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Insight
INVESTMENT

GLOBAL MACRO RESEARCH STATE OF THE WORLD

JULY 2025



BNY | INVESTMENTS



ADRIAN GREY, GLOBAL CHIEF INVESTMENT OFFICER



Adrian joined Insight in April 2003 as Head of European Fixed Income following the acquisition of Rothschild Asset Management Limited, which he joined in 1994. In September 2003, he was appointed Deputy Head of Fixed Income and in 2005 became Head of Fixed Income. Adrian joined the Executive Management Committee in October 2012 and in 2016, he became Chief Investment Officer – Active Management. In September 2018, Adrian took on his current role as Global Chief Investment Officer responsible for the oversight of the firm's investment management teams. He has a BA honours degree in Economics and Politics from Warwick University and an MA in International Economics and International Relations from Johns Hopkins University in the US.

EXECUTIVE SUMMARY

- After triggering significant market volatility, the US has paused the more extreme elements of its new trade policies. Markets have bounced back, and economic data appears resilient, with some front-loading of activity as firms take advantage of the tariff pause.
- Beyond the short-term relief, the structural shift toward US protectionism, anchored by a baseline 10% tariff, poses a growing risk to global supply chains, inflation, and growth. We expect these headwinds to intensify from the summer onwards, with growth stagnating into early 2026.
- The Fed, constrained by tariff-driven inflation, should deliver a modest rate cut in late 2025 before embarking on a more decisive easing cycle in 2026.
- Until we have greater visibility on the outlook, we believe a defensive stance remains appropriate in credit. But opportunities exist in less cyclical sectors like utilities and telecoms, and by exploiting regional divergences. Europe's fiscal expansion and China's stimulus are expected to support regional growth, offering diversification opportunities.
- Longer-term, AI-driven capex and productivity gains, alongside countercyclical policy measures, support a more constructive outlook.
- Fiscal sustainability in the US is a growing concern, driven by ever rising debt levels. This is leading to much greater volatility at the longer-end of yield curves, a phenomenon we expect to worsen over time, leading to steeper yield curves.
- A shift in investor sentiment should weaken the dollar and reduce US market dominance within major indices. Easing hedging costs as the Fed become more dovish could be a pivotal factor in this trend.

RESILIENCE IN ECONOMIC DATA IS LIKELY TO BE TEMPORARY

THE GREAT TARIFF RESET

While the incoming administration's use of tariffs was widely anticipated, the scale of the measures announced in early April far exceeded even the most pessimistic forecasts. This was following by a rapid escalation of tariffs and retaliatory measures between the US and China, bringing bilateral trade to a near standstill.

In response to the significant market volatility that these new policies triggered, the administration paused the most extreme measures for a period of 90 days. This calmed investor nerves, and a steady stream of constructive headlines around trade negotiations has supported a rebound in sentiment, with equity markets approaching previous highs.

Meanwhile, economic data have remained resilient, boosted by a front-loading of trade as corporates take advantage of the tariff pause, and expectations are for a solid second quarter.

WE WOULD WARN AGAINST COMPLACENCY

The pause in reciprocal tariffs has provided some relief, and may well be extended further, but we are witnessing a fundamental redrawing of the rules of global trade. The world now faces a minimum 10% tariff on all goods exported to the US, with additional tariffs on specific sectors such as steel and aluminium. Only goods exported under the United States-Mexico-Canada Agreement (USMCA) are able to avoid this new reality, and that agreement is due for review later in 2025.

Trade deals will be signed, with the UK first to strike a deal, but these will all be on worse terms than has prevailed over recent decades. Some significantly so. As the US repositions trade policy at the heart of its economic agenda, tariffs are once again going to be a defining force in global markets, impacting global supply chains, inflation expectations, and corporate profitability.

While near-term economic data may continue to show resilience, we believe the delayed effects of both direct tariffs and the broader uncertainty created by rapidly shifting policy are likely to weigh on growth as the year progresses. These headwinds are expected to become more visible from the summer onwards. Although a recession is not our base case, the balance of risks is clearly tilted to the downside.

CAUTION BEFORE A DOVISH PIVOT

Typically, we would expect the Federal Reserve to respond to a weakening outlook with a more dovish stance, accelerating the pace of rate cuts to support growth. However, the inflationary impulse from recent tariffs will complicate the Fed's reaction function. Political pressure, focusing attention on Fed independence, is unlikely to help. Against this backdrop, we expect the Fed to proceed cautiously. Rates are likely to edge lower into year-end as evidence mounts that tariff-driven inflation has peaked. We anticipate a more decisive series of rate cuts in 2026, once inflationary pressures subside, and growth concerns take precedence.

