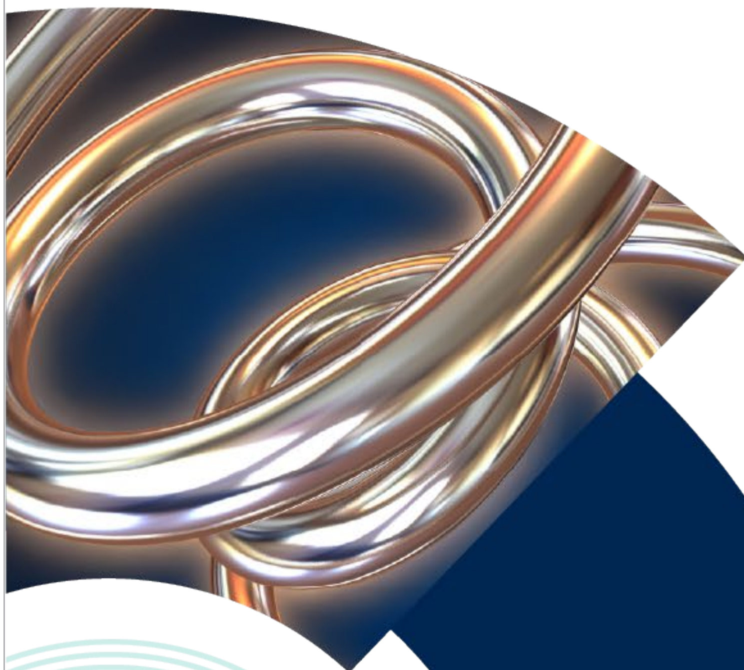

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2025 Midyear Multi-Asset Outlook: A World With More 'Brass Rings'

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- We believe US exceptionalism is not dead but rather entering a new phase, with support to come from the private sector amid AI tailwinds, which we believe will further widen productivity and growth trends in favor of the US. Nonetheless, the US AI opportunity will compete for foreign investors' flows with expanding opportunities outside the US, as well as the need for increasingly expensive FX hedging of the US dollar.
- Germany's fiscal turnabout and the DeepSeek-driven return of China's internet sector are two such competitors for investors' funds, broadening global opportunities in ways that markets did not anticipate heading into 2025. More opportunity elsewhere leads to less crowding into what had been the only game in town – the Magnificent 7 – and the only large fiscally active country post-Covid, which helped US growth to gap above others.
- The rollout of AI in the US and China offers promising opportunities in equities, enhancing productivity growth beyond the tech sector. All data-rich companies, sectors, and regions with the incentive to reach for the AI "brass ring" will benefit from AI, though more of these reside in the US. European industrials and defense stocks remain appealing, and US industrials will benefit from reshoring momentum. We also like Indian stocks due to India's status as an importer and its likelihood of benefiting from US-China tensions.
- Credit spreads remain tight across most markets, making all but Asia (ex China property) credit relatively unappealing to those with cross-asset-class reach. We will look for overreactions to a second half slowdown in the US as tariff-driven stagflation sets in, with US high yield spreads an area we would favor if they widened. We have favored edging up duration after yields spiked this year and before a slowdown emerges, which could be a reason to come back to US Treasuries and mortgage-backed securities (MBS). To date, we have favored UK gilts, German bunds, and the longest areas of Japanese government bonds over Treasuries.
- While the Middle East is a risk to the remainder of 2025, we expect reciprocal (instead of escalatory) retaliation from Iran that avoids damaging global energy infrastructure. The regime will seek to protect its survivability while recognizing that other Middle East nations are currently sympathetic to Iran (and why change that).

