Building Resilience: 2025 Mid-Year Economic and Market Outlook

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The first half of 2025 will be remembered for two defining events: the onset of reciprocal tariffs, marking an American trade war with the world, and Chinese AI developer DeepSeek's revelation that shattered the myth of American AI supremacy. Amidst the fierce rivalry between America and China, these occurrences exposed the opposing forces of de-globalization and globalization, highlighting significant structural changes. These shifts will have profound and far-reaching effects on the global economy and financial markets.

In late January, DeepSeek unveiled R1, an AI tool that rivaled the latest version of ChatGPT but at a fraction of the cost to build. Given its power consumption efficiency, the R1 architecture has rapidly drawn the attention of Western engineers. The technology boasts significant energy savings, using an estimated 10 to 40 times less energy than comparable U.S. models and requiring far fewer computer chips. The next phase of AI's development, carrying significant geopolitical ramifications, is taking shape in Shenzhen and Beijing as much as in Silicon Valley.

On April 2, 2025, President Trump's Liberation Day triggered a global stock market steep decline and marked a significant shift in international trade dynamics. Although markets have since recovered, President Trump's second term has set America on a new course. For the first time in three decades, the United States faces fiscal constraints. An era of low inflation and interest rates, which allowed Congress to cut taxes and increase spending without significantly impacting debt servicing costs, has ended. The introduction of reciprocal tariffs and government spending cuts is a form of fiscal austerity with long-term implications for businesses, consumers, and international capital flows. The abrupt implementation of universal tariffs has introduced numerous uncertainties. The U.S. economy is likely to face higher inflation initially, followed by a period of slower growth. Additionally, the Federal Reserve could again find itself "behind the curve."

Given the current landscape, we anticipate heightened economic risk and market volatility. As a result, we have adopted a cautious and defensive approach across our globally diversified multi-asset portfolios. We aim to capitalize on market dislocations to increase calculated risk strategically, but only when we have strong convictions. Furthermore, we closely observe trade negotiations and policy changes in areas such as tax legislation, deregulation, energy, and defense, which could drive growth and act as potential market catalysts.

Macroeconomics Analysis: A Delicate Balancing Act

The environment has become more complex as we assess the economic trajectory heading into the second half of 2025. While the U.S. economy still shows signs of fundamental strength, recent data and policy developments point to a more delicate late-cycle phase. This stage is defined by slowing momentum, persistent inflation pressures, and growing uncertainty around trade policy and the Federal Reserve's next steps.

First quarter Gross Domestic Product (GDP) showed a 0.3% annualized decline, ending a streak of positive quarters. However, the headline figure requires context. Nearly the entire drag came from a surge in imports, up 41.3%, likely driven by businesses front-running newly announced tariffs. Since imports subtract from GDP, this overstated the underlying weakness. Real final sales to private domestic purchasers rose 3.0%, indicating that core demand remains solid.

Policy sequencing now plays a crucial role. The Trump administration's decision to lead with tariffs, raising the effective U.S. tariff rate from around 2% to over 20%, has not been offset by pro-growth measures such as tax reform or deregulation. These developments are pressuring inflation higher while clouding visibility into second-half growth.

We expect second-quarter GDP data to be pivotal. First-quarter revisions (particularly inventories) may lift the final print, but the average of the first half will be a better gauge. Many firms accelerated purchases to get ahead of tariffs, suggesting business investment could fade. This sequencing likely keeps the Federal Reserve sidelined. The October Federal Open Market Committee (FOMC) meeting could be the next viable window if the Fed refrains from cutting rates in June.

The labor market remains the key cushion, with the economy averaging roughly 140,000 jobs per month this year and the unemployment rate steady above 4%. While hiring has slowed in rate-sensitive sectors, job gains continue, and wage pressures have eased. If employment remains firm, the Fed has room to stay patient.

Our base case is for 1.0% real GDP growth in 2025, with inflation ending the year north of 3%. This outlook reflects the challenges of policy lags and asymmetric inflation risks. That said, the tariff situation is fluid, and should negotiations yield a more positive outcome, the outlook could meaningfully improve.

The Fed may face a classic supply-side shock dilemma: it cannot simultaneously solve both sides of its dual mandate. Specifically, the goals of maximum employment and stable prices can conflict. In this context, we believe the Fed would prefer to keep rates restrictive and risk a mild recession.

The U.S.-China trade standoff has turned a corner with a “90-day truce”, but further slowdown in China, where 20 million jobs[1] remain tied to U.S.-bound shipments, adds pressure on President Xi’s position. Tensions between India and Pakistan have escalated more than markets expected, while the Middle East and Russia-Ukraine conflicts continue to support elevated gold prices and geopolitical risk premiums. Europe and Japan face knock-on effects from supply-chain realignments, while India remains a relative winner. Despite OPEC+ supply surprises, oil prices have remained rangebound, capped by demand concerns tied to tariff uncertainty.

