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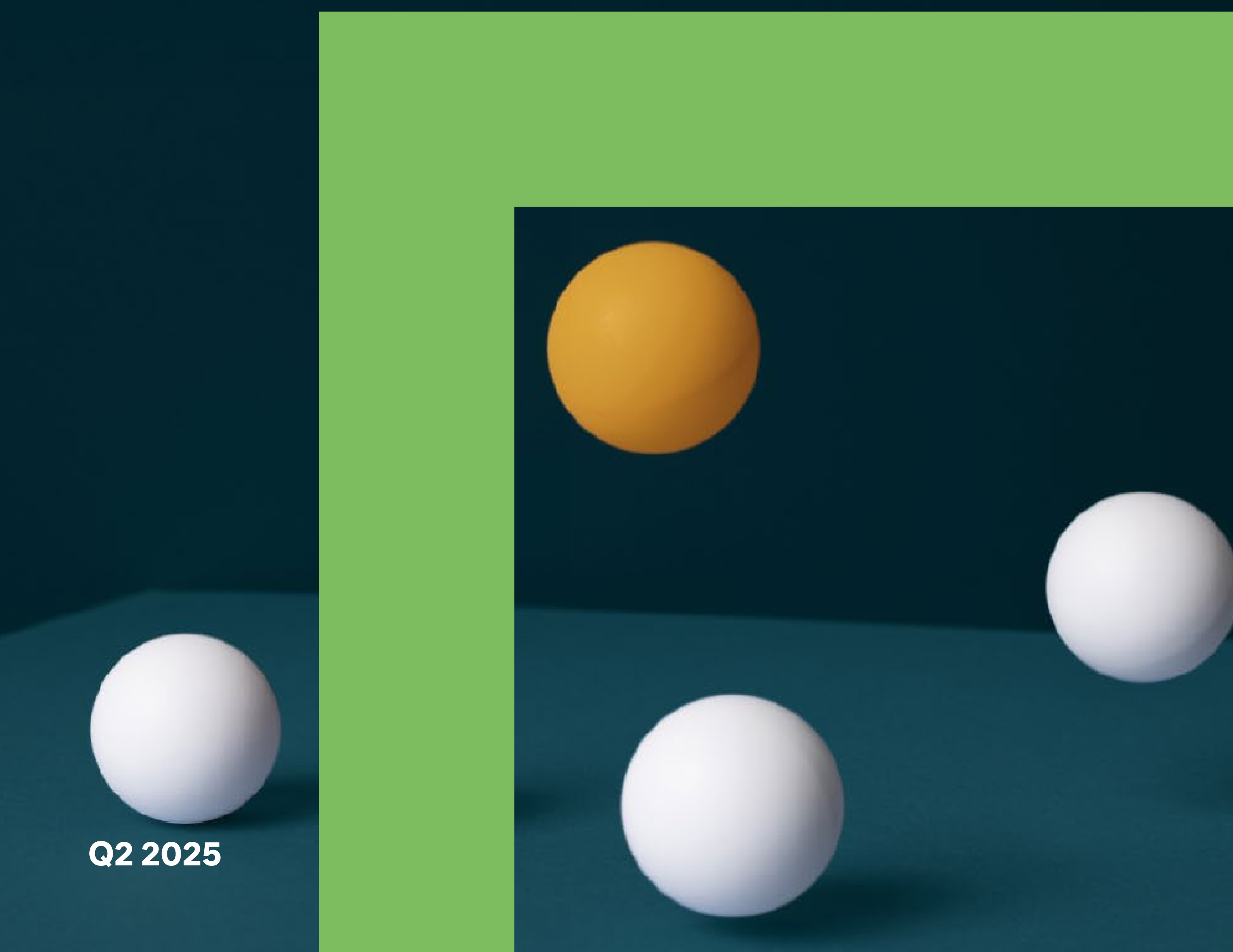
M&G Investments

Quarterly Equities and Multi Asset Outlook

Dispersing the herd



Q2 2025

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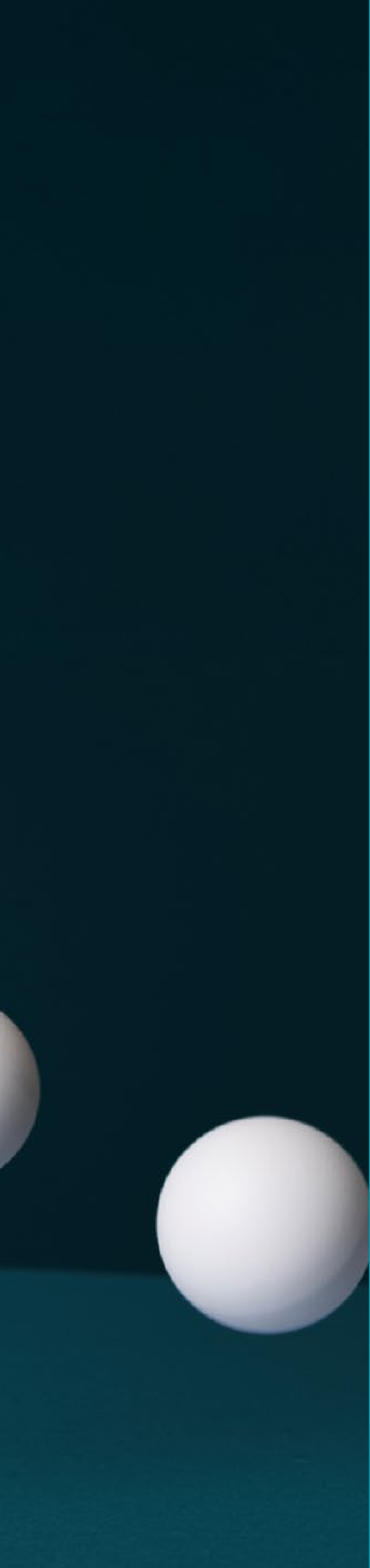


Dispersing the herd

In this environment, taking broad market positions or trying to time events appears foolish, as we contend with the unidirectionality of tariff decisions and increased market velocity. Yet many attempt to do so.

If tariffs don't get reversed, or at least mitigated, the negative sentiment on equity and credit markets is likely to be reprised. When the macro is uncertain, focus on company-specific fundamentals.

While US exceptionalism is alive, in the form of strong intellectual capital, deep capital markets, and a culture that fosters entrepreneurship, the market's traditional belief in the US being a safe haven is being challenged.

We are living through a near-term world economic disorder, which is likely to lead to a new long-term world economic order. There still is no alternative that would warrant completely divesting from the US, but there are options to diversify our portfolios and build in resilience.

Empires fall, but they don't fall in one day

Earlier this month, as the tariff announcements were coming in, with a few ensuing twists and turns, we chose to delay the publication of this Quarterly. We wanted to gather more context and offer our readers up to date thoughts on what was, arguably, a momentous time in markets.

Investors started this year thinking that corporates and governments were better prepared for a Trump 2.0 trade war. That proved not to be the case. Eventually, the tariff announcements caught markets by surprise, as they were broader and deeper than expected. Corporates deliberately diversified their supply chains away from China, only to find out that their new manufacturing locations, for example Vietnam, were also being hit by high tariffs.

As investors, our aim is to establish the range of likely future outcomes and then look for areas where market positioning does not fit with any of those outcomes. This is how we find the mispricing that leads to future alpha. Those outcomes, at the moment, are 180 degrees apart, as they hinge on the decisions of a few individuals, or most likely one, President Trump. The good news is that the longer we live with the current uncertainty, the narrower the angle. The bad news is that the longer we live with the current uncertainty, the angle is narrowing toward the less desirable outcomes.

At the time of writing, we are a few days into a 90-day reprieve on tariffs imposed on a number of non-retaliating countries. We have also had exemptions on consumer electronics, as well as the start of a probe on pharmaceuticals and semiconductors on the grounds of national security, which could end in additional tariffs.

Markets, in equities as in fixed income, have lived many lives since 'Liberation Day'. After a torrid start, equity markets recovered first on news that some countries were open to negotiate, and then on confirmation of a 90-day reprieve. Credit spreads also gave in and initially widened, before experiencing a small improvement. None of the declines were surprising, given the impact that such levels of tariffs – if confirmed –would have on corporate earnings and cashflows. Companies would have to scramble to reset their supply chains and their end markets, leading to an increase in their cost base. This could potentially mean less end demand if they try to pass higher costs on to consumers.

