Q3 2025

House View

US exceptionalism loses its lustre

This document is for professional clients and institutional/qualified investors only.

Contents

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

Key contributors

Michael Grady
Head of Investment Strategy and Chief Economist

Vasileios Gkionakis
Senior Economist and Strategist, Multi-asset and Macro

David Nowakowski
Senior Strategist, Multi-asset and Macro

Joao Toniato
Head of Global Equity Strategy

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

US exceptionalism loses its lustre

- **Macro Outlook:** Global growth is forecast at 2.75-3 per cent for 2025-26, with the US slowing sharply due to tariff-driven stagflation. China continues to face structural headwinds, while the Eurozone and UK show mixed but modest momentum.
- **Inflation & Monetary Policy:** Underlying inflation is expected to remain above target in the near term, but return to target in 2026. Central banks generally expected to keep easing, with the Fed and BoE expected to cut rates gradually through 2025 and into 2026.
- **US Exceptionalism Under Pressure:** The US's global dominance is being challenged by rising protectionism and fiscal imbalances, causing weakening demand for the dollar and Treasuries.
- **Asset Allocation:** We are cautiously optimistic for the remainder of the year, with a small equity overweight, neutral view government bonds (overweight UK), and a preference for European credit. Higher conviction is held on further dollar depreciation due to rising US risk premiums.

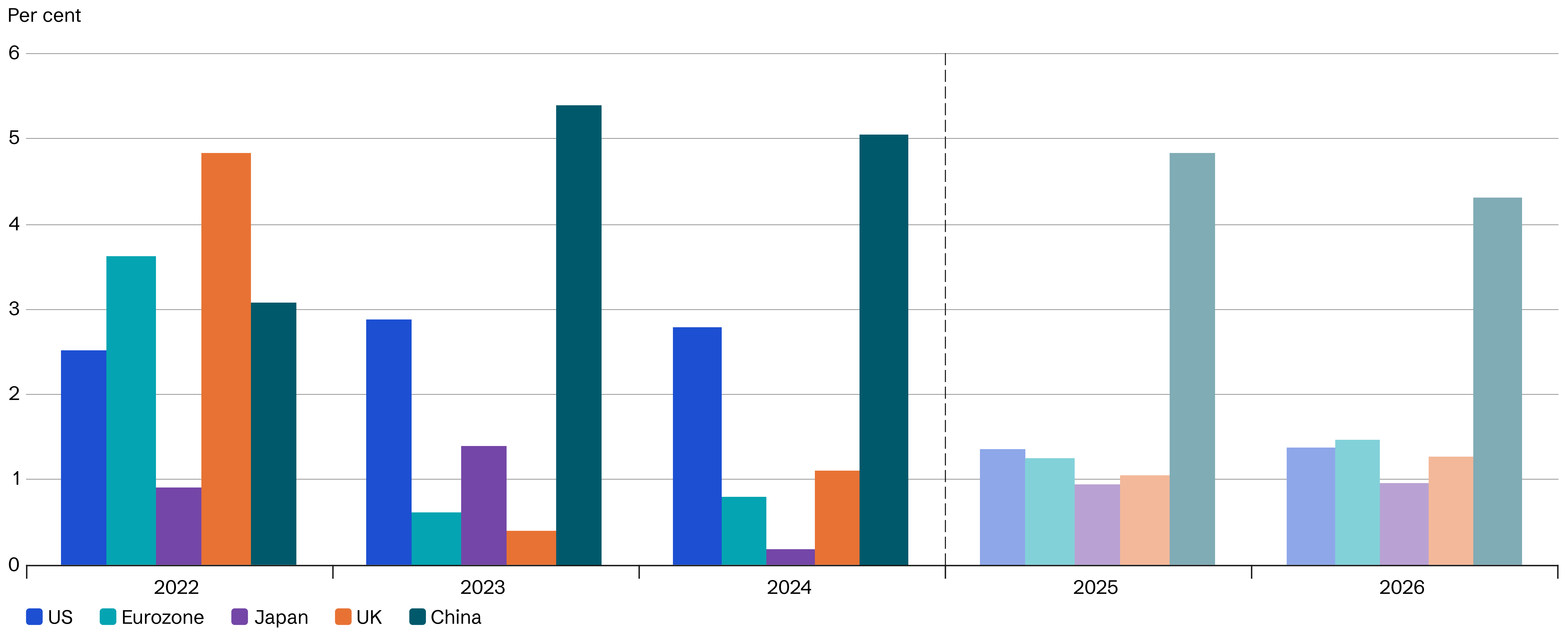
The economic landscape for 2025 continues to be shaped by decisions taken in the White House. In the wake of the "Liberation Day" tariff announcement in April and the subsequent escalation with China, effective tariff rates in the US were briefly as high as around 25 per cent, a level not seen since the early 1900s. Tariffs were raised by so much between the US and China that it was, in effect, a trade embargo. The subsequent pause in reciprocal tariffs and the "Geneva agreement" between the US and China has lowered tariff rates considerably, at least for the time being. We estimate a US effective tariff rate currently of around 15 per cent. There are likely to be new tariff rates imposed on pharmaceuticals and semiconductor and related imports once the Section 232 reports are published, while there may be some changes to the tariffs that rely on the International Economic Emergency Powers if the Supreme Court judges the President to have overstepped his authority. So while the effective tariff rate could rise (or fall) over the coming weeks and months as trade

The US's global dominance is being challenged by rising protectionism and fiscal imbalances, causing weakening demand for the dollar and Treasuries

deals are hammered out, we do not expect it to change materially. As such, uncertainty about the final destination on tariffs may be clearer, but the impact on the US and global economy of a roughly six-fold increase in US tariffs, to levels last seen in the 1930s, remains unclear. In our central scenario, we expect global growth to be in the range of 2.75-3 per cent in 2025 and 2026. While not envisioning recession in any of the major economies, it would represent the slowest pace of global growth in recent decades, outside of major recessions.

The most notable slowing is in the US, where growth is expected to halve this year to 1.4 per cent (Figure 1). The impact of higher tariffs is expected to weigh on disposable income and corporate margins, leading to slower consumer spending and investment. The stagflationary nature of the shock is likely to keep the Federal Reserve cautious in cutting rates, leaving policy modestly restrictive over the coming year. Based on the draft bill, we do not expect the US budget will be a major factor in supporting growth next year, with only modest additional tax cuts and spending measures, partly offset by reduced subsidies. We also expect slower growth in China, with the impact of new tariffs filtering through to exports and many of the structural challenges faced such as those in the property sector, with household spending and demographics remaining unaddressed. In the Eurozone, we continue to expect growth to improve modestly this year and next, with consumer spending expected to be the main driver, as saving rates return to more normal levels and as the large-scale fiscal expansion in Germany takes hold in 2026. The improvement in these areas is expected to more than offset the impact of US tariffs. Meanwhile in the UK, a strong start to 2025 is likely to moderate, with underlying growth notably softer

Figure 1. Aviva Investors growth projections



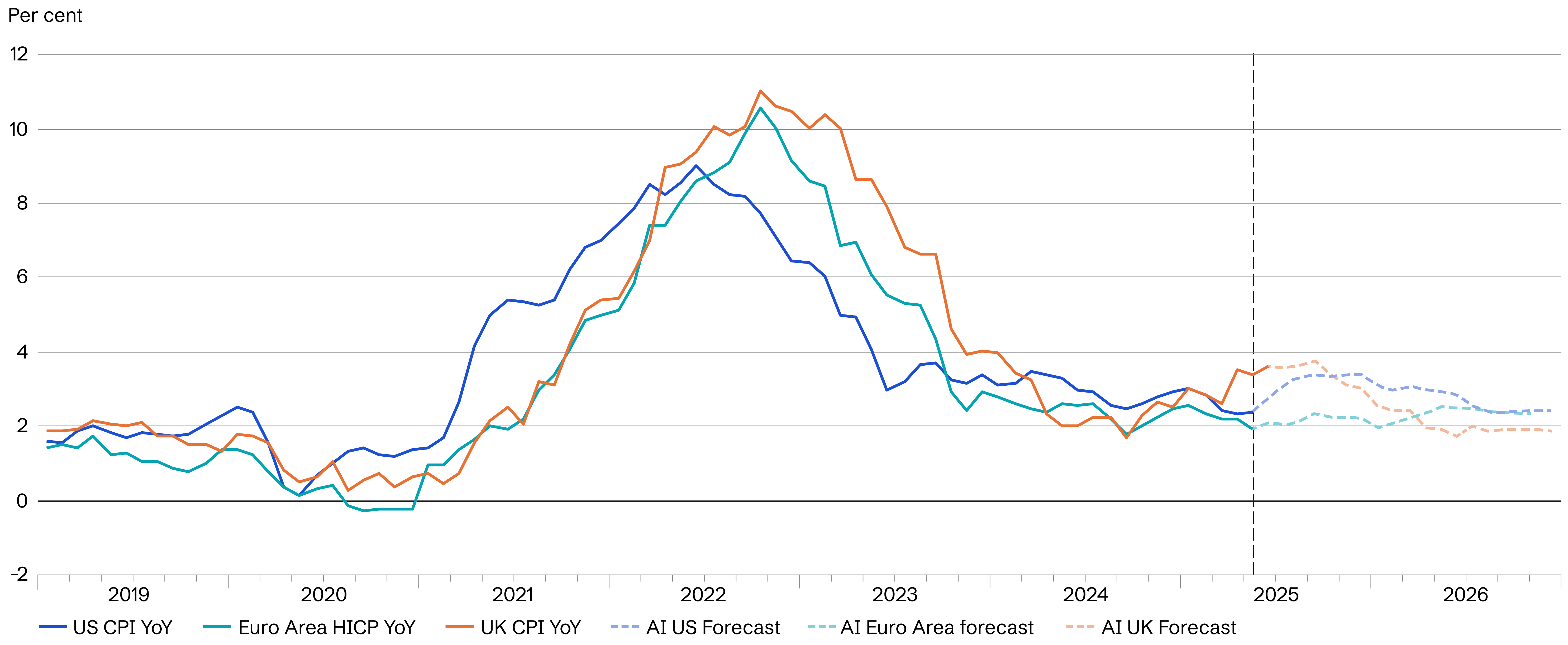
Source: Aviva Investors, Macrobond as at 30 June 2025.

> The most notable slowing is in the US, where growth is expected to halve this year to 1.4 per cent

than headline GDP might suggest. We expect households to remain cautious in the face of a weakening labour market and for restraint from both firms and households ahead of the autumn budget, which could well result in further tax increases.

The inflation outlook remains one of generally above-target inflation gradually heading back down to around 2 per cent. In the US inflation has softened more than anticipated in recent months, with no sign yet of tariff effects passing through. But we expect those to become evident in the coming months, with both headline and core inflation picking up from current rates to around 3.5-4 per cent (Figure 2). The mix of weaker growth and higher inflation pose a challenge for the Federal Reserve. As such, they are likely to remain cautious. We expect them to resume easing policy, removing restriction with another 100bps of rate cuts over the next year. But the risks around that remain wide, with as few as one or two more cuts or much deeper cuts should the labour market weaken significantly. In the Eurozone, the deceleration in wage growth is likely to continue adding to the disinflationary forces. But with growth improving we expect inflation to stabilise around 2 per cent, which means that our central scenario envisages that the ECB is done on its easing cycle – with a risk of delivering one more 25bps cut to 1.75 per cent. In the UK, the deceleration in wage growth is expected to continue as the labour market loosens further, bringing services inflation down with it. To the extent that the recent rise in inflation due to administered prices and indexing effects does not threaten to de-anchor inflation expectations, that should allow the Bank of England to cut interest rates further. However, there remains some underlying inflation persistence which has led us to expect a slower easing cycle than we previously anticipated (one cut per quarter) until the Bank Rate reaches the terminal of 3.25 per cent.

Figure 2. Aviva Investors inflation projections



Sources: Aviva Investors, Macrobond as at 30 June 2025.

Looking beyond the near-term growth and inflation cycle, we have found ourselves increasingly discussing the topic of US exceptionalism and whether it is losing some of its lustre.

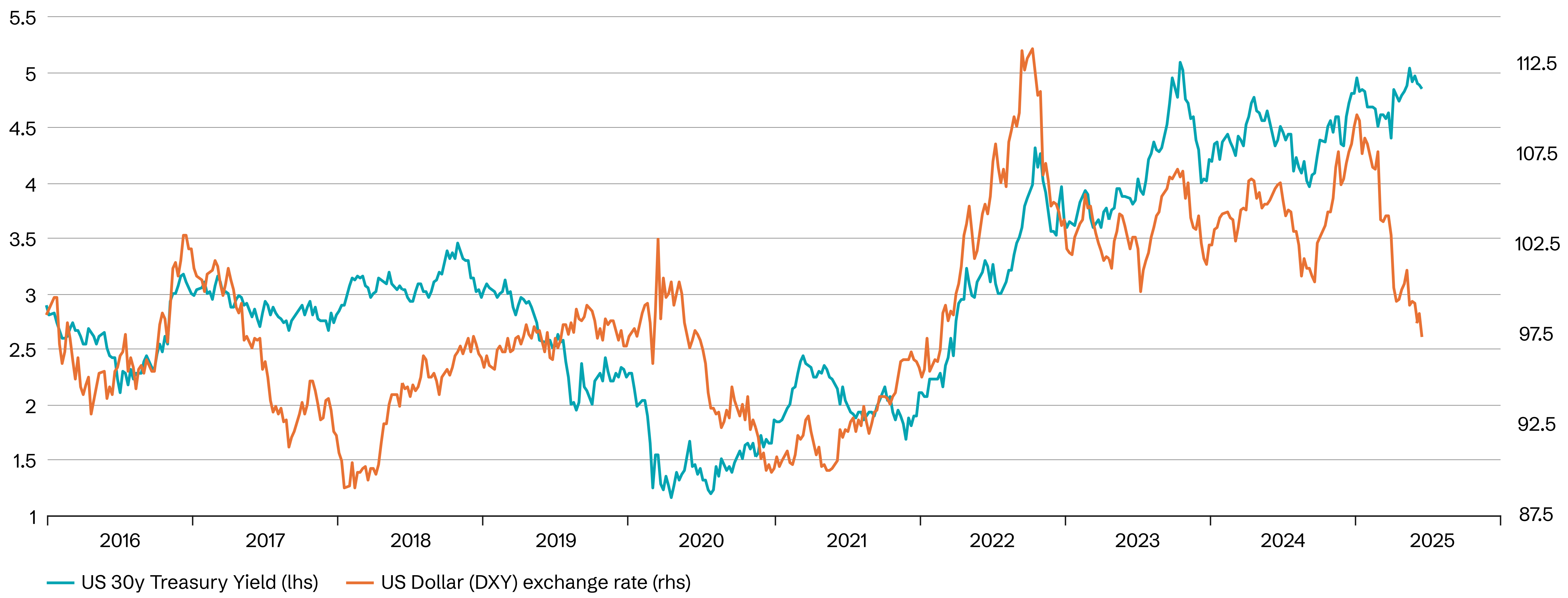
> The inflation outlook remains one of generally above-target inflation gradually heading back down to around 2 per cent

The US has been the global hegemon for decades. It has both driven and benefited from liberalised trade, free markets, easy movement of capital and people and benign fiscal policy. As the issuer of the dollar, it dominates global payments, trade and foreign reserves. The combination of favourable business conditions (light regulation), ease of access to talent (top universities and skilled immigration), flexible labour market and availability of inward investment has allowed the US to run large fiscal and current account deficits. US asset returns have outperformed the rest of the world and the dollar has been strong. However, the Trump administration has brought with it a dramatic increase in political, economic and market volatility. Rising protectionism, trade wars and policies to cut foreign aid may well have negative economic consequences and increase uncertainty, potentially raising risk premiums on US assets. The dollar's reserve status and Treasuries' role in portfolios is also being questioned amid massive global exposure; investment imbalances may drive a shift toward non-US assets and a weaker dollar. Policies to cut foreign aid, research and education may be self-defeating. Immigration restrictions have yet to significantly affect labour markets, though unrest and legal challenges persist. Meanwhile fiscal policy is set to remain on a path that appears to lead to unsustainable public debt dynamics over the long term.

While identifying structural change in real time is incredibly challenging, predicting it is even harder. There are reasons to expect over the longer term US equity market performance could be as strong as in the past. The tech sector remains a global leader, especially in AI, supported by a robust innovation ecosystem. The US is most likely to benefit from the adoption of new technologies. However, the desire for foreign holders to remain exposed to both the underlying asset performance as well as the US dollar may be shifting. Hedge ratios for large pools of capital have fallen to historically low levels and could well shift back to at least historical averages.

That could be a persistent headwind to the dollar, which remains overvalued on almost all metrics. There could also be reduced international demand for US Treasuries, with the recent rise in term premia potentially indicating a change in risk appetite. The combination of these two recent developments is unusual (Figure 3) and would be especially so if they persisted.

Figure 3. The dollar has weakened and Treasury yields risen



Source: Aviva Investors, Macrobond as at 30 June 2025.

Turning to our asset allocation views, while uncertainty around the outlook remains, with US policy a key factor, we judge that the probability of seriously disruptive trade policy has diminished and with it the risk of recession. For equity markets, the recent modest de-rating accompanied by robust EPS growth, strong balance sheets, high margins and lower rates point to potential modest upside in the second half of the year. We therefore prefer a modest overweight (Figure 4). We prefer to be broadly neutral government bonds, but with a preference to be overweight the UK and underweight longer-dated US and Germany, reflecting the likelihood of faster rate cuts from the BoE and the impact of looser fiscal policy in the US and Germany.

In credit, spreads have tightened after perceived trade war risks receded, and corporates again trade at historically tight levels. This reflects solid credit fundamentals and supportive 'technicals', but potential gains are small against possible losses if economic risks materialise. As such, we prefer to be neutral with a bias for Europe relative to the US or hard currency Emerging Markets (EM), with private markets also offering better spreads on the back of illiquidity premium. Finally, in FX we hold high conviction on further dollar depreciation: the US fiscal trajectory is agitating market participants, who, to continue to lend to the US, would require a combination of higher yields and a weaker exchange rate for compensation. In other words, the erosion of US exceptionalism will drive the US risk premium higher and should weigh further on the value of the dollar.

> In FX we hold high conviction on further dollar depreciation

Figure 4. Asset allocation

	Underweight -5	-4	-3	-2	-1	0	1	2	3	4	Overweight 5
Equities								2			
Government bonds						0					
Credit						0					
Cash						0					
Currencies (versus US$)									3		

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 30 June 2025.

Key investment themes and risks

1	2	3	4
Erosion of US exceptionalism?	US domestic upheaval: projects for 2025 and beyond	Rapid evolution of tech revolution	Monetary easing: marching out of step towards the same 'neutral' destination

Erosion of US exceptionalism?