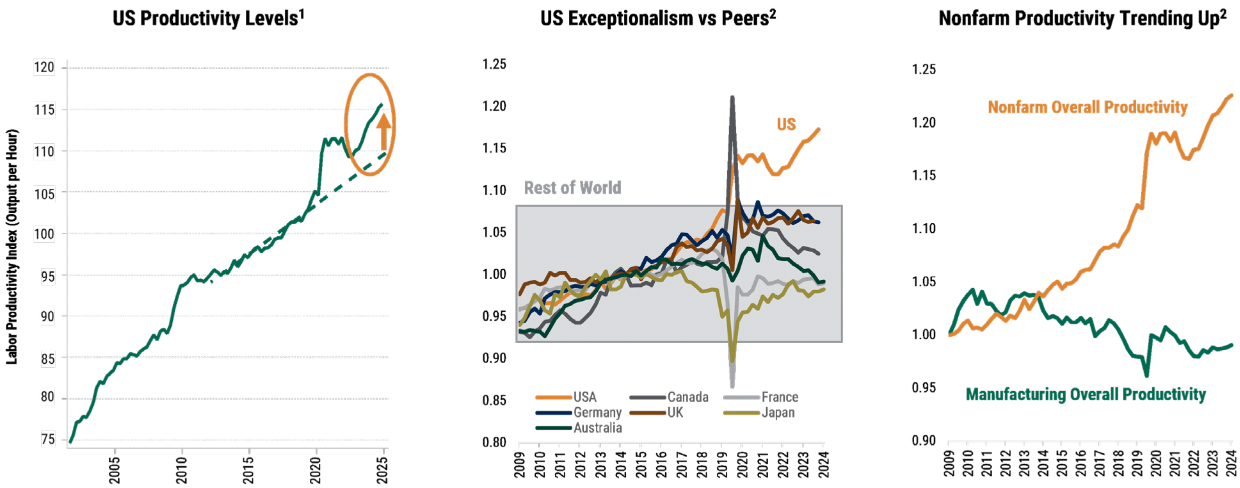
After several years in which global investors piled into US assets – on the premise of US exceptionalism, and with few other compelling opportunities – the narrative in 2025 has shifted to include European defense and industrials, China internet, and all currencies and most yield curves over the US dollar and US Treasuries. This is more than a reaction to the US's erratic trade policy, a spike in tariffs, erosion of US governance structures, and prior overexposure to US assets. There are simply more opportunities arising for non-US investors in particular, who now face a soggy US dollar and require more FX hedging at a higher cost.

We've pointed out that much of what had been labeled "US exceptionalism" was in fact a faster post-Covid relative growth rate propelled by 1) a US-favored productivity gap, but also 2) US fiscal overexpansion (through the CARES Acts 1 and 2, the Infrastructure Act, the CHIPS Act, and the Inflation Reduction Act) at a time when other nations remained fiscally dormant. This gap in fiscal activism is now arguably slowing if not narrowing after taking into account the new fiscal bill working its way through Congress. Recent Goldman Sachs commentary agrees with our assessment.[1] The House bill will neither add to nor alleviate the current 6.5% fiscal deficit run rate once tariffs are taken into account. Most headlines and other analyses point out how fiscally expansive it will be, but do not take tariff-based revenue into account, nor do they compare the bill to the current fiscal deficit run rate. A structural 6.5% fiscal deficit is still too high, yet since Covid the direction of travel was US fiscal deficits widening versus others due to policy. Now this gap appears to be topping out.

Is this a reason not to invest in the US? Yes and no. A structurally higher fiscal deficit (for now) has made it difficult for US rates to drop as much as elsewhere, pushing FX hedging costs to non-US investors higher. Given the drooping dollar's current drag on returns generated by US assets, we also are seeing more of a desire to fully hedge US assets, diminishing appetite among non-US investors. While this may not change anytime soon, it could over time. The baseline 6.5% fiscal deficit will either grow or recede depending upon whether real GDP growth over the next 10 years is faster or slower than the 1.8% assumed by the Congressional Budget Office (CBO). Our view is that it could grow meaningfully faster. We see AI as a sequel to the steam engine, railroads, electricity, and the internet, each of which spurred faster growth through higher productivity, without inflation.

For now, it's clear that the portion of US exceptionalism previously attributable to greater US fiscal expansion has been played out, while other governments have just begun to more actively revive their own economies. Then there was the other reason for US exceptionalism: a private sector productivity gap in the US's favor (see charts below). Looking back, this was attributable to the US more forcefully investing to address Covid challenges. These investments have left a growing productivity gap in their wake. Together, public and private US investments materially outshot other countries to solve Covid-related supply issues and have been a tailwind for faster productivity ever since.

A Productivity Super-Cycle May Drive Disinflationary, Supply-Led Growth



¹Source: Macrobond as of 31 December 2024. ²Source: Bloomberg as of 31 December 2024. For illustrative purposes only. We are not soliciting or recommending any action based on this material. Any opinions, projections, forecasts, and forward-looking statements presented are valid only as of the date indicated and are subject to change.

Looking forward, we see this productivity gap growing further, primarily owing to the US's lead in AI at a time when this secular force is kicking into high gear. Who will benefit the most? In our view, while all eyes are on US government policy, it's the flexible US private sector that will be the difference maker. Not only is the US currently holding the lead as we pivot out of compute-power dominance into application dominance; the mix of data-rich companies and industries most likely to benefit from AI applications also make up a high percentage of the US indices (see below).

