

The July Outlook

Market Stance

MID YEAR OUTLOOK

Global financial markets saw major shifts in H1 2025. Looking ahead we see the following key themes.

Commentary

- Valuation risk is elevated but uneven. This presents opportunities in under-owned areas and risks where perfection is priced in.
- Narrow market leadership, driven by AI enthusiasm, leaves equities vulnerable to modest disappointments.
- Policy uncertainty in the US clouds the outlook, especially around trade and inflation.

Upshot

- We expect slower growth, sticky inflation, and weaker profits – yet equity valuations do not reflect this

GLOBAL ECONOMY

The key global macro issue remains the extent of the aftershocks of tariff impositions, and the potential for further adverse shocks primarily from the US.

Commentary

- Data from the second quarter point to a global growth moderation, but no sharp slowdown.
- We acknowledge upside risks to global growth arising from AI applications, but there is no compelling evidence that as of now this is a material influence.
- Downside growth risks are primarily in the US.

Upshot

- We continue to expect a dominant theme to be weaker global macro momentum in the second half.

ASSET CLASS VALUATIONS

Strong returns across many asset classes since early April reflect a compression in risk premia, to relatively low levels.

Commentary

- Risk assets - equities and credit - have delivered significant returns since early April.
- In equity markets, these have come from higher equity multiples, not better earnings prospects.
- In credit markets, returns have come from lower credit spreads.

Upshot

- Markets are pricing relatively little macro risk at present, when macro risks appear to be rising. This may limit the scope for further significant gains in the near-term.

INFLATION AND INTEREST RATES

With the exception of the US, inflation pressures are relatively subdued, and modest policy easing is in the pipeline.

Commentary

- Modest global growth and muted commodity price gains are constraining inflation pressures.
- The exception is the US, reflecting actual and prospective tariff increases, and also the potential for a highly stimulative fiscal stance.
- Lower policy rates in the major economies are likely to be a theme in the second half, but these are already strongly discounted.

Upshot

- A mid-cycle policy-rate adjustment may provide some support to markets, but we do not expect substantial rate declines.

 The Long Read

2025 Mid-year review: a turning point for financial markets

SNAPSHOT

We set out below our mid-year market assessment. We review the most influential market drivers in the first half of the year, and what the most important themes are likely to be into 2026.

The first half of 2025 marked a notable turning point for global financial markets, characterised by a shift in leadership across asset classes, regions and sectors. Three themes have defined the landscape so far:

First, the relatively muted returns across most major asset classes after a multi-year period of strong gains, particularly from riskier assets.

Second, the underperformance of US equities relative to international markets after a multi-year period of “US exceptionalism”.

Third, the decline in the US Dollar, with ramifications across asset class returns, the inflation outlook, and geopolitics.

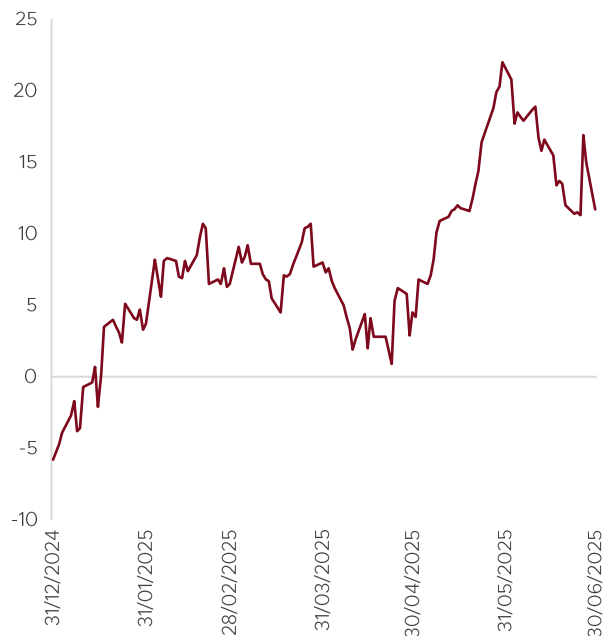
These themes have not only had an impact on portfolio returns, but perhaps also signalled deeper structural and macroeconomic shifts underway in the global economy.

