The Linara Lens

Our perspective and insight

Month of May: Risk assets regained some composure in May as investors saw negotiations between the US and China as a critical event for the de-escalation of trade tensions. Equity markets were up strongly, volatility subsided rapidly, and haven assets like gold were modestly weaker over the month. Bond markets however are less focused on trade tensions and more on deteriorating fiscal deficits in the U.S. and elsewhere.

Tariffs, cooling of tensions: the worst-case scenario appears to be avoided, however significant uncertainty remains. In May, US-China tensions eased after both sides agreed to a 90-day tariff pause. This supported global equity markets and improved sentiment. However, the truce is temporary, set to expire in August without a broader agreement while other tariff reprieves will expire from early July. Policy remains erratic and it appears that a baseline 10% tariff is going to remain in place regardless of "deals" being done.

Soft v Hard Economic Data: A divergence between soft and hard US data continued in May. Survey-based indicators like ISM services and consumer sentiment weakened. However, hard data (retail sales and industrial production) remained solid, pointing to ongoing economic strength. Markets are watching closely to see if soft data translates into real weakness, or if strong fundamentals persist despite deteriorating sentiment and rising uncertainty.

Bond Markets: Bond yields are being primarily responding to worsening fiscal conditions in the US, Europe, and Japan, rather than trade news. US long tenor year yields rose in May amidst concerns around persistent deficits, rising issuance, and a lack of fiscal discipline. Volatility is likely to remain elevated, with markets watching for tariff driven inflation.

Geopolitical conflict: The current Iran-Israel conflict has the potential to escalate with reports of US involvement looking more likely. Initially aimed at curbing Iran's nuclear program, the strikes now appear linked to regime change efforts. Though Iran contributes little to global oil output, disruption in the Strait of Hormuz could trigger supply shocks

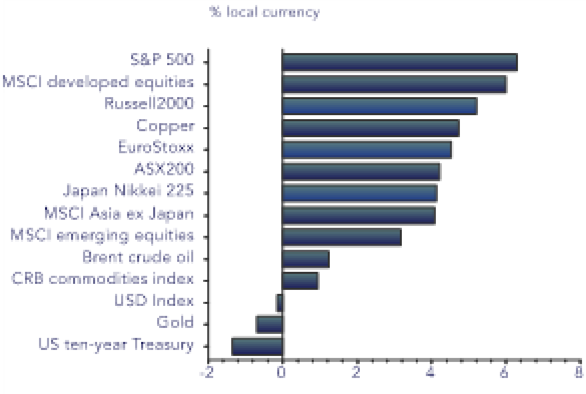
Outlook: While markets rebounded in May, risks loom. The US-China tariff pause may only be temporary, and the Iran-Israel conflict risks expanding, especially with potential US involvement. Meanwhile, US fiscal policy remains loose, with deficits growing despite a healthy economy. Any escalation, be it in trade, geopolitics, or inflation, could derail current optimism. Equity valuations are high, and bond markets appear under-reactive to fiscal risks. The second half of 2025 could be more volatile, particularly if inflation reaccelerates or political instability rises. Investors should prepare for shifting narratives and remain nimble in asset allocation.

How to Position: Investors should stay balanced and flexible. Bonds face opposing forces: inflation and fiscal worries versus weaker growth, creating tactical positioning opportunities. Equity valuations are stretched. Investors should rebalance toward sectors with pricing power and reduce tech concentration. Alternatives and real assets can provide diversification and protection against inflation and geopolitical shocks. In FX, the AUD has stabilised around USD 0.64. While a mild rebound is possible, any hedges should be removed in the high-60s.

Markets in May

Risk assets regained some composure in May as investors saw negotiations between the US and China as a critical event for the de-escalation of trade tensions. Equity markets were up strongly, volatility subsided rapidly, and haven assets like gold were modestly weaker over the month. Bond markets however are less focused on trade tensions and more on deteriorating fiscal deficits in the U.S. and elsewhere.

Chart 1: May Asset Class Performance



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

The ASX 200 rose 4.2% for the month, easing trade tensions between the U.S. and China, and a dovish rate cut from the RBA by 25 basis points to 3.85%, helped to lift investor sentiment. All sectors were in the green for the month, led by Technology (+19.2%) and Energy (+8.6%), while Utilities (0.3%) was the underperformer as bond yields rose globally.

The Global Developed Markets index rose by 6.0% and the S&P 500 by 6.3%, with most markets delivering positive returns in local currency terms. U.S. markets recorded the strongest returns, reflecting the relief of easing trade tensions as well as strong corporate earnings reports. European markets and Japanese equities also rose.

Emerging markets rose 3.2% over the month, with APAC ex-Japan up 4.0% in local currency total return terms, as China rallied on the de-escalation in trade tensions.