This should be sufficient to keep growth in positive territory, but we may well experience a period of stagnation through the second half of 2025 and into 2026.





POSITION DEFENSIVELY, BUT OPPORTUNITIES STILL ABOUND

As we wait for the hard data to soften, our investment regime framework points to a more challenging period ahead and has been guiding us to position accordingly. Although spreads have widened, and yields are clearly more attractive than some months ago, it's still too early for us to aggressively change our risk profile.

This leaves us with a bias towards investment grade credit and government bonds within those mandates where we have the flexibility to take a more defensive view.

But that doesn't mean we don't see opportunities to add value. Less cyclical sectors such as utilities still provide what we believe are attractive spreads, but by their nature they often operate within their domestic market, making them less susceptible to international tariff risks. For these companies, the primary concern is of a broader economic slowdown. This can be mitigated by focusing on companies with predictable and resilient cashflows that can typically withstand economic volatility. Telecoms can exemplify this resilience, as consumers prioritise mobile services over other expenses, ensuring steady demand even during economic downturns.

In the hunt for strong domestic franchises with tariff resilience, it may also be the perfect time to broaden the search. With the appropriate expertise, many such opportunities can be found in the developing world. These companies, which issue debt in US dollars, often dominate their domestic market but their developing market status means they trade at a yield premium. Telecoms in Latin America serve as a prime example for those seeking to take advantage of the spread premium available in lower-rated credits.

There are also opportunities at an inter-regional level. The proposed relaxation of the German debt brake to allow greater defence spending, alongside a new €500bn infrastructure investment fund, is expected to boost growth across the eurozone. Arguably, fiscal largesse has been a critical driver of US exceptionalism in recent years, and Europe now seems ready to embark on a significant fiscal expansion. This is expected to underpin European growth and the outlook for a range of companies operating within the region.

As the outlook clears, we may well start to tactically increase our allocation to lower-rated credits again. Valuations have clearly become more attractive, and BB-rated credits are back at levels that we believe offer value. However, this is not the time to buy weaker CCC-rated credits; these issuers have the greatest leverage and will be most exposed to any period of low or negative growth.



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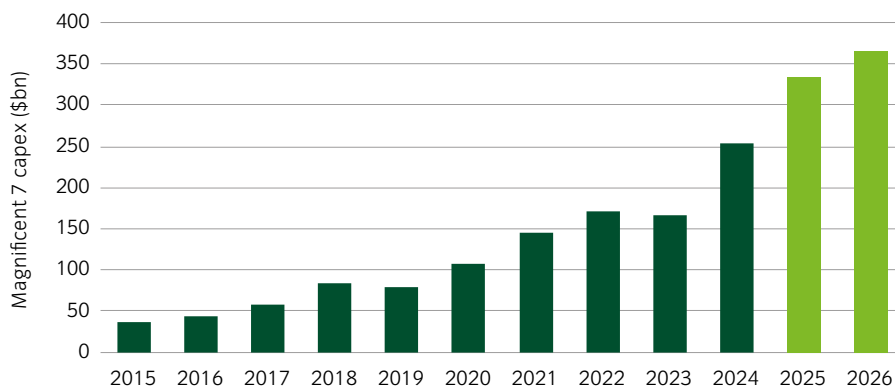
STAGNATION WON'T LAST FOR FOREVER

Although tariffs are likely to remain a drag on growth for some time, we see two key factors – beyond the prospect of easier monetary policy – that support a more constructive medium- to long-term outlook.

THE AI INVESTMENT BOOM

In the US, the global dominance of US mega-cap tech companies puts the country at the forefront of technological development such as artificial intelligence. Data compiled by Goldman Sachs (see Figure 1) suggests that the capital expenditure plans of the Magnificent-7 (Meta, Microsoft, Alphabet (Google), Apple, Nvidia, Tesla and Amazon) are rapidly growing, largely focused on AI. Within the broader US economy, the share of IT capex as a percentage of total capex has doubled to 30% in 2024 compared to 2015. On a wider scale, global IT spending is forecast to increase by nearly 10% in 2025 compared to 2024, reaching a total of \$5.6 trillion.

Figure 1: Magnificent 7 capex to keep accelerating¹



The adoption of AI has accelerated at a pace surpassing the adoption curves of the internet and smartphones. While the speed at which this results in improved productivity is unclear, the direction is clearly positive. McKinsey and PWC estimates suggest that AI-related investments could add 0.5% to 1.5% to annual GDP in the developed world over the next decade, with multiplier effects potentially being higher in the developing world.

