

Q2 2025

House View

Policy disruption reshapes
the world order





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Our House View document is a comprehensive compilation of views and analysis from major investment teams.

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The House View document serves two main purposes. First, its preparation provides a comprehensive and forward-looking framework for discussion among the investment teams. Secondly, it allows us to share our thinking and explain the reasons for our economic views and investment decisions to those whom they affect. Not everyone will agree with all assumptions made and of the conclusions reached.

No one can predict the future perfectly. But the contents of this report represent the best collective judgement of Aviva Investors on the current and future investment environment.



Executive summary

Policy disruption reshapes the world order

- **Policy uncertainty:** The imposition of significant tariffs has created substantial economic uncertainty that is expected to damage US and global economic activity.
- **Geopolitical shifts:** US security role changes in Europe have led to increased defence and infrastructure spending in European countries.
- **Economic outlook:** US growth expected to slow materially this year; global growth projected at 3 per cent, with risks tilted to the downside.
- **Asset allocation:** Cautious approach recommended, with modest underweight in equities and US high yield credit, overweight government bonds and underweight US dollar.

Less than three months into the new Trump presidency and the extreme policy uncertainty we wrote about in our 2025 Outlook has been even greater than we had anticipated. While the initial market reaction to the election victory was positive, the euphoria was soon washed away in a torrent of tariffs. In the first ten weeks of the presidency, tariffs were implemented against all imports from China (at a rate of 20 per cent), around half the imports from Canada and Mexico that were not subject to the USMCA free trade agreement (at a rate of 25 per cent), steel and aluminium (25 per cent) and autos (25 per cent). That raised the effective tariff on US imports from around 2.5 per cent to nearly 9 per cent, the highest rate in over 50 years. But it was the imposition of reciprocal tariffs on the 2 April that will have the most damaging impact. We estimate they increase the effective tariff rate to around 25 per cent, with China now facing a tariff rate of over 60 per cent and the EU 20 per cent. Moreover, tariffs of 25 per cent on semiconductors, pharmaceuticals and copper are expected to be announced imminently.





The imposition of reciprocal tariffs in April will have the most damaging impact on the global economy

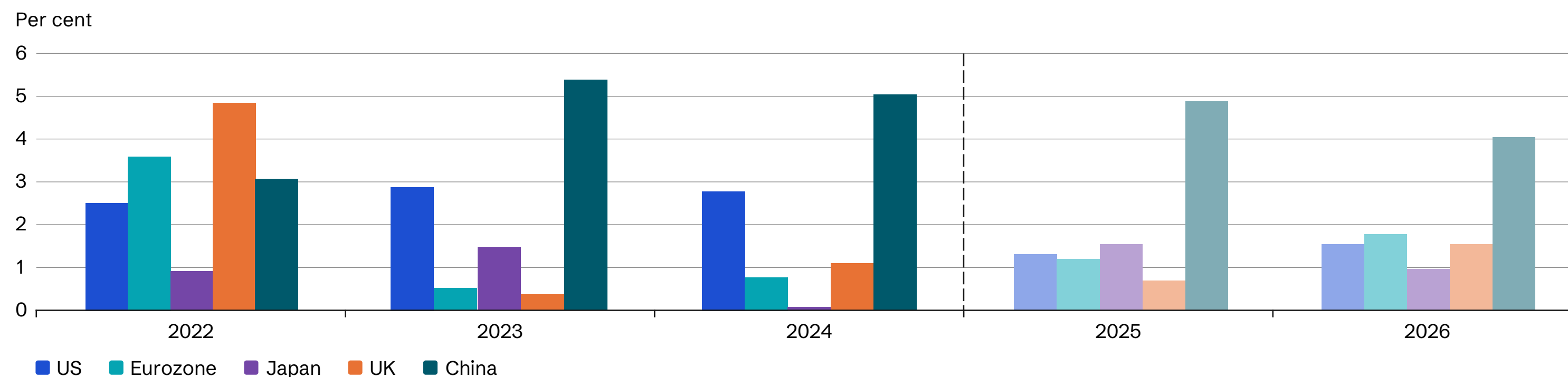


Our framework on the longer-term impact of tariffs remains unchanged: if used primarily as a bargaining tool, they are likely to have only a limited impact on trade and growth; but if used to either actively try to change global trade flows and imbalances or to raise large amounts of revenue, the impacts will be far greater.

The approach to tariff changes has also been erratic, sometimes with an announcement and reversal within a day or two. The uncertainty created by the process could prove to be damaging to activity, with households becoming more cautious in their spending decisions and businesses delaying investment and hiring. And while targeted tariffs on specific sectors or countries might have been more damaging for those exporting countries facing the tariff, broad-based high tariff rates are expected to be more damaging for the United States than elsewhere, depending on the extent of retaliation.

The uncertainty has gone well beyond trade policy though, with rising geopolitical uncertainty. The US has made a clear break with the past on its security role within Europe. While NATO remains in place, no longer can Europe expect that the US will be willing to take an outsized role in maintaining security. That has been evident in the change of position with regard to the war in Ukraine, whereby the US has opened negotiations with Russia, at the exclusion of both the Ukraine and European partners. This dramatic shift in the US' role in Europe has led to equally dramatic policy changes in Europe. Just as in prior European crises, previously unthinkable policy shifts have transpired in a very short space of time. The incoming German government has significantly loosened the self-imposed "debt brake" to allow for a considerable increase in defence

Figure 1. Aviva Investors growth projections



Source: Aviva Investors, Macrobond as at 3 April 2025.

spending, while also pursuing an additional large-scale infrastructure spending package – the combined effect could potentially add over €100bn a year of fiscal spending. While the European Commission has allowed for both a use of the Stability and Growth Pact escape clause to allow countries to borrow an additional €650bn for defence, as well as providing new loans for defence procurement of €150bn.

Meanwhile, in the US the creation of the Department for Government Efficiency (DOGE) has led to uncertainty for Federal departments/agencies and their associated staff and contractors. The drive to cut costs and eliminate fraud in the public sector is not a new one, but the methods being used appear to be blunt and open to potential legal challenge.

While we think this endeavour will ultimately deliver only modest spending reductions (with more material cuts only possible in upcoming budget negotiations), the uncertainty created may permeate more widely across the economy.

While the global economy entered 2025 in reasonable shape, with reasonable growth, more balanced labour markets and more moderate inflation, we think the near-term outlook has deteriorated on the back of elevated uncertainty and a damaging trade war, particularly in the US where we expect little growth on a sequential basis for the first nine months of this year (with calendar-year growth of 1.3 per cent – [Figure 1](#)). Downward revisions elsewhere are smaller, reflecting fiscal and monetary responses.

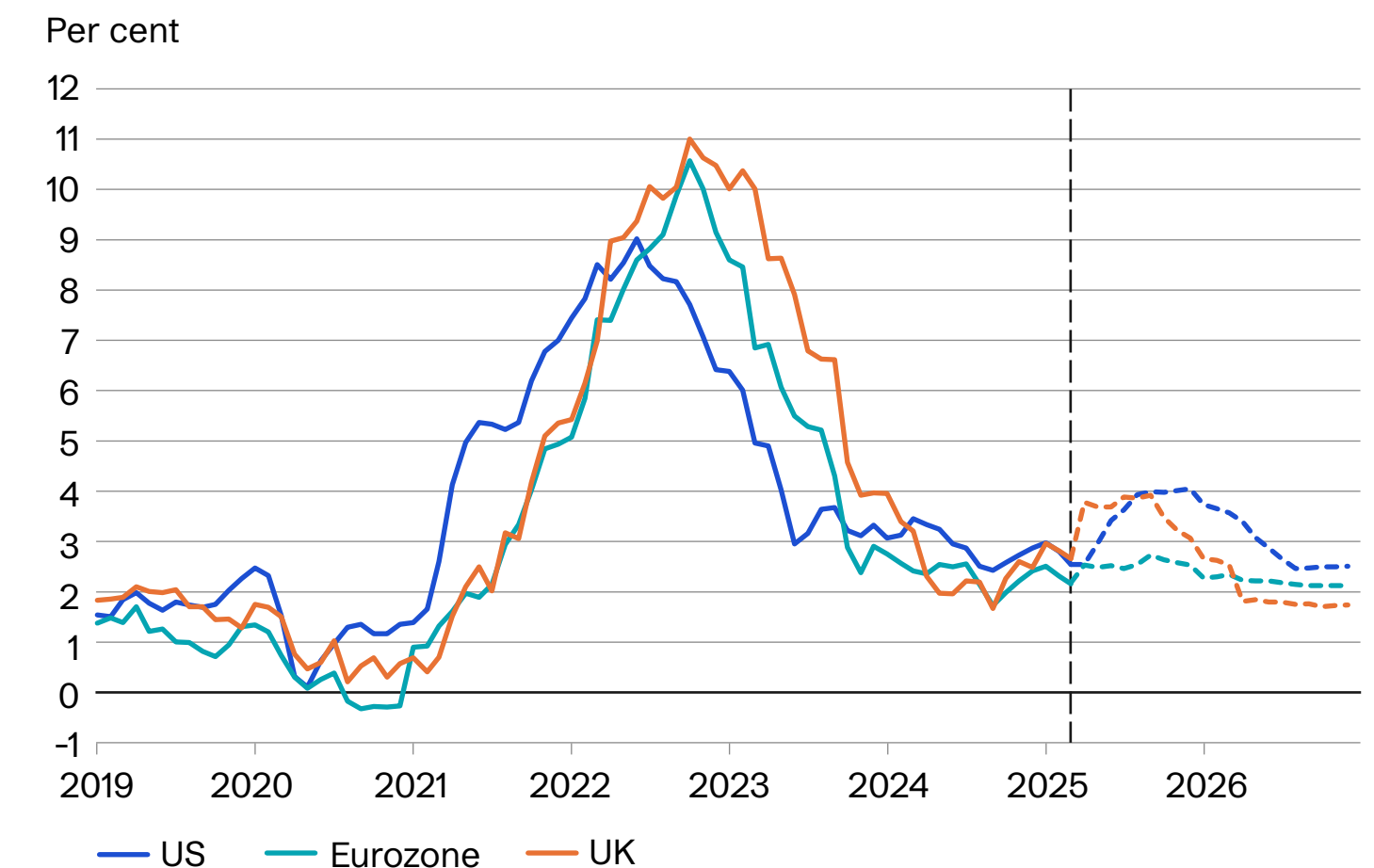
Chinese growth has been revised higher on renewed stimulus efforts. The fiscal package announced at the National People’s Congress in March will boost spending by around 1 per cent of GDP, with a greater focus on consumers and the service sector. That is enough to leave our global growth projection at around 3 per cent for 2025, but we think the balance of risks is clearly tilted to the downside. A full-blown trade war could see global growth fall to below 2½ per cent: outside of the GFC and Covid, the weakest in decades. Looking further ahead, we assume that the trade war uncertainty is largely resolved by the end of this year, opening up the potential for a rebound in sequential growth driven by tax cuts in the US and the ramping up of defence and infrastructure spending in Europe.

The inflation outlook in the US this year is highly uncertain because of tariffs. We have revised up our central scenario, with inflation now expected to rise through the first part of 2025 to around 4 per cent (Figure 2). This includes an adjustment of around 1.3pp for the pass-through of tariffs. However, with uncertainty on the extent to which the dollar, exporter and domestic margins adjust, the impact on inflation is highly uncertain. Our inflation outlook for the Eurozone is little changed, with US tariff effects assumed to be small. The inflationary impacts of the fiscal changes in Germany are also expected to be relatively minor this year. As such, we continue to expect Eurozone inflation to moderate only gradually back to towards target. In the UK, recent developments in energy and administered prices push up on inflation in April, with a peak of around 4 per cent in the middle of the year, before a relatively swift decline to close to the 2 per cent target.

Looking further ahead, we assume that the trade war uncertainty is largely resolved by the end of this year, opening up the potential for a rebound in growth driven by tax cuts in the US and the ramping up of defence and infrastructure spending in Europe.

Our medium-term view on interest rates is little changed. We do not expect a return to the post-GFC era of policy rates at or near the lower bound. We think that neutral real rates have risen and that the distribution of inflation shocks is likely to be more symmetric than in the past, delivering a higher average inflation rate. The disinflation process has largely played out as we expected over the last two years, with services inflation proving sticky, but still on a gradual downward path. That opened the door for limited rate cuts across all the major central banks (the Bank of Japan being the outlier). However, the combination of tariffs, fiscal changes and broader geopolitical events has widened the range of possible monetary policy outcomes

Figure 2. Aviva Investors CPI inflation projections

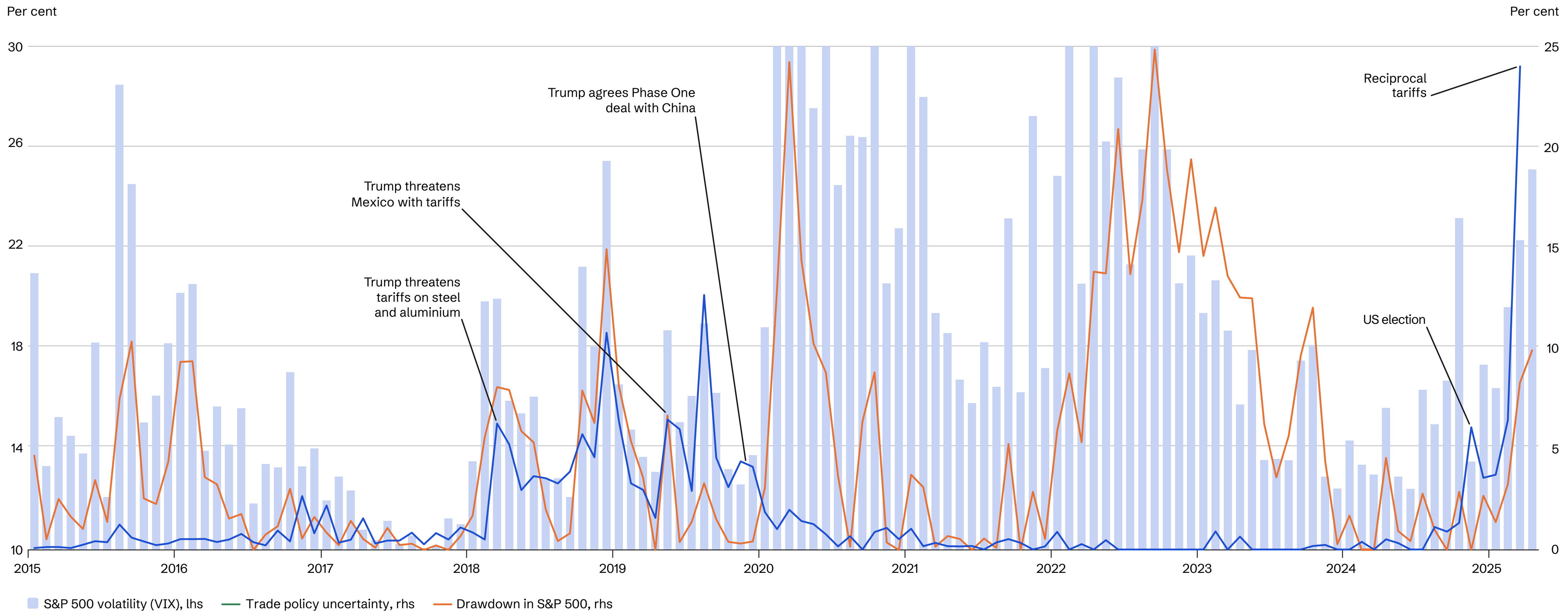


Source: Aviva Investors, Macrobond as at 3 April 2025.

and the potential for greater divergence. In our central case, we expect somewhere between 25-125bps of rate cuts across the Fed, ECB and BoE this year, with BoJ expected to raise rates. But as evidenced by our (and others’) growth (lower) and inflation (higher) forecast revisions, the trade-off is expected to become more challenging, especially in the US. We think that the reaction will focus on the medium-term inflation outlook, treating any near-term pickup associated with tariffs as temporary. If output weakens and unemployment starts picking up in any of the large economies, we would expect to see more rate cuts than currently priced in the second half of 2025.



Figure 3. Trade policy uncertainty leads to increased market volatility and lower equity prices



Source: Aviva Investors, Macrobond as at 3 April 2025.

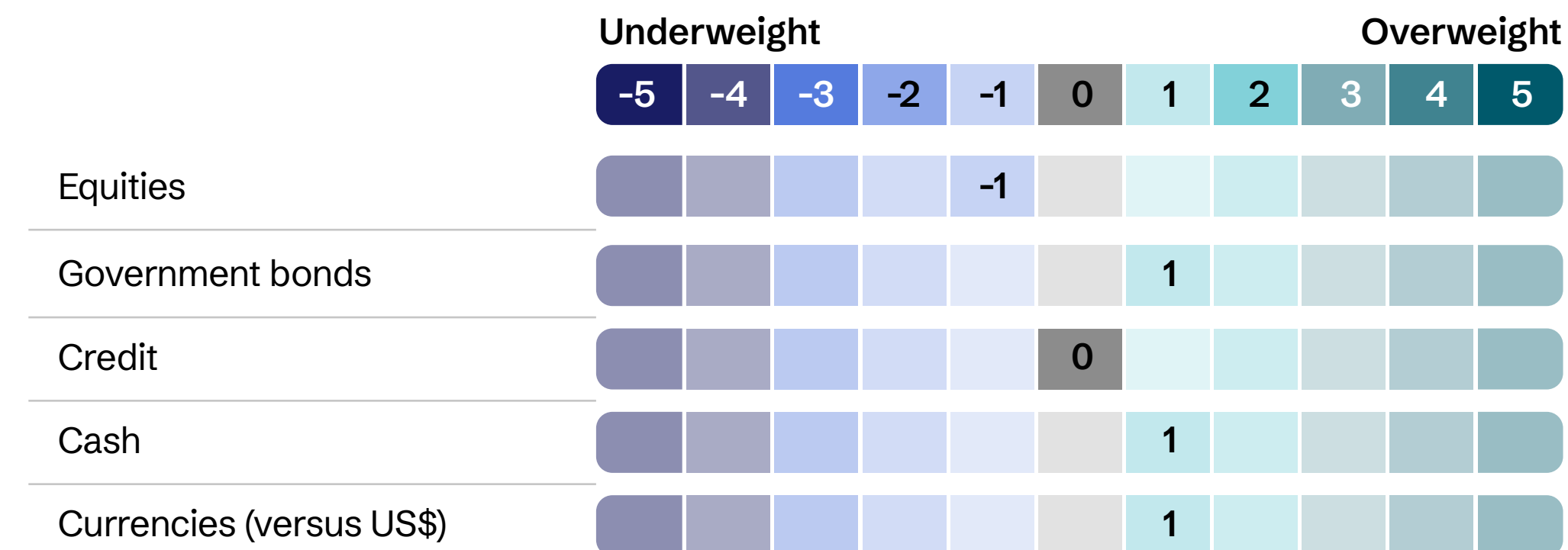


The disruption caused by extreme policy uncertainty has so far propagated primarily through US asset prices. The experience of 2018, when tariffs were first used more actively by the Trump administration, was that equity market volatility and performance were materially impacted by the trade uncertainty (Figure 3). With the broadening of tariff measures this time around, we feel a cautious approach to risk assets is prudent.

We are tactically slightly underweight equities (Figure 4), given the risk of a more material move lower in equities should the uncertainty remain and broad-based tariffs stay in place, but also keep a close eye on the opportunities this correction has opened should uncertainty reduce significantly. We prefer to be broadly overweight government bonds, with a preference to be overweight the UK and underweight Germany, reflecting the likelihood of faster rate cuts from the BoE and the impact of looser fiscal policy in Germany. We prefer to be modestly underweight US high yield credit – which has outperformed risk assets and looks expensive relative to the risks – offset by a modest overweight in European high yield. We prefer to be modestly underweight the US dollar against the yen and euro, with the balance of risks to a sharper slowdown and potential for structural outflows weighing on US assets.

