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Monthly Equity Market Topics

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In Brief

- Trump uncertainty premium and growth concerns on the rise
- Changes in AI and where the opportunities lie
- Europe from ugly duckling to swan?
- Who pays the costs for tariffs?

Navigating Market Uncertainties

Recent events have sparked concerns among investors regarding the potential implications of political and economic uncertainties surrounding the Trump administration's policies and on a rethink of the AI infrastructure buildout. Economic data releases in the United States over the last couple of weeks have sent mixed messages, adding to the unease, while European markets have performed well but not without exogenous risks of their own.

1. Market Dynamics and the Trump Uncertainty Premium

The selloff over the last few weeks has primarily been driven by a reversal in momentum in expensive US stocks and growing risk aversion among investors, exacerbated by uncertainties surrounding the Trump administration's fiscal policies, tariffs and the uncertain prospects of a Ukrainian peace deal. Additionally, a shift towards higher savings rates amid renewed inflation fears may be a sign of growing consumer unease.

2. Economic Indicators and Market Reactions

US 10-year note yields have fallen over the last month as the market is increasingly concerned with growth prospects. The equity market's lack of response to falling yields underscores the importance for investors to focus on reported earnings rather than expectations, given the mixed signals from economic data, including the January effect, where inflation picks up early in the year, and the impact of external factors such as weather and the California wildfires. Manufacturing PMIs recovering from their September lows is a positive as this is typically correlated with positive market performance. If sustainable — and not tariff front running — this could be positive news for market breadth.

3. Sector Performance and Investment Opportunities

There are signs of resilience. The S&P 500 and MSCI World Equal Weighted indices are both in positive territory and have outperformed cap-weighted brethren year to date.

The performance of major indices such as the S&P and MSCI World is significantly influenced by the 'Magnificent Seven' (Mag 7) stocks, which have recently shown a notable variance in performance, highlighted by a substantial 40% year-to-date difference between the top performer, Meta, and the worst, Tesla. Despite their varying business models, the mag 7 continue to be recognized as leaders in their respective fields. However, the increasing scrutiny over the monetization of artificial intelligence (AI) and the shifts brought about by innovations like DeepSeek suggest a changing landscape. While the long-term prospects for AI remain promising, the high valuations across the sector suggest that the market may have set overly-optimistic short-term expectations.

Measured by capex to sales, hyperscalers are now among the most capital-intensive companies in the market, second only to utilities, and face the challenge of transitioning from a capital-light approach to managing significant capital expenditures and the associated depreciation costs. This shift could temper their performance as they adjust to these new financial realities. Earnings growth expectations remain strong but we may be experiencing a period of digesting elevated near-term expectations. The rapid evolution of technology, akin to how smartphones revolutionized the internet, necessitates a vigilant and adaptable investment strategy.

Given this backdrop, uncertainty around AI earnings growth, coupled with an earnings recovery beyond the companies in the AI ecosystem, presents an opportunity for fundamentally focused active managers. If correct, and the Mag 7 goes through a period of digesting valuations, such a shift might remove a headwind to active management, leveling the playing field. Against that backdrop, investors may want to rethink the level of concentration in their portfolios. In such an environment, valuation becomes crucial. Investors should focus not merely on price (i.e., stocks with low multiples) but on value, acquiring shares at reasonable prices for anticipated future earnings. We continue to favor higher-quality, resilient companies, potentially providing a hedge against some of the uncertainties that have been outlined above.

4. European Markets: Ugly Duckling to Swan

Since early 2025, European equities have shown remarkable performance, outpacing those in the US. Several factors have contributed to this trend. However, the key has been earnings expectations, which have remained stable for Europe but have been softening in the US over the last three months. Europe is also benefiting from expectations that the European Central Bank has more room to ease monetary policy than the US Federal Reserve. This benefits European companies as they tend to show greater sensitivity to declining interest rates. Political uncertainty has eased of late, with the German elections playing out largely in line with expectations and France being able to push its 2025 budget through a splintered parliament. Incoming German Chancellor Friedrich Merz's move to follow the "whatever it takes" mantra is expected to result in drastically increased government spending from Europe's largest economy, coupled with increased defense spending across the continent. Lastly, Europe has been under owned by international investors in recent years, suggesting that a normalization of capital flows could provide the region with a tailwind. However, with trade tensions rising, the prospects for US tariffs are a potential stumbling block, as is a breakdown in Ukraine peace talks. Both risk factors remain elevated and could quickly reverse sentiment.

Investors are advised to weigh these factors in assessing their exposure to European markets, which may still offer some value.

5. Tariffs: Who pays the cost

On 4 March, the US put in place 25% tariffs against imports from Canada and Mexico and increased tariffs on China to an average rate of nearly 30%. Beyond the broad effects on economic growth, the impact of tariffs on corporate earnings remains uncertain. Essentially acting as a tax, the burden depends on who ultimately bears the cost. Several factors must be considered in this analysis: each company's manufacturing and supply chain setup for various products, their ability to set prices, the extent to which exporters can absorb costs within their profit margins, the effects of currency fluctuations, the capacity of importers to absorb costs, the availability of alternative products, and the price elasticity of demand for the affected goods.

If companies can pass on tariffs to the consumer without any significant demand destruction, they likely will. To the extent they can't, the costs will be shared between exporters and importers, compressing their profit margins. Currency depreciation may provide some reprieve, but perhaps only a short-term one. Tariffs magnify the importance of stock selection and knowing what you own.

This ambiguity in who pays has been reflected in recent price action. On a sector basis, it didn't seem as though investors were specifically avoiding importers; rather, they were generally shunning risk.

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