Many S&P 500 Constituents Are Likely to Benefit From AI

Industry	AI productivity benefit % revenue	Labor costs as % total costs	EPS CAGR 2023-2033 Slow	EPS CAGR 2023-2033 Moderate	EPS CAGR 2023-2033 Fast
Semiconductors & Semiconductor Equipment	1.4%-2.3%	20%	12.30%	12.50%	12.90%
Software & Services	4.8%-9.3%	57%	8.10%	9.10%	10.90%
Health Care Equipment & Services	2.6%-4.5%	21%	5.60%	7.50%	10.70%
Real Estate Management & Development	1%-1.7%	5%	8.10%	8.70%	9.70%
Consumer Discretionary Distribution & Retail	1.2%-1.9%	11%	7.60%	8.20%	9.10%
Media & Entertainment	1.8%-3.1%	19%	7.70%	8.20%	9.00%
Pharmaceuticals Biotechnology & Life Sciences	2.6%-4.5%	32%	6.70%	7.20%	8.10%
Consumer Staples Distribution & Retail	1.2%-1.9%	10%	4.20%	5.60%	7.80%
Insurance	1.8%-2.8%	9%	6.10%	6.80%	7.70%
Financial Services	2.8%-4.7%	20%	5.90%	6.50%	7.50%
Automobiles & Components	1.4%-2.4%	11%	4.60%	5.40%	6.90%
Capital Goods	1.4%-2.4%	21%	5.30%	5.80%	6.80%
Transportation	1.2%-2%	19%	5.30%	5.80%	6.70%
Consumer Services	1.2%-2%	24%	5.60%	6.00%	6.60%
Commercial & Professional Services	0.9%-1.4%	36%	5.40%	5.70%	6.10%
Technology Hardware & Equipment	1.4%-2.3%	19%	5.00%	5.30%	5.90%
Banks	2.8%-4.7%	28%	3.70%	4.30%	5.20%
Consumer Durables & Apparel	1.4%-2.3%	11%	3.60%	4.10%	5.00%
Household & Personal Products	1.4%-2.3%	9%	3.60%	4.00%	4.70%
Telecommunications Services	1.4%-2.3%	18%	2.20%	2.70%	3.40%
Utilities	0.5%-0.9%	12%	2.80%	3.00%	3.30%
Materials	0.7%-1.2%	11%	2.50%	2.80%	3.20%
Food Beverage & Tobacco	1.4%-2.3%	12%	1.90%	2.40%	3.20%
REITs	1%-1.7%	9%	2.70%	2.90%	3.10%
Energy	1%-1.6%	2%	0.50%	0.90%	1.50%

Source: FactSet, McKinsey, and HSBC as of April 2025.

Given the US's stronger business incentives and demonstrated history in seizing the moment, we expect the US to grow faster than the forecast 1.8%. If so, while the fiscal deficit will remain too high, it should slowly trend down from today's 6.5% starting point, eventually lowering risk premiums and FX hedging costs over our five-year horizon.

That said, we expect a short and shallow tariff-policy-induced slowdown for the remainder of 2025, which investors in risk assets will surely worry about. Over time, productivity continuing to gap in the US's favor will lead to a higher-quality form of private-sector-driven US exceptionalism, at least in the sectors most relevant to the S&P 500 – a 2026 theme that could reverse today's one-way street against US assets. We may get an opportunity to gradually and selectively add to US exposures through what we expect to be a stagflationary head fake during the second half, preparing for better-quality US opportunities in 2026 and beyond.