COUNTERCYCLICAL MEASURES ARE KICKING IN

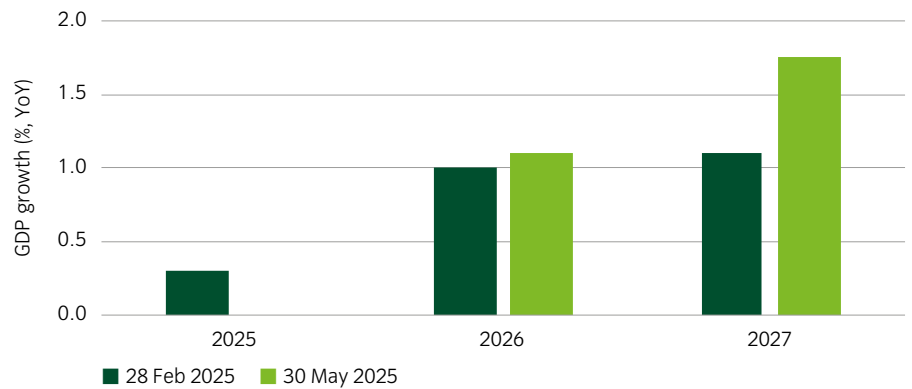
Policy levers that counter trade uncertainty are also crucial. This includes the increase in European defence and infrastructure spending that will stem from Germany's decision to reform its constitutional fiscal rule, known as the 'debt brake'. This will see defence spending above 1% of GDP exempt from borrowing limits and the creation of a €500bn extrabudgetary fund, with €100 billion earmarked for climate-related infrastructure investment. We can already see this feeding into a more optimistic outlook for growth across the eurozone (see Figure 2).

¹ Source: Goldman Sachs and Insight Investment. Published May 2025.





Figure 2: Consensus forecasts for eurozone growth are becoming more optimistic, led by Germany²



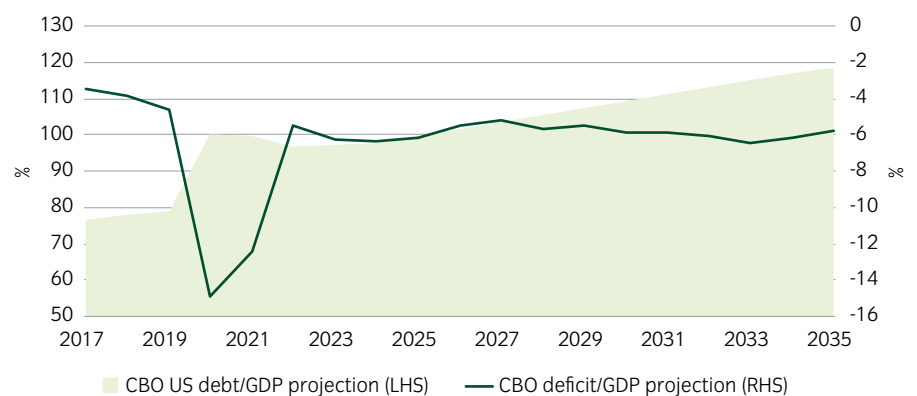
China has also implemented a sizeable stimulus package, expanding its fiscal deficit to 4% in 2025, and expanding both special government bond and local government bond quotas. The proposed package is reported to be on par with that introduced to counter the impact of the 2008 global financial crisis.

AN EYE ON DEBT SUSTAINABILITY

Although still at an early stage, another trend that requires careful consideration is the growing concern around debt sustainability in the US.

President Trump's One Big Beautiful Bill Act aims to extend the 2017 first-term tax cuts that are set to expire at the end of the year. Additionally, the plan includes another \$663bn in new cuts, funded by removing some tax credits and implementing targeted tax increases. However, the non-partisan Committee for a Responsible Federal Budget estimates that the bill would raise the primary deficit by \$2.4 trillion by the end of 2034 and increase the US debt-to-GDP ratio to a record 125%, up from 100% today. This is even higher than the close to 120% of GDP projected by the Congressional Budget Office, which also predicts continuous deficits in the 5-6% of GDP range for the next decade (see Figure 3).

Figure 3: Congressional Budget Office US debt and deficit projections³



² Source: Consensus forecast data compiled by Bloomberg. Data as at 31 May 2025.

³ Source: Insight, Bloomberg and Congressional Budget Office. Data as at 31 May 2025.

In mid-May, Moody's, the credit rating agency, downgraded the US credit rating by one notch from its highest Aaa rating to Aa1, citing declining fiscal metrics. This move followed similar actions by other major rating agencies, such as S&P and Fitch, so it was not surprising in itself. However, the timing reflects growing market unease about the direction of fiscal policy.

