Principal Asset Management℠

Global equities perspectives

MARCH 31, 2025

＜情報提供資料＞

NOTABLE THEMES

Tariff and trade turbulence – early enthusiasm for expected U.S. policy reforms abruptly turned cautious due to tough talk and flip-flops on tariff penalties, reciprocity, and a worrisome deterioration of diplomatic relations, including among historically strong American allies

No monopoly on innovation – the U.S. dollar weakened and international markets materially outperformed, particularly among technology shares in-part fueled by the unveiling of the surprisingly low cost and innovative "Deep Seek" Chinese AI platform

Defense to the forefront – investor flows shifted away from big tech and consumer cyclicals, in favor of less volatile industries, with particularly strong gains among military defense contractors, led by European producers, amid heighted geopolitical uncertainty and increased spending commitments

A disorderly start to the year

At the start of the year, investors were anticipating a growth-friendly administration that would reinforce the narrative of U.S. exceptionalism and enact policies likely to strengthen the U.S. economy relative to the rest of the world. However, policy has not panned out quite as expected. Not only has the sequencing of economic policies been different, but the tariff policy proposals have been considerably more severe than anticipated. With policy uncertainty extraordinarily elevated, the U.S. economy has already begun to be negatively impacted.

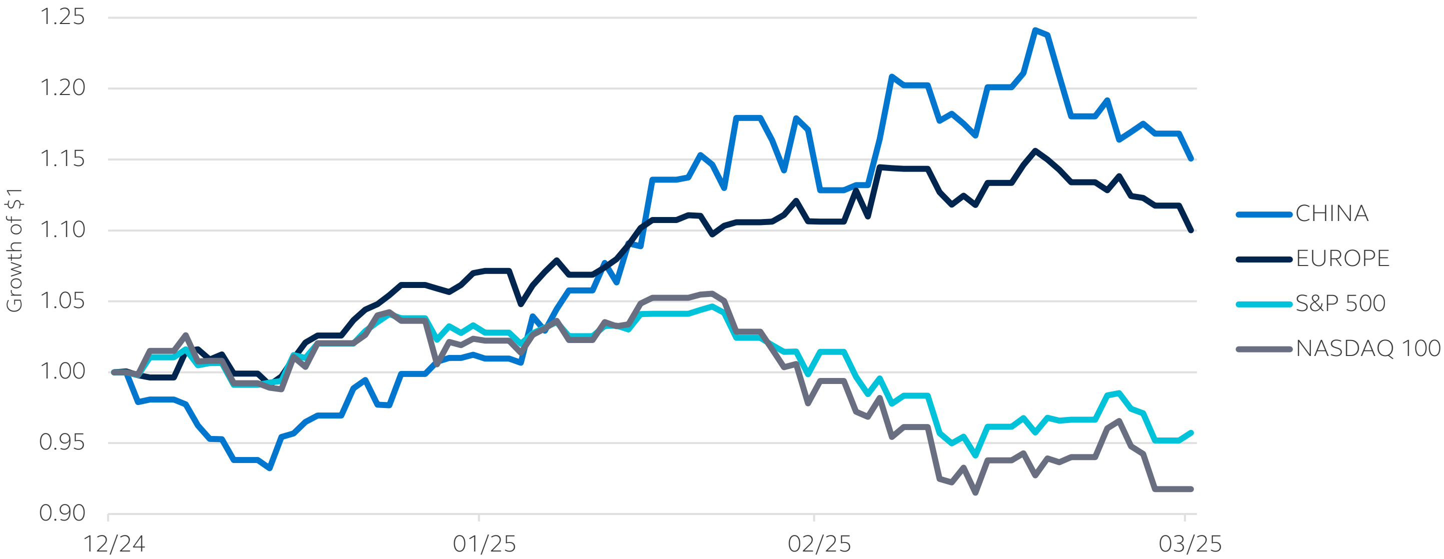
The initial anticipation was that the new U.S. administration would prioritize shoring up the U.S. economy via deregulation in the first quarter. Instead, they prioritized tariffs and federal employee job cuts, with no corresponding moves to ease regulatory policy. Tariff proclamations were not only announced earlier than expected, but are likely to be meaningfully larger than anticipated, with frustratingly inconsistent messaging and numerous flip-flops in guidance along the way.

