

Overview

Don't Fight the Fed

Global equities have been resilient in 2025, despite geopolitical and trade shocks. Although near-term risks persist amid weakening US data, our base case assumes a recession will be avoided, supported by AI-driven investment and policy easing. We foresee a 'quasi-Goldilocks' environment characterised by moderate growth, stable (though elevated) inflation, and more accommodative monetary policy. Fed cuts, global central bank easing, and a weaker US dollar create a favourable backdrop for risk assets. We remain overweight non-US equities.

Global equities have trended higher this year (ACWI +11% year-to-date), despite several shocks, including a sharp rise in US tariffs and a military conflict in Iran. Some short-term caution may still be warranted as US economic data shows signs of weakness. The July US nonfarm payrolls report recorded below-trend job growth of seventy-three thousand, along with material downward revisions to the two previous months. However, if the US avoids a recession this year (our base case), the investment environment favours further strength in global equities.

Our baseline expectation has shifted more positively to a 'quasi-Goldilocks' environment for the second half of the year and early 2026. 'Goldilocks' is typically described as steady economic growth that is neither too hot nor too cold – i.e., a recession is avoided, and inflation remains stable. Stocks can perform well as financial conditions ease and earnings grow. Currently, US growth is downshifting (see chart 1) and will likely remain below trend in the second half of the year as tariffs, immigration restrictions, and slowing consumption weigh on activity. Still, AI-related investment added around 1% point to growth in the first half of the year (see chart 2) and potential positive impacts from deregulation and the One Big Beautiful Bill (OBBB) provide some offset.

We use the term 'quasi-Goldilocks' because inflation is elevated; however, the current trend is not sharply accelerating in response to tariffs. Chart 3 shows a clear rise in goods inflation, based on the increase in core goods prices, indicating that tariffs are impacting prices. There is a risk that prices continue rising this year if further costs are passed on to consumers. On the flip side, services prices show a more benign inflation trend, potentially allowing the Fed to shift focus to its maximum employment mandate.

The market narrative is likely to be centred around the Fed and global central banks in September. Weakening US data is providing a stronger case for a resumption of the Fed's cutting cycle. Two FOMC members have already dissented in favour of cuts and Governor Kugler's replacement should add a third dove to the FOMC and

potentially a 'shadow Chair'. At the current 4.50% policy rate, the Fed has room to react to weaker data. Furthermore, approximately seven trillion dollars is parked in money market funds earning roughly 4% returns, which could be reallocated to duration, equities, or other assets (e.g., hard assets or alternatives) as short-term rates decline. Additionally, a large portion of non-US central banks are either cutting or expected to cut rates this year (see chart 4). Overall, the global monetary backdrop is becoming more supportive for financial assets.

While some risks remain, we observe that elevated global policy uncertainty is declining (see chart 5), and the OBBS passed without triggering a major bond market revolt. US fiscal risks are unresolved over the longer term, as US debt levels rise, but an immediate catalyst for a sharp rise in yields is less obvious. Also, the US dollar is weakening (-6% YTD, based on the Fed's nominal trade-weighted index), and financial conditions are easing (Chicago Fed Financial Conditions index is at its lowest level since 2021, at -0.57). Finally, global earnings revisions have bottomed and turned marginally positive in recent weeks following negative revisions earlier in the year.

Global Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
US	-					
Canada	-					
Eurozone	-					
Switzerland	-					
UK	-					
Japan	-					
Australia	-					
EM	-					

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Source: CLIM

International Equity Allocation Breakdown

	Chg	-2	-1	0	+1	+2
Canada	-					
Eurozone	-					
Switzerland	-					
UK	-					
Japan	-					
Australia	-					
EM	-					

Note: Up/down arrows indicate a positive/negative change in our asset allocation compared to the previous quarter. A dash indicates no change.

Source: CLIM

*This publication reflects asset performance up to 31 July 2025, and macro events and data releases up to 6 August, 2025, unless indicated otherwise.