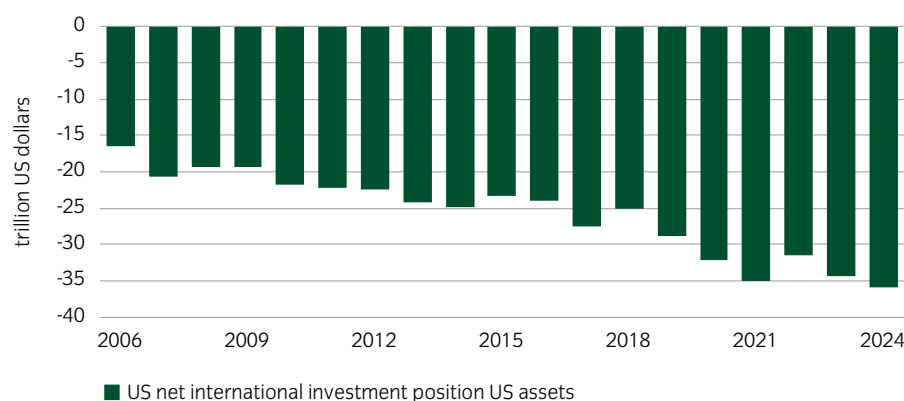
This is leading to much greater volatility at the longer end of yield curves, a phenomenon we expect to worsen over time.

WHAT HAPPENS IF INVESTORS START TO SHIFT AWAY FROM THE US?

When we consider the impact of tariffs and their drag on growth and corporate profitability, alongside a substantial fiscal deficit and the prospect of unsustainable debt accumulation, the natural question becomes: what comes next? We explored this in depth in our paper, US exceptionalism: at a crossroads, where we concluded that one of the most likely casualties of this evolving landscape is the US dollar.

Over the past 15 years, US equities, bond markets, and the dollar have consistently outperformed, underpinned by the country's dynamic, innovation-led economy. Unsurprisingly, this era of exceptional returns has attracted significant investor interest in US assets. As a result, the US net international investment position – the difference between US assets held by foreign investors and foreign assets held by US investors – has steadily deteriorated, reaching a deficit of nearly \$36 trillion by the end of 2024 (see Figure 4).

Figure 4: US net investment position is in deeply negative territory⁴



If the perception of US economic exceptionalism fades and concerns about debt sustainability intensify, it's not hard to imagine non-US investors beginning to unwind their substantial holdings in US assets, while US investor may seek to diversify overseas. While the US dollar has retreated from its peak, the Fed's Trade-Weighted Real Broad Dollar Index remains near multi-decade highs (see Figure 5). This elevated valuation has also inflated the relative size of US equity markets, which made up 71% of the MSCI World Index as of end-May 2025 (see Figure 6). Although mega-cap tech firms continue to show resilience, driven by their dominance in digital ecosystems, a normalisation in the dollar's value would be expected to result in a natural decline in the US market's global weight, echoing the pattern seen in the decade following the turn of the century.

⁴ Source: Insight and Bloomberg. Data as at 31 December 2024.





Figure 5: The broad US dollar sits at multi-decade highs⁵



Figure 6: US equities dominate the MSCI World Index⁶



The Federal Reserve may play a pivotal role here. Its delayed easing cycle has made hedging US assets costly. However, if the Fed shifts to a more accelerated pace of rate cuts in 2026 as we anticipate, this would ease hedging costs and potentially accelerate a reallocation of global capital away from US assets.



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⁵ Source: Insight and Bloomberg. Data as at 31 May 2025. Shows US Fed Trade Weighted Real Broad Dollar Index.

⁶ Source: Insight and Bloomberg. Data as at 31 May 2025. Market value of MSCI US Index as a proportion of MSCI World Index (USD).

CONCLUSION

We believe the resilience in economic data and market sentiment seen in recent months may prove temporary, as the full impact of tariffs, policy uncertainty, and fiscal imbalances begins to weigh more heavily on global growth. While a near-term recession is not our base case, the risks are clearly skewed to the downside, and we expect a period of stagnation to take hold through late 2025 and into 2026.

Against this backdrop we expect to see a weaker US dollar and steeper yield curves, especially in the US. Selectivity and flexibility will be critical in credit markets. Our current positioning reflects a cautious stance, favouring high-quality issuers and defensive sectors with predictable cashflows. Yet we remain alert to opportunities – whether in resilient domestic franchises, undervalued BB-rated credits, or regions poised for fiscal-driven growth, such as Europe.

Looking further ahead, we see reasons for optimism. The AI investment boom and countercyclical policy responses in key economies offer the potential to reignite productivity and support a more constructive medium-term outlook. However, the path forward is also overshadowed by concerns around debt sustainability which, combined with a less exceptional US outlook, could reduce investor demand for US assets.

As the investment regime shifts, so too must our strategies. Staying agile, grounded in fundamentals, and attuned to structural change will be essential to navigating what comes next.

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16396-06-25