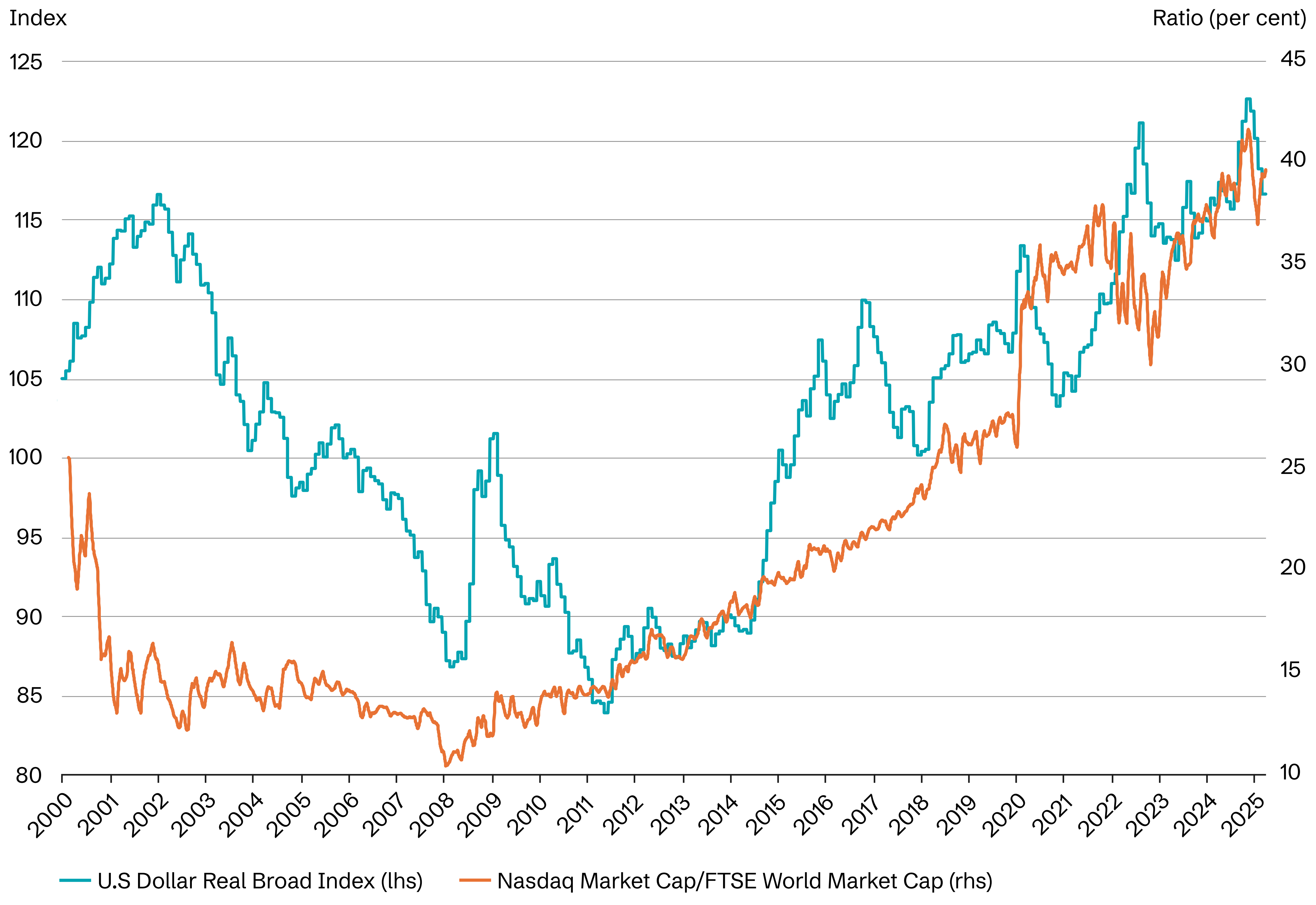
The phrase "American Exceptionalism" can be interpreted a variety of ways, but there is no question that for years or decades, US markets as well as America's place in the global economy and in geopolitics is *sui generis*. Now, for various reasons, the outstanding historical returns of US equities, the dollar, and treasuries is under scrutiny, and the unwind of that extraordinary performance may have only just begun. This theme will depend on the US administration's protectionism and trade/tariff wars (see Theme #2), its isolationism, prompting action by countries unwilling to be potentially reliant on an unreliable partner (discussed in last quarter's House View), US Tech dominance (see Theme #3), and the role of US Treasuries and the US dollar alongside chronic and burgeoning 'twin deficits' in a world that has huge exposure to both assets already. We look at the question of whether US specialness is challenged by breaking it up into several sub-themes:

1. A trade war and tariffs, as part of a move to mercantilism and protectionism, has cyclical considerations first and foremost, as discussed in the Market Outlook. Structurally, not dissimilar to Brexit, such a policy imposes costs and inefficiencies compared to free markets and globalisation. Moreover, policy uncertainty and frequent change is likely to lead to a larger "risk premium" for most US-based assets. Contrary to many predictions, trade tensions have increased uncertainty and weakened the USD.

2. The rift between the EU and the US, along with heightened tensions with Canada and Mexico, has prompted a reaction amongst the EU and other NATO countries. Increased fiscal spending on defence and infrastructure caused a jump in European yields, and in Japan, a nearly 10 per cent ramp-up in defence spending continues a trend towards remilitarisation and contributes to higher deficits and JGB yields. Ironically, as with tech restrictions on China, the US may have actually done these countries a favour, waking them up to their weakness and forcing them to develop their own capabilities.
3. The US has a special ecosystem supporting technology, from seeding start-ups, to VC and hubs of innovation like Silicon Valley. Research centres and universities add to this ecosystem which has created global monopolies or oligopolies in many areas of technology that are key to global markets. The AI revolution is also 'made in America', while as the Draghi report starkly wrote, "Europe largely missed out on the digital revolution and its productivity gains, and the EU is weak in the emerging technologies that will drive future growth." Despite attacks on science funding, immigration, and educational institutions, the US is likely to remain preeminent in many areas (see below). This is especially true for equity markets where the global monopolies/oligopolies already in place impose high barriers to entry and allow US incumbents to "buy out" nascent competitors, though China is already a formidable competitor. Yet, because of huge inflows into US equities and their immense gains, global investors now have much more exposure and concentration risk to this sector (Figure 5). With Tech stock valuations rising substantially over the past decade, the growth surprise that has occurred will be less impactful henceforth, even if lofty expectations are met. But the easiest way for investors to mitigate "US risk" is to hedge out another driver of outperformance: the overvalued dollar.

> The United States is likely to remain paramount in many technologies, including AI

Figure 5. **The US dollar and tech stocks have been remarkable post-GFC**



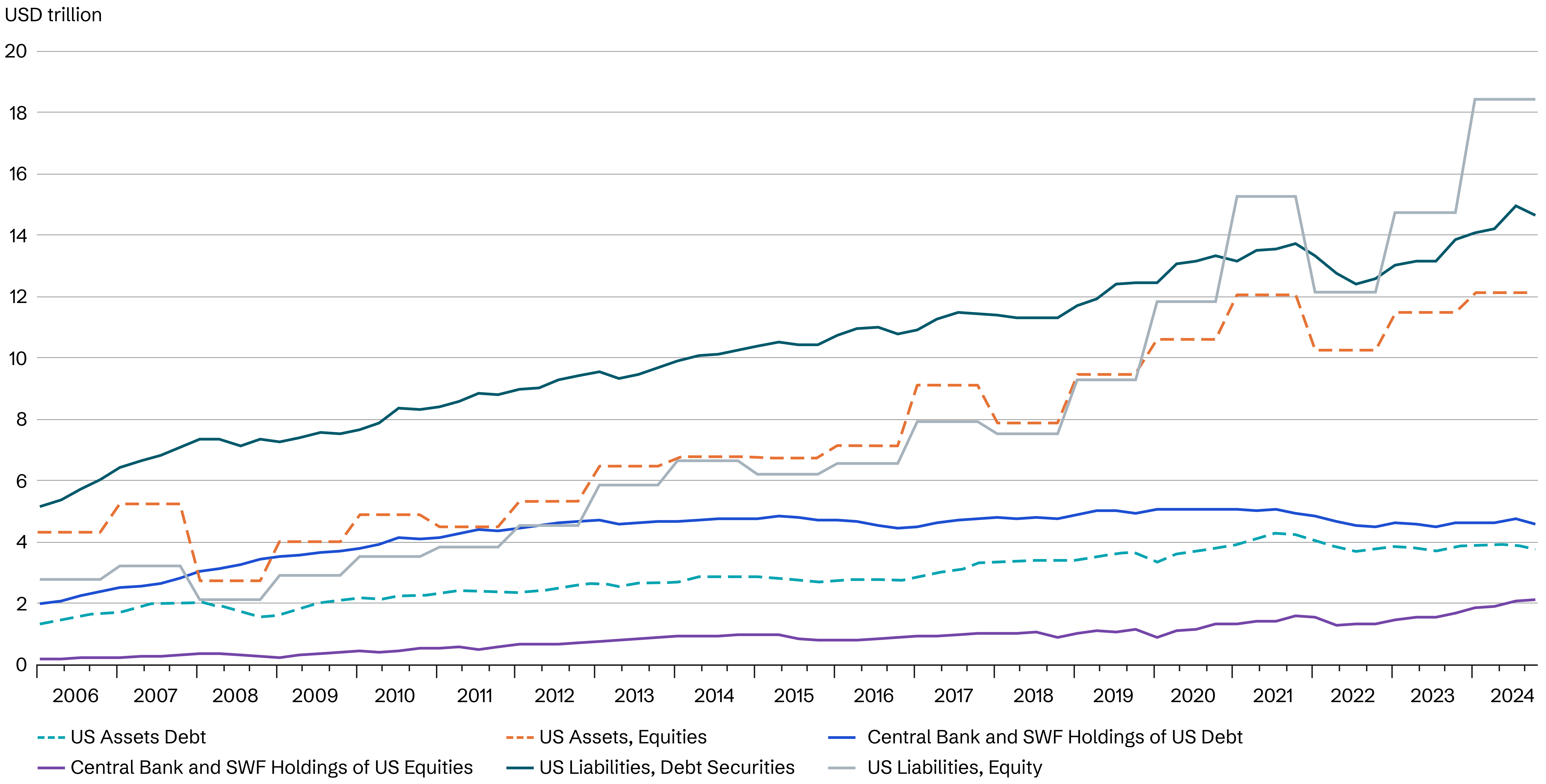
Source: Federal Reserve, Aviva Investors, Macrobond as at 30 June 2025.

The easiest way for investors to mitigate "US risk" is to hedge out the overvalued dollar

4. This is the fourth plank of American exceptionalism: the dollar's status as a reserve currency, the role of Treasuries as a risk-free, diversifying asset for portfolios, and the multiyear appreciation of the exchange rate following the Eurozone crisis, China's growth slowdowns, and equity inflows. All of these assumptions are now less certain, at a point where the Net International Investment Position is negative $26 trillion: global investors own $60 trillion of US assets, but Americans hold a mere $34 trillion of international stocks, bonds, and FDI (Figure 6). There are no limits to gross or net exposures, but such large imbalances may be destabilising, especially as they are destined to grow for as long as the US runs current account deficits and other countries have excess savings. The dollar looks overvalued on a historical basis (Figure 5), and is straightforward to hedge even if investors need to maintain their underlying asset holdings in liquid and safe Treasuries or the magnificent S&P 500 companies. Another risk is that US investors reduce their home bias - households hold over $100 trillion in financial assets. The markets will clear in some way to balance the flows, but a higher relative price of non-US assets, including a weaker dollar, is a likely mechanism to make a less exceptional US less expensive. A bout of growth weakness that leads the Fed to cut rates and decrease the cost of shorting the dollar is a likely catalyst, but there can be other causes, intentional or not.

> The dollar looks overvalued on a historical basis, and is easy to hedge

Figure 6. Foreign holdings of US assets have grown, vastly exceeding US portfolio holdings



Source: Aviva Investors, Macrobond as at 30 June 2025.

US domestic upheaval: projects for 2025 and beyond

Following through on many election pledges is often a surprise in politics. Although President Trump's initial very high tariff levels were not maintained in the face of an adverse market reaction. Yet with sectoral tariffs and an expected re-do on the IEEPA tariffs, we expect something close to the current effective tariff rate to be the baseline, with some sectors facing large levies. While the "left tail" of trade wars, retaliation on US exports, and sudden stops in supply and investment is avoided, the end state should raise a significant amount of taxes in a highly regressive way. This imposition of broad-based tariffs can be thought of as a negative supply shock that, when permanently imposed, raises prices and decreases the economy's overall potential growth. Finally, the uncertainty about future tariffs may act as a deterrent on US investments that depend on imports, which might cancel out any benefits from protection from foreign competitors. So far, while tariff revenues have been collected, it has been harder to discern a large economic impact on inflation or company profits.

The early efforts at austerity and elimination of government programmes did not seem to bear much fruit, but curtailing federal investment in scientific and health research, cutting foreign aid, as well as repelling international students is likely to have negative economic impacts. Quality data collection is also becoming more of a concern. The restriction of immigration and deportation of undocumented residents has been ramped up, but as with tariffs, it has not yet had a material impact on labour supply, wages, or specific sectors such as tourism, agriculture or hospitality. There have been isolated protests and unrest adding to social tensions. Many actions have been challenged in court, and it remains unclear what the policies will be able to accomplish and how much disruption or unrest they will cause.

Two final examples of changing policies in line with "deconstructing the administrative state" are (i) the Health Department's heterodox attitudes towards vaccines and other conventional medical practices, with largescale firings of CDC, NIH and FDA employees, and redirection of funds from biomedical research to "alternative" treatments, and (ii) the dissolution of the Education department after 45 years as a separate branch of the executive government, with power being returned to the states, Justice, Treasury, and HHS. It will be shuttered at the end of the year.

> Tariffs are a regressive tax, and other domestic policy shifts may also disrupt many sectors of the economy

Rapid evolution of tech revolution

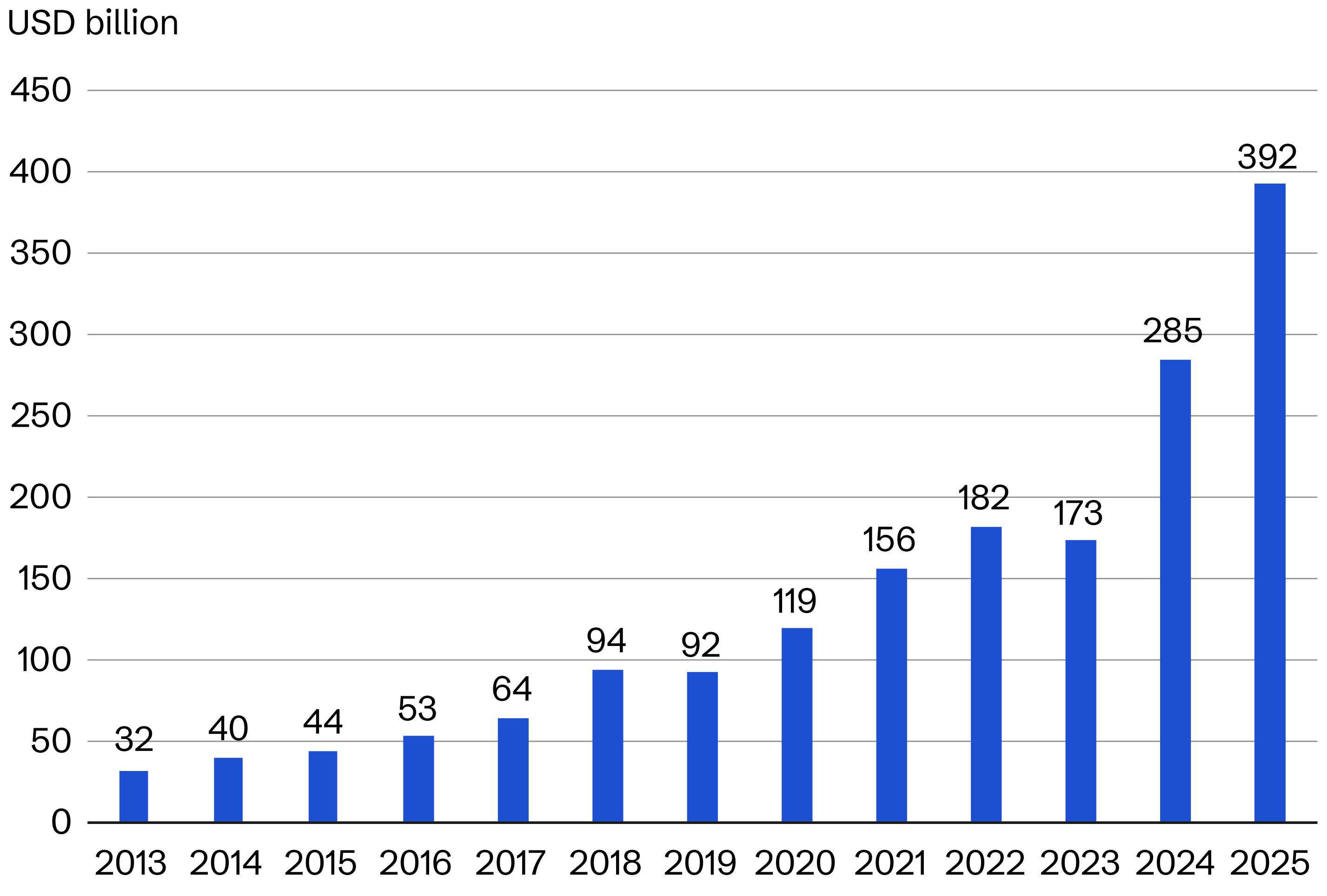
Since the release of DeepSeek-R1 in January 2025, the AI investment narrative has shifted from caution to confidence. Fears that lower cost of training AI models would dampen revenues have been largely assuaged. Accelerating usage, particularly in China, and significant increases in Capex intentions from existing "hyperscalers" (Figure 7), with the likes of Meta raising their capex guidance, proves that lower pricing has been met with higher consumption. Sovereign initiatives such as the $500bn Stargate Project and the EU's €200bn InvestAI further underscore that the global AI race retains momentum. Meanwhile, inference workloads are becoming more compute-intensive and, increasing the demand for AI infrastructure and lower latency chips. The prevailing view now supports a bullish scenario: falling costs are driving broader adoption, not dampening demand.

Despite global enthusiasm, the United States remains firmly in the lead. It dominates AI adoption, with firms like JPMorgan already quantifying AI-driven revenue and cost savings across multiple business lines. Moreover, it would appear the most AI exposed sectors (e.g. Telecoms, Professional Services and Finance) constitute a larger share of GDP in the US compared with other G7 economies. Whilst general equilibrium/network effects might mean that aggregate gains may differ from a simple arithmetic sum of sectoral gains; the US's favourable weighting towards AI exposed sectors may render it as best placed to reap the productivity benefits of AI – and the lion's share of the profits.

Indeed, US tech giants continue to command the highest AI equity valuations, supported by robust earnings growth and aggressive capex. As we have mentioned prior, the recent increase in the US's International Investment liability position has been largely driven by equity portfolio investment, the bulk of which is due to swelling US equity valuations (Figure 8) .

