For professional investors - March 2025

MONTHLY MARKET VIEWPOINT

NOT SO EXCEPTIONAL AFTER ALL

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- Declines in US equities over the last month were initially a function of disappointing economic data and a partial 'Magnificent-7' unwind rather than tariffs. Lately it has been self-reinforced panic selling that we expect will be reversed. We remain optimistic on the medium-term outlook.

- The pre-election expectations for a 'soft landing' this year are perhaps being realised. But inflation, instead of slowing, has accelerated, meaning the boost from meaningful interest rate cuts from the Federal Reserve has not materialised.

- While the risk of a much wider trade war remains present, the US economy should be able to absorb the impact as long as trade tensions are contained. But by the same token, if tariffs end up not being implemented, the recently weaker trend in growth could still persist. We remain data dependent.

- Europe and China equities have surprised positively, but the sustainability of this outperformance is open to question.

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Waning US resilience

If the story of 2024 was the resilience of the US economy in the face of a restrictive policy from the Fed, 2025 has shown signs that the resilience may be waning. Recent tariff news has only added to investor concerns on the outlook for growth.

Weak data over the last two months had already suggested that 'US exceptionalism' was perhaps no longer an apt description of the US economy. The imposition of across-the-board tariffs on Canada, Mexico and China (albeit partially suspended), and retaliation from these countries, risks turning what was possibly just a US slowdown into a global phenomenon. The slump in US equities that began a few weeks ago has now spread to the rest of the world, while safe-haven assets have rallied.

Tariffs and retaliation could turn a US slowdown into a global one

The negative trend has been offset by two factors of debatable sustainability.

First has been the strong performance of Chinese equities, particularly the tech sector, following the DeepSeek announcement in February.

Second has been the push for higher defence spending in Europe and Germany's plans to take its foot off the debt brake and significantly increase infrastructure investments.

Where does US economic momentum stand?

US real yields have been declining since mid-January, partly reflecting this change in the outlook for growth. The data pointing to weaker growth includes:

- Below-expectations fourth-quarter GDP growth
- The 'flash' services sector purchasing managers' index (PMI), which not only declined but dropped to below 50 (indicating sector contraction, though this was subsequently revised upwards)
- Weaker (private) non-farm payrolls
- Negative retail sales
- Declines in consumer sentiment.

Most of this data reflects the existing trend of the 'pre-Trump' economy as it has only been six weeks since the new administration came to power. That is, the slowdown would likely have occurred regardless of who won the US presidential election.

One should recall that prior to the election, most investors expected the US economy to transition to a 'soft landing', that is, a slowdown in growth and inflation, allowing the Fed to cut policy rates several times over the course of the year.

The economic slowdown part of that outlook seems to be occurring, but inflation is not (yet) following the script. Estimates of the number of cuts by the Fed have consequently varied.

It is critical to distinguish between the current trend in growth and inflation, and market dismay over tariffs. President Trump has (again) paused tariffs on Mexico, though this reversal could yet be reversed. The volatility in policy is having as much of a negative impact in the short term as the tariffs themselves.

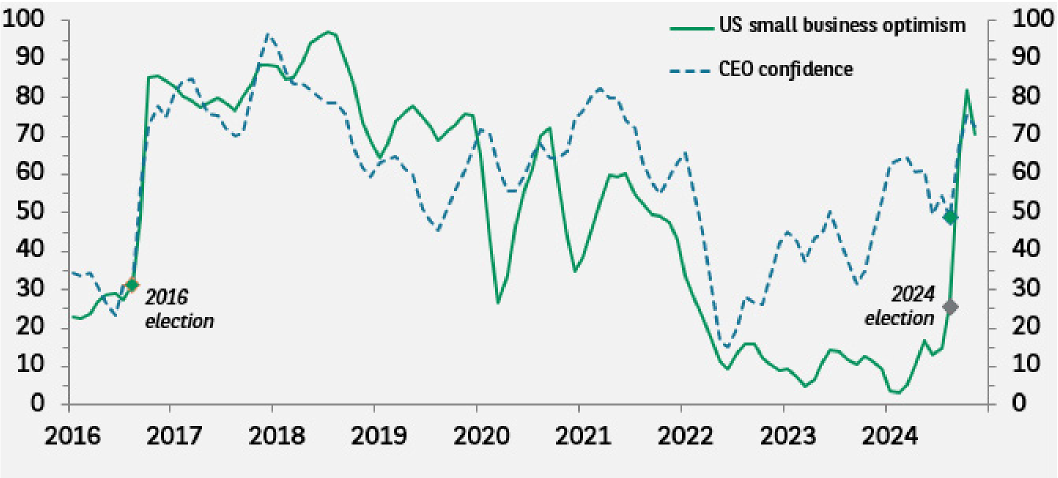
Even if full tariffs are left in place (unlikely in our view), the impact on growth and inflation is unlikely to change the trajectory of the economy. A recent study by the Atlanta Fed estimated that the full "tariff[s] ... could raise consumer prices on everyday retail purchases ... covering about a quarter of the total consumption basket, by 0.81 percent to 1.63 percent," so by 0.2 to 0.4 percent for the broader inflation index, though this would be a one-time impact.