Investment returns moderate as policy risks rise

Global equity returns in the first half of the year have been far more muted compared to what many investors had perhaps grown used to over the past years, particularly for non-Dollar based investors. This comes despite what can be characterised as a reasonably resilient global economy. Although there are regional divergences, in aggregate, the global economy has continued to grow at a reasonably healthy pace, with economic data having largely surprised to the upside, although against relatively modest expectations.

CHART 1

Citi Economic Surprise Index (global)



Source: Citi

Equity returns therefore have been driven less by weakening economic momentum but instead by rising policy risk – most notably the protectionist trade policies under the Trump administration. The reintroduction of sweeping tariffs in April rattled markets, not only impacting global supply chains but also creating uncertainty around capex spending, consumption and inflation.

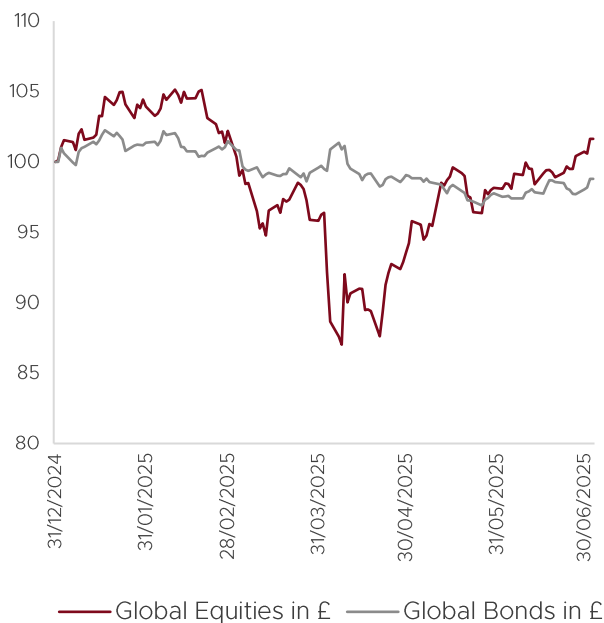
The Long Read

The policy U-turn that followed helped global equity markets recover. However returns remain close to zero for Sterling investors, while Euro based investors lost over 3%.

Fixed income, which typically serves as a defensive asset class in periods of equity weakness, has not fared considerably better. Although yields have fallen somewhat at the short and intermediate maturities, this is primarily relevant to the US bond market, whereas investors in other developed bond markets have had to grapple with rising government bond yields. Importantly, expectations of more fiscal loosening across the US, Europe, and parts of Asia have driven longer-term bond yields sharply higher, leading to a meaningful steepening of yield curves across the globe.

CHART 2

Asset class returns in £



Source: Bloomberg

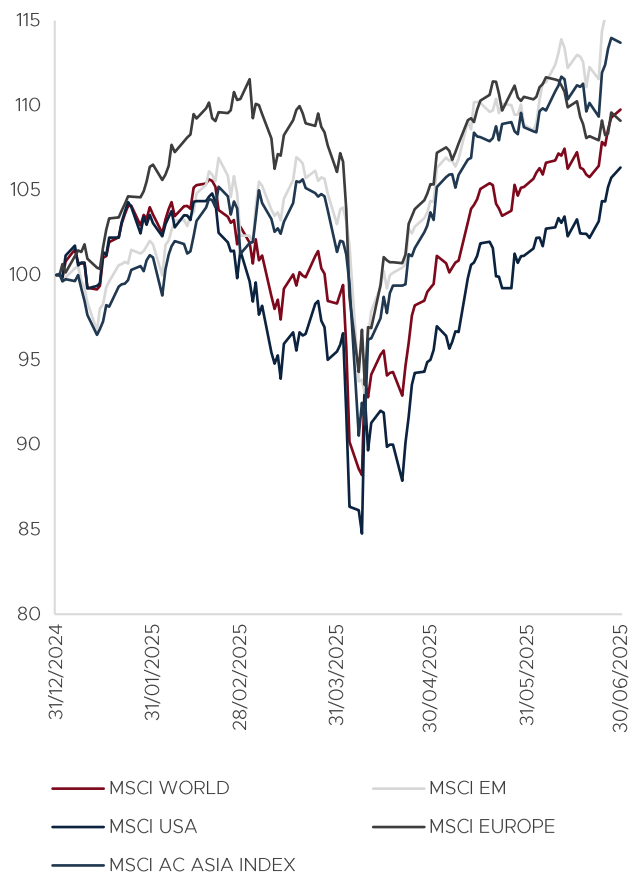
US equities lag on trade disruption and political uncertainty

Within equities, the US lagged international markets by a wide margin in the first half.