The disruption caused by extreme policy uncertainty has so far propagated primarily through US asset prices

Figure 4. Asset allocation summary table



Note: The weights in the Asset allocation table only apply to a model portfolio without mandate constraints. Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.
Source: Aviva Investors, Macrobond as at 31 March 2025.



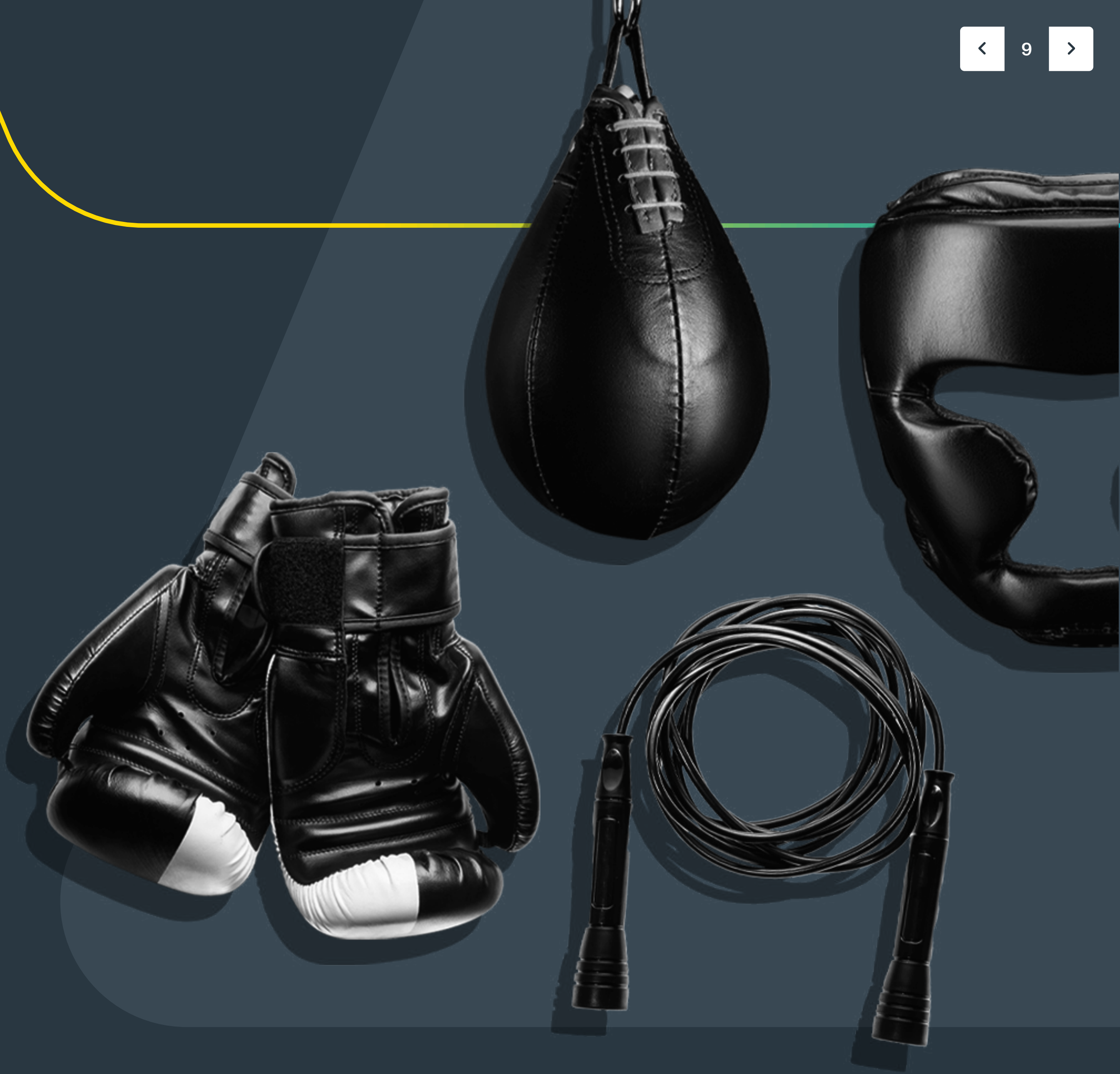
Key investment themes and risks

<p>1</p> <p>Trump 2.0: domestic & trade disorder and disruption</p>	<p>2</p> <p>Solidarity and self-reliance replace the rules-based order</p>	<p>3</p> <p>Tech revolution's testing times</p>	<p>4</p> <p>Monetary divergence driven by economic variance</p>
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Trump 2.0: Domestic & trade disorder and disruption

The trade war has not reached its full apex, but it has well and truly begun, with the so-called “Liberation Day” tariffs significantly adding to the earlier announcements on China, Mexico, Canada, steel and aluminium. It will take time for the full impact on economies and corporate earnings to be felt; a slowdown is virtually guaranteed but this was already our previous House View forecast. The second-order impacts will include damaged consumer confidence and suspended business investment, but the severity and duration is uncertain. Countries impacted will punch back and retaliate – as well as make efforts to dodge, parry, and duck out of the way by rerouting trade, or promising FDI and greater imports, or adjusting their export or foreign investment policies. A move toward protectionism in the US will likely alienate allies and cause damage and ‘deadweight loss’ to the US economy, while raising a modest amount of tax. This imposition of broad-based tariffs can be thought of as negative supply shock that, when permanently imposed, raises prices and decreases an economy’s overall potential growth.

Uncertainty is the only certainty for now, and this can be destructive in its own right





The impact on demand from tariffs can be mitigated with easier monetary policy



Despite the US being a somewhat “closed economy”,¹ the broad suite of announced tariffs would imply a material disturbance in the US. As for the exporting countries facing taxes (paid by importers and ultimately passed on to consumers), and striking back with tariffs of their own, the extent to which the negative supply and demand impulses net against each other will depend on many factors. Estimating the changes in trade patterns and growth involves a plethora of assumptions and guesses – the burden will inevitably be shared between foreign producers, domestic producers, profit margins and inflation. History offers little precedent as the only “trade war” case study of the post war-era is the 2018/19 experience under President Trump’s first term. The literature is quite clear on who paid the price during this episode: US firms and consumers.^{2,3} We expect the same outcome, but 2025’s tariffs are orders of magnitude larger (Figure 5 and 6).

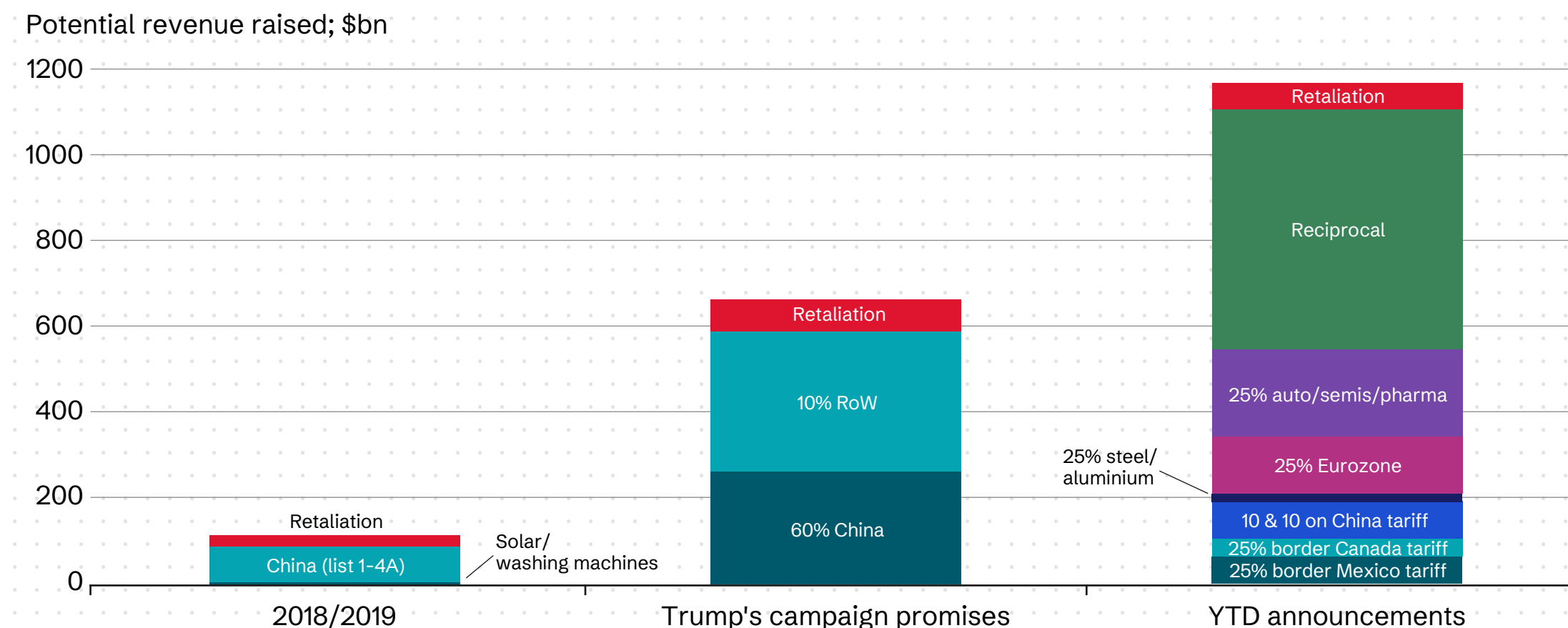
A tariff-driven trade war represents that of a “stagflationary” shock to all. The prospect of more inflation alongside lower growth poses a headache from a monetary policy perspective, as a central bank’s blunt tools cannot solve both problems simultaneously. The loss in potential output from permanent tariffs cannot be restored by monetary policy, but the fall in aggregate demand can be somewhat eased. The mechanical impact of tariffs upon prices will be a “levels shift” in goods prices which might simply fade from the inflation rate in due course. Whether this “one-off” impact affects future inflation will depend on developments in expectations and incomes. Unless the projected loss in demand is sufficiently severe, developments in inflation expectations will prove critical to central bank reaction functions.

Finally, alongside the protectionist policies, the White House and Congress are preparing a slew of other domestic policies. These will probably be a mix of stimulus, from increased defence spending and gigantic tax cuts for businesses and individuals, from which the well-off will benefit disproportionately, to DOGE-driven efforts at austerity and elimination of government programmes, some wasteful and some not. Another big ongoing effort is the restriction of immigration and deportation of undocumented residents, which could impact wages and certain sectors, as discussed below.

1. Total trade (imports and exports) constituted c.20 per cent of US Real GDP in 2024 whilst the San Francisco Fed estimate the share of US consumption basket pertaining to imports to be c.11 per cent [How Much Do We Spend on Imports? - San Francisco Fed](#).
 2. [Who’s Paying for the US Tariffs? A Longer-Term Perspective](#); Bar Steel, Amiti, Redding and Weinstein found near complete passthrough for the 2018/2019 tariffs.
 3. [Economic Impact of Tariffs Under Sections 232 and 301 on U.S. Industries](#) - A recent 2023 paper from the US International trade commission also find a near complete passthrough of 2018/19 tariffs into import prices.

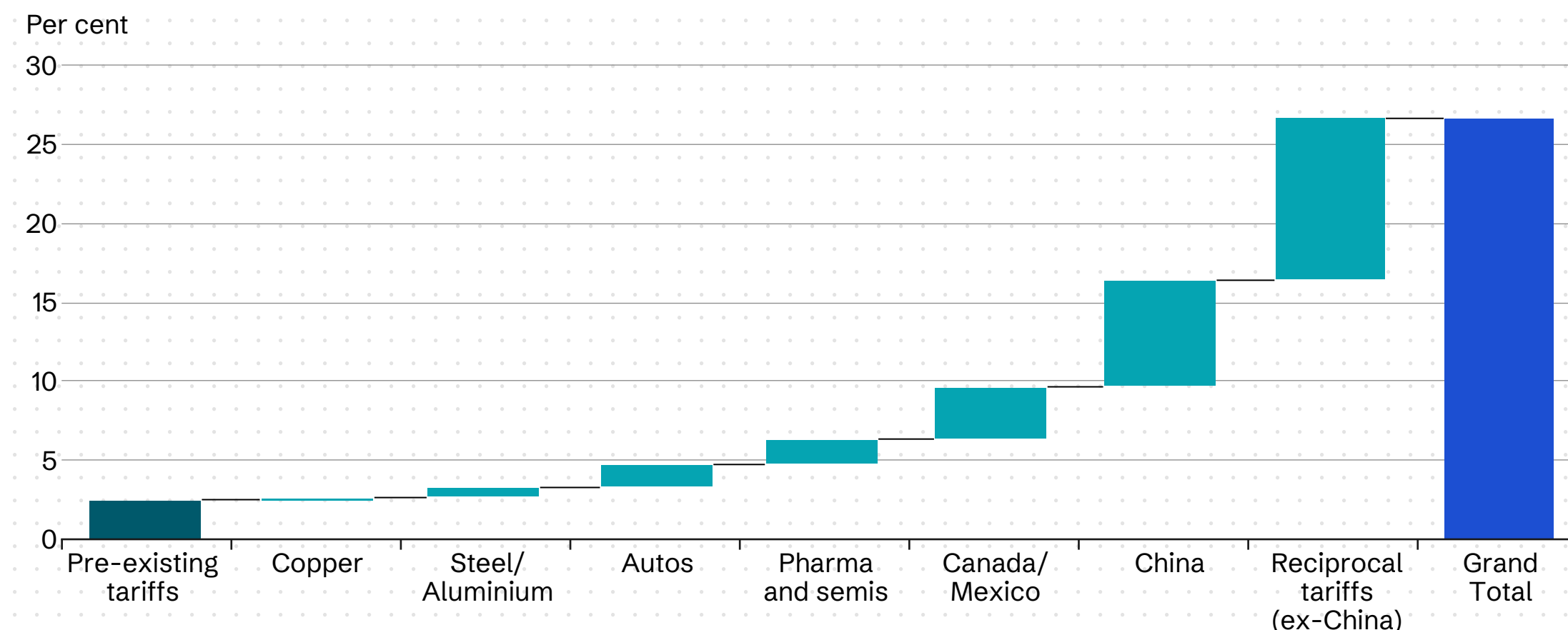
Thanks to Alex Scholefield for co-authoring this section.

Figure 5. There has been a flurry of tariff announcements along both product and country lines



Source: UBS, White House announcements, Aviva Investors as at 3 April 2025.

Figure 6. Effective tariff rate has risen ten fold under the new administration



Source: Aviva Investors, Macrobond as at 3 April 2025.



Solidarity and self-reliance replace the rules-based order

The reorientation of the United States under its new administration, from the willingness to negotiate with the likes of Russia to outright criticism of Europe, has prompted a re-think of many of its allies. “Faced with mounting doubts over Washington’s reliability, US allies in the Indo-Pacific may start charting their own course, prioritizing bilateral intelligence agreements with trusted partners like the U.K., Australia, and New Zealand.” [The Diplomat, March 2025]. Many countries will look to become more self-sufficient militarily – something that the US arguably sees as a good thing, ending the previous “free riding”; private sector companies may also seek to terminate contracts with American firms as much as they invest in the United States in order to remove tariff threats. But the biggest shift away from the previous arrangement is for Europe, where a concerted effort is being made to decrease dependence on the American alliance, to cease internal division and infighting, and to ramp up spending to levels once perceived as fantastical.

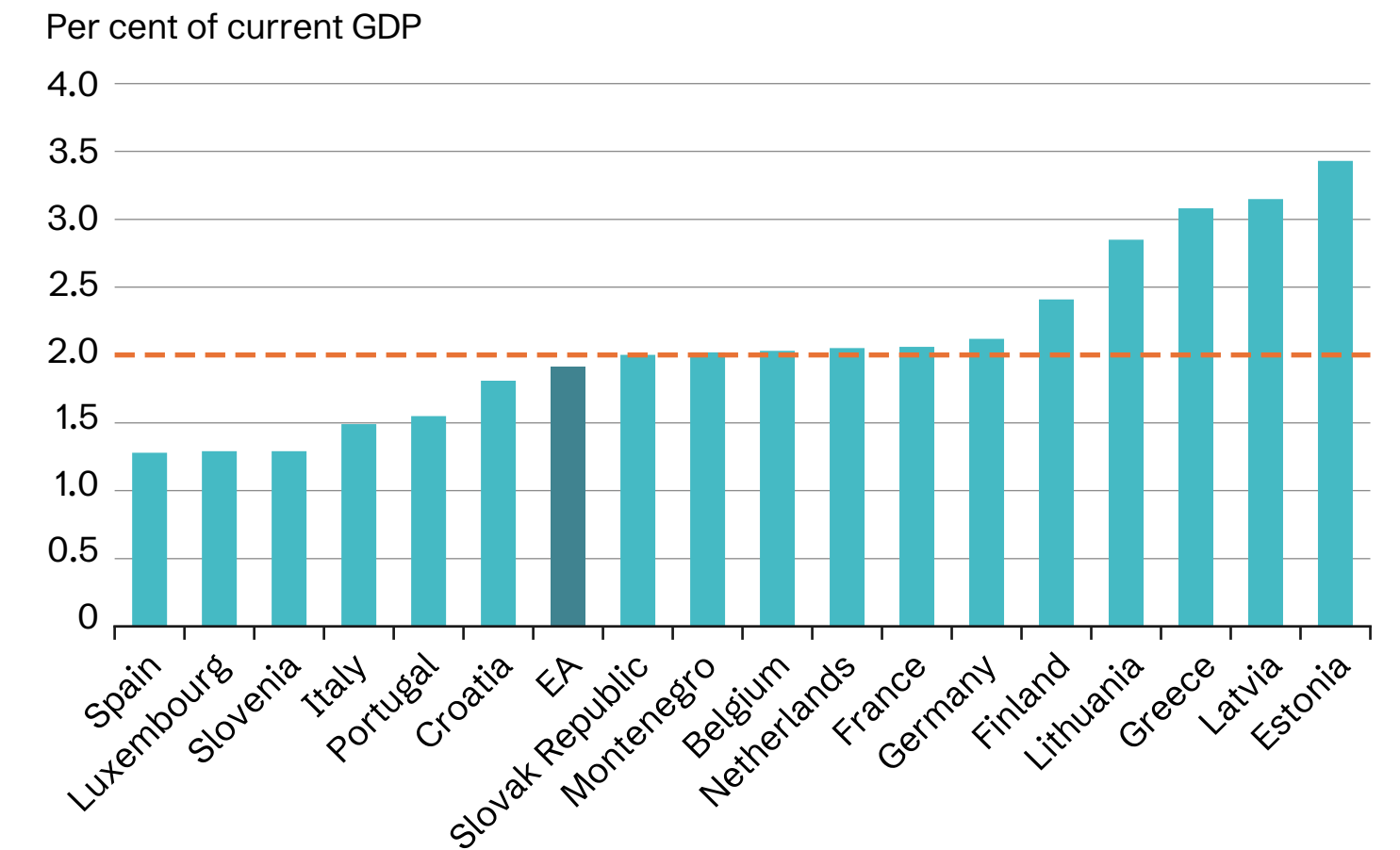
The 18 EU countries that are also members of NATO (i.e. Eurozone excl. Austria and Malta) have considerably increased defence spending over the recent years – both under Trump 1.0 and especially following the 2022 attack on Ukraine. However, on the aggregate the ratio of defence spending to GDP remains below 2 per cent (1.9 per cent) while several countries are materially below this threshold, notably Spain and Italy (Figure 7). Spain would have to increase spending by 0.7ppts of GDP and Italy by 0.5ppts to achieve the 2 per cent target.