If the tariffs are instead lifted, the trajectory of slower economic growth and sticky inflation could continue, threatening the outlook for equity markets. We remain data dependent.

At the same time, not all the data has been poor. The revised services PMI and ISM indices are both above 50. Both the manufacturing sector PMI and ISM have moved back into expansionary territory after six months of sub-50 readings. Industrial production has picked up, and business sentiment has soared (see Exhibit 1) All of this contradicts the view that tariff threats were the key reason for the market declines.

Exhibit 1

Business confidence high despite tariffs

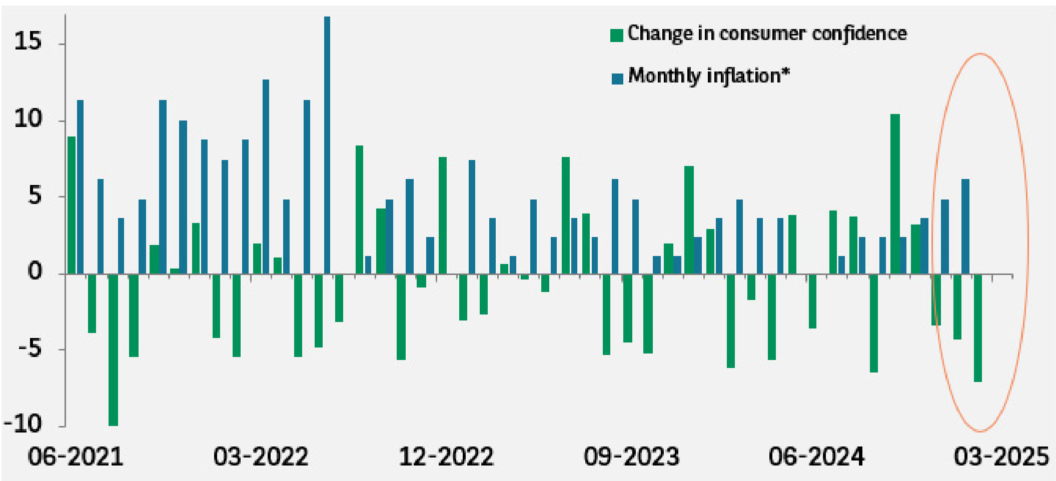


Data as at 7 March 2025. Sources: Bloomberg, BNP Paribas Asset Management.

If growth were slowing alongside slower inflation, investors might be less concerned. But inflation has heated up over the last several months. This turnaround likely explains the declines in consumer sentiment, rather than any worries about proposed tariffs (see Exhibit 2). Consumers still have painful memories of high inflation in 2021 and 2022 and react negatively to signs of a resurgence.

Exhibit 2

Decline in consumer sentiment driven by higher realised inflation



Data as at 7 March 2025. Sources: Bloomberg, BNP Paribas Asset Management.

Any short-term drag on growth from tariffs needs to be considered in the context of what should still be positive medium-term factors such as deregulation and increased M&A activity. Initial investor optimism after the US election was partly premised on an investment boom. Whether that will be enough to sustain a high rate of GDP growth remains to be seen.

Will deregulation, increased M&A and investment be enough to sustain US growth?