While large-cap US equities staged a significant recovery from their April lows to finish June over 6% higher since the start of the year (negative 3% in Sterling terms), developed markets in Europe and Asia, along with select emerging economies, outperformed strongly.

CHART 3

Regional equity returns



Source: MSCI

Three key factors have contributed to this divergence. First, policy uncertainty – particularly around trade – has escalated sharply. The reintroduction of sweeping tariffs in April under the Trump administration injected a new wave of uncertainty into global markets.

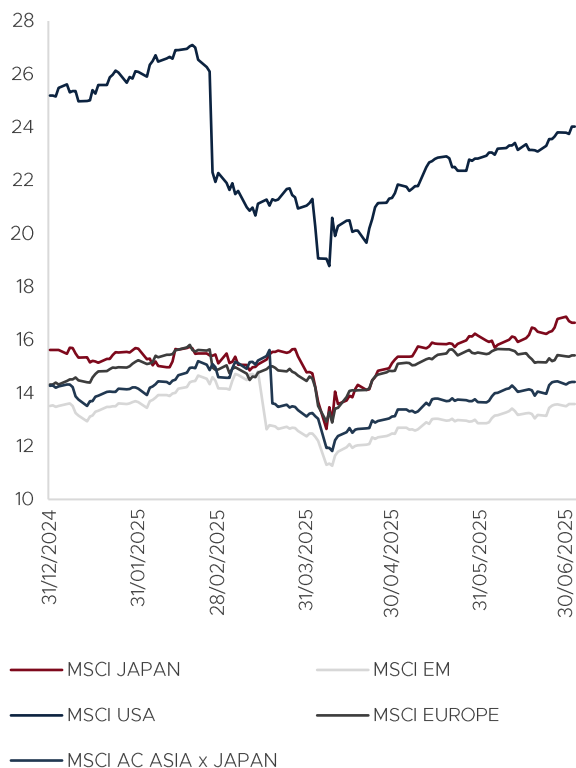
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Businesses and investors alike have struggled to assess the second-order effects on costs, supply chains, and consumer prices. This has inevitably led to increased volatility and reduced risk appetite for US-centric equity exposure.

Second, expectations for more persistent inflation have begun to weigh more heavily on market sentiment. While inflation has moderated from post-pandemic highs, it remains sticky – particularly in services and wage-sensitive categories. The Federal Reserve has signalled greater caution around premature easing, and markets have largely priced out the possibility of aggressive rate cuts in the near term. This hawkish tilt, in contrast to a more dovish stance from other central banks, has put relative pressure on US equity valuations.

CHART 4

Regional Equity Valuations



Source: MSCI

Finally, the elevated starting point for valuations going into 2025 has left US equities more vulnerable to negative surprises. Following a strong year-end rally in 2024 – driven in large part by optimism around a pro-growth policy pivot – major US equity indices entered the year on historically elevated valuations. This left little room for disappointment, and as the economic impact of Trump's policies became more uncertain, markets began to reprice forward expectations.

