Severance: The Split Between the Economy and the Markets

As global markets diverge from economic fundamentals, investors face a landscape shaped by tariffs, policy uncertainty, and shifting regional opportunities.

Key Points

- **Peak tariffs appear to be in the past, but policy uncertainty is still a factor in our view on risk.** We expect lower growth and higher inflation as tariffs eventually weigh on consumers and businesses. While that's not a great environment for risk assets,[1] we see a low risk of recession and think fundamentals continue to support a slight overweight in global equities relative to bonds.
- **We continue to see relative advantages to equity markets outside the US that may benefit from fiscal stimulus**, including Europe and Japan, and from a longer-term trend of declining US exceptionalism. We have a neutral view on European and emerging-market (EM) equities, a moderately overweight view on Japan, and a slight underweight view on the US.
- **We have a neutral view on duration,[2] and a slight overweight view on credit.** The Federal Reserve (Fed) and markets remain in a "wait and see" mode, as they gauge the effect of tariffs on growth and inflation. Thus, we don't see much opportunity in an outright duration view and prefer to take advantage of mispricings in regional bond markets. While spreads[3] have tightened, high yield has earned decent carry[4] with low refinancing risk.
- **We have an underweight view on oil, as we think the market may be in a surplus this year, as OPEC slows production cuts.** Tensions in the Middle East could upend this view by increasing the risk premium[5] for oil. However, we expect the geopolitical flare-up to fade. We maintain our overweight view on gold, given central-bank demand and the metal's potential to protect against stagflation (weak growth and high inflation).
- **Downside risks** include a supply-induced spike in inflation due to tariffs or a sustained rise in oil prices, which could crater global growth; policy uncertainty, which could slow economic activity and raise the risk of a US recession; and an escalation of geopolitical tensions. **Upside risks** include reasonable US trade deals with Europe and Japan; the passage of a US budget deal that reduces taxes and regulation; and a jump in US productivity that increases growth potential without higher inflation.

Since President Donald Trump shook the markets with his Liberation Day tariff announcement in early April, risk markets have climbed the proverbial wall of worry, with stocks bouncing back from double-digit sell-offs. Multiple rounds of tariff threats and walk-backs taught markets that the pattern of threat/détente will probably continue, but the worst-case scenario may be behind us.

Insight from sub-adviser Wellington Management

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Meanwhile, consumers and businesses are hanging in there. Lower-income consumers are under some stress, but higher-income consumers continue to spend. And first-quarter corporate earnings surprised to the upside, especially in technology. The wake-up call from the US administration to other nations to boost spending has resulted in more fiscal stimulus in Europe and Japan. Finally, the inflation bogeyman hasn't come out yet, perhaps because demand is easing.

Against this backdrop, we have a slightly pro-risk stance on equities and credit, assuming a base case of slower growth and sticky inflation. Our caution stems primarily from policy uncertainty, which is weighing on economic activity, but also from the less-discussed impact of immigration restrictions that have shrunk the labor force, a reversal relative to the past few years. We see better value in regional plays in equities and credit and are particularly focused on these relative opportunities. With a nod to the TV series *Severance*, we're on the lookout for markets with "innies and outies"—that is, disconnects between the economy and markets.

For example, recent narrow gains in US equities, on the back of better-than-expected mega-cap tech earnings, have returned valuations to "priced for perfection" levels. As a result, we have an underweight view on the US relative to other regions where we expect the valuation gap to narrow. While Europe has enjoyed the best performance among developed markets (DM) year-to-date, we think it may be Japan's turn to rise, with substantial fiscal stimulus already enacted and more good news on corporate governance. We're also more open to the potential for EM equities to outperform the US, driven partly by improvements in China. Technology innovation and investments in green industries are shifting China's growth engine away from real estate, while fiscal stimulus appears to be boosting consumer spending.

Turning to government bonds, we're most interested in the disparate stances of central banks, as each region's domestic economy is being affected differently by tariffs. We think the market is overly bearish on the UK's fiscal situation, and favor duration there relative to Europe, where the European Central Bank (ECB) has already delivered 175 basis points (bps)[6] of rate cuts over the past year, yet markets expect even more. We prefer a short-duration stance in Japan, where we think the Bank of Japan (BOJ) will finally deliver rate hikes in response to higher inflation, even as more fiscal stimulus could add to inflationary pressure. Despite tight spreads, we maintain our overweight view on high yield, which is supported by continued low default rates, higher-quality names, and limited supply.