Given the geopolitical reality, even 2 per cent of GDP on military expenditures might not be sufficient: to exceed Russia’s spending and deter aggression, the EU would have to increase its defence spending to at least 3 per cent of GDP, equivalent to c.EUR 150bn of additional expenditure per year; for Spain and Italy, that would imply a substantial 1.7 and 1.5ppts (of GDP) increase, respectively (Figure 8).

Taken together with aid for Ukraine, the “bill” would amount to EUR 200bn per year or EUR 2tn over a 10-year period – approximately an additional 1.1 per cent of GDP. Consequently, the mooted EUR 800bn EU package (which is supposed to run until 2030) alongside the likely German defence spending stimulus would barely hit the mark over the next five years. Renewal of the project on a multi-year horizon, alongside full utilisation and scaling up of existing or new facilities would be required.

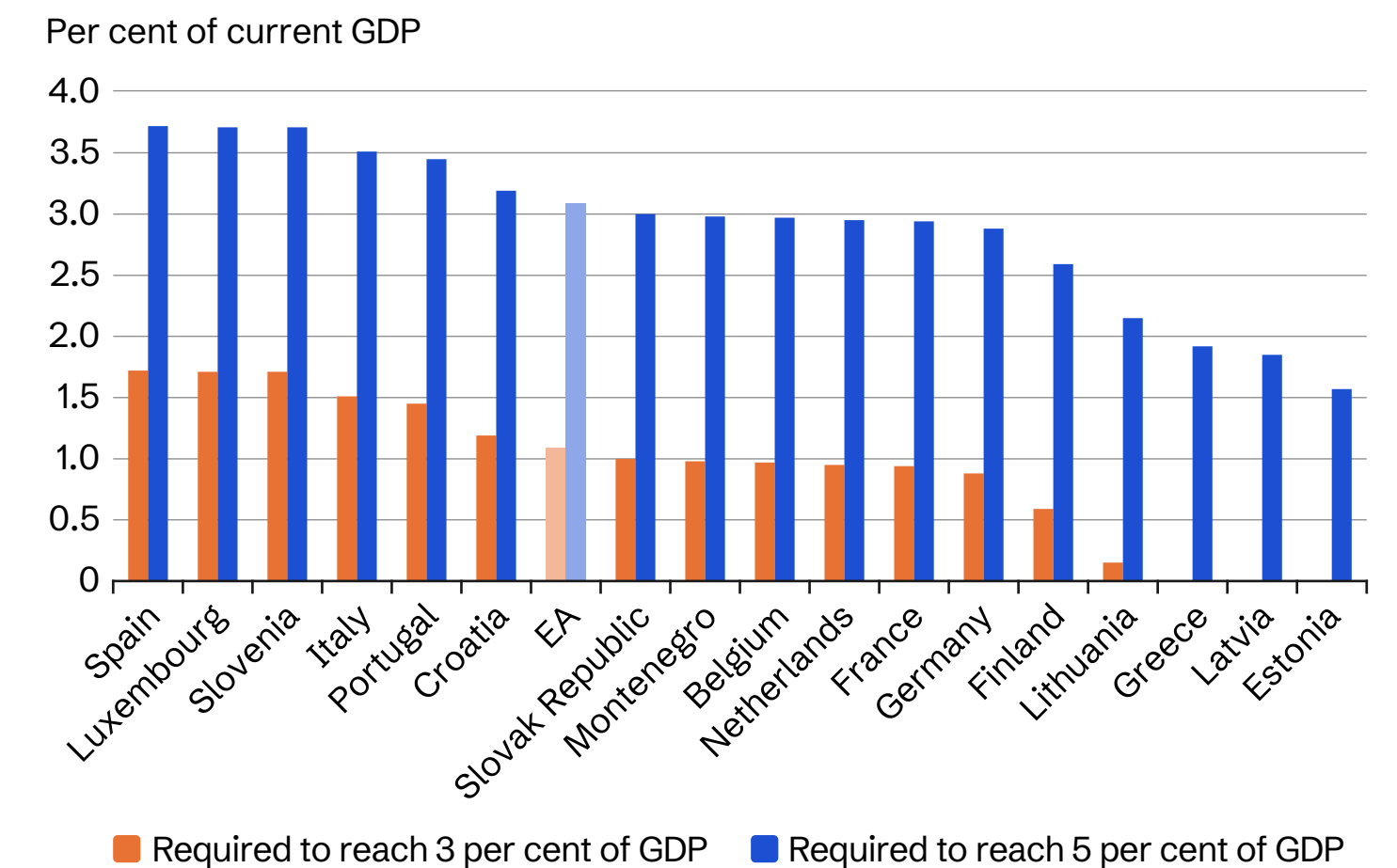
Given the geopolitical reality, even 2 per cent of GDP on military expenditures might not be sufficient to exceed Russia’s spending and deter aggression

Figure 7. Current defence spending in the EU (2024e)



Source: NATO, Macrobond, Aviva Investors as at 31 March 2025.

Figure 8. Required additional defence spending to reach 3 per cent and 5 per cent of GDP



Source: NATO, Macrobond, Aviva Investors as at 31 March 2025.



The machinery of these new borrowing and spending mechanisms is still being formulated. The German proposal is not yet finalised but it is likely to be in the vicinity of EUR 200bn – 300bn (on top of the existing EUR 100bn SPV). It will be funded via German borrowing but any expenditure above 1 per cent of GDP will not be subject to the debt-brake rules. The EU proposal amounts to EUR 800bn until 2030, funded via (1) EUR 650bn of borrowing at the national level under the “general escape clause” which allows member states to deviate from fiscal rules in exceptional circumstances, and (2) EUR 150bn of common debt issuance via a new instrument. Institutions such as the EIB may also be conscripted. This presents challenges.

Despite the EU’s role having grown considerably after the dual shocks of Covid and Ukraine, the Union’s framework was not designed with common defence as a principal component.

This creates several obstacles that include but are not limited to:

1. The issue of (joint) equipment procurement. For example, Germany is in favour of common procurement and Europeanization of defence policy while France is resistant in changing priorities for its own defence companies. More broadly, fragmentation and lack of coordination remain, due to procurement at the national level, different national standards and systems, and member states prioritising interests of their own national industries.
2. Reliance on non-EU suppliers, high import dependence (especially on the US, whose reliance is now questionable) are also issues that need to be addressed in the medium-to-long term.
3. Certain states do not want the European Commission deeply involved in defence matters, while others oppose common debt issuance.

4. Several programmes at the EU level exist in parallel, yet are underfunded, subject to fragmentation and veto of individual countries (e.g. the European Defence Facility; the European Defence Fund; the European Defence Industry Reinforcement through Common Procurement Act; and the Act in Support of Ammunition Production). These need to be upscaled, streamlined and simplified so that they efficiently allocate resources.

For the EU, Canada, Japan, the UK and others, the fiscal boost will have positive growth impact, but may also have inflationary consequences, effects on interest rates and sovereign spreads, currency and balance of payments after-effects, and has already boosted equity sectors like European defence companies.

Despite the EU’s role having grown considerably after the dual shocks of Covid and Ukraine, the Union’s framework was not designed with common defence as a principal component



Whether to defend or rebuild, Ukraine will be costly

Scenario 1: Ukraine/Russia conflict continues

Europe (EU, UK, NO, SZ and IS) and the US have been the main contributors to Ukraine since 2022, providing in total 93 per cent of the near EUR 270bn aid (Europe: 50 per cent, US: 43 per cent). The table below, using data compiled by the Kiel Institute illustrates this alongside the breakdowns for individual aid categories (financial, humanitarian and military aid). The bottom line is that in case of US support withdrawal, Europe would have to do the heavy lifting, providing around EUR 38bn per year (EUR 21bn for military aid alone).

Amounts in EUR billions per year since 2022	Financial Aid	Humanitarian Aid	Military Aid	Total Aid
Europe*	19	4	21	44
US	16	1	21	38
Total (all countries)	39	6	43	89
Europe* (per cent)	48	70	48	50
US (per cent)	39	18	49	43

*Europe includes the EU, the UK, Norway, Switzerland and Iceland.
Source: Kiel Institute, Aviva Investors as at 31 March 2025.

Scenario 2: A peace deal is agreed

In this scenario, aid would take the form of assistance for Ukraine’s reconstruction. The United Nations has estimated that it would require EUR 450bn spread over 10 years for recovery and reconstruction i.e. EUR 45bn per year. It is unknown the share of the amount that Europe would agree to contribute to, but a sensible range is likely to be between 50 per cent and 75 per cent. This would translate to between EUR 22bn and EUR 34bn per year in European contribution.

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Tech revolution's testing times

Since ChatGPT was launched by OpenAI in 2022, LLMs and other generative AI and related technologies have led to a boom reminiscent of the dot-com mania of the 1990s but while during that period there was limited potential for large productivity improvements, the current technological advances, while still unproven, have significantly greater potential for productivity gains than the dot.com era offered at the same stage in the technology curve. For all the hype, we are still in the early days of the gold rush, and are seeing the first of what will doubtless be many corrections and reckonings across the unfolding AI ecosystem.

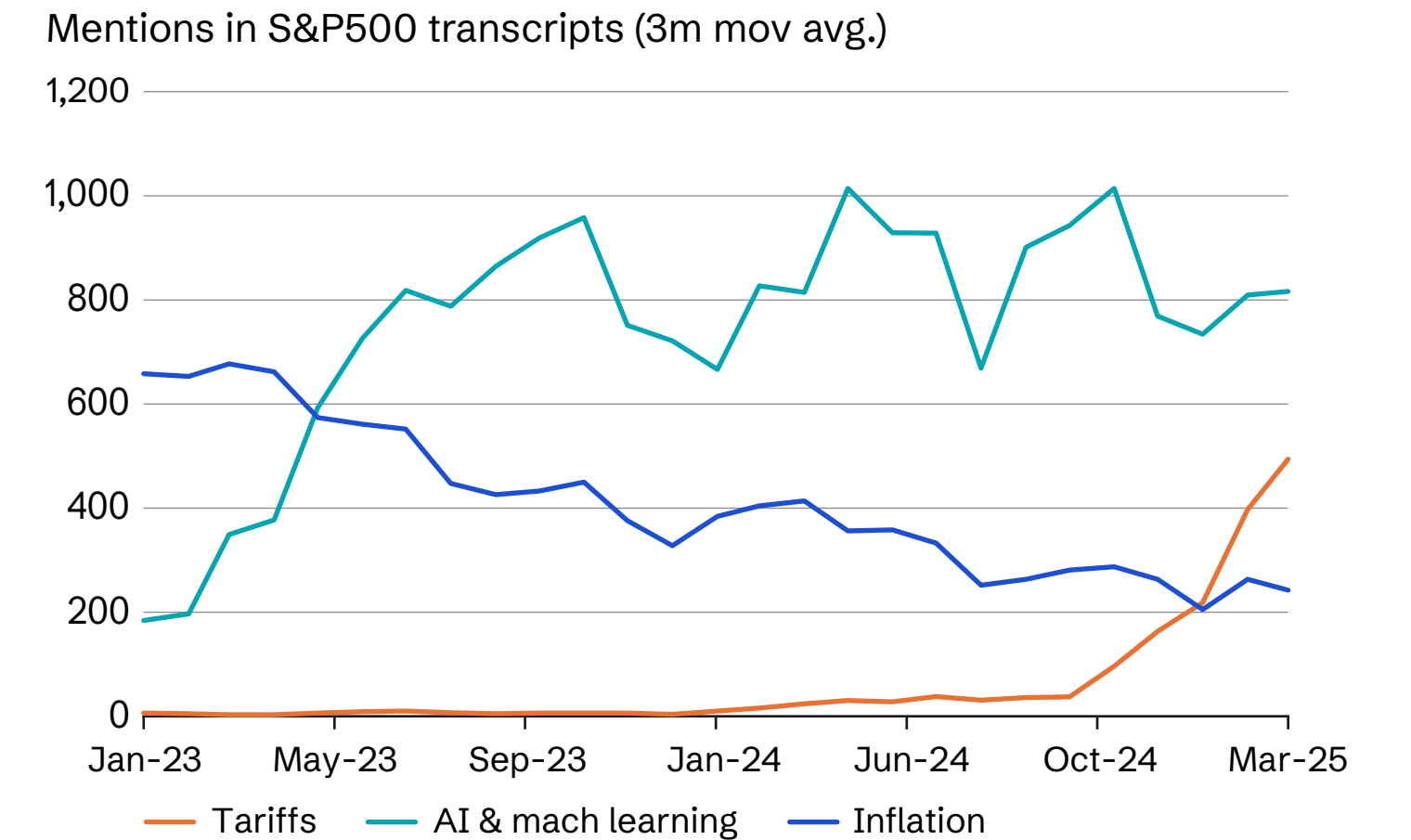
The inputs needed for successful models are expensive, requiring huge numbers of chips and data and energy for training, as well as continued cloud storage and still more electricity to run the systems and improve them over time. The DeepSeek 'event' in early 2025 was a shock for two reasons: first, American dominance was suddenly challenged, and second, the purported efficiency gain made assumptions on semiconductor demand (and profits) less certain. But rapid technological advancement is by its very nature disruptive - moving fast and breaking things isn't fun for everyone, and sometimes creative destruction is, well, destructive.

So far, the c.9 per cent YTD decline in the S&P 500 IT sector is just a blip following a more than 130 per cent gain between October 2022 and December 2024, and is only a third of the major correction in 2002, which saw a 33 per cent decline. There are multiple causes: a combination of heady valuations, concentrated positioning (meme stocks then, Mag-7 now), and some external catalysts that make a reassessment needed (inflation and rate rises then, tariffs and new competition from China and others now - see [Figure 9](#)).

Efficiency and productivity gains are at the heart of the promise of AI, and we should not be surprised to see such advances be made within the sector, as well as in its application. Whether lower unit costs lead to lower investment, and if software improvements result in lower hardware needs, remains to be seen. Typically, demand moves up after a 'positive supply shock', moving along the existing demand curve as prices fall. Falling costs of mobile phones, solar panels, computers and many other goods (tech and non-tech) has led to rapid expansion, not extinction - and lower costs will be good for the margins of the users, if not necessarily the adopters.

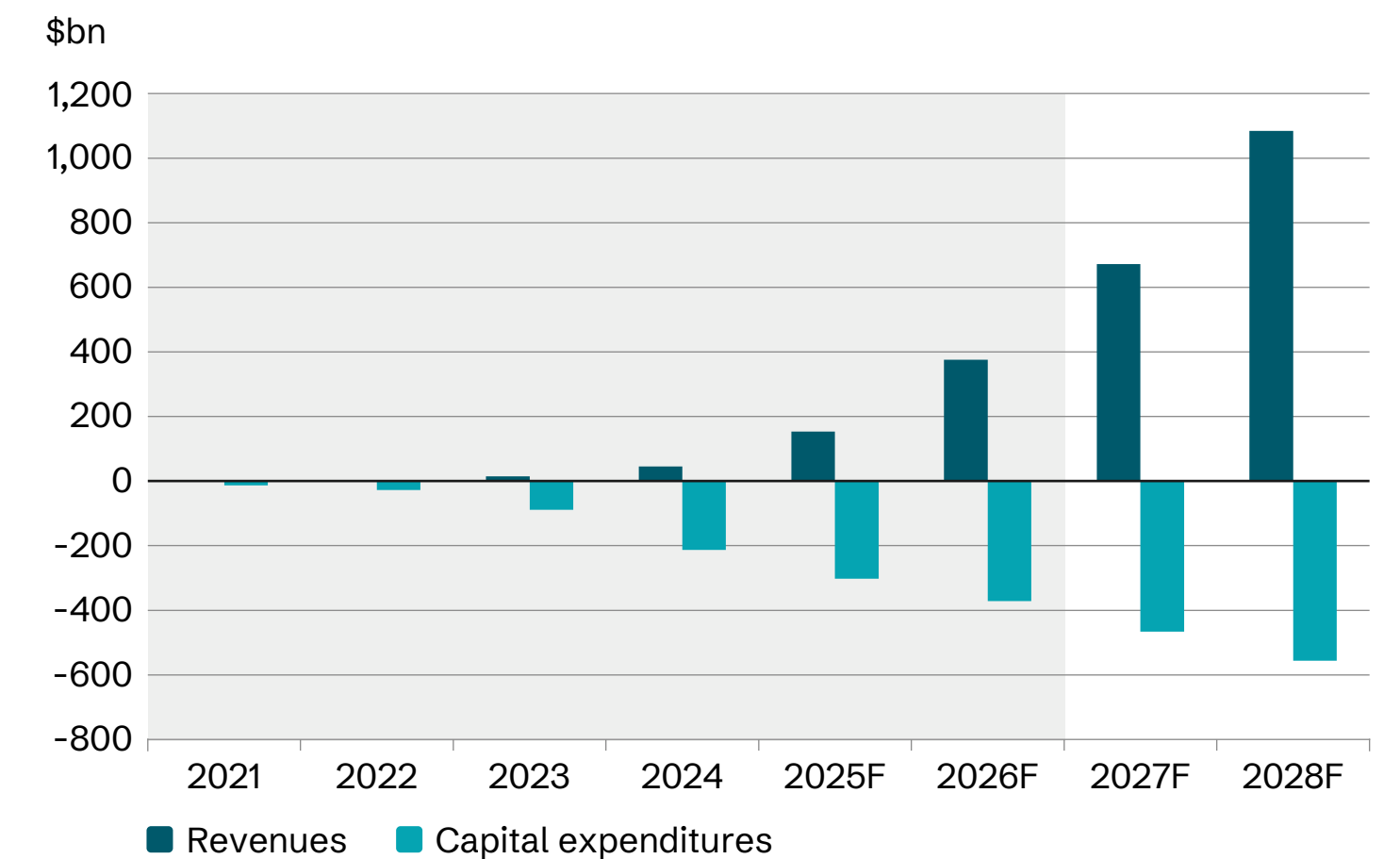
In addition, it is still unclear whether the amount of computing power needed for inference (effectively when a trained large language model produces an answer to a question) is going to prove lower than what is needed for LLM training. More recent reasoning and agentic models (DeepSeek included) need much larger compute to infer answers than previous models did. And as these models become more popular, there is a significant chance we end up with actually greater computing needs than during the training phase. In short, the outlook is bright - but admittedly uncertain, and estimates of when revenues or profits will justify the hundreds of billions of investments needed vary widely. Optimistic projections state that we're just a couple of years away from AI-related revenues surging ([Figure 10](#)), but the competition will be fierce and we should expect winners and losers. That's what progress and capitalism are and have always been!

Figure 9. AI dominates discussions, but tariff worries are rising



Source: Bloomberg, Aviva Investors as at 31 March 2025.