While the U.S. economy is progressing, the risks have become more two-sided. This year’s view is a transition period that will test whether domestic policy support can offset global and trade-related headwinds. We continue to monitor labor trends, inflation dynamics, and global flashpoints as the key variables shaping the path forward.

Fixed Income: Yield, Credit Risk, and Shifting Conditions

Economic growth concerns, tariff uncertainty, and stubborn inflation have contributed to higher levels of interest rate volatility. U.S. Treasury yields started the year trending downward while credit spreads widened. The Federal Reserve (Fed) has maintained its federal funds target range between 4.25% and 4.50% after cutting rates 100 basis points at its final three 2024 FOMC meetings.

We continue to believe today’s policy rates are restrictive and may weigh on economic growth throughout the year. While we anticipate the Fed may cut rates further in 2025, we also see a cautious approach given inflation uncertainties surrounding tariff implementation.

Any Fed rate cuts will likely weigh on the front end of the yield curve while economic growth concerns keep longer-term yields in check. While short-term inflation expectations have been volatile, longer-term market-based inflation expectations have remained well anchored near the Fed’s inflation target. We are closely monitoring the term premium, which has risen to nearly nine-year highs. Increasing U.S. deficits and U.S. Treasury bond issuance are often cited as pressuring yields higher.

[1]Bloomberg. (2025, April 14). Trump Tariffs to Impact Millions of Chinese works in a blow to economy, Business Standard.com, https://www.business-standard.com/world-news/trump-tariffs-to-impact-millions-of-chinese-workers-in-a-blow-to-economy-125041400301_1.html

 See important disclosures on page 6

Corporate bond spreads have held up reasonably well, and much of the spread widening experienced following Liberation Day has since reversed. Overall, given our economic views, we have a cautious view on credit and believe there is more downside risk in the short term, given current valuations.

While emerging market debt provides diversification benefits, it is not insulated from global trade disruptions, tariff uncertainty, and slowing economic growth. Subsiding investor risk aversion would likely harm spreads and valuations. Coinciding with our credit views, we believe there may be a better opportunity to add exposure to this asset class down the road.

In the tax-free world, municipal bond valuations have become more compelling. An influx of municipal bond issuance at the start of the year confronted lackluster investor demand. The 5-year yield ratio between AAA municipal yields and U.S. Treasury yields has increased from roughly 66% in December to 80% at the end of April. Fundamentals remain strong, although we are monitoring trends closely.

As we approach the second half of the year, we are taking a more defensive position within our fixed-income strategies — dialing back on weaker credits and/or lightening up on credit in favor of U.S. governments. Income levels from coupons remain favorable, providing some cushion returns. We continue to focus on short to neutral duration across fixed-income portfolios. We remain diversified across sectors, but believe there may be a better opportunity to add additional risk when monetary policy becomes less restrictive.

U.S. Equities: Staying the Course as Earnings Cloud

Earnings results for the first quarter of 2025 have modestly exceeded expectations. However, the outlook for the remainder of the year has become more uncertain as macroeconomic volatility, inflationary pressures, and renewed tariff risks weigh on sentiment. While the near-term environment presents challenges, we remain constructive over a multi-year horizon anchored in selectivity, valuation discipline, and downside protection.

At the start of the year, our equity research team projected S&P 500 earnings growth of approximately 11% — a conservative forecast compared to the 14% consensus. As of early May, we've revised our forecasted growth to around 8%, with further downside risk likely. Many companies have stopped issuing forward guidance, underscoring the unusually wide range of outcomes and the potential for elevated volatility.

Earnings revisions have been broad-based, particularly within cyclical sectors such as energy, consumer discretionary, and industrial. Even the so-called "Magnificent Seven" have not been immune, with earnings growth expectations trimmed from the high teens to the mid-teens. For the remaining S&P 500 constituents, consensus earnings growth has declined from 13% to 8%.

Valuations have adjusted modestly. The S&P 500 forward P/E multiple has declined from over 23 times at the start of the year to approximately 20 times, still above the historical average. The Magnificent Seven, which comprises about 30% of the index, now trades at 25 times earnings, down from 32 times.

According to BCA Research[2], tariffs could compress S&P 500 operating margins by up to 200 basis points, reducing earnings growth by 20% as companies absorb higher input costs. Tariff pressure could disproportionately affect firms with low gross

[2]BCA Research, May 5, 2025.

margins, limited pricing power, and rigid supply chains, leading to weaker returns on capital and potential valuation re-ratings. On the demand side, higher consumer prices may reduce purchasing power.

Amid the volatility, long-term structural opportunities remain intact. AI is expanding the demand for high-performance computing while lowering data processing costs. This effect creates new growth avenues for software and services companies with high-margin, recurring revenue business models. We also see opportunities in domestic infrastructure, particularly utilities and grid upgrades driven by rising energy needs from data centers.

In Healthcare, despite near-term academic and government funding pressures, secular tailwinds in life sciences tied to aging demographics and innovation pipelines support long-term demand. Personalized medicine also unfolds as genomics, AI, and data integration advances enable more precise, individualized therapies and improved outcomes.

