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MONTHLY MARKET VIEWPOINT

SEEING THROUGH THE TARIFF FOG

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- Investor expectations that US equities would outperform the rest of the world following Donald Trump's election as president have been borne out, but since the beginning of the year the ranking has reversed.

- A period during which US equities paused their ascent is not surprising, but the returns for European equities perhaps more so. While the latest news on a potential resolution of the war in Ukraine will likely provide a further boost for the market, there are still questions as to the sustainability of any outperformance.

- Amidst the slew of policy announcements since President Trump's inauguration, investors may understandably feel overwhelmed. While a common theme is tariffs, there are several motivations for them and it is helpful to consider each one individually in order to better assess what may actually materialise.

BNP PARIBAS ASSET MANAGEMENT

The sustainable investor for a changing world

Investor expectations that US equities would outperform the rest of the world following Donald Trump's election as president have been borne out. From 4 November 2024 through 13 February 2025, the MSCI USA IMI has gained 7.1% vs 1.9% for the MSCI All Country World ex USA IMI (in US dollar terms; the MSCI Investable Market Indices (IMI) include small cap stocks).

Since the beginning of the year, however, the ranking has reversed, with the US index gaining 4.1% versus 5.7% for the ex-US index. Europe has been a standout, as the MSCI Europe index soared by 9.8%. In fact, European equities account for all of the non-US index outperformance. The remaining countries advanced just 1.6%.

The recent news on negotiations between the US and Russia to end the war in Ukraine will likely only add to the positive momentum in Europe. The potential for a reduction in energy prices, less uncertainty, and eventual reconstruction opportunities for European companies are all supportive factors.

A period during which US equities paused their ascent is not surprising, particularly when the Trump administration is implementing its agenda far more aggressively than many expected and investors struggle to assess the implications.

There have been many threats, some realised, of tariffs. The assumption is that this will benefit US equities more (or damage them less) than non-US equities. But such a sharp rebound in Europe was nonetheless unexpected. One wonders how much further it may go.

Investor expectations that US equities would outperform the rest of the world following Donald Trump's election as president have been borne out.

European equity outlook

One cannot point to recent positive economic data as the motivator for the strong European equity returns. Purchasing managers' indices (PMIs) for January disappointed versus expectations and showed a slowdown in services sector activity. The rate of deceleration lessened for the manufacturing sector but still showed activity contracting.

On the other hand, analysts have turned more optimistic over the last few weeks. With the exception of the energy and materials sectors, forward earnings estimates have gained more than 2%, while those for US indices (including NASDAQ) have been nearly flat.

This improvement is partly the result of what has been a good earnings season. So far, profits for companies in the MSCI Europe index have risen by 6% (ex energy), and they have beaten expectations by 6%. Results for the US are even better, but expectations were already so high for the US, and so low for Europe, that the benefit for beating forecasts has been greater for the old continent.

An additional support has been the divergence in monetary policy. As the US Federal Reserve (Fed) pauses to assess the Trump administration's policies and recent high Consumer Price Index (CPI) inflation, the ECB is continuing on its rate-cutting path.

It is partly because of this rebalancing in expectations and the potential for a catch-up by non-US markets that we recently cut our overweight to US equities. We would anticipate, however, that US dominance will return at some point. Even if European growth has bottomed out, the recovery this year is likely to be anaemic, while US GDP should remain above potential.

Consensus estimates for earnings-per-share (EPS) growth in 2025 is 12% for the S&P 500 (ranging from 10% for the Russell 1000 Value index to 18% for the NASDAQ 100), while it is just 8% for Europe. There would have to be more positive earnings surprises in Europe, and disappointment in the US, for that gap to narrow appreciably.