Government bonds, particularly treasuries, were more difficult to interpret as the long end of the curve sold off in an environment where typically a flight to safety would benefit US long duration. Whether the move was due to the need to create liquidity to cover margin positions, or perhaps the unwind of more speculative levered positions, it took markets by surprise. UK gilts followed the same pattern, whereas German bunds moved closer in line with the expected playbook of lower yields at times of uncertainty.

If we add the decline of the US dollar to the US treasury yield behaviour, it does feel as though some of our traditional beliefs in the US being a safe haven are being challenged.

And the challenges do not end here. Markets are evolving in more than one way. One key development, evident to those who sit daily in front of their screens, is the increased velocity of market movements.

Even before the tariff announcements, the S&P's drawdown from its high year-to-date (between the second half of February and the first half of March) was the 8th fastest correction since 1929, occurring in just three weeks, and matching years such as 1930, 1939 and 2003[1]. It was not a deep correction at just over 10%, but it was fast. And on 7 April, we all witnessed the pre-market move in the Eminis (futures indices) staging an approximately US$2.5 trillion market cap gain in the space of a few minutes.

The rise of sophisticated trading systems, easier access to the market by retail investors via their smartphones, and the increased share of passive and quantitative strategies may all be fuelling this increased velocity. Policy news also supports the trend, as the Trump 2.0 administration appears to be in a rush. In the first 85 days, we've had 125 executive orders. This is an impressive number, and compares to 23 during the first Trump administration, and 39 during the Biden

[1] Source: Bloomberg, M&G Investments, April 2025.

administration. Whatever the reasons behind the increased velocity, herd behaviour is on the rise and is increasingly erratic, as many make futile attempts to time the market moves.

As markets have been gyrating, we have been visiting clients in Asia and also spending time on calls with clients elsewhere in the world. The conversation topic and overarching question was fairly unanimous: ‘are we witnessing a shift in the dominance of US markets over the rest of the world? Is US exceptionalism over?’

As I see it, we are living through a near-term world economic disorder, which is likely to lead to a new long-term world economic order. Empires fall, but they don’t fall in one day. US exceptionalism is alive in the form of strong intellectual capital, deep capital markets, and a culture that fosters entrepreneurship. But this doesn’t mean that the US market is the only game in town.

Markets appear to have woken up to such a realisation. We are seeing a slow decay in the world’s belief that there is no alternative to investing in US assets. In my opinion, there still is no alternative that would warrant completely divesting from the US. However, there are options to diversify our portfolios.

The relative economic and fiscal health of the US versus the rest of the world is deteriorating. The probability of a US recession is significantly increasing. While the latest job market data gave a false sense of security, forward looking datapoints, such as confidence both at the corporate and at the consumer level are in a different place. We have already started to see some signs of that erosion that could eventually tilt the balance toward recession.

Earlier this month we saw ISM new orders continue their weakening trend. To me, the key piece of information was the statement that came with one of the most recent releases from the Chair of the ISM Services Business Survey Committee, reporting that the biggest concern expressed about tariffs was business uncertainty and the inability to get long-term agreements in place. It is a slippery slope from there.

“Empires fall, but they don’t fall in one day. US exceptionalism is alive... but this doesn’t mean that the US market is the only game in town”

Also the University of Michigan Consumer Sentiment Index continues to weaken. We need to monitor these datapoints and see if they manifest in economic activity. Of course, a more definitive change in tack from the Trump administration could turn confidence around. But clearly, the longer the tariffs stay in place at current levels, the higher the likelihood of a recession.

And while any positive news on tariffs has proven able to lift sentiment of risk markets, if tariffs don’t get reversed, or at least mitigated, the negative sentiment on equity and credit markets is likely to be reprised. The level of uncertainty at this point remains very high and hinges on President Trump’s decisions.

In a market where the macroeconomic environment is highly uncertain, the best course of action is to focus on the microeconomic environment. This means focusing on specific securities, on the resilience of their businesses, on their exposure to positive drivers and ability to withstand the negative ones. Any market, even one with broad undercurrents as the one we are in, is bound to generate both winners and losers.

Most affected by tariffs will be companies that are exporters with a predominantly Asian supply chain reliance, as it will take years and a significant amount of capital to shift the supply chain to the US, if even feasible. Other companies will suffer from the competition of other players trying to shift end markets. This is not necessarily a case of looking for a sector or a country to be more cautious on but, rather, one of examining circumstances and fundamentals on a company-by-company basis. Of course, there are countries and sectors where we are finding more names that are less exposed to tariffs, or names where the positive impact of other factors more than offsets the negative hit from tariffs.

For example, some companies in Europe will benefit from the increased defence spending as well as from the €500 billion infrastructure fund from Germany. As the European economy is very interconnected, the fiscal spending should impact companies beyond Germany and across Europe. Also, the stimulus comes from a healthy balance sheet (ie, Germany's), which is no small feature in a world of ballooning government deficits.

And the prospects of peace in Ukraine could offer additional support to European corporates, bringing back sanctioned hydrocarbon supply and reducing gas prices. While natural gas prices have come down from the 2022 peaks, they are still twice the level they were in March 2021, before concerns on Ukraine started to escalate and eventually we had the invasion the following year.

Last but not least, another tailwind for Europe is likely to be brought by the shift in regulatory tone. If Mario Draghi's report on European competitiveness did not convince the European Commission to take swift action to cut red tape and bureaucracy, President Trump may just do the work. We are already seeing steps in this direction on the other side of the Channel, with January's easing of certain capital requirements under the UK's new post-Brexit financial framework, and the announcement from the Bank of England that it intends to reduce the 'reporting burden' on UK banks.

Europe is not the only place where we find opportunities. We also see some emerging from the recent sell off in technology stocks in Asia and the US, where we have seen large movements to the downside. For a number of technology players, the long-term outlook remains intact, including names in semiconductors and semiconductor capital equipment. The earnings season that just started, where companies are likely to guide conservatively on near-term outlooks in light of the tariff uncertainty, may offer even more opportunities for active investors in this space.

In Emerging Markets (EM), we are also finding opportunities in India, particularly in the domestic sector. As a country, India is relatively more insulated from tariffs as the share of domestic revenue of the Indian market is above 70%.

Of course, a deep US recession could disrupt the party anywhere in the world. And while the recent volatility at the long end of the treasury yield curve has shaken and confused many market participants, we continue to believe that government bonds remain a good insurance against a significant macroeconomic deterioration.

As with equities, what matters more than the asset class, is the underlying composition and diversification. We have diversified our government bond exposure into UK gilts, which have recently moved in sympathy with US treasuries for no apparent reason of their own, and German bunds which saw a yield increase at the time the fiscal package was announced, and are still founded on a solid balance sheet. In the US, we are diversified along the yield curve (including 5, 10 and 30 year treasuries).

While we have seen volatility, particularly at the long end of the curve, if we were to experience a significant macroeconomic slowdown in the US, the Federal Reserve (Fed) would have to cut rates in response. Of course, this assumes that inflation stays benign. If that were not to be the case, the Fed could also go back to measures last used during COVID, including purchasing corporate debt and treasuries.

This remains an environment where taking broad market positions or trying to time events (and investors' reactions to them) appears foolish. Yet, many attempt to do so. We carefully watch the herd – aimlessly moving from end to end, reacting to an increased amount of noise – and take advantage of the idiosyncratic opportunities that derive from it. We believe this is the best way to serve our clients.

Over the next pages, our Equity and Multi Asset investment teams will discuss their observations on the recent market volatility, and where they continue to find attractive investment opportunities.

We wish you an enjoyable and – hopefully – interesting read.

Fabiana Fedeli
Chief Investment Officer, Equities, Multi Asset and Sustainability

Multi Asset

Gautam Samarth
Fund Manager, Multi Asset

Why hiding in the crowd might be dangerous

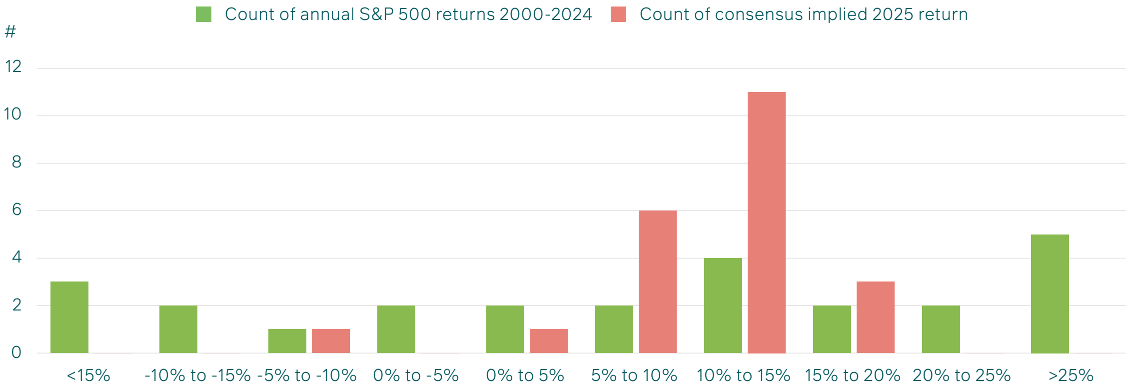
The concept of herding in financial markets is a well-established one. It is a rational human response to ambiguity, where investors seek comfort in crowds. Herding is one of several reasons why momentum in asset prices can persist, often times beyond any fundamental justification. It is also the reason why we, as humans, tend to underestimate a plausible distribution of outcomes when trying to forecast the future.