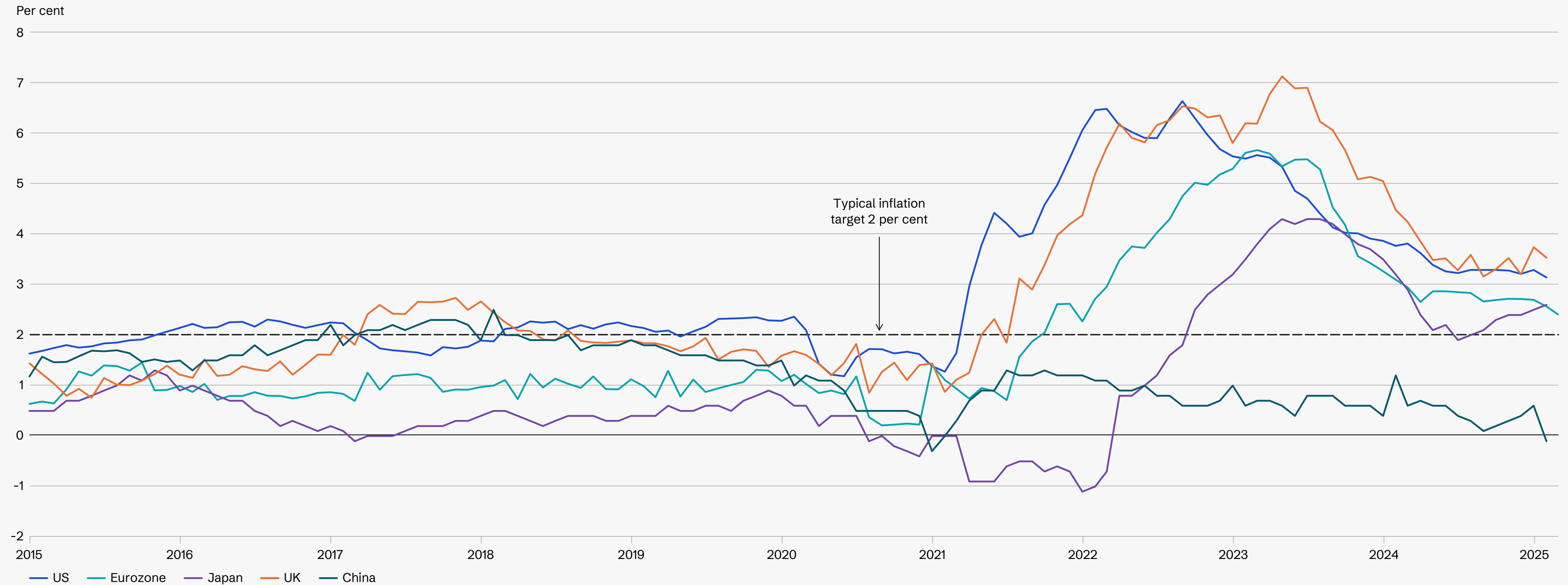
Figure 10. Even optimists see AI-related costs exceeding revenues for some years



Source: Morgan Stanley Research, Aviva Investors as at 31 March 2025.



Figure 11. Inflation is more stable, but above target and heterogeneous



Source: Aviva Investors, Macrobond as at 3 April 2025.



Monetary divergence driven by economic variance

This theme has evolved over the past few months, as central banks that have eased monetary policy from restrictive levels are turning more cautious, and have by-and-large ditched forward guidance in the face of uncertainty and two-sided risks. The causes emanate from tariff risks mentioned earlier, which have multiple potential effects on inflation in their direct application. Yet tariffs also have the potential to push prices down outside the US, due to currency adjustments, weaker demand or excess production being dumped on un-tariffed areas, and to result in lower growth if business and consumer confidence are hit. The gate to faster easing would only be likely if negative shocks hurt capital markets severely, or began to hurt employment. US labour markets may also face their own negative supply shift if ICE deportations revert to or exceed the levels last seen under the Obama administration – that was a disinflationary time of high unemployment, but the fallout now could be inflationary or stagflationary, at least at the margin. Meanwhile in Europe and Japan, anaemic growth is being pushed higher by aggressive fiscal plans, which may bring an end to ECB cuts. In Japan the BoJ needs to hike more, and most likely will do so at a slow and steady pace; in the UK the BoE has pledged to be gradual until the present high uncertainty is resolved.

Finally, the data should speak for themselves: the common shocks of pandemic lockdowns and energy supply cuts, followed by the disinflation of supply chain disruption and labour market normalisation, together with energy prices settling down after 2022, were the huge drivers of inflation rising and then falling in 2021-23 ([Figure 11](#)). Prices have stayed high, enraging many voters, but inflation dropped significantly. However, core and other underlying

measures (median, trimmed) have bounced uncomfortably, and that has meant that central banks have shifted to a more cautious path of reducing restrictiveness on their way to neutral – though we should be open-minded. Inflation may attenuate and economic activity deteriorate, making ‘neutral’ just a waypoint on the way to accommodation.

Tariffs also have the potential to push prices down outside the US, due to currency adjustments, weaker demand or excess production being dumped on un-tariffed areas, and to result in lower growth if business and consumer confidence are hit



“There are many potential hot spots around the world that could cause damaging economic disruption.”



Michael Grady
Head of Investment Strategy
and Chief Economist



Risks

Geopolitical escalation and instability

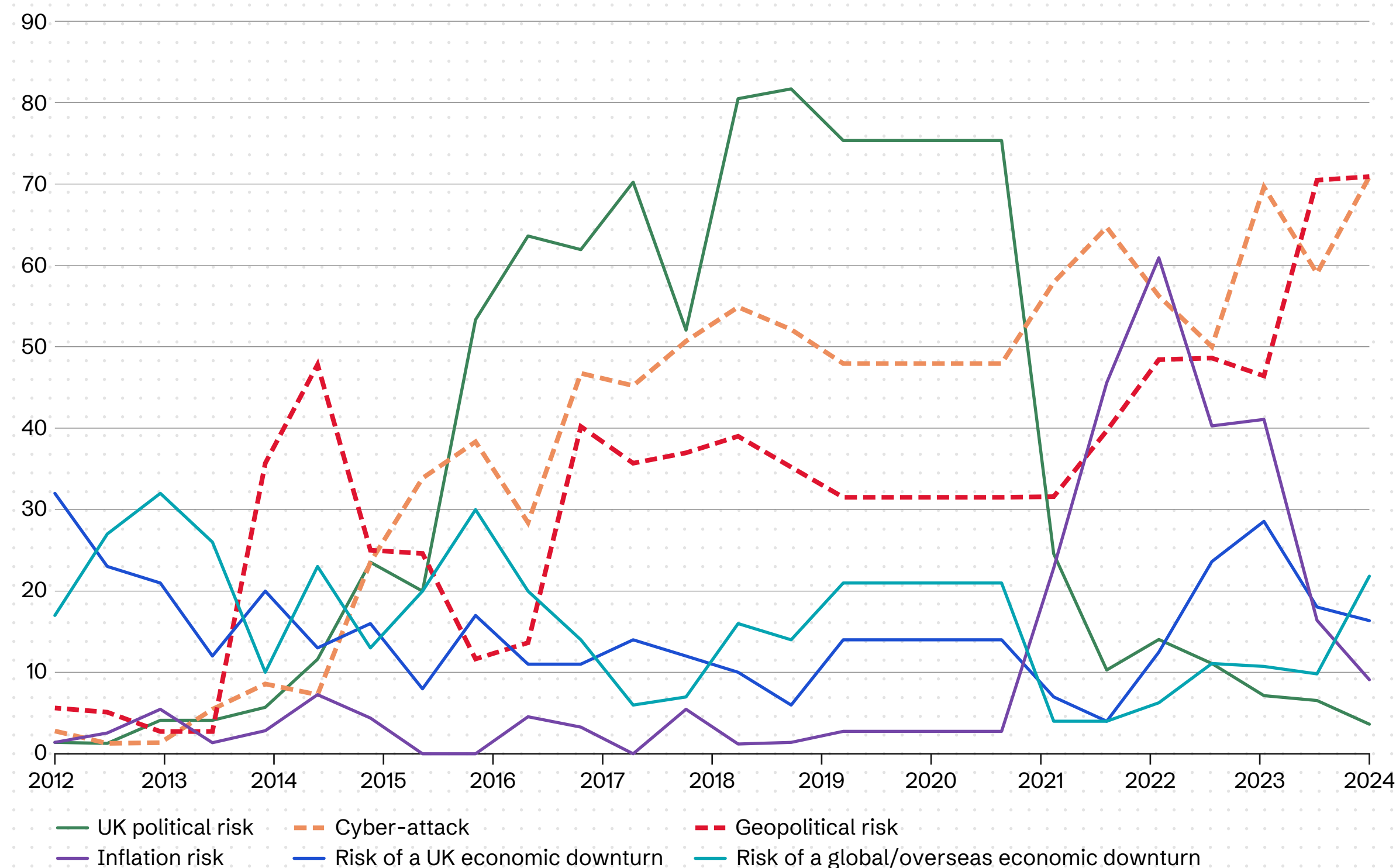
As mentioned in the Executive Summary, the US has escalated verbal attacks on traditional allies, with President Trump breaking post-WW2 taboos in mulling over annexation, while flinging tariffs on former friends and enemies alike. Leaders of countries within NATO, AUKUS, and other defence and intelligence alliances are alarmed, and preparing for a future that is less stable and predictable. America itself may find that a world without true friends, based only on transactional considerations, political favours, and ego, is not really aligned with its long-term interests, or that it is not worth shutting down bastions of soft power that took decades to build.

There are many potential hot spots around the world that could cause damaging economic disruption; as we saw in Ukraine the cost of lives is a tragedy but the repercussions of geopolitical instability or war can be global if key commodities result in energy or food shortages. Cyber-attacks are also a constant threat – Iran and North Korea are ‘leaders’ in this form of unconventional, asymmetric threat. In the Bank of England’s systemic risk survey of firms, these were the top two risks cited by respondents – before the invasion of Crimea in 2014, those dangers barely registered on CEOs’ and CROs’ minds (Figure 12).

Russia’s President Vladimir Putin may opt for a temporary cessation of conflict if it helps Russia’s longer-term aims of conquest, destabilisation and humiliation of the EU and the ‘Rules-based’ order that is supportive of democracy, liberalism, and human rights. The US is no longer a reliable backer of that order, which makes Russia’s territorial threats, as well as China’s designs on Taiwan and various maritime claims, and a plethora of other border disputes around the globe a high risk in coming years.

Figure 12. Cyber-attacks and War are primary concerns for many firms

Most challenging risks (survey respondents, per cent)



Source: Aviva Investors, Macrobond as at 31 March 2025.

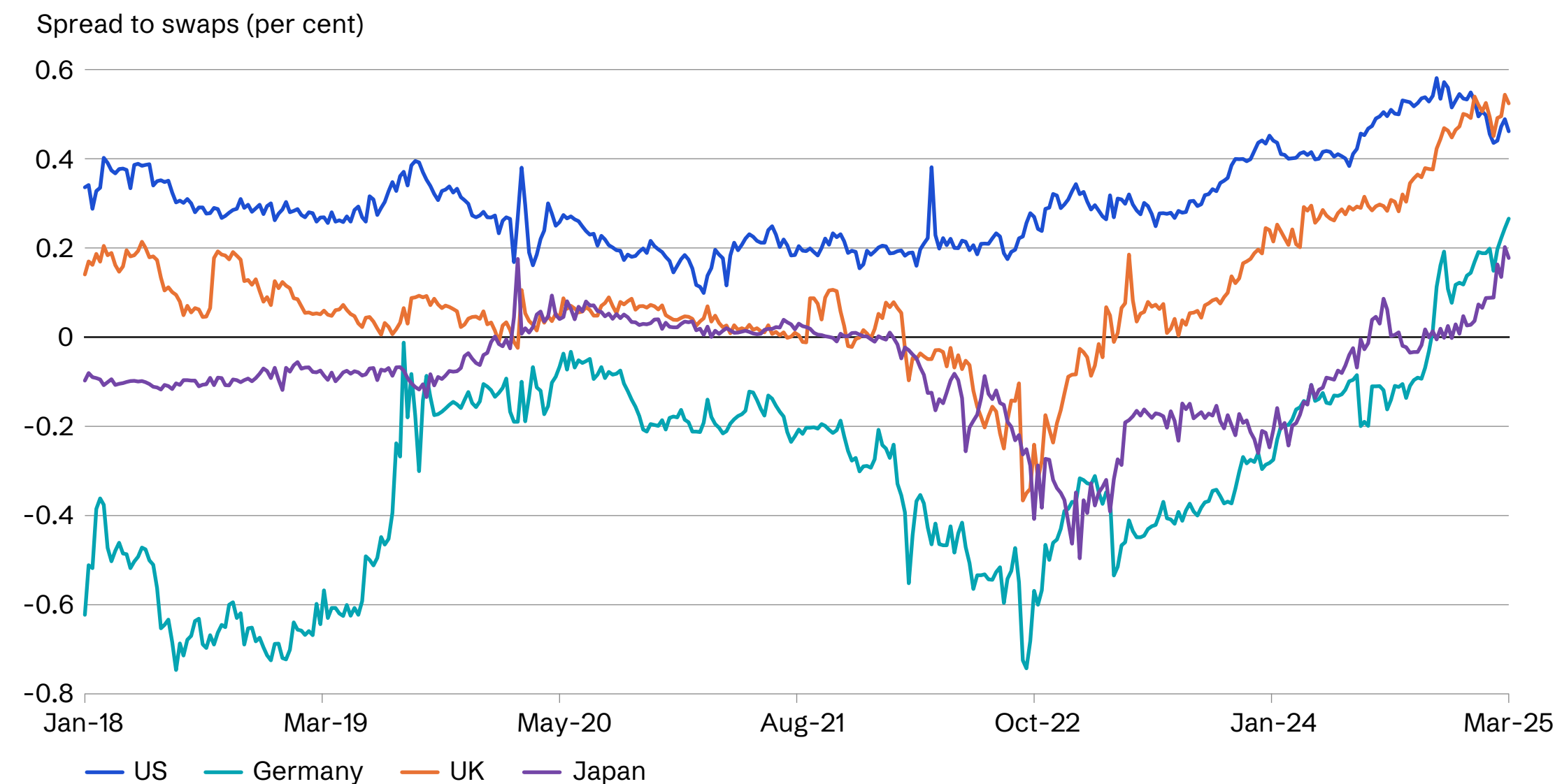
Fiscal expansion's negative side effects

For the past five years, the IMF's fiscal monitor advocated (or at least acknowledged the political necessity) for governments to spend massive amounts on:

1. The Covid pandemic and to the disease itself
2. Recovering from the lockdowns and disruptions and “help people bounce back”
3. Reducing inequality and gaps in access to public services
4. “Addressing the humanitarian crisis and economic disruption” following Russia’s catastrophic failed full-scale invasion of Ukraine
5. “Helping lower inflation [via subsidies] and protect vulnerable households from the cost of living crisis”
6. Achieving climate goals and transfers to protect households, workers, and communities from the disruptions and costs of the green transition
7. Pre-election pressures for “spending on wages, pensions, health, industrial policies, environment, defence, and the UN’s SDGs”.

The world has accumulated over \$100 trillion in public debt, a large chunk of that just in the past few years, and interest costs are now onerous for many countries. The decade of low rates following the GFC is over, and for most economies is gone for good – which is something to celebrate rather than bemoan. Nonetheless, the IMF’s recent Fiscal Monitor was titled “putting a lid on public debt”. It’s a little late for that! Indeed, the multilateral’s economists admit that in all likelihood, debt paths tend to rise faster than rosy projections that assume too much growth and consolidation, and fail to account for crises, wars, and other negative outcomes, as well as contingent liabilities that hide in the shadows. For the major developed market economies, far from tightening their belts, we expect more supplementary budgets in Japan, a meaningful fiscal expansion in China, a revolutionary rethink to issue more debt in Germany and the EU, and of course, an extension and enlargement of tax cuts in the US.

Figure 13. “Risk-free” bonds have been selling off



Source: Aviva Investors, Macrobond as at 31 March 2025.

These imbalances are large and ultimately unsustainable, but are both the cause and the beneficiary of high savings rates, huge wealth creation, and profits for businesses. While fragile economies like Argentina, Sri Lanka and Zambia have defaulted and restructured several years ago, there seems to be little strain or instability in developed bond markets, where auctions proceed smoothly and even the late-2022 episode in the UK proved short-lived. Will there be a “bond vigilante moment” for Treasuries, bunds, or JGBs? What we are already seeing is that G10 government bonds are getting more expensive to issue – not always in absolute yield terms, but most definitely relative to swap rates: spreads have risen by close to a full per cent in some jurisdictions, particularly since QE ended (Figure 13). We do not characterise this as credit risk, but additional term premium or risk compensation that has no strict bound, and may eventually lead to stress or “crowding out”, causing adverse financial conditions in other markets – most likely corporate credit and loans.



Macro forecasts charts and commentary

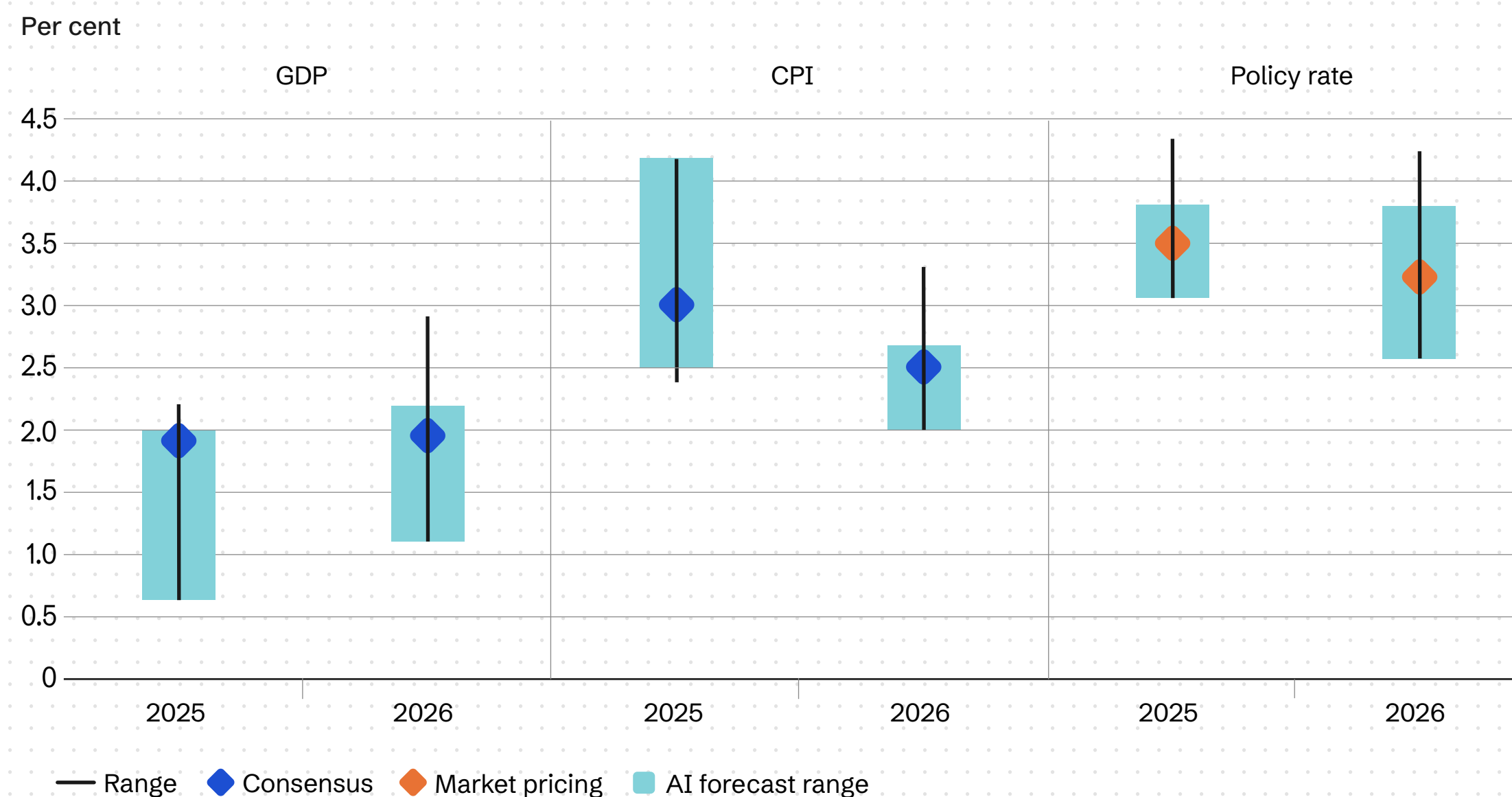
US

Widespread policy changes drive uncertainty higher and growth lower

The Trump administration has undertaken widespread and significant policy changes since coming into office in January. A vast number of executive orders have reshaped the domestic and foreign policy position of the United States. Many of these changes were well-flagged in the election campaign and in policy documents such as The Heritage Foundation “Project 2025”. However, the speed and breadth of execution is unprecedented. The approach has been erratic at times – especially regarding tariffs – and subject to legal challenge in many cases. But it is the combination of uncertainty created by trade policy and ultimately the impact of broad-based tariffs that is expected to weigh materially on growth this year. We have revised down our estimates for 2025, with growth now expected to fall below potential throughout this year as consumers become more cautious and as real disposable income growth declines (Figure 14). Business investment is also expected to weaken given the uncertainty and supply chain disruptions.