Market Strategy:

We continue to favour non-US stocks, which typically outperform US equities as the US dollar depreciates. We also expect DM ex-US small-caps to benefit from USD weakness. Over the next three years, we anticipate 10-20% US dollar depreciation as outlined in our recent note *USD Dollar Weakness: A Crowded Idea, Uncrowded Trade* (July 2025). Within ACWI ex-US, we remain overweight EM, Japan, and the Netherlands, which offer non-US tech exposure at more attractive valuations than the US large-cap tech stocks.

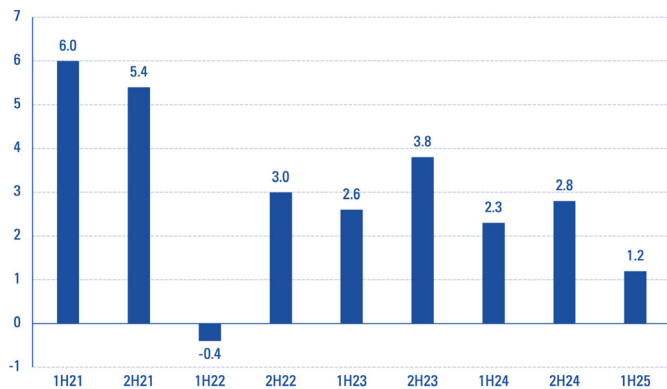
We remain overweight Switzerland. Switzerland has underperformed due to unexpectedly high US tariff rates (39%), and direct pressure on the health care sector - the largest component in the MSCI Switzerland Index. The ACWI health care sector was the weakest sector over the past three months (see chart 7) and appears oversold on some metrics. Tactically, we believe both health care and MSCI Switzerland are due for a rebound. However, we are more inclined to reduce exposure into strength.

Justin Kariya

August 6, 2025**

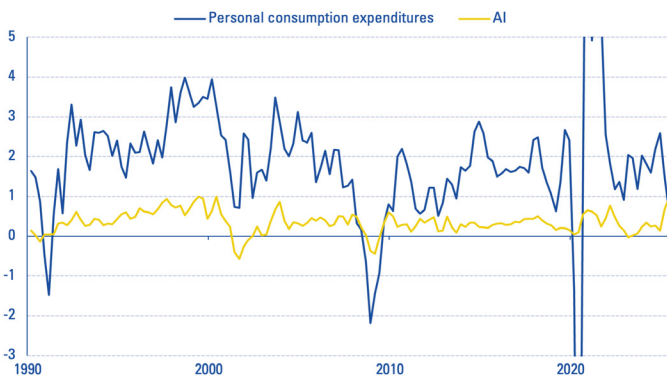
** The document includes contributions from Tom Traill.

Chart 1: US real GDP growth (%HoH annualised)



Source: BEA

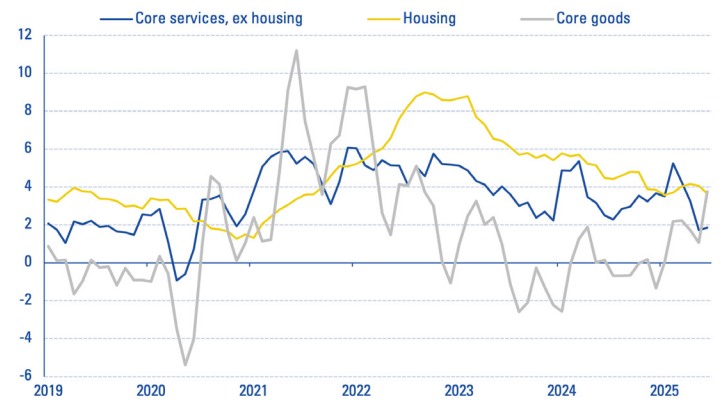
Chart 2: AI Capex contribution to US growth