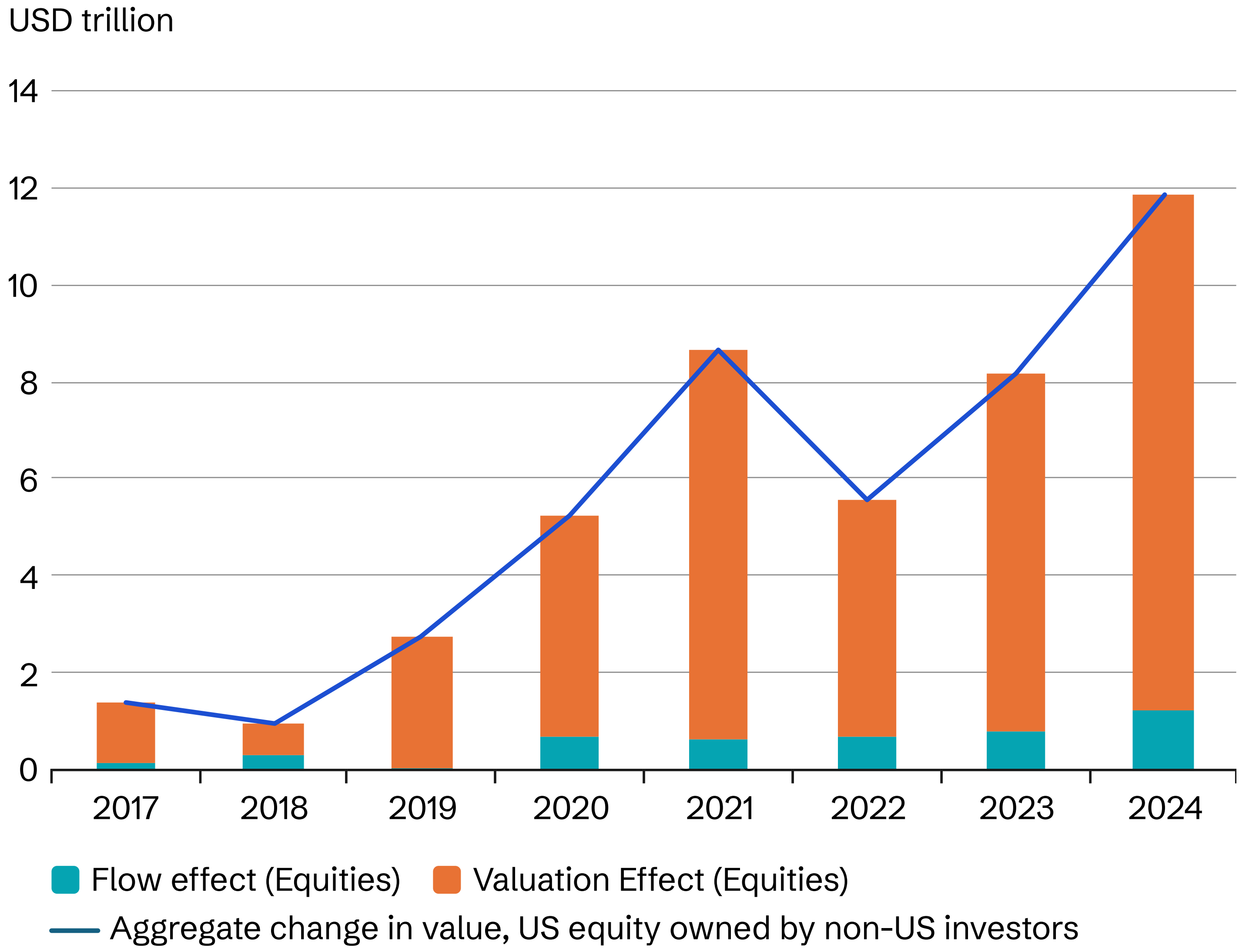
Since the release of DeepSeek-R1 in January 2025, the AI narrative has shifted from caution to confidence

Figure 7. Data/AI capital expenditures, selected US tech companies



Source: Factset, Morgan Stanley Research as at 03 June 2025.

Figure 8. The bulk of the increase in equity portfolio investment is due to swelling equity valuations



Source: Aviva Investors, Macrobond as at 30 June 2025.

Monetary easing: marching out of step towards the same ‘neutral’ destination

Central banks continue to exercise caution after the post-Covid inflation surge proved larger and less transitory than anticipated. While not everything is forecastable, and the Russian invasion of Ukraine caused a spike in oil and gas prices that was a true exogenous supply and inflation shock, the slow hikes and continued QE can be considered an ex-post policy error that contributes to most major regions still having above-target inflation, now for the fourth consecutive year. That said, progress is being made and we expect an erratic march towards neutral policy rates to continue for the rest of the year and into 2026.

The 2 per cent inflation target that is the self-defined interpretation of ‘price stability’ is already unlikely to be achieved this year by many, especially for underlying or core measures (Figure 9) – as we have stressed for some time, services prices remain ‘sticky’ with wages and regulated prices sometimes backward-looking. And all forecasts are being re-estimated whenever a new set of tariff threats or retreats by the unpredictable US administration is unleashed.

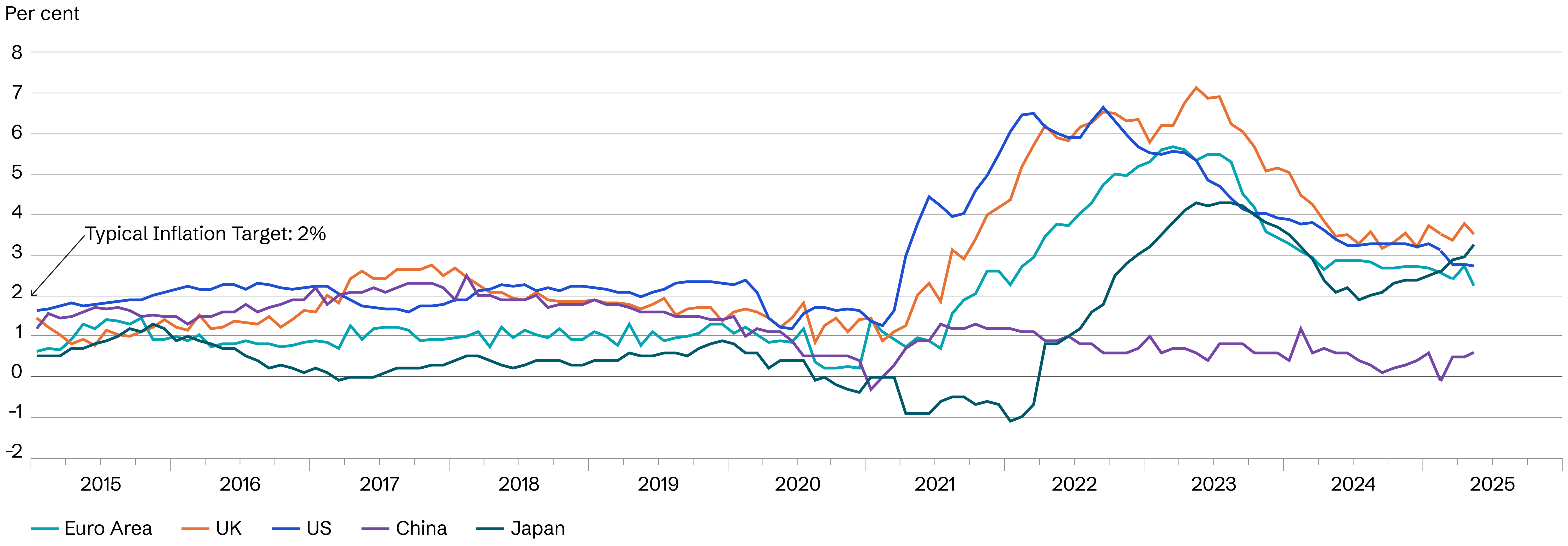
This means that monetary policy is being kept in slightly restrictive territory by the Fed and the BoE – both of which kept rates unchanged in June – and will move lower gradually as CPI disinflates, absent a recession. Many smaller countries’ central banks are in a similar place, e.g. Norway, Australia, and to some degree Canada.

The ECB, though, is already in neutral territory: headline inflation is sub-2 per cent, though core HICP is still at 2.3 per cent y/y. They have cut deposit rates to 2.0 per cent in their yearlong campaign to reduce rates from a high of 4.0 per cent, and are probably close to done. Growth has been weak after the energy shocks and rate hikes sapped growth, but is improving now that rate cuts have had some time to work alongside fiscal adjustment. Sweden’s Riksbank is in a similar situation.

Meanwhile, Japan is facing higher inflation but is unsure of whether it will prove durable, and is only slowly hiking rates. China is facing outright deflation, as is Switzerland – and both have continued to ease rates and liquidity, trying to keep their respective currencies weak, but are seemingly close to their lower bound.

> Most central banks should continue to reduce rates, but hardly in lock-step

Figure 9. Core inflation in the major nations



Sources: Aviva Investors, Macrobond as at 30 June 2025.

“Although a 1980s redux is unlikely, this does not mean that unsustainable fiscal deficits and increasing public debt can be contained painlessly with QE, financial repression and adjustments to issuance.”

Michael Grady
Head of Investment Strategy and Chief Economist

Risks

Geopolitical escalation and instability

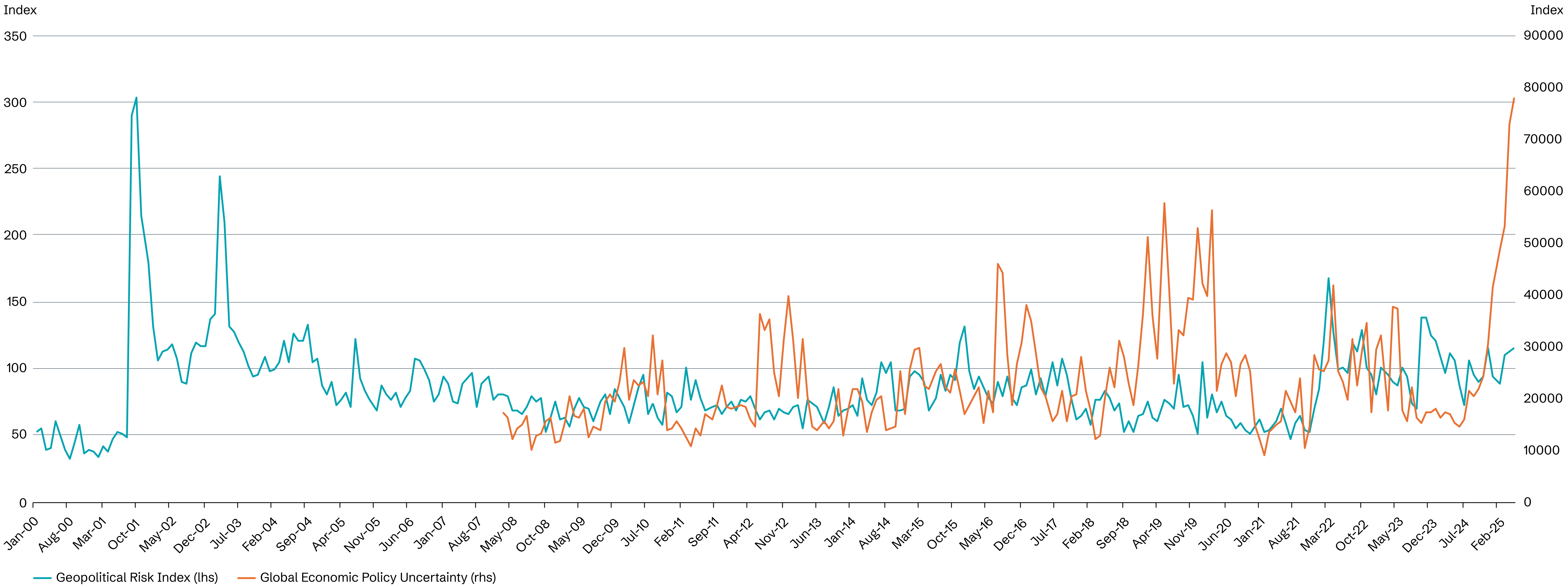
There are several major areas of geopolitical uncertainty, and to some extent this risk has manifested itself in recent months. Yet aside from oil markets and perhaps gold, there has not been much economic or market impact from the most recent Middle East conflict, unlike the devastating supply shock that occurred when Russia invaded Ukraine, affecting oil and gas exports and having its reserves sequestered by the West. The economic uncertainty caused by tariffs is much greater than normal, but geopolitical risks are not yet perceived as having manifested themselves, in comparison with 9/11, the War on Terror, and the invasions of Afghanistan and Iraq (Figure 10).

The Middle East has been an area of almost constant unrest and flux, often violent, so in one sense conflict there should hardly be shocking. However, the bombing of a large country, Iran, which poses an alleged nuclear threat and is a major oil producer, as well as having the ability to threaten some 30 per cent of the world's seaborne crude oil trade, is a few orders of magnitude above the conflicts of recent years, at least in terms of market impact. Oil prices were weak for the past year as economic fundamentals softened, while supply growth was healthy; then in June we saw a sharp, 15 per cent spike in Brent. This dissipated once the conflict stopped, though the ultimate resolution of tensions, and what will happen once the JCPOA expires in October, remains to be determined. But there are multiple tail risks with different outcomes.

Russia and Ukraine are not quite in a stalemate, but more in a punishing war of attrition. While Russia commits war crimes against civilians, Ukraine is increasingly bold in sabotaging Russian military and industrial infrastructure. This also has unsettling implications for the future of warfare – drones and UAVs will play a bigger role and may undermine raw manpower and materiel. The unenthusiastic support for NATO by many in the Trump administration poses additional risks, which is why Europe's fiscal stance has rapidly changed. Their slow pace opens up a window for Putin to create more instability, if he has the means and calculates (or miscalculates again) that such action will strengthen him.

Aside from those areas, Taiwan, North Korea, India-Pakistan, and other sources of tension are well known, and the only surprise would be if nothing happens in this new era of "Warring States" in which the United States, once the world's policeman, is disinterested in deterrence.

Figure 10. Geopolitical risks are not perceived as extremely high



Sources: World Uncertainty Index (WUI), M. Iacoviello; Aviva Investors, Macrobond as at 30 June 2025.

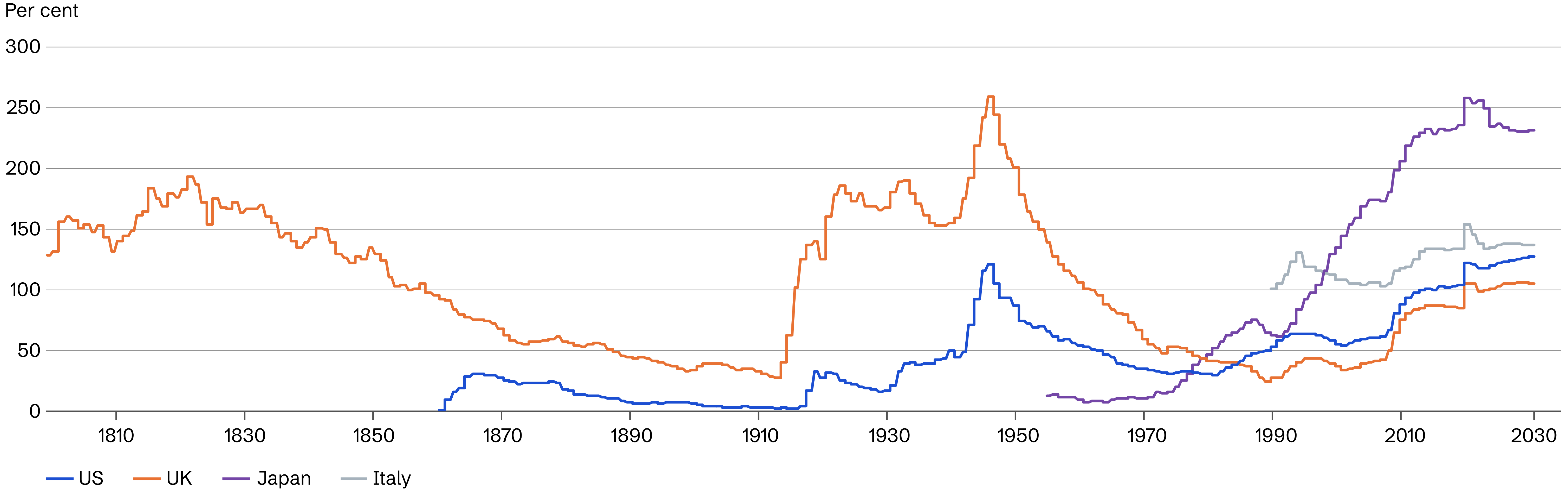
Fiscal expansion ad infinitum causes debt disruption

Will there be a "bond vigilante moment" for Treasuries, gilts, bunds, or JGBs? This question has been asked many times since the GFC began an era of large fiscal deficits, burgeoning debt, Greece's default, and 'money printing' or QE. Our answer remains that a 1980s redux is unlikely, but that does not mean that unsustainable fiscal deficits and ever rising public debt-to-GDP (Figure 11) can be contained painlessly with QE, financial repression, and adjustments to issuance.

Thus far, large deficits have just about stabilised, but are at unsustainable levels in many countries: over 6 per cent of GDP on average in EMs (up from 3-4 per cent pre-Covid), and over 4 per cent in DMs (compared to 2-3 per cent in the post-GFC decade). The US stands out with a 7 per cent net transfer from the government to the private sector, mostly driven by low tax rates in comparison with other advanced economies: tax cuts and loopholes for high-income households and corporations have been a key policy since President Trump's first term. The erosion of US exceptionalism is arguably already contributing to the rise in risk premium, discussed in the market outlook. In theory, there is no limit to where spreads of government bonds trade relative to expected interest rates.

Very high debt levels occurred a handful of times in history, usually following wars or depressions. While EMs and defeated enemies often default, advanced economies, especially with debt in their own currency held by their banks and citizens, have no reason to do so (Greece being a notable exception, as the EU refused a bailout). A mix of growth, financial repression, and inflation resulted in low yields, and decline in debt levels – but the world and monetary systems were much different then. Should we be worried now?

Figure 11. High debt levels historically resulted in low yields later... will this time be different?



Source: Aviva investors, Macrobond as at 30 June 2025.

There are already signs of minor 'indigestion' as yield curves steepen and government bonds cheapen (e.g. using asset swaps as a metric), but markets have functioned smoothly and Debt Management Offices can manipulate issuance, for a time – for example, cancelling auctions and replacing long-dated bonds with bills. There has been little spillover or crowding out thus far.

The risk is that saving decreases and competition for funds becomes more intense, or that inflation and interest rates eventually rise, sparking an exodus and rise in real yields that will pressure economies and financial systems.

> Large fiscal deficits have stabilised, but remain at unsustainable levels ...should we be worried?