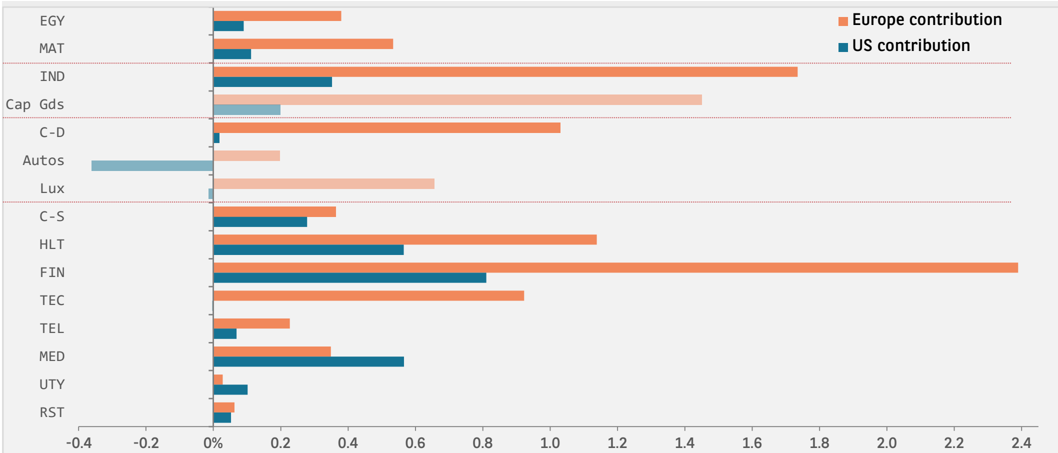
Sector returns for Europe year-to-date also point to a temporary recovery rather than a sustained period of outperformance (see Exhibit 1). Most of the difference in returns between Europe and the US have come from the financials sector, reflecting the divergence in monetary policy.

Higher interest rates have also disproportionately hurt the US given the weight of the tech sector in the index. To the degree the adjustment in policy rate expectations has taken place, there may be little scope for this pattern to persist.

Exhibit 1

Sector contribution to difference in year-to-date return, MSCI Europe IMI and MSCI USA IMI

Local currency terms; IMI includes small cap stocks



Data as at 13 February 2025. EGY=Energy, MAT=Materials, IND=Industrials, Cap Gds=Capital Goods, C-D=Consumer Discretionary, Autos=Automobiles and Components, Lux=Textiles, Apparel and Luxury Goods, C-S=Consumer Staples, HLT=Health Care, FIN=Financials, TEC=Information Technology, TEL=Telecommunication Services, MED=Media and Entertainment, UTY=Utilities, RST=Real Estate. Sources: FactSet, BNP Paribas Asset Managementa.

The imposition of tariffs on steel & aluminium imports has weighed on capital goods and automakers, and illustrates how tariffs are a double-edged sword. While they will benefit US producers, they will harm US consumers. Whether the net effect is positive depends on the availability of substitutes, among other things.

Valuations do favour Europe on a relative basis, as the forward price-earnings (P/E) ratio for Europe is near its long-run average, when it is modestly higher for the NASDAQ (z-score of 0.5), though much more for Russell Value (z-score of 1.1). But valuations are a poor predictor of near-term equity market performance without a catalyst to drive them back to the mean.

Tariff fog

Amidst the slew of tariff announcements since President Trump's inauguration, investors may understandably feel overwhelmed. It has been nearly impossible to assess which tariffs will be implemented when and on whom, given how quickly threats have been made then unwound.

While the common theme is tariffs, there are several different motivations for them and it is helpful to assess each one individually in order to better understand what may actually materialise.

