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The US has been experiencing an unusual economic cycle thus far, with the economy significantly more resilient than market expectations of a few years ago. What has triggered this change, and how is it likely to manifest itself in the ensuing period?

There have been a number of key developments since the start of the decade which may have precipitated this unusual development, but at the core, we believe it was the excessively easy fiscal policy during the initial Covid period which packed together in a couple of months a multiple of the whole fiscal policy enacted during the GFC years.

This fiscal 'bazooka' not only provided the support for consumers to withstand the higher interest rates of 2023-2025 but was also one of the key causes of inflation. In fact, back in July 2020 we were amongst a handful of firms predicting inflation to rise and not to be transitory; our initial 5 reasons for inflation were then identified as:

- (a) *globalisation is receding with supply chains coming closer to where fixed costs are higher;*
- (b) *ongoing geopolitical tensions will retain trade disruptions; rising tariffs; 'national champions';*
- (c) *the magnitude of policy stimulus post Covid-19 has been unprecedented;*
- (d) *and, unlike post-GFC, it's not targeted at systemic institutions, but broad and widespread;*
- (e) *last but not least, central banks would welcome inflation to help erode part of the huge debt.*

What followed and accentuated inflationary pressures further was another key development of the past five years, Russia's invasion of Ukraine. Alongside the elevated inflationary pressures from energy prices, this event also triggered a seismic shift in EU fiscal policy to counterbalance Trump's stance on NATO and EU's contribution, driving another fiscal expansionary policy on defence, energy, communications etc.

Bringing us back to today, during his Jackson Hole speech and latest Fed meeting, Powell focused on the weaker employment numbers having seen significant adjustment and raising the probability of a weaker labour market. Given the Fed's dual mandate of full employment and stable prices he felt it appropriate to adjust policy to reflect this shift in the balance of risks. We do not agree with the Fed and see the risk of a policy mistake.

We believe the US economy remains more resilient than survey data suggests and with inflationary prices well above target and on a rising trajectory, as companies start to pass through tariffs, we believe policy should have remained more restrictive for the US. Furthermore, employment may have been weakening but the rate of unemployment is still low, yields are contained and corporate profits/earnings continue to be supportive. For example the latest US GDP (+3.8% for Q2) was quite strong.

On the other hand, the 'Goldilocks' inflationary numbers out of the EU with its strong currency could merit a more dovish outlook from the ECB versus market expectations.

1. Your thoughts on the US economy, interest rates and yields

The US economic outlook has surprised market participants with its resilience year to date. Our outlook had been quite constructive, given our expectation that President Trump would be more pragmatic in his negotiations with the bilateral trade discussions in order to avoid an economic recession or a stock market crash.

The concerns we see therefore, are more on the inflation side, where our probability scenario has risen to 70% of low

and rising inflation, potentially heading to the upper end of our 2.5% – 3.5% range. This in our view should not have permitted the Federal Reserve to cut rates in September and October, raising the possibility of a policy mistake, but relieved to hear Powell adjusting expectations of a further December rate cut with the phrase 'far from it'.

Still, we remain constructive on 10yr US Treasuries given the positive real yields, the expectation that the Fed remains orthodox and anchors inflation expectations, and finally the diversification govies offer against a weaker economy or a risk-off event. It is worth highlighting here that, unlike the policy error during Covid or the political error during 7th-9th April of this year, we do not believe bonds and equities will move in unison.

2. Has President Trump changed the traditional economy and how it reacts to geopolitical news?

As we briefly touched upon in our answer to No.1 above, our view on President Trump following his Liberation Day announcements was quite stoic. We did not believe Trump would want to be associated with either a US recession or a stock market crash, and hence, when Treasury yields started to rise between April 7th – 9th alongside equity markets and risk assets selling off, he backtracked and U-turned on a number of the initial announcements he had made.

In fact, on the preceding weekend, Saturday 5th April, we had an unprecedented policy and process meeting, where we decided that markets had been under-pricing any potential right-tail-risk. Our premise was that President Trump was approaching his pain threshold and that the Federal Reserve would remain orthodox, hence the unpredictability that markets had started to fear 'could go both ways'. As a result, early morning on Monday April 7th we decided to turn Positive Nasdaq, which turned out to be the recent cycle lows.

In conclusion therefore, Trump has introduced a new level of political and policy uncertainty which will remain throughout his Presidency, and potentially extend to another term should a strong economy by next year's mid-terms in November 2026 prove supportive for the Republican party to challenge the 22nd and 12th Amendments and have Trump v Obama in 2028...