Plot twists out of Germany and China

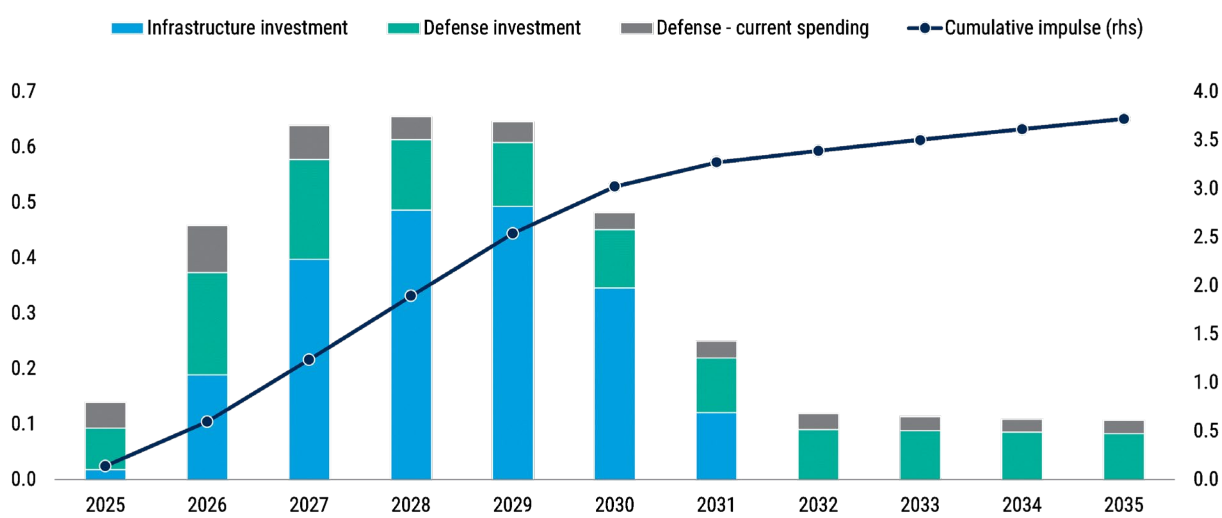
While we understand the sentiment that coercive trade practices and governance slippage have dimmed the appeal of US assets (and the fiscal bill's Section 899 "revenge tax" proposals can't be helping), the story of how US assets lost their leadership this year is more nuanced.

Germany's debt brake, instituted after the global financial crisis, has been a drag on growth in Europe – especially during and after the financial crisis and pandemic, when the private sector was naturally retrenching and could have benefited from governments taking the opposite tack. Yet in the wake of Putin's coming eastward, moving first on Georgia in 2008, then Crimea in 2014, Eastern Ukraine in 2022, and now amassing troops along the borders of the Baltics, Germany is now loosening the fiscal purse strings to rearm.

The electorate slowly began to contemplate removing the debt brake to revive Germany's military and infrastructure. **Coming into this year, sentiment began to shift toward a change in the German government, the debt brake, and more fundamentally, the nation's stance on providing its own primary source of defense.** Right out of the gate in early 2025, German assets began to outperform as these expectations coalesced, especially for fiscal beneficiaries.

While there may have been good reasons for investors in US assets to go home after 2 April, a thesis had formed much earlier in 2025 for rising opportunity in Europe, attracting attention. Germany's fiscal reboot has medium-term growth implications, and while it is primarily a German story, there is some spillover into the rest of Europe.

Germany's Fiscal Impulse Has Legs



Source: Barclays as of 18 June 2025.

The second surprise coming into 2025 **was a return of the investment viability of China's internet sector, largely on the back of the DeepSeek breakout** and the promise it holds for China tech more broadly. DeepSeek will help enable innovation by making powerful large language models (LLMs) accessible to a wider range of Chinese internet companies (including those without access to leading-edge AI chips), allowing them to develop more sophisticated services. As DeepSeek models improve, they may enable Chinese companies to become more effective global competitors and increase adoption of Chinese AI solutions.

DeepSeek's arrival is another development that for many came seemingly out of nowhere yet now represents a high-conviction theme for us and for other global investors. DeepSeek also provided a new opportunity for China's government and private sector to come together again. At least within technology, the government's prior crackdowns appear to be over, with nurturing beginning anew. While DeepSeek has enabled more than just the hyperscalers to benefit from LLM breakthroughs, new chapters are opening up in AI incorporating voice, vision, and reasoning. This temporary LLM catchup via DeepSeek suddenly needs more dimensions upon which to not only catch up, but also to keep up.

Flows vs. fundamentals

The narrative that US exceptionalism has tumbled focuses on the rebalancing of flows away from the US as its desirability for investors has declined. Yet this explanation calls into question what drives markets and how they behave. Most studies show that fundamentals drive prices, which in turn lead flows – flows do *not* lead prices. We are inclined toward that thinking, though even for those in the "flows lead prices" camp, recent flow data illustrate not so much rampant *selling* of US assets as *less buying*.