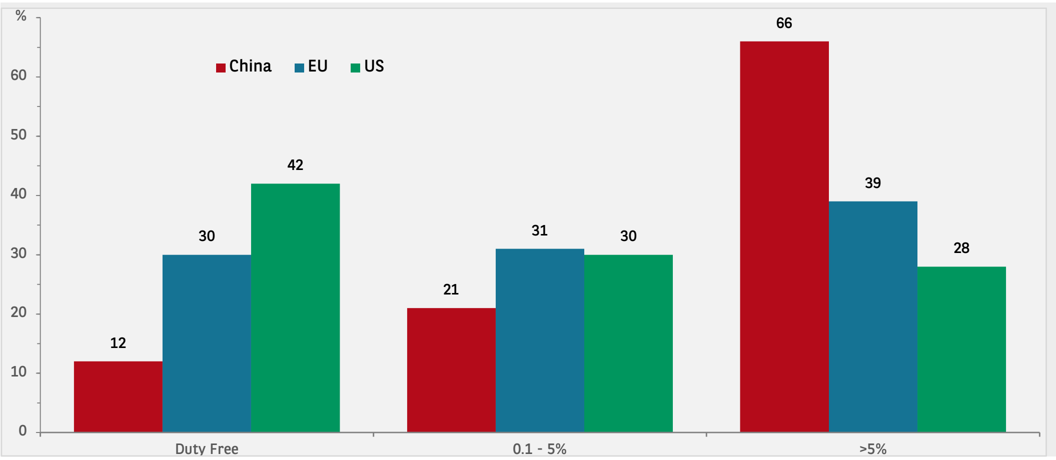
The first motivation is the use of tariff threats as a negotiating tactic – simply a means to an end. This has been the case in President Trump's discussions with Colombia, Mexico and Canada. The tactic has been effective because of the size of the US market and the large gap between US imports and exports. That is to say, many countries depend far more on the US for their exports than vice versa. For example, 83% of Mexico's exports go to the US.

While other countries may not have such a disproportionate exposure, the US has significant leverage to use tariffs to achieve other aims. To the degree that countries are willing to negotiate with President Trump, it is less likely these threatened tariffs will actually be implemented.

A second motivation for tariffs is to level the global trade playing field, at least from the point of view of the US. The US generally has lower tariff levels than its trading partners. Over 40% of US imports enter the country duty free, compared to 30% for the EU and just 12% for China (see Exhibit 2). The US has a 2.5% tariff on European saloon and sports utility vehicle (SUV) imports, while the EU places a 10% tariff on US exports.

Exhibit 2

Share of imports for each import tariff level



Data as at December 2024. Sources: WTO, BNP Paribas Asset Management

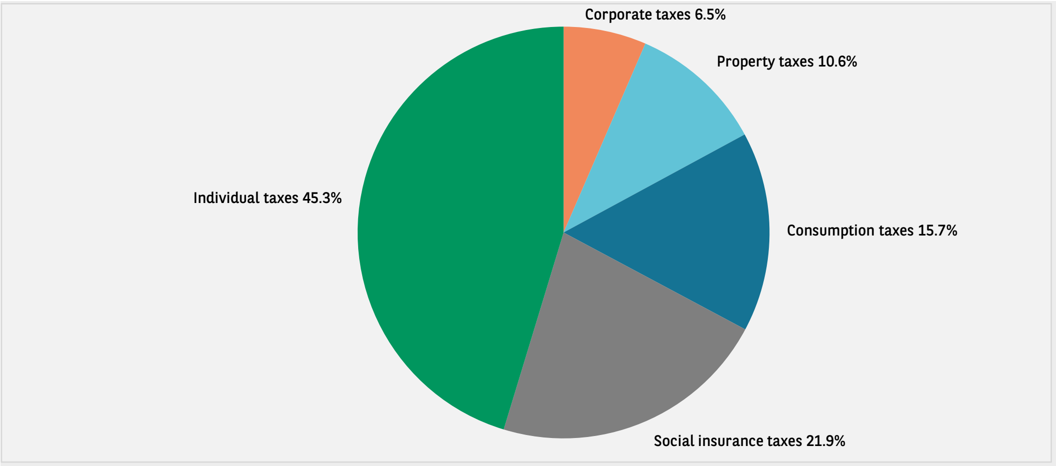
President Trump has threatened to raise US tariffs to the level of its trading partners if they do not lower theirs to US levels. While the risk of escalation exists, if the President's strategy is successful, we may actually see some tariffs decrease.

