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Market Insights

7 April 2025

Tariffs and Turmoil: What Do Markets Need to Stabilize?

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Last week's US tariff announcement has triggered a global market correction, with no signs of near-term relief.

Risky asset indices have suffered heavy losses, with most equity markets around the globe down by about 10% — if not more — since the tariff package was announced on 2 April. Global markets have not experienced such stress and volatility since the early days of the pandemic in 2020. Equity volatility, as illustrated by the VIX index, has skyrocketed to over 50, its highest level since April 2020. Within the S&P 500, only 23% of stocks stand above their 200-day moving average, a level that is broadly comparable to that of the global financial crisis and the pandemic. Looking at broader markets, government bond yields have fallen markedly, reflecting a significant safe haven bid. US 10-year yields are now around 4%, having declined by some 20 basis points since 2 April. Likewise, 10-year bund yields have declined by the same amount. Meanwhile, credit markets have started to show signs of stress. This is particularly the case for high-yield spreads, which have widened by some 85 bps in the United States and by 60 bps in Europe since last Wednesday. In currency markets, the Japanese yen and the Swiss franc have outperformed over the past few days, given their defensive characteristics. Finally, in commodities, oil prices have corrected much lower, now down to low $60 levels, owing to their vulnerability to a global risk aversion shock.

This is a highly unusual crisis on many levels.

For a start, the source of the turbulence relates to a discretionary policy announcement by a single country, which is a rare occurrence. In fact, we are struggling to identify similar episodes in recent market history. In addition, in contrast to previous market responses, the US dollar is no longer perceived as a defensive currency. This can be largely explained by the fact that the US has been the epicenter of the global market storm. More broadly, it seems that US markets have underperformed their peers, which is also unusual at times of widespread market stress. For instance, emerging market sovereign spreads have shown more resilience than their US counterparts. Moving to prospective macro scenario analysis, there are no comparable shocks, which makes assessing the potential impacts complicated, but it appears that the equity markets are well ahead of fixed income in pricing in the worst-case scenario. Indeed, the recent market moves in equities are consistent with the pricing in of elevated recession risks, something that we don't see in fixed income. For instance, US investment-grade spreads would historically have to exceed 200 bps to signal a recession, so we are still a good 90 bps away from that level.

Investors fear a US — and by extension — global recession.

The implementation of broad-based tariffs undeniably has the potential to tip the US economy into a recession if they are kept in place for a sufficient period. While the US consumer had been healthy, the tariff shock — which essentially acts as a tax on consumption — could curtail domestic demand in a major way. In addition, in the face of elevated policy uncertainty, business sentiment is likely to deteriorate. Patience will be needed to assess the macro risks, as the potential shock to private consumption will materialize with a lag of several months. In terms of data, it is likely that this quarter's corporate earnings will largely be ignored. Likewise, companies will probably not provide much guidance, given the prevailing uncertainty.

Looking ahead, there are a few scenarios that may lead to a recovery in the global market backdrop.

In the near term, it is possible that tariffs will be negotiated down, although there is little visibility on this front. More importantly, the US government's policy focus may shift to a more growth-supporting agenda, including potential income tax cuts and business-friendly deregulation measures. If these are put in place soon, the net impact on the US economy may tilt positively, thereby allaying recession fears. This will be a key item to watch.

While waiting for the dust to settle, it may be appropriate to look into de-risking multi-asset portfolios.

With that in mind, we believe that fixed income remains well positioned in the period ahead as an attractive de-risking asset class. The case for being long duration has strengthened considerably over the past week, reflecting the downside risk to growth and growing expectations that global central banks may have to accelerate the pace of policy easing in the face of a growth shock. Within fixed income, we believe that the lower-beta, longer-duration asset classes appear to be better positioned amid the current turbulence. These include securitized assets, munis and higher-rated segments of fixed income. For the non-US investor, currency exposure should be carefully considered given the negative outlook for the US dollar. On the equity side, we anticipate that the global rotation away from the US may persist until we reach the point of the US being clearly identified as a buying opportunity. That time may come, but it is impossible for now to make that call. Understandably, we would currently favor a quality bias when looking at security selection as well as exposure to lower-beta sectors.

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