Take for example consensus expectations for returns on the S&P 500 Index at the start of the year:

The average 2025 year-end target price for the S&P 500 Index implied a c.10% return, with only 1 out of 22 strategists suggesting that the index might decline over the year[1].

Despite the general sense of optimism, there was an unwillingness from those polled to stick their necks out, with over half of the forecasts falling within 2% of the average. This narrow range of forecasts was all the more surprising when you consider the historical distribution of annual returns from the index which has been much wider, with outlier outcomes (big down or up years) just as likely as the average outcome (see chart below)[2].

Distribution of forecast 2025 S&P 500 Index returns versus the past 25 years delivered Index returns



Source: Bloomberg, M&G Investments, April 2025. Bloomberg consensus estimates. Distribution of consensus implied 2025 returns for the S&P 500 Index versus delivered annual returns 2000-2024. Past performance is not a guide to future performance.

> "Herds are slow to adjust to shifts in decades long trends"

What drove such confidence in the central forecast?

Narratives certainly played a part here. That a Trump election victory and a Republican sweep of both houses would be a boost to the corporate sector was taken as a given. Tariff threats were dismissed as a negotiating tactic alongside a sense that US exceptionalism would deal with any ensuing trade disruption better than the rest of the world.

I'd suggest two other reasons, the first being an extrapolation of recent experience. On almost all accounts, the ownership experience of US equities has been a rather enjoyable one. The last two years of c.25% annual returns caps off a 10-year period over which the S&P 500 Index

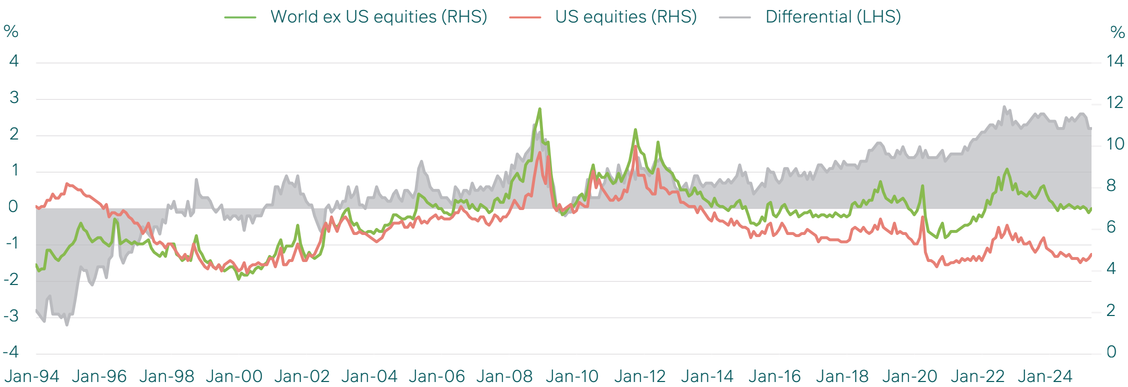
[1] Source: Bloomberg, M&G Investments, April 2025. Bloomberg consensus estimates.
[2] Source: Bloomberg, M&G Investments, April 2025. Bloomberg consensus estimates.

has returned 13% pa. Only the Turkish equity market returning 30% pa (but incurring a similar rate of currency depreciation) and Taiwan, which has returned c.15% pa have outperformed the US equity market in local currency terms over this period. You can start to see how market participants become more confident in positive outcomes after experiencing decades long resilience[3].

The second reason has to do with social acceptance. It wasn't long ago that strategists were predicting a recession on the back of the Federal Reserve's (Fed) rate hikes through 2022/2023. Those that forecast falling equity markets on the back of such an economic slowdown were embarrassed by the subsequent strength in US equity markets, making it all the more difficult to retain a bearish view – it's far more comfortable to hide in a crowd of optimists than stand out as a pessimist.

As is often the case, markets have been extremely surprising in 2025. Against a backdrop of generally higher global equity markets, the S&P500 Index declined c.10.4%[4], reversing all of its post-election gains. This was even before the 'Liberation Day' tariff-induced market turmoil ensued. It raised the question – was this just a bump along a continuation of a long established trend, or the start of a more meaningful reversal in US equity leadership?

Equity Earnings Yield: US vs World ex US



Source: LSEG DataStream 1 April 2025. MSCI Indices used for comparative purposes.

We've often reiterated that when market participants hold narrow and confident beliefs (as has been the case with US equities), a shock to such beliefs can create outsized asset price adjustments.

In the case of US equities, continued strength is predicated on rich valuations being supported by above-trend earnings delivery. This belief is starting to be tested but has hardly been shaken – the sharp rebound in US equity performance on 9 April, on the announcement of a 90-day delay in implementing tariffs shows that appetite for US exceptionalism is still rife.

Herds are slow to adjust to shifts in decades long trends, making a contrarian bet on US equities still look very attractive from a risk-reward perspective. As such, we retain our short S&P 500 Index exposure in our most tactical strategies, while remaining underweight across our long only multi asset range.

[3] Source: Bloomberg, 9 April 2025, 10-year period: 31 December 2014 through 31 December 2024.
[4] Source: Bloomberg, 11 April 2025.

Global

Richard Halle
Fund Manager, European Equities

Is it time to 'value' more than a narrow subset of the equity market?

Europe has been out of favour for so long that international investors have largely ignored it, and global investors have opted for the region's well-known growth stocks. Consequently, the cheapest quartile of stocks has been overlooked. Similarly in the US, the dominance of the Magnificent-7 (Mag-7) reignited the concept of US exceptionalism, neglecting undervalued companies. The result is a substantial valuation gap between growth and value stocks in both regions.

To some extent, this is down to the prolonged period of low/zero interest rates, during which time growth stocks possessed attributes that investors favoured, prompting these stocks to rerate to unprecedented levels, without regard for valuation boundaries.

Regime Shift

Many of the attributes that allowed growth companies to rerate significantly are no longer present in the market. We have entered a new regime with different trends and increased volatility. Historically, during such turning points, the companies that perform well in the subsequent decade are often different from those that excelled in the previous decade. Therefore, we could very well see many growth stocks start to disappoint more broadly, while the cheapest quartile could become the new growth stocks. This shift is already underway and has been extraordinarily powerful.

> "We have entered a new regime with different trends and increased volatility"

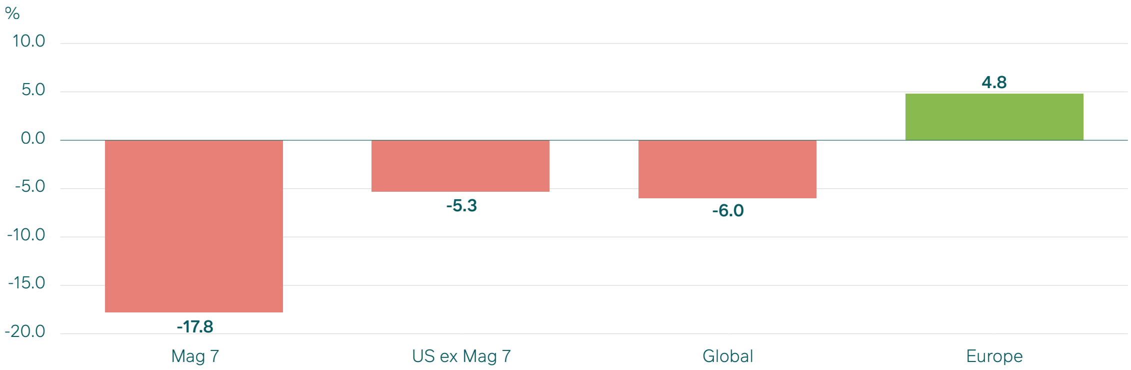
Putting the theory into practice

The Mag-7 has dominated market headlines over the past few years. Investors likely did very well with this concentrated cohort, whilst other businesses with strong fundamentals were overlooked.