Equities: It's All Relative

We retain our slight overweight view on global equities. We still expect positive earnings growth across all major regions and believe downward earnings revisions may have bottomed out, but we're cautious on valuations. The current tight equity risk premium suggests excessive optimism, in our view, and implies that tail risks are underpriced. While there are reasons for optimism, as noted earlier, the market seems to assume that tariffs and other policies will avoid causing any economic damage, and it's incorporating little geopolitical risk premium.

We maintain an overweight view on Japan relative to the US, thanks in part to the valuation gap between the two. Governance reforms in Japan are gaining momentum, boosting both return on equity (ROE) and corporate balance sheets. Japan has historically lagged in ROE compared to global peers, but this is changing and strengthening the argument for higher price-to-earnings multiples (**FIGURE 1**). Along with Europe, Japan has one of the highest levels of cash return to shareholders, through both dividends and buybacks. Policy—and specifically the potential for yen strength—could be a headwind, however, preventing us from taking a larger overweight stance against the US.

Our Multi-Asset Views

Asset Class	View	Change
Global equities	Moderately OW	—
DM government bonds	Neutral	—
Credit Spreads	Moderately OW	—
Commodities	Neutral	—
Cash	Moderately UW	—
Within Asset Classes		
Global Equities		
US	Moderately UW	↓
Europe	Neutral	—
Asian DMs	Moderately OW	↑
EMs	Neutral	—
DM Government Bonds		
US government	Neutral	—
Eurozone government	Moderately UW	↓
UK government	Moderately OW	↑
Japan government	Moderately UW	↓
Credit Spreads		
Global investment grade credit	Neutral	—
Global high yield	Moderately OW	—
EM debt	Neutral	—

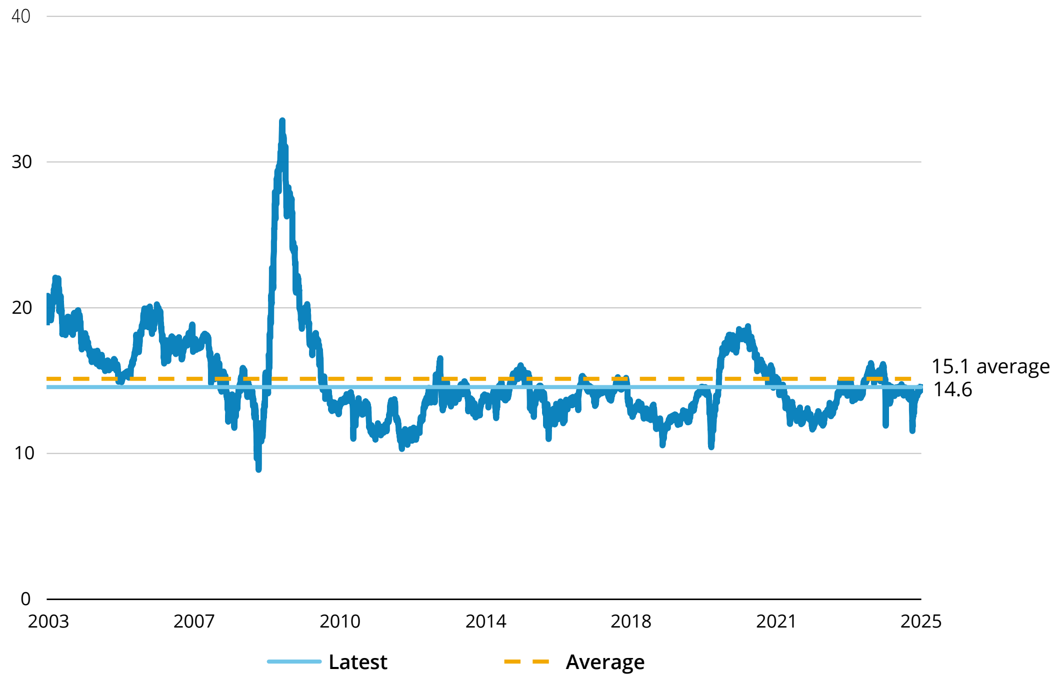
OW = overweight, UW = underweight

Views have a 6–12-month horizon and are those of the authors and Wellington's Investment Strategy Team. Views are as of 6/30/25, are based on available information, and are subject to change without notice. Individual portfolio management teams may hold different views and may make different investment decisions for different clients. This is not to be construed as investment advice or a recommendation to buy or sell any specific security.

