Investment Views

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BUTTERFIELD

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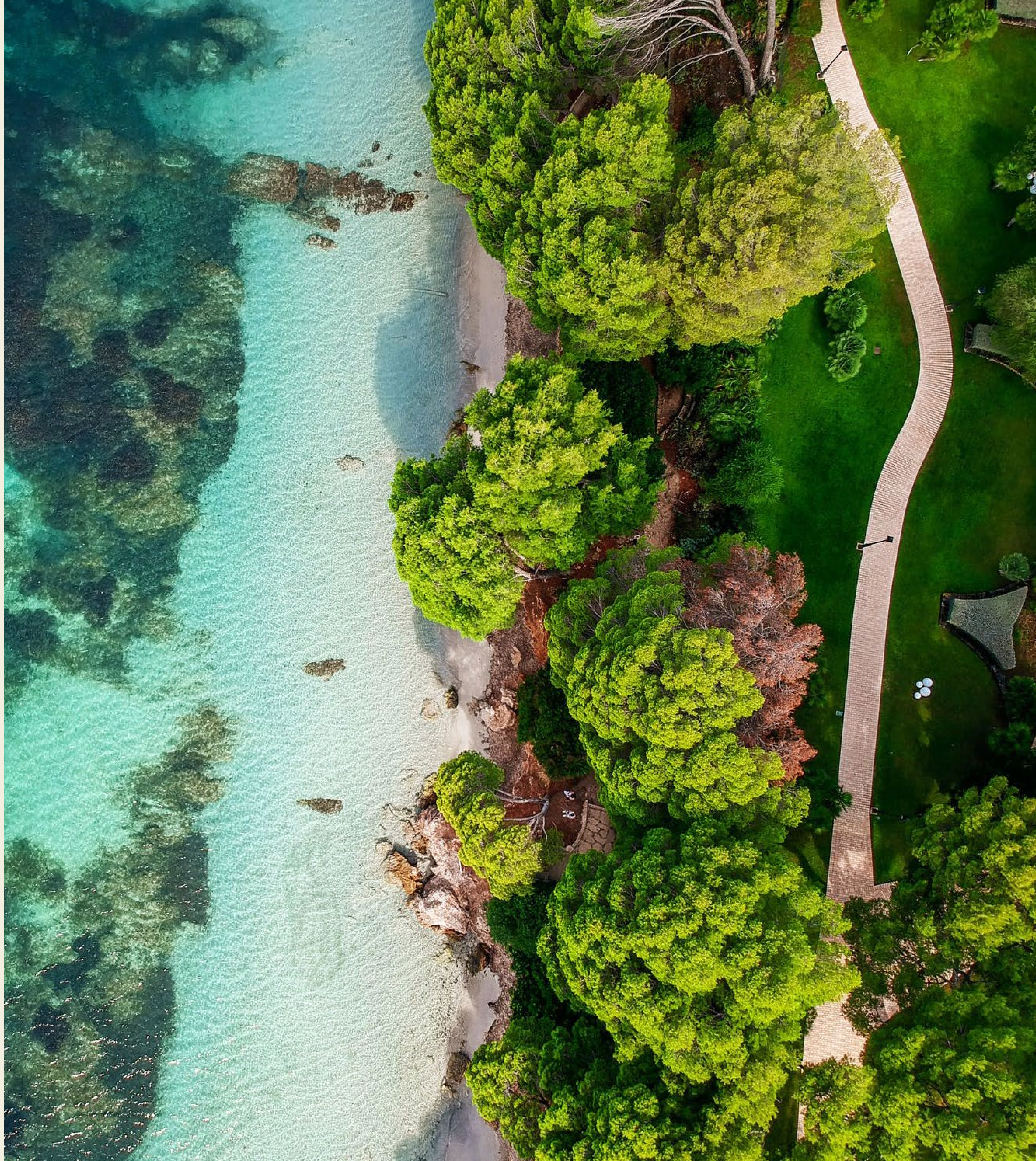
Moving Fast and Breaking Things

- Erratic US tariff policy unsettles markets
- Government spending cuts may lead to a “detox period”
- Strong start to the year for European and Chinese equities

In the early days of Facebook, founder Mark Zuckerberg had an internal motto: “Move fast and break things.” This philosophy encouraged a culture of rapid innovation and aggressive experimentation, even if it meant making some mistakes along the way. It speaks to a broader culture in Silicon Valley, where early-stage companies aim to disrupt established industries quickly before competitors bring competing products to market.

Historically, Silicon Valley has been more supportive of Democratic administrations. However, that has changed. Tesla CEO Elon Musk



was a pivotal figure in President Trump's election campaign, with other high-profile leaders in the technology sector publicly supporting the new Republican administration. Many attended Trump's inauguration and were given prominent roles.

The first 100 days in office is often seen as a benchmark for a new administration, and President Trump wasted no time in implementing his agenda. His campaign promises were wide-ranging and included positive measures for equity markets, such as tax cuts and deregulation, but also risks, such as trade tariffs. What has become increasingly clear in the early weeks of his presidency, is that Trump aims to fundamentally reset the relationship between the US and the rest of the world in terms of both trade and foreign policy. Furthermore, his administration also aims to reduce the size of government in favour of the private sector.

