bump" many investors had relied on does not appear to be happening and the reality of widespread tariffs on imports is starting to hit home. While we are yet to see earnings downgrades from corporates crimping margins amidst rising import costs, many US firms did comment that the uncertainty was already having an impact. Us equity markets have not been enjoying the uncertainty, with all post-election gains and more now gone.

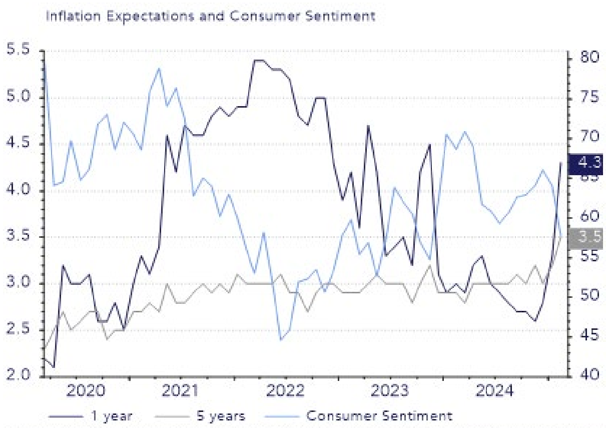
Chart 4: US Equity Post-election Performance



Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

Survey data suggests that consumer confidence has dipped, as has business confidence. Somewhat concerning for the US Federal Reserve as well, is the dramatic rise in longer term inflation expectations. This has raised prospects of the US heading to a period of stagflation – where growth slows while inflation is rising. It is probable that the Fed will look through any short-term impact on prices from the introduction of tariffs, should these price rises persist they are going to find themselves in a difficult position of potentially having to support a rapidly slowing US economy while also managing a re-emergence of broad-based inflationary pressures.

Chart 4: Uni of Michigan Inflation Expectations and consumer sentiment



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Outlook

The outlook for tariffs is incredibly difficult to predict. However, there are three broad possibilities from here:

(i) A sharp burst of activity where the US establishes tariffs and other nations retaliate, leading to markets navigating some calmer water at some stage in the medium term.

(ii) A prolonged and escalating tariff war, that harms global trade, growth, and confidence, and leaves investors constantly guessing what is next?

(iii) Tariffs lead to the Trump Administration doing "deals" on a range of foreign, trade, intellectual property, and immigration policies. Tariffs are either wound back, reduced, or delayed. The best outcome for risk assets.

Regardless, we expect asset volatility to be elevated in the short-to-medium term as markets second guess trade policy and the impact of trade policy on inflation, growth, and consumer confidence regardless of the outcome. We therefore reiterate the need to be nimble, to take advantage of the significant rise in volatility, and ensure adequate allocation to alternative and non-correlated strategies.

Chart 6: US v EU Economic divergence

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

The challenge to US economic exceptionalism is resulting in a flight of capital towards other markets. While US data is starting to disappoint and the outlook grows more clouded, European economic growth expectations have been universally upgraded following the elections in Germany, the announcement of a large defence and infrastructure fiscal package. The hope is that this additional spending will flow through to corporate earnings.

Despite these developments, structural challenges persist in Europe, particularly in productivity and competitiveness. If the U.S. imposes tariffs on European goods, these issues could well be exacerbated and the hit to the European economy, especially export focused Germany, could be severe.

Chart 7: Global Equity Market Performance

Source: LSEG Datastream/Fathom (Note: Past Performance is not a reliable indicator of future performance)

We are not chasing European equities here; however, we do believe that European defence stocks could have further to run, even in the event of a truce or peace deal in Ukraine.

Given the current economic outlook, it would normally not be a great time to be looking to emerging markets, however China remains one of the fastest growing economies in the world (targeting 5% GDP growth per annum) and looks set to stimulate their economy to hit that target. Tech entrepreneurs have been brought back into the fold after a period of government crackdowns. And finally, much of the world both ex-US and the US will still trade with China regardless of tariffs.

How to Position

Recent changes to our portfolios where we added further gold exposure, hedged out AUD strength, while retaining high exposure to uncorrelated alternatives and an underweight to equities has served us well.

Equities: A change in market leadership?

Aside from the capital flight away from the US market to other geographies, megacap technology stocks have been leading the market lower, just as they were the driving force of the rally for the last two years. Any recovery in the US could be led by a broader number of stocks, focus shifts to domestic industrial and consumer stocks less reliant on imports. We will look harder at neutralising part of our underweight to global equities should the S&P500 reach our target of ~5300.

Chart 8: Mag 7 S&P500 Weighting

Cash Rates: RBA to cut multiple times?

The RBA reluctantly cut the cash rate by 25bps in February. It is unlikely to move in April, just before the Federal election. Governor Bullock pushed back on market pricing for numerous cuts this year at the February meeting press conference, but it is hard to see the RBA cutting once and then sitting still for an extended period. A couple more cuts evenly spread through the rest of 2025, back towards a mid-3% cash rate seems likely in our view.

Corporate Bonds: Not yet the canary

Credit spreads are not moving dramatically wider despite the risk-off sentiment, despite being historically tight. That tells us that recession fears in the US may be overblown. With rates likely to stay higher for longer given inflationary fears and the lack of US budget repair, investment grade credit remains a good place to hide and earn income well above cash.

Alternatives: Ride out the storm

Conditions for alternatives remain supportive. We continue to look at various private equity options, both domestically and internationally. Even if economic conditions deteriorate, the range of secondary market opportunities for managers out there remains strong, while valuations are not demanding.

Currencies: AUD more resilient

In this type of environment, you would expect a trade linked currency like the AUD would have weakened further. However, mixed performance for the USD of late has kept the AUD around 62 cents. Also supporting the currency is the prospect of more Chinese stimulus and solid commodity prices. We continue to view 62 cents as a good place to hedge global equity currency risk.

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Sayers Investment Solutions Team

14 March 2025

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