Uncertainty around the timing, magnitude, coverage, and duration of tariffs has undermined consumer confidence, business sentiment, and ultimately investor sentiment. Among business leaders, the uncertainty is already weighing on capex plans as companies decide to put investment and hiring plans on hold with several large corporates already sounding alarm bells across a host of industries and economic sectors. The lack of clarity also makes it more difficult for the Fed to determine the path of monetary policy. For now, their hands are essentially tied.

While this whirlwind of proclamations has been made in the name of strengthening America's competitive position, the early response by global equity markets has signaled quite the opposite.

Contrary to consensus expectations

Year to date gross total returns (USD)



As of 31 March 2025. Source: Bloomberg.

Particularly, concerning has been the impacts on U.S. consumer discretionary stocks and smaller company shares, both of which portend cracks in the broader economic outlook. Unsurprisingly, technology stocks have also been in the epicenter of the looming trade war and associated uncertainty. Also defying early expectations, the value of the U.S. dollar has slumped relative to nearly all major trading partners. For the quarter, the British Pound gained 3.1%, the Euro 4.4% and the Yen 5.2%. While not directly relevant to most global equity investors, the Russian Ruble ominously gained nearly 30%.

A new twist in the AI arms race

Pressure on U.S. tech stocks was also elevated as investors reassessed lofty valuations following the release of a powerful open-source AI model by Chinese startup DeepSeek. The model, which seems to rival those from top U.S. developers but at a significantly lower cost, has raised concerns about the sustainability of current equity premiums.

While DeepSeek's initial development cost estimates were dubious, and its processing efficacy not yet fully confirmed, it's launch announcement was undoubtedly a seminal moment for the industry. The fact that it was quietly developed by a private organization in China surprised many. More importantly, its unveiling called into question the need for the previously anticipated massive capital spending on advanced chips, and having those chips come only from the most advanced semiconductor manufacturing companies (i.e. the hyper-scalers in the U.S., Taiwan and Belgium). Critically, however, it also could dramatic improve potential A1 use-case scenarios, with a lower cost of entry for a broad swath of productive applications. In other words, it an opportunity to democratize AI technology to the benefit of the broader economy and equity markets.

For context, note that technology stocks within the S&P 500 declined 12.7% during the quarter, while their counterparts within the MSCI China Index gained 25.6%.

Germany sparks a European sentiment boost

President Trump's decision to suspend military aid to Ukraine in early March, plus his evolving approach to global security, has prompted a significant re-think on defense spending in Europe and accelerated a long-awaited fiscal shift in Germany.

In response, the German government has changed its constitutional rules, bringing the following changes:

a. The creation of a €500bn infrastructure investment fund.

b. Exemption of defense spending above 1% of GDP from the debt brake rule, which restricts annual structural deficits to 0.35% of GDP (This effectively permits open-ended borrowing for defense).

c. Easing of fiscal constraints for federal states.