The broader, larger and more long-lived the tariffs are, the more damaging it will be to the US economy. In our central scenario we now assume broad-based tariffs remain in place, with targeted, but impactful retaliatory tariffs on US exports. We expect the policy focus to shift to domestic affairs in H2 2025, with the extension of the TCJA tax cuts, as well as further tax breaks for households and lower corporation tax the focus. That should see growth recover through 2026. At the same time, changes to immigration policy are expected to reduce potential supply growth by as much as 0.5 per cent, with the risk of potentially more disruptive measures through large-scale deportations lowering growth further.

Figure 14. US



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
 Source: Aviva Investors, Bloomberg as at 3 April 2025.



CPI inflation is expected to rise to 4 per cent this year, as the impact of tariffs pass through to traded goods prices. We assume limited second-round effects due to a weakening in aggregate demand and a careful approach from the Fed in lowering rates this year. Inflation is then expected to decline through 2026 with spare capacity and higher unemployment rate weighing on both wages and margins. We expect the Fed will cut rates three to four times this year, although the wide range of outcomes on tariffs and other policy measures could well see significantly more rate cuts. Looking further ahead, if recession is avoided, the Fed could well have little reason to lower rates much further in 2026 and may in fact be looking at tightening policy if fiscal stimulus measures once again boost growth.

The broader, larger and more long-lived the tariffs are, the more damaging it will be to the US economy



Eurozone

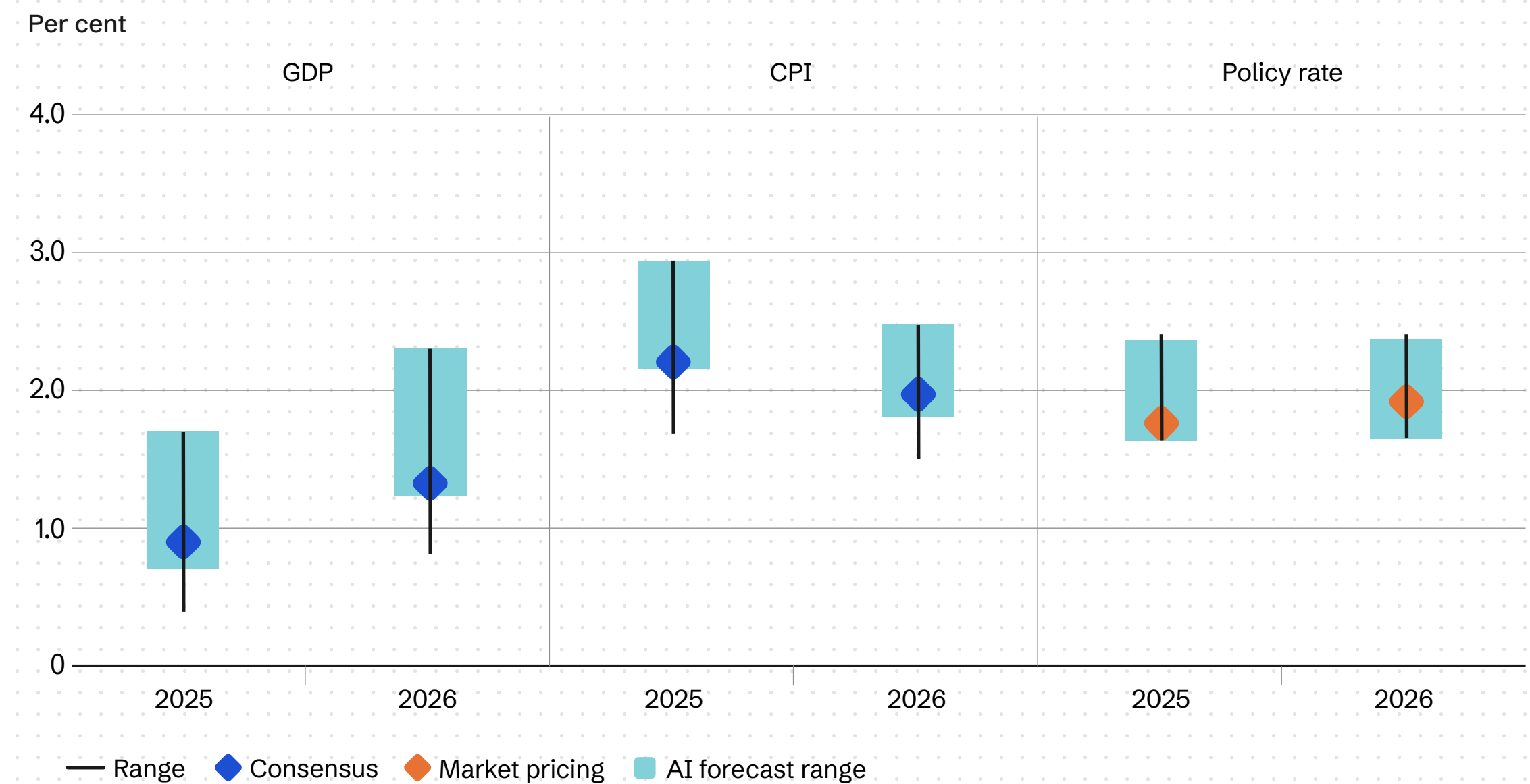
A monumental shift in European/German fiscal stance against trade conflicts

The Euro area economy grew by 0.8 per cent in 2024, a lacklustre performance mostly due to German weakness and a decline in investment. Like 2023, household consumption grew by 1 per cent, held back by further rises in the savings' rate - which, however, peaked in Q2. At the same time, inflation normalised lower to 2.2 per cent, although services inflation remained stubbornly high and energy prices rose in Q4. Due to fiscal announcements (see below), we have revised considerably higher our growth forecasts, mostly for 2026: we see GDP growing at 1.2 per cent this year and by 1.8 per cent in 2026. We estimate headline CPI will stabilise close to 2.5 per cent YoY this year, before falling towards 2 per cent in 2026. We expect the ECB will cut rates to 2%, with downside risks owing to global trade conflict escalation ([Figure 15](#)).

The unemployment rate held near all-time lows (just over 6 per cent) while the vacancy rate continued to normalise following the labour market disruptions of 2021-23, although it remained steady in late-2024 at 2.5 per cent. Consequently, the labour market has incrementally loosened while wage growth seems to be settling lower. However, at just over 4 per cent YoY, it remains high relative to price stability, in part due to frictions in the labour market that generate lagged responses to prior increases in inflation.

Interestingly, and following several quarters of sharp increases in the savings' rate, Q2 seems to have marked the peak. This is important for future consumption: the savings ratio reached 15.6 per cent of gross disposable income and has been a principal driver of weak household expenditure. The recent (in Q3) decrease together with higher frequency money supply data suggest that this process is now reversing as consumers no longer need such excessive amounts of precautionary buffers. If so, 2025 is shaping up to be a year of stronger consumption growth.

Figure 15. Eurozone



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
 Source: Aviva Investors, Bloomberg as at 31 March 2025.



Fiscal policy is helping in that regard. The German proposed package amounts to at least 2 per cent of GDP per year and represents the largest fiscal expansion in post-war Germany. Using conservative multipliers, the measures have the potential to add 1ppt to 2026 German GDP growth with spillover sentiment impact in 2025. Together with the defence package announced by the European Union (c.1 per cent of GDP per year until 2030), it could add 0.7ppts to 2026 and 2027 Euro area real GDP growth. This is substantial, but it also acts as a confidence boost, both for foreign investors (via flows) and domestic consumers and businesses.

We expect services inflation to moderate but at a slow pace, while energy prices, food and non-energy industrial goods represent upside risks. Hence our forecast for inflation to stay above the 2 per cent target and around current levels (c.2.5 per cent). Nonetheless, a potential ceasefire in the war between Ukraine and Russia poses downside risks to energy and natural gas prices, which could drag the euro area headline CPI lower.

The combination of residual persistence in services inflation, elevated wage growth as well as the potential for a strong rebound in consumption (via a drop in savings rates and the fiscal impulse) suggest to us that the ECB is close to the end of its easing cycle. We think the terminal rate will be at 2 per cent - still somewhat higher than the market is pricing. But downside risks exist due to the escalation in global trade conflicts.

Risks to our Euro area outlook include:

- The imposition of US tariffs has been very sizeable and creates unequivocal downside risks to growth; moreover, any potential EU retaliation would generate upside risks to inflation, increasing thereby the odds of a stagflationary period.
- Bottlenecks (or outright rejection) in policy decisions on the fiscal/defence package/s that could significantly weigh on activity and sentiment.
- Re-escalation of the conflict in Ukraine/Russia resulting in higher energy prices pushing inflation higher and growth lower.

We estimate headline
CPI will stabilise close to
2.5 per cent YoY this year,
before falling towards
2 per cent in 2026



UK

The UK has begun the year on a weak footing; a looser labour market does not suggest a strong performance in 2025; the BoE is likely to cut by more than expected

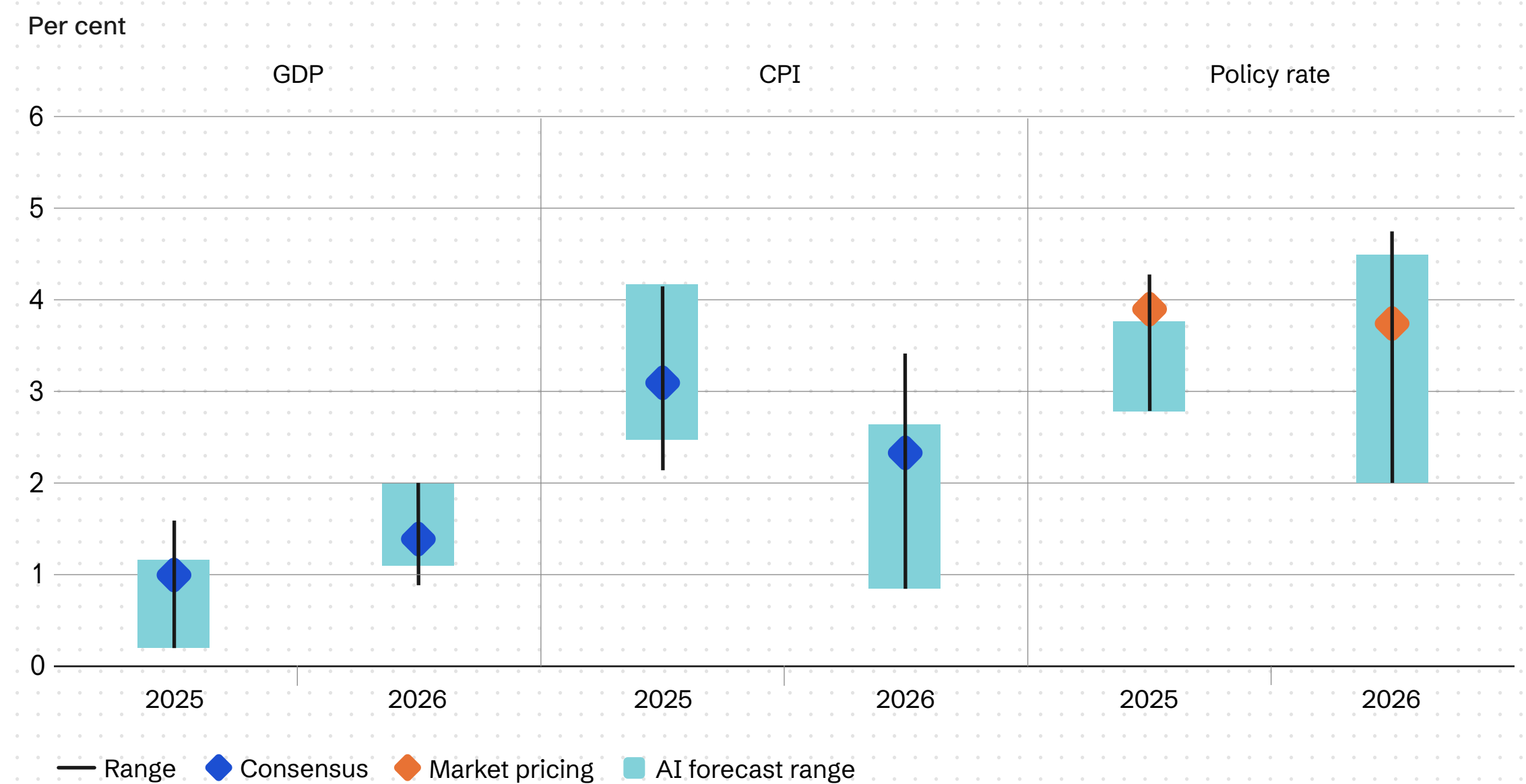
The UK economy grew by 0.9 per cent in 2024, with GDP expanding by 1.2 per cent in the first half but stagnating in H2 due to high borrowing costs and fiscal uncertainties. Weak export performance also contributed to the slowdown. As a result, our 2025 GDP growth forecast has been revised down to 0.9 per cent, despite the stimulatory impact of the budget. The 2026 forecast remains at 1.5 per cent due to expected Bank of England (BoE) easing in the second half of this year. Headline inflation fell for most of 2024. However, it rose in the fourth quarter due to energy price increases, ending the year at 2.5 per cent. We forecast it to end 2025 around 3 per cent but fall below the 2 per cent target in 2026. We expect the BoE to ease policy more than the market has priced, bringing the base rate to around 3.25 per cent by year-end (Figure 16).

Unemployment rose from 3.9 per cent to 4.4 per cent in 2024, while job vacancies fell by 12 per cent. Further loosening of the labour market is expected due to employer National Insurance Contributions (NICs) hikes, impacting employment and wage growth. While some price passthrough is to be expected, declining profit margins, increased spare capacity, and higher availability of prospective staff, suggest that lower pay growth rates and employment will absorb most of the NICs impact.

Poorer employment prospects, still rising mortgage rates, and fiscal uncertainty are likely to weigh on consumer demand, which has been weak for the past two years. The increased savings ratio (10 per cent of gross disposable income) can provide a buffer, but higher unemployment and mortgage costs are likely to keep consumers cautious.

Inflation is expected to pick up due to energy price effects and rises in regulated price components but should normalise lower from mid-third quarter onwards, ending the year around 3 per cent and falling below the 2 per cent target in 2026.

Figure 16. UK



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2025.



Weak demand and the transitory nature of inflation pressures should allow the BoE to engage in a more rapid easing of policy from late second quarter onwards, cutting interest rates in every meeting and bringing the base rate close to 3.25%.

Risks to our UK outlook include:

- NICs increases having a bigger price effect, leading to stagflation and forcing the BoE to keep rates higher for longer.
- Consumers tapping into savings could strengthen demand and inflation, implying a higher terminal interest rate. Equally, a higher terminal rate would materialise if the supply potential of the economy has been compromised more than we estimate.
- The imposition of US tariffs both to the UK but mostly to its main trading partner (EU) has increased downside risks to growth.
- Fiscal policy: the weak economic performance means that the attainment of fiscal goals has become more difficult; if these goals and rules are changed then the market would perceive this as loss of credibility, sending UK yields notably higher, putting pressure on the economy.
- Finally, an upside risk to sentiment could come from a partial reset of the UK's relationship with the EU, reducing trade costs and facilitating more immigration, which would allow faster policy easing and benefit activity through lower business costs and higher productivity in the more medium term.

The 2026 growth forecast remains at 1.5 per cent due to expected Bank of England (BoE) easing in the second half of this year



China

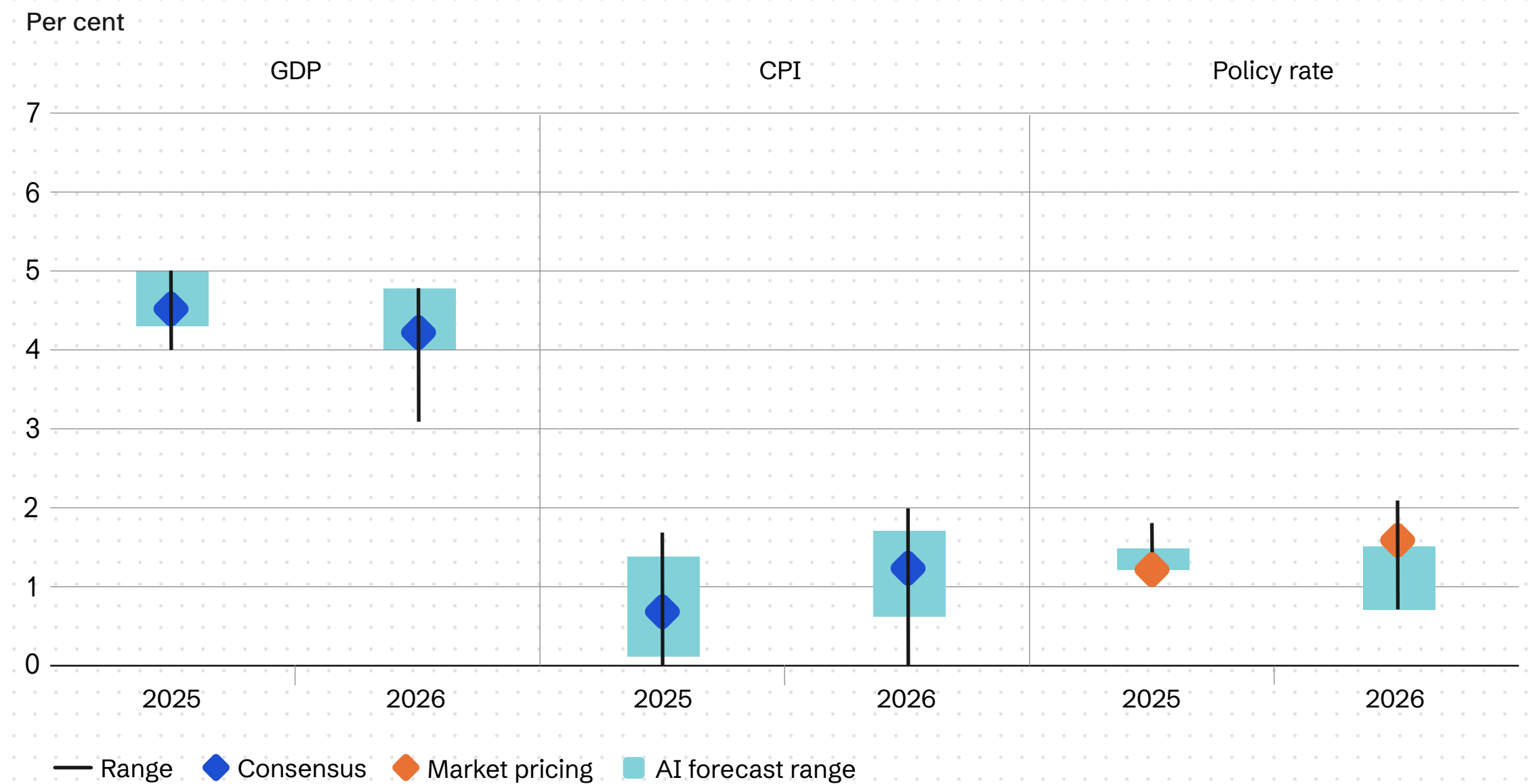
More meaningful policy stimulus and support for private enterprise to cushion consumption against tariff blows

As we expected, the election of President Trump in the US made much higher tariffs a certainty; this is now a reality but the ultimate intensity and damage from the unfolding trade war is unclear. This will depend on sequencing of future levies, China’s response (which has so far been fairly measured), and subsequent negotiations on trade and unrelated matters – for example, China’s support for Ukraine reconstruction, or Russian aggression.