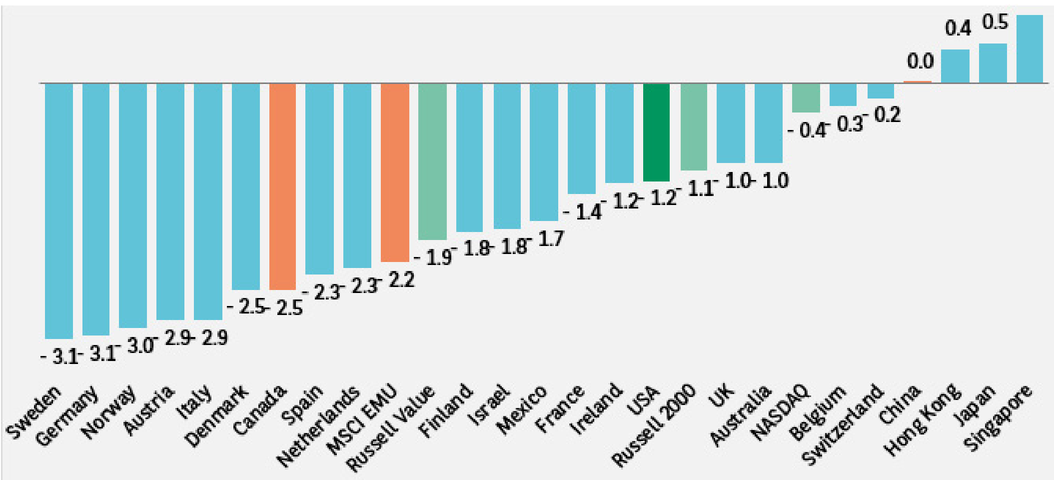
There have been several announcements by companies planning to invest significant sums in the US, particularly in artificial intelligence (AI) related industries and we are still optimistic on the outlook for the sector. At the same time, investments linked to the Inflation Reduction Act (IRA) will not take place. One should also recall that even as the IRA investments were being made, the US manufacturing PMIs remained stuck below 50.

It is worth noting that the original bull case for US equities after the election was that, even knowing that tariffs were likely, investors believed tariffs would be less negative for US equities than for the country's trading partners.

To judge by the returns on the day of the Canada and Mexico tariff announcements, that assumption proved to be correct: US equities, while declining, outperformed most other markets (see Exhibit 3). Moreover, the tech-heavy NASDAQ (and to a lesser degree small-cap stocks) outperformed the broad S&P 500.

Exhibit 3

One-day returns on 4 March 2025



Data as at 7 March 2025. Sources: FactSet, BNP Paribas Asset Management.

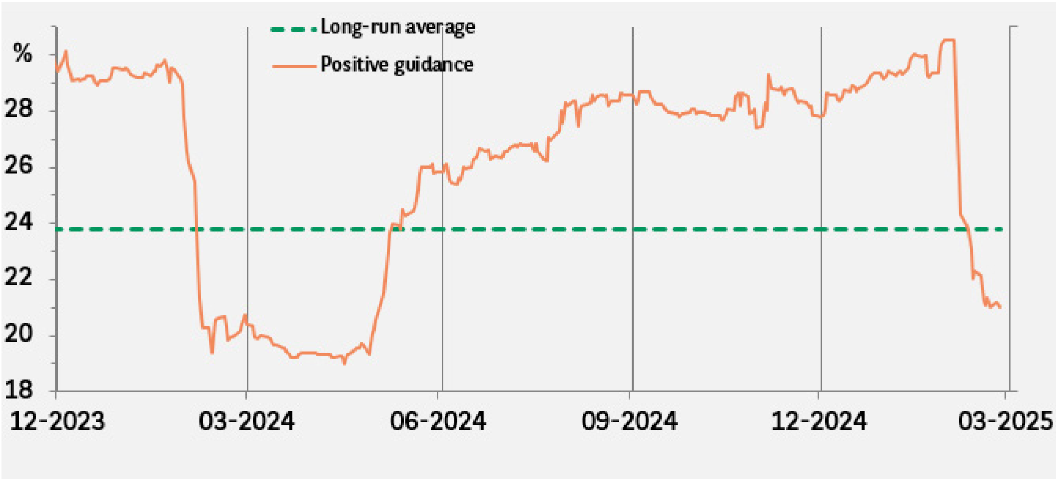
Earnings signals

While results from the most recent earnings reporting season were positive, particularly earnings surprises, there was perhaps a warning sign in the guidance provided by companies. Typically, only 24% of companies raise their guidance for profits during their earnings calls. For the quarter just completed, the rate was 21% and it deteriorated in the last weeks of the quarter (not coincidentally just after the DeepSeek announcement).