A third motivation is to impose tariffs for industries deemed to be strategic, such as steel and aluminium, regardless of the economic consequences. This is not an uncommon practice globally and was reinforced during the Covid pandemic when many countries realised they were too dependent on foreign production for key goods.

A final motivation — and one that suggests that eventually there may be permanently higher tariffs — is to raise government revenues. As members of the Trump administration have noted, early in the previous century, before the imposition of income taxes, a large share of US government revenues came from tariffs.

When the system was changed in 1913, the average tariff rate was 17.7% compared to 2.4% today (the initial income tax rate put in place was 1%). It is possible that a share of US revenues will come from tariffs in the future, allowing for a reduction in either corporate or individual taxes (see Exhibit 3).

Exhibit 3
Sources of US government tax revenue



Data as at 2022. Sources: OECD, BNP Paribas Asset Management.

While tariffs are accurately described as a consumption tax (and therefore bad for demand), given the dire US government fiscal situation, taxes do need to rise (and government spending to decline). Consumption taxes are arguably a less harmful way of doing so.

If the imposition of any permanent, broad tariffs occurs in a measured fashion, companies would have time to adjust their production. While there will be consequences, they do not have to be catastrophic. This more benign perspective may help explain why equity market volatility has fallen since the election and remains below the historical average.

US Treasury yields

The sell-off in US Treasuries that began in early December reflected the higher growth and inflation that markets were expecting as a result of the expansionist policies of the Trump administration. After peaking at 4.8%, however, 10-year yields dropped back to 4.4% (before moving up again recently after the hotter-than-expected CPI data). The retracement reflects two factors.

The first is concern about the impact of tariffs (both from the US and from its trading partners) on US economic growth. While equity markets would ostensibly also be worried about this, continued positive returns suggest equity investors are not unduly concerned. Equity and bond markets often assess risks differently, with fixed income more cognizant of the risks and equities more focused on the opportunities.

The change in Treasury yields also reflect worries about the US economy overheating, which wax and wane with the data. The January non-farm payrolls release showed surprisingly large gains in the number of jobs. The more recent data indicated much more moderate job creation. Services sector PMIs, while still above 50, declined compared to December. CPI inflation points in the other direction. Markets will likely remain volatile until there is a more discernible trend.

As investors, and the Fed, await further administration policy announcements and implementation, we would anticipate Treasury yields moving within the range we have seen over the last several months, with overheating risks battling stagflation worries.

Gold

Another indicator that the broad optimism seen in equity markets is not necessarily shared by all investors is the performance of gold. After the 27% gain in 2024, gold prices have moved up another 12% this year. This likely reflects ongoing demand from central banks and worries about inflation, but also a desire for investors to hedge against the significant uncertainties in the market.

While overheating risks seem to be waning, there are still scenarios where US Treasury yields move up sharply, and equity prices down sharply, leaving gold as one of the few assets that could maintain its value.

MULTI ASSET CLASS VIEWS

- In January, in light of global tensions and higher bond yields, we took the opportunity to initiate a long EMU duration position. Sovereign bonds looked attractive given eurozone growth weakness and prospects for ECB easing. We maintain long positions in European yields combined with short positions in US T-Notes, as we expect increasing decoupling between Europe and US in terms of economic growth and monetary policy.
- Our allocation is now neutral on equities as we tactically closed our overweight exposure to US equities in early February. While growth and earnings prospects remain supportive over the long run, uncertainties created by geopolitical tensions linked to a potential trade war call for more caution in the market. We noted stretched valuations and technical fragilities (high concentration, decreasing volumes, high investor positioning).
- Our positive conviction remains strong on gold, whose uptrend should continue even after the recent positive performance.

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