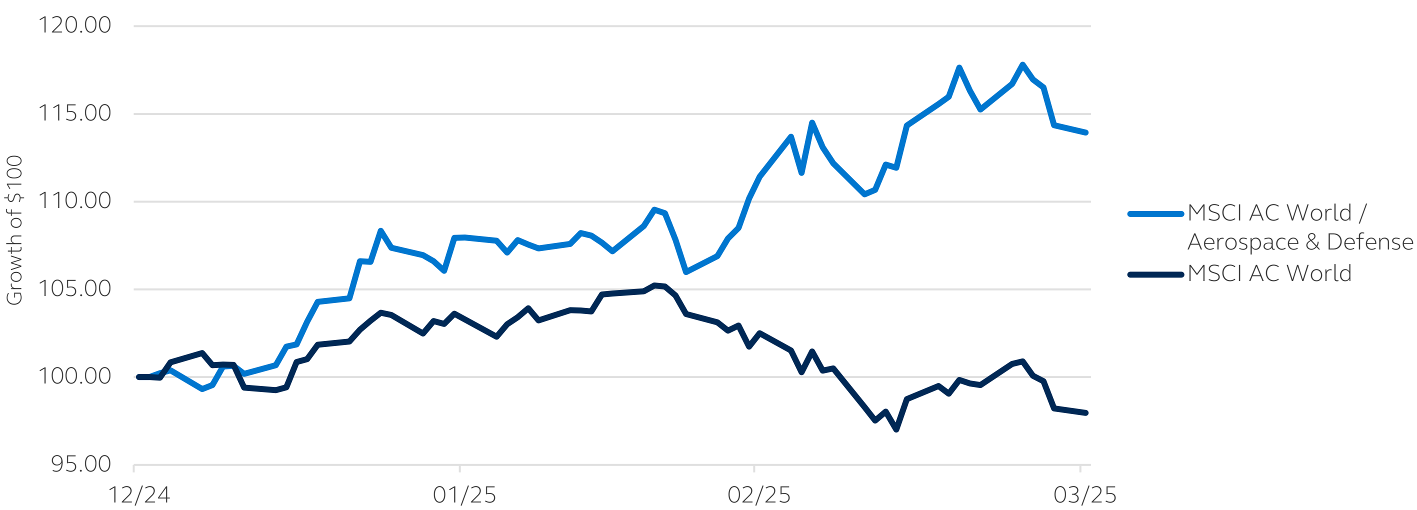
Taken at face value, Germany is set to embark on a major fiscal expansion—over €1 trillion—far exceeding expectations. While a policy shift wasn't a surprise, the scale marks the biggest change in Germany's fiscal approach since reunification 35 years ago. The reforms could raise allowable structural net borrowing by more than 2% of GDP annually, though questions remain about how quickly the funds can be deployed.

Germany makes up about a third of Euro area GDP and is poised to lift broader European growth through its fiscal expansion. At the same time, the EU has proposed a modest but supportive fiscal shift, including looser budget rules to enable more defense spending, a "national escape clause" for member states, and a new €150 billion loan facility (SAFE) to support investment. While the EU-wide impact will be smaller than Germany's, it should still provide a slight boost to Euro area GDP in the coming years.

Perhaps unsurprisingly, this culmination of events, coupled with other ongoing geopolitical conflicts, sparked a sharp rally among military defense stocks, particularly among those based in Europe (including the U.K.) and notably also in South Korea.

Playing defense, literally

Global Aerospace & Defense versus broad market, year-to-date total returns (USD)



As of 31 March 2025. Source: FactSet.

By the numbers

The S&P 500 posted a total return -4.3% led by double-digit declines in the technology and consumer discretionary sectors at the epicentre of the tariff and trade conflicts. Conversely, energy and utilities shares posted relief rallies in response to reprieves on prior tariff threats against Canada (for now). Given that set-up, its no surprise that value-oriented benchmarks handily outpaced their growth counterparts by wide margins, in the U.S. and globally. The Russell 1000 Value index posted a 2.1% gain versus a 11.1% decline for the Russell 1000 Growth. Small Cap shares in the U.S. were also hard hit, despite their more domestic orientation, on rising recession/stagflation fears. The Russell 2000 Index shed 9.5%.

International markets helped blunt the pain, particularly amid weaker exchange rates for the U.S. dollar. The MSCI EAFE Index posted a solid 7.0% gain, while the World ex U.S. Small Cap index eked out a 3.8% advance. Similarly, the MSCI Emerging Markets Index a 3.0% rise, fuelled by the 15% rally in China. Conversely, Taiwan shed 12.6% in sympathy with the sell-off among U.S. mega-cap tech shares. Stylistically, high dividend and low volatility strategies finished in the black, countered by declines among high quality and momentum-oriented benchmarks.

While it is challenging to identify the silver-lining within the recent clouds, the events of 2025 thus far serve as a timely reminder of the case for international diversification.