3. How do we see Fixed Income assets and Credit products?

Following the post GFC zero interest rate policy market environment, where asset allocations had divested of traditional fixed income assets for private markets and alternative asset classes, the return of fixed income is prevalent across global portfolios amongst institutional investors and asset owners.

Government fixed income, whether developed or emerging market, has performed well amidst prudent central banks containing inflation expectations with orthodox policies. Similarly, public and private credit products have benefited from lower interest rates and strongly recovering economies since Covid.

The ensuing environment for fixed income continues to be quite supportive in our view, partly due to the real yields it provides amidst prudent central banks and the diversification benefits in an unconstrained global portfolio. Credit valuations are indeed stretched, but with strong market price behaviour and supportive fundamentals, they continue to offer value as a strategic asset allocation, if not tactically overweight given level of spreads.

Furthermore, we believe the Federal Reserve and other major central banks will continue to pursue an inflation targeting mandate, independent from political intervention, reducing the risk of an inflationary crisis. As discussed earlier, we are not aligned with the market's expectation of aggressive rate cuts by the Fed as prices are coming off the lows alongside a resilient economy. Critical over the next quarter will be the assessment of the US payroll numbers, and in particular any impact on traditional leading indicator sectors such as manufacturing jobs or residential construction.

In terms of private credit more specifically, any weakness in the economy will prove to test this asset class, which has yet to see a down cycle, thus placing more emphasis on the bottom-up decision-making process, covenants and credit selection. Unlike Private Equity however, which seems to be in a crisis driven by low distributions and reduced allocations by asset owners, private credit remains resilient. There are signs of some stress with lite covenants and rise of Back PIKs but the industry has diversified further, moving beyond Direct Lending to structured credit CLOs, ABF etc.

4. Are there any sectors which stand out for the ensuing period?

Given the structural changes in the political arena since President Trump's inauguration, there have been some critical changes in the economic and political landscape on both sides of the pond. ESG and climate for example, have both seen a significant downgrade of focus whilst defence, technology, and AI have seen a commensurate rise. This is particularly pertinent given both the MEGA (Make Europe Great Again) movement taking place following the realisation that the Transatlantic relationship is no longer what it used to be, but also Europe's deeper involvement in the Russia/Ukraine war with the elevated regional geopolitical uncertainty.

But apart from the structural geopolitical factors impacting some of the industries and sectors such as Banking, which would help re-finance the eventual reconstruction of Ukraine, there are underlying economic drivers which help rank the sectors accordingly. For example, in early August, we turned Positive US Healthcare given the sharp deterioration in margins following Trump's intervention which make Forward PEs attractive in an otherwise very expensive US market. Within that, there are nuances such as avoiding managed healthcare more susceptible to Trump's policies, but focusing instead more on pharmaceutical and healthcare equipment as an example. Still, the most recent tariff announcements will require further clarification, given that they exceed prior agreements.

Technology is also amongst the top three of our sectoral views and although we turned Positive Nasdaq at the absolute lows on April 7th we find current valuations expensive. Still, we do not agree with comparisons to the dotcom bubble; today's corporates are generating significant revenues and investing capex through free cash flow as opposed to the debt-fuelled expansion of the late 90s, which led to a speculative bubble and burst.

5. Similarly, are there any particular regions or geographies which stand out?

Across the developed market world, our preference on the equity side has been for Europe, UK, Japan, and China with some opportunistic views on the US market, such as turning Positive Nasdaq in April at the lows as discussed above, or some particular preference for Sectors such as Consumer Discretionary, Communication Services and more recently Healthcare. Of these developed countries, our process ranks EU and Japan as the most attractive, followed by UK. We are Neutral the US (at overall index level), given supportive Fundamentals, Market Price Behaviour, Politics & Geopolitics, but very expensive Valuations.

Moving aside from the major economies and markets, we have been Positive China, and during the recent 12-day war in the Middle East we turned Positive South Korea, Turkey and Eastern Europe. South Korea, following the constructive resolution of the political debacle, with an orthodox and balanced parliament and a prudent central bank. Turkey, despite the still poor scoring fundamentals, we believe 2025 will be an inflection year where the hard work of tight monetary policy will drive inflation and interest rates lower, supporting the underlying economy. Last but not least, we have also turned Positive Eastern Europe, partly on the idiosyncratic factors supporting the individual countries, but also the impact of the MEGA movement trickling from Euro Area to Europe and Ukraine's eventual reconstruction.