However, the start of 2025 has highlighted the changing market dynamics; now even meeting consensus expectations is not enough to ensure stable or rising share prices. With a backdrop of growing uncertainty, investors are recalibrating their exposures, shifting the fortunes of the Mag-7, which is down 17.8% year-to-date, versus around -5.3% for the US-ex-Mag-7, -6.0% for the MSCI World Index and positive returns (+4.8%) for the MSCI Europe Index (in US dollar terms)[5].

[5] Source: Bloomberg, 11 April 2025, MSCI World and MSCI Europe indices used for Global and European equity price returns respectively.

Year-to-date price performance



Source: Bloomberg, 11 April 2025, MSCI World and MSCI Europe indices used for Global and European equity price returns respectively. Returns in US dollars. Past performance is not a guide to future performance.

This is not just a recent phenomenon. Once considered value traps with structural problems, the European banks have undergone significant changes and have outperformed the NASDAQ and the Mag 7 in recent years. Beyond banks, the defence sector has rallied; having suffered from weak end markets for many years, investors now anticipate benefits from Europe's rearmament stance.

We continue to find new opportunities in this changing regime, such as in materials. The European rearmament story relies on European reindustrialisation. Suffering from demand and supply imbalances and weak end markets, the market has derated construction-related stocks like steel and cement to single-digit multiples. However, some companies here are delivering strong profits, with further potential upside from the industrial recovery.

Slow wins

We believe the current market volatility creates excellent opportunities for bottom-up, fundamental investors like us. In this environment, valuations truly matter. Our approach focuses on building solid portfolios that can withstand various geopolitical scenarios. We believe that buying undervalued stocks which are relatively well financed positions us well. By embracing our 'slow wins' approach, we hope to continue navigating through further market volatility and macroeconomic uncertainty, seizing opportunities that may arise.

Impact

John William Olsen
Head of Impact Equities

Avoiding fragility, building in resilience and taking opportunities

Herding in financial markets happens when many investors make the same choice based on what others are doing – typically linked to an obvious trend, a belief that there will be more buyers at even higher prices, and a fear of missing out. Market diversity declines when investors herd; it becomes fragile and more prone to booms and busts.

As active managers, our long-term portfolios are run with a focus on fundamental value (the risk-adjusted and discounted value of probable future cash flows) and proper diversification, which can be challenging when market participants 'herd'.

We have witnessed this behaviour becoming more pronounced in the last couple of years, particularly in US equities, leading a high-growth segment of the market (for which it is more difficult to predict cash flow streams over the next ten years) to outperform dramatically.

The idea of 'American Exceptionalism' was challenged in the first quarter of 2025, and we began to see a reversal of the narrow market leadership we'd witnessed in 2024.

We believe our global strategies are relatively well set up to deal with the dispersing herd in the US equity market. The flip side of last year's challenges from the concentration of market returns in a small number of stocks, and our focus on creating less fragile portfolios becomes a relative tailwind. Not just because relative performance becomes less challenging, but also because it can open up opportunities that are behaviourally easier to step into, if real turmoil hits markets.

> "Market diversity declines when investors herd; it becomes fragile and more prone to booms and busts"

European equity markets saw a sharp rise in value stocks in the first quarter, driven by defensive value, such as large cap pharmaceuticals, and more cyclical defence and infrastructure companies, driven by both fundamental macroeconomic factors and a shift out of US growth to European value. US growth stocks, especially in the US tech sector, still look fragile, and the cyclical lower quality stocks will be more at risk when macroeconomic sentiment slips.

The Trump administration's back and forth on tariffs has been testing investors' resolve. Some investors can get caught up in the short-term whipsaw mechanisms of the market. For us, we think that by maintaining a

well-balanced portfolio, with a clear focus on companies that have a proven ability to navigate challenging environments (while still looking reasonably valued), we are well positioned to deliver long-term value for our clients, but also to take advantage of those relative near-term opportunities when these high-quality names are caught in the wave of indiscriminate selling.

One last, and yet important, point. In the Impact Equities team, our focus on promoting climate consciousness in our investee companies has definitely become challenged by the change in political focus in the US, both across our Paris-Aligned and Impact strategies.

But that just increases further the importance of our efforts to pursue the intentions of our investor base, and push our investee companies to improve real world outcomes. We do not see it as a financial performance headwind, nor a material limitation in pursuing opportunities, and most of our companies already share our values.

Thematic Technology

Jeffrey Lin
Head of Thematic Technology Equities

Potential for slower growth near term, but data centre demand continues to support capital spend

The first quarter of 2025 was a very volatile period caused principally by geopolitical concerns. The prospect of a global trade war driven by tariffs has created uncertainty with regard to economic growth, inflation, corporate profitability, and consumer demand. In addition, the US Department of Government Efficiency (DOGE) is reducing US government spending and reducing money supply into the US economy.

The tariff announcements in early April were more severe than expected, and the subsequent decision to pause some reciprocal tariffs for 90 days on trading partners (ex China) saw markets whipsawing in a matter of hours. However, the ratcheting up of tariffs between the US and China remains, and the longer and more intense the trade war persists, the higher the likelihood we will see downside earnings revisions at least in the near term.

Specifically, it's important to note that a meaningful percentage of end-market goods such as smartphones, PCs, and servers are manufactured in China, Mexico, and Taiwan and thus the direct and indirect impact is not insignificant from a technology supply chain perspective.

The net result of the above is potentially slower economic growth and inflation as the costs of tariffs are passed to the end buyer. From a capital markets perspective, the uncertainty is increasing cost of capital and lowering growth expectations, leading to lower equity valuations.

The valuations of high-growth companies are more sensitive to changes to growth and cost of capital changes and, hence, have been more impacted than most companies.

In the area of technology, there have been concerns on the sustainability of infrastructure spending for Artificial Intelligence (AI) as well as revenue from the US federal government in the near term. On the latter, whenever there is a change of leadership, government spending's normal purchasing cycle changes in the near term as the new leadership takes over. With DOGE, and government spending under additional scrutiny, the pause is likely to be more severe than during a normal transition. The US government, going forward, will need to do more with less and will need to improve its IT infrastructure to improve efficiency.

> “While we expect the near term to be volatile, we believe innovation will continue to drive investment returns over the long term”

While the macroeconomic situation is uncertain in the near term, we remain confident in the long term prospects for many technology stocks because tariffs imposed can be reversed and technology innovation continues. Political regimes in the US are temporary and will evolve during the next election cycles.

NVidia held its annual GPU Technology Conference (GTC) in mid-March and highlighted its product roadmap through 2027, along with potential new applications of AI that could become possible with increased computational capabilities. Generative AI for the past two years has driven demand for AI infrastructure. Future AI use cases for Agentic AI (ability to reason) and Physical AI (Autonomous vehicles and Robots) are entirely possible with increasing computational power.

More complex AI use cases requiring higher levels of compute power

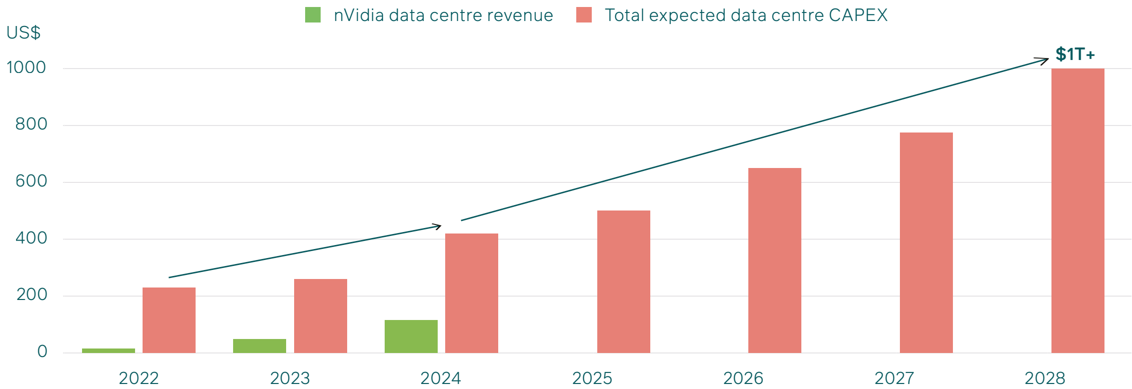
I need to seat seven people around a table at my wedding reception, but my parents and in-laws should not sit next to each other. Also, my wife insists we look better in pictures when she's on my left, but I need to sit next to my best man. How do I seat us on a roundtable? But then, what happens if we invited our pastor to sit with us?