Growth will decelerate towards 4 per cent in the medium term (Figure 17), in part from the increased taxes on imports from China, and also because of the falling population and overinvestment in property and infrastructure. In coming quarters growth could pick up as the real estate downturn finally bottoms out and fiscal firepower is deployed towards fixed asset investment and consumer subsidies. Fewer attacks on private businesses and corrupt sectors and individuals will also stabilise confidence. However, all of this support may be offset by tariff hits from the US, and other areas may also restrict China’s exporters trying to maintain volumes by flooding their markets.

The “stimulus” announced at the March Two Sessions of the NPC expanded fiscal spending by around 1 per cent of GDP, with a priority to boost domestic consumption and provide more support towards services in particular, while maintaining a focus on industrial policy. This rotation and rebalancing has already been a goal for many years, but as long as cheap credit is funnelled from state-owned banks to state-owned enterprises, the economy will probably be saddled with excess savings and therefore high debt-fuelled investment with a declining efficiency of growth per unit of borrowing. There is hope for ‘new quality productive forces’ to contribute meaningfully; examples include DeepSeek in AI and Unitree H1 in robotics.

Figure 17. China



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2025.



Tech more broadly, especially the “new three” of EVs, batteries and solar panels – continue to roar and make major advances in scale and quality as they benefit one another. The NPC readout makes clear that Beijing would like to replicate this success, cultivating champions in the industries of the future, such as Biomanufacturing, Quantum Computing, and 6G. This tailwind should help industrial production growth remain solid at over 5 per cent y/y. These positives and large past investment in metals and consumer goods will contribute to support exports as well as domestic disinflation, and both CPI and interest rates should stay low despite the fiscal impulse ([Figure 17](#)). With recent dollar weakness, the FX no longer needs to depreciate against the USD to regain competitiveness, and we expect a stable USDCNY, unless there is a bout of pronounced dollar strength alongside heavy tariffs.

There is hope for ‘new quality productive forces’ to contribute meaningfully; examples include DeepSeek in AI and Unitree H1 in robotics



Japan

Steady growth and reflation supported by wage growth will keep the BoJ hiking cycle going

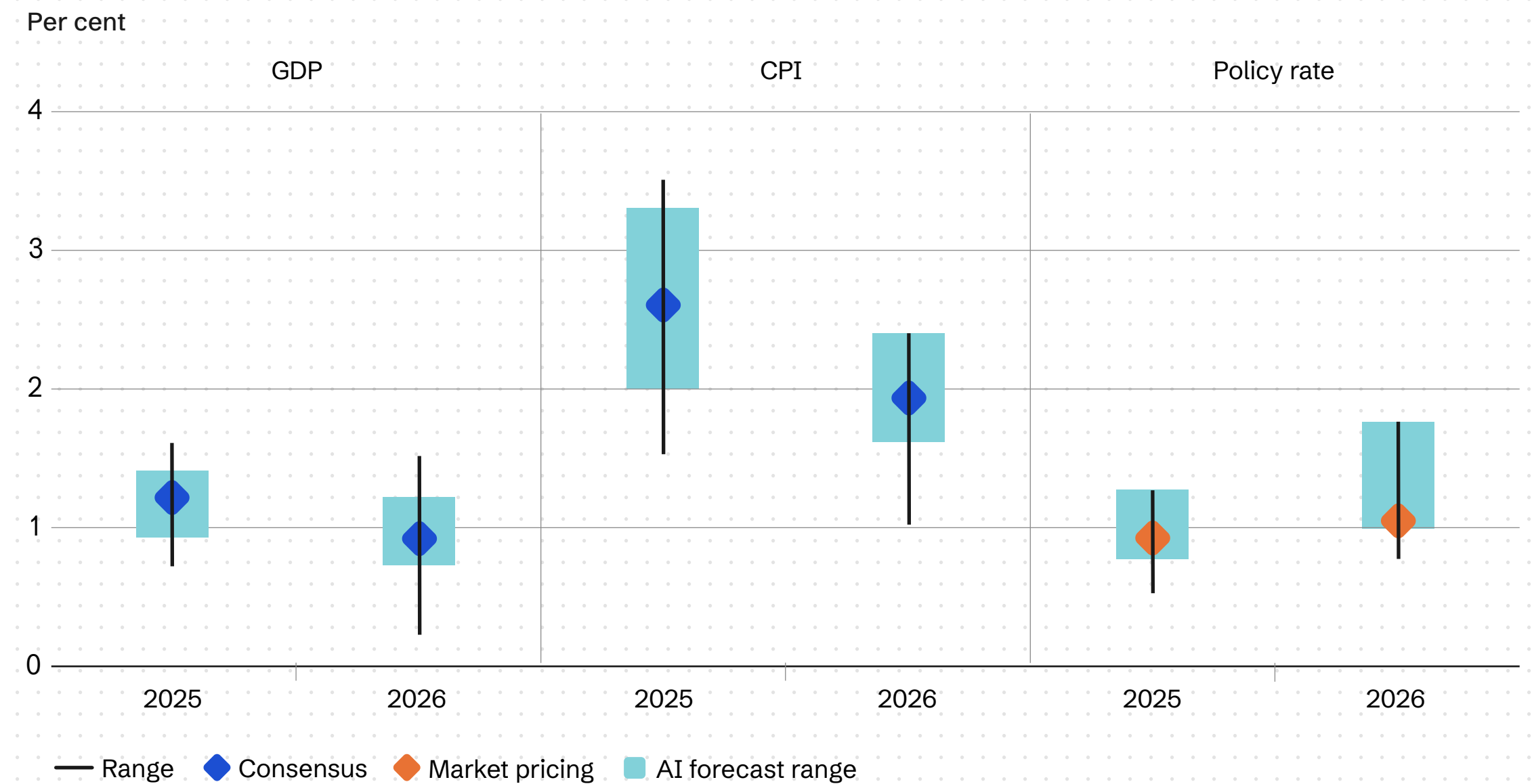
Despite tariffs and a slowing China, domestic demand and wage gains should sustain Japanese growth in coming quarters. While inflation has jumped to 3 per cent, core measures are closer to 2 per cent, which is the BoJ’s target. We expect that shunto gains should end up being in the 4-5 per cent y/y range (with some unions indicating nearly 6 per cent pay rises), enough to provide real gains and overcome some consumer uncertainty around price rises and currency volatility.

The corporate sector has been reforming and refocusing on growth and profitability for some years; this is now bearing fruit with higher margins and cap-ex. Labour shortages are a driving force too, and the gains in AI mean that robots-per-capita will probably become a more common measure across many countries with declining populations. The relatively low 1.0-1.5 per cent GDP growth we expect to continue (Figure 18) needs to be processed in the context of a falling population, and is thus dependent on productivity gains and sustained investment, especially in technology.

While reflation is a success story, price hikes have not been popular and along with a weak yen, have caused consumer confidence to be fragile. The yen has strengthened from its lows, but BoJ hikes of ~50bp per year are not sufficient support, unless other central banks cut rates more rapidly. The weak yen should continue to support export earnings but also made Japan a target for US tariffs, which were initiated at high levels – first on autos and subsequently on a ‘reciprocal’ basis. Prime Minister Shigeru Ishiba has played several cards in a bid to avoid friction, including promises of FDI and LNG imports – time will tell if this ‘transactional approach’, along with remilitarisation to support the defence alliance in the Pacific, will bear fruit.

The weak yen should continue to support export earnings, but this made Japan a target for US tariffs

Figure 18. Japan



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 31 March 2025.



Canada

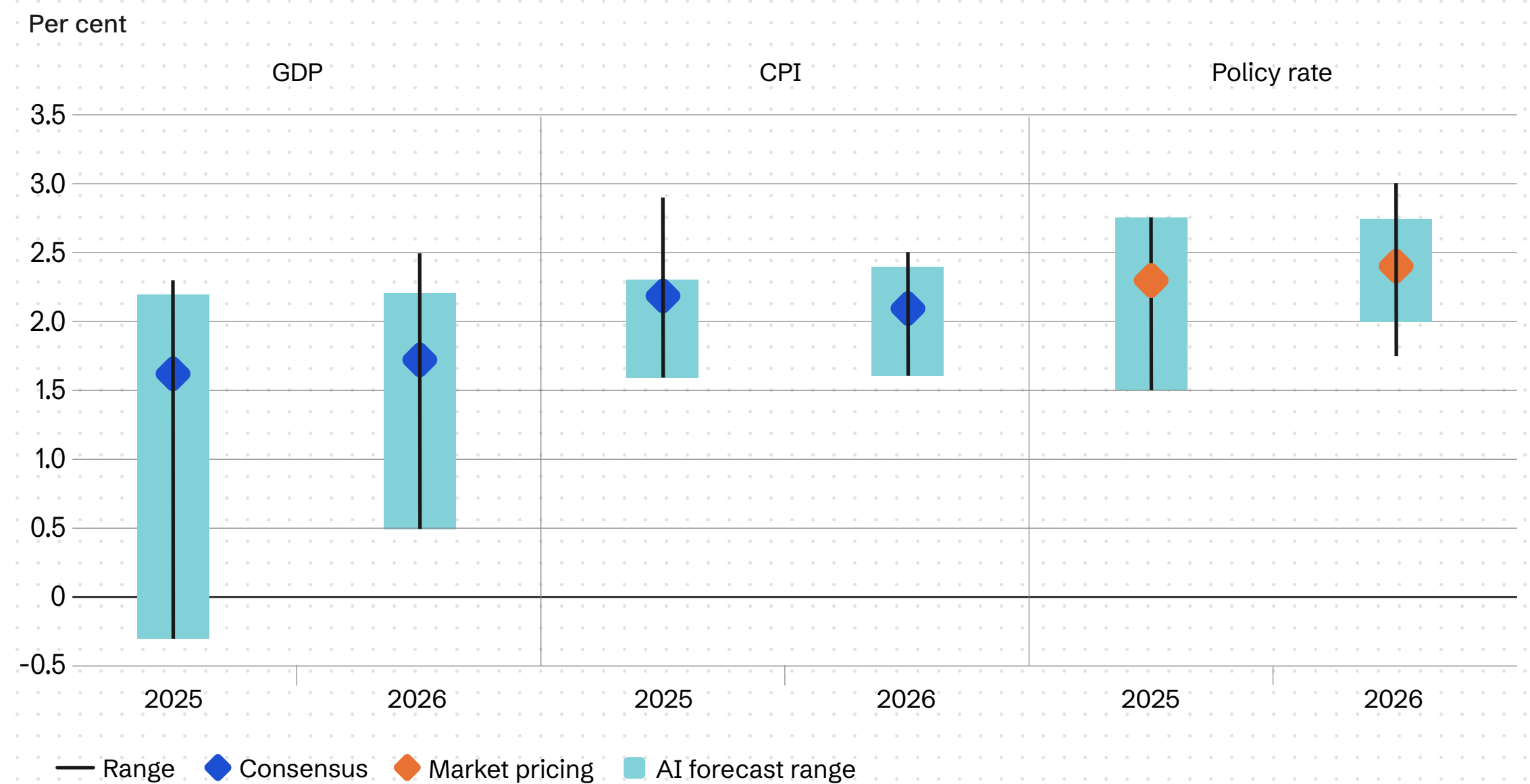
Looming tariffs threaten to derail 2025's growth revival

The economic data in Canada has surprised to the upside in 2025. Indeed, the revisions to growth in prior quarters have shifted the outlook in Canada rather dramatically. Having been revised up to 2.2 per cent from a meagre 1 per cent, Q3 2024's growth no longer looks sluggish. This has changed the picture, with Q4 GDP growth at 2.4 per cent, significantly higher than the Bank of Canada's expectations of 1.8 per cent. However, this is not to say that the past slack seen in the economy has been a false signal. The softening in the labour market, with the steady rise in the unemployment rate and falling vacancies as well as the progress made in disinflation all attest to the existence of a negative output gap, which justifies the BoC's response in lowering its policy rate by over 200 basis points. Indeed, we think Canada's highly levered economy has seen the BoC's aggressive easing quickly feed into activity. Whilst structural challenges in the form of lacklustre productivity and an overreliance upon labour supply remain, the Canadian economy is on a much better footing than previously thought.

Inflation has also behaved surprisingly at the turn of the year. The expiration of the temporary GST/HST tax holiday has pushed headline CPI up to 2.6 per cent YoY as of February. Whilst this in part is due to "one-off factors", the average of the BoC's "core measures" are now testing upper limit of the 3 per cent range, and these trends in inflation will be hard for the BoC to ignore. It is now arguable as to whether the Bank of Canada would be warranted in lowering their policy rate any further this year.

But harder data is backward looking and diminishes in relevance given the tariff event risk that lies ahead. The trend in activity, whilst currently robust, can easily be derailed given the breadth and magnitude of the tariffs that have been announced.

Figure 19. Canada



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
 Source: Aviva Investors, Bloomberg as at 31 March 2025.



Canada is a far more open economy than the US, and its US exports constitute 75 per cent of Canada's total as well as c.20 per cent of Canadian total output (using 2024's figures). Should these tariffs induce lower trade volumes, the negative growth impulse will be sizeable, either directly via lower trade volumes or through indirect spillovers from lower export demand and heightened trade policy uncertainty. Retaliatory tariffs would boost inflation in the short run as well as constrain potential growth. Considering that Canada has far more sizeable fiscal space relative to the rest of the G10, there may be scope for some fiscal stimulus to offset the growth headwinds - the upcoming election in the Spring may prove critical in this respect.

Nonetheless, the stagflationary shock of lower demand via US tariffs and higher prices via retaliatory measures would pose a headache for the BoC. However, we believe that as long as long-run inflation expectations remain anchored close to 2 per cent (as they currently are), the BoC can adopt a somewhat dovish bias ([Figure 19](#)).

We believe that as long as long-run inflation expectations remain anchored close to 2 per cent the BoC can adopt a somewhat dovish bias



Global market outlook and asset allocation

Equities: The environment for equities is much more uncertain than we have seen for at least two years. The earnings story remains very robust up to now and there is still a path back to equity upside. But that path is getting narrower the longer the tariff induced turmoil lasts.

Fixed income: In our base case, we see steeper curves across the board and underperformance of European bonds vis-à-vis the UK and the US.

Credit: While we expect Euro IG to outperform, on balance, we remain cautious on the overall level of spreads, which we feel are too compressed and do not provide adequate compensation.

Currencies: We have turned bearish on the dollar, and expect EURUSD to rise towards 1.15, with the main risk being severe and permanent tariff imposition on the EU.





Global market outlook

It has been an unexpected quarter in many respects. The tariff announcement rollercoaster initially resulted in elevated uncertainty that weighed primarily on US sentiment, while confidence on the other side of the Atlantic (Europe) has solidified as the H2 2024 slowdown appears to be bottoming out and fiscal announcements are re-rating European growth expectations higher; however, the recent tariff announcement has the potential to spread the US negative sentiment globally and impact risk assets in other regions that have so far been largely immune to the turmoil. Further east, the Chinese stimulus packages have come broadly in line with expectations while the economy has recently started showing signs of improvement across retail sales, industrial production and fixed asset investment. In Japan, the BoJ is proceeding cautiously with its monetary policy tightening.

Overall, Q1 2025 ended with significant underperformance of US equities and a material outperformance of US sovereign bonds. The latter has been mirrored in currency markets, with the trade-weighted dollar having depreciated by 3 per cent so far this year, having fallen against all G10 and major EM FX. In credit, Euro IG greatly outperformed US IG and has remained resilient in the face of elevated trade uncertainty.

Going into Q2 2025, our base case economic and fundamentals assumptions envisage:

1. In equities, markets are pricing in a sea change. Major structural stories of the past couple of years, such as Artificial Intelligence, are being questioned, new stories such as European fiscal and military investments are being embraced and above all the impact of the trade war is being priced in. In our base case, there is still a chance of upside for equities over the year ahead given the solid earnings backdrop we have seen up to now. That is dependent on some of the more aggressive tariffs being negotiated down to more reasonable levels, and offsetting measures such as tax cuts, fiscal stimulus, etc being put forward by the US administration. And this needs to happen sooner rather than later as the longer the current uncertainty persists the higher the risk that the earnings foundation of the equity rally of the last couple of years crumbles.
2. Continued steepening of yield curves across the board (most pronounced in the UK) and further underperformance of European government bonds as fiscal stimulus announcements are sizeable and will result in both more term premia and an upward re-rating of future growth.

3. In credit, we remain cautious on the overall level of spreads, which we feel are too compressed and do not provide adequate compensation for risk; we expect further Euro IG outperformance.
4. Finally, we have turned bearish on the dollar and consider the policy announcements in Europe as a structural tailwind for the euro.

In our base case we foresee some negotiating away of the sizeable tariffs being imposed; however, there is a clear risk that these trade barriers remain fully in place putting even more pressure on global trade and growth and reversing some of the trends we envisage for asset prices.

The tariff announcement rollercoaster has resulted in elevated uncertainty that is weighing on US sentiment, while confidence on the other side of the Atlantic (Europe) has solidified



Equities: Sentiment in the driving seat

Fundamentals remain strong up to now, with the recent Q4 2024 earnings season delivering very robust results. The US is growing EPS at circa 13 per cent, surprising on the upside by circa 7 per cent. Meanwhile Europe is broadly flat, but the positive earnings surprises on the Q4 season were the strongest for over a year.