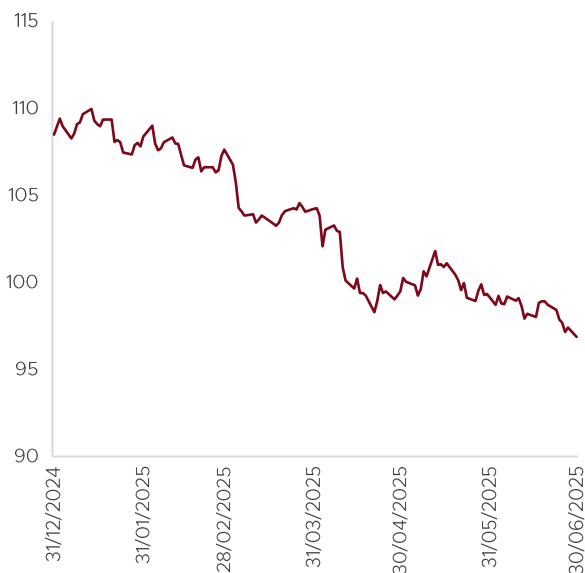
By contrast, international equities have benefited from more supportive valuations, relative policy stability, and currency tailwinds from a weakening US Dollar. Therefore, for global investors, the risk-reward profile outside the US has become increasingly attractive, prompting renewed allocations toward Europe, Japan, and Emerging Markets.

US Dollar weakness undermines safe-haven status

The third major theme has been the sustained weakness of the US Dollar. The Dollar index (DXY) declined by over 10% since the start of the year, marking its steepest first-half fall in several decades.

CHART 5

US Dollar Index (DXY)



Source: Bloomberg

The Long Read

It appears the market has been adjusting to a US policy environment that is both more insular and more unpredictable. Trade policy, as mentioned, is now viewed as a source of inflationary risk rather than growth stimulus. Meanwhile, the growing fiscal deficit – compounded by new spending commitments and extended tax cuts – is raising long-term concerns about debt sustainability. Not to mention the administration's well-publicised desire to see a weaker currency relative to its main trading partners in an attempt to address the trade deficit.

Beyond that, there is an increasing level of Presidential scrutiny with regard to the Federal Reserve's monetary policy. While the Fed has so far resisted direct interference, the perception of politicised monetary policy has perhaps prompted some capital to rotate toward other currencies, including the Euro, Yen, and commodity-linked currencies such as the Canadian and Australian Dollars.

Looking ahead: Three broad themes

As we look toward the second half of the year, a number of issues should remain front of mind for investors. While markets have shown resilience in the face of rising policy uncertainty and uneven performance across asset classes, the path forward is likely to be shaped by three broader themes.

1. Valuations remain elevated – and increasingly concentrated

Global equity valuations continue to look rich by historical standards, but the aggregate picture conceals wide underlying dispersions. In the US, for example, headline valuation multiples – whether based on forward earnings, dividend yield, or free cash flow – appear once again rich following the market rally of the past few months. It is evident however that these elevated levels are once again concentrated in a relatively small cohort of mega-cap technology stocks, particularly those linked to AI infrastructure and cloud computing. As was the case for the technology-led equity rally during the pandemic of 2020, these companies have once again driven a disproportionate share of the index-level gains and are trading at significant premiums to historical norms.

By contrast, valuations across the broader US market – particularly in mid-cap, value-oriented, and cyclical sectors – are more aligned with long-run averages. Similarly, non-US equity markets remain attractively priced. European, Japanese, and Emerging Market equities are generally trading within historical valuation bands, with some EM markets still below average despite a solid earnings recovery and supportive demographics.

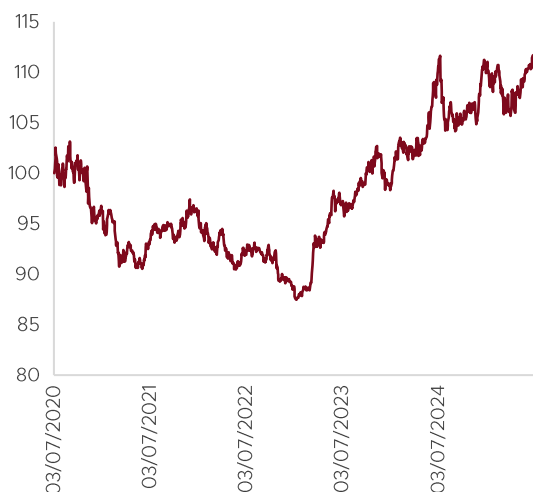
This concentration of valuation risk raises the potential for sharp downside at the broader index level in the event of a derating of a relatively small number of very large index constituents. In other words, valuation risk is high, but not uniformly distributed. For investors, this creates both opportunity – in under-owned and more fairly valued segments – and risk, particularly in areas where expectations may already be priced for perfection.