Traditional Large Language Model (LLM) Tokens: 439	**Reasoning Model** Tokens: 8559
	Reasoning On **20x more tokens** **150x more compute**

Source: Nvidia AI Global Technology Conference, March 2025. Tokens, in the context of large language models (LLMs), are the basic units of text that the model processes. They can influence how efficiently a model processes language and its overall performance in various tasks.

Historically, increasing computational power has increased addressable markets for computing. While the investment opportunity for AI for the past two years has principally been focused on AI-enabling technology, we have seen the investment opportunity broaden to AI beneficiaries and AI providers, which are two key investment areas in our AI investment strategy. Additional improvements to AI-enabling technology will further accelerate this trend. By 2028, data centre capital spending is expected to reach US$ 1trillion annually, driven by more complex AI use cases needing higher levels of computer power, and we think demand supports this growth trajectory[6].

Computing at inflection point – Data centre capital expenditure expected to reach $1 trillion annually by 2028



Source: Nvidia AI Global Technology Conference, Dell'Oro Group, March 2025, Data Center CapEx expected to reach US$ 1trillion annually by 2028 and surpass this by 2029: Data Center Capex to Surpass $1 Trillion by 2029, according to Dell'Oro Group.

Where to go from here?

While we expect the near term to be volatile, we believe innovation will continue to drive investment returns over the long term. Companies that are innovating to improve efficiency and increase their revenue opportunities remain highly attractive in our view.

[6] Source: Nvidia AI Global Technology Conference, Dell'Oro Group, March 2025.

UK

Michael Stiasny
Head of UK Equities

UK equities: offering diversification and alpha potential in a world where crowding has raised risk.

As of the first quarter 2025 drew to a close, the dispersion in performance across sectors and companies in the UK market was notable and for the sharp-eyed active manager this is fertile ground.

Two sectors stood out in particular during the first quarter: defence and banking. Their strength is emblematic not only of the broader macro shifts underway, but also of the changing nature of risk, regulation, and geopolitics.

The outperformance of the UK defence sector has been striking

Geopolitical tensions have been elevated with the arrival of the new Trump administration in the US and the changing nature of the relationship it wishes to pursue with both their traditional allies and traditional adversaries. With continued conflict in Eastern Europe, a more assertive China, and Western concerns about being dependent on the US for defence, we are seeing a focus on spending.

Against this backdrop, prospective defence budgets are climbing globally, and the UK is no exception. In March, the government confirmed a significant uplift in spending, with a renewed commitment to modernisation and cyber capabilities. The potential for significantly increased European spending could also impact at least the European subsidiaries of UK-listed defence companies. This policy clarity has buoyed investor confidence, and companies such as BAE Systems and Babcock have rallied strongly, benefiting from solid order books, improving margins, and a clearer growth runway than many expected just a year ago.

Meanwhile, UK banks quietly delivered one of their strongest quarters in years. While the market continues to debate the timing and extent of interest rate cuts from the Bank of England, expectations grew during the first quarter that rates would likely stay higher for longer than previously anticipated.

With the arrival of tariffs this assumption is being challenged in the market but the favourable net interest margin environment that UK domestic banks have been enjoying since mid-2023 is likely to continue at levels that deliver decent net interest margins, even if not at the levels hoped for in March.

Another tailwind has been the shift in regulatory tone. January's easing of certain capital requirements under the UK's new post-Brexit financial framework, and the announcement from the Bank of England that it intends to reduce the 'reporting burden' on UK banks, has injected fresh optimism into the sector.

While the risk of motor finance restitution costing some companies significant sums continues to be of some concern for specific banks, the sector as a whole started in the first quarter to be seen as not just stable, but increasingly as a capital-return story. This has been challenged in the first few weeks of the second quarter as Trump's tariffs impacted the UK's Asia-focused banks (eg, HSBC and Standard Chartered) particularly negatively.

> “…beneath the surface we are seeing meaningful opportunities in how sectors and companies are reacting”

However, the wider investor base still sees the UK domestic banks (eg, Lloyds and NatWest) as much stronger and better capitalised than at any point since the Global Financial Crisis. They also regard the medium-term opportunity in a sub-sector of the banks sector as (possibly) less susceptible to the vagaries of geopolitics (albeit this notion is being tested in the current volatility).

Events in early April have served as a reminder that markets remain reactive and fast moving. The factors that supported performance in the first quarter are now being tested, and what worked in the first three months of the year may not carry the same tailwinds going forward. Volatility has returned to both bond and equity markets, and correlations are shifting quickly, underscoring the need to stay nimble and grounded in fundamentals.

Looking ahead to the remainder of 2025, several implications arise from the first quarter’s divergent sectoral performance.

First, dispersion is back. While the last week has shown that markets can still move sharply in one direction, particularly in response to tariff tensions, beneath the surface we are seeing meaningful opportunities in how sectors and companies are reacting. For active managers, that’s an encouraging sign. It suggests that idiosyncratic drivers, fundamentals, competitive positioning and capital allocation are regaining influence.

Second, thematics are reasserting themselves. Geopolitics, energy security, defence, and monetary policy are no longer peripheral considerations, they’re central to equity strategy. Investors should be prepared to follow these threads closely, even across borders. The recent bout of volatility triggered by tariff concerns has only reinforced this, creating fresh opportunities as the broader market sells off, often indiscriminately.

Finally, this may be the year where London’s equity market begins to reassert its global relevance. With select sectors thriving and valuations still relatively attractive, the UK market may offer both diversification and alpha in a world where crowding in mega-cap US tech and a focus on the US market has raised risk.

In 2025, dispersing from the herd may be the best investment decision you make.

Japan

Carl Vine
Co-Head of Asia Pacific Equities

Japan: a country learning how to manage a new equilibrium

The Japanese equity market took a pause in the first quarter, extending what has essentially been a sideways move for the last year, in local currency terms. Following a strong run in 2023 and the first quarter of 2024, where the Japan market revisited levels last seen in the early 1990s, the twelve months to the end of the first quarter 2025 have delivered little in the way of fresh momentum, with a broadly-flat market performance in yen terms. This reflects a waning of foreign interest, which following a short-lived burst of interest in 2023, has since remained relatively muted.

The fly in the ointment is clearly global macroeconomics, geopolitics and more latterly tariffs. A resurgent dollar, sticky global inflation, and hawkish signals from the Federal Reserve (Fed) have kept risk assets in check worldwide in the year leading up to the end of the first quarter. Japan is not immune to these forces. Investors have long since viewed Japan as a levered play on global growth. Whilst we are less convinced this remains the case today, that investor-muscle-memory is real. As such, growing concerns over global growth and geopolitics, in our view, have undermined Japanese equities in the last year.

And while the equity market was broadly flat in local currency terms, forward earnings-per-share estimates as of the end of the first quarter are approximately 11% higher than a year prior[7]. Implicitly, investors have been modestly nervous about the earnings estimates/outlook. This feels fairly rational given political uncertainties, the tariff issue and the potential for yen strength.

As we look into the second quarter and beyond, the situation has of course been completely overtaken by US tariff activity. This is now the single most critical topic facing global markets and the closest thing we've seen to an existential threat since the Global Financial Crisis. For us, the issue is not so much the direct impact of tariffs but the collapse of economic trust and the erosion of global economic governance. Investors clearly underestimated the ideological resolve of the White House. Whether one accepts this ideology or not, there can be little debate that the magnitude and the speed of the changes being sought are almost as shocking as the bluntness of the tools being deployed. One imagines someone trying to perform open-heart surgery with a blunt knife.

> "This is not just a [global] growth scare, it's a question mark over the nature of the regime we operate in"

Understandably, markets are rattled and companies are already hitting the brakes. Recession could be on the cards. The question is how deep and how long? This is not just a growth scare, it's a question mark over the nature of the regime we operate in. Investors will need clarity, one way or another, on the global growth and tariff debate, before they can move forward, sustainably, in a pro-risk manner. Japan will not be immune from this over-arching backdrop.

[7] Source: Bloomberg, 9 April 2025. Bloomberg consensus estimates.