Macro forecasts charts and commentary

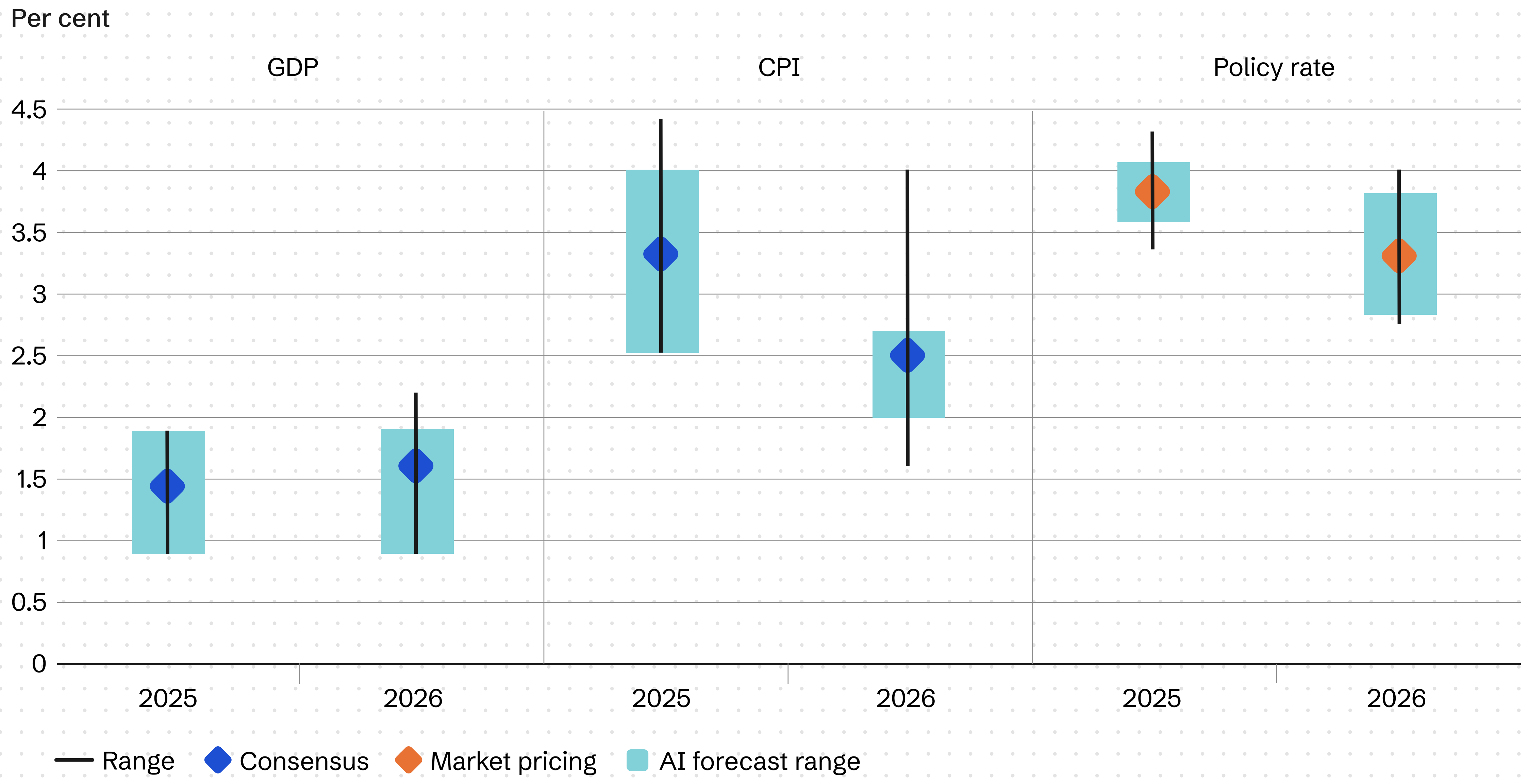
US

Growth and inflation trade-off expected to worsen

The past three months have seen extremes in policy developments out of the US administration. From the "Liberation Day" reciprocal tariff shock, to the pause in implementing those tariffs just a week later, the ratcheting of tariffs between the US and China to effectively embargo levels, only for those to be dramatically reduced again. At the time of writing, there is just one trade deal agreed – with the United Kingdom – which sees a new tariff rate of 10 per cent imposed. There remains uncertainty on the outcome of negotiations with other regions/countries as we approach deadlines in July and August. We expect basic framework agreements will be put in place that will likely keep effective tariff rates at similar levels to where they were in June. That would equate to an effective tariff rate of around 15 per cent, roughly a six-fold increase compared to when President Trump came into office. That would equate to around a 1-1.5 per cent of GDP increase in taxes in the US and an increase in core inflation of around 1 per cent. We expect that the impact of tariffs, combined with the uncertainty created by erratic policy decisions will be a material headwind to activity this year, with calendar-year growth expected to halve to around 1.4 per cent (Figure 12).

The draft Budget reconciliation bill (One Big, Beautiful Bill Act) extends existing tax rates permanently, while introducing a number of other small personal and business tax cuts. However, the draft bill also includes significant cuts in discretionary spending on healthcare and defence, as well as the removal of a number of tax incentives from the Inflation Reduction Act on electric vehicles and other areas of the green transition. Overall, we assess the fiscal impulse of the draft bill (which excludes the impact of tariffs) to be a small positive in 2026, but broadly neutral in 2027 and contractionary thereafter. Deficits are expected to remain around 6-6.5 per cent of GDP throughout the Trump presidency.

Figure 12. US



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2025.

Judging the momentum in the US economy currently is challenging. The expectation of tariffs led to significant shifts in the timing of expenditure on those areas expected to be impacted. That led to a surge in imports and inventories in Q1. Much of that is likely to reverse in Q2. We think underlying growth has slowed though, with both consumer spending and business investment also boosted in Q1 by the bring-forward of spending. The labour market has also showed signs of slowing through May and June, with unemployment claims rising and vacancies falling. We think this is consistent with a period of slow growth for the remainder of this year.

Despite the imposition of tariffs in April, there has so far been surprisingly little impact on prices. The May CPI data contained few hints of outsized price changes in impacted goods categories. We expect that this largely reflects lags in pricing changes, with surveys pointing to companies expecting to pass on the tariff costs in their pricing. We expect inflation to peak around 3.5-4 per cent this year.

The mix of weaker growth and higher inflation poses a challenge for the Federal Reserve. Inflation has only just about got back to around target after five years, only to move higher again due to tariffs. Until the effect of tariffs is seen in activity and the labour market, it is difficult for the Fed to pre-empt how much growth will deteriorate. As such, they are likely to remain cautious. We expect them to resume easing policy, removing restriction with another 100bps of rate cuts over the next year. But the risks around that remain wide, with as few as one or two more cuts or much deeper cuts should the labour market weaken significantly.

The mix of weaker growth and higher inflation poses a challenge for the Federal Reserve

Eurozone

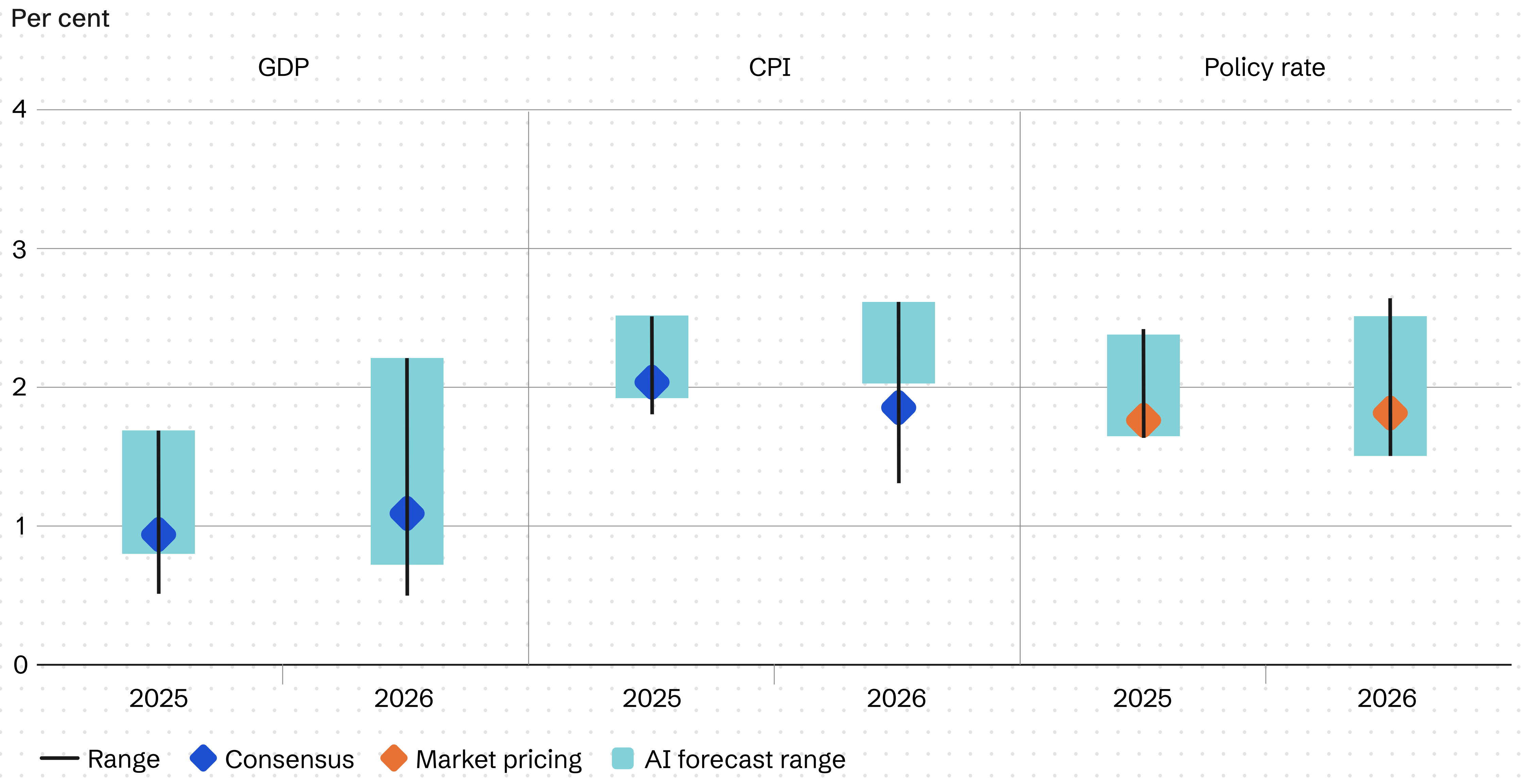
A tug of war between fiscal expansion and trade headwinds

The Euro area (EA) economy grew by 0.6 per cent QoQ in Q1 25, above expectations. However, this was partly due to an outsized growth in Irish GDP and partly due to front-loading of exports (due to tariffs) which grew by 1.8 per cent QoQ. Investment growth was also strong while consumption growth decelerated, managing to expand by 0.2 per cent QoQ despite rising global uncertainties. As energy prices declined for most of H1, inflation declined to target (2 per cent), although services inflation has remained high by historical standards.

Trade tariffs and related uncertainty will mean that export growth reverses and investment growth decelerates; however, we expect consumption to hold up in the presence of large excess savings. We have thus not changed our 2025 GDP growth forecast of 1.2 per cent (Figure 13). For 2026, it will be a tug of war between fiscal expansion and trade-related headwinds: our baseline scenario envisages that tariffs could shave between 0.2 and 0.4ppts off annual GDP vs a boost of 0.5-0.7 per cent from the fiscal thrust (German and EU-wide measures) using conservative multipliers. We thus now expect 2026 GDP to grow by 1.5 per cent, still considerably higher vis-à-vis the consensus of 1.1 per cent.

On inflation, the deceleration in wage growth is likely to continue adding to the disinflationary forces. However, the recent decline has been largely due to energy prices with underlying inflation still (slightly) above target and services inflation elevated by historical standards. With household consumption holding up, we expect inflation to hover around target in 2025 and 2026 which also means that our central scenario envisages that the ECB is done on its easing cycle - with a risk of delivering one more 25bps cut to move policy rates to 1.75 per cent.

Figure 13. **Eurozone**



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30th June 2025.

Risks to our EA outlook include:

- Sizeable and broad tariffs' imposition by the US on a permanent basis (i.e. no agreement in reciprocal and section 232 tariffs) which would put growth and global and EA trade under pressure and result in the ECB likely cutting rates below our expectation.
- Bottlenecks in policy decisions on the fiscal/defence package/s that could significantly weigh on activity and sentiment.
- Further escalation in Middle East tension that pushes oil prices considerably higher and threatens both growth and inflation expectations; this would bring the ECB in a difficult spot as activity would decelerate but inflation would roar its head driven by higher energy prices.

We now expect 2026 GDP to grow by 1.5 per cent, still considerably higher vis-à-vis the consensus of 1.1 per cent

UK

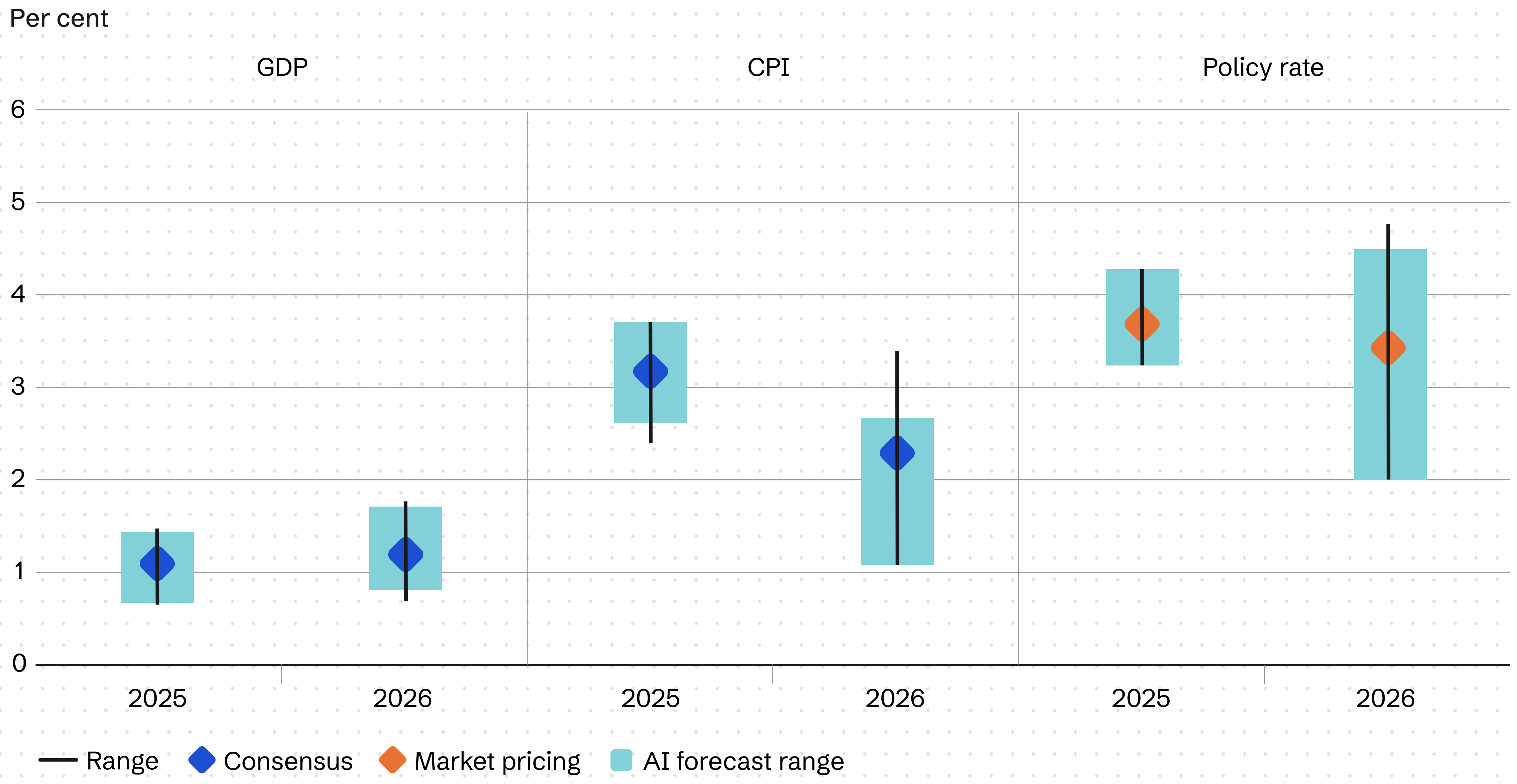
The strong start to the year is unlikely to last

The UK economy grew by 0.7 per cent QoQ in Q1 25, significantly above expectations. This was driven by quarterly acceleration in consumption growth, very strong business investment and a significant contribution from exports because of front-loading due to tariffs. At the same time, inflation is now running at 3.4 per cent, considerably higher than the 2 per cent target; this, however, is largely due to temporary factors, including increases in a number of regulated prices.

On balance, we expect growth to slow notably in the remainder of the year and have pencilled in a 1 per cent annual GDP expansion for 2025 (unchanged) and 1.3 per cent for 2026 (slightly lower than before – Figure 14). We think that consumption growth will decelerate as consumers are still in the process of accumulating savings and the labour market will loosen further with payrolls having contracted for four successive months. Business investment should also decelerate due to tariff/trade uncertainty globally, as will export growth. The recent monthly GDP readings corroborate this bearish view on activity. Finally, we expect the autumn budget to include tax increases, which itself would be a headwind to near-term growth.

On inflation, the deceleration in wage growth (which is still high) is likely to continue as the labour market loosens further. The crux of our bearish view is that the National Insurance Contributions (NICs) hikes will end up being absorbed more by employment losses and wage growth deceleration than inflation passthrough. And to the extent that the recent rise in price growth does not threaten to de-anchor inflation expectations that should allow the Bank of England (BoE) to cut interest rates further. However, there remains some underlying inflation persistence which has prompted us to now anticipate a slower than before easing cycle (one cut per quarter) until the bank rate reaches the terminal of 3.25 per cent (which is still lower than the market has priced).

Figure 14. UK



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2025.

Risks to our UK outlook include:

- NICs increases having a bigger price effect, causing stagflation and forcing the BoE to keep rates higher for longer.
- Consumers tapping into their savings could strengthen demand and inflation, implying a higher terminal interest rate.
- Global trade uncertainty could prolong, hitting the UK via the external sector and sentiment, weighing on activity even more.
- Fiscal policy: there is a risk that the Chancellor decides to adjust her fiscal rules in the upcoming budget – if changes are material this would be perceived as a loss of credibility, yields would rise higher due to higher risk premia and borrowing costs would weigh on the economy.
- While it is difficult to have a strong view on the final agreement as far as the UK-EU reset relationship goes, the upside risk relates to mutual recognition of standards and youth mobility. If there is progress there then (1) this could allow the OBR to score them high in terms of potential output and (2) they would reduce trade costs and facilitate more immigration, which would allow faster policy easing and benefit activity through lower business costs and higher productivity (in the more medium term).