2. Artificial Intelligence euphoria will dominate market sentiment

The surge in artificial intelligence-related equities has created a market structure defined by narrow leadership. The S&P 500, for example, has seen an increasing share of its gains driven by a handful of firms – primarily in semiconductors, cloud computing, and software – tied to the AI value chain.

CHART 6

Capitalisation versus equal weighted S&P 500



Source: Saranac, Standard & Poor's

The Long Read

This trend has led to a widening divergence between market-cap weighted and equal-weighted indices, with the spread between the two reaching decade highs toward the end of June.

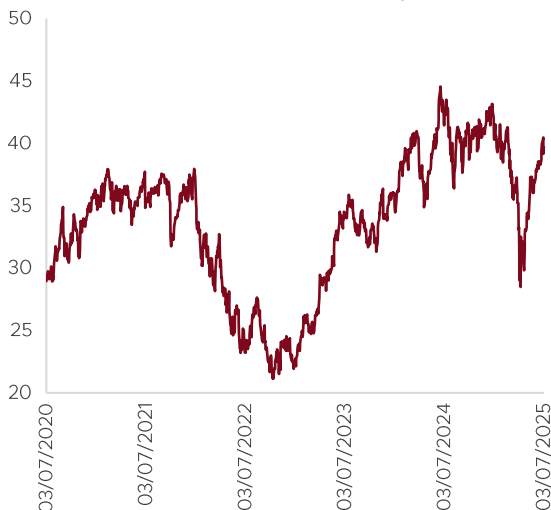
This dynamic introduces significant concentration risk. While investors have been rewarded for leaning into AI themes, the sustainability of the rally now rests on two pillars:

1. The real-world adoption and monetisation of AI technologies across industries, and
2. the continuation of elevated capital expenditure by hyperscalers and cloud providers to support AI infrastructure.

AI adoption remains in the early stages in most sectors, and while it has the potential to drive meaningful productivity gains, those are largely still theoretical in nature, rather than evident in hard data. At the same time, any moderation in capex – from budget constraints, regulation, or competition – could deflate revenue growth expectations for key suppliers to the AI ecosystem. Given how much forward multiple expansion has already occurred, modest earnings misses or guidance cuts from the major AI firms could reverberate well beyond the sector.

CHART 7

S&P500 Information Technology P/E Ratio



Source: Saranac, Standard & Poor's

3. Continued policy uncertainty adds to market risk premium

Policy uncertainty – particularly in the US – remains a central macro risk in the second half. The Trump administration's aggressive stance on trade has already reintroduced tariffs on Chinese and European imports, disrupting global supply chains and weighing on business investment. While the direct economic impact has been moderate, policy volatility has introduced a higher risk premium across US assets, contributing to the underperformance of US equities against international markets and the depreciation of the US Dollar.

Looking ahead, additional layers of uncertainty are emerging. A new Federal Reserve chair is expected in 2026, and political rhetoric around Fed independence has intensified. Markets are likely to price in a less predictable monetary policy regime, with implications for both rates and inflation expectations.

Compounding this is a shift in US immigration policy. The administration has tightened legal immigration pathways, which could constrain labour supply in key sectors – including healthcare, agriculture, construction, and services. While politically popular, this shift raises structural concerns about labour shortages and wage inflation, particularly in an already-tight labour market. A reduced labour force participation rate could hinder long-term potential GDP growth and complicate the Fed's job in bringing inflation sustainably back to target.

Portfolio implications

In Saranac multi-asset portfolios we have not chased the equity market rally but continue to hold a somewhat lower equity weight than usual, and higher weights in short-dated credit and other alternatives. Our preferred economic scenario is commensurate with an environment of slower growth, higher inflation and lower growth in corporate profits. We do not think such outcome is reflected in equity market pricing. The higher than usual weight in alternative assets is designed to provide protection to portfolio returns in the event of the market dislocations which a less stable political environment might deliver.

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Saranac Partners Limited

+44 (0)20 7509 5700

16 St James's Street London SW1A 1ER

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