Source: BEA

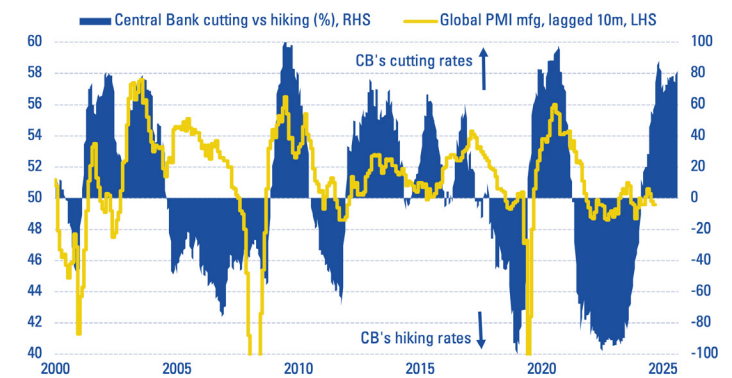
Note: AI includes Information Processing Equipment & Software. PCE is truncated in 2020 to fit on chart. Both series are a two-quarter moving average.

Chart 3: PCE Price Index, 3m annualised



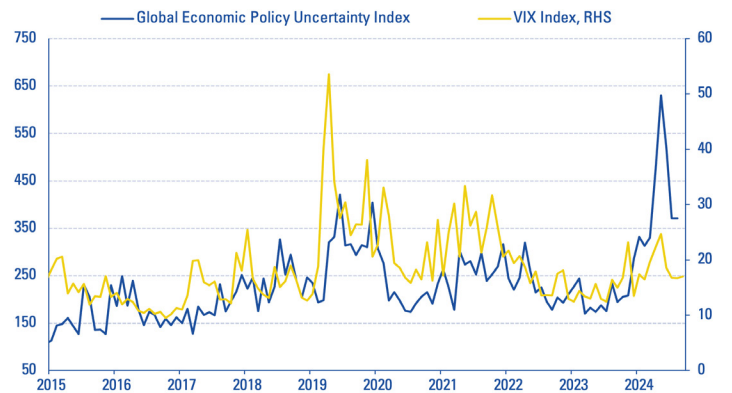
Source: BEA

Chart 4: Global central banks cutting vs. hiking



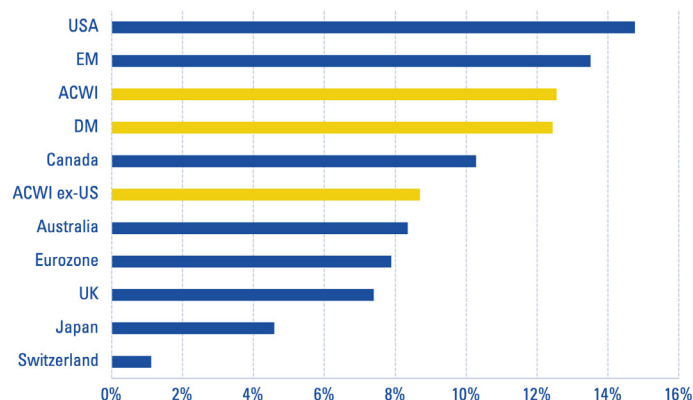
Source: Bloomberg

Chart 5: Global Economic Policy Uncertainty Index



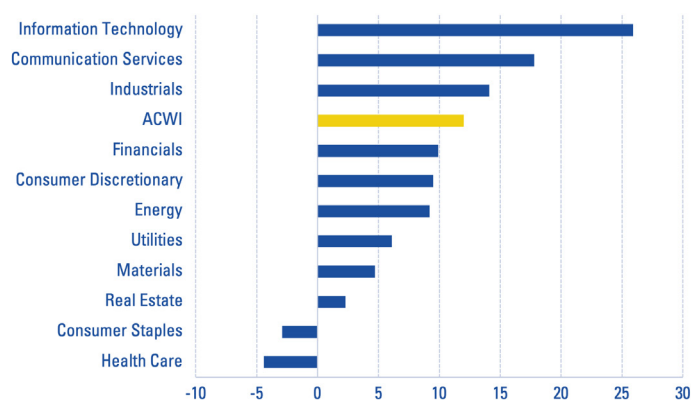
Source: Bloomberg and Baker, Bloom, and Davis