While volatility may continue through the second half of 2025, we view this as a favorable environment to allocate capital selectively into high-quality businesses with resilient earnings power and secular growth tailwinds. Companies with durable competitive advantages such as scalable domestic production, tiered pricing strategies, strong balance sheets, and diversified customer bases are best positioned to navigate inflationary and trade-related shocks.

Global Equities: Positive Shifts Underway

The first half of 2025 has marked a significant shift in global markets: international equities, historically the underdogs in global portfolios, are now outpacing U.S. stocks. Year-to-date, the MSCI EAFE and Emerging Markets indices have delivered stronger returns than their U.S. counterparts, buoyed by favorable policy changes, currency movements, and improving economic clarity. This global approach is beginning to pay for investors who maintained diversified allocations and resisted concentrating solely on U.S. mega-cap stocks.

European equities have benefited from a series of preemptive rate cuts by the European Central Bank (ECB), which has lowered its benchmark rate to 2.5% as inflation approaches the target and growth remains subdued. These moves have provided clear tailwinds for risk assets, particularly in cyclical sectors such as Industrials, Financials, and Consumer Discretionary. Notably, European corporate earnings are now seeing positive revisions for the first time in six quarters, suggesting that the current rally is supported by improving fundamentals, not just higher valuations.

After years of ultra-loose monetary policy, the Bank of Japan initiated a carefully managed exit from negative interest rates in the first quarter. Rather than unsettle markets, this shift has been interpreted as a sign of confidence in Japan's domestic momentum. Wage inflation remains modest but positive, capital expenditures are rising, and a weaker yen continues to support Japanese exporters.

Subdued expectations at the start of the year in China have set the stage for potential upside, while India[3] continues its robust trajectory, driven by infrastructure investment and digitalization. Southeast Asia[4] is reaping the benefits of supply

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[3]McKinsey & Company. (2025, April 10) India: The promise and possibilities for global companies, https://www.mckinsey.com/industries/industrials-and-electronics/our-insights/india-the-promise-and-possibilities-for-global-companies

[4]EDB Singapore. (2025, Jan 20). What are 5 business trends emerging from Southeast Asia's foreign investment boom? https://www.edb.gov.sg/en/business-insights/insights/what-are-5-business-trends-emerging-from-southeast-asias-foreign-investment-boom.html

chain diversification and increased cross-border capital flows. Latin America[5], meanwhile, it has gained from commodity strength and improved governance. However, performance dispersion across emerging markets remains high, underscoring the importance of selectivity and active management.

The outperformance of non-U.S. markets may signal more than a short-term reversal. The U.S. equity market faces headwinds from recent policy uncertainty, while many international markets are enjoying the benefits of earlier policy support, currency tailwinds, and more attractive valuations.

The message for investors is clear: rebalancing across geographies is not just about risk management — it's about capturing global opportunities that align with individual risk and reward profiles. As market leadership broadens beyond U.S. technology giants, high-quality international equities will likely maintain renewed investor attention.

Alternatives: Liquid Diversifiers with Quality Income

Persistently high interest rates, economic uncertainties, and geopolitical instability have diminished our confidence in private lock-up strategies like private equity, private credit, and venture capital. Uncertainties have stalled market activity for these return-enhancing strategies within alternative investments. Consequently, significantly reduced deal activity leads to fewer distributions to Limited Partners and lower returns[6]. This lack of distributions also translates to tepid fundraising for new funds.

We have maintained our positioning in this environment by leveraging diverse liquid alternative strategies that provide defensive capital preservation and portfolio protection, opportunistic positioning, and exposure to highly volatile market dislocations. Managers who have proven the robustness and effectiveness of their strategies throughout this ongoing volatility cycle are poised to drive industry growth for years to come.

Active Management and Resilience

From the rise of reciprocal tariffs to technological shifts like the emergence of DeepSeek's R1 AI model, investors were introduced to significant volatility and structural challenges in the first half of 2025. Alongside these events, core economic fundamentals remain resilient, supported, for example, by steady labor markets and robust consumer demand. Our team is keenly aware that the interplay between restrictive trade policies and supply-side constraints presents a delicate balancing act for policymakers. We remain vigilant, adapting to changing conditions while seeking opportunities in a market defined by disruption and resilience.

Active management becomes particularly crucial during economic and market volatility periods as it allows for navigating complex market environments and potentially enhancing returns through strategic decisions. As an experienced team with substantial track records, we remain flexible in adjusting portfolios in response to changing market conditions. We prioritize risk management to mitigate losses and ensure stability during turbulent times. We seize opportunistic investments, as volatility often leads to mispriced assets, allowing us to capitalize on undervalued opportunities.

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[5]Jeremy Sutch and Sean Taylor. (2024, Aug 15). Latin America's Long-Term Potential. Matthews Asia.com, https://www.matthewsasia.com/insights/emerging-markets/latin-americas-long-term-potential/
[6]Pitchbook, Global Fund Performance Report, May 7, 2025