The crux of our bearish view is that the NICs hikes will end up being absorbed more by employment losses and wage growth deceleration

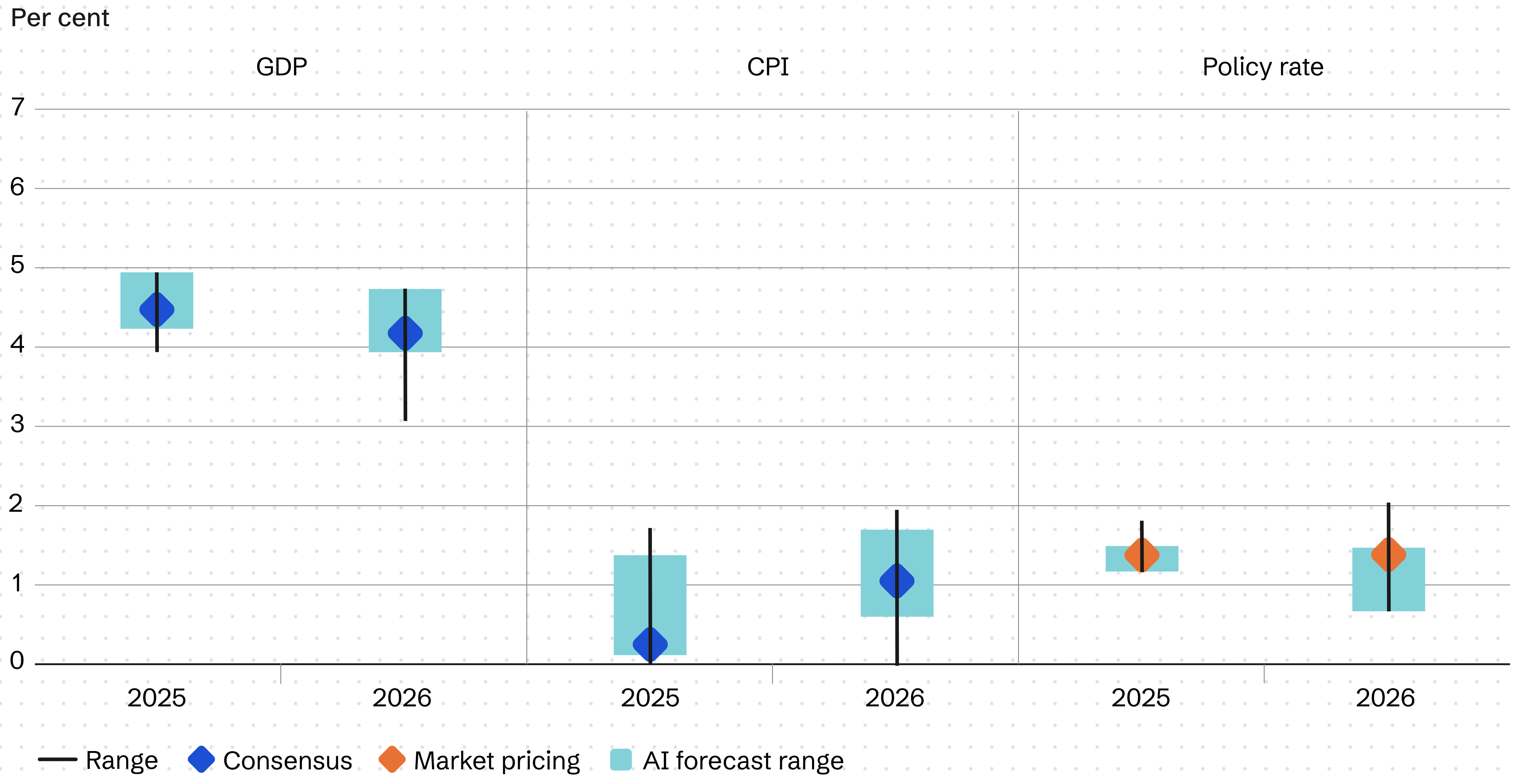
China

Holding some good cards in a high-stakes game of chicken

Nearly everyone is a net loser from the erratic trade war launched by the US, but China in particular was singled out for punishment, and responded in kind. Some de-escalation from an effective ban occurred in May, but much higher tariffs are the reality; further negotiations on trade, semiconductors and rare earths, IP protection and opening markets, and unrelated matters will determine the end state. Full decoupling seems unlikely, but military and high-tech items will be highly restricted over time, with China developing its own capabilities and also looking to circumvent the dollar-based, US dominated global trading and financial system. That is a long and difficult road.

For now, exports were booming in early 2025, as the threat of imminent tariffs led to massive inventory build and precautionary imports; the current account surplus jumped from ~2 per cent of GDP in late 2024 to 2.9 per cent as exports grew 4.5 per cent y/y, while imports were decreasing. Manufacturing and investment is also strong in both industry and infrastructure. However, retail sales weakness shows that consumer confidence is still damaged by the real estate depression, which continues to show no signs of ending amidst oversupply and price declines. Although consumption may improve if trade stabilises, this will also mean that fiscal and monetary policy remain modestly supportive, rather than ultra-aggressive, as in past crises. Trend growth is sliding down towards 4.0 per cent (Figure 15) as demographics and debt continue to weigh on productivity; technology leadership and Supply Side Structural Reforms could help offset these structural negatives, but overcoming entrenched interests' resistance is difficult as it will be painful: yet another long march, barely begun.

Figure 15. China



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2025.

Fiscal and monetary loosening are also needed to prevent worsening deflation, caused by weak demand and past overinvestment leading to overproduction and eroding margins. A 1 per cent central government fiscal boost to a 4 per cent deficit is more stabilisation than stimulus; it includes initiatives for white goods and auto trade-ins to support consumption, employment and education, and throwing more money at local governments for infrastructure and rural and urban renovation and revitalisation. We pencil in 4.9 per cent growth (thanks partly to 2024 weakness) but this could be a weaker outturn if trade and investment are damaged; growth slows to 4.3 per cent next year. CPI should be close to zero, with PPI negative as the trade war impact outside the US is disinflationary; PBOC should keep USDCNY stable, and with the dollar expected to weaken, the renminbi will also depreciate in trade-weighted terms.

Risks to our forecasts include:

- A return to an escalating trade war if talks with the US break down.
- Financial instability caused by overleveraged local governments, SOEs, or related vehicles.
- More aggressive fiscal and monetary stimulus coupled with social and economic reforms.

Fiscal and monetary loosening are needed to prevent deflation, caused by weak demand and past overinvestment leading to overproduction and eroding margins

Japan

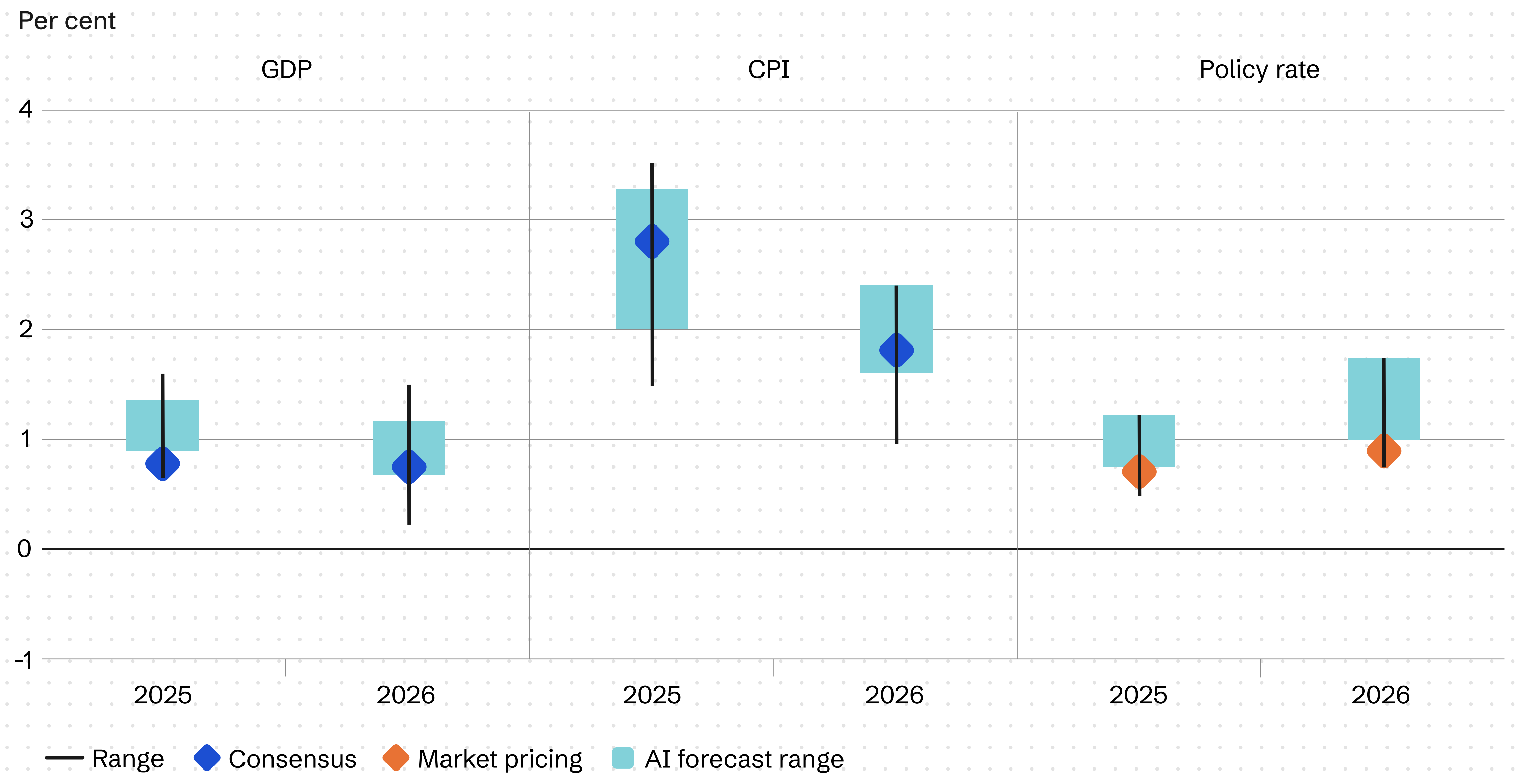
Bank of Japan will go 'slower for longer'

Inflation has been sustained at over 3 per cent, and core measures are closer to 2.5 per cent, with solid wage and shunto gains being enough to provide real gains and overcome some consumer uncertainty. The BoJ seems unable to believe what should be a successful reflation, and continues to be ultra-cautious in raising rates and withdrawing from its QE purchases, which are slowly being tapered. The rise in government bond yields after YCC was ended has been dramatic: the 10-year JGB yield has jumped from zero to 1.5 per cent and the 30-year is around 3 per cent. Yet, these are still extremely low yields and hardly out of line in a global context; if nominal GDP growth stays in the 2.5-3.5 per cent range then only minor consolidation is needed to attain fiscal stability, and this is not urgent.

A falling population and high savings and investment rates mean that technology and productivity are key to growth. Near term, though, risks are high due to tariffs imposed by the US, particularly on autos, and possible disinflationary forces should global demand weaken and RoW supply cause margin pressures. Risks are therefore two-sided, around a central scenario of 0.7-1.0 per cent GDP growth (Figure 16). A consumption tax cut could help support the economy, but would only temporarily lower inflation. Still, this combination should keep the BoJ cautious, with hikes only materialising slowly and once the known unknowns are hurdled or removed.

The dollar's weakness now seems more structural, as global portfolios are overweighted in US assets – Japanese portfolios in particular, because of the decades of low yields and active depreciation of the JPY since Abenomics. Excess savings and current account surpluses have ballooned foreign asset holdings to around $11 trillion, over 250 per cent of Japan's GDP – much of it unhedged. After a 40 per cent depreciation of the yen in 2020-24 driven mainly by US rate hikes, a 10 per cent appreciation to 145 is probably just the beginning of a longer adjustment, in line with past dollar supercycles.

Figure 16. Japan



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2025.

Canada

Tariff uncertainty returns the Bank of Canada to the tightrope

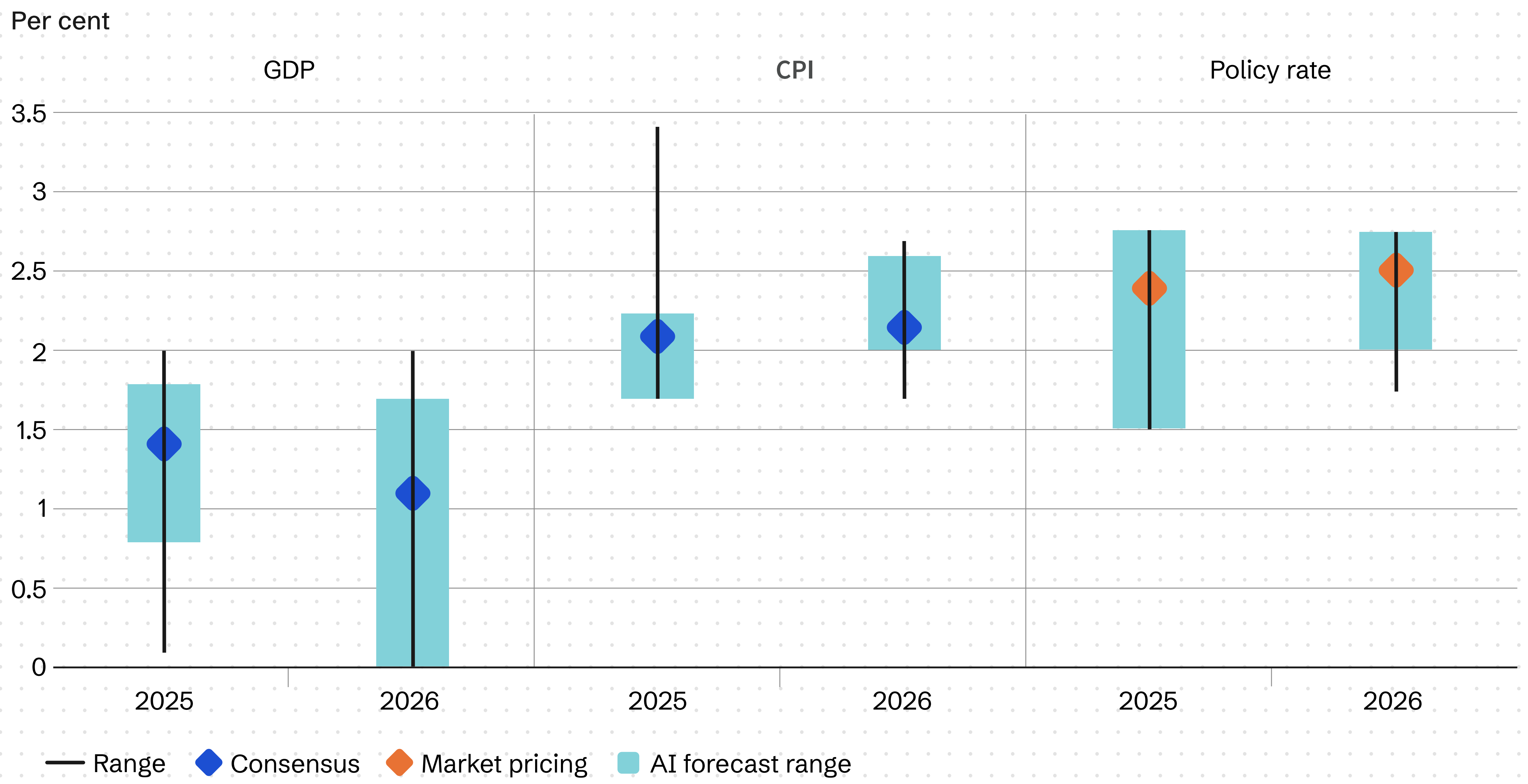
At the turn of 2025, to use the BoC's words, "monetary policy had done its job." Growth seemed to have turned a corner, whilst inflation seemed benign. But the trend in the economic data has reversed course since March, surprising to the downside as tariff threats and surging trade policy uncertainty appear to have hamstrung the ongoing economic recovery.

Being a largely open economy that derives much of its trade from the US, the pervasiveness of the effects of US erratic trade policy does not come as a surprise in Canada's case. Whilst the initial stance of the US's tariff policies has been watered down, uncertainty remains rampant, and this has been having a clear impact on sentiment as demonstrated by the sharp deterioration in survey responses across both household and firms.

Unlike other developed markets, this downturn in the sentiment based/soft data is being clearly seen in the harder data. Q1's GDP print may have surprised consensus to the upside at 2.2 per cent QoQ annualised, but much of this growth was owed to trade and inventory builds due to frontloading. Indeed, judging from the latest trade figures, these short-lived tailwinds have already begun to reverse. Looking beyond the headline Q1 GDP figure, domestic demand fell from an annualised QoQ pace of over 5 per cent in Q4 to -0.08 per cent in Q1, consistent with the downbeat tone indicated by the surveys. The labour market outturns have been equally lacklustre; the unemployment rate has now reached a new cycle high at 7 per cent, with LFS Canadian payrolls running at a 3-month average pace of c.-5k job as of May, a far cry from the +c.50k pace as of February.

Whilst it's true that the losses in employment have been somewhat "localised" to export-oriented industries, the trends in the employment of non-exporters are far from invulnerable, having also notably weakened in recent months. Ultimately employment is

Figure 17. Canada



Note: GDP calendar year growth; Consumer Price Index (CPI) Q4/Q4; Policy Rate Q4.
Source: Aviva Investors, Bloomberg as at 30 June 2025.

a lagging indicator, and should final domestic demand continue to weaken, prompting further caution from firms and households, it is probable that the acute weakness within export-oriented sector hiring will propagate across the economy.

Even as the activity picture has faltered, inflation has shown uncomfortable signs of revival after appearing "contained" come the end of 2024. Whilst the headline figure appears benign at 1.7 per cent YoY, there has been a consistent upward trend building in underlying inflation which may constrain the BoC from further easing.

The BoC now find themselves in the unenviable position of a deteriorating labour market alongside a potential revival in domestically generated inflation. The upside risks to their 2 per cent price stability mandate have undoubtedly returned, making them somewhat myopic regarding their ability to provide forward guidance. Whilst we find the risks around the BoC's price stability mandate to be more two sided than we had earlier, we retain our 2025 terminal rate forecast of 2.25 per cent (Figure 17).

Unsurprisingly, a favourable and conclusive outcome to the US-Canada trade talks could provide meaningful relief to the downside tail risks on growth. Excess savings may still be historically elevated, but we are still cautious of the ongoing drag from mortgage renewals as a downside growth risk. Meaningful stimulus from the new liberal government could provide a backstop to growth but may potentially remove the scope for further BoC cuts.

The BoC now find themselves in the unenviable position of a deteriorating labour market alongside a potential revival in domestically generated inflation

Global market outlook and asset allocation

Equities: Modest outperformance expected for the remainder of the year, with questions about US exceptionalism unlikely to affect equities as much as they do other asset classes.