Chart 6: ACWI, Net TR USD, May-Jul, %



Source: Bloomberg

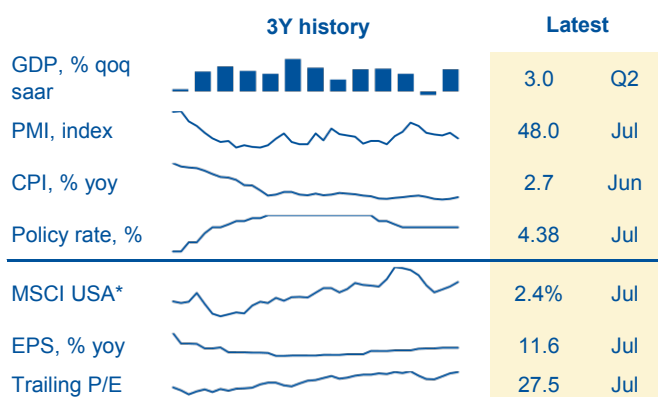
Chart 7: ACWI Sectors, Net TR USD, May-Jul, %



Source: Bloomberg

United States

UW (Global Index)



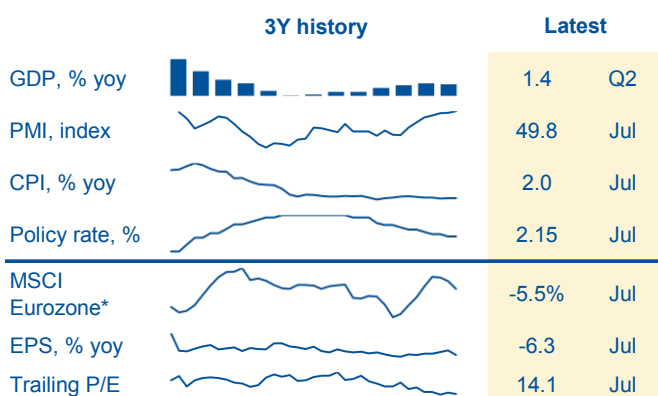
*US\$ total return relative to MSCI ACWI. Latest is three-month return.

Source: Bloomberg

- In absolute terms, US equities are likely to continue trending higher if earnings growth remains positive and financial conditions improve. However, continued US dollar weakness has historically been associated with outperformance by international stocks. We expect further USD depreciation, driven by both cyclical and structural forces. Potential Fed cuts in the fall would further add to USD pressure.
- The MSCI USA Index is highly exposed to technology stocks, which have been the primary driver of earnings growth and US equity strength. AI growth could further cement US large-cap tech dominance. However, significant AI-related capex spending presents a potential risk for profit margins for some of the most richly valued hyperscalers, while non-US tech companies are well-positioned to benefit from global demand for AI.
- The US market continues to screen as relatively expensive. The index will likely underperform if USD weakness persists and large capex investments fail to translate into revenue growth. We maintain a small *underweight*.

Eurozone

NW (Global and Global ex-US index)



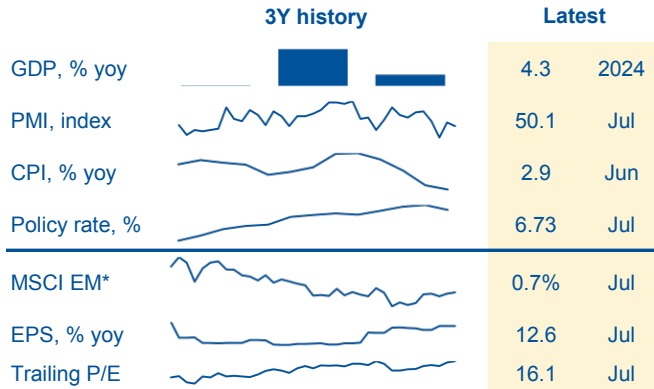
*US\$ total return relative to MSCI ACWI. Latest is three-month return.