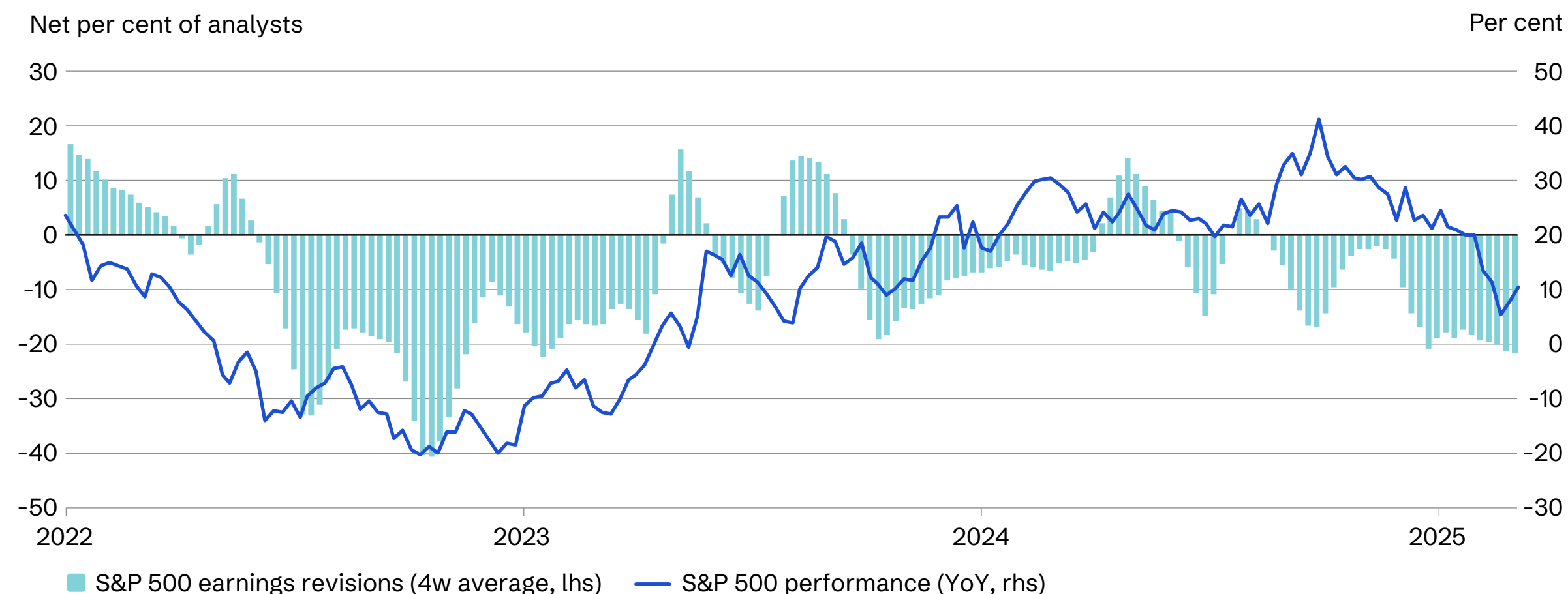
However, despite the fundamentals showing resilience, since December 2024 we have seen a sharp shift in sentiment and expectations. Fears of a recession have come back to the spotlight, key structural stories and drivers of growth (such as AI) are being questioned and earnings expectations are being downgraded.

It is worth highlighting that the shift in sentiment is visibly more negative around the US so far, while in Europe the market is focusing on positives with the recent fiscal announcements especially being seen as a strong positive driver for European equities. While we do not estimate any equity market is pricing in a high probability of recession at this point, there are indications that this recession risk pricing process has started in the US, while it is hard to see any indication it has started in markets outside of the US. In January, while the US was seeing the sharpest downgrades to earnings since the bear market of 2022 (Figure 20), Europe was seeing very few downgrades and by mid-February the earnings expectations in the continent were broadly the same as they were around November 2024, before the US election (circa 8 per cent). It has been only in the last few weeks that we started seeing downgrades to European earnings (Figure 21 - European EPS growth currently sits at circa 6.5 per cent for 2025).

Meanwhile, US earnings expectations had been downgraded by circa 3 percentage points over the same November 20 to February 20 period. That was from a higher base, of course, (circa 15 per cent in November, to circa 12 per cent in February). Current US earnings expectations are for circa 11.5 per cent in 2025 - broadly in line with our own earnings expectations set in the previous House View.

The extent of the change in sentiment can also be seen in the AAI bull-bear sentiment indicator. That is back roughly to the lows of the 2022 bear market when the majority of market participants expected a recession (Figure 22).

Figure 20. Earnings revisions in the US have been the most negative since 2022



Source: Aviva Investors, Refinitiv Workspace as at 3 April 2025.

This all points to an environment of sentiment driving and fundamentals on the backseat. And this, by its turn, makes for a market prone to sharp moves and high volatility



This all points to an environment of sentiment driving and fundamentals on the backseat. And this, in turn, makes for a market prone to sharp moves and high volatility. And it will take some time until equities can fully understand and price the impact of tariffs and other recent developments.

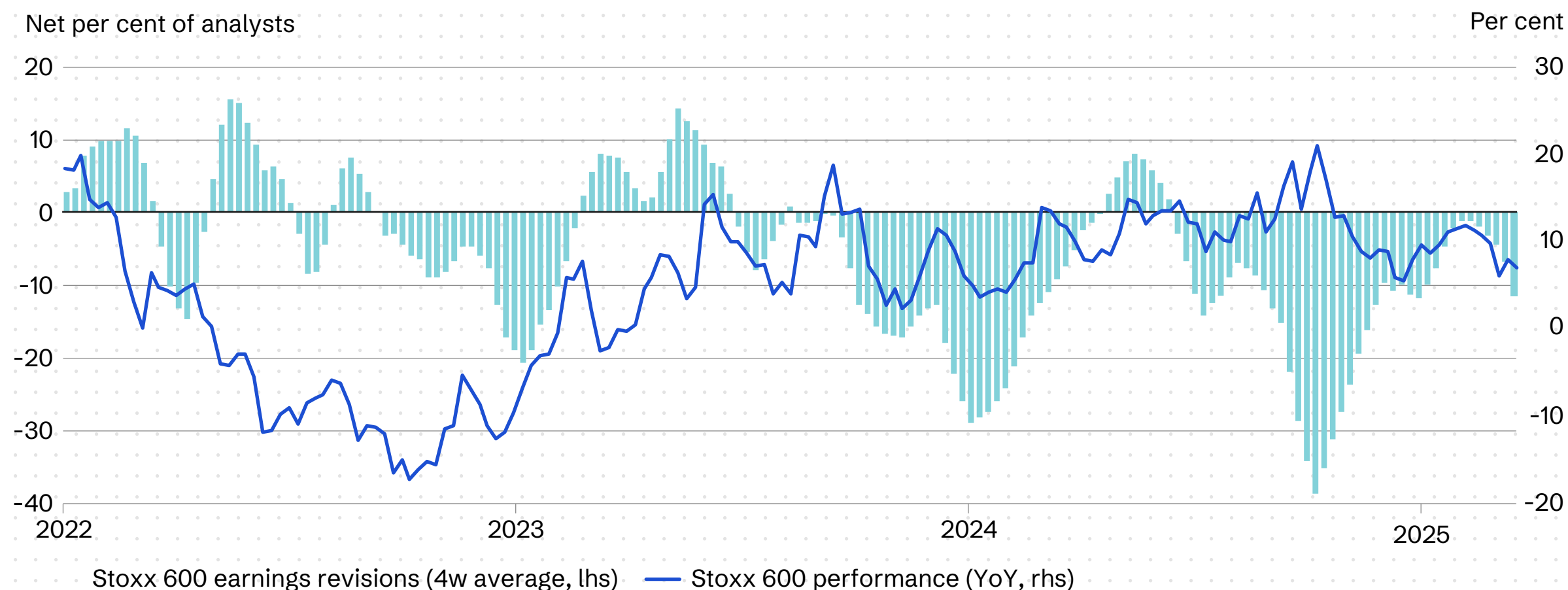
With that in mind we take a more cautious approach to equities. However, while the negative sentiment could eventually lead to a significant weakening of fundamentals and profit growth, we have not seen that materialise yet. As highlighted above, earnings growth remains strong in the US while other regions seem to be recovering from a downturn in 2024.

Ultimately, until we have enough data to show the negative sentiment is in fact derailing what is a very robust earnings story, the fact is we remain in an environment of rate cuts accompanied by strong earnings growth. And this is a very positive fundamental backdrop for equities.

Still, the market is saying we are seeing the start of a tectonic shift with Trade Wars, US policy uncertainty and European fiscal investments transforming the equity market environment. This might well prove to be the case, but it is far from guaranteed. While higher risk and higher volatility are clearly here, fundamentals have not changed significantly yet. So far, significant changes have mainly been in sentiment indicators only.

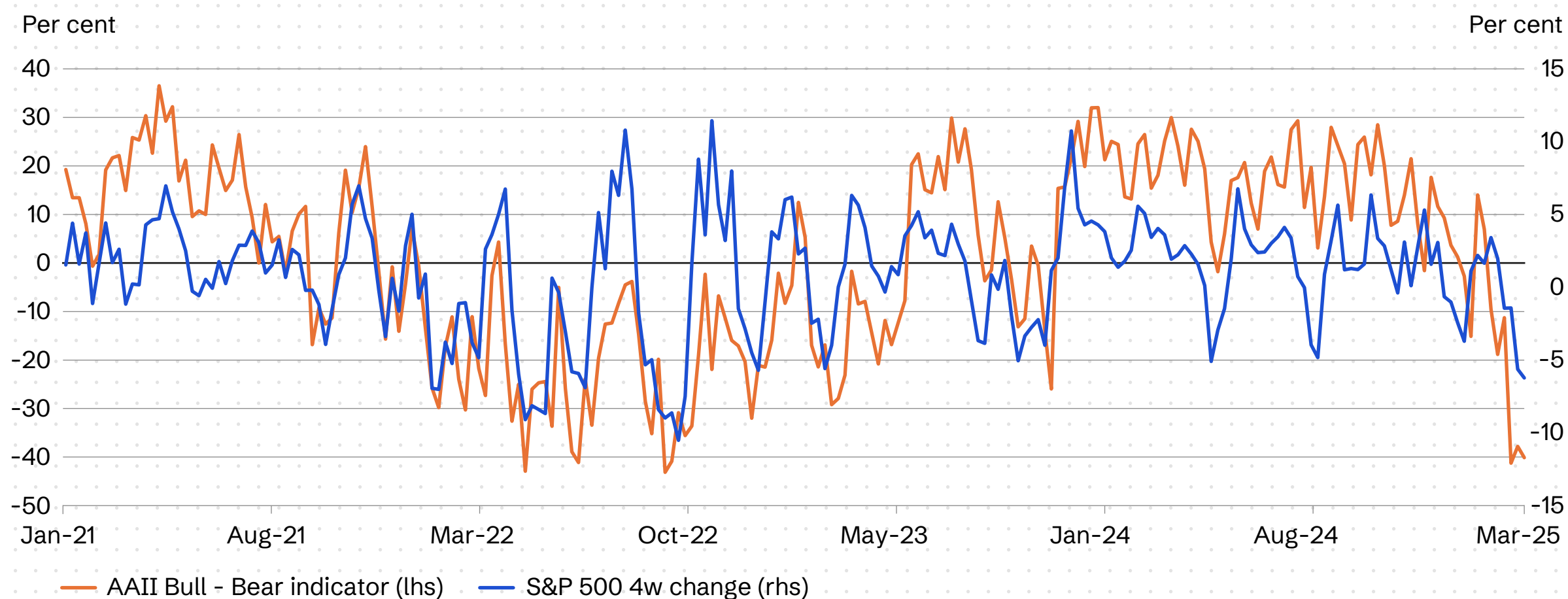
So, while we shall proceed with caution from here, up to now equity movements remain (just) within the scope of a bull market correction. At the time of writing, reciprocal tariffs have just been announced. The initial market reaction is sharply negative but the longer term impact is still highly uncertain. We need to closely observe the earnings announcements from companies in the earnings season which is about to start. The Q4 season in January provided the some (temporary) relief, but this time the test for earnings is even tougher and the market will be looking for guidance from corporates. For equities to resume their upside trajectory that guidance needs to reassure investors that the earnings growth story remains in place.

Figure 21. Earnings revisions in Europe were broadly neutral earlier in the year, but negative momentum is starting to build in the last few weeks.



Source: Aviva Investors, Refinitiv Workspace as at 3 April 2025.

Figure 22. The AAI bull-bear sentiment indicator is back roughly to the lows of the 2022 bear market



Source: Aviva Investors, Refinitiv Workspace as at 31 March 2025.

Defensives regain lost ground

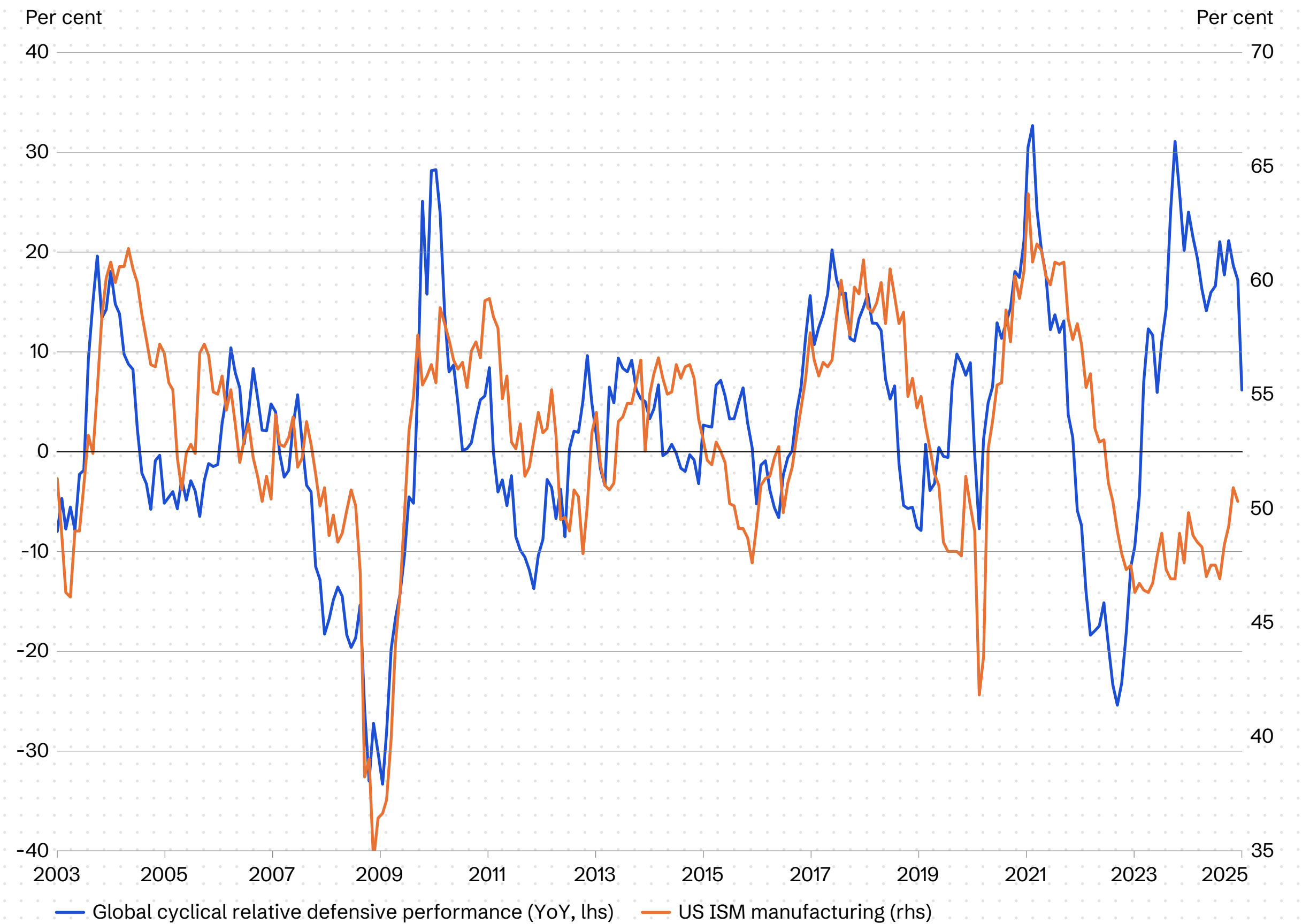
One key difference between the current correction and the corrections we had seen over the past couple of years is that while defensives are outperforming this time around, defensive sectors and stocks failed to offer appropriate support during the market downturns up to this one. This suggests the current correction has a more significant element of concerns about growth and a potential recession than the previous corrections had.

Since 2023, Cyclical stocks have delivered much stronger performance than traditional leading indicators suggested. If we look at manufacturing ISMs for instance, the cyclical vs defensive performance of the last couple of years would be more in line with ISMs running at around 60, while in fact they were marginally below 50 for most of the period (Figure 23). In this current correction we are finally seeing Defensives (at least in the US, as the correction is very much a US phenomenon so far) outperforming and providing some safety in the downturn.

We have been through a long period of Cyclical outperformance and the level of uncertainty in markets has significantly increased, and this greater unpredictability is likely here for the long run. Given all that, we see further room for Defensives to continue to recover lost ground. If markets remain volatile, Defensives should continue to offer protection given the drivers of the volatility this time around and even if equity gains resume going forward, we see an environment where the positioning should be more balanced between Cyclicals and Defensives, as opposed to the strongly pro-Cyclical environment of the last two years.

Defensives (at least in the US, as the correction is very much a US phenomenon so far) are finally outperforming and providing some safety in the current downturn

Figure 23. Cyclical vs Defensives performance decoupled from ISMs over the last couple of years



Source: Aviva Investors, Refinitiv Workspace as at 31 March 2025.



Fixed income: Steeper curves and higher Bund yields

The start of the year has seen unusual diverging performance in bond markets across the major economies. In the US, bonds have rallied across the curve, while in the UK, the curve steepening was far more pronounced as UK2Y yields fell but UK10Y rose. In the euro area, yields rose across the board, mostly at the longer-end of the curve. Japan also saw higher yields, with the 10Y exceeding 1.5 per cent for the first time since 2009.

For Q2 there will be plenty of themes dominating rates markets, frequently opposing one another: trade/tariff uncertainty and its impact on growth (dampening), inflation and Fed policy; fiscal stimulus in Europe (higher yields); the conflict between Ukraine and Russia and a potential ceasefire (disinflationary); as well as more country-specific themes like the budget in the UK and progress on the BoJ hiking cycle in Japan.

We summarise below our main market views for the next three months or so:

1. In the US we would prefer to be somewhat overweight, but with a bias for curve steepening: growth is still OK, albeit slowing, but the recent batch of soft data releases suggests that the risk of a recession is rising, and the market has taken note. This means more two-way price action, both in terms of Fed pricing as well as the long end of the curve, which is also likely to keep incorporating some term premia due to fiscal concerns. Our strongest view here is a steepening in the 2s10s in both Treasuries and the swap curve.
2. In Europe, the monumental shift in German fiscal mentality alongside important decisions at the EU level suggest substantially increased supply over the next few years. To us, this translates to (1) higher bund yields (we have a FV estimate of c.3.4 per cent ([Figure 24](#)) and a (conservative) target of 3.5 per cent; (2) a steeper

curve, as the short end can reprice higher but the long will more than offset that owing to a rerating higher of growth expectations and wider term premia; and (3) tighter swap-yield spreads (i.e., swaps outperforming bunds).

3. In the UK, for both swaps and gilts we expect significant steepening in 2s10s ([Figure 25](#)) being driven by a repricing lower at the front-end (though later in Q2) and some term premia remaining at the longer end of the curve. We expect the BoE will start its aggressive cutting cycle (meeting-by meeting) in late Q2, so we would be receiving the short and middle parts of the curve vs Germany.
4. In Japan, inflation and wage dynamics are strong, arguing for tighter monetary policy; however, political hurdles may prevent the BoJ from hiking rates more than the market expects (currently 35bps of hikes in 2025). We still see scope for the long end to rise further but suspect that the speed will be appreciably slower; this should also facilitate some flattening in the curve.

The start of the year has seen unusual diverging performance in bond markets across the major economies



We remain cautious on the overall level of spreads, which we feel are too compressed and do not provide adequate compensation to own material credit risk



Turing to credit, US markets have finally been jolted from 2024's slow grind tighter as a result of Trump tariff policies and growth concerns. This combined with prospective fiscal loosening and a Russia/Ukraine resolution has seen Euro IG greatly outperform US IG and remain largely resilient in the recent market weakness. Europe does face some headwinds which could cause setbacks going forward, namely tariffs, higher funding costs for corporates (especially HY) and a stronger Euro impacting corporates with large international operations. Despite this, we still believe that Euro IG should outperform versus the US in the near-medium term.