What is distinct about this economic and financial market episode is that it is manufactured. This is not an economic iceberg that causes instant damage. This is a policy step that can be reversed at any time. This makes portfolio construction problematic. If the Trump administration misjudges, markets could easily spin out of control. On the other hand, if it pulls back, significant price relief will likely ensue. At the time of writing, Trump had just announced a 90-day pause on some reciprocal tariffs with trading partners, but the tit-for-tat tariff hikes with China continue. For once, amidst turmoil, we are for now mostly sitting on our hands and a low tracking error, waiting for a clearer sense of asymmetry before being more active.

From a relative perspective, we think Japanese equities are, once again, very attractively valued for mid-term investors. They remain well capitalised (under-levered) with a better-than-ever inclination to exploit low-hanging fruit on the self-help and productivity front. This opportunity is well spread across a stock market that has breadth. This is distinct from the US situation where the market is heavily concentrated by ultra-large market cap companies that have been amongst the world's biggest beneficiaries of the very global trade model that the current administration seemingly wants to dismantle.

Closer to home, the Bank of Japan's exit from negative interest rates – while modest and well-telegraphed – has reignited debate about the implications for asset valuations, funding costs, and currency dynamics. But these are tactical headwinds, not structural flaws. Real interest rates are still deeply negative. And inflation, while elevated by Japan's standards, is largely being driven by benign forces: wage growth, mild pricing power, and ongoing economic normalisation. This is not a country fighting to escape deflation anymore. It is a country learning how to manage a new equilibrium.

The enduring investment case for Japan lies not in monetary policy or global flows, but in something quieter: the changing behaviour of corporate Japan. The foundational forces that powered the 2023 rally remain intact and are, in some respects, strengthening. M&A, buybacks and dividends are all tracking towards yet another record year.

At the corporate level, animal spirits are growing. Japan's microeconomic environment, then, continues to offer a compelling case for durable, compound returns underpinned by self-help and capital discipline – attributes that rarely go out of fashion.

Asia Pacific ex Japan

Dave Perrett
Co-Head of Asia Pacific Equities

Volatility creating interesting opportunities for disciplined investors

With the events in early April serving the most volatile trading conditions since the start of the pandemic in 2020, it is easy to forget that the first quarter in its entirety, was also eventful.

Broader Asian indices were essentially flat in local currency terms, but this apparent calm marked material dispersion below the surface. Chinese markets were up mid-teens led by index heavyweights such as Alibaba, Xiaomi and BYD.

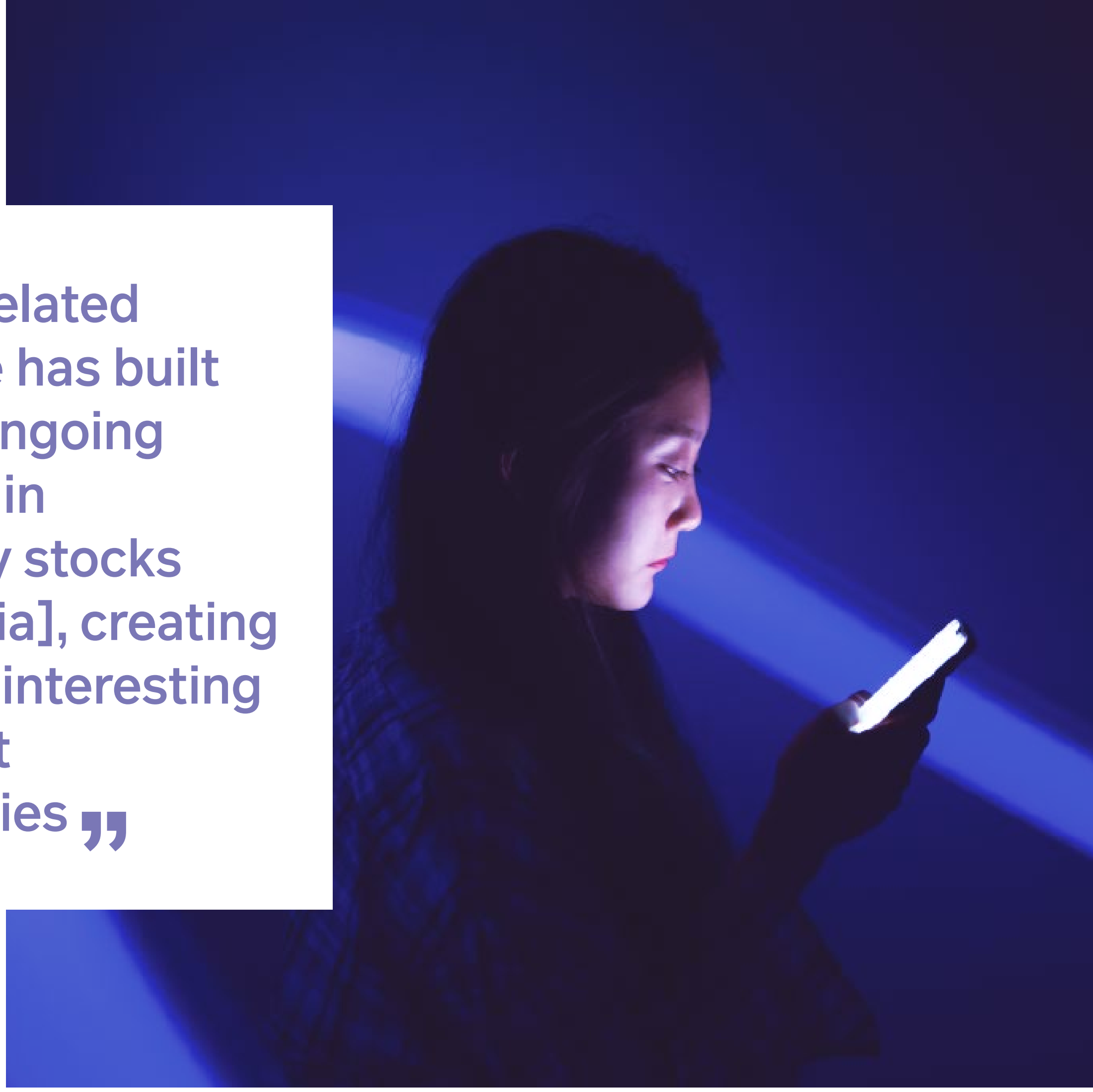
Within China, there was further dispersion with onshore A share markets lagging their overseas peers in Hong Kong. This Chinese equity market strength took place at a time when the US hiked tariffs on Chinese exports and geopolitical tensions remained heightened – thus, the rally surprised many investors. Taiwan was the weakest large market during the period, as some of last year's AI winners gave up part of their gains. South East Asian markets, such as Indonesia and Thailand, also lagged, partly for country-specific reasons and partly due to a shift in allocations to China.

Chinese equity strength was attributed to a number of factors, in particularly the unveiling of DeepSeek, which potentially reduced the cost of AI applications, while at the same time showcased China's technological progress. More importantly, DeepSeek brought global investors' focus back to Chinese stocks for the first time in a number of years and, in the process, drew their attention to the material improvement in profit and shareholder return that has occurred among Chinese internet companies, and Chinese equities more broadly, over the last two years – particularly higher dividend payments and share buy backs.

Indeed, looking forward, many Chinese equities remain attractively valued from a bottom-up perspective, while interest rates and inflation remain low. Low interest rates are typically very positive for financial asset pricing, as long as investors have confidence the recovery is becoming self-sustaining and the economy is escaping the grip of deflation. While there are some encouraging signs with real estate prices stabilising in top tier cities and a more positive start to consumer spending at the beginning of the year, however, there remain headwinds not least tied to trade, with the recent sharp escalation in trade tensions.

Tariff turbulence

The initial impacts of the very high China tariffs imposed by the US will be demand destruction and scarcity, as global supply chains and end consumers struggle to deal with much higher end pricing. Critically, for some products, there is no competitive alternative to China and hence the initial adjustments will be painful for all involved. In the absence of a negotiated agreement, it is likely that China will seek to boost consumer spending to offset macroeconomic headwinds, as the authorities seek to support consumer confidence. There is also the risk of further escalation as both sides jockey for leverage in negotiations.



> “the tariff-related turbulence has built upon the ongoing correction in technology stocks across [Asia], creating some very interesting investment opportunities”

Importantly, from a bottom-up perspective, this additional economic uncertainty and market turbulence is taking place at a time when a number of very interesting investment opportunities already exist. This is certainly the case for a number of Hong Kong stocks, especially mid-cap names. A number of Indonesian stocks also look very attractive, in our view, with near-term economic and political concerns creating what appears to be excessive levels of risk premia.