Source: Bloomberg

- The Eurozone economy has been gradually improving. PMI data has been trending higher since the start of the year, but it remains one of the weaker DMs. The bloc may benefit from German investment following the vote to alter its 'debt brake'. The ECB has cut rates year-to-date, which should continue to support activity and limit euro appreciation.
- Although a weakening dollar tends to help international stocks, a strong euro and below-trend global growth have historically been a headwind for the Eurozone. Earnings are forecast to be weak in 2025, and below the global average in 2026. The trade deal with the US (15% tariff rate) reduces some near-term uncertainty.
- We see more value in small-cap exposure and favour tech hardware, which within the Eurozone is most apparent in the Netherlands. We maintain a *neutral* position for the Eurozone overall, with an *overweight* in the Netherlands funded by a small *underweight* in the bloc's other countries.

Emerging Markets

OW (Global and Global ex-US index)

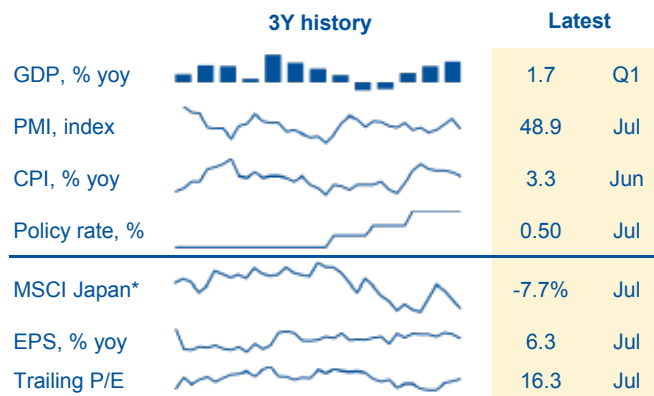


*US\$ total return relative to MSCI ACWI. Latest is three-month return. Economic indicators are GDP-weighted with the exception of PMI, which is value-added-weighted.
Source: Bloomberg

- EMs (primarily Taiwan and Korea) remain leaders in the production of advanced semiconductors and high-bandwidth memory chips. Robust demand for AI-related hardware provides a clear structural growth story for this sector. These companies are well positioned and more attractively valued than their US counterparts.
- Recent tariff developments have shifted our relative preferences within EM, creating some winners and losers. However, the overall rise in US tariffs has been in line with expectations and trade uncertainty appears to be moderating following the August 1st reciprocal tariff deadline. Fed cuts and easier financial conditions should further support EM performance.
- A falling US dollar has historically benefited EM. Earnings growth has been robust and is expected to remain strong, while valuations have room to re-rate. We remain *overweight*.

Japan

OW (Global and Global ex-US index)

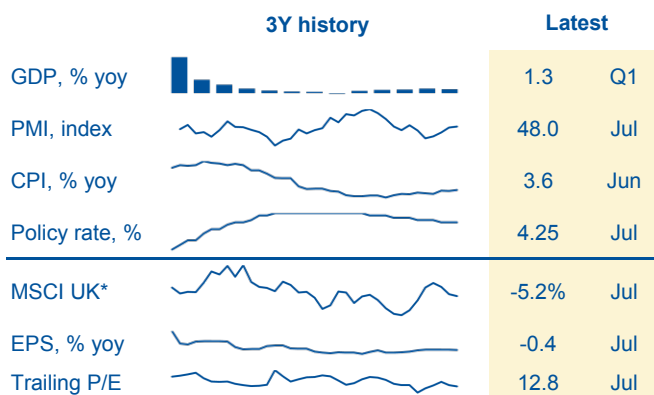


*US\$ total return relative to MSCI ACWI. Latest is three-month return.
Source: Bloomberg

