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Optimal Income Strategies

Following eased tariff tensions, discussions resume.

- Trade tariffs pressure eased, but are back centre stage next month
- US nuclear site bombing in Tehran leads to a spike in global tensions
- ECB cuts rate again but hints a pause, China stays resilient

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What's happening?

The impact of tariffs has yet to fully materialize, but the trade truce between the US and China has mitigated some downside risks to growth. While we don't anticipate that the recent near-deflation CPI readings will be enough to trigger yet another policy rate cut, we intend to look forward the impact of fiscal policy that could bolster growth taking into account the negative tariff effects before any potential further rate reductions.

In the US, the Federal Reserve's new forecasts released in June conveyed a hawkish tone, with the FOMC revising its median GDP growth projections downwards for 2025 and 2026. The GDP growth for next year is now anticipated to be slightly below trend at 1.6%, down from the previous estimate of 1.8%.

In the Eurozone, our revised growth outlook appears more volatile, reflecting an anticipated front-loading of weakness. We project a GDP contraction of -0.2% quarter-on-quarter in Q2, followed by flat growth in Q3 and a further decline of -0.1% in Q4. This places the euro area on the brink of recession rather than experiencing a mild downturn.

Meanwhile, in China, several factors contributed to a boost in retail spending in May; however, price levels within the economy remain subdued. Chinese exports have shown resilience, bolstered by transshipment to ASEAN regions and the EU, though uncertainties still pose significant headwinds.

We expect upcoming changes in US trade policy to prompt most developed central banks to pursue additional measures. Specifically, we now foresee the Federal Reserve implementing two rate cuts this year, in October and December, bringing the rate down to 4.0%. Similarly, we anticipate the European Central Bank will also cut rates twice, in September and December, to reach 1.5% by year-end. The Bank of England is expected to lower its Bank Rate to 3.75% by the end of the year, aligning with market expectations, while the Bank of Japan may implement one more hike, increasing the rate to 0.75%.



Portfolio positioning and performance

	GLOBAL OPTIMAL STRATEGY			OPTIMAL STRATEGY			DEFENSIVE OPTIMAL STRATEGY		
	Dec-24	May-25	Jun-25	Dec-24	May-25	Jun-25	Dec-24	May-25	Jun-25
Net Equity	87,9%	64,3%	93,8%	76,3%	60,7%	77,8%	34,6%	40,0%	42,1%
Equities	79,7%	71,2%	73,7%	72,9%	65,9%	69,2%	37,0%	24,6%	24,8%
Equities derivatives	13,9%	1,8%	26,6%	5,2%	1,2%	14,1%	-2,4%	15,4%	17,3%
Risk Mitigation Strategies	-5,7%	-8,7%	-6,5%	-1,8%	-6,4%	-5,5%	0,0%	0,0%	0,0%
Fixed Income	5,0%	11,7%	12,8%	23,6%	25,1%	25,9%	62,9%	28,1%	47,4%
Govies	0,0%	0,0%	0,0%	0,0%	0,0%	0,0%	0,2%	2,3%	0,3%
Bond Derivatives	45,0%	27,6%	19,6%	27,4%	21,5%	15,9%	10,4%	27,5%	18,8%
High Yield Credit	1,0%	2,1%	2,2%	5,6%	4,7%	5,1%	16,3%	19,0%	19,0%
Investment Grade	3,9%	9,5%	10,3%	17,6%	20,0%	20,8%	46,0%	6,4%	27,5%
Emerging Debt	0,1%	0,1%	0,3%	0,3%	0,3%	0,0%	0,5%	0,5%	0,6%
Diversification	11,6%	8,7%	8,6%	2,2%	2,0%	2,0%	5,9%	8,9%	8,2%
Cash & Money Market	-4,4%	15,2%	-15,3%	-1,9%	12,2%	-5,7%	-3,4%	22,9%	2,3%

In June, amid easing market tensions and a more balanced risk-reward backdrop, we adjusted our portfolio to reflect a more constructive outlook. While policy unpredictability —particularly out of Washington with trade tariffs back on the table of negotiations early July—remains high, improving sentiment and positioning data led us to continue re-risking our portfolios.

We increased our overweight position in global equities using derivatives, reflecting a positive equity allocation view that we are encouraged to sustain into July. This decision is bolstered by neutral equity allocations within systematic strategies and a gradual narrowing of the gap between hard and soft economic data. However, we remain mindful of the potential uncertainty, especially with the return of tariff discussions expected in July. Thus, our approach to equity risk remains agile.

In contrast, we are underweight US small-cap stocks relative to the Nasdaq and financials, as small-cap companies are particularly vulnerable to adverse news regarding the US economy. Although recent updates on the domestic economy have been more favourable, our growth forecasts have deteriorated since the beginning of the year.

On the interest rate front, we are taking a neutral stance on long-end sensitivity, favouring short-dated German bonds. German government bonds continue to serve as a key instrument for duration views; however, recent weaknesses in the Japanese government bond (JGB) curve and the steepening of the US Treasury curve pose significant risks to the long end of Euro interest rate curves. Although short rates may be less attractive in terms of absolute returns, they provide a more secure way to express our belief that the European Central Bank remains in a cutting phase and is likely to deliver more than current market expectations suggest.

Outlook

After six months of significant policy-driven volatility, including the third highest stress spike in modern history—surpassed only by the Covid-19 pandemic and the 2008 Global Financial Crisis—we enter the second half of 2025 with fundamentals and valuations largely unchanged from the start of the year. Whether this stability is seen as complacent or uncomfortable, it is reassuring to have moved past such elevated levels of uncertainty.

On the macroeconomic front, the gap between declining forward-looking soft data (like consumer confidence and business surveys) and resilient backward-looking hard data (particularly retail sales and trade flows) has begun to close positively. This gap often signals potential troubles ahead, and we incorporate it into our tactical risk appetite framework. While hard



data remains steady, the Atlanta Fed's GDP growth tracker indicates an annualized growth rate of +3.4% for Q2 2025, significantly above the US's potential growth and suggesting that the earlier economic contraction was not the start of a downturn. The US labour market also shows resilience; while job creation is slowing, a collapse in immigration has reduced the number of new jobs needed to maintain the unemployment rate at 4.2%, the same level as nearly a year ago. Additionally, US inflation news is favourable, aligning with or falling below economists' expectations. Fed Chair Powell could reiterate his May 2024 statement: "I see No Stag nor Flation."

On the other side of the soft-hard data gap, soft data have modestly improved, with the NFIB optimism survey for US small- and medium-sized businesses showing increased hiring intentions. This sentiment shift may reflect relief following President Trump's quick reversal on tariffs, removing worst-case scenarios from consideration. With Treasury Secretary Scott Bessent (a proponent of lower tariffs) gaining influence over tariff hawks like Peter Navarro, it appears that the peak of US trade policy uncertainty is behind us. This shift is partly influenced by China's strategic use of its rare earth reserves, representing a credible threat compared to further selling of US Treasury bonds.

What keeps us overweight in portfolio risk allocation? US retail investors have consistently "bought the dip," returning to or nearing historical maximum equity exposure, in line with hedge funds. However, many systematic strategies have lagged in this V-shaped rally due to elevated recent volatility. These strategies are typically only back to neutral in terms of equity risk. Unless a significant volatility shock occurs—something the ongoing tensions in the Middle East have not yet triggered—we expect these strategies to increase their equity exposure, providing strong technical support for equity markets.

Overall, after a tumultuous first half of the year, we remain confident that diversified multi-asset portfolios will continue to deliver attractive risk-adjusted returns in the latter half of 2025.

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