Prior to the inauguration, there was significant debate about whether tariffs would be used as a negotiating tool with other countries or whether they were ultimately intended to rebalance trade and raise revenue. This debate is ongoing, but we have seen some erratic trade policies including tariffs imposed on allies such as Canada with more threatened in early April. Tariffs have also been applied to additional imports from China, although this was expected.

Musk has been appointed as an unofficial leader of the Department of Government Efficiency (DOGE), established in January by an executive order and tasked with cutting government spending and improving efficiency in federal departments. With an elevated budget deficit at around 7%, it is widely accepted that government spending should be reduced. However, the nature of some of the cuts has created significant uncertainty and pushed the boundaries of presidential power, leading to legal challenges.

The combination of uncertainty from tariffs and efforts to cut government spending has made the outlook for the US and global

economy bumpier than anticipated. Trump recently noted, “there will be a little disturbance, but we’re okay with that,” while the Treasury Secretary stated, “there’s going to be a natural adjustment as we move away from public spending to private spending… there’s going to be a detox period”.

Recent survey data are now flashing warning signs, highlighted by a disappointing consumer sentiment survey from the University of Michigan. Confidence, income expectations, and inflation have all moved in the wrong direction. Wall Street has wasted no time downgrading growth forecasts, with Goldman Sachs trimming its 2025 GDP estimate from 2.4% to 1.7% and JP Morgan from 1.9% to 1.6%. Inflation forecasts are also being revised higher due to tariffs.

Moving fast and breaking things can work at start-up companies where disruption is the objective, but when it comes to government and trade policy, it can be highly disruptive. These are both very complex systems. Indeed, in 2014, Mark Zuckerberg moved away from the motto, replacing it with “move fast with stable infrastructure,” acknowledging the costs of making mistakes in a larger organisation.

It is possible that the US is transitioning to a streamlined government and a more efficient private sector with less regulation. It is also possible that aggressive trade policy will ultimately bring down barriers to trade, as other countries lower their trade restrictions to avoid US tariffs. However, we are witnessing a high-risk strategy that may erode US strength and cause long-term damage due to a less predictable operating environment and inconsistent rule of law. This uncertainty has had a detrimental impact on the US equity market and the US dollar. Meanwhile, European and Chinese equity markets have had a strong start to the year, reinforcing the need for diversification across both sectors and geographies.

Tariffs, Inflation, and Deficit Cuts

- Trump presidency brings heightened global economic uncertainty
- DOGE targets deficit reduction, limiting policy support
- US inflation expectations remain elevated due to tariff concerns

As we enter the Trump presidency, the coming four years appear poised to significantly reshape not only the US domestic economy but the economies of close allies and trading partners. Fixed income markets are currently grappling with the implications of potential US tariffs and substantial debt-funded defence spending in Europe, raising economic uncertainty to unprecedented levels. Coupled with already rich valuations, there is mounting concern about the possibility of further market volatility.

This heightened uncertainty is further intensified by limited policy support. The US administration is focused on shrinking the substantial fiscal deficit and the Federal Reserve faces challenges

in promptly responding to a resurgence in inflation. Against this backdrop, maintaining a strong emphasis on risk management remains crucial, especially as fiscal and monetary policies finally have the opportunity to align and complement each other rather than working at cross purposes.

Global bond markets are exhibiting divergence, with rising tariffs posing a threat to Canada's economic growth, thereby driving yields lower. In contrast, Japanese government 10-year bond yields have continued their ascent, reaching an 18-year high of 1.37%, driven by expectations of increased defence spending and strong macroeconomic data—an alarming development given Japan's debt-to-GDP ratio exceeding 200%.

Over the past month, US government bond yields declined, with the 10-year yield falling to 4.21% from an intra-month peak of 4.62%. With inflation expectations remaining relatively stable, this decline has mainly resulted from more dovish base rate expectations, now pricing in around 70 basis points of rate cuts in 2025 and a terminal rate of 3.8%, down from 4.1%. Despite increasing uncertainty, fixed income volatility has remained largely range bound, decoupling from equity volatility measures such as the VIX, which have risen. This stability, combined with lowered US growth forecasts and a negative correlation to risk assets, has also contributed to a reduction in the term premium.

Weaker US macroeconomic data helped drive the rally in yields, as payrolls, sentiment, consumer confidence, housing, and retail sales all fell short of market expectations. Consumer prices rose by 3% year-over-year, which was hotter than anticipated. However, given evidence of a consumer slowdown and weaker energy prices, inflation appears likely to remain on track towards the Fed's target. Nevertheless, ongoing tariff-related news continues to dominate headlines, keeping market-based inflation expectations elevated. DOGE-related expense reductions are also impacting government employees and we expect to see further increases

in the US unemployment rate, which fell back to 4% in January, with the employment multiplier effect impacting up to two private sector jobs for each government worker.