- Efforts to improve Japanese corporate governance are showing incremental progress, evidenced by increased share buybacks and reduced corporate crossholdings. Continued reform would support a higher valuation multiple. Additionally, a lower oil price – one of the Trump administration’s stated aims – typically benefits Japan.
- The Bank of Japan is an outlier among DM central banks, as it is expected to raise rates rather than cut. The yen remains at relatively depressed levels and could strengthen, improving FX-adjusted returns - particularly for Japanese small-caps.
- MSCI Japan continues to trade at a greater-than-usual discount to ACWI and is well positioned to benefit from a decline in US exceptionalism given that it is a large alternative market. We remain *overweight*.

United Kingdom

UW (Global and Global ex-US index)

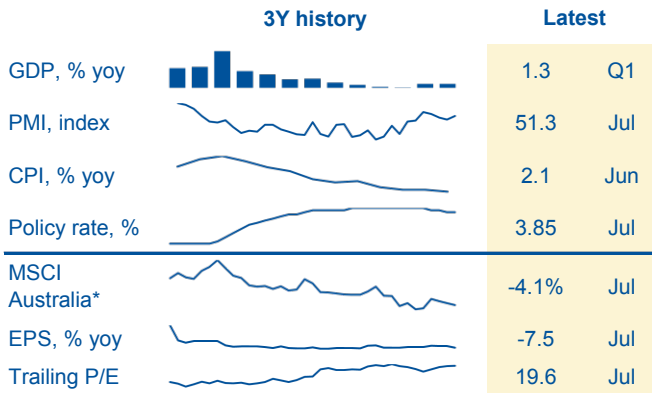


*US\$ total return relative to MSCI ACWI. Latest is three-month return.
Source: Bloomberg

- The UK market suffers from a lack of growth drivers and a compelling narrative to attract inflows. We anticipate stronger performance from international stocks over the coming years due to exposure to AI (e.g., EM), corporate governance reform (e.g., Japan), and greater fiscal spending (e.g., Eurozone/Germany). The UK does not offer a convincing macro narrative or earnings backdrop to attract flows from the US.
- The index has a high weight to energy, which remains a headwind given ample global oil supply, and the US has a stated aim to keep energy prices down. Financials may also come under pressure if falling global rates reduce net interest margins.
- The UK continues to trade at a discount to ACWI, in line with its five-year average. We see value in the small-cap space, but less so for large-caps. Earnings expectations are negative for 2025 and unremarkable for 2026. We remain *underweight*.

Australia

UW (Global and Global ex-US index)



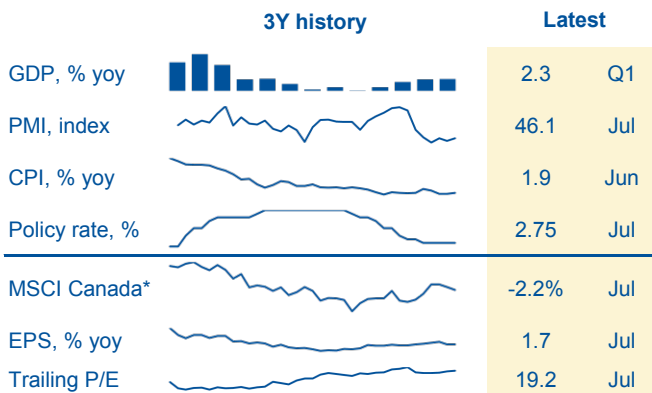
*US\$ total return relative to MSCI ACWI. Latest is three-month return.