FIGURE 1

Japan Is Building a Case for Higher Earnings and Multiples

12-Month Forward Price/Earnings



Daily Data: 6/30/03-6/27/25. **Past performance does not guarantee future results.** Indices are unmanaged and not available for direct investment. Index used: IBES MSCI Japan, which is a free-float adjusted market-capitalization index designed to measure large- and mid-cap Japanese equity market performance. The price-to-earnings ratio measures a company's share price relative to its earnings-per-share and helps assess the relative value of a company's stock. Data Sources: Wellington Management, MSCI, and Refinitiv.

High US valuations and the post-Liberation Day performance reversal reflect a skew to the most positive scenarios and contribute to our underweight view. Moreover, US market gains continue to be driven by the outperformance of a narrow group of the largest companies. We would prefer to see broader earnings growth and more widespread price trends. However, expectations for that broadening have been delayed. Companies are increasingly unable to pass through all the tariffs and may be forced to absorb some of the higher costs, which could dent profit margins.

We have a neutral view on European equities. We're positive on prospects for economic multipliers from the fiscal expansion underway in Germany, which provides some support for European equity valuations. However, earnings-per-share growth[7] may take time to materialize, particularly with currency strength weighing on foreign earnings. Key uncertainties also remain, including progress in trade negotiations.

We also have a neutral view on EMs. The US dollar remains soft, which typically supports EM assets. The likely peak of US-China trade headwinds, coupled with additional Chinese stimulus, provides upside. Inflation is largely under control in many EM economies, giving central banks room to ease policy and cut rates. However, we'd want to gain more conviction on global growth developments, tariffs, and geopolitical developments before we turn positive here.

Within sectors, we have an overweight view on utilities, financials, industrials, and consumer discretionary, against underweight views on information technology, materials, and energy. Utilities and financials are our highest-conviction overweight views, driven by fundamental tailwinds such as infrastructure spending and a more favorable regulatory environment for banks. On the other hand, macro headwinds to materials and energy equities persist, with our energy sector underweight view complementing our new underweight view on oil.

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Government Bonds: Central Banks Go Their Own Way

Pity the central bankers who must figure out how fiscal and trade policy moves will impact their economies! The consensus appears to be that tariffs will drive growth lower and inflation higher in the coming months. While we await definitive evidence of these outcomes, we don't see a big opportunity in being long or short overall duration. Fed Chair Jerome Powell has articulated a similar case for patience on interest rates. He argues that as long as the US economy is solid, the right thing to do is stick with the current policy stance and learn more over the summer. Signs of labor-market weakness are surfacing, and we think the Fed may be more likely to tilt in favor of its employment mandate and cut rates sometime this year, trusting that above-target inflation will ease. This expectation is priced in by markets.