Fixed income: In our baseline, we see higher risk premia, mostly in the US, and steeper curves.

Credit: We maintain a cautious stance with a broad preference for European over US credit.

Currencies: Erosion of US exceptionalism means that the dollar is likely to keep weakening, with the euro the main beneficiary.

Private Markets: Offers exposure to long-term thematic trends amidst the uncertainty.

Global market outlook

Q2 started with heavy losses for risk assets following the tariff announcements on the 2nd of April. That drawdown in equities was as powerful as it was short-lived. From mid-April risk assets started their recovery and by mid-May global equities were roughly back to their February highs. On the way down, Europe, UK and EM were the best performers, falling less than US and Japan. In the recovery since mid-April, that picture largely reversed with the US and Japan outperforming Europe and the UK. The exception was EM equities which fell the least on the way down and still were among the top performers on the way up.
In bond markets, despite rising term premia (most evident in the US), bond yields maintained familiar ranges in 2Q25, albeit with some volatility and divergence across regions. Disruptive trade and broader US policies alongside a weakening labour market meant that the theme of US exceptionalism erosion gained ground: as a result, and despite recent rises in US yields, the dollar weakened substantially (6 per cent QoQ) as investors became concerned about future inflows and about the trajectory of US deficits. Credit saw small gains over the quarter, with Europe IG outperforming the US. Even in equities, which as we argue below have a less clear direct link to questions of US exceptionalism, we saw the "sell US" trade take hold. The S&P 500 suffered a drawdown of circa 19 per cent and the Nasdaq 100 of circa 23 per cent. This was a significantly sharper fall than equity markets in Europe or EM.

Going into the third quarter of the year, we see the following themes playing out:

In equities, a common criticism is that since global equities are back at around all-time highs, the asset class must be ignoring risks and headwinds. We disagree. There have been sharp downgrades to earnings – especially in the US, despite the dollar weakness supporting EPS – together with modest valuation de-rating, in an environment that provides many supports for equities (robust EPS growth, strong balance sheets, high margins, lower rates, etc). This all points to equities indeed taking account of the risks and we see potential for equity upside in the second half of the year.

In fixed income, we see risk premia rising further and curve steepening continuing. We expect this to be more pronounced in the US, due to disruptive policies and wide deficits with little fiscal impulse. We also anticipate the UK front-end to reprice lower and would also position for flatteners in Japan.

In Credit, spreads have re-tightened after perceived trade war risks receded, and corporates trade at historically tight levels. This appropriately reflects solid credit fundamentals and very supportive 'technicals' across both IG and HY, but potential gains are small against possible losses if economic risks materialise. There is somewhat more value in Europe relative to the US or hard currency, and private markets also offer better spreads.

Finally, in FX we hold high conviction on further dollar depreciation: the US fiscal trajectory is agitating markets who to lend to the US would require a combination of higher yields and a weaker exchange rate for compensation. In other words, the erosion of US exceptionalism will continue to drive the US risk premium higher and should weigh further on the value of the dollar.

> The erosion of US exceptionalism will continue to drive the US risk premium higher and should weigh further on the value of the dollar

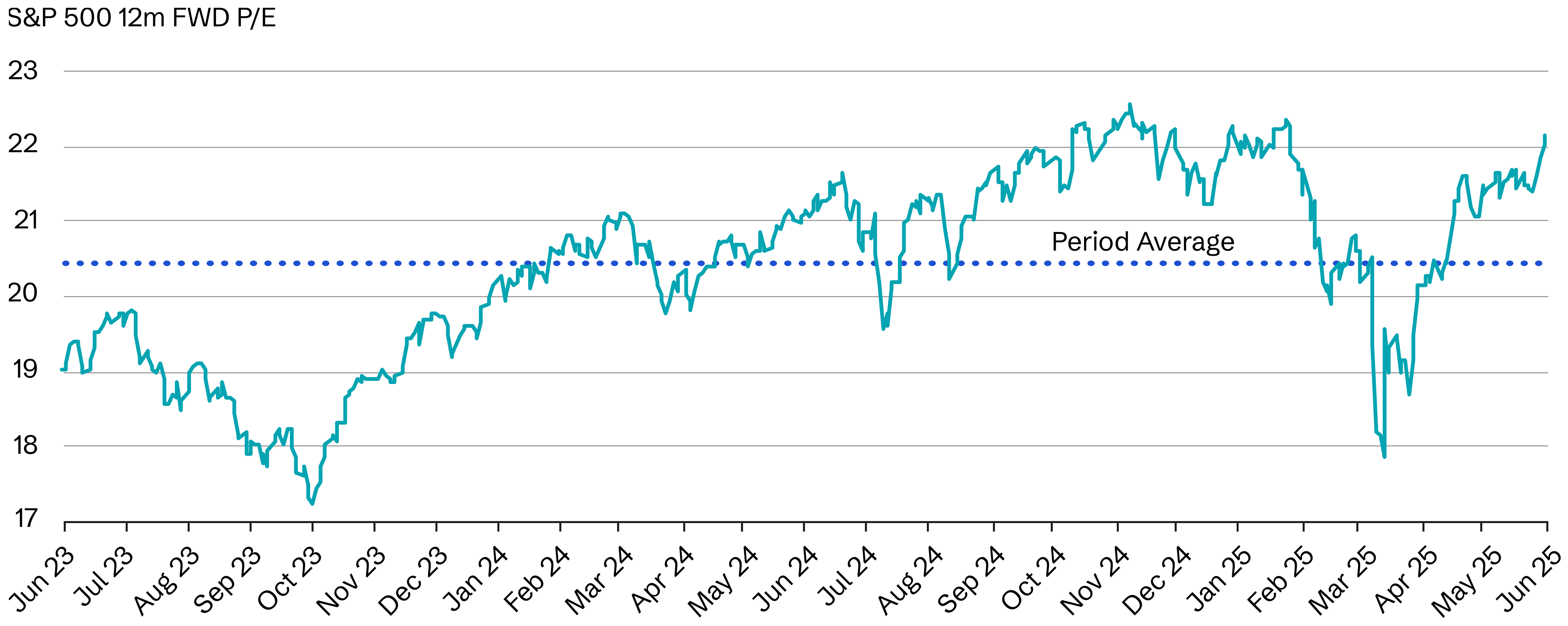
Equities: can the uncertainty derail equities?

Global equity markets are up high-single digits year to date with the MSCI ACWI reaching new all-time highs in early June. To many that suggests equity markets are complacent and/or failing to take into account the uncertainty and risks we described above affecting the global economy today. We beg to differ.

While markets are trending higher again, this was after a c.16 per cent drawdown in global equities from the February peak to the April through – within that, US and Japan were the worst performers on the way down, with the S&P 500 retracting almost 20 per cent. S&P 500 trailing P/E ratios contracted nearly 5 P/E points in the drawdown and while most of the de-rating in valuations was recovered since April, current forward P/Es are still circa half a point lower than at their peak in December 2024 (Figure 18).

In parallel to that de-rating, earnings forecasts have been lowered significantly (which mathematically pushes P/Es higher by lowering the denominator in the ratio). At their peak in late 2024, expectations for 2025 EPS growth for the S&P 500 were circa 15 per cent; today they are circa 9 per cent. And while 9 per cent is still a very robust level of earnings expansion, it implies significant growth deceleration for the remainder of the year, as the actual earnings growth at the end of the first quarter was running at c.13 per cent.

Figure 18. While valuations for the S&P 500 have recovered we are still below the levels in Q4 2024 and early 2025.



Source: Aviva Investors, Refinitiv Workspace as at 30 June 2025.

> Global equities have made new all-time highs in June and many believe this must mean investors are complacent and risks are being ignored. We disagree.

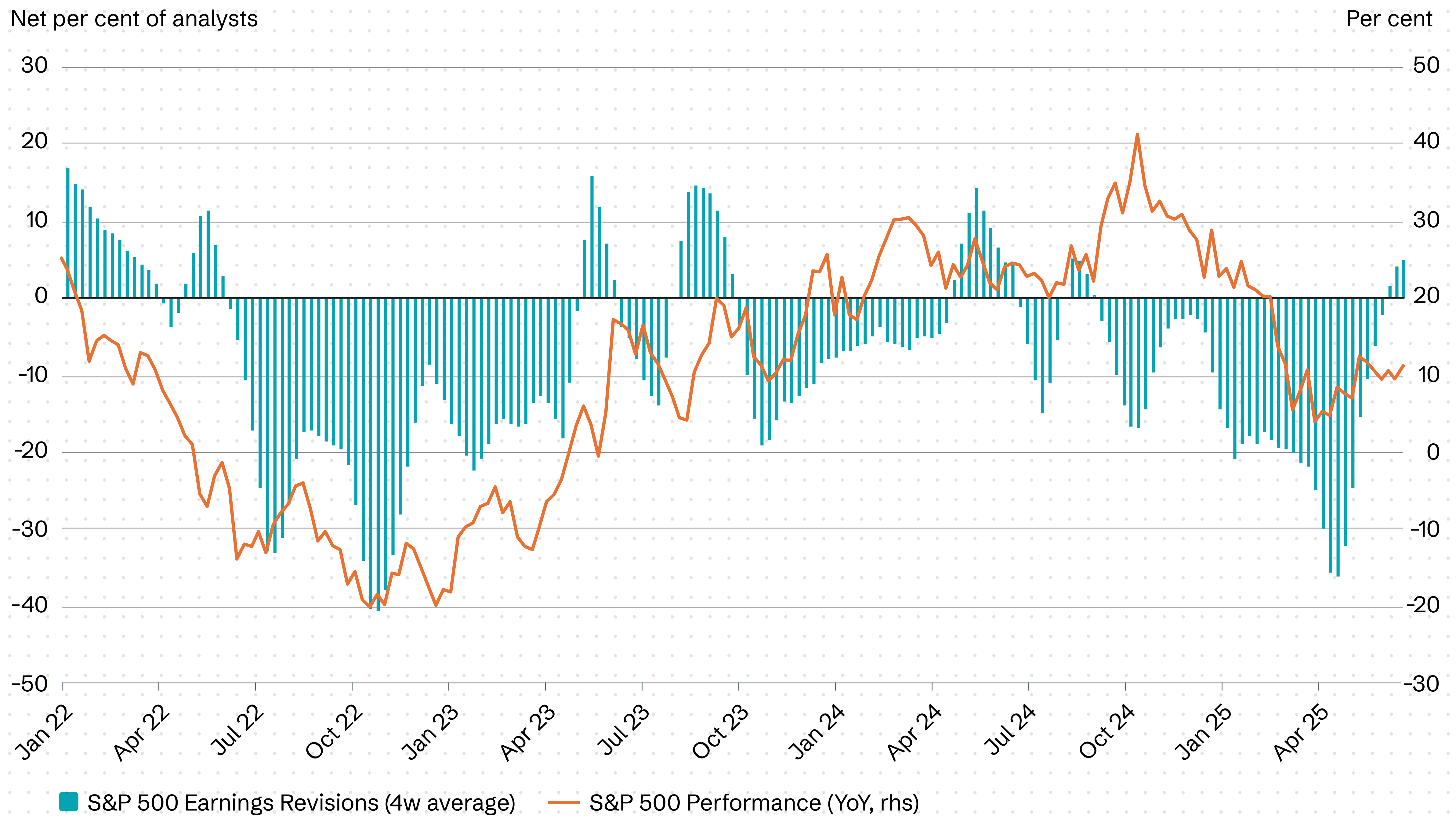
In addition, that level of downgrades has come through despite the weakness in the USD which works as a tailwind for S&P 500 EPS growth. The breadth of downgrades was very significant as well: April saw what was the broadest downgrades to S&P earnings since 2022 (Figure 19), when most market participants expected a recession. Close to a net 50 per cent of analysts downgraded EPS in the worst week of downgrades in mid-April. This has reversed significantly since, and we now have a net c.5 per cent of analysts actually upgrading earnings in the market.

So, all in all, there were very broad and sharp downgrades to earnings, and now the market trades at marginally lower P/E ratios, despite significantly lower EPS growth (which again pushes the P/E ratio up), despite lower USD (which drives earnings higher).

This sequence suggests to us that equities are indeed taking account of risks. While valuations were, and still are, a concern, high valuation ratios alone are rarely a catalyst for de-rating. The environment is one that is supportive of equities: earnings growth is robust (even after the tariff induced downgrades we still expect high single digits EPS growth), margins are running at historical highs, so are RoEs, balance sheets are healthy, we have clear structural tailwinds that support equities (Artificial Intelligence, fiscal spending, etc), inflation is running at levels that benefit equities and rate cuts are providing further support. The environment does not seem to be one in which equities should adjust multiples lower.

The conclusion we arrive at is that it is too simplistic to assume equities are ignoring risks because they are no longer in negative territory year to date. Equities are indeed being held back by risks and uncertainty in our view, and in the absence of further geopolitical shocks or sharp re-escalation in trade wars, equities should see further upside in the second half of the year as uncertainty reduces and companies adapt to tariff headwinds. And while US economic exceptionalism might be in question, that has limited consequences for US equities, which can still benefit from the trends described above.

Figure 19. Earnings downgrades for US equities in April were the broadest since late 2022



Source: Aviva Investors, Refinitiv Workspace as at 30 June 2025.

The real source of exceptionalism in equities and the "un-broadening" risk

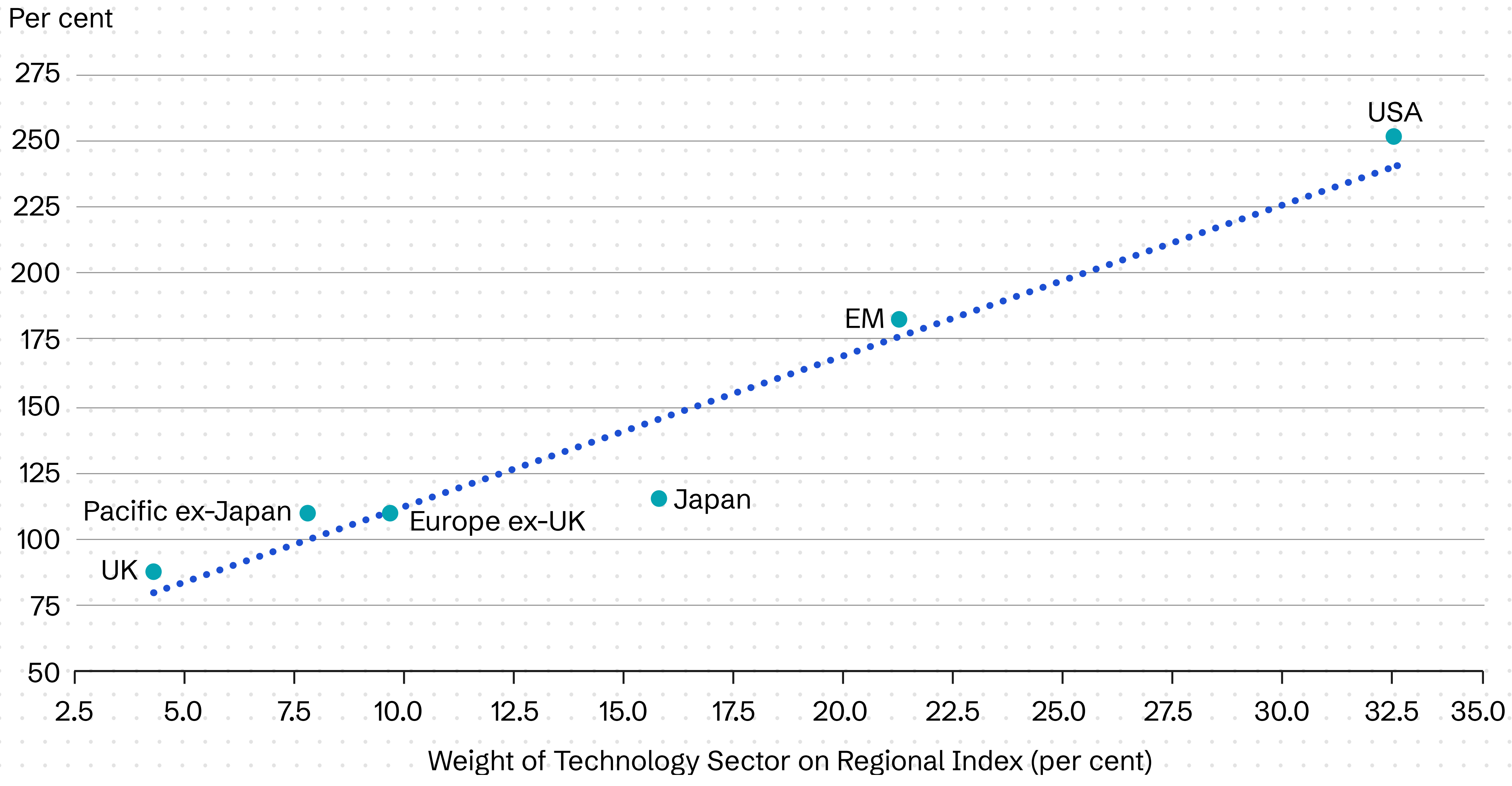
Looking within equities, we see the issue of market concentration again taking centre stage. Most market participants spent the past year discussing a "broadening out" of equity markets. While most of the rally and most of the earnings growth over the past two years was driven by a few stocks (Mag-7) and few sectors (Tech in particular); in more recent quarters we were seeing a clear broadening of earnings and a convergence where earnings for the Mag-7/Tech cohort were moderating and earnings for the rest of the market (which, had briefly dipped into negative territory in early 2024) were recovering.

The last earnings season and the recent macro developments, however, suggest to us that this broadening out process is at least partially reversing. A number of Mag-7 and other Tech companies appear to be surprising on the upside and showing more resilient earnings growth than anticipated. Meanwhile, the recovery in earnings for much of the rest of the market is now in question due to tariffs and trade uncertainty.

Looking at that in the context of "US exceptionalism", we see the US equity exceptionalism and the US economic exceptionalism as separate issues. Ultimately, regional allocation decisions were of much smaller consequence over the last decade and a half than sector allocation decisions. The key allocation decision that would lead to long-term outperformance in the past decade or so was to invest in the Tech sector. The regional performance has been by and large a consequence of how much Tech a given regional index has (Figure 20). Even if we exclude the US from the figure on the right, the trend line remains virtually unchanged; among other regions, Tech remains the driver.

This suggests Tech was the true source of exceptionalism in equity markets, not the US. The US simply had significantly more Tech than all others. So, believing in a reversal of the exceptional performance of the US over the last many years is believing Tech stocks will no longer be the main drivers of growth, and market leadership will reverse to other sectors outside of Tech. To us that assumption is a step too far. While Tech outperformance is likely to be less pronounced going forward than in past years, we still see it a structural winner over the medium and long term.

Figure 20. Tell me how many Tech companies you have, and I'll tell you your performance



Source: Aviva Investors as at 30 June 2025.

> Regional allocation decisions were of much smaller consequence over the past decade and a half than sector allocation decisions. Regional equity performance was largely a consequence of how significant the Tech sector is within the regional index.