This pattern is similar to what occurred in the year-ago quarter as guidance typically falls at the end of the fourth-quarter reporting season (see Exhibit 4).

Exhibit 4

Corporate guidance has deteriorated

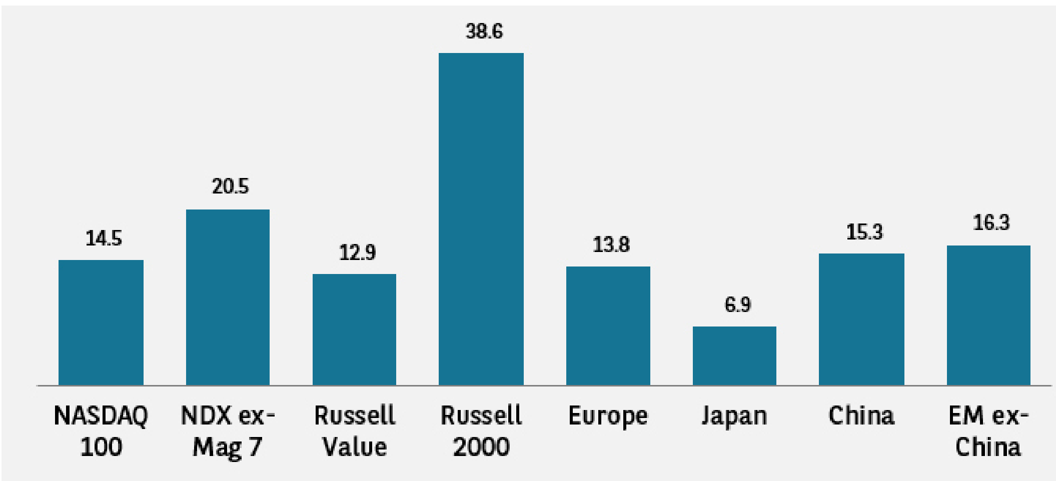


Data as at 7 March 2025. Sources: Bloomberg, BNP Paribas Asset Management.

Analyst estimates for earnings this year are comfortably high (see Exhibit 5). This is, however, a lagging indicator, so it is possible that recent market weakness has simply not yet been reflected in the forecasts. But the double-digit growth estimates mean there is quite a large 'margin for error' for earnings growth to still prove to be positive for 2025, even in the case that earnings estimates are revised down.

Exhibit 5

Earnings expectations high enough to handle some negative revisions



Data as at 7 March 2025. Sources: FactSet, BNP Paribas Asset Management.

European equities

Certainly, one of the biggest surprises of the year so far has been the outperformance of European equities. Earnings revisions have already turned positive and will likely rise further thanks to the significant fiscal stimulus that has been proposed in Germany and the greater conviction across the EU of the need to increase defence spending. One of the key drivers of European equity outperformance this year has been the aerospace & defence sector.

The stimulus is reminiscent of what occurred in the US at the beginning of the Biden administration with the $1.9 trillion Covid relief bill and, later, the Inflation Reduction Act. They contributed meaningfully to strong US economic growth in the subsequent years.

The difference is that much of the US Covid relief was sent directly to households and so had an immediate impact on consumption. The planned European stimulus, by contrast, will be focused more on investment, both in infrastructure and the military. The immediate impact on GDP (and corporate profits) will consequently be less, though infrastructure spending should raise the trend rate of growth over time.

There is also a question of the country's capacity to quickly absorb such a large increase in spending due to labour market and regulatory constraints. Much of a previous German special fund on defence spending has not yet been disbursed.

Europe: Hopes run high around fiscal stimulus and increased defence spending

In addition, the bulk of the market capitalisation of the MSCI World Aerospace & Defence index is made up of companies from the US (66%), followed by France (14%) and the UK (10%). At least some of any increase in defence spending is likely to flow to US companies until the European industry has become much larger. One can wonder how long the enthusiasm will last if peace is agreed between Russia and Ukraine, to say nothing of the question of how to finance the spending given that few countries can match Germany's fiscal scope.