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)

Equity valuations are once again at the high end of historical ranges with the forward price-to-earnings (P/E) ratio on S&P 500 rising to 21.3x. Valuations on other developed markets also increased but remain more modest with the ASX 200 at 18.8x, MSCI Europe at 14.6x, and MSCI Japan at 14.4x.

10-year yields on Australian government bonds rose 16 bps to 4.27% over the month, following yields in other markets higher. 10-year yields on U.S. Treasuries were up 24 bps to 4.39%, while 30-year yields tested the 5%-mark, as markets are increasingly concerned over a lack of fiscal discipline by the US Government.

Gold prices edged down 0.7% in May. Crude oil prices fell to USD 62.8/bbl despite the potential OPEC+ production hike. The USD was mostly unchanged over the month. While the euro and Japanese yen weakened.

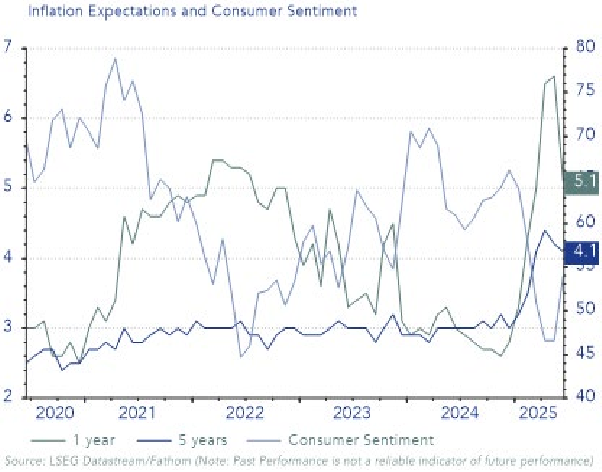
Key Themes

Tariffs – worst case scenario now behind us?

During May, the US and China initiated high-level talks in Geneva. As both nations sought to reduce tensions after April saw the effective decoupling of the two economies through the imposition of tariffs as high as 145%.

Following the talks, both nations agreed to a 90-day "pause" in their trade war: the US would reduce its effective tariffs on Chinese imports from as high as 145% to 30%, and China would cut retaliatory tariffs from 125% to 10%. While it is encouraging, it is temporary, with tariffs set to resume by August 12 unless replaced by a lasting agreement. There are other sticking points, with the US still seeking an agreement that reopens access to China's rare earths.

Chart 3: Uni of Michigan Survey



In May 2025, markets increasingly focused on the growing divergence between soft and hard US economic data. Survey-based indicators such as the ISM services PMI and consumer confidence showed signs of weakening, pointing to slower momentum in the economy. In contrast, hard data, particularly retail sales and industrial production, remained more resilient, suggesting that actual economic activity had not yet caught up with the deterioration in sentiment or may not end up reflecting it at all.

This divergence complicated the Fed's path forward, as policymakers balanced weakening forward-looking indicators with still-solid realised outcomes.

It is arguably too early for much of the uncertainty and impact on tariffs on prices to be revealed in much of the hard data. Market participants are looking to July and beyond for inflation to potentially increase as price rises are passed on to consumers. A review of the Producer Price Index vs Consumer Price appears to show that producers are absorbing prices rises rather than passing them on at this stage.

Chart 4: Citi Economic Surprise Index

The current tariff pause has reduced uncertainty for businesses and consumers alike, temporarily easing inflationary pressures and giving the Fed more room to stay patient. Markets interpreted the tariff reprieve as a potential turning point for global trade, reinforcing the rally in risk assets, even as soft data hinted at caution ahead. The durability of this optimism, however, remains contingent on whether the tariff pause becomes a permanent reset or merely a temporary reprieve. It is possible that the political uncertainty that if it continues, will or already has, derailed corporate hiring plans, investment, and expansion plans.

Outlook

Regime change in Tehran?

At the time of writing Iran and Israel continue to trade missile and drone attacks, with the US potentially planning to enter the conflict with missile strikes of its own against Iran. Initially, the conflict was seen as a way of destroying Iran's nuclear weapons ambitions or at least acting as a significant deterrent. Now, it appears more likely that the end goal is both a nuclear deterrent and a regime change in Tehran. Therefore, the potential for a longer and drawn-out conflict that has greater potential to destabilise the region.