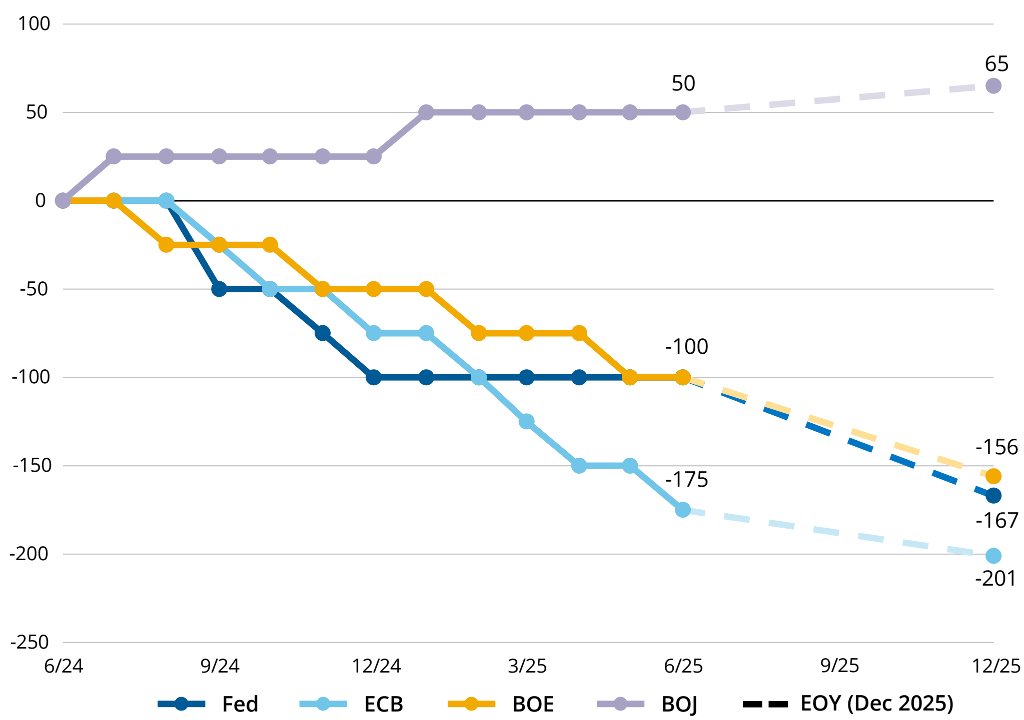
That said, central banks around the world are dealing with varied regional dynamics that require different policies (**FIGURE 2**), so "severance" between economies and markets abounds. In the euro area, as noted, markets expect the ECB to cut rates beyond the 175 bps already delivered. We see upside risks to longer-term yields, including tentative signs that euro-area demand is picking up from looser financial conditions and fiscal policy, and that inflation assumptions are too low. The details of a US-European trade deal will be important as well. We think the risk skew favors a hawkish scenario in which growth and inflation pick up, and 10-year yields rise.

> Powell argues that as long as the US economy is solid, the right thing to do is stick with the current policy stance and learn more over the summer.

FIGURE 2

Divergent Central-Bank Policy

Current Cumulative Policy Rate Changes vs. End-of-Year Expectations



Monthly Data: 6/24-6/25. Policy rate changes from major central banks: the Federal Reserve (Fed), European Central Bank (ECB), Bank of England (BOE), and Bank of Japan (BOJ), along with end-of-year (EOY) expectations for December 2025. Regional Overnight Index Swap (OIS) models used for rate expectations in Europe, Great Britain, and Japan; Fed funds rate model used for rate expectations in the US. The OIS is a financial derivative that reflects the average overnight interest rate over a set period and is used to estimate market expectations of future interest rates. The federal funds rate is the target interest rate set by the Federal Open Market Committee at which commercial banks lend and borrow excess reserves from each other overnight. Data Sources: Wellington Management and Bloomberg.

In Japan, inflation is becoming a problem. First-quarter nominal GDP was running above 5% year-over-year—10 times the policy rate of 0.5%. Business conditions are strong, especially among domestically oriented sectors, while labor markets are tight, and inflation expectations are accelerating. The BOJ should be hiking rates, but tariffs, which could cut into GDP and reduce confidence, remain a concern. Election uncertainty is also muddying the picture: Upper House elections happen on July 20, and the candidates are effectively competing on who can loosen fiscal policy more. Poor demographics are always pulling real yields in the other direction, yet we think the combination of inflation and fiscal risks will bias longer-term yields higher.

Where do we see opportunities relative to these concerns about Europe and Japan? We think yields could decline in the UK, where worries about fiscal slippage caused a spike in the term premium[8] that we believe is overdone, while the employment picture appears to be weakening.

Credit: Tight Spreads Okay in a No-Recession Scenario

Credit spreads roundtripped the widening we saw in early April and are back to historically tight levels. Given that our base case is no recession, balance sheets are healthy, and supply/demand technicals are still solid. We retain our slight overweight view on credit spreads. This is expressed in US high yield, which provided an all-in yield of 6%–7% as of June 24 that we think will continue to attract carry-seeking allocators. We also continue to highlight the secular improvement in the quality of the US high-yield market, as well as the alternative financing options available to issuers via the private credit markets, which have kept the default rate low. While spreads are tight, we also know that spreads can stay tight for a long time.