European politics also came into focus as Germany elected a new government, with a three-party coalition expected to be led by the CDU with support from the SPD and the Greens. This coalition is likely to remove constitutional fiscal constraints, enabling increased borrowing to fund significant boosts in defence spending and infrastructure projects - stimulus that is urgently needed, as European growth remains stalled. Ironically, however, a strengthening euro and rising bond yields could temporarily push the region back into recession, as most of the fiscal stimulus is not expected to positively impact growth until much later. Market expectations for European Central Bank policy now arguably appear excessively dovish, considering the potential for upward revisions in growth and inflation forecasts.

Portfolio positioning in our US dollar bond funds has been tactically overweight US duration, but at month-end, we shifted back to a neutral stance, considering current market pricing and awaiting additional evidence of a US slowdown. Australian duration remains attractive and serves as a hedge against an escalation in the China-US trade conflict.

In currency markets, we continue to hold a small overweight in the US dollar, along with the Swedish krone. The recent rally in the Japanese yen, which reached 150 against the US dollar, may prove vulnerable in the coming weeks given the pessimism already priced into US asset markets. While corporate credit markets currently lack value, our preference for quality means we selectively maintain exposure, expecting risk-adjusted returns to outperform riskier equity markets if a growth scare emerges in 2025.

Uncertainty Drives Markets Lower

- Defensive sectors outperforming
- The “Mag 7” has become the “Lag 7”
- Chinese Technology sector back in favour

The global equity market peaked in mid-February, with the MSCI World Index closing down only 0.7% for the month in US dollar terms. As of mid-March, the index has dropped another 5%, as tariff negotiations dent investor confidence. In February, we saw the first signs of a flight to safety, with the Consumer Staples sector rallying 4.9% and Healthcare and Utilities posting positive returns. The worst-performing sectors were cyclical ones, such as Consumer Discretionary and Communication Services. The Technology sector treaded water in February, having already lagged in January. US Treasury yields fell, which was beneficial for the Real Estate sector.

“US exceptionalism” has been called into question, with the US lagging behind European markets. Smaller company stock prices

took a hit and continue to underperform. The lower yields seen in February were not enough to offset the drop in investor confidence and the growth scare stemming from the trade war. The S&P 500 equal-weight index outpaced the S&P 500 market capitalization-weighted index, as the "Mag7" (Magnificent Seven: Alphabet, Amazon, Apple, Meta, Microsoft, Nvidia, and Tesla) became the "Lag7".

2024 was a strong year for equity markets, but the landscape has since changed. When Trump won the US presidential election, the US equity market rallied, confirming the consensus view that his presidency would be beneficial for the market. At the time, the economy was in a strong position and inflation was trending lower. The S&P 500 fourth-quarter earnings season was positive, with aggregate earnings surprises returning to historical highs and aggregate earnings growth reaccelerating into double-digit territory year over year.

Consensus earnings growth for the S&P 500 for 2025 was projected to be around 10%. President Trump was inaugurated on January 20th, and shortly afterward, the Chinese AI company DeepSeek announced they had developed a new AI model that required a lot less computing power than others. A week later, Trump introduced the first trade tariffs. Since then, policy uncertainty on the trade front has unsettled investors.

Consumer confidence appears to be weakening, and investors are now questioning whether Trump is, in fact, good for equity markets. Concerns about a US recession have resurfaced, leading some analysts to trim their year-end price targets for the S&P 500. Gold is reaching all-time highs, small-cap stocks are declining, and bonds are rallying. The US administration insists that this weakness is temporary and that the economy is undergoing an adjustment phase. As the year progresses, markets will be closely monitoring earnings revisions and corporate commentary.

10%

The percentage that is projected Consensus earnings growth for the S&P 500 for 2025.

On the flip side, there appears to have been a thawing in relations between the Chinese government and the Chinese technology sector. Alibaba founder Jack Ma was recently pictured at a high-profile event, which may signal an important shift, given that he had largely withdrawn from public life since 2020.

The recent sell-off may provide a good entry point for sectors and stocks with favourable long-term structural themes. One such theme is Artificial Intelligence (AI). The MSCI World Semiconductors Index has significantly underperformed the broader index since the correction, partly due to recession fears, but also in response to the DeepSeek announcement, which raised concerns about US technology leadership. Despite these fears, deployment of AI technology is gaining traction, and companies have reiterated their commitment to investing in this fast-growing sector. Rather than attempting to predict policy moves, we have been focusing our efforts on exposure within equity allocations.

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Global Asset Allocation

The chart below details our 6-12 month tactical investment strategy

	UNDERWEIGHT -	+ OVERWEIGHT
Asset Allocation	EQUITIES (MODEST UNDERWEIGHT)	CASH (MODEST OVERWEIGHT)
Fixed Income		EMERGING MARKET DEBT INFLATION PROTECTION
Equities Regional		JAPAN EMERGING MARKETS EX CHINA
Equities Sector	CONSUMER DISCRETIONARY	UTILITIES HEALTHCARE

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