Finally, the tariff-related turbulence has built upon the ongoing correction in technology stocks across the region, creating some very interesting investment opportunities. Our perspective has been that there are a number of technology stocks which had performed well last year as AI proxies, but this outperformance was likely not appropriate over the medium term, given they lacked a lasting ‘moat’ for their businesses. A number of these stocks have corrected sharply year to date, particularly in Korea and Taiwan. More interestingly, there has now been substantial weakness in genuine regional AI leaders and this is creating an interesting set up for longer-term investors.

Overall, markets have been volatile year to date and geopolitical headlines continue to buffer sentiment. This environment is likely to persist. While unsettling on a day-to-day basis, this volatility can create an interesting opportunity set for disciplined bottom-up investors.

Emerging Markets

Michael Bourke
Head of Emerging Market Equities

Improving returns in relatively resilient markets

Is it really only April? 2025 has started with a bang as markets recoiled from President Trump's aggressive protectionist drive and DOGE-driven public sector cuts, while the associated on-off nature of the tariff discussion has deepened uncertainty and snarled up global supply chains as industries rushed to build inventory in the right places ahead of fast-moving tariff deadlines. Economic data for the first quarter is going to look very noisy, with robust trade surpluses across a number of Emerging Markets (EM) exporters reflecting a potentially sizeable US import bill. Markets have also begun to re-assess the degree to which Trump's actions impact negatively the US economy itself with the uncertainty delaying corporate decision-making and sending a chill down the spine of the consumer.

As ever, the reaction to such risk events in EM is not uniform with material dispersion between winners (Chile +9.6%) and losers (Thailand -14.5%) year to date. China led the way through to the end of the first quarter; delivering a handsome +15.1% as a re-assessment of the China economic stimulus measures and China's DeepSeek AI moment has led to an abrupt recovery in investor confidence, acutely so in the technology sector. Post the ratcheting up of the US/China tit-for-tat tariffs in early April, year-to-date returns for the MSCI China Index remained in positive territory (+3.3%). As my colleague Dave Perrett, co-Head of Asia Pacific Equities has mentioned, we saw further dispersion in Chinese equities, with onshore A share markets lagging their overseas peers in Hong Kong.

Brazil has also bounced from its fourth-quarter malaise as markets embraced the very elevated real yields and the lack of any further bad news on the fiscal front (Bovespa +7% in US dollar terms, +3% in local ccy terms)[8], alongside a collapse of President Lula's poll ratings ahead of the 2026 Presidential election season. However, Brazil is vulnerable to US rate rises so not immune to volatility in the US treasury markets.

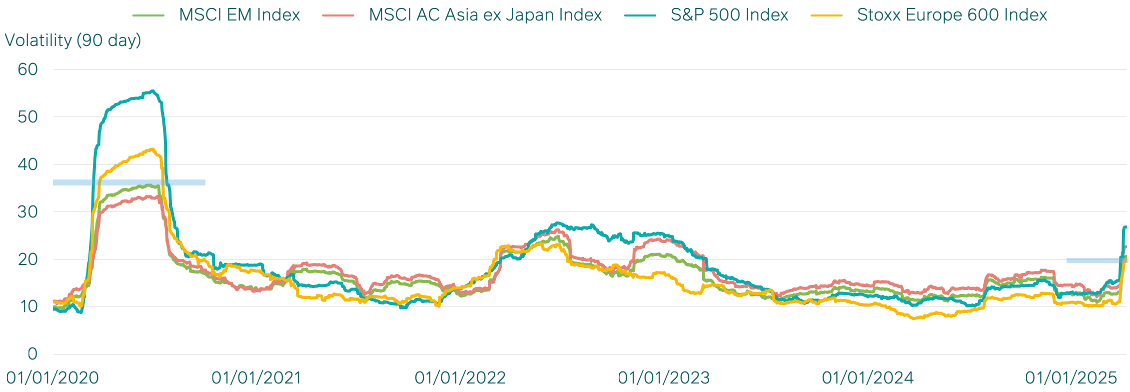
> **"EM companies... have been diversifying supply chains and building new networks away from direct exposure to the US"**

Mexico's President Claudia Sheinbaum has proven adroit in her dealings with President Trump – and while there remain questions about the stability of the US President's stance towards Mexico and the rapid relocation of supply chains – she has maintained an effective 8% tariff rate on exported good to the US (with exclusions accounted for) as the US administration continues to hit other trading partners with far more elevated tariffs. The market has taken notice, with Mexico delivering returns of 7.1% year to date. Overall, the MSCI EM Index is down -3.7% year to date, as April's trade war concerns weighed on sentiment[9].

We have been reminding our clients for a while now of the resilience within the asset class. This is evident in looking at the subdued volatility of EM equities, especially versus the S&P 500 Index.

[8] Source: Bloomberg: year-to-date returns as of 10 April 2025. All returns in US ccy terms unless otherwise stated.
[9] Source: Bloomberg: year-to-date returns as of 10 April 2025. All returns in US ccy terms unless otherwise stated.

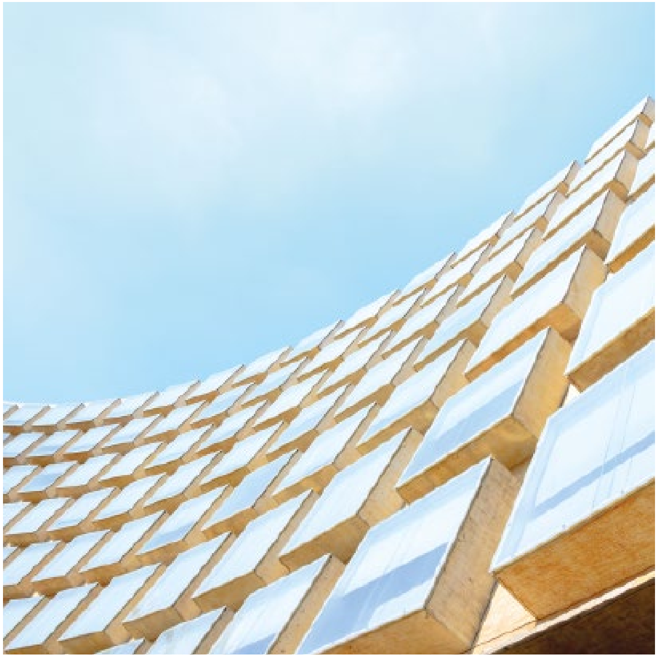
Resilience in EM equity markets –
Volatility in markets more subdued, particularly with reference to the S&P 500 Index



Source: Bloomberg, 14 April 2025. 90-day volatility of selected indices. Past performance is not a guide to future performance.

As we go to publication, the impact of President Trump's Liberation Day tariffs action have ricocheted through the asset class, causing mayhem and very elevated levels of volatility. But, Trump's team are already back-pedalling in the face of market turmoil with a reduction of the tariffs applied to the 10% baseline ex-China and a widening of the exemptions list to include all smartphone, laptop and PC products: essentially a large carve-out of the tariffs applied to China given the concentration of those industries there.

Perhaps in the days and weeks ahead the dust will settle and the outcome may be a step back by President Trump.



This may be a very important moment for EM for three reasons:

i. if we do see agreement on lower effective tariffs, this will mark a peak in the tariffs debate, prompting the markets to breathe a sigh of relief

ii. if Trump's team calm markets, US rates will likely fall given the confidence shock to the economy and the very real risk of recession (the market is now expecting the Federal Reserve (Fed) to cut three times before the end of the year; such a move would be very positive for EM risk assets), and

iii. the blow to the reputation of US risk assets and the confidence shock is unlikely to fade quickly; potentially directing further outflows from US assets into broader international assets (from which EMs will benefit).

More broadly, EM companies have reduced leverage and, since Trump, have been diversifying supply chains and building new networks away from direct exposure to the US. EM countries have lower capital outflow vulnerabilities given the lower levels of current account surpluses overall and the (mostly) floating exchange rates.

Perhaps most importantly from our perspective is the fact that returns within EM equities have been improving, the ultimate harbinger of positive long-term shareholder return. This is a positive environment for the active stockpicker.