What could go wrong? The risk is that the combination of tariffs and an oil shock could increase the odds of a recession and weigh on risk assets in general. However, as long as inflation doesn't spike, we don't think a slower growth outlook would be problematic for spreads.

Commodities: Weighing Geopolitical Opportunities and Concerns

We maintain our neutral view on commodities. Structural tailwinds remain favorable for gold, including the geopolitical environment and flows from EM central banks and retail investors. The prospect of an acceleration in central-bank efforts to diversify their reserves may provide an additional kicker. That said, we see a case for pausing to wait for a more favorable entry point for a long position in gold. This comes within what we acknowledge is a strong uptrend (albeit with some volatility). A recent geopolitical premium has provided what we believe is a short-term boost to prices, and structural tailwinds remain, but valuations are extreme (the highest since 1980).

We moved to a small underweight view on oil following the recent spike in geopolitical concerns. While the situation in the Middle East is fluid, there's already a significant geopolitical risk premium in the oil market, even though prices have come down since the US strikes on Iran. Given that we see a low probability of a significant supply disruption, we think higher prices could give producers the opportunity to hedge 2026 production. This could reverse the trend of capital expenditures[9] and production discipline. We agree with the consensus view that there could be oversupply by the end of the year, creating a potentially attractive entry point for shorting crude, with the primary risk being the substantial negative carry drag.

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Investment Implications

Here are four things investors may want to consider:

- **Maintaining a slight pro-risk stance** — We believe we're past peak uncertainty, but trade-policy uncertainty remains relatively high. Given our base case of no recession, we see a case for maintaining some risk in both global equities and credit. Within global equities, we favor utilities and financials. We have underweight views on materials and energy, with the latter reflecting our expectation that oil supply could lead to lower prices.
- **Positioning for equities outside the US to potentially outperform** — With the recent rebound, US equities remain narrowly concentrated in mega-cap tech stocks. We've seen comparable earnings growth outside the US at lower valuations, and we also expect continued foreign flows away from the US into other regions. We think allocators may want to consider shifting some of their US equity exposure to other developed markets and EMs.
- **Watching for fixed-income opportunities resulting from divergent policies** — While we don't currently have a strong overweight/underweight view on global duration, we see regional duration opportunities that can potentially add alpha[10] to portfolios. In particular, yields in the euro area and Japan look expensive relative to the UK given our expectation that fiscal stimulus, improving growth, and rising inflation expectations could push yields higher in the former markets.
- **Staying steady in spreads** — Given a no-recession base case, we maintain our slight overweight view on credit spreads, specifically in US high yield. Fundamentals and technicals continue to be supportive, and we think the all-in yield of 6%–7% is still attractive.

Talk to your financial professional about how to position your portfolio amid a changing economic landscape.

[1] Risk assets refer to assets that have a significant degree of price volatility, such as equities, commodities, high-yield bonds, real estate, and currencies.

[2] Duration is a measure of the sensitivity of an investment's price to nominal interest-rate movement.

[3] Spreads are the difference in yields between two fixed-income securities with the same maturity but originating from different investment sectors.

[4] Carry is the difference between the yield on a longer-maturity bond and the cost of borrowing.

[5] A risk premium is the investment return an asset is expected to yield in excess of the risk-free rate of return.

[6] A basis point is a unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

[7] Earnings-per-share growth is the projected growth rate in earnings per share for the next five years.

[8] The term premium is the amount by which the yield on a long-term bond is greater than the yield on shorter-term bonds. This premium reflects the amount investors expect to be compensated for lending for longer periods.

[9] Capital expenditures are funds used by a company to acquire, upgrade, and maintain physical assets such as property, plants, buildings, technology, or equipment. Capital expenditures are often used to undertake new projects or investments by a company.

[10] The measure of the performance of a portfolio after adjusting for risk. Alpha is the excess return of a portfolio over its benchmark.