Finally, the relatively positive performance of European equities has come primarily from the banking sector, which has benefited from a steeper yield curve. Since banks engage in maturity transformation, a steepening of the curve, which provides more of a boost to longer-term yields than to short-term yields, raises the rate on interest-earning assets more than the cost of liabilities.

The significant moves we have seen in both US and German yields over the last several weeks may not continue to the same degree.

China's Magnificent-7

The MSCI China index has gained 19% so far this year compared to 10% for Europe (both figures in local currency terms through 7 March 2025). The performance in China, however, has been concentrated, reminiscent of the dominance of the US Magnificent-7 in 2024.

The H-share MSCI China index has outperformed the MSCI All Country World index by 25% in US dollar terms since 23 January 2025 (just after the DeepSeek announcement), but the domestic A-share index has only done 7% better. This disparity suggests the markets' gains are not primarily a function of an improved domestic outlook. Instead, the driver has been the performance of stocks linked to the AI theme.

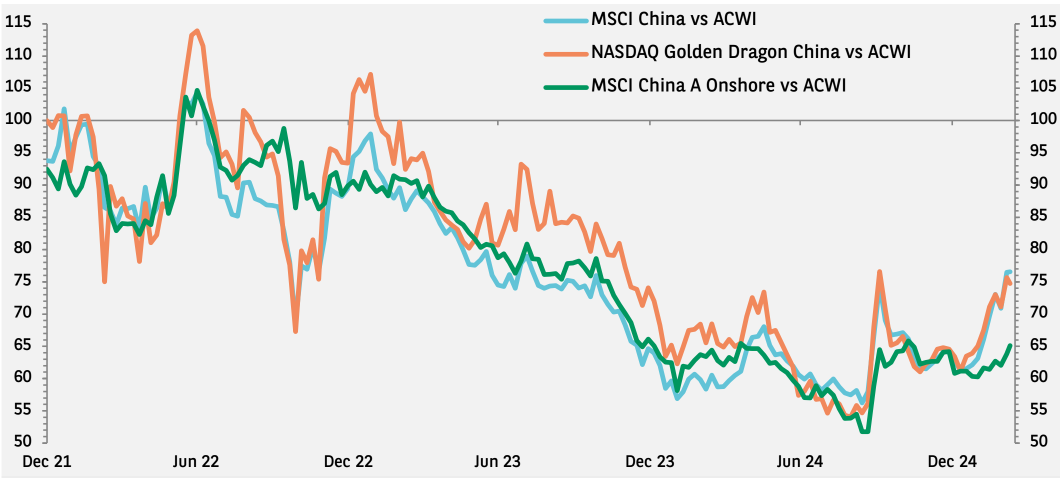
Stocks linked to the AI theme have driven performance

The outperformance of the NASDAQ Golden Dragon index mirrors that of the broader 600-stock MSCI China index, meaning it is the tech part of the MSCI China index which is gaining. What is notable is that the dominance of AI stocks not only explains the relative performance of the MSCI China index recently, but also over the last several years (see Exhibit 6).

One's view on the outlook for China equities may thus depend less on macroeconomics than on the prospects for some of the leading companies in the tech/AI industries.

Exhibit 6

The relative performance of Chinese equities is concentrated in the tech sector



Data as at 10 March 2025. Sources: FactSet, Bloomberg, BNP Paribas Asset Management.

ASSET ALLOCATION

- The current high level of uncertainty around international trade, geopolitics, and the potential impact on global growth supports our neutral positioning in equities. Despite favourable microeconomic data and improved technical factors, a lack of visibility may weigh on the market.
- In the context of a rise in bond yield volatility on the back of a possible increase in European public financing needs linked to higher military spending, we decided to move to neutral our position in sovereign bonds. Europe and the US decoupling in terms of economic growth and monetary policies remains our central scenario. Its expression through long positions in European yields combined with short positions in US T-Notes is being closely monitored.
- Solid company fundamentals and steady investor demand should continue to support eurozone investment-grade credit, which remains our strongest positive conviction.
- The strong year-to-date performance of gold led us to take partial profits on our positions in late February. Our positive conviction over the medium run remains intact: this asset class should continue to be supported by central banks' reserve accumulation and geopolitical tensions.

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