The latter, in our view, is more reflective of choices for global investors beyond the Mag 7 that weren't previously available, when investors were compelled to herd into US assets. Even in the US, opportunity is spreading beyond the narrow list of hyperscalers to a broader (but still admittedly narrow) set of software and data-rich companies with the wherewithal, incentives, and plans to seize the moment – and the next dimension of the AI "brass ring." More breadth underlying renewed European and China opportunities is good for global growth and for global equity fundamentals. Whether leadership returns to US markets will depend on where the fundamentals go from here … which leads us back to the US.

Why do we believe US fundamentals will outperform once again? To be clear, we do not expect this immediately. Tariff price pressure has not yet manifested; in the second half of 2025, inventories that were accumulated at lower costs to front-run the tariffs will wear off and related goods prices will rise, crimping purchasing power and thus growth. We see this, however, as a one-off event. Even more important is the services, which make up a far greater percentage of the economy and are not directly impacted by tariffs, which keep disinflating. AI's impact as a new secular force will lead to stepped-up growth and productivity in services in particular. This new secular trend is coming on quickly (note that LLMs were built at first on the presumption that justifying use cases would come, and we're now seeing those come through).

Now, instead of a crisis incentivizing investment, greater opportunity is doing so, inspired by AI use cases that the flexible private sector of the US economy is seizing upon. To wit, while the US government is not stepping up, the private sector hyperscalers are, and they are forging ahead despite trade-related uncertainty that was expected to halt all investment.

China's competitiveness took a timeout after the Ant Group IPO was blocked, and leading-edge technology companies became quite conservative about reinvesting in their businesses. That investment is coming back now in the wake of DeepSeek, yet on the high end of innovation; while DeepSeek helped China get back into LLMs, AI is moving onto voice and reasoning, and China still does not have easy access to leading technologies. The US is also likely to see less angst and fewer job protection measures than in Europe that limit or slow the implementation of AI. We view the US indices as weighted more heavily to companies with the ability and incentive system to benefit.

Despite these US productivity-enhancing prospects, markets may have a tough time keeping their eye on this ball amid the (temporary) stagflationary slowdown ahead. We say "temporary" because tariffs historically have had one-off impacts on boosting prices and slowing growth – an empirical observation. We spent early 2025 favoring investments in European beneficiaries of Germany's fiscal turnabout, China internet opportunities, and India's continued growth spurt. We're now on the lookout for compelling opportunities to gradually rebuild targeted US equity investments through the remainder of 2025.

The policies of this US administration are certainly a mixed bag and create challenges. Yet investors should not lose sight of the vibrancy of the US private sector, which we expect to drive the next leg of US opportunity – one that encompasses a broader and broader set of companies and industries poised to benefit from AI opportunities.

Equities: Eying quality

Tariff risk has de-escalated, notwithstanding continued upward flickers from time to time. Still, higher tariffs remain a potential threat to profit margins, making quality companies with resilient moats and margins more likely to outperform. The rollout of AI in both the US and China offers promising opportunities over the medium term, enhancing productivity growth beyond the tech sector (see table above). European industrials and defense stocks remain appealing, supported by upcoming German fiscal initiatives.

The trend toward US reshoring had begun prior to Trump's escalation, starting with Biden's legislation on infrastructure, the CHIPS Act, and the Inflation Reduction Act. It should now gain more momentum as tariffs influence capex decisions, benefiting select US industrials that assist in such reshoring. We are also constructive on Indian stocks, which we view as well positioned against today's backdrop, both due to India's status as an importer (with deflationary pressures poised to spread outside the US) and its likelihood of benefiting from US-China tensions.

Fixed income: Beyond the US

All year long we have favored moving from US Treasuries to UK gilts given the UK's limited scope to expand its fiscal deficit, as Germany is doing (and unlike the US, has plenty of room to do), and which other European nations are considering. Credit spreads remain tight across most markets, supported by the formerly strong growth environment (and prior to seeing the extent of a temporary slowdown as tariffs flow through). We have also preferred German bunds over Treasuries, with inflation and monetary policy about to diverge, and the very longest areas of Japanese government bonds have likewise become attractive. With the exception of Asia credit (ex China property), narrow spreads have made credit less appealing to those with cross-asset-class options at a time when more countries and industries are seeing new equity-oriented growth opportunities.