Source: Bloomberg

- Over 40% of the MSCI Australia Index is composed of financials, which have performed well in recent periods. We see scope for bank net interest margins to come under pressure, yet valuations remain elevated, despite lacklustre trailing and forward earnings growth.
- Continued growth in AI and further electrification of the global economy will lead to increased demand for copper – a commodity with which the Australian index typically correlates. However, the broader natural resources sector has historically been buoyed by Chinese demand, and we do not expect another broad commodity supercycle (e.g., iron ore and coal).
- MSCI Australia is trading at an elevated P/E ratio and has weak earnings growth expectations for both 2025 and 2026. As a result, the index is vulnerable to de-rating. We maintain our *underweight* position.

Canada

UW (Global and Global ex-US index)



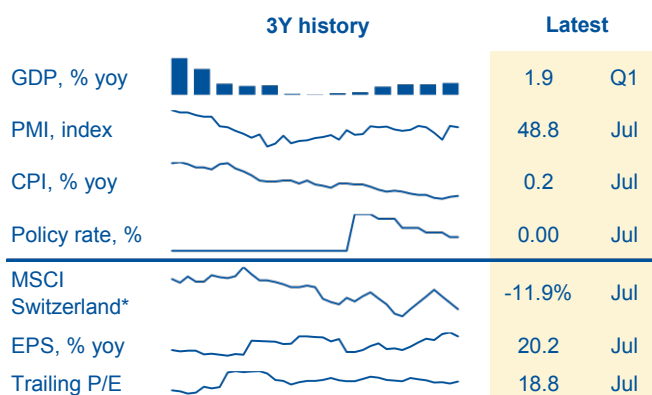
*US\$ total return relative to MSCI ACWI. Latest is three-month return.

Source: Bloomberg

- The MSCI Canada Index's heavy exposure to energy and financials is likely to act as a headwind. The energy sector has limited upside if global oil supply remains abundant. Meanwhile, the Canadian financial sector has performed well in recent months and is now trading at an elevated P/E ratio. Economic weakness and lower Bank of Canada rates could compress net interest margins.
- The Canadian economy remains vulnerable to higher US tariffs, although the effective rate is currently mitigated by USMCA exemptions. Canada's commodity endowments (e.g., uranium) offer potential upside as the US tries to nearshore its supply chains. However, financials and fossil fuels continue to be the dominant drivers of the index.
- MSCI Canada is richly valued and, in our view, offers limited upside. We remain *underweight*.

Switzerland

OW (Global and Global ex-US index)



*US\$ total return relative to MSCI ACWI. Latest is three-month return.

Source: Bloomberg

- Health care is the largest sector in the MSCI Switzerland Index. Both the health care sector and Swiss equities have underperformed recently. US tariffs are creating issues for the billing of health care companies and the Trump administration is also trying to push pharma companies to sell to the US at more competitive rates.
- Switzerland has been given an unexpectedly high tariff rate by the US at 39%. Despite strong earnings growth, current news flow has severely dampened sentiment towards Swiss equities. Switzerland is trading at a wider-than-usual discount to ACWI, suggesting that much of the negative news may already be priced in.
- Historically, Switzerland has been an attractive safe haven, with a low-beta sector composition, and a defensive currency. While a recession is not our base case scenario, the Swiss market could outperform in a slowing economic environment. We remain *overweight*, though we may look to remove this position in the future if the health care sector outlook remains weak.