Fixed income: Curve steepening to continue

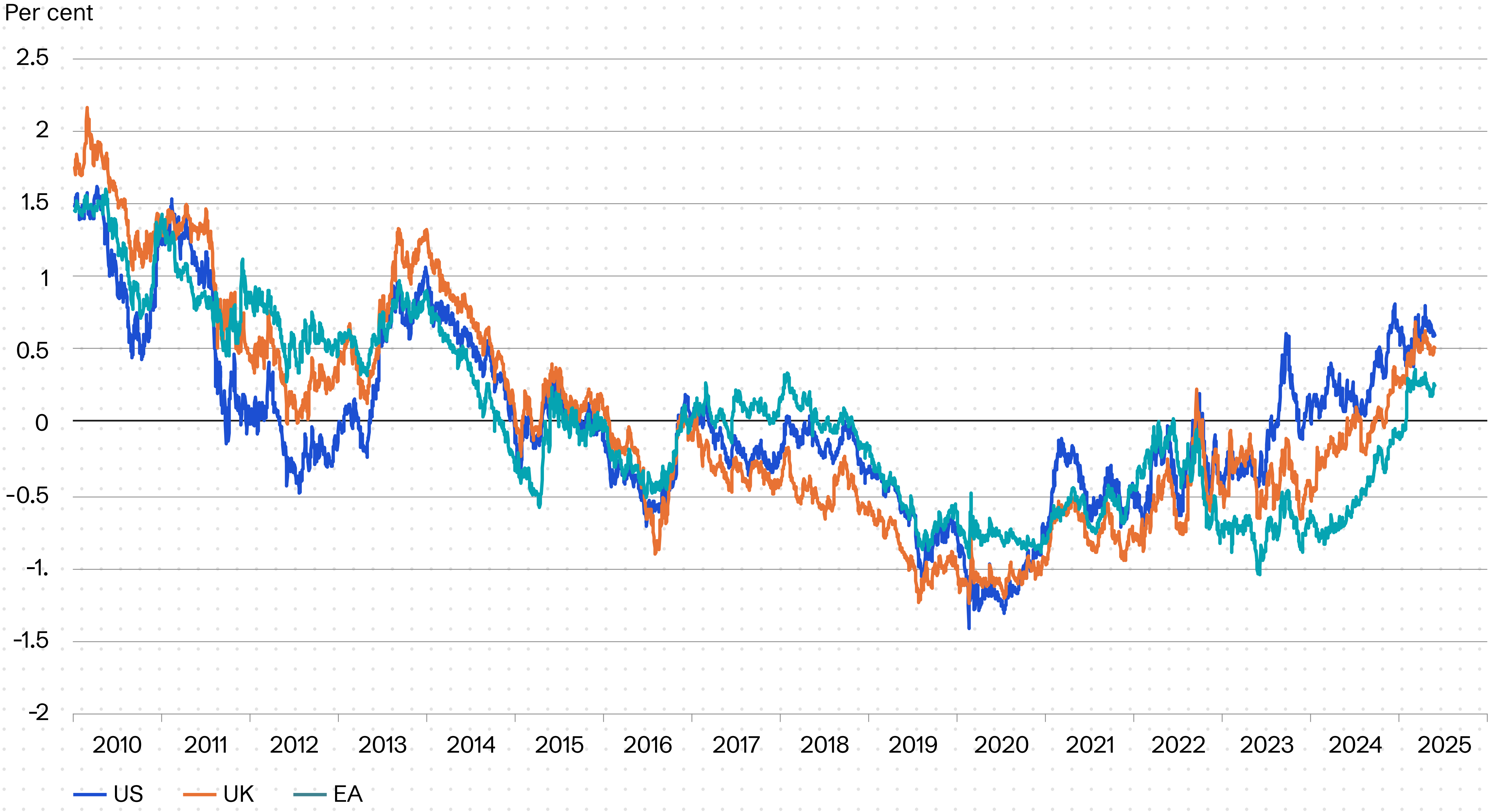
Despite term premia rising (mostly in the US), bond yields maintained familiar ranges in 2Q25, albeit with some divergence across regions. In the US, front-end rates have risen marginally, while the long end shifted higher, mostly due to higher risk premia, resulting in a steeper curve. In contrast, EA and UK yields moved lower, although for different reasons: slowdown concerns in the UK and flight to safety in Germany; the curve steepened further in the UK but remained broadly unchanged in core Europe, while peripheral spreads tightened due to upside surprises in growth metrics and euphoria over the upcoming fiscal packages. On balance, Japanese yields – while subject to increased volatility – have remained stable over the quarter, although the very long end (30Y) moved considerably higher.

We expect the theme of US exceptionalism erosion to continue playing out into the third quarter of this year, pushing US risk premia even higher. More specifically:

The US slowdown is priced but it can extend further at the short end of the curve. At the same time, we see the long end being pulled in opposite directions: lower due to US activity weakening but higher due to increased US risk premia (Figure 21). On balance, we have a bias for a slightly higher long end which together with our view at the front end means that we hold a high conviction in US curve steepeners (Figure 22).

In Europe, we think the short end could come under some upside pressure (we believe the ECB is done cutting rates) while seeing the long end here too subject to opposing forces: lower due to flight to safety and higher due to the German/EU fiscal packages. In the end, we believe long yields in Europe will gravitate higher due to higher deficits and that peripheral spreads could tighten a bit more. We expect curve steepening here too, although more modest compared to the US due to the short end remaining well anchored.

Figure 21. 10Y risk premia on the rise



Source: Aviva Investors, Macrobond, Bloomberg as at 30 June 2025.

> We expect the theme of US exceptionalism erosion to continue playing out into the third quarter of this year

In the UK, we expect the front end to outperform while the long end will end up being a function of the beta to the US and the autumn budget announcements. If fiscal rules are modified, there is potential for more risk premia to be priced and push long-end yields higher, steepening the curve further.

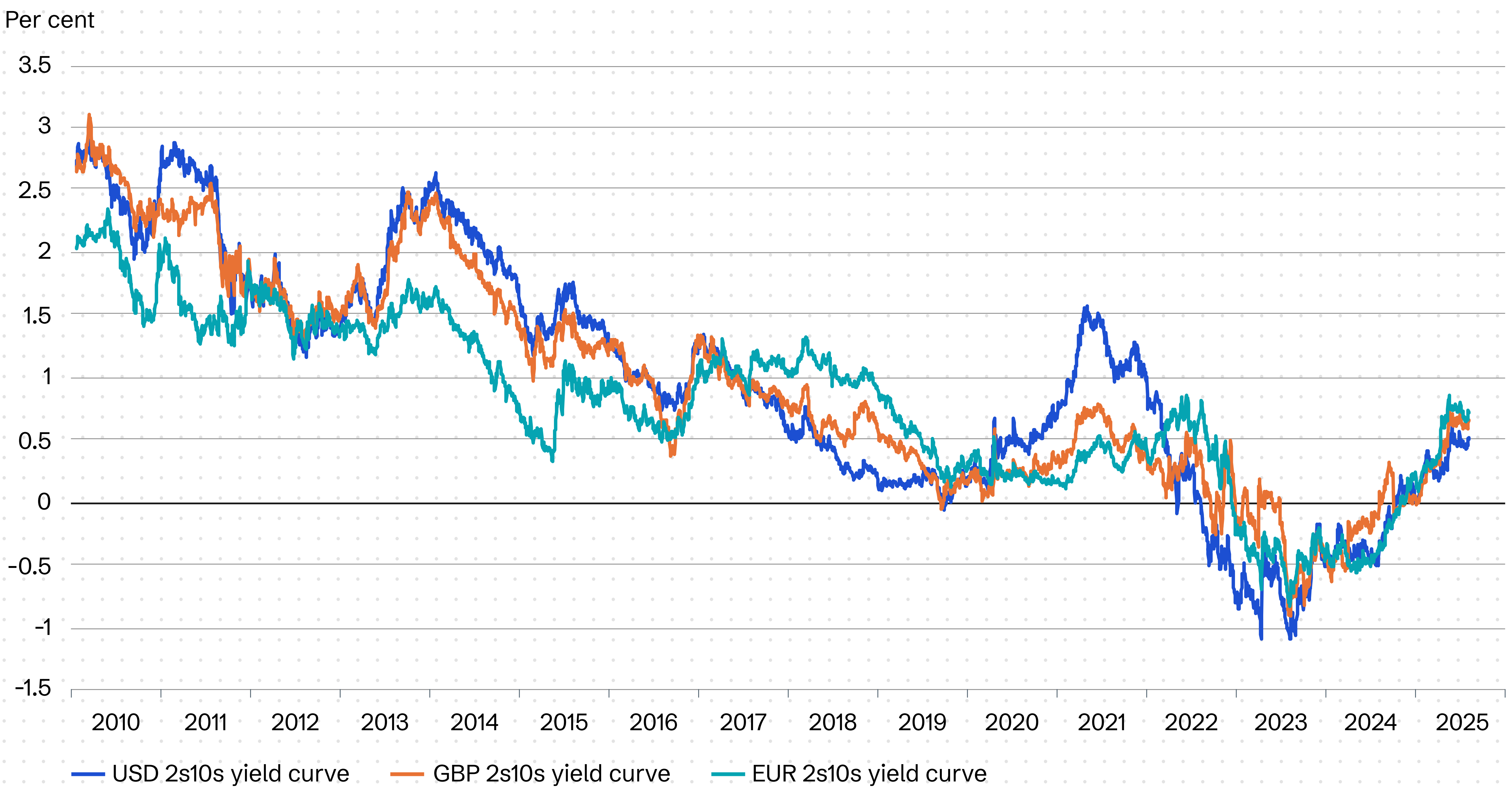
In Japan, we expect long-end flattening of the curve as it seems likely that the government will switch issuance from longer-dated bonds to shorter-dated ones. Monetary policy is firmly on a (cautious) tightening path, although we acknowledge that the timing remains highly uncertain.

Turning to credit, it has largely recovered post the Liberation Day volatility, with spreads close to pre-tariff tights. However, there is a feeling that current spread levels do not compensate for the wide range of macroeconomic risks that may come to fruition over the next quarter. These risks are finely balanced against an incredibly strong technical support in credit markets. This is comprised of relatively light investor positioning, high levels of coupon income and still positive inflows (though less immense versus 2024). Summer also provides a period of seasonally stronger risk markets and lower credit supply, reinforcing this technical.

Company fundamentals currently remain resilient though on a continued lower trajectory, while uncertainty around tariffs continues with certain sectors potentially more at risk such as autos and healthcare. Overall, we maintain a cautious stance with a broad preference for European over US credit, with the former likely seeing lower default rates in the HY space. We prefer quality positioning though still like carry in our portfolios, with key overweights in banking and communications.

The main risk to our views would be a reacceleration in US activity that would force the market to reprice the Fed terminal rate higher; it would also lead to US credit outperforming global/European peers.

Figure 22. Curves are steepening but not too steep by historical standards



Source: Aviva Investors, Macrobond, Bloomberg as at 30 June 2025.

> In credit, there is a feeling that current spread levels do not compensate for the wide range of macroeconomic risks

FX: Erosion of US exceptionalism to drive the dollar further lower

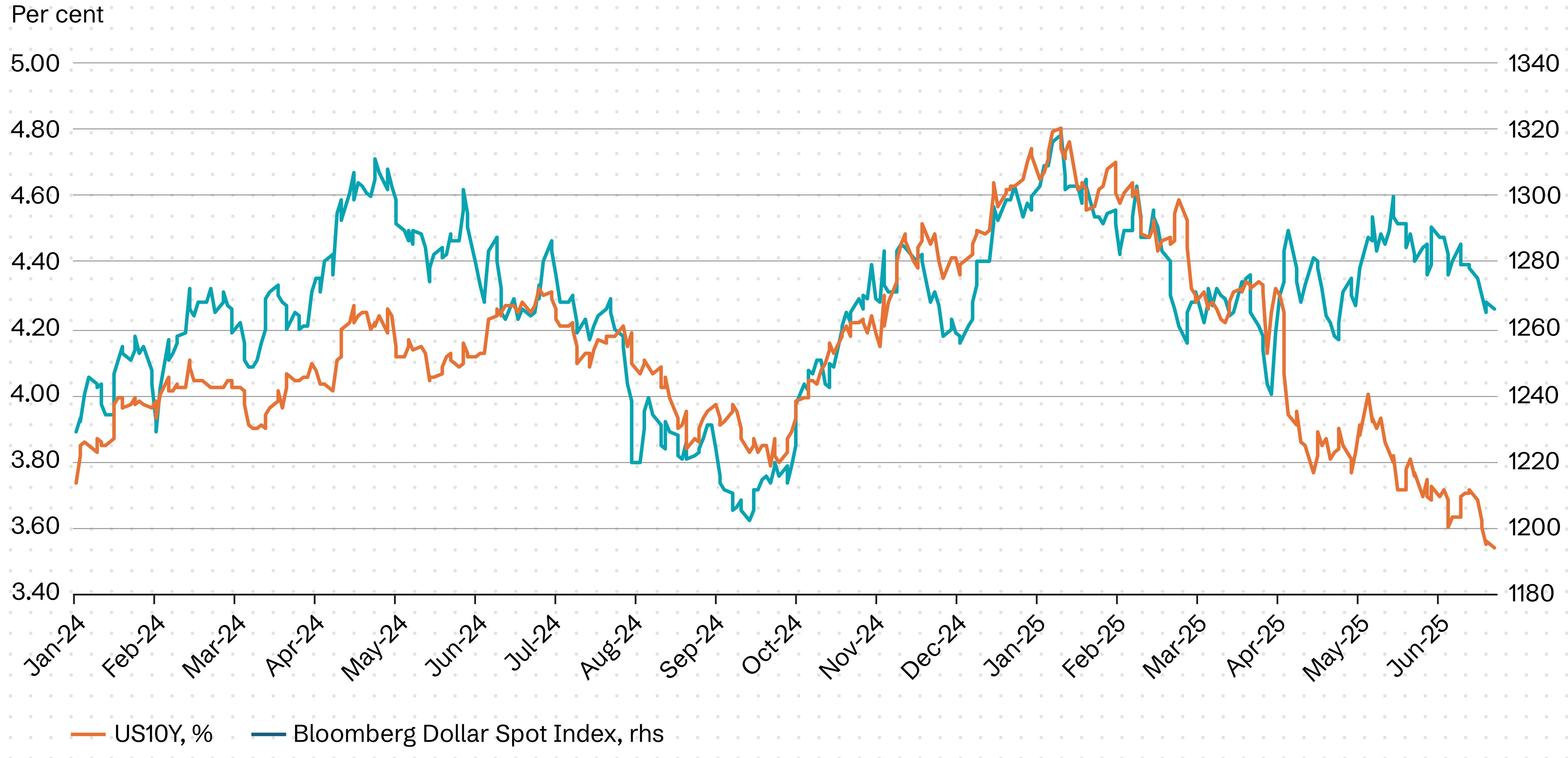
In our previous House View, we fleshed out a bearish dollar view predicated on (1) the German/EU fiscal expansion and (2) the erosion of US exceptionalism on the back of the tariff (and other policy measures) rollercoaster. Things have played out in line with this view, and we continue to expect further dollar weakness ahead. More specifically:

Since mid-Jan the trade-weighted USD has declined by c.9 per cent. However, while dollar depreciation came hand-in-hand with US yields declining until early April, US yields have moved sharply higher since “Liberation Day” but the USD weakened further (one can reach a similar conclusion if looking at the yield spread vs G10 economies) see Figure 23. This confounds “market logic”: aren’t interest rates / rate differentials supposed to be the fundamental driver of currency markets?

One interpretation is that equity flows have been the main driver: as the market prices out US exceptionalism, it diverts equity allocations away from the US and into other developed markets putting pressure on the USD. While there is some validity in this argument, we would highlight that, for example, the EURUSD has decoupled from relative equity performance since May suggesting that equities have not been the main driver of the move recently. In fact, we think that USD weakness is much broader than equity flow reshuffling and related to underlying risk premia.

For starters, large equity allocators do not shift materially their (strategic) asset/country allocation in such short periods of time. Second, we suspect that instead of actual equity flows, a driver for the currency has been (the more flexibly adjusted) hedging ratios: for years now, US equity strength and dollar appreciation coincided which provided little incentive to efficiently FX hedge US equity allocations; as investors reassess US exceptionalism they might have been increasing their FX equity hedges resulting in a pressure point for the dollar.

Figure 23. The dollar has diverged materially from US yields since “Liberation Day”



Source: Aviva Investors, Macrobond, Bloomberg as at 30 June 2025.

We continue to expect further dollar weakness ahead

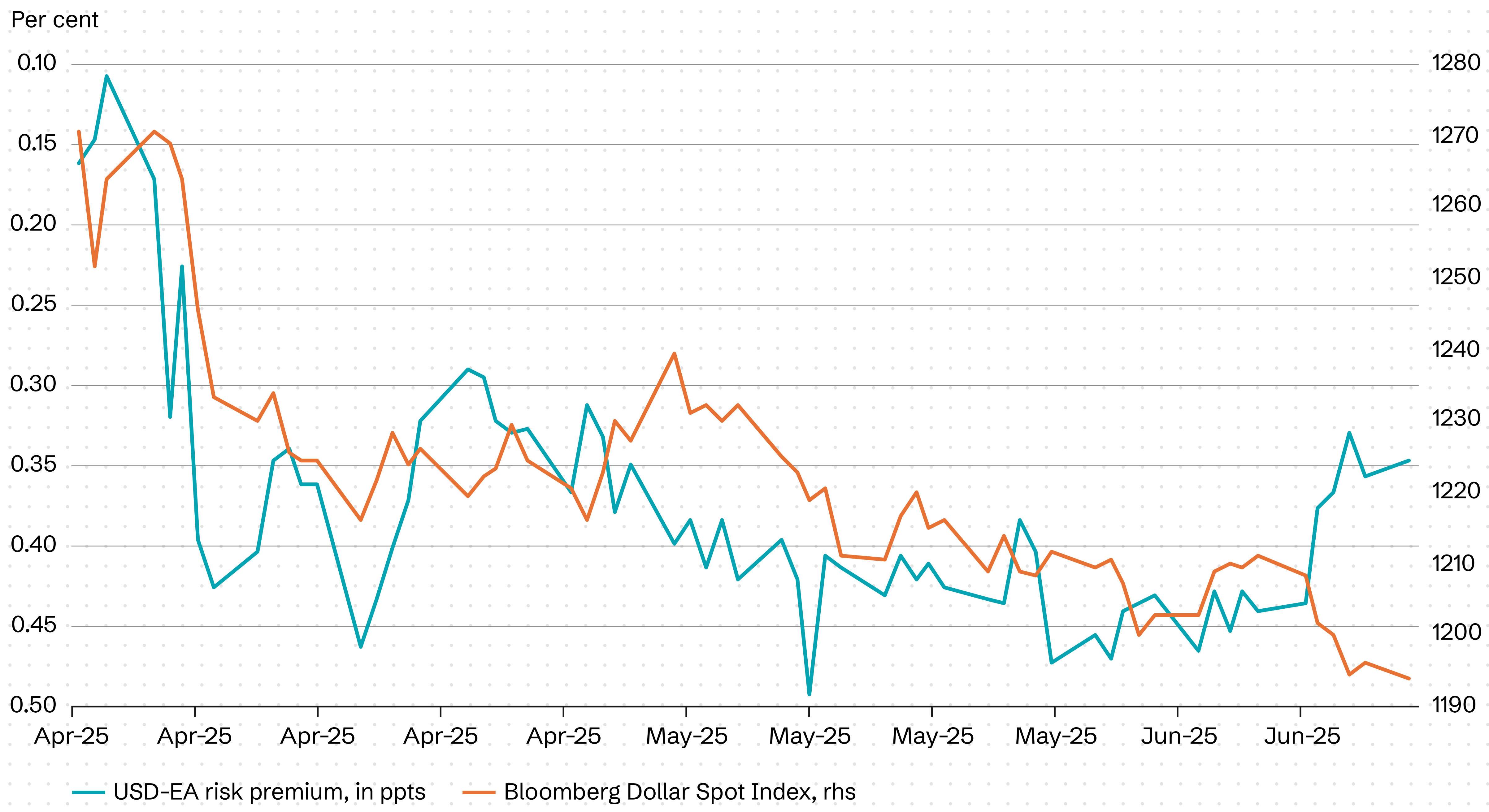
Which brings us to our last – and more important – point: risk premia. The US has been enjoying an exorbitant privilege for decades, with higher issuance being matched by foreign investors' appetite for US paper. This is now shifting, with the US likely to run large fiscal deficits for years without a commensurate fiscal impulse – and against a backdrop of an extended net international investment position. All this is agitating markets, who to continue to lend to the US, would require a combination of higher yields and a weaker exchange rate for compensation. In other words, the erosion of US exceptionalism is driving the US risk premium higher and is weighing on the value of the dollar. Indeed, our estimate of the US10Y risk premium has correlated rather well with the dollar movements since April (Figure 24).