GROSS TOTAL RETURNS AS OF 31 MARCH 2025

	3 months	12 months
Developed Markets	**-1.7%**	**7.5%**
North America	-4.3%	8.2%
Europe	10.6%	7.5%
Pacific	0.5%	0.9%
Emerging Markets	**3.0%**	**8.6%**
China	15.0%	40.4%
Asia Ex China	-5.8%	-3.7%
Latin America	12.7%	-13.6%
EEMEA	8.1%	12.9%
All Country World	**-1.2%**	**7.6%**
Communication Services	-2.4%	15.5%
Consumer Discretionary	-7.5%	5.3%
Consumer Staples	5.8%	7.8%
Energy	9.4%	2.7%
Financials	6.2%	21.3%
Health Care	5.1%	-0.4%
Industrials	2.3%	5.6%
Materials	4.9%	-5.1%
Real Estate	3.0%	7.0%
Technology	-11.6%	4.0%
Utilities	6.8%	18.3%
Global Style Groups		
Growth	-6.8%	5.9%
Value	4.9%	9.4%
Small Cap	-3.9%	0.0%

Source: MSCI Indices in USD

Update from our CIO

George Maris, CFA - CIO, Global Head of Equities
April 3, 2025 – "Liberation Day" tariffs

The dramatic nature of these tariffs and lack of ready softening measures implies equities will likely be in risk-off mode until something catalyzes change. While markets priced in tariff risk, the actual measures announced are more severe than expected and future actions remain uncertain. This ambiguity, combined with the stagflationary nature of the shock, limits the Fed's ability to offset with policy support removing a pillar of potential market resilience.

We may be nearing peak uncertainty. There is an optimistic scenario where tariffs are a negotiating tactic intended to build credibility and pave the way for fiscal stimulus. This may be via tax cuts especially tied to on-shoring or a market-driven reduction in rates. If paired with tighter immigration policy, this could support real wage gains at the lower-income cohort and incentivize pro-cyclical responses from foreign economies (e.g. China & Germany). But this outcome requires policy clarity and we are not there yet.

Until a credible resolution emerges, either through de-escalation or fiscal offset, the market is likely to be defensive. Rising costs, limited visibility and uncertain policy path argues for caution in equity positioning. In this backdrop, companies with strong free cash flow generating capabilities remain attractive.

Authors

Compiled by Scott Leiberton, Brandon Lensmeyer, and Ryan Linder with generous thanks to the Principal AM Global Insights team.

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Index Descriptions

MSCI World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI World Index is available upon request.

MSCI Emerging Markets Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. The index covers approximately 85% of the free float-adjusted market capitalization in each country. Information regarding the comparison to the MSCI Emerging Markets Index is available upon request.

MSCI AC World Index is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of developed and emerging markets. The MSCI AC World NTR Index consists of developed and emerging market country indices and covers approximately 85% of the global investable equity opportunity set. Information regarding the comparison to the MSCI AC World Index is available upon request.

MSCI ACWI Growth Index captures large and mid cap securities exhibiting overall growth style characteristics across 23 Developed Markets countries and 24 Emerging Markets countries. The growth investment style characteristics for index construction are defined using five variables: long-term forward EPS growth rate, short-term forward EPS growth rate, current internal growth rate and long-term historical EPS growth trend and long-term historical sales per share growth trend.

MSCI ACWI Value Index captures large and mid cap securities exhibiting overall value style characteristics across 23 Developed Markets countries and 24 Emerging Markets countries. The value investment style characteristics for index construction are defined using three variables: book value to price, 12-month forward earnings to price and dividend yield.

MSCI ACWI Small Cap Index captures small cap representation across 23 Developed Markets and 24 Emerging Markets countries. With 6,087 constituents, the index covers about 14% of the free float-adjusted market capitalization in each country.

S&P 500 Index includes 500 leading companies in industries of the U.S. economy. It was first published in 1957.

S&P 500 Top 50 consists of 50 of the largest companies from the S&P 500, reflecting U.S. mega-cap performance. Index constituents are weighted by float-adjusted market capitalization.

S&P 500 Equal Weight Index is the equal-weight version of the S&P 500 and includes the same constituents as the capitalization weighted S&P 500, but each company in the S&P 500 EWI is allocated a fixed weight - or 0.2% of the index total at each quarterly rebalance.

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