Global Research

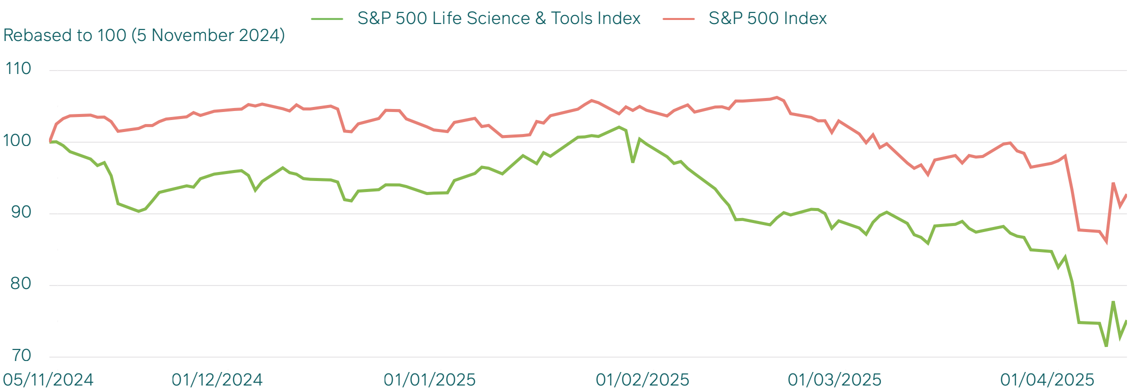
Tim Alexander
Senior Global Healthcare Analyst

Revenue diversification in Life Sciences and Tools suggests underappreciated resilience

Since President Trump's election in November, the Life Sciences and Tools sector has experienced significant volatility. Stocks have declined sharply, with the S&P 500 Life Sciences and Tools Index down 21.5%[10] in absolute terms, and also versus the broader US market. This sell-off is attributed to apprehensions surrounding proposed reductions in National Institutes of Health (NIH) funding and broader US academic and government revenues, with tariff fears and potential signs of biotechnology demand destruction layered on top.

The US administration's policy signals, including a proposed 15% cap on indirect costs and staff reductions at NIH, have heightened these concerns. However, to some extent, this reaction is overstating the actual impact – particularly as, in some areas, the sector's reliance on these revenue streams has been steadily diminishing, while the growing dependence on revenue from pharmaceuticals and beyond suggests a more resilient outlook.

S&P 500 Life Sciences & Tools sector has underperformed the wider Index



Source: Bloomberg, 11 April 2025. Price returns rebased to 100 as of 5 November 2024. Past performance is not a guide to future performance.

The NIH funding narrative does warrant scrutiny.

Historically, academic and government grants have been significant for Life Sciences and Tools companies, providing critical demand for laboratory equipment, diagnostics, and sequencing technologies. A decade ago, these sources accounted for perhaps a third of sector revenues. Today, that figure has declined to less than a quarter. This long-term shift reflects diversification away from government funding, which, while still substantial at nearly $48 billion annually for NIH, is less pivotal to the sector's topline than it once was – at one leading Tools company, academic and government revenue has fallen from 25% to 15% of sales between 2016 and 2024[11].

[10] Source: Bloomberg, As of 10 April 2025. US dollar terms. Indexed to 100 on 5 November 2024. Past performance is not a guide to future performance.
[11] Source: M&G Investments, National Institutes of Health, April 2025.

Exposure to the BioPharma sector has grown significantly, with the multi-omics and spatial biology revolutions[12] driving a need for ever more sensitive tools, and more complex drugs becoming harder to discover through the expensive clinical trials process. In the medium term, the US is unlikely to relinquish its dominant position in biomedical research, a cornerstone of both economic and scientific prestige. Despite campaign rhetoric and policy uncertainties, such as potential NIH cuts or public health stances from figures like RFK Jr., dismantling this leadership would seem unlikely to be an aim of the Trump administration – particularly with China waiting in the wings.

Admittedly, uncertainties persist. The full impact of NIH cuts remains unclear, with legal challenges delaying implementation, while international exposures – like Thermo Fisher's 8% China revenue – could face tariff-related headwinds. Nevertheless, the sector's fundamentals suggest the current sell-off overstates NIH risks and underappreciates the long-term underpinnings and strength in the Life Sciences and Tools space.

[12] Multi-omics refers to the combination of different biological omics data sources and is an analytic approach in which the data sets are derived from multiple 'omes,' such as the genome, proteome, transcriptome, epigenome, metabolome, and/or microbiome. Spatial biology is the study of molecules, cells, and tissues in their native 2D or 3D spatial context. Scientists use techniques to visualise molecules within individual cells and tissues, examining their organisation and interactions.

> "[The] long-term shift [in make up of the sector's revenues] reflects diversification away from government funding"

Convertibles

Leonard Vinville
Head of Convertibles

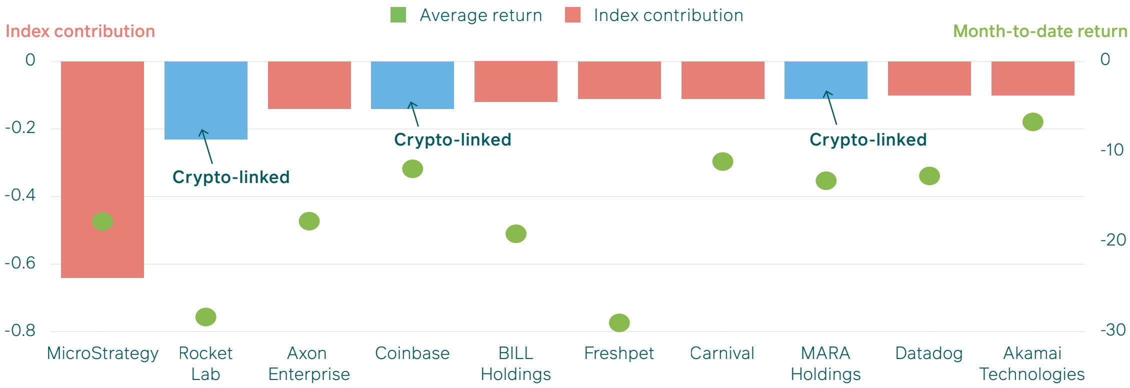
It is time for the convertible bond floor to play its role

Within the convertibles market, defining what qualifies as a 'herd' investment has been challenging as it is a combination of opportunistic issuances and market beliefs.

The convertibles market is well known for monetising volatility of expensive stocks. Over the last few years we have seen issuers coming to tap the convertible bond market usually in 'herds'; US SaaS (software as a service), US SPAC issuers, green energy-linked and US utilities issuers, to name a few.

More recently, post-US presidential elections, crypto and AI-related data centre convertibles issuances have surged to account for nearly 5% of the global convertibles market. Most of these issuers are free cash flow negative businesses, trading at rich multiples, that have benefited from the 'Trump tailwind' – promising a beneficial crypto regulatory framework and US corporate-friendly measures. As the air has come out of the 'bubble' (with the Bitcoin Miners ETF down more than 50% since peak Trump sentiment)[13], being contrarian has helped us.

Bottom US convertible bond performers – Crypto-linked names were amongst the top negative contributors



Source: BofA Global Research, ICE Data Indices, LLC. Data as of 28 February 2025. Coral bars: Crypto US Convertible bonds; Blue bars: Crypto-linked US Convertible bonds. Past performance is not a guide to future performance.

As always, convertibles are not only sensitive to equity movements but also credit. As equity falls, convertibles could end up trading in the 80s, yielding 'equity-like returns'. Contrarian investing requires deep-dive credit reviews to 'bottom fish'. We believe opportunities will appear in the near future, either with recently opportunistically-issued convertible bonds and/or with refinancing needs at attractive terms and conditions.

Looking in the rear-view mirror, US SaaS issuers have also de-rated significantly from late 2021 highs, with a possible US recession looming.

[13] Bloomberg, 26 March 2025, Coinbase Valkyrie Bitcoin Miners ETF. Peak Trump sentiment high at 6 December 2024.

It's worth remembering these high-growth names were traded at extremely rich multiples, driven by digital transformation as well as AI/thematic tailwinds. Bottom-up selection is now offering opportunities in the space for patient convertible investors.

It's also worth mentioning how 'brutal' a de-rating can be when bubbles are bursting, with US SaaS companies retreating from an average of c.21.5x EV/Sales (LTM) in February 2021 to an average of 5.4x EV/Sales currently[14].

The Trump headwind related to the new US import tax tariffs mechanism has in recent days created a huge market selloff, understandably. As global growth expectations are being reset, equity valuation combined with detailed credit analysis will remain the primary driver of the convertible bond stockpicking playbook. It is time for the convertible bond floor 'to play its role'.

[14] Source: Bloomberg, 14 April 2025. 99 stocks in the SaaS group. Greater than 90% of which are CB issuers. February 2021 average ratio is trailing 12 months (LTM) and current ratio is current estimate for 2025.

> "As global growth expectations reset, equity valuation [and] detailed credit analysis will remain the primary driver of [selection]"