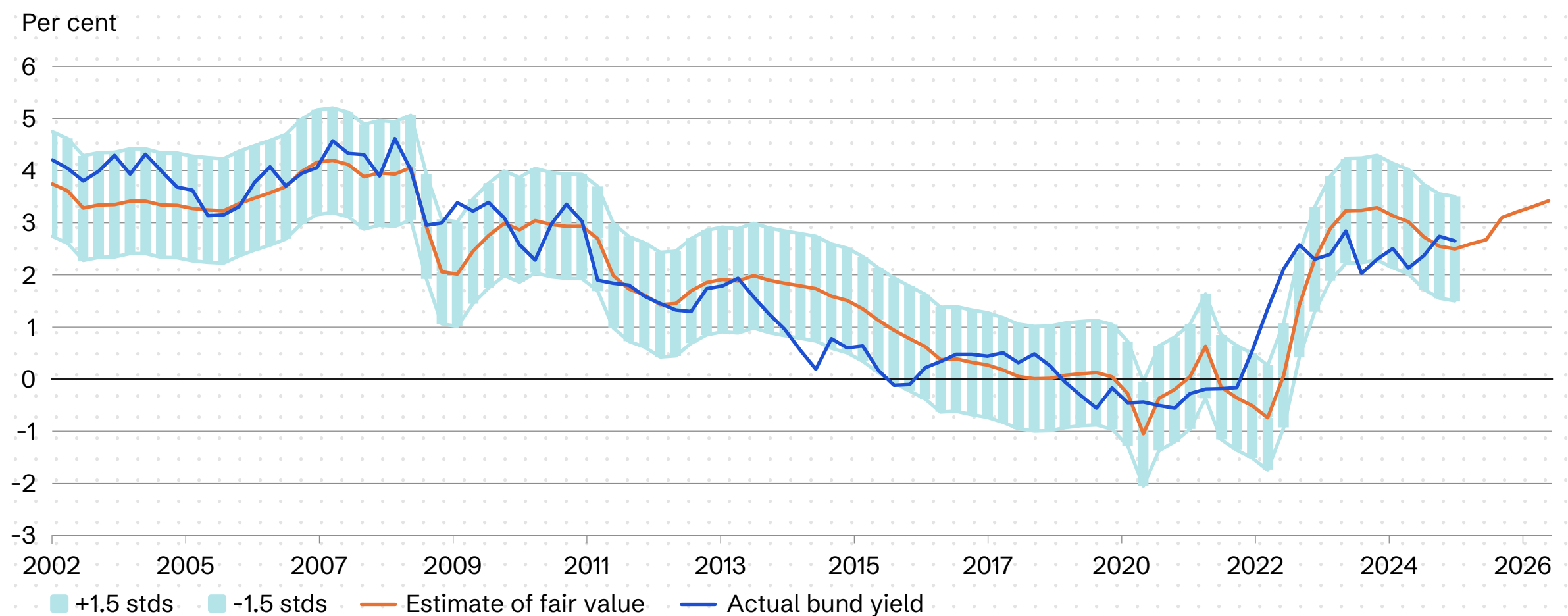
On balance, we remain cautious on the overall level of spreads, which we feel are too compressed and do not provide adequate compensation relative to the downside risk. This is especially true in a more severe growth downturn – a possibility if Trump's policy uncertainty lingers on too long or tariffs imposed cause material damage to consumption, investment, and earnings and elicit significant retaliation. Broadly, we prefer up-in-quality trades given the level of compression, with a more defensive tilt in our sector and security allocation.

The positive aspect of the story is the technical side, where inflows into the asset class kept spreads floored for much of 2024. Negative total returns over short periods have not deterred these flows, likely due to the attractiveness of all-in-yields on offer.

Risks to our yields/rates outlook include: (1) a bigger growth impact due to tariffs that would put downside pressure on rates/yields, especially at the short-end of the curve; (2) stagflation in the UK which would translate into the BoE keeping rates higher for longer; (3) BoJ proceeding only very incrementally with rate hikes resulting in some unwinding of the relevant trades.

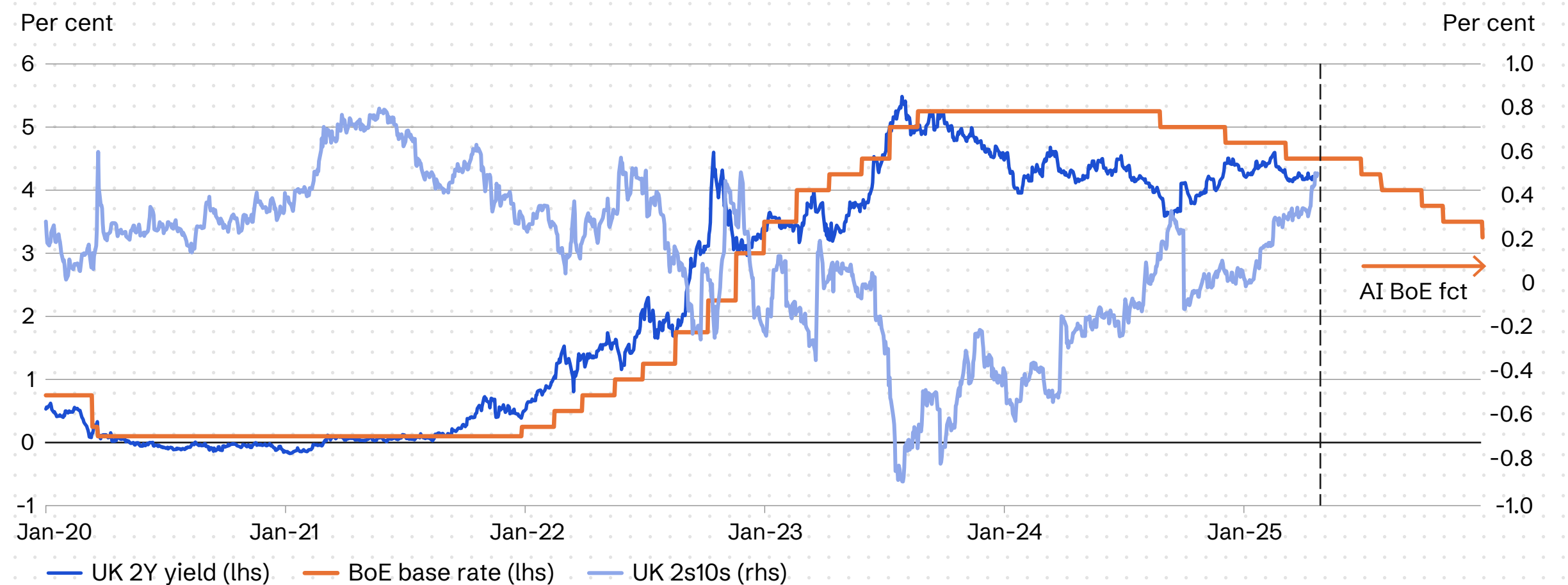
Thanks to Karan Power for co-authoring this section.

Figure 24. Actual vs estimate of Bund yield fair value (using projections on defence spending)



Source: Macrobond, Bloomberg, Aviva Investors as at 31 March 2025.

Figure 25. UK yield curve to steepen further



Source: Macrobond, Bloomberg, Aviva Investors as at 31 March 2025.



FX: Turning USD bearish

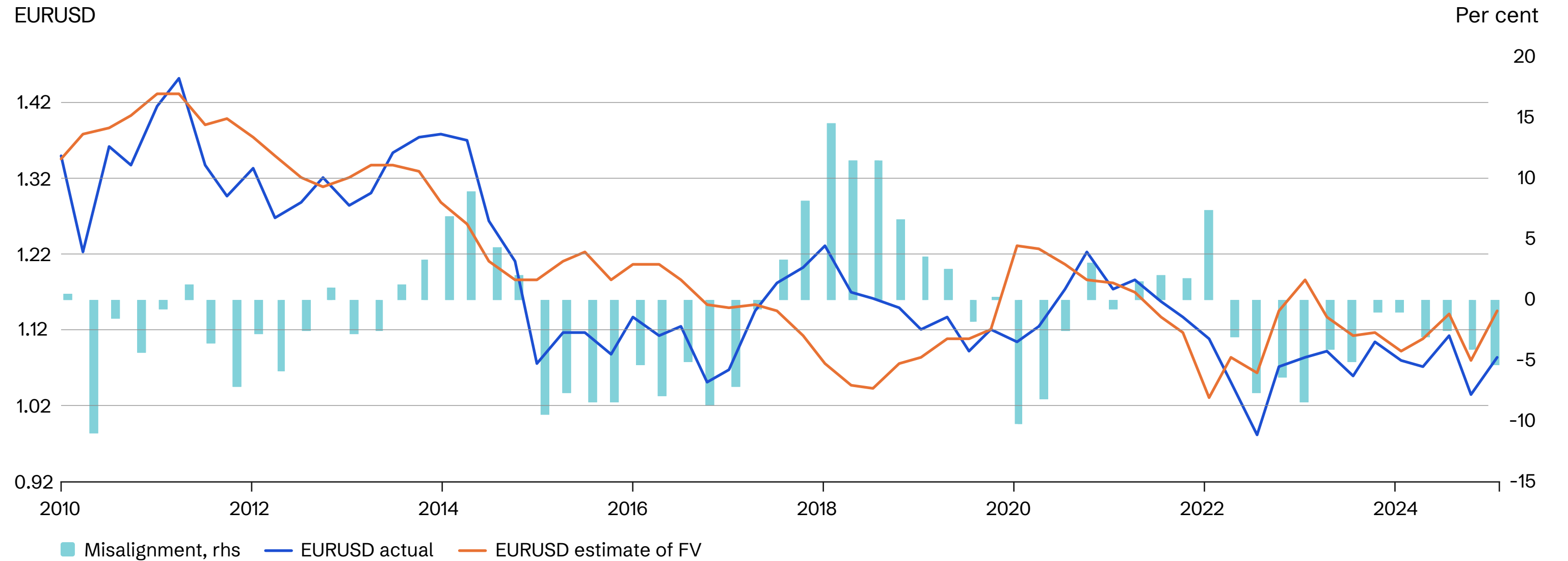
In our previous House View, we fleshed out a bullish view on the dollar predicated on (1) widening US-RoW rate differentials and (2) re-rating of global growth expectations lower due to tariff impositions.

We have been wrong, as neither of the two pre-conditions has played out: while we expected a bottoming out of the euro area growth, the fiscal announcements in Germany and the EU were a sizeable surprise and resulted in a significant upward pressure on bund yields while US yields have been moving lower owing to softer-than-expected data domestically and the imposition of sizeable tariffs. The rollercoaster produced worries weighing on US growth expectations (rather than the rest of the world).

We consider the German/EU fiscal measures as a game changer and we expect further euro appreciation (our fair value estimate is at 1.15 [Figure 26](#)). First, fiscal implementation will result in a notable re-rating higher of euro area growth (as discussed previously) in 2026 and 2027, with spillover sentiment effects this year as well. Second, and equally importantly, the German announcements constitute a monumental shift in the country's fiscal stance, one that provides structural upside to the currency.

In principle, we expect the euro and dollar narratives to dominate, with USD likely weakening across the board: we expect the sizeable US tariff imposition to weigh predominantly on US growth and more than offset the negative euro-impact emanating from declining global trade. We anticipate JPY appreciation while we think GBP rallies will likely be limited due to rate expectations moving lower in late Q2 onwards.

Figure 26. Actual EURUSD and estimate of fair value



Source: Macrobond, Aviva Investors as at 31 March 2025.

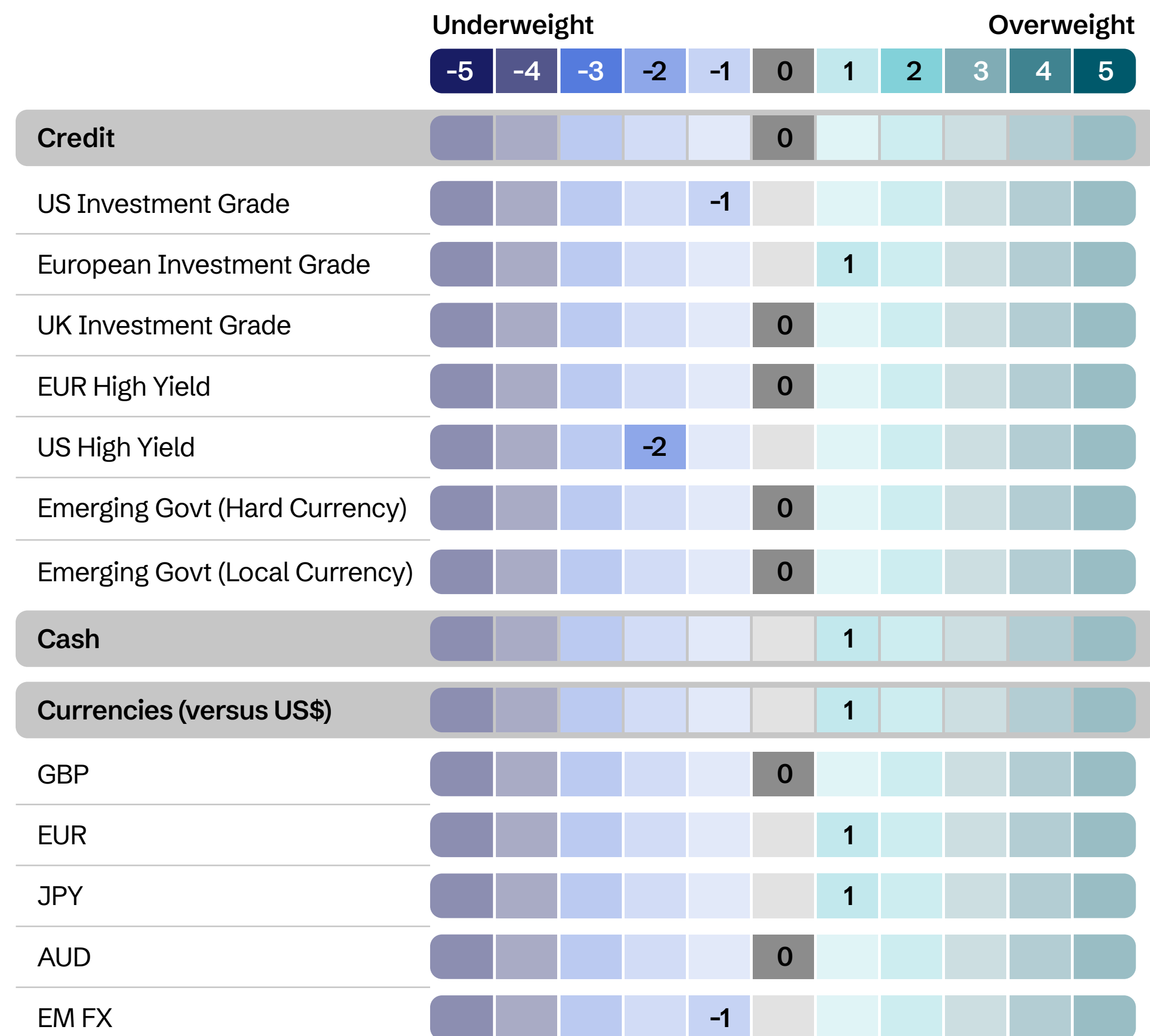
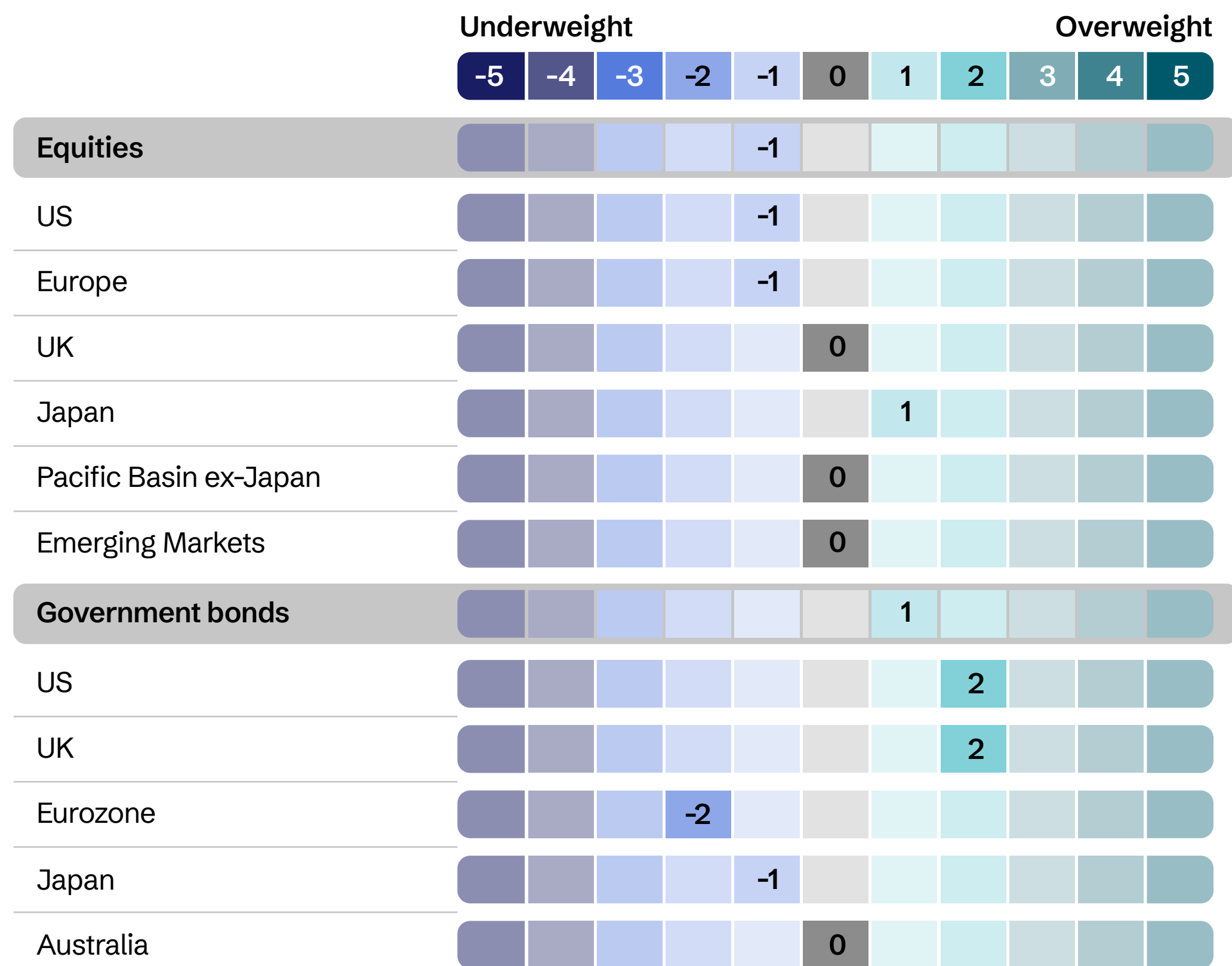
In China, the measures announced so far point to stabilisation, rather than an outright boost to growth/consumption. We believe the PBoC will move along these lines as far as the currency is concerned (contrary to what we expected initially), something corroborated by the stability of CNY fixings since the beginning of this year.

The main risk to this view stems from the uncertainties relating to (1) the impact of (the very) harsh US tariffs on global growth and trade; and (2) any potential retaliation, both of which could trigger a flight to the safety of the dollar. Even so, we would expect the fiscal measures in Europe to provide a backstop to the euro.

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Figure 27. Asset allocation



Note: The weights in the Asset allocation table only apply to a model portfolio without mandate constraints. Our House View asset allocation provides a comprehensive and forward-looking framework for discussion among the investment teams.

Source: Aviva Investors as at 31 March 2025.



 **Webcast**

House View Q2 2025

24 April 2025 | 15:00 BST | 45 MINS

Register now for our House View Q2 2025 webcast hosted by Peter Smith, Senior Investment Director, who will be joined by Vasileios Gkionakis, Senior Economist and Harriet Ballard, Portfolio Manager as they discuss the latest economic changes impacting asset allocation.



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