We have seen similar stories during the euro area debt crisis and in the UK in 2022. During these periods, risk premia in the EA and the UK rose sharply by at least 100 basis points. Since "Liberation Day", they have risen some 35 basis points in the US by our estimates. Disruptive trade and more broadly institutional policies are unlikely to contain the rise in US risk premia. It seems to us that USD weakness has much more room to run.

We believe the main beneficiary will be the euro, and the yen to a lesser extent as long as the stagflationary theme plays out in the US. This backdrop should help EM currencies continue to perform well, particularly against the USD, where the ELMI+ index has gained over 9 per cent in H1. Carry is a strong driver, with high real yields in many countries providing a cushion even if FX rates are stable; on the rates side, most central banks have room to lower rates modestly and this should support some additional bond price gains, particularly in LatAm and CEE. Brazil and Turkey stand out as high beta high-yielders. Taiwan's experience exemplifies what large, unhedged USD exposures can precipitate when the tide turns: the currency surged 11 per cent in Q2, and implied yields are severely negative, indicating appreciation pressure persists.

The main risk to our bearish dollar view would be an acceleration in US activity which would then – in tandem with inflation – result in markets pricing out Fed rate cuts and restore some or all of the positive correlation between US yields and the dollar.

Figure 24. Relative risk premia an important driver of the dollar



Source: Aviva Investors, Macrobond, Bloomberg as at 30 June 2025.

> We believe the main beneficiary will be the euro, and the JPY to a lesser extent as long as the stagflationary theme plays out in the US

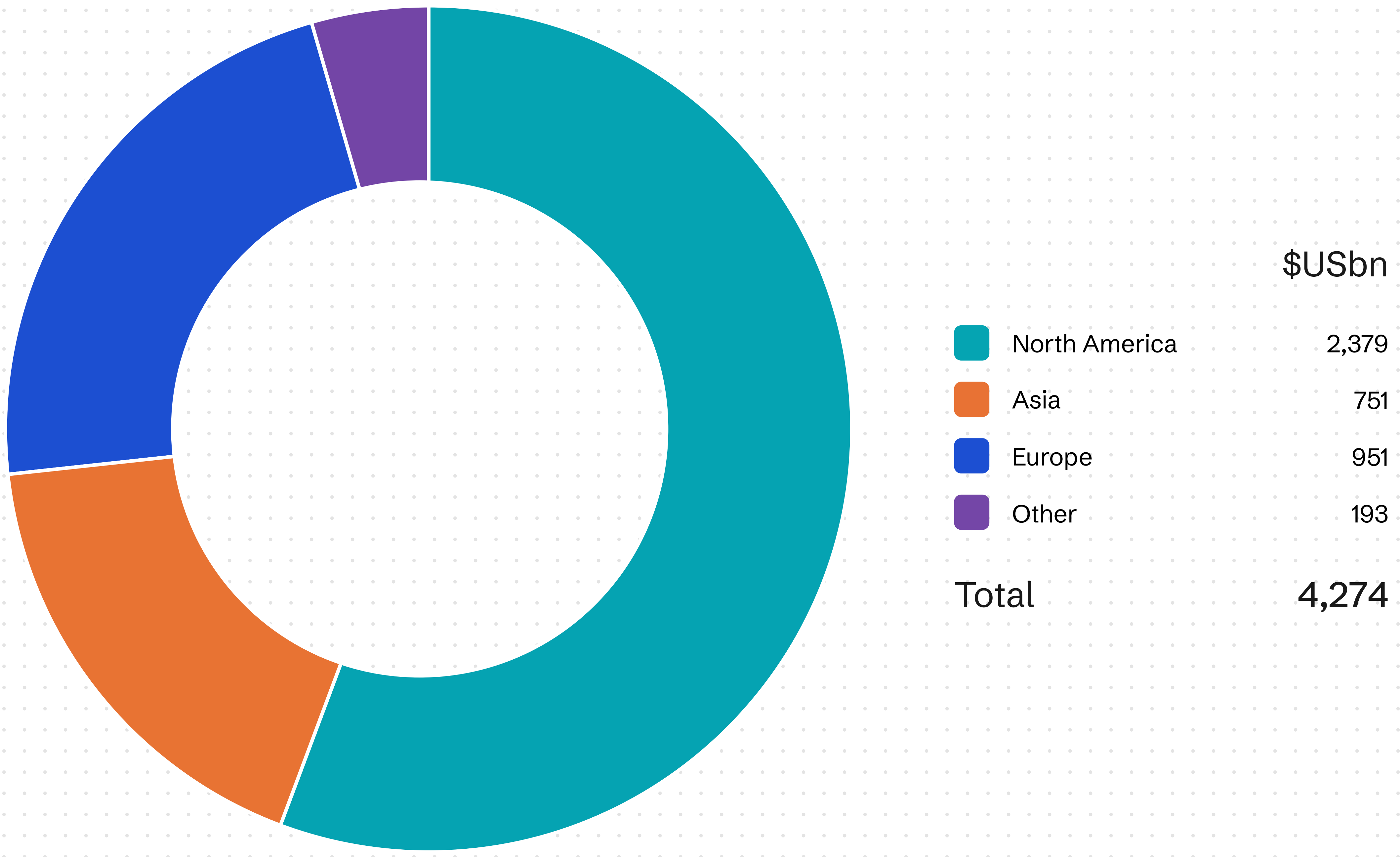
Private markets outlook 2025: trends, diversification and illiquidity premium

In a year marked by macroeconomic and geopolitical uncertainty, private markets can offer investors a diverse mix of opportunities with exposure to long-term structural thematic trends and illiquidity premium.

The Aviva Investors Private Markets Study 2025 reveals a deepening conviction in the asset class: over 70 per cent of institutional investors expect private markets to outperform public markets over a five-year horizon. This conviction is not merely cyclical; it reflects a structural shift in how investors are approaching portfolio construction in a world of heightened volatility and evolving risk premia.

At the same time, the growing narrative around the erosion of US exceptionalism is prompting a reassessment of global capital flows. Outside of the US, Europe (Figure 25) holds the largest pool of private markets dry powder (committed capital that has not yet been called for investment).

Figure 25. Global private markets dry powder (US$ bn)



Source: Preqin, as at 30th June 2025. Latest available data point September 2024.

Private debt: multi-sector opportunities

Investor appetite remained robust through Q1 2025, particularly in real estate debt, where larger transactions gained traction and liquidity conditions improved. Despite ongoing macroeconomic uncertainty, property investors were active across both acquisition and refinancing strategies, supported by a broad base of capital from banks, debt funds, and institutional investors. Lenders demonstrated a greater willingness to underwrite larger commitments than in the same period last year, leading to tighter loan margins and higher advance rates – especially in whole loans and higher-yielding segments, a trend we would expect to continue with the rates environment becoming more accommodating.

Infrastructure debt also remained resilient, with European issuance reaching £30 billion in Q1, including £8 billion from the UK alone. Against a backdrop of elevated public debt levels, infrastructure investment is increasingly viewed as a lever for economic growth, energy transition, and digital transformation. The asset class continues to benefit from strong policy alignment and a growing need to bridge the infrastructure funding gap.

In the structured and corporate debt space, the recent market volatility and uncertainty created opportunities for attractive entry points. Spreads widened across private and sub-sovereign issuers, particularly in the wake of tariff-related market dislocations. Investment-grade borrowers remained active, supported by stable base rates, while sub-investment-grade markets experienced a liquidity squeeze – most notably in high-yield segments. This resulted in spreads widening and illiquidity premia increasing for opportunistic capital. Defensive sectors such as healthcare and consumer staples have emerged as relative safe havens. For example, the CLO market responded swiftly to the post-"Liberation Day" volatility, with BB tranche spreads widening and illiquidity premia increasing for opportunistic capital.

We remain constructive on the relative value offered by private debt. The higher-rate environment continues to support attractive all-in yields, while illiquidity premia remain compelling – particularly in the sub-investment-grade space, where bank and insurance competition is limited. In contrast, investment-grade private debt has seen premia compress toward long-term averages amid increased bank activity.

As dispersion increases across sectors and structures, we believe a multi-sector approach – anchored in disciplined underwriting and active risk selection – will be key to capturing value in 2025 and beyond.

Infrastructure equity: megatrends meet market tailwinds

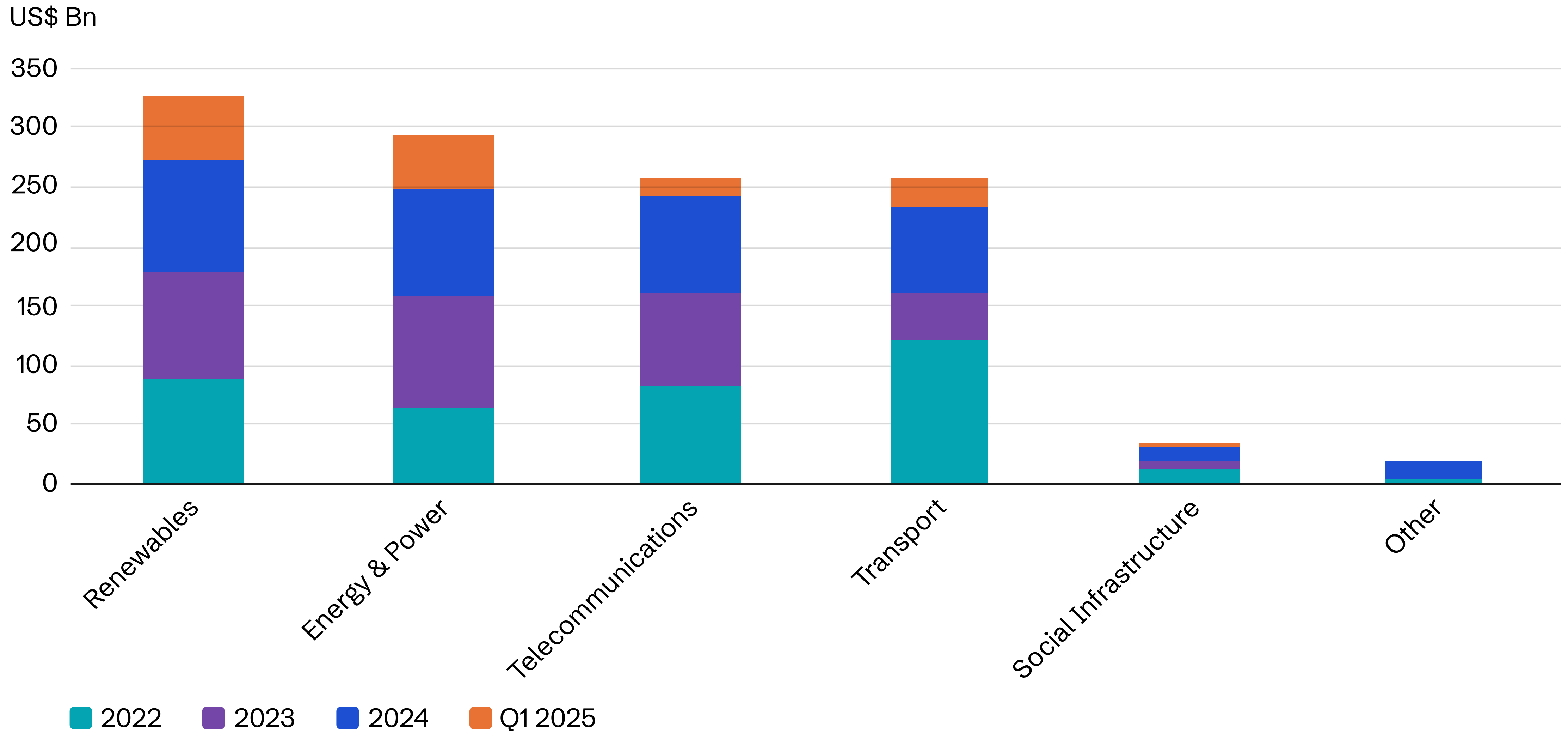
The macroeconomic environment is once again tilting in favour of infrastructure, with central banks easing policy and government bond yields having likely peaked. After a prolonged period of negative real yields that increased the attractiveness of private assets and drove up asset pricing, the move into positive territory prompted a necessary correction across infrastructure valuations over the last 18 months. That repricing phase, while uncomfortable, has laid the groundwork for a more sustainable and attractive entry point.

Today, economic growth remains subdued but stable, and inflation, though still above target, is moderating. Against this backdrop, infrastructure stands out as a beneficiary of both cyclical and structural forces. We expect valuation multiples on equity investment to expand, driven by a considerable volume of capital targeting European Infrastructure, particularly in sectors aligned with long-term megatrends (Figure 26). From a top-down perspective given the macro outlook, we remain positive on the asset class.

Nowhere is this more evident than in the renewables sector, which continues to dominate capital flows. Q1 2025 saw strong investment volumes, extending a three-year trend. Energy security has become a central pillar of domestic policy across Europe, while net-zero commitments and decarbonisation targets are driving sustained demand for clean energy infrastructure. Technological advances are also improving project economics, enhancing both scalability and efficiency.

We believe the electrification theme, particularly the surge in electricity demand from data centres, offers a compelling opportunity. Investors can gain exposure through renewable generation and battery storage, both of which are attractively priced relative to their growth outlook. Looking forward we see infrastructure not just as a defensive allocation, but as a forward-looking enabler of the energy and digital transitions.

Figure 26. **European infrastructure investment by sector**



Source: Infralogic, data as at 30 June 2025.

> Infrastructure stands out as a beneficiary of both cyclical and structural forces

Real estate equity: stabilisation and selective opportunity

Following a period of repricing and capital market dislocation, real estate markets have stabilised, revealing a more selective but compelling opportunity set. Investors are increasingly focused on sectors aligned with long-term structural trends where fundamentals remain robust despite broader macroeconomic uncertainty. In the near term, we expect income to be the primary driver of performance, with sectors demonstrating strong rental growth positioned to outperform.

The European Living sector exemplifies this dynamic. Structural undersupply, demographic tailwinds, and affordability pressures are keeping renters in the market for longer, particularly in urban centres where homeownership is increasingly out of reach. High mortgage costs and tight credit conditions have reinforced this trend, sustaining demand for high-quality, professionally managed rental housing.

In the UK, Single Family Housing (SFH) remains a conviction theme. There has been a persistent shortfall in homebuilding relative to government targets for a decade, resulting in strong demand. As traditional housebuilders retreat from high-cost commuter markets, institutional capital is stepping in to meet demand. We see this as a long-term core allocation opportunity, with growing appetite from investors seeking stable income and exposure to resilient residential fundamentals.

In Spain, Multi-Family is gaining traction in dynamic urban centres such as Barcelona, Madrid, Palma, and Valencia. These markets are characterised by strong rental growth, driven by urbanisation and inward migration, alongside limited new supply. The combination of supportive fundamentals and attractive entry pricing is creating a compelling investment case for long-term capital.

Logistics and warehousing remain supported by long-term structural trends, even as trade uncertainty and geopolitical risk reshapes global supply chains. While the sector is arguably the most directly exposed to the impact of tariffs within real estate, this is expected to accelerate a bifurcation in performance, a dynamic that was already beginning to take hold. Markets with high exposure to cross border trade are likely to face cyclical headwinds, particularly where reliance on global throughput leaves them vulnerable to policy shocks. In contrast, domestically oriented logistics hubs are expected to benefit from thematic trends in e-commerce, reshoring, and inventory diversification. These forces are driving sustained demand for modern, energy-efficient assets, with prime locations continuing to command rental growth and attract long-term capital.

> We see value in sectors aligned with long-term structural trends, such as living and industrial, where fundamentals remain robust despite broader macroeconomic uncertainty

Figure 27. **Asset allocation**

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Equities								2			
US								2			
Europe								2			
UK						0					
Japan						0					
Pacific Basin ex-Japan						0					
Emerging Markets							1				
Nominal Government						0					
US						0					
UK							1				
Eurozone					-1						
Japan					-1						
Australia						0					

	Underweight										Overweight
	-5	-4	-3	-2	-1	0	1	2	3	4	5
Credit						0					
US Investment Grade					-1						
European Investment Grade						0					
UK Investment Grade						0					
EUR High Yield							1				
US High Yield					-1						
Emerging Govt (Hard Currency)							1				
Emerging Govt (Local Currency)							1				
Cash						0					
Currencies (versus US$)									3		
GBP						0					
EUR									3		
JPY									3		
AUD						0					
EM FX								2			

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 30 June 2025.

Webcast

House View Q3 2025

24 July 2025 | 15:00 BST | 45 MINS

Register now for our House View Q3 2025 webcast hosted by Peter Smith (Senior Investment Director), who will be joined by David Nowakowski (Senior Strategist), Dean Cook (Multi-Asset Fund Manager), and David Hedalen (Head of Private Markets Research), as they delve into the big macro themes, opportunities and risks impacting asset allocations.

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AVIVA INVESTORS

Contact us

80 Fenchurch Street,
London EC3M 4AE
+44 (0)20 7809 6000

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