Chart 5: US and Iran % of global oil production

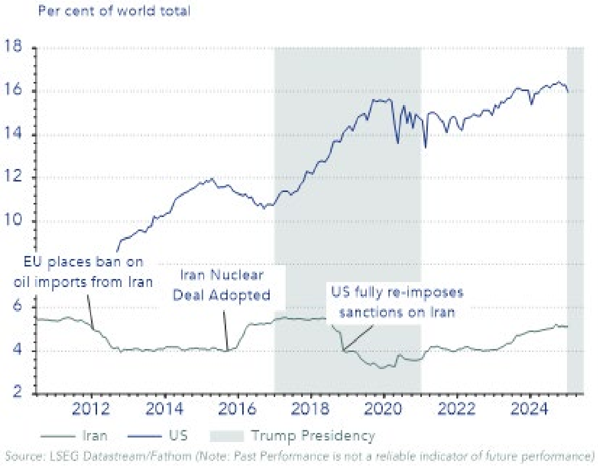
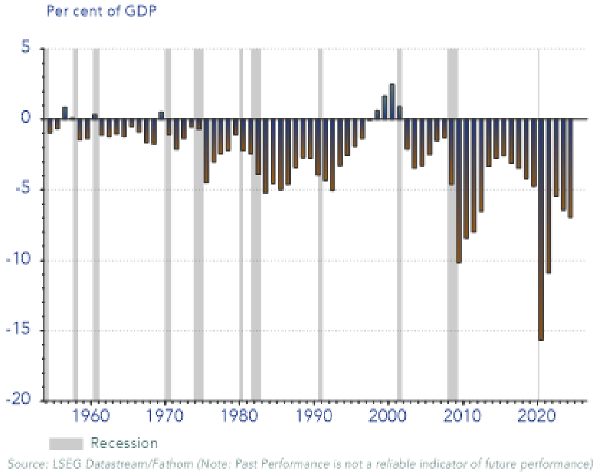


Chart 6: US Government Budget Deficit



Parallels to the early 1970s are limited. At that time, the US was reliant on Middle Eastern exports for its energy supplies. That is most definitely no longer the case, with the US a major oil producer, while Iran is a small fraction of global supply.

A closure of the Hormuz Strait or shipping companies choosing to avoid the strait will likely cause a supply shock, put further upward pressures on prices as it will take 7-10 days longer for ships to travel around the Horn of Africa at greater expense.

Where are the bond vigilantes?

In addition to trade policy, the lack of budget repair on the agenda has caused weakness in the US Dollar and until the conflict in Iran-Israel commenced, a rise in bond yields. The US budget deficit continues to grow despite an economy that is in good shape. Existing tax cuts are proposed to be extended and new ones implemented, while the revenues raised from the tariff policy nor cost cutting initiatives likely to bring the gap.

According to the nonpartisan Congressional Budget Office (CBO) is projected to increase the federal deficit by $2.4 trillion over the 2025–2034 decade. We have been surprised that bond yields have not been testing higher levels in this environment and would highlight this as a key risk moving forward.

Chart 7: US Dollar v US 10 Year Yield

How to Position

Cash Rates: Monitor RBA's Policy Stance

The RBA appears comfortable with inflation trending within its target band and look set to adjust rates lower over the course of the year. Investors should maintain a decent amount of liquid cash on hand in the event that markets again become dislocated and throw up opportunities.

Bonds: Adjust for Rising Yields and Inflation Risks

Volatility is likely to persist in bond yields. The pressure for higher yields will continue via tariff induced inflation and a fiscal position which continues to deteriorate. On the other side, the risk of slower growth in from trade tensions and reduced confidence is likely to shower up in sluggish growth and lower bond yields. There are likely to be good opportunities to adjust positions over the coming months. While credit spreads have narrowed alongside equities, vigilance is necessary, particularly in lower-quality credit segments where growth risks may reemerge and undermine the credit worthiness of borrowers.

Equities: Exercise Caution Amid Elevated Valuations

The recent rally in U.S. equities, driven largely by mega-cap technology stocks, has pushed valuations to historically high levels. While AI optimism and resilient earnings have supported this surge, the elevated valuations suggest a potential for correction, especially if tariffs begin to impact corporate profits. Investors should be cautious and consider rebalancing portfolios to manage concentration risk in technology-heavy indices, focusing on sectors with pricing power and margin protection.

Alternatives: Emphasise Diversification

The recent market volatility underscores the importance of diversification. Allocating to uncorrelated strategies and non-public equities can help reduce exposure to public market fluctuations. Real assets and infrastructure investments may also serve as effective hedges against inflation and geopolitical risks, contributing to portfolio stability.

Currencies: Maintain Flexibility Amid Global Uncertainties

The U.S. dollar, after a reset lower in April, has stabilised as markets digest trade policy shifts and inflation dynamics. The Australian dollar has shown resilience, maintaining its position around USD 0.64. While some commentators are expecting the Australian dollar is likely to trend back towards 75 cents, we expect our dollar to appreciate only a little further from here and would be comfortable in removing any currency hedges in the high 60 cent range.

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