GLOBAL EQUITY - KEY ECONOMIC AND FINANCIAL INDICATORS

Developed Markets	% change on year ago				Macroeconomic Data				Market Performance						Forecast†				
					Latest 12 months														
	Annual GDP Growth	Quarterly GDP Growth QoQ*	Industrial Production Growth	Consumer Price Index	Budget Balance % of GDP 2025F**	Trade Balance	Current Account Balance	Foreign Reserves 2025 Latest	Foreign Reserves 2024 Year ago	Currency vs \$ Latest	Currency vs \$ 2024 Year ago	Short-Term Interest Rates	Sovereign Rating S&P	% MSCI ACWI Net***	Stock Market Index (MSCI ACWI Net) US\$	Change since 12/31/24 US\$	Change since 12/31/24 Local	2025 P/E Forecast	3-month Currency vs \$ +/-
	%	%	%	%		\$ Bn	\$ Bn	\$ Bn	\$ Bn			%		July 31, 2025	July 31, 2025	%	%		
EMERGING MARKETS	4.2	n.a.	4.3	2.9	-4.7	1185	865	8109.44	7876.36	1837.27	1741.82	6.73	n.a.	10.47	674.39	17.51	14.53	14.0	n.a.
JAPAN	1.7	-0.2	4.0	3.3	-3.4	-29	207	1151.69	1100.69	147.57	147.36	0.44	A+	4.74	9495.22	10.17	5.50	17.1	+
SWITZERLAND	1.9	2.0	8.5	0.2	0.3	75.7	58.3	894.24	791.62	0.81	0.87	-0.06	AAA	2.06	20730.38	16.84	4.69	18.0	-
DENMARK	2.6	-5.1	-2.7	2.3	2.1	43	53	105.40	97.77	6.40	6.83	1.60	AAA	0.42	41999.78	-20.96	-28.45	15.4	+
EUROZONE	1.4	0.4	3.7	2.0	-3.3	2	5	368.88	300.39	1.17	1.09	0.64	n.a.	7.81	556.36	25.96	14.03	15.6	+
HONG KONG	3.1	1.6	0.7	1.4	-2.3	-51	57	430.84	417.08	7.85	7.79	1.58	AA+	0.46	71563.97	26.70	27.97	14.7	+
ISRAEL	2.8	3.5	6.7	3.3	-5.5	-37	18	223.65	205.85	3.41	3.78	4.44	A	0.21	234.01	13.60	9.22	12.9	+
NEW ZEALAND	-0.7	3.2	10.3	2.7	-3.4	-2.8	-14.9	24.32	14.49	0.59	0.60	0.00	AA+	0.04	588.62	-1.18	-6.22	53.0	-
NORWAY	-0.7	4.1	4.2	3.3	12.2	68.4	85.0	84.00	75.05	10.28	10.81	4.28	AAA	0.13	12316.45	26.14	14.33	12.6	+
SINGAPORE	4.3	-2.6	8.0	0.8	0.9	192.6	96.9	388.57	355.75	1.28	1.32	1.70	AAA	0.39	1863.47	22.72	17.99	15.5	+
SWEDEN	0.9	-0.8	13.5	0.8	-1.4	7.1	40.2	44.65	41.82	9.57	10.54	2.10	AAA	0.78	37170.41	19.77	7.69	21.2	+
UNITED STATES	2.0	3.0	0.7	2.7	-6.4	-1065.0	-1360.0	39.47	35.24	1.00	1.00	3.97	AA+	64.93	18237.78	8.53	8.53	24.3	uc
UK	1.3	2.8	-0.3	3.6	-4.3	-58.7	-106.6	116.90	102.15	1.35	1.28	3.98	AA	3.26	10229.56	20.28	13.84	13.9	+
AUSTRALIA	1.3	0.8	0.2	2.1	-1.0	36	-39	39.97	37.64	0.65	0.66	2.70	AAA	1.53	6188.26	12.14	7.85	20.0	+
CANADA	1.2	2.2	-6.5	1.9	-1.7	-17	-10	98.53	94.96	1.38	1.37	2.69	AAA	2.84	10108.32	15.83	11.35	17.6	+

Note: All data shown are as at August 8, 2025 unless otherwise stated. S&P credit rating shown is long-term foreign currency rating. * % change in GDP on previous quarter, annual rate. **Bloomberg consensus forecast.

MSCI All Country World Index Daily Total Return Net. *IP data from CPB; Currency level from MSCI EM Currency Index; GDP, CPI, budget and interest rate data from Bloomberg.

†Any forecasts are based on Bloomberg consensus forecasts, where available, and assumptions. Actual results may vary from any such statements or forecasts. Past performance is no guarantee of future results. This is Stage Two of City of London's three-stage asset allocation process.

Source: Bloomberg, CLIM



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