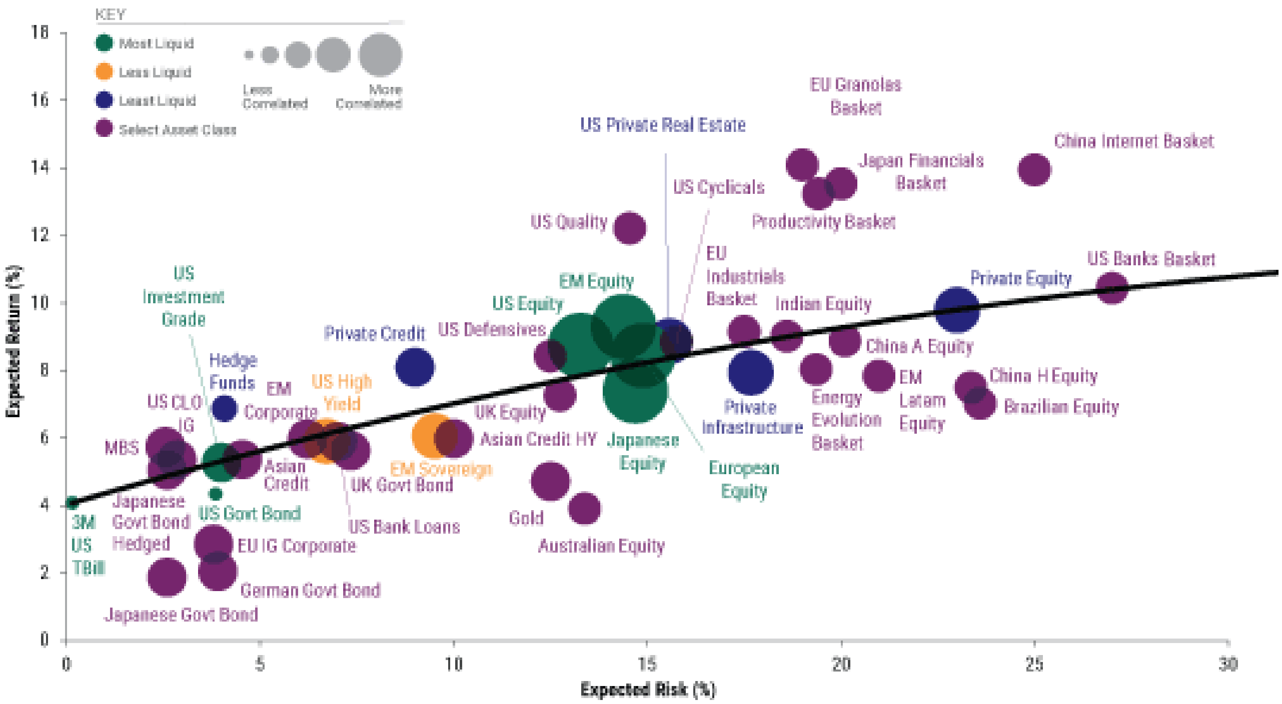
With a slowdown about to gain traction, we have begun to favor inching up overall duration, even in Treasuries and mortgage-backed securities (MBS), after taking a cautious stance for a number of years. Additionally, regulatory relief for larger US banks in the form of the Supplemental Lending Ratio (SLR) is still likely on its way, which will encourage banks to hold more MBS and Treasuries. Meanwhile, we are watching for overreactions to recession risks in US high yield spreads as the hard data weaken in the months ahead.

Alternatives: Gold shimmers

The trend of de-dollarization among Global South central banks is expected to continue, supporting gold prices. We have not witnessed de-dollarization in transactions between private parties, although some diminishment seems likely. Beginning in January (prior to Liberation Day), overseas investors began investing new flows back home, pursuing new opportunities in Europe and China. The lack of huge inflows into overexposed US assets led to weakening of the USD. Gold also benefits from a decline in the dollar. Despite those favorable near-term trends, gold has been in a bull market since the global financial crisis, driven by Western central banks' quantitative easing, which caused global M2 money supply growth to outpace global nominal GDP growth. That put a strong wind in gold's sails.

Currently, the Fed and the European Central Bank continue to reduce their balance sheets, and the People's Bank of China has not yet meaningfully stepped up its own. We believe it will do so should trade negotiations with the US break down. In the interim, we have favored a temporary reduction in gold exposure, given its year-to-date strength. Yet if trade negotiations with China turn south (not our base case), then China's M2 growth alone could sustain global M2 expansion relative to global nominal GDP, boosting gold's allure once again.

High Dispersion Across the Capital Market Line (Local Currency)
Dispersion highlights several pockets of value that are positioned to benefit from the reflationary regime.



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For more insights into the trends moving markets in the second half of the year, see our **2025 Midyear Investment Outlook.**

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